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Wilmington Update

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Message from Our Managing Partner

The Wilmington office welcomes Bradley W. Voss, as he joins Pepper as a partner in the Commercial Litigation Practice Group. We expect Brad, who has sterling credentials, to strengthen and help grow our already significant Chancery Court litigation practice. Elsewhere in this issue, we focus on various aspects of bankruptcy, finance and M&A transactions.

First, Mike Reed and John Schanne report on how the Court of Appeals for the Third Circuit, in reconsidering one of its earlier decisions, overruled the "accrual test" it had previously established, establishing a new test for determining how a claim for products liability arises under the Bankruptcy Code.

My article visits how the U.S. Bankruptcy Court for the District of Delaware court has embraced a discretionary standard for the appointment of a trustee or examiner in bankruptcy. I note that some courts consider such appointment mandatory above a certain threshold, while others have lately considered such appointments discretionary.

And, among Pepper's online highlights, we note a podcast featuring Tim McTaggart and Rick Eckman discussing private equity investments in finance, Henry Jaffe's discussion of a recent court ruling about a creditor's right to credit bid on assets in bankruptcy, and our webinar on the risks and opportunities of distressed M&A transactions.

David B. Stratton, Partner

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Third Circuit Overrules 'Accrual Test' Established by Widely Criticized *Frenville* Decision

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In a recent decision, JELD-WEN, Inc., *f/k/a Grossman's Inc. v. Gordon Van Brunt (In re Grossman's Inc.)*[1] *(Grossman's)*, the United States Court of Appeals for the Third Circuit reconsidered one of its most controversial bankruptcy decisions. Sitting *en banc*, the court overruled the "accrual test" established by its highly criticized decision in *Avellino & Bienes v. M. Frenville Co. (Matter of M. Frenville Co.)*[2] *(Frenville)*. In overruling *Frenville*, the Third Circuit established a new test for determining when a "claim" based upon products liability arises under the Bankruptcy Code[3] (the Code), but left the issue of whether a claim has been discharged by a plan of reorganization to be determined based on the facts of each particular case.

In 1977, Mary Van Brunt purchased home remodeling products that allegedly contained asbestos from Grossman's, a home improvement and lumber retailer located in New York. Twenty years later, in April 1997, Grossman's filed a voluntary petition under Chapter 11 of the Code in Delaware. At the time of the Chapter 11 filing, the debtor knew that it had previously sold products containing asbestos and apparently was aware of its potential liability for asbestos personal injury claims, although no claims had been asserted against it at that time. The debtor provided notice by publication of the deadline for filing proofs of claim. However, the notice contained no suggestion that the debtor might have future asbestos liability. The debtor eventually

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filed a plan of reorganization that provided for the discharge of all claims that arose before the plan's effective date. The bankruptcy court confirmed the plan in December 1997.

At the time of bankruptcy, Mrs. Van Brunt was not aware that she might hold a claim against the debtor. She had not yet manifested any symptoms related to asbestos exposure so she had no reason to file a proof of claim in the bankruptcy case. However, in 2006, almost ten years later, Mrs. Van Brunt began to manifest symptoms of mesothelioma, a cancer linked to asbestos exposure. She was diagnosed with the disease in March 2007. Shortly after her diagnosis, she filed an action for tort and breach of warranty against JELD-WEN, which was the successor in interest to the debtor, and 57 other companies who allegedly had manufactured the types of products that she had purchased from the debtor in 1977. JELD-WEN moved to reopen the debtor's Chapter 11 case, seeking a determination that the plaintiff's claim had been discharged in the Chapter 11 case. The plaintiff died in 2008 while the case was pending and her husband was substituted in the action as the representative of the estate.

In *Frenville*, the Third Circuit held that a "claim" under § 101(5) of the Code[4] does not "arise" until a cause of action has "accrued" under applicable nonbankruptcy (typically state) law. The court described this as the "accrual test."

In *Grossman's*, after the bankruptcy case was reopened, the bankruptcy court, relying on *Frenville*, held that the plan did not discharge the plaintiff's claims because, under relevant New York state law, no causes of action accrued until after the injury manifested itself, meaning that no "claim" under § 101(5) of the Code existed when the plan was confirmed and, accordingly, the plaintiff's claims were not discharged. The district court affirmed the bankruptcy court's holding that the plaintiff's tort claim was not discharged.[5]

The Third Circuit noted that the lower courts had correctly applied the *Frenville* test in determining that the plaintiff's tort claim arose after the bankruptcy discharge was granted and was therefore not discharged.

