

ROUNDTABLE

BANKRUPTCY LITIGATION



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Bankruptcy litigation cases are on the rise. In such situations, legal expertise and efficiency is paramount to resolve disputes between creditors, bondholders, investors and other stakeholders. But in cross-border cases, issues tend to be more complex and the potential pitfalls even greater. ▶▶

THE MODERATOR



James H.M. Sprayregen
Partner, Kirkland & Ellis LLP
T: +1 (312) 862 2481
E: james.sprayregen@kirkland.com
www.kirkland.com

James H.M. Sprayregen is recognised as one of the country's outstanding restructuring lawyers, and has led some of the most complex Chapter 11 filings in recent history. He has extensive experience representing major US and international companies in and out of court as well as buyers and sellers of assets in distressed situations. He has experience advising boards of directors, and generally representing domestic and international debtors and creditors in workout, insolvency, restructuring, and bankruptcy matters.

THE PANELLISTS



James M. Lawniczak
Partner, Calfee, Halter & Griswold LLP
T: +1 (216) 622 8364
E: jlawniczak@calfee.com
www.calfee.com

James M. Lawniczak has more than 30 years experience representing clients in complex corporate reorganisations and bankruptcy and creditors' rights issues, as well as commercial business and finance matters. He is a contributing author to the 16th and 15th edition revised of 'Collier on Bankruptcy' – the leading national treatise on bankruptcy law.



Ian Ratner
Principle, GlassRatner Advisory & Capital Group LLC
T: +1 (678) 904 1990
E: iratner@glassratner.com
www.glassratner.com

For the past 20 years, Ian Ratner, one of the founders of GlassRatner, has worked almost exclusively in the area of bankruptcy consulting, bankruptcy litigation and forensic accounting. Mr Ratner is active in all facets of the Bankruptcy & Restructuring profession from advising creditors and debtors in formal bankruptcies to working on pre-filing work-outs and restructuring to advising the FDIC on structured loan sales. He is an active expert witness in bankruptcy disputes.



John K. Sherwood
Member, Lowenstein Sandler PC
T: +1 (973) 597 2538
E: jsherwood@lowenstein.com
www.lowenstein.com

John K. (Jack) Sherwood has more than 20 years of experience in bankruptcy and debtor-creditor matters including related litigation. Mr Sherwood represents debtors, creditor committees, secured creditors, landlords, stockholders, trustees, directors, officers, employees and other parties in bankruptcy cases and non-bankruptcy business reorganisations, and represents parties in debtor-creditor litigation matters such as fraudulent conveyances, preferences, director and officer liability and contract disputes. He also counsels corporate management in insolvency situations.



Van Durrer
Partner, Skadden, Arps, Slate, Meagher & Flom LLP & Affiliates
T: +1 (213) 687 5200
E: van.durrer@skadden.com
www.skadden.com

Van Durrer leads Skadden's corporate restructuring practice in the western United States and the Pacific Rim. He represents public and private companies, major secured creditors, official and unofficial committees of unsecured creditors, investors and asset-purchasers in troubled company M&A, financing and restructuring transactions, including out-of-court workouts and formal insolvency proceedings.



David E. Lemke
Partner, Waller Lansden Dortch & Davis, LLP
T: +1 (615) 850 8655
E: david.lemke@wallerlaw.com
www.wallerlaw.com

David Lemke is a partner at Waller Lansden and serves on the firm's board of directors. His practice focuses on bankruptcy and corporate restructuring. Mr Lemke has extensive experience in the areas of bond defaults and corporate trust administration, bankruptcy, corporate restructuring, workouts, creditor's rights, general commercial litigation, foreclosures and receiverships.



Adam Stochak
Partner, Weil, Gotshal & Manges LLP
T: +1 (202) 682 7001
E: adam.stochak@weil.com
www.weil.com

Adam Stochak is a partner in the Business Finance and Restructuring Department a Weil, Gotshal & Manges LLP. He represents debtors and creditors in bankruptcy cases in a wide variety of industries, including real estate, telecommunications, manufacturing, retail, financial services, and others. He currently represents General Growth Properties, Inc., Lexington Precision Corporation, and Washington Mutual, Inc. in their Chapter 11 cases.

