BANKRUPTCY LAW *Update*

Young Conaway Stargatt & Taylor, LLP December 2007

IN THIS ISSUE:

Summaries of important opinions of the U.S. Court of Appeals for the Third Circuit, the District and Bankruptcy Courts for the District of Delaware and the Delaware Supreme Court released from April through September, 2007 are available in this update.

Copies of any of the opinions or transcripts summarized in this or past issues are available upon request.

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U.S. COURT OF APPEALS FOR THE THIRD CIRCUIT

ALTHOUGH A PARTY MAY HAVE AN OBLIGATION TO ARBITRATE A DISPUTE, SUCH PARTY MAY NOT BE COMPELLED TO ARBITRATE WHERE AN AWARD CANNOT BE ENFORCED AGAINST IT

THE PURCHASE OF CLAIMS BY A NON-DEBTOR INSIDER DURING THE CONFIRMATION VOTING PROCESS, AND THE SUBSEQUENT RECLASSIFICATION OF SUCH CLAIMS TO OBTAIN VOTES, RENDERS THE PLAN UNCONFIRMABLE

COMMUNICATIONS WITH AND DOCUMENTS CREATED BY THE GENERAL LEGAL DEPARTMENT OF A CORPORATE FAMILY MAY NOT BE SUBJECT TO THE ATTORNEY-CLIENT PRIVILEGE IN A LATER DISPUTE BETWEEN A PARENT AND ITS PAST SUBSIDIARIES

A SHIPMENT TERM IN AN EXECUTORY CONTRACT WAS A “MATERIAL AND ECONOMICALLY SIGNIFICANT” TERM SUCH THAT IT HAD TO BE COMPLIED WITH IN ORDER FOR THE CONTRACT TO BE ASSUMED AND ASSIGNED

U.S. DISTRICT COURT FOR THE DISTRICT OF DELAWARE

AN INDENTURE TRUSTEE IS NOT ENTITLED TO COMPENSATION OR REIMBURSEMENT OF EXPENSES, INCLUDING PROFESSIONAL FEES, WHERE THE INDENTURE TRUSTEE DOES NOT MAKE A SUBSTANTIAL CONTRIBUTION

THE SALE OF A TRADEMARK LICENSE PURSUANT TO SECTION 363 IS PROTECTED ON APPEAL BY SECTION 363(m)

U.S. BANKRUPTCY COURT FOR THE DISTRICT OF DELAWARE

IN THE CONTEXT OF A PRIVATE STOCK SALE, WIRE TRANSFERS FROM A FINANCIAL INSTITUTION ARE “SETTLEMENT PAYMENTS” AND ARE NOT AVOIDABLE; TO RECOVER A FRAUDULENT CONVEYANCE UNDER SECTION 544 OF THE BANKRUPTCY CODE AND DELAWARE LAW, THE TRANSFEROR MUST BE A DEBTOR

SECTION 502(b)(6)’S STATUTORY CAP ON DAMAGES RESULTING FROM REJECTION OF A LEASE OF NON-RESIDENTIAL REAL PROPERTY APPLIES TO ALL DAMAGES, NOT JUST DAMAGES FOR UNPAID RENT AND RENT RESERVED

AN ACTION TO RECOVER DAMAGES AND FOR A DECLARATION THAT INSURANCE POLICIES COVER PREPETITION LIABILITY IS A NON-CORE PROCEEDING

MODIFICATION OF AN “ORDINARY COURSE EMPLOYEE BONUS COMPENSATION PLAN” CANNOT BE CHALLENGED IF THE MODIFICATION IS IN THE ORDINARY COURSE OF BUSINESS; HOWEVER, THE MODIFICATION MUST COMPLY WITH THE BANKRUPTCY CODE, INCLUDING SECTION 503(c)

PROCEEDS OF A D&O POLICY ARE NOT PROPERTY OF THE ESTATE WHERE THE DEBTOR'S ABILITY AND NEED TO SEEK COVERAGE UNDER THE POLICY IS SPECULATIVE OR HYPOTHETICAL

A CORPORATE OFFICER'S CLAIM FOR ADVANCEMENT OF FEES AND INDEMNIFICATION WAS NOT SUBJECT TO DISALLOWANCE UNDER SECTION 502(e)(1)(B) OF THE BANKRUPTCY CODE

