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IN THIS ISSUE

SECOND AND SEVENTH CIRCUITS ISSUE DECISIONS ON THIRD-PARTY RELEASES

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For decades now, debtors in chapter 11 have proposed in their chapter 11 plans "third-party releases," whereby creditors are deemed to have released certain non-debtor parties (such as officers, directors, or affiliates of the debtor) upon the confirmation and effectiveness of the plan. For an equally long period, such third-party releases have engendered controversy in the courts and elsewhere as to when, if ever, such releases are appropriate. Over the years, the issue has been considered by several courts of appeals, with somewhat differing results. Until recently, the Second Circuit Court of Appeals (covering New York, Connecticut, and Vermont) was widely thought to be one of the most favorable jurisdictions to debtors on the issue of the propriety of third-party releases in a chapter 11 plan.

On February 15, 2008, however, the Second Circuit struck down a third-party release in the long-running Johns-Manville Corporation chapter 11 case, *In re Johns-Manville Corp.*, 517 F.3d 52 (2d Cir. 2008), and in so doing potentially signaled a shift in that Circuit's position on the issue. Not long after, on March 12, 2008, the Seventh Circuit Court of Appeals (covering Illinois, Wisconsin, and Indiana) issued its own opinion on third-party releases in the case of *In re Airadigm Communications, Inc.*, 2008 WL 649704 (7th Cir. Mar. 12, 2008). In approving the third-party release in that case, the Seventh Circuit now may be viewed as a relatively favorable jurisdiction for debtors on the issue. As such, the Circuit split on third-party releases continues.

THIRD-PARTY RELEASES UNDER A CHAPTER 11 PLAN

In general, a chapter 11 plan may contain two different types of releases—an estate release and a third-party release. An estate release is a release by the debtor of claims that the debtor itself possesses. By contrast, a third-party release prevents a nondebtor (especially creditors) from prosecuting claims against another nondebtor. There are two types of third-party releases—voluntary and involuntary. Voluntary third-party releases are those to which a creditor has consented, for instance by agreeing to the release on its plan ballot. Most courts do not find voluntary third-party releases controversial, since they essentially represent an agreement between the creditor and the released nondebtor party.

By contrast, involuntary third-party releases compel a creditor or nondebtor to release another nondebtor without consent. These releases always have been controversial. In fact, the Ninth and Tenth Circuits essentially have found such releases to be prohibited by the Bankruptcy Code. *See In re Lowenschuss*, 67 F.3d 1394 (9th Cir. 1995); *In re Western Real Estate Fund Inc.*, 922 F.2d 592, 600 (10th Cir. 1990). Similarly, the Fifth Circuit has held that a bankruptcy court lacks jurisdiction to grant an involuntary third-party release where the third-party claim is not sufficiently related to the bankruptcy. *See In re Zale Corp.*, 62 F.3d 746 (5th Cir. 1995). The Fourth and Sixth Circuits, by contrast, have permitted third-party releases in certain mass-tort cases, but only where the nondebtor that is released makes a substantial contribution to the plan. *See In re A.H. Robins*, 972 F.2d 77 (4th Cir. 1992); *In re Dow Corning Corp.*, 280 F.3d 648 (6th Cir. 2002). Previously, the Second Circuit also had permitted third-party releases (including in prior proceedings in the *Manville* case itself) where the court found that the release was important to the chapter 11 plan and where the parties covered by the release were necessary to the plan. *See In re Drexel Burnham Lambert Group, Inc.*, 960 F.2d 285 (2d Cir. 1992); *MacArthur Co. v. Johns-Manville Corp.*, 837 F.2d 89 (2d Cir. 1988). Prior to the *Airadigm* case, the Seventh Circuit had never ruled on the issue. Instead, it ruled in *In re Specialty Equipment Co.*, 3 F.3d 1043 (7th Cir. 1993), that consensual third-party releases were permissible, although the language of its opinion potentially suggested a negative view of involuntary third-party releases.

THE SECOND CIRCUIT'S OPINION IN *JOHNS-MANVILLE*

The recent Second Circuit *Manville* case arose out of an attempt by various of Manville's asbestos personal-injury claimants to bring conspiracy and breach-of-duty claims against Travelers Insurance Company. Travelers was Manville's primary insurer from 1947 to 1976 and became a focal point of

the *Manville* bankruptcy case once Manville filed for chapter 11 in 1982 as a result of spiraling asbestos personal-injury lawsuits against the company. A primary asset of the Manville bankruptcy available to pay asbestos creditors was the insurance coverage that Travelers had provided to Manville over the years. As is the case with insurers in essentially all asbestos-related bankruptcies, Travelers was unwilling to reach an agreement with Manville concerning the extent to which that insurance would be contributed to the bankruptcy estate without "global finality" with Manville and its asbestos creditors. Otherwise, Travelers might find itself contributing millions of dollars of insurance coverage to the Manville plan of reorganization, only to be later sued by Manville's asbestos creditors directly for millions more.

As such, the order confirming Manville's 1986 plan of reorganization, in exchange for Travelers' contribution of nearly $80 million to the trust being funded under the plan, contained an injunction (the "1986 Plan Injunction") that prohibited Manville's asbestos creditors from ever suing Travelers on account of claims that were "based upon, arose out of, or related to" Manville's insurance. Those claims instead were channeled to the asbestos trust created by the plan. The injunction was broadly worded in order to provide Travelers with the "global finality" it sought in connection with Manville.