However, the *en banc* court considered whether it should continue to adhere to the *Frenville* decision. The court acknowledged that Frenville had been universally rejected; all courts of appeal that had examined the case had declined to follow the decision and bankruptcy scholars had also been critical of its holding. Due to the universal disapproval of the case, the Third Circuit was persuaded that it should reexamine the approach adopted in *Frenville*.

> IT REMAINS TO BE SEEN HOW THE DECISION WILL BE APPLIED BY THE LOWER COURTS IN DETERMINING WHETHER CLAIMS HAVE BEEN DISCHARGED IN PARTICULAR CASES.

The Third Circuit noted that other courts had declined to follow *Frenville* primarily because those courts concluded Frenville's narrow interpretation of the term "claim" conflicted with the expansive definition of "claim" contained in § 101(5) of the Code. The court also found that both the legislative history of the Code and Supreme Court precedent supported the other **courts' conclusion** that the term "claim" is to be construed very broadly. The court ultimately agreed that the *Frenville* holding interpreted the term "claim" too narrowly and, accordingly, overruled the *Frenville* "accrual test."

Overruling *Frenville* left the court with the task of articulating a new standard for when a claim arises under the Code. The court acknowledged that such a decision had many implications, chief of which was whether the bankruptcy discharge could extinguish the debtor's liability on the claim. The determination of when a claim arises also has significant due process implications because the discharge of a claim without adequate notice to the claimant raises concerns under the 14th Amendment.

The Third Circuit noted that two tests had predominated in the case law in the analysis of when a claim arises under the Code: (i) the "conduct test" and (ii) the "pre-petition relationship test." The conduct test looks only for pre-petition conduct, while the pre-petition relationship test looks for pre-petition conduct plus a pre-petition relationship between the debtor and the claimant. The court noted that while variations of the two tests had been used, there was a general consensus that in order for a products liability claim to arise under § 101(5), there had to be pre-petition exposure to a product or other pre-petition conduct of the debtor affecting the claimant: "a 'claim' arises when an individual is exposed pre-petition to a product or other conduct giving rise to an injury, which underlies a 'right to payment' under the

Bankruptcy Code." Applying this new test, the court found that the appellee's claim arose pre-petition on the date the plaintiff was exposed to the product.

Although the court established a new bright-line rule for determining when a products liability claim arises,[6] under which the appellee was found to have held a pre-petition claim, that holding left open the question of whether the appellee's claim was discharged. Inadequate notice to the claimant might violate the principles of due process and preclude discharge of a claim in bankruptcy.

The court noted that Congress had created safeguards to protect against due process violations that allowed for the discharge of future claims of individuals whose asbestos-related injuries were not manifest at the time of the bankruptcy when it enacted § 524(g) of the Code. Added as part of the Bankruptcy Reform Act of 1994, § 524(g) provides for the creation of a trust from which asbestos-related claims are paid with a concomitant channeling injunction against such claimants. In *Grossman's*, however, the plan of reorganization did not provide for the creation of such a trust.

In the absence of a § 524(g) trust, the court explained that whether a products liability claim is discharged by a plan of reorganization will depend largely on considerations of due process. In determining whether a claim has been discharged in a particular case involving products liability, the court suggested that bankruptcy courts should consider the following nonexclusive list of factors: the circumstances of the initial exposure to the harmful product, whether and/or when the claimant was aware of her vulnerability to the product, whether the notice of the claims bar date came to the claimant's attention, whether the claimant was a known creditor, and whether the claimant had a colorable claim at the time of the bar date. A determination of these considerations is best made by the appropriate trial court because of their case-specific nature. Therefore, the court remanded the case to the lower courts for a determination of whether due process was satisfied enabling the appellee's claim to be discharged under the plan of reorganization.

The test established in *Grossman's* for when a products liability claim arises is in accordance with the decisions in the other circuits and is more consistent with the broad definition of claim found in § 101(5) of the Code. At first blush, the Third Circuit's holding in *Grossman's* would appear to expand the universe of tort claims that can be discharged in Chapter 11 cases filed in the Third Circuit. However, it remains to be seen how the decision will be applied by the lower courts in determining whether claims have been discharged in particular cases.

Endnotes

1 Case No. 09-1563 (3d Cir. June 2, 2010).

2 744 F.2d 332 (3d Cir. 1984).

3 11 U.S.C. § 101 et seq.

4 When *Frenville* was decided, the definition was codified at § 101(4) of the Code.

5 The bankruptcy court had also held that the plaintiff's breach of warranty claim was not discharged. The district court reversed, holding that the breach of warranty claim arose when the product was delivered. The plaintiff did not appeal that holding.

