



New York Bankruptcy Court Holds Broker Liable to Return Over \$141 Million in Margin Payments

In *Gredd v. Bear, Stearns Secs. Corp. (In re Manhattan Inv. Fund Ltd.)*, 359 B.R. 510 (Bankr. S.D.N.Y. 2007) (Lifland, J.), the United States Bankruptcy Court for the Southern District of New York found a prime broker liable to return, to the bankruptcy estate of a hedge fund, over \$125 million in margin payments made by the hedge fund in the course of a massive Ponzi scheme – even though the broker itself had earned only \$2.4 million in fees from the hedge fund. The Bankruptcy Court’s decision has been appealed.

Factual Background

The Manhattan Investment Fund (the Fund) was a hedge fund that purported to make profits by short selling technology stocks. In reality, the Fund was engaged in a Ponzi scheme, using money from new investors to cover its losses and pay “returns” to old investors.

As a short seller, the Fund was required to maintain a margin account with a stockbroker such as Bear Stearns with a reserve to cover trading losses. In 1999, the year before the Fund filed for bankruptcy, Bear Stearns made frequent margin calls and received eighteen separate transfers totaling \$141 million into the Fund’s margin account.

The monies in the Fund’s Bear Stearns account were used by the Fund to engage in securities trading. Under the account agreement between Bear Stearns and the Fund, Bear Stearns held a security interest in the monies in the account and could, at its sole discretion, use such monies to cover any open short positions of the Fund (obligations for which Bear Stearns itself would otherwise have been liable).

The Fund’s Ponzi scheme collapsed and it filed for bankruptcy in March 2000. A month later, the Fund’s court-appointed trustee filed suit against Bear Stearns to recover \$141 million in margin payments, plus interest.

Bankruptcy Court Rejects Broker’s Defenses

Bear Stearns advanced three unsuccessful defenses to recovery of the margin payments. First, Bear Stearns argued that it was not an “initial transferee” within the meaning of § 550, but rather was a “mere conduit” for the margin payments. Although the terms of the account agreement gave Bear Stearns the limited ability to direct the use of funds in the account to cover open short positions, Bear Stearns argued that it nonetheless lacked sufficient dominion and control over the money to be considered a transferee.

Second, Bear Stearns argued that the margin payments fell under the safe harbor of § 546(e) of the Bankruptcy Code. That section promotes stability and certainty in the securities market by strictly limiting the circumstances under which a trustee may recover margin or settlement payments.

Finally, Bear Stearns argued that it took the margin payments for value and in good faith, since it was unaware of the fraudulent nature of the Fund’s activities. Under § 548(c) of the Bankruptcy Code, Bear Stearns asserted,

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it was therefore entitled to retain its interest in the margin payments.

Broker Was Not a “Mere Conduit”

The Bankruptcy Court acknowledged that the Second Circuit Court of Appeals has adopted the Seventh Circuit’s “dominion and control” test to determine whether an entity is an initial transferee from which an avoided transfer can be recovered. That test was articulated in *Bonded Fin. Servs., Inc. v. European Am. Bank*, 838 F.2d 890 (7th Cir. 1988), in which the court explained that an entity is an initial transferee where it has “the right to put the money to [its] own purposes” and is free to “invest the whole [amount] in lottery tickets or uranium stocks.” *Id.* at 893-94.

It appears, however, that the Bankruptcy Court applied a different test in this case. Although Bear Stearns clearly was not free to invest the margin payments in lottery tickets or uranium stocks, and could only use the monies to cover the Fund’s open short positions, the Bankruptcy Court nonetheless held that this was sufficient dominion and control to give rise to initial transferee status. In reaching this conclusion, the Court relied on the Ninth Circuit’s decision in *Universal Serv. Admin. Co. v. Post Confirmation Committee of Unsecured Creditors of Incomnet Comms. (In re Incomnet)*, 463 F.3d 1064 (9th Cir. 2006), in which the Ninth Circuit apparently distinguished the *Bonded* court’s “dominion and control” test:

It is of no consequence that the recipient cannot invest the funds in – to use the Seventh Circuit’s colorful phrase – “lottery tickets or uranium stocks. . . .” [The statutory] legal restrictions merely limit how [the recipient] will exercise its dominion over the funds; they do not preclude [it] from having dominion at all.

