

## ROUNDTABLE



## BANKRUPTCY LITIGATION

Restricted access to financing and deteriorating economic conditions have spurred a rise in corporate defaults and bankruptcy filings. These challenging times trigger disputes between secured creditors, unsecured creditors, bondholders, trustees, debtors, strategic investors, equity investors and other stakeholders. Since corporate insolvency brings a host of contentious issues to the table, bankruptcy litigators are gearing up for a busy period ahead.

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**Sprayregen: In your opinion, how has the nature of bankruptcy litigation changed in this cycle from the previous cycle?**

**Elkin:** During the last cycle, litigation became more prevalent in bankruptcy cases, especially against officers, directors and lenders. This has become even more pervasive in this cycle. Today, it is not uncommon for the unsecured creditors or second lien holders to threaten to sue the senior secured lenders simply because the company failed, even before any investigation has occurred. The old taboo against lenders suing lenders seems to have disappeared. As the pie becomes smaller, valuation fights and inter-creditor squabbles will become more common. In the early stage of the cycle, litigation will undoubtedly be viewed as the road to recovery for creditors which are out of the money. However, creditors will begin to see that litigation has its limits, and that winning the litigation does not necessarily result in an economic win. As such, many creditors will start to choose structured settlement procedures over litigation.

**Tuliano:** The depressed valuations characteristic of this economic cycle have caused bankruptcy litigation to become a primary source of recovery for unsecured creditors. This factor, combined with the aggressive nature of certain transactions that were put together in the years preceding the recession, has led to a significant increase and acceleration of bankruptcy related litigation matters. We are seeing the unwinding of highly levered capital structures resulting from recent years' unprecedented liquidity and credit availability, including use of second lien financing and securitisation structures. There also have been a number of new players providing that financing, including the growth of the hedge fund industry. These factors, in turn, have increased the complexity of restructurings and have led to more litigation of intercreditor issues during bankruptcies.

**McDonald:** Insolvency in the current market often involves more complex financial structures and products, with an increased use of multi-layered loan structures and a proliferation of credit investors. This has presented additional challenges to insolvency practitioners and courts. Many of the traditional principles of insolvency law still apply, but with added layers such as the EC Regulation, UNCITRAL and the Financial Collateral Regulations. Many bankruptcy developments are forged in the crucible of a recession. An example from the last recession was the cross-border co-operation protocol in the BCCI liquidation. The pace of innovation tends to slacken in this area as the crucible cools. It is now heating up, and it will be interesting to see how quickly the momentum of innovation from the last recession picks up again.

**East:** Bankruptcy litigation has not changed in this cycle per se; we are just seeing a return to an environment which encourages litigation based solutions. At the moment the increase in litigation is being driven by four principal factors: complexity in capital structures; material destruction of value; the lack of liquidity and the ability to trade or reorganise out of distress; and the lack of case law or guidance from the courts as to how certain issues are likely to be resolved. This is a heady mix and is forcing various stakeholders to look for recovery through other means, namely litigation. The disputes we are seeing emerge can be broadly viewed within two major categories, firstly disputes regarding the allocation of value, and secondly disputes orientated to achieving additional recovery as a way of recapturing value that has been irretrievably lost.

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ANTHONY W. CLARK

**Hood:** There has been a real shift to problem solving and away from dispute resolution. Never in modern times has the scale of the threat to various parts of the world's economic systems provoked so much emergency clarification of hitherto mundane aspects of the bankruptcy process. The Lehman litigation by Four Funds and RAB Capital in the UK is a fine example, where attempts to short cut the Administrators' determination to deal in an orderly manner with highly complex issues on security and ownership rights were resisted in a comfortably pragmatic judgement. Suddenly, queue jumping by aggressive litigants is being weighed in the balance of broader interests and quite rightly so.

**Tarpley:** The focus has changed away from financing issues to operational issues. Previously, the litigation disputes centred on the scope, terms and type of financing that would be utilised during the bankruptcy as DIP financing, and later in the plan as exit financing. Now, with liquidity sources very limited, the early-case litigation focus is on operational issues, i.e. can the company slim down to an expense level that matches its income? Similarly, in the later-case plan litigation, the feasibility question now turns heavily on attempting to provide credible projections of market conditions in a context where credible projections do not exist. Further, the issue of whether a quick sale of the assets/business is possible is almost always a key, up-front question, more so than in the past cycle.

**Clark:** When talking about litigation trends, it is important to consider threatened as well as filed claims. Claims that are threatened, whether overtly or implicitly, arise much more frequently and often have a greater impact on business decisions than formal proceedings. Lately, a great many disputes have arisen over whether loan and equity purchase commitments made in earlier times are enforceable or may be avoided based on material adverse change or similar provisions. Some of these disputes have resulted in high profile litigations, but many more have been hotly argued and settled behind closed doors. Also, there has been an upsurge in activity by distressed debt traders, who have never shied away from bringing litigation.

**Heroy:** Overall we see two conflicting, contrasting trends. Generally, there is less interest in litigating core bankruptcy issues due to debtors being more highly leveraged with fewer sources of exit capital, thereby shrinking available cash to fight over. On the other hand, in certain circumstances it has backed junior credi- ►►

tors into corners producing litigation we might not otherwise see. Each situation is sui generis.