Sprayregen: What have been the biggest differences in litigation trends this year compared to last year? Are you seeing disputes arise in any areas of the market where previously litigation was rare?

Strochak: The rapid recovery in some segments of the capital markets has made the bankruptcy courts the focus of distressed M&A activity and takeover litigation. We have seen an increasing trend of litigation relating to corporate governance, including derivative claims and challenges to the decision-making of boards of directors in connection with distressed M&A transactions and other Chapter 11 transactions. Purchasers and potential purchasers are playing a greater role in the Chapter 11 process and there has been an increase in litigation by disgruntled bidders challenging transactions. Another development in this cycle is the involvement of the federal government in so many cases, particularly in the automobile and banking industries. State and local taxing authorities are also vigorously litigating to protect their treasuries.

Lawniczak: In my view, both long-term trends and a short-term trend in bankruptcy litigation have continued into this year. The first long-term trend relates to continued increased litigation as to officer and director liability, for both pre and post-petition actions. The second long-term trend is a continuation of increasing litigation of constructive fraudulent transfers. Every pre-petition sale of business assets is closely scrutinised and many more cases are now being brought challenging such sales as constructively fraudulent because of a too-favourable purchase price for the buyer. This is leading many buyers who are considering acquiring assets from financially challenged companies to insist on section 363 sales, which completely obviates the fraudulent transfer risk. The short-term trend that began last year and is continuing into this year is that economic analyses of the potential net recovery in litigation is looked at with much greater intensity. In these more challenging economic times, both parties and attorneys are very conscious of the need to be sure that value is being added.

Durrer: We are seeing two major and growing trends in bankruptcy litigation. First, there has been an increase in avoidance actions, particularly targeting lenders and creditor groups. Second, we have noted a marked increase in valuation controversies.

Lemke: The most significant increase we have seen is fraud litigation. Of course, there are the famous or infamous cases, such as Madoff and WexTrust. But there has been a dramatic increase in what might be called ‘plain vanilla bank fraud’ – where the borrower simply lied to the bank about revenues, assets, liabilities, collateral, or a combination of these. The increase in fraud claims appears to be the result of three primary factors. First, there are a lot of dishonest people out there who are very good at being cheats. Second, the competitive lending environment of previous years opened the doors wide for these folks to ply their trade. And third, as Warren Buffett said, ‘only when the tide goes out do you discover who’s been swimming naked’. Mr Buffett may not have been referring only to bank frauds, but it is because the credit tide went out that many of these frauds were exposed. There simply were no more patsies available to provide more money to cover up

the prior acts. The increase in fraud claims has also resulted in an increase in civil conspiracy claims and avoidance actions related to the fraudulent schemes. Not only are the perpetrators being pursued directly for the fraudulent conduct, but so are those who may have benefited from it, whether knowingly or even unwittingly in some instances.

Sherwood: With the increase of balance sheet restructurings over the last 18 months, the litigated issues have adapted to this trend. These cases are driven in large part by the senior lenders, so the conduct of the senior lenders will be subject to a very high level of scrutiny. The Touse case out of Florida should be a warning to pre-petition lender groups that transactions on the eve of insolvency will be closely examined by the unsecured creditors. The common theme in many of the balance sheet restructurings is that the creditor groups below the senior debt are out of the money so valuation is being litigated more now than in the past. It is hard to believe that a company that at one time, for example, supported \$750m of senior and subordinated debt, is now worth \$100m or thereabouts. The junior creditor classes are keenly focused on valuation in these circumstances.

Ratner: Depending on who you speak to, the current bankruptcy cycle started as far back as 2007. Whether that is the exact case or not, certainly by mid to late 2008 most professionals would agree we were officially in a bankruptcy cycle. The deeper into the cycle we go, the more bankruptcy litigation is evident. Litigation is often held out to be dealt with at a later point in the case. In fact, certain types of litigation claims, such as preference claims and other types of claims, are often dealt with as part of a plan confirmation process. For example, certain litigation is held for the plan administrator or liquidating trustee to deal with. So based on this common practice, by definition, increases in litigation occur as we work through the cycle.