Id. at 1074 (quoted in *Bear, Stearns*, 359 B.R. at 521).

The Bankruptcy Court gave considerable weight to the fact that Bear Stearns received \$2.4 million consideration for its services and would have had liability in the transaction as a whole if the transfers had not been made. The Court reasoned that “Bear Stearns had the ability to exercise control and use the Transfers to protect its own economic well-being and thus, is not a mere conduit with respect to those Transfers.” *Bear, Stearns*, 359 B.R. at 522.

Publications

- Evelyn Meltzer recently was named a contributing editor for the ABI Commercial Fraud Task Force Committee e-newsletter
- David Stratton and Mike Reed co-authored an article titled, “A Measured Response to Critics of Delaware Venue,” published in two parts in the April and May 2007 issues of the *ABI Journal*
- Fran Lawall published a chapter, “Bankruptcy Trends: Paradigm Shift or Simple Evolution?,” that appeared in *Aspatore Thought Leadership: Bankruptcy & Financial Restructuring Law*, 2007 edition
- Kay Kress and Jim Carignan are publishing an article in the May/June 2007 issue of *Business Law Today*, Volume 16, entitled “Keeping Current: Bad Faith Debtors Can’t Convert from Chapter 7”

Recent and Upcoming Events

- Robert Hertzberg moderated a panel at Distressed Debt: The 2007 Summit in New York. The panel dealt with opportunities for distressed investors in Latin America, the U.S. and Canada
- Kay Kress and Robert Hertzberg spoke at the 23rd Annual Bankruptcy and Restructuring Conference in Chicago, Illinois on Thursday, June 7. Ms. Kress spoke on a panel discussing “Alternative to Bankruptcy, A Better Way?” Mr. Hertzberg spoke on a panel discussing “KERPs and the new 503.”
- Fran Lawall will be speaking at the June 18 PBI session in Philadelphia on “Preferences and Fraudulent Conveyances - 2007”

- **Bill Cohen** will speak on two panels at the Midwest Regional Bankruptcy Seminar in Cincinnati on August 9-10, 2007, “Pre-Chapter 11 Restructuring Issues” and “Post BAPCPA Hot Topics”
- **Leon Barson** is speaking at the ABI Mid-Atlantic Workshop in Cambridge, Maryland on August 9-11, 2007. His topic is “Workers of the World, Unite!: Pensions, Union Issues and MEPA Liability.”

Announcement

Bill Cohen has been elected Vice President of the American College of Bankruptcy.

The American College of Bankruptcy is a prestigious, nonprofit, honorary association of bankruptcy and insolvency professionals. Formed in 1989, the College has approximately 663 fellows from across the globe that are selected by a Board of Regents from among recommendations received from the Circuit Admissions Council in each federal judicial circuit. The Regents select members who meet the highest professional qualifications and ethical standards. Fellows include lawyers, judges, law professors, accountants, appraisers, auctioneers, officers of the government, officers of lending institutions, reorganization, workout and liquidation specialists and others dedicated to the improvement of the bankruptcy process and the enhancement of the professional quality of and public respect for the insolvency and bankruptcy practice.

Pepper is honored to have five partners as members of the College, including Detroit partners Barbara Rom, Kay Kress, Robert Hertzberg and Bill Cohen, and Mike Reed in Philadelphia.

Judge Lifland’s decision in *Bear, Stearns* represents a departure from initial transferee caselaw in the Second Circuit and is in marked contrast to his own decision just three years earlier in *Geltzer v. D’Antona (In re Cassandra Group)*, 312 B.R. 491 (Bankr. S.D.N.Y. 2004) (Lifland, J.). In that case, the trustee sought to recover rent payments made on behalf of the debtor by the defendant, the debtor’s attorney. The funds had been transferred from the debtor to the defendant by means of checks made out to the defendant. The checks were deposited into the defendant’s client trust account. The defendant held broad powers over the client trust account, including the power – which he exercised – to pay his own fees out of the funds. *Id.* at 495. The Court, applying the *Bonded* test, found that the defendant lacked sufficient dominion and control over the account to be an initial transferee of the funds. *Id.* at 496-97.