**Sprayregen: Are trends in bankruptcy litigation similar globally, or are you seeing significant variance across different jurisdictions?**

**Tarpley:** The absence of liquidity, either from traditional lenders or in the DIP financing context, is common across jurisdictions. Thus, the traditionally litigated issues in Chapter 11 bankruptcies tend to have a correspondingly common focus.

**Hood:** Litigation trends vary widely around the world, often reflecting the relative sophistication of the various jurisdictions and their business, banking and bankruptcy regimes. The issues being decided in New York tend to be rather different to those in Hanoi. The level of judicial capacity also dictates trends. In developed jurisdictions, many issues are being tested. Elsewhere there is something close to rationing, especially where there are no specialist bankruptcy courts and levels of non-bankruptcy commercial disputes are being driven up by the crisis.

**Heroy:** Some are global, some are not. Some of the US litigation issues developed in the 1990s have spread elsewhere. For example, the use of debt purchases in hostile distressed M&A has spread from the US to Europe, though with mixed results as Apollo learned in Germany a few years ago. Overall, however, there is interest in many jurisdictions with the UK-based insolvency system in converting to all or part of a US-based chapter 11 system, litigation issues and all.

**Elkin:** Litigation as a recovery method is increasing outside of the US, but it is not nearly as prevalent or successful. Even in jurisdictions with developed and efficient legal systems, the taboo still exists against pursuing officers and directors and banks. These nations also tend to have laws which discourage US style litigation, such as more labour-friendly laws on employee termination and plant closings or 'loser pay' traditions. Certain other jurisdictions around the globe are known for legal systems which operate slowly or with greater bias, such that litigation becomes unattractive. In cross-border insolvency cases, litigation is often filed to take advantage of one country's laws, but such forum shopping is mostly discouraged.

**Clark:** The process of initiating insolvency cases is very different in many non-US jurisdictions, as the court will often first have to hold a hearing to decide whether the debtor has established that it should be declared bankrupt. If so, the court will appoint an insolvency officeholder who usually has extensive executive powers, and there often is little that creditors can do to second-guess the administrator's decisions. The scope of bankruptcy litigation in these jurisdictions, therefore, is quite limited, as contrasted with the US. So one may compare the litigation-intensive chapter 11 process for Lehman in the US, in which there have been more than 3400 court filings and more than two dozen separate adversary proceedings commenced in just seven months, with administration proceedings in Europe. In England, for example, various creditors of Lehman Brothers International Limited as prime broker have tried to bring proceedings in the Chancery Division of the High Court to gain access to or information concerning their assets. The administrators have successfully opposed these attempts.

**McDonald:** We are seeing some differences in bankruptcy litigation trends across jurisdictions. This can be seen in the different approaches taken by courts in the UK and US supervising the Lehman Brothers bankruptcies. In the UK, the Court has taken a hands-off approach, giving the administrators considerable leeway to conduct the administration in the manner that they consider appropriate. This can be contrasted with the more interventionist attitude of the US courts. One can see the relative merits of both approaches. Certainly, from an English perspective, the Court has given creditors the clear message that, for now, challenges to the administrators' choices will fail. We may see that attitude shift as time progresses.

**Sprayregen: What developments have you seen in litigation involving directors and officers, and their responsibilities related to insolvency?**

**Hood:** We are seeing a re-drawing of moral boundaries on business ethics and standards of management behaviour, albeit governed by a cynical dose of 20:20 hindsight. The battleground for litigation is going to be the patchwork of differing rules on Twilight Zone issues, which is being re-stitched as the global crisis unfolds. Germany has relaxed its draconian rules on bankruptcy filing time limits, while Spain has eased potential liabilities for directors concerning non-disclosure of capital impairment. It is doubtful that such government indulgence will deter stakeholders from seeking redress from directors and officers, who may find that adopting the ostrich posture is no protection.

**Tarpley:** We have seen a heightened level of pre-bankruptcy concerns, uncertainty and anxiety among directors about the issues of where their responsibilities lie and what range of discretion they have. However, in the actual litigation context, recent Delaware court decisions have tended to eliminate many of the uncertainties created by the oft mentioned zone of insolvency and deepening insolvency concepts.

**Tuliano:** Actions of directors and officers of distressed companies continue to receive tremendous scrutiny as creditors attempt to access D&O insurance coverage. The fundamental questions focus upon what factors led to the financial distress and whether the directors and officers acted in accordance with their fiduciary duties at all times. The most significant development in this area ►►

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RALPH TULIANO

that we have seen is that, in many cases, D&O coverage may be viewed by unsecured creditors as their only source of potential recovery. Accordingly, the level of scrutiny applied to actions of directors and officers will only increase until and unless valuations increase or other sources of recovery are identified.

**Clark:** There has been a significant increase in litigation against former directors and officers by creditors and trustees appointed in bankruptcy cases. Some involve claims of actual fraud, but even more frequent are breach of fiduciary duty allegations in connection with ‘constructive’ fraud or fraudulent transfer claims related to significant transactions in the years leading up to bankruptcy. It is my impression that, as compared with non-bankruptcy shareholder ‘strike suit’ claims, these litigations are being defended more vigorously and settled less frequently, perhaps due in part to a trend wherein directors and officers have been required to contribute financially to settlements above and beyond whatever insurance proceeds may be available.