6 While the court's new test will apply to the determination of when a products liability claim arises in a Chapter 11 case, the court noted that it might take a different approach where the claim involved arises under an environmental law. slip op. at p. 18, n.11.

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Delaware Court Embraces Discretionary Standard for Not-So-Mandatory Appointment of an Examiner

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Section 1104 of the Bankruptcy Code addresses the appointment of a trustee or examiner. Section 1104(c) provides in relevant part that

> [At] any time before confirmation of a plan, on request of a party in interest or the United States Trustee, and after notice and a hearing, the Court **shall** order the appointment of an examiner to conduct such an investigation of the debtor as is appropriate … if – (2) the debtor's fixed, liquidated, unsecured debts, other than debts for goods, services, or taxes, or owing to an insider, exceed $5,000,000. (Emphasis added).

11 U.S.C. § 1104(c). Where unsecured debt exceeds the threshold amount of $5million, some courts have held that the appointment of an examiner is mandatory. See, e.g., *In re Revco D.S., Inc.,* 898 F. 2d 498, 500-01 (6th Cir. 1990); *In re Walton*, 398 B.R. 77, 83-84 (N.D. Ga. 2008); *In re UAL Corp*, 307 B.R. 80, 86 (Bankr. N.D. Ill. 2004); *In re Loral Space Commc'ns*, 2004 WL 29797856, *5 (S.D.N.Y. Dec. 23, 2004). However, other courts had found that the court retains discretion not to appoint an examiner if circumstances warrant. For example, in *In re Bradlees Stores, Inc.*, 209 B.R. 36, 39 (Bankr. S.D.N.Y. 1997), the court held that the movant had waived its right to request the appointment of an examiner when the Debtor had already conducted an investigation, which the examiner's investigation would duplicate, and that appointing an examiner would be wasteful. See also *In re Schepps Food Stores, Inc.*, 148 B.R. 27, 30-31 (S.D. Tex. 1992) (refusing to appoint an examiner when the request seemed calculated to delay the already scheduled confirmation hearing and the party's concerns could be addressed as objections to the plan).

In the face of the increasing number of motions for the appointment of examiners, other courts have recently begun to question the mandatory reading of the statute. This has occurred several times recently in the United States Bankruptcy Court for the District of Delaware.

In *In re Spansion, Inc.*, 2010 WL 1292837, *8 (Bankr. D. Del, April 1, 2010), Chief Judge Carey denied a motion to appoint an examiner under Section 1104(c)(2), which was filed on behalf of an ad hoc committee of junior noteholders on the eve of the hearing on confirmation of the Debtor's plan. After reviewing the case law, legislative history of Section 1104(c)(2) and guidance on the subject offered by *Colliers*, Chief Judge Carey concluded that there was no investigation that would be appropriate:

> The record before me does not provide sufficient evidence of conduct that would make an investigation of the Debtors "appropriate," but rather reveals deep and heated differences of opinion about the value of the Debtor companies. Moreover, the allegations of bad faith against the Debtors' management for rejecting the Convert Committee's Alternative Rights Offering provides a classic confirmation dispute, rather than grounds for an investigation by an examiner. Throughout this case, the Creditors' Committee and various ad hoc committees have vigorously represented the interests of unsecured creditors. All of the parties have had ample opportunity to conduct – and have conducted – extensive discovery, and to investigate the Debtors. Appointment of an examiner at this time, based on this record, is neither warranted nor appropriate, and would cause undue cost to the estate, which would be harmful to the Debtors and would delay the administration of this chapter 11 case. The request for appointment of an examiner pursuant to §1104(c)(2) will be denied.

Id. This approach has been employed by other judges in the court recently. In rapid succession, Judge Walrath recently found in three cases that no investigation was necessary and therefore declined to appoint an examiner. *See In re Magna Entm't Corp.*, Case No. 09-10720 (MFW) (Bankr. D. Del. April 20, 2010) (Walrath, J.); *In re HSH Delaware GP LLC*, Case No. 10-10187 (MFW) (Bankr. D. Del. April 23, 2010) (Walrath, J.); *In re Washington Mut., Inc.*, Case No. 08-12229 (MFW) (Bankr. D. Del. May 5, 2010) (Walrath, J.).