“Margin Payment” Defense Under § 546(e) Does Not Apply in Context of Ponzi Scheme

The safe harbor of § 546(e) does not cover transfers that are actually, as opposed to constructively, fraudulent. The trustee argued that because the margin payments were made in furtherance of a Ponzi scheme, they fell outside of the safe harbor provision. The Bankruptcy Court agreed, noting that “transfers made in the course of a Ponzi operation could have been made for no purpose other than to hinder, delay or defraud creditors.” *Id.* at 517-18.

Broker Did Not Act in Good Faith Because It Was on “Inquiry Notice” of the Fraud

There was no dispute that Bear Stearns had taken the margin payments “for value,” since § 548(d)(2)(B) of the Bankruptcy Code provides that a stockbroker that receives a margin payment takes for value to the extent of such payment.¹ The only question before the Court was whether Bear Stearns had taken the margin payments in good faith. As appears to be the trend in fraudulent transfer cases, the Bankruptcy Court applied the demanding standard of “inquiry notice.” The Court explained that the issue was not what Bear Stearns actually knew, but what it *should have known*. If “diligent inquiry would have discovered the fraudulent purpose,” then Bear Stearns could not claim good faith. *Bear, Stearns*, 359 B.R. at 524.

In this case, one of the executives of Bear Stearns had had a conversation at a 1998 Christmas party with an investor in the Fund, who mentioned that the Fund was reporting a 20 percent profit for the year. This conflicted with the executive’s impression, based on risk-related conference

calls within Bear Stearns, that the Fund was losing money. The executive informed his superiors of the conversation. Bear Stearns then held a conference call with the Fund's manager, who explained that the discrepancy was due to the fact that Bear Stearns was only one of eight or nine prime brokers used by the Fund. Bear Stearns – in the Court's opinion, “apparently wearing ‘blindness’” – accepted this explanation without attempting to verify it. *Id.* at 525. A diligent review of the notes to the Fund's financial statements, however, would have revealed that Bear Stearns was, in fact, the only broker used by the Fund.

In ruling against Bear Stearns, the Court held that “Bear Stearns failed to act diligently in a timely manner and accordingly, Bear Stearns cannot satisfy its burden of showing that it acted with the diligence required to establish good faith under section 548(c) of the Bankruptcy Code.” *Id.* at 526-27.

Conclusion

This case stands as a cautionary tale not only to the brokerage industry, but to depository banks and secured lenders as well, particularly if the case is a signal that courts in the Second Circuit are moving away from the *Bonded* test and toward the apparently more expansive theory of “dominion and control” articulated by the Ninth Circuit. Under that theory, any entity that (1) receives an economic benefit from transfers, and (2) would have faced liability in the absence of such transfers, may find itself deemed an initial transferee from which the transfers may be recovered – even if it actually had little control over the transfers. Moreover, the diligence required under the “inquiry notice” standard of good faith means that brokers, banks and other entities involved in the securities trade should consider establishing programs designed to monitor and, where appropriate, investigate their customers' activities to ensure that funds received are not the result of, or being used to facilitate, fraudulent activities. The appeal in this case should be watched with interest by those who might likewise find themselves in Bear Stearns' position.

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This case stands as a cautionary tale not only to the brokerage industry, but to depository banks and secured lenders as well, particularly if the case is a signal that courts in the Second Circuit are moving away from the Bonded test and toward the apparently more expansive theory of “dominion and control” articulated by the Ninth Circuit.

Endnotes

- 1 The term “margin payment” is defined in §§ 101 and 741 of the Bankruptcy Code, and includes a payment or deposit of cash, securities or other property that secures the obligations of a participant in a securities clearing agency.

Prior Lien Defense Trumps Reclamation Claims

Another recent decision of note by Judge Burton R. Lifland of the Southern District of New York, in *In re Dana Corporation*, __ B.R. __, 2007 WL 1199221 (Bankr. S.D.N.Y., April 19, 2007), is where he held that (i) there is no federal right of reclamation created by section 546(c) of the Bankruptcy Code; and (ii) unless a particular claimant holds a reclamation claim in excess of the value of the claims of prior lienholders, the reclamation claim has no value.