Notwithstanding the 1986 Plan Injunction, various asbestos claimants later filed suit against Travelers in several states, alleging that Travelers was involved in a conspiracy with Manville in violation of state law to suppress the hazards of asbestos or that Travelers violated certain duties to disclose asbestos-related information it learned from Manville during its tenure as Manville's insurer (the "Misconduct Claims"). The plaintiffs in these cases asserted that their claims involved independent misconduct by Travelers not prohibited by the 1986 Plan Injunction. Originally, Travelers moved the New York bankruptcy court that had issued the 1986 Plan Injunction to enjoin the Misconduct Claims as a result of the injunction. Ultimately, however, Travelers determined to settle certain classes of the Misconduct Claims in the bankruptcy court for the payment of nearly $500 million, but only on the condition that the bankruptcy court issue a new order finding that the 1986 Plan Injunction always had barred the Misconduct Claims. The bankruptcy court approved the settlements and had little difficulty finding that the 1986 Plan Injunction was broad enough to cover the Misconduct Claims.

The plaintiffs appealed the bankruptcy court's decision. On appeal, the district court reached the same result and labeled the suits "creatively pleaded attempts to collect indirectly against the Manville insurance policies." Both courts relied, in part, on the Second Circuit's 1988 opinion in *MacArthur* upholding the validity of the 1986 Plan Injunction in connection with an attempt by a distributor of Manville (who had been sued for asbestos liability) to seek indemnity against Travelers under certain vendor endorsements in insurance policies that Travelers had issued to Manville.

Notwithstanding its prior decision in *MacArthur*, the Second Circuit reversed the lower courts and found that the bankruptcy court lacked jurisdiction to enjoin the Misconduct Claims. The court found that the Misconduct Claims differed significantly from the vendor endorsement claims in *MacArthur*. The court believed that the Misconduct Claims sought damages unrelated to the Travelers insurance and that these were based not on Manville's alleged misconduct, but on Travelers' own. Ultimately, the court held that "a bankruptcy court only has jurisdiction to enjoin third-party, nondebtor claims that directly affect the res of the bankruptcy estate" and that the Misconduct Claims did not directly affect the *res* at issue—*i.e.*, the insurance policies that Travelers had issued to Manville.

While the Second Circuit may not have believed that it was effectuating a material change or clarification in the law on involuntary third-party releases, the *Manville* opinion certainly could be interpreted as having done so. Prior to the *Manville* decision, the Second Circuit had not issued an opinion on involuntary third-party releases that focused on the jurisdictional issue that lay at the heart of the Second Circuit's ruling in *Manville*. In *Deutsche Bank AG, London Branch v. Metromedia Fiber Network, Inc.*, 416 F.3d 136 (2d Cir. 2005), the Second Circuit did express concerns about the third-party involuntary release under the plan in that case, which was given for the benefit of the debtor's insiders, and the court ultimately found only that the challenge to that release was equitably moot on appeal. Nonetheless, there is no discussion in *Metromedia* of possible jurisdictional limitations on the release based on an impact on estate property. Similarly, in *Drexel* the Second Circuit did not require any impact on estate property in order to issue the involuntary third-party releases for the benefit of the debtor's directors and officers in that bankruptcy case (although the ruling was in the context of approval of a plan-related mandatory, non-opt-out class action rather than the plan itself).

Given the new focus on jurisdiction in the *Manville* decision that does not appear in *Airadigm*, as well as the split in other Circuits on the issue of involuntary third-party releases, it is certainly possible that a *certiorari* petition to the U.S. Supreme Court could be filed in either case and that the Supreme Court might ultimately decide to address this important jurisdictional question in chapter 11 cases.

The *Manville* ruling may be difficult for courts to apply in connection with third-party releases that may be proposed under future chapter 11 plans in that Circuit. As an initial matter, the decision should not affect voluntary third-party releases, which have generally not been controversial and which were not involved in *Manville*. What constitutes a sufficient impact on "the res of the bankruptcy estate" necessary to confer bankruptcy-court jurisdiction to approve an involuntary third-party release, however, likely will engender much debate. For instance, chapter 11 plans sometimes propose a third-party release of a debtor's officers, directors, and affiliates by the debtor's creditors. Any creditor that affirmatively accepts, or does not object to, such a release likely will be bound, notwithstanding the *Manville* decision. But as to any creditor that does object to the third-party release, *Manville*, unless limited to its facts, potentially suggests that the debtor will need to establish some impact on the "res of the bankruptcy estate" that will form the jurisdictional basis for the proposed release. In many cases, the objecting creditor likely will assert that there is no such impact and that therefore the bankruptcy court lacks jurisdiction to approve the release.

To the extent that courts accept this position, the result will have clear implications for certain types of chapter 11 cases. For instance, bankrupt professional-service firm partnerships often have funded their chapter 11 plans with contributions from current and former partners, which (like Travelers in the *Manville* case) will make such contributions only if they receive a release in their favor that is binding on all of the partnership's creditors. If partnerships no longer can grant such third-party releases under their chapter 11 plans because no impact on the *res* of the debtor can be shown, then it may be difficult for such partnerships to marshal assets under their plans to repay creditors in a coordinated fashion. In addition, the *res*-based rule could cause difficulties for debtors wishing to release under a chapter 11 plan their officers and directors from actions that are in some sense "derivative" of the creditors' claims against the debtor itself but do not have a clear impact on the bankruptcy estate. The Second Circuit, as well as other Circuits, previously has found that a bankruptcy court does have jurisdiction to approve a plan of reorganization that causes the involuntary release of such derivative claims, especially where such releases are essential to confirmation of the plan.

THE SEVENTH CIRCUIT'S OPINION IN *AIRADIGM*

Airadigm involved an appeal of entry of a confirmation order in the second chapter 11 case of a cellular service provider that had bid for C-block licenses from the Federal Communications Commission ("FCC") in the mid-1990s. Like several other C-block licensees that had financed their purchases from the FCC with debt, Airadigm filed for chapter 11 in the late 1990s, when the value of those licenses had dropped precipitously. At that time, the FCC took the position that the licenses were forfeited as a result of Airadigm's failure to pay for the licenses in full, and Airadigm's first chapter 11 case proceeded as if the licenses were no longer an asset of the company. In 2003, however, the Supreme Court concluded in *NextWave Personal Communications, Inc. v. FCC*, 537 U.S. 293 (2003), that the FCC could not cancel a C-block license simply because the licensee had filed for bankruptcy prior to payment for the license.