**Elkin:** D&O litigation will remain an active area as long as insurance remains a viable source of repayment for creditors. Creative attorneys will always look for theories that are covered by insurance in the hope of coaxing a settlement. It will be interesting to see if the US Supreme Court’s recent pronouncements on pleading sufficiency, along with strong statements in support of the business judgment rule by the Delaware Supreme Court, will eliminate all but the most obvious cases of corporate governance malfeasance. However, recent conflicting case law on the *in pari delicto* defence and its mirror image, the standing of a debtor to pursue its own alleged co-conspirators, will continue to make this type of litigation viable. Judges are going to be called on to make hard decisions.

**McDonald:** Whilst insurers are reported to be dealing with a large number of notifications of potential claims against directors and officers, there has not yet been a large influx of litigation in the UK involving directors and officers, unlike in the US. To the extent that claims have been made in the UK, they increasingly involve allegations that directors failed to understand the business of the company and failed to take expert advice in relation to it. The reckless abandon with which directors were willing to adopt “get rich quick” solutions like entering into derivatives contracts and investing in asset-backed commercial paper will now, with hindsight, come back to haunt them.

**Heroy:** We have seen increasingly successful litigation taken against directors for fraudulent trading in Europe and parts of Asia, mainly Australia, without much traction in the US. If anything, Delaware courts have grown increasingly conservative as to directors’ liability for pre-petition conduct, especially in the ordinary course of business. It has become questionable as to the obligations to creditors in the zone of insolvency, as assumed by most practitioners for years after the Pathe Communications decision in Delaware. A notable exception has been one decision that fortifies the right to challenge pre-petition sales that do not follow a traditional sales process. Given that the increased leverage of current chapter 11 debtors has left junior creditors scraping for other sources of payment, however, an increase in director lawsuits seems inevitable.

**East:** I have not seen anything surrounding director and officer liability that has not already been around for some time in the UK.

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JUDITH ELKIN

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Of course, in the event of failure and liquidation, directors and officers will obviously face a careful review of their actions from the perspective of both the office holder and investors. There have been some recent amendments to the UK Companies Act, and it sets out in very clear terms what the responsibilities are, although falls short of stating, for example, that the directors owe duties to creditors. In the common law at least, the law regards directors as having a duty to consider the interests of creditors where the company is approaching insolvency or is becoming distressed, but this ‘duty’ has no real bite from the perspective of creditors.

**Sprayregen: Can we expect to see more bankruptcy-related disputes arising from actual or suspected fraud? What are the key issues in these cases?**

**Heroy:** As Warren Buffet has noted, the tide has receded, and seemingly successful businesses have been discovered to have been engaged in one kind of actionable, arguable fraud or another. Key issues here will be third party recoveries as the perpetrators rarely have sufficient assets to satisfy judgments. Several issues will be litigated in this area, including suits against family members or other colleagues to recover assets transferred to them; investors who recovered their investments in what seemed to be the ordinary course of business within a six year period prior to the filing under state fraudulent conveyance law; and lawyers, accountants and other financial advisors, or shareholders under various fraud theories.

**McDonald:** Economic downturns commonly result in an increase in fraud revelations, and it will be no different this time around. We have seen it already with insolvent hedge funds and Satyam, among others. We will see an increase in the actual occurrence of fraud, as more struggling businesses commit fraud to stay afloat and avoid corporate restructuring or, in some cases, to take advantage of attention directed elsewhere. Fraudulent activity that may have been occurring for a number of years may only now be uncovered. The key legal issue will usually be the evidential burden of proving that fraudulent activity occurred and that the defendants were dishonest.

**Tuliano:** Fraud related cases continue to increase in both number and dollars at issue. Actual fraud cases, such as Madoff, will centre on standard of care issues involving those who were involved ►

as intermediaries in the process. If proven, the focus will be on finding assets that might be recovered for the estate. However, the extent and speed of changes in the nature and complexity of the financial instruments at the heart of a number of actual and suspected frauds have made it difficult for regulators, ratings agencies and other external participants to identify, quantify and mitigate sources of risk. As a result, there will be an increasing demand for the financial skills necessary to investigate the frauds and prosecute the perpetrators.

**Tarpley:** When a rapid loss of value occurs, allegations of fraud often follow. However, because of the widespread and widely publicised declines in values across the board, my sense is that allegations of generic ‘fraud and corporate waste’ based exclusively on the loss of value will decline. Yet, we have seen an increase in the instances of what might be termed specific fraud where, for example, a company owner attempts to invade segregated assets to cover operating losses believing that things will turn around in time for the unauthorised use of the segregated assets to be replaced. Trust fund violations, misapplication of customer deposits, and unauthorised use of collateral and the resulting financial statement cover-ups are the types of fraud we anticipate will increase.

**Elkin:** Frequently, the theme of a case becomes whatever has recently been in the news. Last year, many bankruptcy filings were a result of a housing slump, and the related subprime crisis resulted in much litigation. With Madoff and Stanford becoming notorious, the fraud theme will become more prevalent. Expect fraud cases to spin off a number of allegations that the officers, directors, professionals and others were negligent in not dealing with the fraud that was later discovered. It is important to remember that from a bankruptcy standpoint, fraud is a double-edged sword. Nearly all D&O insurance policies do not cover fraud, thereby eliminating the main ‘deep pocket’ of litigation against officers and directors.