BREACH OF A CRITICAL VENDOR AGREEMENT BY THE VENDOR ENTITLES THE DEBTOR TO RECOVERY OF THE CRITICAL VENDOR PAYMENT

COMMITTEE PROFESSIONALS ARE ENTITLED TO COMPENSATION FOR WORK PERFORMED THAT IS CONSISTENT WITH THE COMMITTEE'S FIDUCIARY DUTIES; RATES CHARGED BY NEW YORK AND SAN FRANCISCO PROFESSIONALS WERE NOT EXCESSIVE; ADMINISTRATIVE WORK PERFORMED BY PARALEGALS IS COMPENSABLE

POST-PETITION INVOICES FOR OBLIGATIONS THAT AROSE PREPETITION UNDER A LEASE ARE PREPETITION CLAIMS FOR WHICH SECTION 365(d)(3) DOES NOT REQUIRE PAYMENT

WHERE A LANDLORD SELLS PROPERTY AFTER A LEASE IS REJECTED, THE LEASE IS DEEMED TERMINATED UNDER VIRGINIA COMMON LAW AND THE LANDLORD IS NOT ENTITLED TO FUTURE RENT OR A CLAIM FOR THE PERIOD AFTER THE SALE

DELAWARE SUPREME COURT

A CREDITOR MAY NOT BRING A DIRECT CLAIM FOR BREACH OF FIDUCIARY DUTY AGAINST A CORPORATION'S BOARD OF DIRECTORS, REGARDLESS OF WHETHER THE CORPORATION IS INSOLVENT OR IN THE "ZONE OF INSOLVENCY"

U.S. COURT OF APPEALS FOR THE THIRD CIRCUIT

ALTHOUGH A PARTY MAY HAVE AN OBLIGATION TO ARBITRATE A DISPUTE, SUCH PARTY MAY NOT BE COMPELLED TO ARBITRATE WHERE AN AWARD CANNOT BE ENFORCED AGAINST IT

Continental Airlines, Inc. v. E. Pilots Merger Comm., Inc. (In re Cont'l Airlines, Inc.), 484 F.3d 173 (3d Cir. Apr. 24, 2007) (Fuentes, J.)

After years of unsuccessful litigation with Continental Airlines, certain pilots of Eastern Airlines brought an action seeking to compel Continental and its pilots to arbitrate a dispute over seniority rights resulting from Continental's purchase of Eastern.

In prior appeals, the Third Circuit Court of Appeals had held that the relevant collective bargaining agreement gave Eastern's pilots "rights of payment" (or claims) that were discharged in Continental's bankruptcy. Thereafter, to avoid violating various orders and the discharge injunction, Eastern's pilots settled or waived any claims in Continental's bankruptcy.

In the instant action, the bankruptcy court compelled Continental to arbitrate, but the district court reversed and enjoined the pilots' action. On appeal to the Court of Appeals, Eastern's pilots contended that although they could not recover from Continental in an arbitration, *i.e.*, all rights of payment (claims) had been settled, waived, or discharged, Continental had a duty to arbitrate that was not discharged. The Court of Appeals disagreed and held that when the pilots' claims were settled, waived, and discharged, Continental's duty to arbitrate was satisfied.

With respect to the claims against Continental's pilots, Eastern's pilots contended that the lower and appeals courts lacked the jurisdiction to consider whether Eastern's pilots had a duty to arbitrate; rather, this issue could only be resolved by an arbitrator. Again, the Court of Appeals disagreed. The Court held that because Continental's pilots were not parties to the collective bargaining agreement, neither the agreement nor applicable law required Continental's pilots to arbitrate.

Accordingly, the district court's decision was affirmed.