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

Sherwood: The economy being what it is, creditors seem more willing to accept that the cause of business failure is something other than gross mismanagement by directors and officers. This is especially true in the retail and manufacturing sectors where everyone is aware of the market conditions. Thus, we have not seen an increase in litigation involving directors and officers based on neglect of their responsibilities leading to insolvency. This may also be due to the fact that directors and officers of troubled companies are seeking and getting better advice when things go bad. The exceptions are in the financial sector where directors and officers are paid to evaluate market risk and have failed to do so, and in circumstances involving the restatement of a company’s financials. There, claims based on breach of the duty of care are being widely investigated.

Lawniczak: There has been an increase in both the review of pre and post-petition officer and director actions that is now undertaken and the amount of litigation actually brought challenging such actions. This trend is continuing to accelerate despite favourable court rulings that essentially have ended the ►►

idea of liability for deepening insolvency and the concept of duty to creditors when in the zone of insolvency. It has gotten to the point where officer and director actions are closely examined in essentially every case I know of. Insurance issues, especially the availability of insurance on directors and officers cases, have become more important than ever. I have seen an ERISA case brought by a Chapter 7 trustee, even though the Chapter 7 estate would not be benefited by any recovery.

Ratner: During this go around it is almost becoming standard practice to file some type of litigation against officers and directors associated with losses during the period leading up to the bankruptcy. These cases can get complex as damages experts try to determine losses resulting from ‘continuing to operate beyond the point that the company was solvent’ or ‘taking on additional debt when the company should have been liquidated’. These cases are complex for a myriad of reasons, not the least of which is the appropriate method to calculate damages and how to express the losses.

Strochak: The action – and inaction – of boards is coming under closer scrutiny, particularly during the Chapter 11 process. There are more challenges to settlements and board decisions to pursue litigation aggressively or settle are being contested in connection with approval of Chapter 11 plans that incorporate settlements. One development is derivative actions and shareholder lawsuits attacking the decision-making of directors in Chapter 11, raising complex questions at the intersection of the automatic stay and corporate governance. In General Growth, for example, a shareholder filed a post-petition lawsuit seeking to require the board to sell the company; the bankruptcy court concluded this action was subject to the automatic stay. In Washington Mutual, shareholders dissatisfied with the proposed plan of reorganisation filed suit to compel a shareholders’ meeting and an election to try and replace the board; the court there found the stay inapplicable.

Lemke: At least in situations where the company is a Delaware corporation, the trend towards litigation against directors and officers, and their responsibilities related to insolvency,

appears to be on the down swing. It has eroded steadily over the last couple of years, and with some of the recent decisions that have come out of Delaware, including the Delaware Bankruptcy Courts, the concept of suing a director or officer for deepening insolvency is basically dead. Deepening insolvency is not recognised as a separate cause of action or independent basis for establishing a breach of fiduciary duty. It can, however, still be considered as part of a damages calculation, but that only becomes relevant if there has been an independent breach of the duty of care or loyalty. In addition, the case law appears to have evolved that a director or officer owes no different duties if the company is insolvent or in the ‘zone of insolvency’; their duties are still the duty of due care and loyalty. And they are still entitled to the benefit of the business judgment rule. The difference – once a company becomes insolvent – is that creditors, as well as shareholders, may have standing to bring derivative actions against an officer and director for breach of fiduciary duty.

Sprayregen: What trends have you seen in litigation disputes arising from actual or suspected fraud at investment funds? What are the key issues in these cases?

Ratner: Litigation in Ponzi and investment fraud cases is always interesting. As we saw in the Madoff case, the public has a hard time understanding how victims of fraud can be sued after the fact as part of the wind down process. The difficulty in these cases is often finding sources of recovery since many of the victims just don’t have any money left, even if they got out earlier. We have seen an increase in litigation against auditors, law firms, administrators, banks, business valuation firms – who performed annual NAV valuations for hedge funds – and other professional service providers associated with these investment funds. Almost any professional who was perceived to have a duty of care associated with the investment fund can find itself as a defendant.

Sherwood: The principals at the investment funds have argued that losses have been incurred due to unforeseeable but legitimate economic forces. The reality is that, in many cases, these funds had the wherewithal to identify problems with investment strategies earlier in the process and failed to do so for reasons that may not have been legitimate. It is essential in these matters for the creditors to conduct a full forensic investigation that is adequately funded. A recent trend has been the appointment of an examiner to investigate pre-petition conduct such as in Lehman. It makes sense in some of the more complex fund restructurings to allow an examiner to take the lead on the fraud investigation and then let the financial parties-in-interest base their litigation strategy on the examiner’s findings.