**Hood:** The Madoff and Stanford scandals are the tip of the fraud iceberg, mere headlines for a much bigger story. As creditors and other stakeholders scabble for the crumbs left in bankrupt enterprises, they will be looking to see where the cake has gone. Bankruptcy professionals will be hunting more and more often as a team with forensic accountants and asset tracers, and their work will take them further afield in pursuit of the money. The key issues are speed

of action and prioritising those actions most likely to produce positive outcomes. Unlike many other bankruptcy realisation decisions, the balance between speed and quantum needs to be different, with a recognition that patience may be the most productive talent.

**Clark:** A tsunami of financial fraud schemes, some alleged and some admitted, has come to light in recent months. Bernie Madoff, Alan Stanford, Danny Pang and PEMGroup, Tom Petters – the list goes on. I think one of the more significant bankruptcy litigation issues coming up in the Ponzi scheme cases is the extent to which a trustee acting for the wrongdoer’s estate can claw back. Bankruptcy trustees have an obvious incentive to bring these claims, so considering that state statutes of limitation on fraudulent transfer claims extend as long as six years, I am confident we will see this kind of litigation for quite some time to come.

**Sprayregen:** In what ways can the presently difficult financing environment affect the litigation process at the front end of a bankruptcy case? Do you expect to see an improvement in the loan market for insolvent entities, to a point where there is competition to lend?

**Tuliano:** The challenging conditions in the credit markets are leading to an acceleration of the litigation process, as the focus shifts from reorganisation to liquidation combined with litigation. Additionally, the limited field of DIP financing options has provided significant negotiating leverage for lenders and resulted in expensive and restrictive post-petition financing arrangements with features such as ‘roll-ups’ and sale timetables. The combination of these factors will lead to litigation regarding valuation issues much earlier than would have been the case. We expect that the credit markets will improve in the latter part of this year, but such improvement will likely be gradual and certainly more disciplined than in the past.

**McDonald:** Companies are struggling to find cash to pursue litigation. Where the insolvent company has sufficient liquid assets of its own to set aside a fighting fund, creditors may be willing to forego a higher return from litigation in return for a lower but more certain recovery from existing assets. Obtusely, if there is less money in the pot, creditors may demand that potential recoveries from litigation are explored. Third-party funding for insolvent entities is available, but liquidators are still likely to need to explore alternative funding options to plug the gap and to bring their investigations to the point where there is a good claim against a defendant with deep pockets.

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**Tarpley:** Perhaps counter intuitively, the absence of funding may decrease front end litigation because all parties may perceive that the debtor is very fragile and that litigation costs may effectively kill the company. It is difficult justifying a fight over a pie if there is no pie. I anticipate that bankruptcy funding sources will slowly return in sync with the return of relative stability in the overall economy. Relative stability may exist by late 2009, early 2010. Note, however, that commercial mortgages defaults may and likely will be a wave that has just begun to gain momentum.

**East:** Where companies have gone into liquidation, and there is very little in the way of assets for distribution to creditors, creditors and liquidators are going to be unwilling to commit to litigation with a view to improving recoveries. However, there is a ►►

IAN McDONALD

growing market in funds that are prepared to provide litigation funding for the purposes of bringing claims on the basis that they will recover some proportion of the damages award. There have always been funders in the London market, but the emergence of multiple sophisticated funders will encourage competition and hopefully lead to very competitively priced funding for liquidators to pursue claims.

**Elkin:** If a company cannot secure DIP financing, its sole operating funding will come from the use of its cash, with or without the consent of its secured creditors. As such, funds for litigation will be limited, and courts are not generally inclined to allow a secured creditor's cash collateral to be used to sue that same creditor. A limited ability to use cash collateral will certainly chill such litigation. However, if the litigation is viable and against a third party other than the secured lenders, the lenders may be willing to finance the litigation to increase their own recovery. DIP lending will come back at some point and the cash that has been sitting on the sidelines will once again become available.

**Clark:** There is more priming litigation where pre-petition secured lenders choose not to be in the DIP facility and will not be subordinated to the DIP lenders. Also, there are more intercreditor disputes, between senior secured lenders and other lien lenders that require litigation to resolve. As for the DIP financing market, virtually all facilities have been provided defensively by the pre-petition secured lenders to protect their collateral. There are hopeful signs that major financing sources will once again start to compete for business, but we do not expect to see a normalised DIP market until at least 2010.

**Heroy:** There are fewer financing fights because third party DIP financing sources are currently rare to nonexistent. However, the market can only improve. The extraordinarily high pricing for DIP loans that has been the result of the current market is beginning to draw interest that should, over time, restore competition to the market with a concomitant return to cash collateral usage and priming litigation.

**Hood:** Funding is scarce in all markets, despite some tentative signs of a thaw. The inevitable outcome will be a rationing of both front and back end litigation, as well as a much harder attitude to the risk/reward calculation. The return of competition in lending to insolvent entities will be a function of when investors believe they can see the bottom of the market. There is no shortage of funding available, nor any lack of willingness to deploy it, just a continuing uncertainty about timing. Until there is clarity on market levels, funding will be restricted to government bail outs for major players in strategic industries, while smaller businesses are allowed to go to the wall.

**Sprayregen:** Will the complexity of debtors' financing packages and capital structures lead to intercreditor disputes in the bankruptcy process?