Return to Top

THE PURCHASE OF CLAIMS BY A NON-DEBTOR INSIDER DURING THE CONFIRMATION VOTING PROCESS, AND THE SUBSEQUENT RECLASSIFICATION OF SUCH CLAIMS TO OBTAIN VOTES, RENDERS THE PLAN UNCONFIRMABLE

In re Machne Menachem, Inc., No. 05-5425, 2007 U.S. App. LEXIS 9067 (3d Cir. Apr. 19, 2007) (Fuentes, J.) (NOT PRECEDENTIAL)

During the voting process concerning the debtor's plan of reorganization, at the debtor's request, the son of a director of the debtor purchased four claims. These claims had been classified under the plan as non-insider claims. After the claims were purchased, they were reclassified to and voted in a separate class for insiders. As a result of the purchase and reclassification, the non-insider class voted to accept the plan by a 7 to 4 vote. The proponent of a competing plan argued that by purchasing the four claims and voting them in another class, the insider impermissibly altered the outcome of the vote.

On appeal, the Court of Appeals held that the debtor's plan was unconfirmable because, among other things, (i) the reclassification of claims was vote manipulation by impermissibly gerrymandering classes and (ii) the plan was confirmed in bad faith. Accordingly, the district court's decision was affirmed.

Return to Top

COMMUNICATIONS WITH AND DOCUMENTS CREATED BY THE GENERAL LEGAL DEPARTMENT OF A CORPORATE FAMILY MAY NOT BE SUBJECT TO THE ATTORNEY-CLIENT PRIVILEGE IN A LATER DISPUTE BETWEEN A PARENT AND ITS PAST SUBSIDIARIES

In re Fleming Cos., 499 F.3d 300 (3d Cir. July 17, 2007) (Ambro, J.)

In litigation between members of a corporate family, a dispute arose over whether certain documents were subject to the attorney-client privilege and, as a result, were not discoverable. The documents at issue were all created by or communications with the corporate family's general legal department while all of the litigants were members of corporate family. However, at the time of the litigation, certain entities were no longer members of the corporate family. Because the dispute implicated the co-client (or joint client) privilege, its exceptions, its scope and a lawyer's ethical obligations, the Court of Appeals embarked on a thorough background discussion of various legal concepts related thereto. After reviewing and clarifying these legal concepts, the Court of Appeals determined that there was insufficient evidence to determine whether the attorney-client privilege applied and to require production of documents to the ex-members of the corporate family. As a result, the case was remanded to the District Court.

Return to Top

A SHIPMENT TERM IN AN EXECUTORY CONTRACT WAS A "MATERIAL AND ECONOMICALLY SIGNIFICANT" TERM SUCH THAT IT HAD TO BE COMPLIED WITH IN ORDER FOR THE CONTRACT TO BE ASSUMED AND ASSIGNED

In re Fleming Cos., 499 F.3d 300 (3d Cir. Aug. 22, 2007) (Chagares, J.)

During the debtor's bankruptcy, the debtor sold certain assets, including the rights to designate assignees of supply contracts and property leases. After the sale, the purchaser designated an assignee for a contract that required shipment of products from a specific facility, mainly the debtor's facility in Tulsa, Oklahoma. Shortly before the motion to assign the contract was filed, the debtor filed a motion to reject the lease associated with the Tulsa facility at the direction of the contract-assignee. As a result, it was impossible for the assignee to comply with the shipment term of the contract. On this basis, the counterparty to the contract filed an objection to the assignment motion and argued that the assignee could not provide adequate assurance of future performance because it could not (and admittedly would not) ship from the Tulsa facility. In response, the assignee asserted that it would ship from another facility in Oklahoma, which would not materially impact the counterparty's rights. The bankruptcy court held that the assignee could not provide adequate assurance of future performance and denied the motion. The district court affirmed.

On appeal, the Court of Appeals affirmed. The Court of Appeals found that the shipment term was a "material and economically significant" term of the contract. As such, the Court held that because it was impossible for the assignee to ship from the Tulsa facility — the lease for the Tulsa facility had been rejected — the assignee could not provide adequate assurance of future performance. The Court of Appeals also rejected the argument that the shipment term was an anti-assignment clause. In reaching this conclusion, the Court recognized that there is a fine line between a burdensome obligation and a *de facto* restriction on assignment. In part due to the assignee's decision to have the lease for the Tulsa facility rejected, the court found that the shipment term was more akin to a burdensome obligation. Accordingly, the bankruptcy court was affirmed.