Section 546(c) of the Bankruptcy Code, as amended by the Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA), which took effect in October 2005, gives vendors the ability to reclaim goods that the debtor received during the 45-day period prior to filing for bankruptcy. However, the reclamation is subject to the claims of creditors who hold a prior security interest in the same goods, such as a lender with a blanket lien on the debtor's inventory that is continued in connection with a post bankruptcy loan extended by the lender to the debtor – a concept commonly known as the “prior lien defense.”

In *Dana*, the Bankruptcy Court established a reclamation procedure for creditors claiming a right of reclamation. Thereafter, in defending against the reclamation claims, the debtors obtained Court approval to litigate the Prior Lien Defense separately and before any other defense they intended to pursue with respect to reclamation claims. The debtors argued that the reclamation claims were subordinate to the liens of its pre-bankruptcy lenders, who held liens on virtually all of the debtors' assets and that the reclamation claims were valueless. To make this argument, the debtors relied on a pre-BAPCPA decision, *In re Dairy Mart Convenience Stores, Inc.*, 302 B.R. 128 (Bankr. S.D.N.Y. 2003), which held that (i) reclamation claimants could not require an oversecured, pre-bankruptcy lien creditor to first take assets not subject to reclamation in satisfaction of its lien; and (ii) goods subject to reclamation and securing a pre-bankruptcy lender's debt are effectively disposed of when they are used as collateral for new post-bankruptcy financing. In support of their claims, the reclamation claimants urged the Court to apply the contrary view set forth in *In re Phar-Mor, Inc.*, 301 B.R. 482 (Bankr. N.D. Ohio 2003), and hold that the liens of the pre-bankruptcy lenders were paid from the new funds obtained from the post-bankruptcy financing, not from sale of the goods subject to the reclamation claims.

While the Dana decision, as well as the analogous decision in Advanced Marketing Services, makes it more difficult for creditors to enforce reclamation claims, reclamation creditors can take certain steps to protect their interests when a customer files for bankruptcy.

Judge Lifland first addressed whether section 546(c) of the Bankruptcy Code creates a new federal common law right of reclamation that is absolute and trumps state law reclamation rights. Although section 546(c), as amended, no longer refers to the state law right of reclamation, Judge Lifland found that the section did not grant an independent federal right of reclamation or create a comprehensive federal scheme for reclamation because it did not use “language of creation,” such as “a seller may reclaim goods when...” He further noted that, if Congress had intended to create a *federal* reclamation right, section 546(c) would not be subject to the provisions of the Bankruptcy Code that permit a trustee or debtor to avoid certain state law rights and claims.

After concluding that amended section 546(c) does not create a federal reclamation right, Judge Lifland examined *Phar-Mor, Dairy Mart* and *In re Advanced Marketing Services, Inc.*, __ B.R. __, 2007 WL 162685, (Bankr. D.Del. Jan. 22, 2007), a decision by the Delaware Bankruptcy Court in which reclamation claims were held to be subject to pre- and post-bankruptcy liens, and ruled that the Prior Lien Defense rendered the reclamation claims that had been asserted in *Dana* valueless. The Court found that the pre-bankruptcy collateral, including the reclaimed goods, was subject to the pre-bankruptcy lenders' liens. Pursuant to a prior order entered in the case that permitted the debtors to use the collateral securing the pre-bankruptcy lenders' liens, the post-bankruptcy lenders were simultaneously given a replacement lien in all of the debtors' prop-

erty, including the pre-bankruptcy collateral. The Court reasoned that granting the replacement lien was a necessary condition of the post-bankruptcy lenders' agreement to extend financing, which in turn was used to pay off the pre-bankruptcy liens. Consequently, the reclaimed goods were either liquidated in satisfaction of the pre-bankruptcy liens or were pledged to the post-bankruptcy lenders pursuant to the post-bankruptcy financing arrangement; therefore, they were effectively disposed of and are valueless pursuant to the Prior Lien Defense. Accordingly, the reclamation claimants were not entitled to reclaim goods pursuant to amended section 546(c).