**McDonald:** We saw intercreditor and bondholder disputes last time, and it will only increase this time. Whether litigation occurs will depend on funding issues. We have already seen a number of intercreditor disputes arising from the collapse of structured investment vehicles, with another one due to come before the House of Lords later this year. These complex financial documents were

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GEORGE H. TARPLEY

often not drafted with a focus on default. They contained complex waterfalls and enforcement provisions, but the wording is often ambiguous. When the interpretation of one phrase in a document can mean the difference between recovering billions or zero, creditors are going to be at odds.

**Tarpley:** Lenders in consortium groups find themselves in radically different circumstances vis-à-vis other lenders. Some are strong, most are anxious, and some are just waiting for regulatory takeover. This difference among lending group members should cause significant differences in views on how to respond to a default situation. Indenture trustees should anticipate some lively discussions within the group, particularly where regulatory takeover of a significant lender group member has occurred or is imminent. Also, with the serious decline in asset values, significant disputes between first and second lien holders on valuation are now much more likely.

**Hood:** In current markets with such hugely material losses and so many non-professional investor casualties, it is inevitable that legal advisors will seek to peel away at the onion in search of an advantage. The challenge will be the cat's cradle of competing interests, where creditors appear in various positions in structures. Court decisions are bound to be unpredictable. Common sense suggests that pragmatic settlements some way before the steps of the court should be the order of the day, but with so much at stake there will be an interesting tension between the need to get a result and the sheer weight of caseloads for harassed attorneys, which may force more compromises.

**Elkin:** Several factors make intercreditor disputes more common. As asset values shrink, creditors have to look to each other to enhance their recoveries. This is exacerbated by the increased complexity of debtors' capital structures and the inherent ambiguities of various intercreditor agreements drafted when high asset values were a given and covenant light loans were in vogue. In a time of limited resources, creditors should resort to creative solutions to fix a company's problems, and skilful practitioners will find solutions instead of immediately resorting to the kind of litigation that hurts everyone.

**Heroy:** Yes, and we already are seeing priority disputes among creditors, particularly where providers of mezzanine and other ju- ►►

nior lien debt are involved. More can be expected as filings increase and overly leveraged companies have less value to satisfy junior claims. Random US bankruptcy court decisions such as the 9<sup>th</sup> Circuit BAP's Clear Channel decision only exacerbate the situation.

**Tuliano:** Intercreditor disputes will continue to be a significant part of the process, but from our perspective such disputes will be driven more by valuation issues than by complexity in the capital structure. Ultimately, each constituency will be looking to influence the process, which will largely depend upon whether or not they have an economic stake in the company from a valuation perspective. However, the new financing structures, the participation of new players providing that financing, and the fact that many of these structures have not been tested in a restructuring cycle will increase the frequency of high-stakes litigation.

**Sprayregen:** The plethora of opaque agendas of various players has introduced significant uncertainty into the negotiation process. Can potential bankruptcy litigation provide transparency to credit default swap issues and other derivative issues that may drive conflicting agendas of creditors in bankruptcy cases?

**East:** Litigation in the UK can be a particularly useful tool to resolve issues that are very important to different stakeholders and drive value. Notably, the satellite litigation in and around a restructuring can be bought very quickly in front of English courts, particularly if it is just a question of the legal interpretation of a contract. I think if there are difficult issues on the faces of credit default swaps and other derivatives, those types of things can be litigated quite quickly, and the English court has a very good habit of coming to sensible and commercial views on what contracts mean.

**Clark:** Litigation is public by nature and will therefore provide more transparency to complex financial instruments than has been the case to date. As debtors and their counterparties move to unwind swaps and other derivative instruments, more will be revealed about the structure of these transactions, the legal ramifications and the motivations of the competing parties. One way or another, each side will have to decide how it thinks the economics should be netted out. As a practical matter, because of parties' potential hidden agendas, they may be forced to take positions in litigation that may seem contrary to what their economic interests would be if the sole

focus were the particular swap transaction at issue in the litigation.

**McDonald:** When a company is seeking to restructure or negotiate its way out of debt with creditors, it is generally assumed that creditors will approach negotiations with a view to saving the company or maximising their recovery in the insolvency. However, if some creditors have entered into credit derivatives, whereby it is financially more advantageous for them if the company collapses, that key assumption breaks down. Until recently, the existence of such credit derivatives was not transparent and so the creditor's conflict of interest was not known until after the fact. This timing makes the prospect of litigation which would allow the restructuring negotiations to proceed unlikely. New transparency and disclosure requirements at a regulatory level may well ease this issue going forward.

**Elkin:** A primary opaque agenda is really a function of claims trading. Continually shifting claimholders with different agendas is challenging because the deal that works one day with one group is not acceptable to the next group. Additionally, as creditor groups have fought the increased disclosure of position rules, it is not really possible to know how many and which positions in the capital structure any one creditor has in order to assess that creditor's real agenda. Litigation, and the discovery process that accompanies it, will certainly create transparency, but the costs and delays associated with litigation may make it a Pyrrhic victory.

**Hood:** All practitioners have come to terms with the steadily increasing multiplication of the parties round the negotiating table and their sometime confusion over the conflict between their internal risk management strategies and their publicly-stated objectives. Before the current crisis, there was a theory that this phenomenon was useful often acting as a catalyst to speed up negotiations and force solutions on more traditional stakeholders. Litigation is certainly a useful instrument in compelling greater openness, but a somewhat blunt and expensive one.