Return to Top

U.S. DISTRICT COURT
FOR THE DISTRICT OF DELAWARE

AN INDENTURE TRUSTEE IS NOT ENTITLED TO COMPENSATION OR REIMBURSEMENT OF EXPENSES, INCLUDING PROFESSIONAL FEES, WHERE THE INDENTURE TRUSTEE DOES NOT MAKE A SUBSTANTIAL CONTRIBUTION

Law Debenture Trust Co. v. NorthWestern Corp. (In re NorthWestern Corp.), No. 05-603, 2007 U.S. Dist. LEXIS 24063 (D. Del. Apr. 2, 2007) (Farnan, J.)

An indenture trustee filed a request for payment of fees and expenses, including professional fees, incurred in connection with the debtor's bankruptcy case. The indenture trustee argued that the fees and expenses were incurred while making a substantial contribution to the debtor's case, including the trustee's service as a fiduciary to the holders under the indenture. The debtor opposed the request, arguing that the indenture trustee cost the estate millions of dollars by commencing adversary proceedings and filing multiple objections during the case.

The bankruptcy court agreed with the debtor and held that the indenture trustee did not provide a substantial contribution to the case. On appeal, the district court affirmed, holding that, in conducting the fact-intensive analysis required by section 503(b) of the Bankruptcy Code, the bankruptcy court did not abuse its discretion. Furthermore, the court held that a party who merely carries out its fiduciary obligations during a bankruptcy case is not *per se* entitled to a substantial contribution administrative expense. Instead, the benefit must be more than an incidental benefit arising from activities pursued in protecting one's own interests. Because any benefit provided by the indenture trustee was incidental, the indenture trustee was not entitled to an administrative claim.

Accordingly, the bankruptcy court's decision was affirmed.

Return to Top

THE SALE OF A TRADEMARK LICENSE PURSUANT TO SECTION 363 IS PROTECTED ON APPEAL BY SECTION 363(m)

Regal Ware, Inc. v. Global Home Prods., LLC (In re Global Home Prods., LLC), 369 B.R. 770 (D. Del. May 31, 2007) (Farnan, J.)

The bankruptcy court approved a sale of substantially all of certain debtors' assets, including a trademark sublicense agreement, pursuant to section 363(f) of the Bankruptcy Code. The plaintiff appealed the order and contended that, among other things, the sale and assignment of the sublicense was impermissible under section 365 of the Bankruptcy Code. The debtors moved to dismiss the appeal as moot under section 363(m) of the Bankruptcy Code. The district court agreed with the debtors and dismissed the appeal as moot. In so holding, the district court found that the standard under section 363(m) was satisfied because (i) the bankruptcy court's order was not stayed — all requests were denied, and (ii) the sale had closed and the purchaser had taken substantial steps to implement the terms of the sale order and trademark sublicense agreement.

Return to Top

U.S. BANKRUPTCY COURT
FOR THE DISTRICT OF DELAWARE

IN THE CONTEXT OF A PRIVATE STOCK SALE, WIRE TRANSFERS FROM A FINANCIAL INSTITUTION ARE "SETTLEMENT PAYMENTS" AND ARE NOT AVOIDABLE; TO RECOVER A FRAUDULENT CONVEYANCE UNDER SECTION 544 OF THE BANKRUPTCY CODE AND DELAWARE LAW, THE TRANSFEROR MUST BE A DEBTOR

Brandt v. B.A. Capital Co. (In re Plassein Int'l Corp.), 366 B.R. 318 (Bankr. D. Del. Apr. 20, 2007) (Gross, J.)

(It should be noted that the trustee apparently used the wrong party names in its complaint, an error that was carried over in the opinion.)

The debtor was formed to acquire various privately held manufacturing companies through a series of leveraged buyouts. Through the LBOs, a non-debtor affiliate of one of the debtors borrowed money from Fleet Bank to acquire the target companies. The affiliate used the borrowed funds to purchase the stock of each of the target companies and to repay any existing secured debt of such companies. In return for the loans to the affiliate, each target company jointly and severally guaranteed the obligations to Fleet Bank and granted security interests on substantially all of their assets. Thereafter, the debtor and the target companies filed bankruptcy, but the affiliate did not.