Strochak: There are two distinct sides of the litigation story in Ponzi scheme cases: clawback claims against the ‘haves’ who took money out of phony investment funds and reimbursement claims against the defunct funds and intermediaries by the ‘have nots’ who invested far more than they ever took out. One challenge of the clawback litigation is the international nature of the problem. The ease of moving capital around the globe means many of these defendants are not based in the US and this presents jurisdictional obstacles to suing them in US courts and practical problems in enforcing judgments. Reim ►►

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ADAM STROCHAK

bursment claims asserted by investors in the Madoff funds have resulted in wide-ranging litigation. One key issue is how to calculate investors' losses for purposes of determining their pro rata distributions from the assets recovered by the trustee. The bankruptcy court recently concluded in the Madoff case the net asset value of investor accounts should be determined based on the actual amounts invested, less money withdrawn. The court rejected an alternative method that would have valued the account based on the last account statement, recognizing that the information reported in these statements was fictitious. The decision is on appeal.

Sprayregen: Have complex financing packages and capital structures led to more intercreditor disputes in the bankruptcy process? Are these issues difficult to resolve?

Lawniczak: Many years ago, participants in intercreditor agreements were either banks or insurance companies that had originally signed up for the loans. In almost every case, in my experience, any disputes among them were resolved without public disagreement and certainly without litigation. This started to change in the 1980s, and that change has accelerated noticeably. A prime example of a group that could not agree on what to do was the Chrysler secured bank debt group. I think the fact that there is more variety in the participants in such agreements and the fact that many of the participants have bought in after the original loan is a greater factor in the fact that there are more public disagreements than the fact that financings are more complex.

Durrer: Market pressures, combined with more complex capital structures, have definitely led to more litigation, particularly involving intercreditor disputes. More specifically, the volatile market, absence of rescue financing and the absence of market transactions, which experts would typically look to in the valuation of distressed companies, have created uncertainty in the anticipated distribution of value among constituencies of a troubled enterprise. In addition, many enterprises now may have several layers of secured debt, plus mezzanine financing, not to mention layers of high yield debt, all leading to a cast of players in a downgraded credit with different interests and goals. These two factors combined have led to increased sparring over valuation as well as how a company should be restructured.

Lemke: The availability of easier funding in the years leading up to the current credit crisis resulted in loans being made without the usual covenants, sometimes referred to as 'covenant light' terms. In addition, there was a significant increase in second lien lending with intercreditor agreements becoming commonplace. Many of the intercreditor agreements contain provisions whereby the second lien holder purportedly waives a number of its rights, including some basic rights in the bankruptcy process. For example, a typical intercreditor agreement might call for the junior lien holder to waive its right to seek adequate protection, object to the use of cash collateral, or object to DIP financing. All of these waivers seemed like good ideas at the time when everyone believed there would never be a day of reckoning. Unfortunately, that day has arrived and now the second lien creditors do not want to go quietly into the night. As a result, they are looking for ways to challenge the enforceability of the waiver. Without a lot of case law to

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VAN DURRER

guide the parties or the courts, all of these factors have led to more intercreditor disputes in the bankruptcy process. Over the past couple of years, many non-traditional lenders have entered the market. These lenders, such as hedge funds, have different investment strategies than traditional bank lenders. So where there are traditional and non-traditional lenders in the same case – or even the same credit – a fair amount of jockeying can occur. The relative ease by which positions in a particular credit can be traded is also fertile ground for disputes. Creditors can and often do trade in and out of positions in a credit throughout a default. Because of the active trading, this means not all of the creditors at any one time will have the same amount of investment in the game; this can result in serious disputes among and between creditors when a restructure that sounds good to one group does not meet another group's investment objective. This also results in high frustration for the debtor due to its inability to achieve consensus.