**Tuliano:** Litigation and the related discovery process naturally opens a window to previously confidential information, though often over a more protracted time period and with some limitations on the distribution and use of that information beyond the subject litigation. A more important way of improving transparency regarding various agendas is increasing the rigour of disclosures required of major parties in the case by the court and the US Trustee.

**Sprayregen:** To what extent is litigation occurring with regard to valuation matters in bankruptcy cases? How has widespread market turbulence affected bankruptcy valuations?

**Clark:** Going concern valuations of corporate enterprises have always been at least as much art as science. The imprecision inherent in these kinds of valuation exercises is materially exacerbated by the extreme volatility that has reigned in the markets for the past year-plus. And if the valuations concern financial companies or complex financial instruments, the room for disagreement increases exponentially. So this is very fertile ground for litigation disputes between debtors and creditors or between competing creditors in bankruptcy cases.

**East:** There is not really a bankruptcy valuation process or model ►►

**The satellite litigation in and around a restructuring can be bought very quickly in front of English courts, particularly if it is just a question of the legal interpretation of a contract.**

RICHARD EAST

in the UK within the context of any UK insolvency process, although there is always obviously a significant valuation issue behind all consensual and non-consensual reorganisations. Perhaps most controversially at the moment, there is always a opaque valuation issue behind administration pre-packs, because the administrators make decisions with respect to how they treat secured and unsecured creditors in a pre-pack environment, ultimately based on their own assessment of value. I suspect at some point there may well be a challenge to this process, although I doubt very much that the English court will have very much sympathy for any such challenge.

**Elkin:** In today's market, valuation is one of the most important issues because it determines who stands where in the capital structure and whether any given creditor body is in the money or not. As such, valuations become critical and will be a focal point for litigation. On the one hand, valuation fights seem to have increased in recent cases because while such litigation is expensive, it is the only way to force resolution of the issue of who is entitled to what. On the other hand, actual asset values have become so diluted that the 'sell now' mentality may start to be replaced with a 'wait and hold' strategy.

**Heroy:** As a practical matter, valuation trials are extremely difficult these days due to market uncertainties as to normalised revenues, EBITDA, cash flow and multiples. Consequently, there are fewer disputes but in those cases that are litigated more uncertainty. However, valuation is likely to emerge as a key issue in bankruptcy litigation as things stabilise. Cases from a few years ago in the Southern District of New York and the Third Circuit are likely to provide guidelines going forward.

**Tuliano:** Valuation is a central issue in most major bankruptcy cases, and the current market dynamics are such that its importance is even more critical than in the past. When a stakeholder constituency finds itself out of the money or otherwise disadvantaged, a valuation fight is likely to ensue. That fight may ultimately take the form of litigation, either looking back at past transactions or looking ahead at who the go forward stakeholders will be. The current market turbulence has certainly affected valuations in bankruptcy. With the current dislocation and elimination of markets for certain securities and assets, market-based assessments are made more difficult.

**Hood:** Litigation on valuation has traditionally been a minor part of overall bankruptcy litigation, with most professionals taking great care to support disposal actions with robust valuations, especially during the recent vogue for pre-pack solutions. The exception is in the financial services arena, where the Lehman debacle is highlighting a raft of valuation issues in situations where the last resort of the uncertain practitioner, i.e. testing the open market, is not available. The basic tenet has always been that something is worth what a willing and properly funded buyer will pay for it. With few buyers and even less funding, valuations continue to head southwards.

**McDonald:** In the current market, it is extremely difficult to obtain accurate and agreed valuations on many asset classes, particularly in relation to the value of products for which there is no longer a market, or where there are dramatic short term fluctuations in value. From a litigation perspective, this certainly leaves

## Valuation is likely to emerge as a key issue in bankruptcy litigation as things stabilise. Cases from a few years ago in the Southern District of New York and the Third Circuit are likely to provide guidelines going forward.

DAVID HEROY

more room for argument when valuation is in issue. In particular, valuations are being disputed by creditors close to the point at which the value breaks. The valuation aspects of bankruptcy litigation are likely to be hard-fought and particularly difficult.

**Tarpley:** Market turbulence has eliminated the reliability of most valuation benchmarks and methods. The mark-to-market controversy highlights this condition. Hence, the focus of litigation as it pertains to valuation now begins with an iteration of the question: 'of what possible utility is your recitation of allegedly comparable sales from a year ago, or a week ago, and why is your testimony about cap rates anything other than a guess in this market and thus entitled to no weight by the court?' The bottom line is that if no one has a defensible basis on which to project values, the party with the burden of proof loses.

**Sprayregen:** How might the recent public and political outrage over employee bonuses paid by government-funded financial institutions affect retention strategies in bankruptcy cases? Could this become a contentious area of litigation going forward?

**Heroy:** In addition to the effect on retention strategies, a potentially more interesting issue would be the ability to recover pre-filing bonuses. To set aside a payment as a fraudulent transfer, it must be argued that the bonus was not paid for services having 'reasonably equivalent value'. Given the proliferation of large bonuses in the financial industry, it will be very difficult to be successful in that argument for all but the most egregious cases. A second possible theory – prosecuting a breach of fiduciary duty claim against the directors who authorised the payments – would face similar obstacles. Unless there could be proof of gross negligence, or there is an insider angle to trigger the duty of loyalty, the theory would be forced to rely on the duty of care. Put together with the 'meeting market competition' defence, the case would be extremely difficult to make.