The chapter 7 trustee sought to avoid the payments to the shareholders (the sellers) of the target companies as fraudulent transfers. The shareholders alleged in response that (i) they were the recipients of "settlement payments" within the meaning of section 546(e) of the Bankruptcy Code, and (ii) the payments were made by a non-debtor (the affiliate). As a result, the transfers were not avoidable.

The bankruptcy court agreed. First, the court held that the transfers were settlement payments because the funds were wired by a financial institution (Fleet Bank) in connection with a sale of securities. In reaching this conclusion, the court was not persuaded that section 546(e) of the Bankruptcy Code applied only to transactions involving publicly traded securities. Second, the court held that because the transfers were initiated by the affiliate, a non-debtor, the trustee could not avoid the transfers under section 544 of the Bankruptcy Code and Delaware law. Accordingly, the trustee's complaint was dismissed.

Return to Top

SECTION 502(b)(6)'S STATUTORY CAP ON DAMAGES RESULTING FROM REJECTION OF A LEASE OF NON-RESIDENTIAL REAL PROPERTY APPLIES TO ALL DAMAGES, NOT JUST DAMAGES FOR UNPAID RENT AND RENT RESERVED

In re Foamex Int'l, Inc., 368 B.R. 383 (Bankr. D. Del. May 16, 2007) (Gross, J.)

The debtor's landlord filed a proof of claim resulting from the debtor's rejection of a lease. The claim included amounts for unpaid rent, unpaid taxes, and repair obligations. The debtor objected to the claim and asserted that repair obligations were improperly asserted in the landlord's 502(b)(6) claim because they did not satisfy the *McSheridan* test. Relying on cases that declined to follow *McSheridan*, the landlord argued that repair and maintenance obligations arose prior to rejection; therefore, the damages were independent of the damages available under (and not capped by) section 502(b)(6).

Relying on *McSheridan*, the bankruptcy court held that a landlord is entitled to one claim and one claim only for all damages resulting from rejection of a lease. Moreover, this claim is limited by section 502(b)(6) of the Bankruptcy Code. Accordingly, if a landlord's claim exceeds the statutory cap under section 502(b)(6) of the Bankruptcy Code, *i.e.*, a portion of the "rent reserved" plus unpaid rent, the landlord is not entitled to a claim for the excess amount or entitled to assert a separate claim for other damages arising from rejection of the lease. The bankruptcy court also held that the repair obligations did not satisfy the *McSheridan* test, *i.e.,* the obligations were not fixed, periodic and regular. Accordingly, the repair obligations could not be included in calculating the "rent reserved" under the lease. In reaching its conclusions, the bankruptcy court recognized that the Third Circuit Court of Appeals' decision in *First Bank, N.A. v. FDIC*, which adopted the *McSheridan* test in a non-bankruptcy context, was the Circuit Court's implicit, if not explicit, approval of the *McSheridan* rationale and holding, regardless of the context.

Return to Top

AN ACTION TO RECOVER DAMAGES AND FOR A DECLARATION THAT INSURANCE POLICIES COVER PREPETITION LIABILITY IS A NON-CORE PROCEEDING

Consol. SWINC Estate v. Ace USA, Inc. (In re Stone & Webster, Inc.), 367 B.R. 523 (Bankr. D. Del. May 4, 2007) (Walsh, J.)

Prior to the petition date, the debtor made a claim for coverage under its insurance policies as a result of environmental tort claims. The insurers denied coverage and refused to defend the debtor. After the bankruptcy case was filed, the debtor initiated an adversary proceeding seeking to recover damages from its insurers for their refusal to defend and denial of coverage and a declaration that the policies covered environmental liabilities. The insurance carriers filed a motion with the bankruptcy court for a determination whether the action was core or non-core. The bankruptcy court held that the proceeding was non-core because (i) no substantive rights under the Bankruptcy Code were implicated and (ii) the obligations to defend and provide coverage arose prepetition. In reaching this conclusion, the bankruptcy court declined to consider whether the outcome of the proceeding would augment amounts for distribution to creditors because this consideration was contrary to precedent in the Third Circuit.