In the *Washington Mutual* case, the Official Committee of Equity Securityholders filed a motion for the appointment of an examiner. The committee was not appointed until 15 months into the case, and the motion was filed several months later, after the Debtors had filed a plan and a motion seeking the approval of a

settlement agreement with the principal constituents in the case. The court began its analysis by noting that Section 1104(c)(2) gives the court discretion in deciding whether or not to appoint an examiner. Judge Walrath identified four factors that the court will consider in determining if an investigation is appropriate under Section 1104(c)(2): (i) whether another party has already conducted the investigation, (ii) whether the appointment of an examiner will result in increased costs and delays with no corresponding benefit, (iii) the timing of the motion, and (iv) whether the motion is a litigation tactic. Transcript of Hearing at 97:5-24. The court denied the motion, finding that the Debtors had been "investigated to death" and that the committee could conduct the investigation for which it sought an examiner. Transcript of Hearing at 98:12 – 101:12.

Several other Delaware bankruptcy court judges have adopted the position that the Section 1104(c)(2) standard leaves some discretion with the court. *See, e.g. In re Idle Air Tech. Corp.*, Case No. 08-10960 (KG) (Bankr. D. Del. June 13, 2008) (Gross, J.) (refusing to appoint an examiner in the fast-moving case based on the "as appropriate" clause, where the committee had been actively involved in the case); *In re Am. Home Mortgage Holdings, Inc.*, (Sontchi, J.) (court overruled motion for appointment of an examiner where committee was conducting investigation and governmental entities were already examining the same issues); *SATelecomms., Inc.*, Case Nos. 97-2395 – 97-2401 (PJW) (Bankr. D. Del. March 26, 1998) (Walsh, J.) (the court has discretion in deciding whether or not to appoint an examiner under Section 1104(c)(2).

The Delaware court has also used the "as appropriate" language to place restraints on what an examiner does. There are numerous examples of orders directing an examiner to provide the court with a work plan and budget. It is common – in fact, it is the rule – for the court to set limits on the examiner's investigation, to direct that the examiner's report be filed by a date certain and to approve a budget for the examiner and her professionals.

While the number of cases in which parties move for the appointment of an examiner may be increasing, the Delaware bankruptcy court has continued to move toward a position that permits them to control whether or not an examiner is appointed and, if so, what investigation the examiner conducts. Through these rulings, the court has asserted control over the cases in which an examiner gets appointed, what they do and the fees they incur.

The Deal and Pepper Hamilton's Legal Roadmap to Success - PE Investments in Finance

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Bradley W. Voss Joins Pepper Hamilton's Commercial Litigation Practice

Bradley W. Voss has joined the firm as a partner in the Commercial Litigation Practice Group, resident in the Wilmington office.

Mr. Voss has represented parties in courts in Delaware and other jurisdictions, with much of his practice focused on matters pending before the Delaware Court of Chancery, which is often described as the nation's premier business court. His practice emphasizes commercial business disputes, corporate governance and fiduciary duty disputes, including class actions and derivative lawsuits, actions arising out of mergers and acquisitions, requests for preliminary injunctions and other equitable relief in the corporate context, statutory proceedings under the Delaware General Corporation Law, including appraisal actions, and matters relating to Delaware alternative entities.

Mr. Voss earned his J.D., with honors, from The University of Chicago Law School in 1998 and his A.B., with honors, from Harvard University in 1995. He served as judicial clerk to the Honorable Steven M. Colloton of the U.S. Court of Appeals for the Eighth Circuit.

Mr. Voss is a member of the Delaware, District of Columbia, and California (inactive) bars.

Recent Events

WEBINAR:
Critical Considerations in Distressed M&A Transactions - Exploring Risks and Opportunities

In this webinar recording, Pepper partners Leon R. Barson and David M. Fournier address issues of interest to life sciences companies and their investors, whether the company is looking to grow through acquisition or is struggling and looking to preserve value. The webinar provides an overview of the process, opportunities and pitfalls associated with the acquisition or sale of enterprises through bankruptcy, with a particular focus on considerations applicable to companies in the life sciences industry. For those companies that are struggling, Mr. Barson and Mr. Fournier address the duties of officers and directors as they evaluate restructuring options, including the use of bankruptcy to effect a sale or other restructuring transaction.

The recording and slides are available on Pepper Hamilton's website at http://www.pepperlaw.com/webinars_update.aspx?ArticleKey=1732.

Peppercast: Indenture Mandates that Any Credit Bid Come from Trustee

In this podcast, Pepper attorney Henry Jaffe, a partner in Pepper's Philadelphia and Wilmington offices and a member of the firm's Corporate Restructuring and Bankruptcy Practice Group, discusses a recent court ruling that dealt with a creditor's right to "credit bid" on an asset for sale in a bankruptcy case.

In the Chapter 11 bankruptcy case of *Electroglas Incorporated*, the court decided, the creditor's right was compromised because the creditor is a bondholder or noteholder whose rights are subject to a trust indenture agreement. Specifically, the court ruling stated that credit bids come from the trustee, not the noteholder.

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