**Tuliano:** Employee retention plans were among the perceived abuses that Congress attempted to stem in 2005's BAPCPA legislation. While this has generated changes in the way that such programs are implemented within the bankruptcy process, there has also been a recognition that companies in bankruptcy need to compensate and motivate their employees in order to achieve bet- ►

ter results. Bonuses and compensation have always been a highly contentious issue in cases where labour concessions represent a key part of a successful restructuring scheme. The recent publicity regarding bonus payments will heighten awareness of the issue, but will not directly result in significant litigation.

**Elkin:** Retention and compensation is already the subject of great disputes and controversy in bankruptcy cases. The Bankruptcy Code Amendments eliminated many of the more egregious KERP provisions, and certainly some creditors will start to argue that people employed by bankrupt companies do not have the large number of other alternatives available to them in times of high unemployment such that a retention programme is unnecessary. These programs will continue to be contentious until the public understands that retention payments are not rewarding employees for their company failing, but are a cost-savings device that has been employed to protect the knowledge base of the debtor.

**Tarpley:** Oddly perhaps, the bankruptcy context may provide a better arena to obtain retention bonuses of moderate amounts even for companies operating on government loans because the decision to award them will be made by a court and not by entrenched management. The court will not likely entertain extraordinarily high dollar requests, but it also likely will appreciate in a very real sense the need for the retention of key employees.

**Clark:** It is easy to see how employee retention plans in Chapter 11 cases, which are already lightening rods for creditors and rank and file employees, become more controversial when a case involves a company that has received bailout funds. On the other hand, even strident critics of management compensation programs acknowledge that managers need to be paid competitively if a good performance is to be achieved. While future compensation programs in bankruptcy reorganisation cases are likely going to continue to mirror the non-bankruptcy marketplace, there is also likely to be increased creditor and judicial scrutiny of these programs through more contested hearings in the future.

**Hood:** The Fred Goodwin pension saga at Royal Bank of Scotland is instructive. Despite massive public outrage, the UK government has huffed and puffed in a gloriously ineffective attempt to find a way to force the regurgitation of this enrichment. The legal position seems to inhibit any formal action and, unlike with the

AIG bonuses, there has been no happy ending yet. Whilst there will be some instances where there is a legal route to the recovery of unjustified bonuses, most situations will get caught in the usual mire of overturning antecedent transactions.

**McDonald:** In the UK, administrators of insolvent companies that are continuing to trade will be in a quandary over employee bonuses. On the one hand, the company is most likely to succeed if existing employees, with their valuable knowledge of the company, can be retained. On the other hand, administrators and courts will be under pressure not to be seen to be paying bonuses to staff who contributed to the company's downfall. If the company has been bailed out by the government, there will be additional political pressure over this issue. Administrators are likely to seek directions and approval from the Court for the terms on which they retain employees, to protect themselves from subsequent criticism.

**Sprayregen:** **What general advice would you give to parties involved in bankruptcy litigation in today's climate? What basic considerations and preparations should they make before proceeding?**

**Tarpley:** Focus your disputes on areas that improve operations, i.e. eliminating excessive compensation packages, rejecting unnecessary contracts and leases, early closing of plants with excess capacity, and fighting the traditional practice of unduly layering expensive professionals onto the reorganisation. Not every situation needs a financial advisor, accountant and shadow management consultant.

**McDonald:** Litigation can be used to achieve recoveries or strategic outcomes, but only where those outcomes are realistically defined from the outset. Parties can sometimes lose track of the fact that litigation will not result in a recovery of \$100m if there are only \$20m of available assets. Bearing in mind any time constraints, as much investigative work as possible should be carried out to establish the case before litigation is commenced. From a potential defendant's point of view, taking steps before a claim is contemplated to recognise and manage risks, organise documents and establish a protocol for managing requests for information will better enable to defend claims.

**Hood:** Be sure you have clear objectives and that the plaintiff can pay if you win - not just the award, but your costs as well. Think also about how the public exposure of your position and your tactics will be viewed in these judgemental times, particularly those in the private equity and hedge fund markets. Ignoring public censure in pursuit of the last dollar, pound or euro may turn out to be a short-sighted and potentially damaging strategy.

**Tuliano:** First, understand the dynamics that drive the litigation process. Deals can be structured in bankruptcy to avoid the time and expense of litigation, and the achievement of such a deal may be the primary objective of the parties involved. Second, thoroughly understand the facts leading up to the bankruptcy, as these facts will often reveal the risks of the litigation process. Third, retain the best attorneys and advisors you can find, since there is wide disparity in the skills and experience of professionals practicing in the field. Finally, approach the matters as objectively as you can - a realistic risk assessment is essential to early resolution. ►►

**Whilst there will be some instances where there is a legal route to the recovery of unjustified bonuses, most situations will get caught in the usual mire of overturning antecedent transactions.**

NICK HOOD

**Clark:** If possible, settle disputes before they get to litigation. Otherwise, hire the best litigator you can find, and be prepared for an expensive and inherently unpredictable process. Even then, keep an open mind to settling. Even before a judge instead of a jury, which will be the situation in bankruptcy court, litigation is by its very nature a crap shoot; that explains the adage that a bad settlement is better than a good lawsuit. One other important consideration – take all necessary steps to preserve all documents and records that may be relevant; those who fail to do so risk having adverse presumptions applied against their interests in court.