Return to Top

MODIFICATION OF AN "ORDINARY COURSE EMPLOYEE BONUS COMPENSATION PLAN" CANNOT BE CHALLENGED IF THE MODIFICATION IS IN THE ORDINARY COURSE OF BUSINESS; HOWEVER, THE MODIFICATION MUST COMPLY WITH THE BANKRUPTCY CODE, INCLUDING SECTION 503(c)

In re Nellson Nutraceutical, Inc., 369 B.R. 787 (Bankr. D. Del. May 24, 2007) (Sontchi, J.)

During the debtor's bankruptcy, the debtor implemented an "ordinary course employee bonus compensation plan," which applied to various tiers of employees, including senior management. The plan provided for payment of bonuses only if the debtor reached certain EBITDA targets. The debtor did not meet any of the EBITDA targets, and, as a result, no bonuses were paid under the plan.

Thereafter, the debtor modified the plan to provide for payment of bonuses. Based on agreements with creditors and prior representations to the bankruptcy court, the debtor sought approval of the modifications, notwithstanding that the debtor believed court approval was unnecessary because the modifications were in the ordinary course of business. In support of the modifications, the debtor presented evidence of repeated past modifications of prior plans and expert testimony on similar plans in the industry. Guided by this evidence, the court conducted "horizontal and vertical" analyses and determined that the modifications were in the ordinary course of the debtor's business. Thus, so long as the modifications were an exercise of business judgment, they could not be challenged on that basis.

However, the bankruptcy court went further and held that the modifications must also comply with the Bankruptcy Code. Because the plan, prior to and after the modifications, contemplated payments to insiders, the bankruptcy court held that section 503(c) was applicable. In analyzing the plan under section 503(c)(1), the bankruptcy court found that its primary purpose was to motivate employees, including senior management. As a result, the plan did not run afoul of section 503(c)(1). Furthermore, section 503(c)(2) was not implicated because the plan did not contemplate severance payments. Finally, because the modifications were in the ordinary course of business, section 503(c)(3) was not implicated either. Therefore, the modifications were permissible.

Return to Top

PROCEEDS OF A D&O POLICY ARE NOT PROPERTY OF THE ESTATE WHERE THE DEBTOR'S ABILITY AND NEED TO SEEK COVERAGE UNDER THE POLICY IS SPECULATIVE OR HYPOTHETICAL

Miller v. McDonald (In re World Health Alternatives, Inc.), 369 B.R. 805 (Bankr. D. Del. Jun. 8, 2007) (Gross, J.)

In securities litigation pending elsewhere, the debtor's former officers and directors entered into and sought approval of a settlement. Proceeds from the debtor's directors' and officers' policy would be used to fund the settlement. Before the settlement was approved, the chapter 7 trustee moved for a preliminary injunction to enjoin the former officers and directors from entering into the settlement and funding it with proceeds from the policy.

The trustee argued that because the debtor was covered by the policy, the proceeds of the policy were property of the estate. However, the bankruptcy court disagreed and followed the *Allied Digital* (Del.) and *Adelphia Communs.* (S.D.N.Y.) decisions. The bankruptcy court held that although the debtor was covered for indemnification obligations under a portion of the policy, the debtor's indemnification obligations had not been triggered and were speculative and hypothetical. Thus, the proceeds of the policy were not property of the estate, and the preliminary injunction was denied.

Return to Top

A CORPORATE OFFICER'S CLAIM FOR ADVANCEMENT OF FEES AND INDEMNIFICATION WAS NOT SUBJECT TO DISALLOWANCE UNDER SECTION 502(e)(1)(B) OF THE BANKRUPTCY CODE

In re RNI Wind Down Corp., 369 B.R. 174 (Bankr. D. Del. Jul. 9, 2007) (Sontchi, J.)