Accordingly, Airadigm subsequently refiled for chapter 11 in 2006 to, among other things, account for the Supreme Court's decision. Airadigm's chapter 11 plan was dependent

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NEWSWORTHY

Corinne Ball (New York), ***Jeffrey B. Ellman (Atlanta)***, ***Gregory M. Gordon (Dallas)***, ***David G. Heiman (Cleveland)***, ***Tobias S. Keller (San Francisco)***, ***Paul D. Leake (New York)***, ***Heather Lennox (Cleveland)***, ***Charles M. Oellermann (Columbus)***, and ***Carl E. Black (Cleveland)*** have been recommended as "Leaders in their Field" in *Chambers USA* for 2008.

On April 10, ***Gregory M. Gordon (Dallas)*** sat on a panel discussing "The Evolving Role of Market Valuation: Vlasic, Iridium, and Delphi, and Their Impact Upon Market Makers and Hedge Funds" at the ABA Section of Business Law Spring Meeting in Dallas.

On May 12, ***Pedro A. Jimenez (New York)*** sat on a panel discussing recent trends in international restructurings at the American Bankruptcy Institute's 10th Annual New York City Bankruptcy Conference in New York.

On April 7, ***Robert W. Hamilton (Columbus)*** gave a presentation regarding "Appeals of Confirmation Orders and the Doctrine of Equitable Mootness" at the 30th Annual Current Developments in Bankruptcy & Reorganization seminar sponsored by the Practising Law Institute in New York.

An article written by ***Pedro A. Jimenez (New York)*** and ***Mark G. Douglas (New York)*** entitled "Two and One-Half Years and Counting: The Rapidly Maturing Jurisprudence of Chapter 15 of the Bankruptcy Code" appeared in the May 2008 edition of *Pratt's Journal of Bankruptcy Law*. Their article entitled "Chapter 15 of the Bankruptcy Code—Key Court Rulings" was published in the April 2008 edition of *Financier Worldwide.*

An article written by ***Craig F. Simon (Dallas)***,"The Attorney-Client Privilege Within Corporate Families: Learning from Teleglobe," was published in the March 2008 edition of the American Bankruptcy Institute's *Bankruptcy Litigation Committee* newsletter.

On May 5, the International Insolvency Institute awarded ***Andy Soh (New York)*** its 2008 international insolvency studies Gold Medal for his article appearing in the October 2007 edition of the *Norton Journal of Bankruptcy Law and Practice*, entitled "Chapter 15 of the U.S. Bankruptcy Code: An Invitation to Forum Shopping?"

An article written by ***Pedro A. Jimenez (New York)*** and ***Mark G. Douglas (New York)*** entitled "Recent Ruling Highlights Purpose Behind Ch. 15" appeared in the May 30, 2008, edition of *Bankruptcy Law360*.

An article written by ***Mark G. Douglas (New York)*** entitled "The Year in Bankruptcy: 2007" appeared in the April 2008 edition of *Pratt's Journal of Bankruptcy Law*. His article entitled "For Calpine Stakeholders, Plan Participation Was Key" was published as a guest column in the April 25, 2008, editions of *Bankruptcy Law360* and *Energy Law360*.

upon financing provided to Airadigm by Telephone and Data Systems ("TDS"). The plan, in consideration for the financing, provided TDS with a third-party release for post-petition actions related to the debtor's second bankruptcy filing. The plan stated:

> Except as expressly provided … [TDS shall not] have or incur any liability to … any holder of any Claim … for any act or omission arising out of or in connection with the Case, the confirmation of this Plan, the consummation of this Plan, or the administration of this Plan or property to be distributed under this Plan, except for willful misconduct.

The FCC argued that such an involuntary third-party release was not authorized by the Bankruptcy Code. The Seventh Circuit disagreed, holding that a bankruptcy court may grant an involuntary third-party release under appropriate circumstances.

The Seventh Circuit made no mention of the need for any *res* of the bankruptcy estate to be involved in order for a bankruptcy court to grant such a release. Instead, the Seventh Circuit found the power of a bankruptcy court to issue such a release to be inherent in its broad equity power, as well as authorized by sections 105(a) and 1123(b)(6) of the Bankruptcy Code. The former section authorizes a bankruptcy court to issue orders "necessary or appropriate" to carry out the Bankruptcy Code, and the latter section provides that a plan may include any provision "not inconsistent with" the Bankruptcy Code. Since TDS was providing significant financing to the plan, and since TDS's release was limited in several respects, the Seventh Circuit found that the release was appropriate. In so doing, the court appears to have given bankruptcy courts in the Seventh Circuit wide discretion to grant involuntary third-party releases where appropriate and without a *res*-based limitation, thereby potentially establishing that Circuit as a relatively favorable jurisdiction to debtors on the issue.

CONCLUSION

Travelers has sought reconsideration of *Manville* by the Second Circuit *en banc*, so there could be further developments in that case or modifications of the decision of the Second Circuit. Given the new focus on jurisdiction in the *Manville* decision that does not appear in *Airadigm*, as well as the split in other Circuits on the issue of involuntary third-party releases, it is certainly possible that a *certiorari* petition to the U.S. Supreme Court could be filed in either case and that the Supreme Court might ultimately decide to address this important jurisdictional question in chapter 11 cases. Only time will tell.