Ratner: The complexity in the capital structure has certainly led to complex, after-the-fact disputes between different creditor groups. Some of the agreements are so complex, and the drafters are not at the table today, that litigators and bankruptcy attorneys are left interpreting agreements that may not have ever been tested by a fall out. So many real estate loans made during the boom were multi-bank participation agreements. During a workout it is not unusual these days for one of the creditor participants in a loan to be going through their own work out. We have seen this situation in a number of large credits.

Strochak: Although few have worked their way into court, there are intercreditor disputes lurking in commercial mortgage-backed securities. Typical CMBS structures have multiple layers of holders and when asset values decline, the interests of the so-called B-note holders may not align with others. The servicers of CMBS loans will have to balance these competing interests and we are likely to see disputes as commercial real estate restructurings work their way through the courts. To date, many of these disputes have been averted as the most common restructuring of these obligations has been to amend and extend the existing loans. ►

Sherwood: One question is whether a subordinated creditor group can participate on a creditors' committee that takes action that is arguably prohibited by a subordination agreement. In one case last year, the senior lender group threatened litigation against the junior creditors because they served on a creditors' committee, which objected to the DIP financing proposal and a pre-negotiated Chapter 11 plan. The senior creditors had a very low opinion of the value of the business and proposed a deal where they would get paid approximately 80 cents on the dollar and subordinated creditors would get nothing. The subordinated creditors took the risk of being accused of breaching their duties and responsibilities under the intercreditor agreement by challenging the plan. Ultimately, in an alternative transaction, the senior secured debt came out at par and there was substantial value left on the table for the junior note holders and the other unsecured creditors.

Sprayregen: Has volatility in the markets led to an increase in valuation litigation? If so, what constituencies are driving this trend?

Lemke: Volatility in the market should lead to more valuation disputes. In many instances there are no longer reliable comparables to even help determine market value, or the market for a particular piece of collateral, such as intellectual property, may be non-existent. This uncertainty provides an ability for under-secured creditors, unsecured creditors, and equity holders to challenge any restructuring that may put them out of the money.

Lawniczak: Valuation litigation is risky due to the subjective nature of the topic. In section 363 and other sales, although valuation could be a major issue, it is almost always taken off the table by use of public sales and putting the question to any objector to a sale on value, whether they would be willing to actually pay more, with real money. In my experience, other valuation issues have generally been resolved, and I have not seen any difference approach in recent times. Valuation issues are critical to section 548 and state law fraudulent transfer cases, but they have always been critical and have to be ad-

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IAN RATNER

dressed in each such case.

Strochak: Valuation is a cornerstone issue in many bankruptcies, but we have not observed any increase in the frequency of valuation disputes that end up getting litigated. What the volatility has caused, however, is much debate about the proper valuation methodologies in circumstances where there are no trades in the marketplace. This has been a particular issue in commercial real estate restructurings. We went from a period of very robust activity and frothy valuations in 2005-2007 to a full stop in the fall of 2008, and even now there are only limited transactions, so valuation work has relied more heavily on discounted cash flow analysis than on comparable transactions.

Durrer: Subordinate holders, often entering a troubled credit through the secondary market, have been more aggressive in pursuing the appointment of multiples creditor committees and even equity committees, to prosecute valuation fights with the company's own resources. Some groups have even funded these valuation litigations with their own money.

Ratner: The volatility in the market has added some interesting wrinkles to the process for business valuation experts. When forming a valuation opinion, the appraiser now has to consider how the volatility in the market might have affected his sample of transactions or the results from his comparable companies. For example, if the valuation date of the project just happens to be at a date when stock prices were temporarily down 10 percent or 15 percent but recovered a mere 30 days after the valuation date and the appraiser does not consider the stock price volatility, it is possible that he allowed sudden stock price changes to overly affect his opinion.

Sherwood: We have seen a sharp increase in valuation litigation, particularly where there are assets that are unencumbered by the senior lenders' liens or where there may be value over and above the claims of the secured classes. The volatility in the markets has certainly contributed to these disputes especially in industries where there are reasonable grounds for disagreement as to where the market is headed. This trend is driven at the outset by the debtor's management who, after extensive efforts to refinance and restructure have failed, reach the conclusion that the value of the business does not support the debt structure. At that point, they often decide on a course of action that is not popular with the subordinated notes and unsecured creditors and the valuation litigation follows.