In so ruling, however, Judge Lifland made sure to mention newly enacted section 503(b)(9), which provides reclamation claimants with an administrative expense claim in an amount equal to the value of any goods received by the debtor within 20 days before the debtor files for bankruptcy, if the goods were sold to the debtor in the ordinary course of the debtor's business.

While the *Dana* decision, as well as the analogous decision in *Advanced Marketing Services*, makes it more difficult for creditors to enforce reclamation claims, reclamation creditors can take certain steps to protect their interests when a customer files for bankruptcy:

- Timely make demand to reclaim any goods delivered to the customer within 45 days before the customer filed for bankruptcy. Demands must be made not later than 45 days after the goods are received by the customer or not later than 20 days after the date on which the bankruptcy case is filed, if the 45-day period expires after the bankruptcy case is filed.
- Promptly file a request for payment of an administrative expense claim pursuant to section 503(b)(9) for the value of any goods received by the debtor within 20 days before the debtor filed for bankruptcy.¹
- Review the debtor's motion to use cash collateral and/or to obtain post-petition (DIP) financing and, to the extent economically or otherwise feasible, file an objection if (a) the debtor's pre-bankruptcy lender is over-secured and the debtor's motion attempts to provide post-bankruptcy or replacement liens on goods that are subject to reclamation; and (b) the motion proposes a budget that does not include funds to pay section 503(b)(9) administrative claims or expressly prohibits their payment with DIP funds.

- Monitor the bankruptcy case for a motion seeking to establish procedures to handle section 503(b)(9) claims, which motions typically require creditors to file such claims by a special bar date and provide specific procedures to be followed by claimants in order to maintain and pursue their claims.

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Endnotes

- 1 The Bankruptcy Code does not specify when section 503(b)(9) administrative expense claims must be paid. Recent decisions have held that the timing of the payment is left to the discretion of the Court. See *In re Global Home Products, LLC*, 2006 WL 3791955 (Bankr. D.Del., Dec. 21, 2006), and *In re Bookbinders' Restaurant, Inc.*, 2006 WL 3858020 (Bankr. E.D.Pa., Dec. 28, 2006), both denying motions for immediate payment of section 503(b)(9) claims and holding that payment can be deferred until the end of a Chapter 11 case, after considering (a) the prejudice to the debtor, (b) the hardship to the claimant, and (c) the potential detriment to other creditors.

Ten Issues to Consider When Filing a Proof of Claim

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Federal Rule of Bankruptcy Procedure 3001(a) defines a proof of claim as a written statement setting forth a creditor's claim. Although at first glance filing a proof of claim appears to be a simple exercise, there are numerous pitfalls a creditor must be careful to avoid. Failure to avoid these pitfalls can result in serious and unintended consequences, including disallowance of the creditor's claim. Below is a list of 10 important issues to consider when filing a proof of claim.

1. What is the deadline to file the proof of claim?

When a creditor becomes aware of a pending bankruptcy case, the creditor should review the docket to determine the applicable bar date. The bar date is the last date by which the claims agent and/or the court must have received the proof of claim. A creditor who fails to file its proof of claim timely will be required to show excusable neglect in order to have its claim allowed. Demonstrating excusable neglect can be very difficult and may require the expenditure of significant legal fees. Accordingly, it is extremely important to determine and calendar the bar date in order to ensure that the creditor's proof of claim is timely filed.

2. Is the creditor required to file a proof of claim?

Certain creditors do not have to file a proof of claim to participate in a bankruptcy case. For example, a secured creditor generally does not have to file a proof of claim to preserve its lien in a bankruptcy case. In addition, in chapter 11 cases, a claim or interest listed in the schedules filed by the debtor is deemed to be allowed in the amount listed unless the claim or interest is listed as being contingent, unliquidated or disputed. Before filing a proof of claim, a creditor should consider whether it is required to file a proof of claim in order to assert its claim against the debtor's estate. If a creditor is not required to file a proof of claim, the creditor can avoid incurring costs related to filing (and possibly litigating) a proof of claim and the consequences associated with filing a proof of claim, as discussed below.