SUPREME COURT APPROVES CHANGES TO BANKRUPTCY RULES

On April 23, 2008, the U.S. Supreme Court approved and forwarded to Congress amendments to the Federal Rules of Bankruptcy Procedure. The amendments generally reflect interim rules already adopted to implement the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA"). The interim rules, which were adopted by nearly all bankruptcy courts in August 2005, are effective until permanent rules are put in place to implement each of BAPCPA's provisions. The amended rules take effect on December 1, 2008, unless Congress acts affirmatively before that time to reject, modify, or defer them.

Among the rule changes affecting large business-bankruptcy cases are the following:

Rule 1007 continues to require debtors to file a variety of lists, schedules, statements, and other documents. The amendments require any chapter 15 petition filed on behalf of a foreign debtor to be accompanied by a list of entities with which the debtor has been engaged in litigation in the U.S.

Amended Rule 1010 requires service of a summons and a chapter 15 petition (voluntary or involuntary) on any debtor with respect to which recognition of a foreign nonmain proceeding is sought, as well as any entity against which the foreign debtor's representative is seeking provisional or additional relief. The rule also requires each corporate petitioner in an involuntary chapter 15 case to file a corporate-ownership disclosure statement.

Rule 1011 as amended provides that the debtor named in an involuntary chapter 11 petition, or a party in interest to a petition for recognition of a foreign proceeding, may contest the petition. It further provides that, in the case of an involuntary chapter 15 petition against a partnership, a nonpetitioning general partner, or a person who is alleged to be a general partner but denies the allegation, may contest the petition. The rule also now includes a requirement that any corporation responding to an involuntary or voluntary chapter 11 petition must file a corporate-ownership disclosure statement.

New Rule 1021 establishes procedures for designating a debtor as a health-care business.

Amendments to Rule 2002 require the bankruptcy court to provide notice to a foreign debtor and to entities against which relief is sought of a hearing on a petition for recognition of a foreign proceeding under chapter 15.

New Rule 2007.2 requires a patient-care ombudsman to be appointed in the first 30 days of any health-care business-bankruptcy case unless the court finds it is not necessary for the protection of patients. The rule also establishes procedures for a party in interest to seek or object to the appointment of an ombudsman.

Amended Rule 2015 requires a foreign representative in a chapter 15 case to file notice of a change in status in the foreign proceeding or in the representative's appointment.

New Rule 2015.1 governs reports issued by a health-care ombudsman and the protection of patient privacy when the ombudsman requests access to patient records.

New Rule 2015.2 authorizes and prescribes procedures for the relocation of patients when a health-care debtor business is being closed.

New Rule 2015.3 requires a chapter 11 debtor-in-possession or trustee to file periodic reports of the value and profitability of any entity in which the debtor has a substantial or controlling interest.

Amended Rule 3003 provides that the bankruptcy court may extend the time for a creditor with a foreign address to file a proof of claim in a chapter 9 or chapter 11 case.

REDISCOVERING CHAPTER 9 AS FINANCIAL WOES OF MUNICIPALITIES ESCALATE

Erica M. Ryland and Mark G. Douglas

Even though chapter 9 of the Bankruptcy Code has been in effect for more than 30 years, fewer than 200 chapter 9 cases have been filed during that time. Municipal bankruptcy cases—or, more accurately, proceedings involving the adjustment of a municipality's debts—are a rarity, compared to reorganization cases under chapter 11. The infrequency of chapter 9 filings can be attributed to a number of factors, including the reluctance of municipalities to resort to bankruptcy protection due to its associated stigma and negative impact, perceived or otherwise, on a municipality's future ability to raise capital in the debt markets. Also, chapter 9's insolvency requirement, which exists nowhere else in the Bankruptcy Code, actually discourages municipal bankruptcy filings.

As the enduring fallout from the subprime mortgage disaster and the commercial credit crunch that it precipitated continue to paint a grim picture, portending hard times ahead for the U.S. economy, municipalities are suffering from a host of troubles. Among them are skyrocketing mortgage-foreclosure rates and a resulting loss of tax base, bad investments in derivatives, and the higher cost of borrowing due to the meltdown of the bond mortgage industry and the demise (temporary or not) of the $330 billion market for auction-rate securities ("ARS"), which municipalities have relied upon for nearly two decades to float inexpensive debt. The cost of borrowing in the ARS market has almost doubled since January 2008, according to the Securities Industry and Financial Markets Association. This confluence of financial woes is likely to propel an increasing number of municipalities to the brink of insolvency and beyond. This, in turn, may mean a significant uptick in the volume of chapter 9 filings. In anticipation of chapter 9's emergence from relative obscurity, it is important to understand the mechanics that federal bankruptcy law provides for addressing municipalities' financial problems.

CONSTITUTIONAL CONFLICT

Ushered in during the Great Depression to fill a vacuum that previously existed in both federal and state law, federal municipal bankruptcy law suffered from a constitutional flaw that endures in certain respects to this day—the Tenth Amendment reserves to the states sovereignty over their internal affairs. This reservation of rights caused the U.S. Supreme Court to strike down the first federal municipal bankruptcy law as unconstitutional in 1936, and it accounts for the limited scope of chapter 9 as well as the severely restricted role that the bankruptcy court plays in presiding over a chapter 9 case and in overseeing the affairs of a municipal debtor.

CHAPTER 9 ELIGIBILITY

Access to chapter 9 is limited to municipalities. A "municipality" is defined by section 101(40) of the Bankruptcy Code as a "political subdivision or public agency or instrumentality of a State." Section 109(c) of the Bankruptcy Code sets forth other prerequisites to relief under chapter 9:

- A state law or governmental entity empowered by state law must specifically authorize the municipality (in its capacity as such or by name) to file for relief under chapter 9;
- The municipality must be insolvent;
- The municipality must "desire[] to effect a plan" to adjust its debts; *and*
- The municipality must either: (a) have obtained the consent of creditors holding at least a majority in amount of claims in classes that will be impaired under the plan; (b) have failed to obtain such consent after negotiating with creditors in good faith; (c) be unable to negotiate with creditors because negotiation is "impracticable"; or (d) reasonably believe that a "creditor may attempt to obtain" a transfer that is avoidable as a preference.