Sprayregen: Many examiners have been appointed in recent US bankruptcy cases. What impact has this had on litigation issues?

Durrer: Our sense is that the growing number of examiner appointments is more of an effect of the increase in litigation in bankruptcy cases and less of a cause. The root causes remain the volatility of markets, the corresponding difficulty in ascertaining value and the various levels of constituencies in a company's capital structure.

Lemke: In many instances, the examiners and their findings have been effective road maps to allow the trustee or committee to pursue litigation against the parties who were the fo ▶▶

cus of the examiner's investigation. Similarly, an examiner's report can be the basis for the appointment of a Chapter 11 trustee.

Ratner: The use of examiners seems to increase the volume of litigation as their work often is used in litigation by others. In some cases, this reduces the cost of future litigation but in other cases it makes it easier for various parties to pursue litigation since they can make reasoned arguments and allegations based on the examiners' findings with no or little new work. In these cases, there is increased cost to the estate from defending claims, which ultimately might reduce recovery to certain parties but increase recoveries to plaintiffs. All in all, the use of examiners as fact finders does add to the transparency in the system.

Sherwood: We have seen requests for examiners by junior creditor groups where the senior lenders and debtors have concluded that there is little, if any, value in the claims at the subordinated debt levels. Where the junior creditors cannot assert their position effectively through the use of the creditors' committee, an examiner is a viable option for them. Examiners can also be charged with responsibility to investigate fraud or other prepetition misconduct that could give rise to causes of action. The standard for the appointment of an examiner in cases where unsecured funded debt exceeds \$5m is usually easy to meet, the notable exception being the recent decision of the bankruptcy court in the WaMu case, which denied the appointment of an examiner.

Strochak: There are two levels to this question: litigation over the appointment of an examiner and litigation that results from an examiner's investigation. On the first, the courts are taking a harder look at the statute and the trend appears to be an interpretation that gives bankruptcy judges discretion in denying appointment of an examiner, or limiting the scope of the examination, when appointment is sought by litigants for tactical purposes. This issue is now on appeal in the Washington Mutual case. Where examiners are appointed, the result is more frequent establishment of litigation trusts to pursue claims for the benefit of creditors.

Sprayregen: Can you describe how the cross-border nature of many large bankruptcy cases (such as Lehman, Readers Digest, Nortel and Japan Airlines) affects the litigation process?

Ratner: Cost, cost, cost, and more cost. These cases can be fascinating but they are expensive. In some instances just determining what court to pursue a matter in can take on a life of its own. As a fiduciary, there is the added challenge that your powers will not be 'recognised' equally in each jurisdiction, which can cause some interesting challenges. Ultimately, when there is enough money at stake, these situations can be very interesting.

Strochak: Cross-border cases require enormous coordination and planning and you have to build in extra time for this. In the US courts, a litigant can file a motion and in many cases get a hearing and a decision within a month. In cross-border cases, coordination with foreign administrators, liquidators and trustees takes much longer. In some proceedings, deci-

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JOHN K. SHERWOOD

sions of foreign tribunals are gating issues for the resolution of disputes in the US, or vice versa. For example, in the Lehman Brothers case the US debtor is a guarantor on debts of subsidiaries in foreign proceedings. Because liability on the primary obligation will be determined in the foreign proceeding, the US debtor has an interest in participating in the foreign case and resolution of the guarantee claim must await the conclusion of proceedings on the primary claim.

Durrer: A cross-border scenario further complicates what is already complex litigation, often in ways that are difficult to predict. For example, one needs to contend with the different substantive restructuring rules and protocols of foreign insolvency regimes, the different players – including offshore trustees and creditors – and different timetables.

Sherwood: There is no question that parties are trying to use cross-border cases to impact the litigation process to their benefit. We have seen efforts by insolvent companies to shut down claims against directors and officers in Chapter 15 cases where the laws outside of the US – such as Canadian law – may be more favourable to that type of relief. This leads to litigation at the recognition stage over whether the claims against the directors and officers in the US should be enjoined. In this litigation, the proponent of the relief seeks to impose the law of the foreign jurisdiction on US creditors through the bankruptcy court. Then there are situations where the US-based debtor tries to impact litigation abroad by extending the reach of American bankruptcy law, the automatic stay, to creditors seeking relief against non-debtor foreign subsidiaries.