Pursuant to the debtor's articles of incorporation, a former officer of the debtor filed a claim for indemnification and advancement of his defense costs incurred in a civil SEC lawsuit. The plan administrator filed an objection that sought to disallow the claim, pursuant to section 502(e)(1)(B) of the Bankruptcy Code, as a contingent claim for reimbursement of debt. The bankruptcy court held that the plan administrator failed to satisfy its burden under section 502(e)(1)(B) of the Bankruptcy Code, which requires proof that the claim is (i) contingent claim (ii) for reimbursement of a debt (iii) for which the debtor and the claimant are co-liable. Taking the elements out of order, the court first found that the claim was for indemnification, and accordingly, the second element was satisfied. With respect to the remaining elements — the first and third elements — the court held that the elements were not satisfied. Specifically, the court held that the claim was not contingent because the officer's right to pre-indemnification advancement of fees and expenses presently existed. Furthermore, although the amount of the claim was unknown, the claim was not contingent; instead, it was unliquidated. Finally, because there was no risk of the debtor having to make a double payment, the third element was not satisfied. Accordingly, the claim objection was overruled.

Return to Top

BREACH OF A CRITICAL VENDOR AGREEMENT BY THE VENDOR ENTITLES THE DEBTOR TO RECOVERY OF THE CRITICAL VENDOR PAYMENT

In re Meridian Auto. Systems-Composites Operations, Inc., 372 B.R. 710 (Bankr. D. Del. Aug. 23, 2007) (Walrath, C.J.)

Early in the debtor's case, the bankruptcy court entered an order authorizing the debtor to make payments to critical vendors. Under the order, any vendor that received a payment was required to continue to provide goods/services to the debtor post-petition on customary trade terms, including price, in effect within 120 days of the petition date. During the case, a vendor (i) refused to provide goods, (ii) twice demanded price increases, (iii) attempted to negotiate a waiver of any preference claims, and (iv) failed to timely ship sufficient quantities of goods. After the debtor's plan was confirmed, the post-confirmation debtor filed a motion to compel the vendor's compliance with the terms of the critical vendor order by disgorging the critical vendor payment it had received early in the case. The bankruptcy court granted the motion and held that the vendor's conduct, including its attempts to renegotiate price terms, was a breach of the critical vendor order. The vendor asserted multiple defenses, including that the trade agreement was assumed under the plan. The court rejected this defense because the agreement was no longer executory as of the effective date of the plan. After rejecting all remaining defenses, the bankruptcy court ordered the vendor to disgorge the critical vendor payment.

Return to Top

COMMITTEE PROFESSIONALS ARE ENTITLED TO COMPENSATION FOR WORK PERFORMED THAT IS CONSISTENT WITH THE COMMITTEE'S FIDUCIARY DUTIES; RATES CHARGED BY NEW YORK AND SAN FRANCISCO PROFESSIONALS WERE NOT EXCESSIVE; ADMINISTRATIVE WORK PERFORMED BY PARALEGALS IS COMPENSABLE

In re 14605, Inc., No. 05-11910, 2007 Bankr. LEXIS 3147 (Bankr. D. Del. Sep. 19, 2007) (Walrath, C.J.)

The reorganized debtor and its parent/lender objected to the final fee applications of certain professionals of the official committee of unsecured creditors on the bases that (1) the work done by the committee's professionals was excessive, unnecessary, and duplicative (2) the hourly rates charged by certain of the Committee's professionals were excessive, (3) fees for the preparation of the professionals' fee applications are not compensable, (4) the committee's professionals overstaffed the case, and (5) several of the professionals were billing for purely administrative or clerical work. The bankruptcy court overruled the objection and allowed the fees in full. In overruling the objection, the bankruptcy court held as follows: (i) fees associated with investigating the validity of claims of a parent/lender are compensable and consistent with the fiduciary duties of committee professionals; (ii) fees associated with participating in a 363 sale process, including analysis of the deal, negotiation with the buyer and attempts to attract additional buyers, are compensable; (iii) fees associated with reviewing the pool of claims are compensable because committee professionals have a fiduciary duty to review the claims to determine the extent of recovery in a case; (iv) the rates charged by the committee's professionals (based in New York and San Francisco) were not excessive because the case was complex; (v) fees associated with preparing fee applications, as well as fees associated with defending fee objections, are compensable; (vi) when a case is sufficiently complex, intra-office conferencing is necessary in order to coordinate tasks within the firm and avoid duplication of efforts; and (vii) fees associated with work performed by paralegals will not be reduced merely because the work is administrative (reviewing/distributing pleadings) in nature.