The municipal debtor bears the burden of establishing that it is eligible for relief under chapter 9.

Prior to 1994, the authorization requirement had been construed to require general authority, rather than specific authorization by name, for a municipality to seek chapter 9 relief. However, the Bankruptcy Reform Act of 1994 amended section 109(c)(2) to require that a municipality be "specifically authorized" to be a debtor under chapter 9. As the bankruptcy court explained in *In re County of Orange*, 183 B.R. 594 (Bankr. C.D. Cal. 1995), courts construing the amended provision have concluded that state law must provide express written authority for a municipality to seek chapter 9 relief and that the authority must be "exact, plain, and direct with well-defined limits so that nothing is left to inference or implication."

As noted, no other chapter of the Bankruptcy Code includes insolvency among the criteria for relief. "Insolvency" in the context of chapter 9 eligibility does not refer to balance-sheet insolvency. Instead, it requires a showing that as of the filing date, the debtor either: (i) is generally not paying its undisputed debts as they become due; or (ii) is unable to pay its debts as they become due.

The dictate that a municipality "desires to effect a plan to adjust" its debts requires that the purpose of the chapter 9 filing must not be simply to buy time or evade creditors. A debtor need satisfy only one of the disjunctive pre-filing requirements set forth in section 109(c)(5), all of which are unique to chapter 9. The pre-filing negotiation requirements were inserted by Congress to prevent capricious chapter 9 filings.

GOOD-FAITH FILING REQUIREMENT

Section 921(c) states, "After any objection to the petition, the court, after notice and a hearing, may dismiss the petition if the debtor did not file the petition in good faith or if the petition does not meet the requirements of this title." No other chapter of the Bankruptcy Code expressly incorporates a good-faith filing requirement. If the court does not dismiss the petition under section 921(c), it "shall" order relief under chapter 9. Notwithstanding its permissive language, section 921(c) has been construed as requiring dismissal of a petition filed by a debtor that is ineligible for relief under chapter 9. Factors that may be relevant in determining whether a chapter 9 petition has been filed in good faith include:

(i) The debtor's subjective beliefs;

(ii) Whether the debtor's financial problems can be addressed by chapter 9;

(iii) Whether the debtor's motivation for filing is consistent with the purposes of chapter 9;

(iv) The extent of the debtor's pre-petition negotiations, if practical;

(v) The extent to which the debtor considered alternatives to chapter 9; and

(vi) The scope and nature of the debtor's financial problems.

Standing alone, a municipal debtor's refusal to impose or raise assessments or to borrow funds is not sufficient to warrant a finding of bad faith. Dismissal of a chapter 9 case is the only option if the debtor does not seek chapter 9 relief in good faith or cannot confirm a plan—the assets of a chapter 9 debtor cannot be liquidated involuntarily.

BANKRUPTCY COURT'S LIMITED ROLE

Due to constitutional restrictions, the bankruptcy court's role in a chapter 9 case is quite limited. Section 903 of the Bankruptcy Code expressly reserves to the states the power to control municipalities that file for chapter 9 protection, with the caveat that any state law (or equivalent judgment) prescribing a method of composition among a municipality's creditors is not binding on dissenters. Section 904 further provides that unless the debtor consents or the plan so provides, the court may not "interfere" with any of the debtor's "political or governmental powers," any of the debtor's property or revenues, or the use or enjoyment of its income-producing property. Thus, unlike a chapter 11 debtor, a municipal debtor is not restricted in its ability to use, sell, or lease its property (section 363 does not apply in a chapter 9 case), and the court may not become involved in the debtor's day-to-day operations.

In addition, control of a municipal debtor is not subject to defeasance in the form of a bankruptcy trustee (although state laws commonly provide a mechanism for transferring control of the affairs of a distressed municipality). A trustee, however, may be appointed to pursue avoidance actions (other than preferential transfers to or for the benefit of bondholders) on behalf of the estate if the debtor refuses to do so. A municipal debtor's ability to borrow money outside of bankruptcy is not limited by chapter 9, and the municipal debtor is not subject to the reporting requirement and other general duties of a chapter 11 debtor.

As the financial problems of municipalities continue to mount, there may be a significant surge in chapter 9 filings.

A chapter 9 debtor enjoys many of the rights of a chapter 11 debtor-in-possession but is subject to few of the obligations. Pursuant to section 901, many provisions contained elsewhere in the Bankruptcy Code are expressly made applicable to chapter 9 cases. These include, among others, the provisions with respect to the automatic stay; adequate protection; administrative priority or secured post-petition financing; executory contracts; administrative expenses; a bankruptcy trustee's "strong arm" and avoidance powers; financial contracts; the formation of official committees; and most, but not all, of the provisions governing vote solicitation, disclosure, and confirmation of a chapter 11 plan. Chapter 9 expands the scope of the automatic stay to enjoin actions against officers and inhabitants of the debtor that seek to enforce claims against the debtor. Nonrecourse special-revenue obligations do not become recourse debt in a chapter 9 case, but liens securing such obligations attach to the chapter 9 debtor's post-petition revenues previously dedicated to the obligation in question. Municipal leases that are subject to termination if the debtor fails to appropriate rent are not treated as executory contracts in a chapter 9 case. Only administrative claims are entitled to priority in a chapter 9 case—the remaining categories of unsecured priority claims specified in section 507(a) do not apply in chapter 9.