Sprayregen: Have you seen judges in multiple jurisdictions in cross-border cases working more or less closely together this year?

Sherwood: Quebecor and Nortel are examples of cases where the judges worked very well together, managing both the restructuring and related litigation issues. In those cases and most others, the courts are generally moving towards the same objective and the disputes that arise are resolved with deference and rationality. In the Lehman case, however, we have seen some problems with the establishment of the cross-border

der protocol but this seems to be due to the size and complexity of that case as opposed to anything else.

Lawniczak: My prior experience was that the judges have in the past worked closely and well together, at least as to jurisdictions that are commonly involved together – for example, Canada, the UK and the US.

Strochak: Cross-border insolvency procedures are working effectively. Courts and counsel have become more accustomed to the procedures of Chapter 15 of the Code. It has become increasingly common for judges in cross-border cases to hold joint hearings. This occurred in the SemGroup case and the procedure worked smoothly, with judges in both the US and Canadian proceedings holding a joint hearing at confirmation.

Ratner: Coordination of courts and lawyers in the same country can be difficult enough. When taking it to the next level, for instance multi-jurisdictional level, it gets tough to predict.

Durrer: One cannot rely on the potential for cooperation among judges in different cross-border insolvencies. For example, there is little cooperation, if any, between Chapter 11 cases in the US and an insolvency in Japan.

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?

Lemke: Litigation in general has become much more expensive and, in many situations, the stakes are much higher, as there is a great deal more money involved. The same holds true in bankruptcy litigation. Therefore, it should be used as a last resort in most instances, though it can certainly be used as a tool to work towards a consensual resolution. Regardless of why it is used, the parties should be aware of the fact that litigation is expensive, time consuming, and very disruptive to the businesses involved. Moreover, at least in bankruptcy cases, the litigation is likely to move fast. This means you

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DAVID E. LEMKE

need your case fairly well developed before you even start the litigation because you will not have much time to conduct discovery once the litigation is commenced. And any discovery that is conducted must be very focused – there is no time to cast broad nets and hope to develop your case over months or years of litigation. Moreover, you need to have a very good idea of what you really want to accomplish when you initiate the litigation, and what concessions you might make and will need the other side to make in order to resolve the dispute. Finally, and maybe most importantly, the parties need experienced lawyers, as well as financial advisers and other anticipated expert witnesses on board before litigation is commenced.

Strochak: Parties need to move quickly, so mapping out the litigation strategy, retaining experts, and doing the leg work in advance is critical. Volatility in the markets, along with the 2005 amendments to the Code limiting the exclusive period for filing a plan of reorganisation to 18 months, is speeding up Chapter 11 cases and no one – judges included – wants to miss the market while the parties spend months or years litigating. The trend toward the use of section 363 sales to effectuate the sale of a deeply troubled business (Chrysler and General Motors are examples) means that litigants must be prepared at the very beginning of a Chapter 11 case to litigate aggressively and, if they lose, to seek a stay pending appeal in order to preserve appellate remedies.

Ratner: Bankruptcy litigation can be time consuming, expensive and uncertain. The same advice that plaintiffs and defendants get when considering general litigation is appropriate here. Consider the probability of success. Consider the time and cost involved. Get references from other parties prior to selecting counsel. Try to settle the matter if you can. Consider the pros and cons of pursuing a matter. In some situations you may even need to ‘turn off’ prior litigation after determining that the cost benefit analysis done by a prior decision maker was outdated or relied on faulty assumptions.

Durrer: Before embarking on any significant litigation it is important to understand the time and company resources that the litigation will consume and what outcome the litigation may realistically bring. In other words, it is important to understand that the ultimate outcome of litigation may not match the preferred business outcome desired by the company. Negotiation is always the best method of resolving a dispute, and mediation may be a way to achieve that outcome.

Sherwood: Since valuation is an inexact science and it is more difficult now than ever to predict where the markets are going in the future, parties that rush to firm conclusions on valuation sooner than necessary are bound to end up in litigation. Where possible, valuation conclusions should be based on something more than an abbreviated sale process – expert reports, market studies and robust sale efforts form a good basis for valuation. To avoid litigation, it is worthwhile to consider offering the parties negatively impacted by the restructured balance sheet some participation in the ‘upside’ to the extent that the valuation proves to be too conservative.