3. Is it in the creditor's best interest to file a claim?

Even if a creditor determines that it is required to file a proof of claim in order to assert its claim against the debtor, for tactical reasons the creditor may not want to file a proof of claim. By filing a proof of claim the creditor voluntarily subjects itself to the bankruptcy court's jurisdiction to adjudicate the claim as well as counterclaims. Additionally, by filing a proof of claim, a creditor may waive its right to a trial by a jury in any avoidance action asserted against the creditor. Accordingly, a creditor should carefully consider whether it is in its best interest to file a proof of claim before simply doing so.

4. Is the creditor using the correct proof of claim form?

Recently, some debtors have been requesting that the court permit them to make modifications to the official proof of claim form. For example, a debtor may request that personal injury claimants complete a proof of claim tailored to provide the debtor with information regarding the claimant's injuries and any pending personal injury lawsuit. Before simply filing a standard proof of claim form, a creditor should review the docket in order to ascertain whether the court has entered an order permitting the debtor to modify the official proof of claim form. Failure to use the correct proof of claim form may result in the proof of claim not being accepted by the claims agent or court, which in turn could result in the proof of claim not being filed timely.

5. Who should file the proof of claim?

In most instances, a proof of claim will be filed by a creditor or the creditor's authorized agent. In addition, parties authorized by the Bankruptcy Code to file a proof of claim on behalf of a creditor include the debtor, a trustee, a guarantor, a surety, an endorser or other co-debtor. If a third party files a proof of claim on behalf of the creditor and the third party has no legal basis to do so, the creditor's claim will be disallowed. For example, an agent of the debtor, who acts as a mere conduit of funds from the debtor to the creditor for services provided by the creditor to the debtor and who is not jointly liable with the debtor for the

amounts owed to the creditor, does not have a legal right to file a proof of claim on behalf of the creditor. Accordingly, a creditor should consider its relationship with the party filing a claim on its behalf and determine whether such third-party has the legal right to file a claim on the creditor's behalf.

6. Has the creditor properly asserted its claim?

A proof of claim identifies the amount the claimant believes is owed to the creditor by the debtor and the status the creditor believes the claim should have in the bankruptcy case. Prior to the expiration of the bar date, a creditor is generally free to amend its proof of claim. After the expiration of the bar date, however, courts only will allow a creditor to amend a claim if the original proof of claim provided adequate notice of the existence, nature and amount of the amended claim. For this reason, when filing a proof of claim it is important to consider carefully the facts and circumstances giving rise to the claim and to detail fully all relevant facts and potential legal theories in an explanatory statement attached to the proof of claim. Additionally, if it is unclear whether some portion of the claim may be entitled to priority status, the creditor should indicate on the proof of claim that it reserves its right to amend the proof of claim to seek priority status. By taking the time to gather information and properly prepare a proof of claim, a creditor increases the chance that it will

be permitted to amend its proof of claim after the bar date should the need arise.

7. Has the creditor attached adequate documentation in support of the claim?

A properly filed proof of claim constitutes prima facie evidence of the validity of the claim. However, where a creditor fails to provide documentation in support of its claim, the claim will not be accorded its prima facie validity. Failure to attach adequate documentation in support of the claim likely will result in the claim being objected to and ultimately disallowed. In order to avoid this unintended result, a creditor should attach sufficient documentation in support of its claim. For example, where a claim is based on a contract, a copy of the contract should be attached to the proof of claim. Similarly, where a creditor is claiming a security interest in property of the debtor's estate, the creditor should include a copy of the security agreement and a copy of documents evidencing the perfection of the security interest with the proof of claim. Where a creditor's damages are based on a formula, such as in the rejection of a lease, the creditor should attach documentation detailing how the damages were calculated. By providing detailed documentation in support of the proof of claim, the creditor will reduce the likelihood of an objection or at least narrow the scope of any objection that is filed.

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8. Who should receive notices about the claim after it is filed?

In addition to providing information about the underlying claim, a proof of claim provides the name and address where notices, objections and other documents pertaining to the proof of claim should be sent. It is imperative that in designating a name and address that the creditor ensures the appropriate person(s) will be made aware as quickly as possible of any objection to the claim. A creditor who fails to timely respond to an objection to its claim may have its claim disallowed or reduced. Moreover, if at any time after the proof of claim is filed, the information regarding where notices should be sent changes, the creditor should immediately notify the claims agent, court and debtor of its updated contact information.