Section 1113 does not apply to chapter 9 cases. Thus, it is unclear what standard would apply (*i.e.*, the standard in section 1113 or the less restrictive requirements in section 365) if a municipal debtor were to attempt to reject a collective bargaining agreement. Section 1114 is also inapplicable, although state law would presumably govern any proposed changes to the benefits of a municipality's retired employees.

PLAN FOR ADJUSTMENT OF DEBTS

As with chapter 11, the raison d'être of chapter 9 is confirmation of a plan (either consensually or otherwise), but with one significant difference—a municipal debtor may not be liquidated in chapter 9. Only the chapter 9 debtor has the right to file a plan, and indeed is obligated to file a plan, either with its petition or within such time as the court directs. The confirmation standards are comparable to those under chapter 11. As in chapter 11, creditor claims must be classified under a plan, and at least one impaired class of creditors must approve the plan for it to be confirmed. Chapter 9 also incorporates the cram-down confirmation rules, including the requirement that a plan not "discriminate unfairly" and that it be "fair and equitable" with respect to classes of secured and unsecured claims. The "fair and equitable" requirement, however, offers scant solace to unsecured creditors in a chapter 9 case. The absolute-priority rule in section 1129(b)(2)(B)(ii) provides little protection when the debtor has no shareholders whose interests can be wiped out due to less than full payment of creditor claims.

Section 943(b)(7) of the Bankruptcy Code provides that a chapter 9 case can be confirmed only if it "is in the best interests of creditors and is feasible." Unlike in chapter 11, where the test compares creditor recoveries under a plan to what they would receive in a liquidation, the "best interests" requirement in chapter 9 mandates that a proposed plan provide a better alternative for creditors than what they already have. This is often fairly easy to demonstrate. Because creditors cannot propose a plan, the case cannot be converted to a liquidation, and a trustee cannot be appointed, the only alternative to a chapter 9 plan is dismissal (discussed below). Outside of bankruptcy, there is little possibility that unsecured creditors will be repaid, especially if the municipality's debt burden is too high to be retired by taxes. Any possibility of payment under a chapter 9 plan is often perceived by creditors as a better alternative. Even so, courts are likely to compare what creditors are to receive under a chapter 9 plan with what they could reasonably expect to recover outside of bankruptcy if they were to exercise their remedies under applicable nonbankruptcy law. As noted by the bankruptcy court in *In re Mount Carbon Metropolitan Dist.*, 242 B.R. 18 (Bankr. D. Colo. 1999), to be feasible, "a plan should offer a reasonable prospect of success and be workable." In assessing feasibility, the court must evaluate whether it is probable that the debtor can both pay pre-petition debt and provide future public services at the level necessary to maintain its viability as a municipality.

DISMISSAL

If the debtor cannot confirm a plan, the only option available to the court (and creditors) is dismissal of the chapter 9 case. Under section 930, the court may dismiss a chapter 9 case for "cause," which includes unreasonable delay by the debtor that is prejudicial to creditors, failure to propose or obtain confirmation of a plan, or material default under a plan after it has been confirmed. If the court refuses to confirm the debtor's plan (either on the first attempt or after giving the debtor additional time to modify the plan or propose a new one), it "shall" dismiss the chapter 9 case. Dismissal is appropriate even if the debtor is clearly insolvent and the creditors would be better off if the chapter 9 case were not dismissed.

OUTLOOK

The present-day legislative scheme for municipal debt reorganizations was implemented in the aftermath of New York City's financial crisis and federal government bailout in 1975, but chapter 9 has proved to be of limited utility thus far. Only a handful of cities or counties have filed for chapter 9 protection. The vast majority of chapter 9 filings involve municipal instrumentalities, such as irrigation districts, public utility districts, waste-removal districts, and health-care or hospital districts. In fact, according to the Administrative Office of the U.S. Courts, fewer than 500 municipal bankruptcy petitions have been filed in the more than 60 years since Congress established a federal mechanism for the resolution of municipal debts. Until this year, Bridgeport, Connecticut (pop. 138,000), was the only large city even to have attempted a chapter 9 filing, but its effort to use chapter 9 in 1991 to reorganize its debts failed because it did not meet the insolvency requirement. In 1999, mid-sized Camden, New Jersey (pop. 87,000), and Prichard, Alabama (pop. 28,000), also filed for chapter 9. Camden's stay in chapter 9 ended abruptly when the State of New Jersey took over the failing city in 2000. Prichard confirmed its chapter 9 plan in October 2000. More recently, the City of Vallejo, California (pop. 117,000), filed a chapter 9 petition on May 23, 2008, claiming that it lacked sufficient cash to pay its bills after negotiations with labor unions failed to win salary concessions from firefighters and police. The San Francisco suburb became the largest city in California to file for bankruptcy and the first local government in the state to seek protection from creditors because it ran out of money amid the worst housing slump in the U.S. in over a quarter century. Orange County, California (pop. 2.8 million), is the other prominent municipality to have taken the plunge. Having filed the largest chapter 9 case in U.S. history and confirmed a plan in 2005, Orange County stands alone as the only large municipal debtor to have navigated chapter 9.

Even so, the only alternative to chapter 9 is restructuring by the municipality under applicable state law, which may be difficult and require voter approval. The ability to bind dissenting creditors without obtaining voter approval may make chapter 9 preferable. Thus, as the financial problems of municipalities continue to mount, there may be a significant surge in chapter 9 filings. To be sure, chapter 9's utility in dealing with some of these problems may be limited. For example, to the extent that a municipality's questionable investments include securities, forward or commodities contracts, or swap, repurchase, or master netting agreements, bankruptcy (and the automatic stay) will not prevent the contract parties from exercising their rights. Also, although a chapter 9 debtor can restructure its existing debt, new long-term borrowing at any kind of favorable rate of interest is likely to be problematic. Still, the suspension of creditor collection efforts and the prospect of restructuring existing debt may mean that chapter 9 is the most viable strategy for many beleaguered municipalities.