Lawniczak: It is critical that suppliers ensure that they keep and have access to transaction histories, particularly so that ►►

they can defend preference cases. With many corporate mergers and restructurings going on, it is important that the parties to such restructurings ensure the continued ability to access prior records. In addition, often companies update their operating systems. When they do so, they need to be sure that they can still access prior records. Knowing as much as you can about your opponent is critical. Litigators should take the time to find out all they can about their opponent and what they are trying to accomplish. What is the financial status of the other side? What are their goals? Who are their constituencies? Almost all bankruptcy litigation is settled and this knowledge is critical to that process. Defendants should quickly explore the possibility of settlement. If that can be done fairly and quickly, the party will come out ahead. If it cannot be done quickly and there are multiple defendants involved in litigation with a liquidation trust or other trustee, then it might be best to try and have your case come up at the end of the process if possible.

Sprayregen: Do you see opportunities for efficiently resolving bankruptcy litigation through mediation, arbitration or other dispute resolution mechanisms in the current cycle?

Lawniczak: Yes, and the more complex and sophisticated the issues subject to the litigation are, the more likely mediation in particular is likely to be effective. We had a very complex, multi-party fraudulent transfer litigation, and mediation was probably the only way to reach global resolution of all the issues and all the cases. It does, of course, depend on the reputation and ability of the mediator. For the process to work, the mediator needs to have a top-notch reputation with all the parties and that reputation needs to be justified. There has recently been several separate instances where mediation has been ordered by the bankruptcy courts as to a series of mostly simple preference cases. My experience is that mediation in those instances is less helpful, although the cost of mediation often compels settlement prior to the scheduled mediation.

Sherwood: Mediation seems to be the most common ADR format in US bankruptcies and its use should continue. Most bankruptcy litigation involves significant risk and expense and since most cases ultimately settle, it is better to get into mediation sooner rather than later. A good mediator can help bring the parties' expectations to reasonable levels and ultimately get them to a settlement range that is workable.

Lemke: Alternative dispute resolution will be used more and more during the current cycle. First, most parties have been involved in one form or another of alternative dispute resolution so the concept is not new. In addition, there are a lot of factors that can come together in the bankruptcy context that make mediation attractive. The case law may not be well developed on the issue at hand. The stakes are high for both sides. Litigation is increasingly expensive and distracting to the businesses involved. The bankruptcy courts want the cases to move along so there is little time to engage in lengthy litigation. Finally, the issues are really business issues – without a lot of human emotion – being decided by experienced business people, lawyers, and financial advisers. These factors create a perfect storm for mediation to work.

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JAMES M. LAWNICZAK

Durrer: Mediation can be a very effective and efficient tool for resolving litigation from several perspectives. First, it is inexpensive. Second, it is less time consuming than litigation. Third, it involves a third party neutral who can help the parties focus on the key issues and risks. Lastly, and most important, it allows the parties to achieve a resolution of disputes that would often transcend the best outcome they might achieve following litigation, which is better for all parties, particularly in an insolvency situation.

Ratner: The use of mediation to resolve bankruptcy disputes appears to have become a common practice. It can be very efficient and is a great tool to get people back to the table, especially when lines of communication have become frozen. A good mediator can really focus parties on getting the dispute behind them and getting on with bigger issues. Mediation can be successful in the bankruptcy process – it could be that the whole bankruptcy process and bankruptcy claims process is more deal-oriented and for that reason it might be better suited for mediation than traditional litigation.

Strochak: Arbitration does not have much utility for disputes that relate to the core restructuring work in a Chapter 11 case – they move too slowly and don't provide opportunity for participation by the many constituencies that may have a stake in the dispute. Mediation can facilitate the resolution of disputes, but the results are very mixed and the key variable is the skill, tact and stature of the mediator. Mediation also works better in bilateral disputes than in multilateral ones. The current economic cycle doesn't seem to be changing the game for alternative dispute resolution. If anything, the addition of several bankruptcy judges in key jurisdictions such as New York and Delaware since the last economic downturn has relieved some of the pressure of very busy dockets. ■