Return to Top

POST-PETITION INVOICES FOR OBLIGATIONS THAT AROSE PREPETITION UNDER A LEASE ARE PREPETITION CLAIMS FOR WHICH SECTION 365(d)(3) DOES NOT REQUIRE PAYMENT

In re Pac-West Telecomm, Inc., No. 07-10562, 2007 Bankr. LEXIS 3332 (Bankr. D. Del. Oct. 5, 2007) (Shannon, J.)

Prior to the petition date, the debtor and a landlord entered into two leases of non-residential real property. Each lease provided that the landlord would bill the debtor on a monthly basis for electricity charges. After the debtor filed bankruptcy, the landlord invoiced the debtor for multiple months' worth of electricity charges. The debtor argued that these "obligations" arose prior to the petition date, notwithstanding that they were invoiced after the petition date, and declined to the pay them. The landlord filed a motion, pursuant to section 365(d)(3) of the Bankruptcy Code and the Third Circuit Court of Appeals' decision in *Montgomery Ward*, to compel the debtor to pay the outstanding invoices. The bankruptcy court denied the motion and held that the obligation to pay for the electricity arose prepetition. In so holding, the court rejected the landlord's argument that the invoice date controlled because, (the court found) the invoices "were supposed to arrive prior to the [p]etition [d]ate under the terms of the leases" but did not because of the landlord's delay in invoicing the debtor. On this basis, the court distinguished the *Montgomery Ward* decision.

Return to Top

WHERE A LANDLORD SELLS PROPERTY AFTER A LEASE IS REJECTED, THE LEASE IS DEEMED TERMINATED UNDER VIRGINIA COMMON LAW AND THE LANDLORD IS NOT ENTITLED TO FUTURE RENT OR A CLAIM FOR THE PERIOD AFTER THE SALE

In re FLYi, Inc., No. 05-20011, 2007 Bankr. LEXIS 3518 (Bankr. D. Del. Oct. 17, 2007) (Walrath, C.J.)

The distribution trust objected to the claim of a landlord on the basis that the landlord had sold the underlying premises, thereby eliminating any claim for future rent and/or rejection damages. Under Virginia common law, a landlord has three options upon breach by a tenant: (i) re-enter the premises with the limited intent to re-let; (ii) refuse to re-enter and sue for damages under the lease; or (iii) re-enter the premises and terminate the lease. Although, the bankruptcy court acknowledged that parties are free to "contract around" the common law, the court held that an attempt to contract around common law principles must be strictly construed. In reviewing the lease, the court strictly construed the relevant provisions and found that the lease did not contradict common law; as a result, the parties did not "contract around" the common law, and principles of common law applied. Because Virginia common law recognizes that a sale of premises is an exercise of sufficient dominion over the premises to constitute acceptance of abandonment by a tenant, the lease at issue was terminated and no further rent was due from the debtor's estate. Accordingly, the bankruptcy court sustained the objection.

Return to Top

DELAWARE SUPREME COURT

A CREDITOR MAY NOT BRING A DIRECT CLAIM FOR BREACH OF FIDUCIARY DUTY AGAINST A CORPORATION'S BOARD OF DIRECTORS, REGARDLESS OF WHETHER THE CORPORATION IS INSOLVENT OR IN THE "ZONE OF INSOLVENCY"

N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla, 930 A.2d 92, 2007 Del. LEXIS 227 (Del. May 18, 2007) (Holland, J.)

A creditor of a Delaware corporation sued the corporation's directors for alleged breaches of fiduciary duties. Rather than sue the directors derivatively, the creditor filed direct claims against the directors because the company was insolvent or in the "zone of insolvency." The directors moved to dismiss the complaint, and the Chancery Court granted the motion. The Supreme Court affirmed.

In affirming dismissal of the complaint, the Supreme Court held that Delaware law does not recognize direct breach of fiduciary duty claims for creditors of an insolvent company or a company in the zone of insolvency. The Court further held that directors' fiduciary duties do not change in the zone of insolvency. Thus, directors "must continue to discharge their fiduciary duties to the corporation and its shareholders by exercising their business judgment . . . ." However, once a corporation becomes insolvent, creditors take the place of shareholders and may maintain derivative breach of fiduciary duty claims against the corporation's directors.

Return to Top

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