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WHEN BROKERS GO BROKE: SUBPRIME MELTDOWN MAY MEAN MORE STOCKBROKER BANKRUPTCIES

Charles M. Oellermann and Mark G. Douglas

By almost every estimate, the fallout from the subprime mortgage/investment disaster has proved to be worse than anticipated, numbering among its casualties more than 50 mortgage lenders as well as venerable 85-year-old Wall Street icon Bear Stearns Cos., Inc. Once the fifth-largest securities firm in the U.S., Bear Stearns agreed to be acquired by JPMorgan Chase & Co. (with up to $30 billion in Federal Reserve emergency financing) on March 24, 2008, at the bargain-basement price of $1.2 billion, or $10 per share, only a week after expressing outrage at JPMorgan's initial offer of only $240 million ($2 per share) and 10 days after its market value had been pegged at $4.1 billion. The acquisition was completed on May 31, 2008.

As Bear Stearns' affairs unraveled at lightning speed, there was a good deal of speculation that the company might seek bankruptcy protection in an effort to stave off billions of dollars in margin calls. However, although Bear Stearns is a global investment banking firm, a significant percentage of its business involves prime brokerage clearing services to hedge funds and other investors. It is, in fact, the third-largest prime brokerage firm in the U.S., behind Goldman Sachs Group Inc. and Morgan Stanley.

To the extent that Bear Stearns' respective business entities are considered "stockbrokers" (defined generally to include any securities broker), those entities would be ineligible for relief under chapter 11 of the Bankruptcy Code. As a result, the alternative would be liquidation under either chapter 7 or the Securities Investor Protection Act of 1970 ("SIPA"). The potentially disastrous consequences of liquidating Bear Stearns' brokerage assets for customers and creditors (including trade counterparties to credit-default-swap contracts carrying an outstanding value of more than $2.5 trillion), as well as the inability to stay the liquidation of many of those contracts even if a bankruptcy were filed, provided the principal impetus for the Federal Reserve's decision to provide emergency loans backing the JPMorgan acquisition/bailout.

An increasing number of broker-dealers will be forced to consider their options, as the inevitable onslaught of litigation and federal investigations ensues regarding the subprime investment scandal. Creditors and customers of U.S. broker-dealers will similarly be keenly interested in the likely ramifications of a broker's meltdown. In anticipation of those concerns, a short primer on stockbroker liquidation proceedings may be instructive.

FEDERAL REGULATION OF STOCKBROKERS

As a consequence of the financial mayhem that precipitated the Great Depression, the securities industry is among the most heavily regulated sectors in the U.S., with the Securities and Exchange Commission ("SEC") presiding over enforcement of the Securities Act of 1933 and the Securities Exchange Act of 1934 (the "1934 Act"). Those statutes were designed to restore investor confidence in U.S. capital markets by providing investors with more reliable information and clear rules of honest dealing. The SEC's enforcement mandate includes the obligation to regulate securities brokers, transfer agents, and clearing agencies as well as U.S. securities self-regulatory organizations ("SROs"), such as the New York and American Stock Exchanges and the National Association of Securities Dealers, which operates the NASDAQ system.

That mandate, however, does not include the responsibility to preside over the liquidation of a securities broker. The history of federal legislation governing stockbroker liquidations in the U.S. extends back to the Bankruptcy Act of 1898 and before. The modern legislative framework is contained principally in two related statutes: SIPA and subchapter III of chapter 7 of the Bankruptcy Code.

SIPA AND SIPC

Following a period of great expansion in the 1960s, the U.S. securities industry hit hard times, leading to the failure or instability of a significant number of brokerage firms. The resulting crisis in customer and investor confidence and the prospect that capital markets might fail altogether as solvent brokers were dragged down by failing brokers unable to honor trade commitments prompted Congress to enact SIPA in 1970. The law was substantially revamped in 1978 in conjunction with the enactment of the Bankruptcy Code.

A SIPA proceeding is commenced against a broker-dealer when the Securities Investor Protection Corporation ("SIPC"), a nonprofit corporation whose members include most interstate broker-dealers, files an application for a protective decree regarding one of its members in federal district court. The court will issue a protective decree if the broker-dealer consents or fails to contest the petition, or if the court concludes that the broker-dealer: (i) is insolvent (on a balance-sheet basis) or unable to meet its obligations as they mature; (ii) is the subject of a proceeding pending in any court or before any federal or state agency in which a receiver, trustee, or liquidator has been appointed; (iii) is not in compliance with the financial responsibility or securities hypothecation requirements of the 1934 Act, SEC rules, or applicable SRO rules; or (iv) is unable to prove that it is in compliance with such rules. If the district court issues a protective decree, it appoints a trustee to oversee the broker-dealer's liquidation and refers the case to the bankruptcy court.

Few options are available to stock or commodity brokers intent upon obtaining a breathing spell while they attempt to sort out financial problems brought on by the subprime disaster. More likely than not, escalating liabilities will propel many brokers toward either SIPA or chapter 7, both of which are geared toward protecting customers rather than creditors.

SIPA affords limited financial protection to the customers of registered broker-dealers. A "customer" is any person who has a claim

> on account of securities received, acquired, or held by the debtor in the ordinary course of its business as a broker or dealer from or for the securities accounts of such person for safekeeping, with a view to sale, to cover consummated sales, pursuant to purchases, as collateral security, or for purposes of effecting transfer.

The term also includes "any person who has deposited cash with the debtor for the purpose of purchasing securities."