9. Is the claim being filed against the correct debtor?

Unless otherwise provided in a claims procedures order, a creditor is required to file a proof of claim against each debtor that owes the creditor money. It is not uncommon for a creditor to be uncertain about which of various affiliated companies the creditor is actually contracting with. If the creditor asserts its claim against a debtor which is not liable, the creditor's claim will be disallowed. To avoid this unfortunate result, a creditor should file a proof of claim against each of the multiple debtors for the total amount of the claim, together with an explanatory statement indicating that the creditor is uncertain which of the debtors is responsible for all or any portion of the claim.

10. How should the proof of claim be sent to the claims agent and/or the court?

Many creditors simply will mail a proof of claim to the claims agent and/or court, enclosing an extra copy of the proof of claim, along with a pre-addressed, postage-paid envelope so that the claims agent can return a copy of the date-stamped proof of claim to the creditor. Although a date-stamped copy of the proof of claim reflects when the claims agent recorded the claim, it cannot confirm when the claim was received by the claims agent. If, for example, the claims agent misplaces the proof of claim, resulting in the proof of claim being recorded after the bar date, the creditor may not be able to prove that the claims agent received the proof of claim prior to the bar date. Therefore, a creditor should send the proof of claim by certified mail with return receipt requested. Alternatively, a creditor can

send the proof of claim to the claims agent via overnight carrier, keeping confirmation of delivery in its file. It is important that the confirmation of delivery be printed at the time the proof of claim is delivered to the claims agent, as the overnight carrier most likely will not have this information several months or years later, if and when the claim is objected to. Regardless of how the proof of claim is sent, if the creditor does not receive confirmation from the claims agent within a reasonable amount of time, the creditor should follow up with the claims agent to confirm the timely filing of its claim.

The filing of a proof of claim is a crucial step that must be undertaken in a timely and thoughtful manner. By addressing the ten issues set forth above in consultation with bankruptcy counsel, a creditor is more likely to have its claim allowed and to avoid the additional time and expense of dealing with an objection to its claim.

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Delaware Supreme Court Rejects Direct Cause of Action by Creditors Against Directors for Breach of Fiduciary Duty

For directors guiding a struggling company through the troubled waters of insolvency, an increasing worry has been the potential for exposure to creditor lawsuits for breach of some fiduciary duty claimed to be owed directly to creditors. In a decision that silences the debate on that issue, the Delaware Supreme Court has ruled, in *North American Catholic Educational Programming Foundation, Inc. v. Gheewalla*, that no direct claim for breach of fiduciary duties may be asserted against directors by creditors of an insolvent corporation, or by creditors of a solvent corporation operating in the zone of insolvency. Clarifying dicta from preceding Court of Chancery opinions that creditors had seized upon to argue for the existence of such fiduciary duties, the Court recognized as a general rule that directors do not owe creditors duties beyond the relevant contractual terms.

“When navigating in the zone of insolvency,” the Court ruled, “the focus for Delaware directors does not change: directors must continue to discharge their fiduciary duties to the corporation and its shareholders by exercising their business judgment in the best interests of the corporation for the benefit of its shareholder owners.” Likewise, in rejecting the notion that directors of an insolvent corporation assume fiduciary duties directly to individual creditors, the Court stated that “Directors of insolvent corporations must retain the freedom to engage in vigorous, good faith negotiations with individual creditors for the benefit of the corporation.”

While the Court noted in dicta that creditors of an insolvent corporation do acquire standing to assert *derivative* claims against directors on behalf of the corporation for breach of fiduciary duties, it did not address whether such standing exists when a corporation is not insolvent but is in the “zone of insolvency.” The Court also declined to precisely define “zone of insolvency.”

With this ruling, the Court charts a clearer course for directors navigating the zone of insolvency, and casts aside one of the two weapons that creditors have sought to wield

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against directors of insolvent Delaware corporations in recent years. The other, being the much-debated theory of “deepening insolvency” rejected by Vice Chancellor Strine in *Trenwick America Litigation Trust v. Ernst & Young, L.L.P.*, is before the Delaware Supreme Court on appeal from that decision, and a decision is anticipated imminently.

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