**Elkin:** First and foremost, litigation should not be a knee-jerk reaction to the anger and frustration of a bankruptcy and the inability of a debtor to pay you back. Parties should fully explore their options before starting litigation that could prevent a successful reorganisation. Today's environment makes it difficult for a company to remain in bankruptcy for an extended period of time. If the litigation cannot be resolved swiftly and a plan cannot be confirmed before the litigation is resolved, the company might not survive the process. Additionally, parties should recognise that sometimes, despite people's best efforts, companies fail.

**East:** It pays to get an early view on issues and to take action quickly, because both The European Regulation on Insolvency and The Judgments and Jurisdiction Regulation encourage and support the court which first takes COMI jurisdiction or is first seized of a dispute. The jurisdiction can determine so many important procedural and substantive issues, which will have a major impact on the client's likely outcome.

**Sprayregen: Do you see opportunities for efficiently resolving bankruptcy litigation through mediation, arbitration or other dispute resolution mechanisms in the current cycle? Are these options more viable now compared to previous downturns?**

**Hood:** Legal outcomes have never been less certain than in these markets, nor the attorney dollar scarcer and more precious. Looking at alternative dispute resolution techniques should be the first thought, not the reaction to an impasse in litigation. But the same rules apply as in litigation, so it must be the art of the possible and the collectible. The good news is that under some circumstances it may avoid embarrassing disclosure of at least some inconvenient facts and figures. One issue may be professional capacity, in terms of mediators and arbitrators. Plenty of people use these labels, but the good ones are relatively few and far between.

**Elkin:** The complexity of companies' capital structures and the cost of litigation have put a priority on professionals' ability to develop creative solutions. Whether this is accomplished through formal alternative dispute resolution processes or through skilful counsel, a solution must be found. The costs of restructuring cases are escalating. The absence of either replacement financing or financial buyers means that companies will have to deal with the creditors they take with them into the bankruptcy and make the best with what they have available. To the extent these options are more cost effective than litigation, they will positively impact dispute resolution and creditor recoveries.

**Heroy:** Yes, current trends in North American jurisprudence, with the exception of proposed labour law revisions, all point towards increasing use of alternative dispute mechanisms. Bankruptcy is no exception. The bankruptcy courts have been virtually unanimous in not only enforcing arbitration clauses, but in implement-

ing wide-ranging mediation programs, especially to break log-jams in large cases. The asbestos cases in particular were resolved primarily by these types of processes. We expect these trends to accelerate, especially given the lack of value for junior creditors in many cases due to excessive leverage.

**McDonald:** If a consensual solution to a dispute can be reached, a more commercially agreeable result may well be likely, not least because of the reduced legal fees and shorter timeframe. In particular, issues that involve significant uncertainty and scope for more than one answer lend themselves to resolution by a process less rigid than formal litigation. This is particularly true of bankruptcy litigation, where parties have usually resigned themselves to accepting something less than the full amount of their claim and so may be more willing to compromise on the basis that some recovery is better than none. Particularly in cross-border disputes, improvements in the ability to enforce settlement agreements and arbitration awards mean that these dispute resolution mechanisms are more attractive to parties than they were in previous downturns.

**Tuliano:** Alternative dispute resolution processes are viable avenues, and court awareness and openness to such options has certainly increased. While they should be pursued when and where possible, we have not seen many early resolutions result from such avenues. The best opportunity for early resolution, in our view, resides in a consensual plan of reorganisation that fully recognises and addresses the legitimate claims of all stakeholders.

**Clark:** Alternative dispute resolution procedures are unlikely to be any more or less viable in today's environment than previously. That said, mediation is often helpful in resolving matters where the parties have not been able to agree on a settlement. I have not often seen bankruptcy litigation matters referred to arbitration absent a pre-petition contract requiring it, perhaps because it does not generally offer a significant timing advantage over bankruptcy litigation, which tends to be faster paced than most other kinds of litigation. While arbitration can be useful for certain kinds of disputes, particularly those in which the material facts are largely undisputed, it can be less desirable, and not necessarily more cost effective, in high stakes matters where the facts are hotly contested and witness credibility may be important.

**Tarpley:** Bankruptcy litigation is usually part of an overall process that is much more than just the resolution of a specific, one-off dispute. The strategy of bankruptcy litigation frequently evolves over the life of a case and can change as the relative position of the parties often change. For example, today's foe may be tomorrow's friend, and the flexibility to resolve litigated issues in return for support on a key financing pleading or a plan, for example, is often more important than actually obtaining an answer to a specific litigated question.

**East:** Given the drivers for litigation at the moment – destruction in value, unclear law and kind of winner-takes-all issues – there is not much of a base for mediation. Arbitration is different because it is usually mandated in the contract, but other forms of ADR will not have much of a role in the current environment. I think we are back to 'blood and guts' litigation. Parties, in my view, will either commit in the contractual documents to arbitrate, in which case they will be bound by whatever forum they have agreed to. If they are not bound, I think it will be rare for parties to voluntarily commit to arbitrate. ■