SIPA liquidations generally involve customer claims and the claims of general unsecured creditors, such as vendors or judgment creditors. The former are satisfied out of a customer estate (a fund consisting of customer-related assets, such as securities and cash on deposit), while the latter are paid from the general estate (any remaining assets). The value of a customer's account, or its "net equity," is the measure of its preferred SIPA customer claim. "Net equity" is the total value of cash and securities owed to the customer as of the petition date, less the total value of cash and securities owed by the customer to the debtor as of the petition date. SIPC advances funds to the trustee as necessary to satisfy customer claims, but limits them to $500,000 per customer, of which no more than $100,000 may be based on a customer claim for cash. SIPC is subrogated to customer claims paid to the extent of such advances. Those advances are repaid from funds in the general estate prior to payments on account of general unsecured claims.

As noted, the bankruptcy court presides over a SIPA case, and the case proceeds very much like a chapter 7 liquidation, with certain exceptions. SIPA expressly provides that to the extent consistent with its provisions, "a liquidation proceeding shall be conducted in accordance with, and as though it were being conducted under[,] chapters 1, 3, and 5 and subchapters I and II of chapter 7 of title 11." This means, for example, that the automatic stay precludes the continuation of most collection efforts against the debtor or its property (but, as described below, not the exercise of certain rights under financial or securities contracts). Similarly, the SIPA trustee has substantially all of the duties of a bankruptcy trustee as well as a bankruptcy trustee's powers, including the "strong arm" and avoidance powers and the ability to assume and assign executory contracts. Customers and creditors are required to submit proof of their claims against the debtor.

STOCKBROKER LIQUIDATION UNDER CHAPTER 7

Chapter 7 of the Bankruptcy Code incorporates provisions separate and apart from (albeit similar to) SIPA that govern stockbroker liquidations. These provisions, which are contained in subchapter III of chapter 7, were enacted to address the lack of uniformity in rules and procedures governing intrastate stockbrokers that are not subject to the SEC's financial responsibility rules. Stockbroker liquidations under chapter 7, as opposed to SIPA, are relatively rare. Once SIPC commences a SIPA proceeding against a broker-dealer, any pending chapter 7 case with respect to the debtor is automatically stayed and will be dismissed upon completion of the SIPA liquidation case.

One important distinction between SIPA and chapter 7 stockbroker liquidations is that a SIPA trustee is required to distribute *securities* to customers to the greatest extent possible in satisfaction of their claims, while a chapter 7 trustee is entrusted with *converting securities to cash* as quickly as possible (except for securities specifically registered to particular customers) and delivering the cash to creditors, including customers, in satisfaction of their claims. Thus, SIPA presumes that customers prefer their securities, while chapter 7 presumes that they prefer cash. Notably, in both SIPA and chapter 7 cases, commencement of the case does not stay any exercise of the contractual rights of a creditor to liquidate, terminate, accelerate, or net out obligations under a financial or securities contract, or to foreclose on any cash collateral pledged by the debtor. Disposition of or foreclosure on securities collateral, however, may be enjoined.

OUTLOOK

As noted, the Bankruptcy Code precludes relief to a securities broker under any chapter other than chapter 7. Recourse to chapter 11 is precluded because the complexities of chapter 11 are incompatible with the narrow purpose for which the special stockbroker liquidation provisions in chapter 7 were designed—the protection of customers. Notable attempts have been mounted to circumvent that proscription, but with limited success. For example, Drexel Burnham Lambert Group Inc. filed for chapter 11 protection in 1990, but only after selling its brokerage operations, which were ultimately liquidated. Commodities broker Refco Inc. filed for chapter 11 in 2005, notwithstanding a similar ban on commodity-broker chapter 11 filings, contending that it should be permitted access to chapter 11 because its substantial brokerage activities were carried out by an offshore vehicle. The bankruptcy court ruled otherwise, and the Refco affiliate that was a registered commodities broker was liquidated in chapter 7 while Refco's remaining operations and assets were ultimately liquidated in chapter 11.

Thus, few options are available to stock or commodity brokers intent upon obtaining a breathing spell while they attempt to sort out financial problems brought on by the subprime disaster. More likely than not, escalating liabilities will propel many brokers toward either SIPA or chapter 7, both of which are geared toward protecting customers rather than creditors.

FOCUS ABROAD: LATEST DEVELOPMENTS IN ITALIAN BANKRUPTCY LAW

Vittorio Scognamiglio

After a number of unsuccessful attempts, Italy managed to enact comprehensive reforms of its bankruptcy laws in 2005 and 2006. Among other things, the new legislation: (a) redefined the basic focus of bankruptcy proceedings toward satisfaction of creditor claims and away from penalizing debtors for their inability to pay their debts; (b) expanded the role and scope of creditors' committees; (c) allowed for the continuation of a debtor's business operations during a bankruptcy proceeding; (d) introduced the concept of a discharge from indebtedness for individual debtors; and (e) simplified the procedures for liquidating a debtor's assets and distributing the proceeds among creditors.

With the enactment of the Corrective Decree, distressed Italian companies have greater flexibility in attempting to address their financial problems by means of court-approved creditor compositions or debt-restructuring agreements that, if successful, can ward off commencement of insolvency proceedings.

These enactments were complemented on September 12, 2007, by the Italian government's approval of Legislative Decree No. 169 (the "Corrective Decree"). Effective January 1, 2008, the Corrective Decree further amended Italy's bankruptcy laws to provide for more effective and efficient procedures governing the liquidation and/or reorganization of distressed companies. Notably, the Corrective Decree introduced more flexible pre-insolvency procedures, including the possibility for arrangements between debtors and creditors similar in substance to "pre-packaged" reorganizations under U.S. bankruptcy law.

Prominent among the pre-insolvency reorganization procedures that were amended, simplified, or clarified by the Corrective Decree are the following:

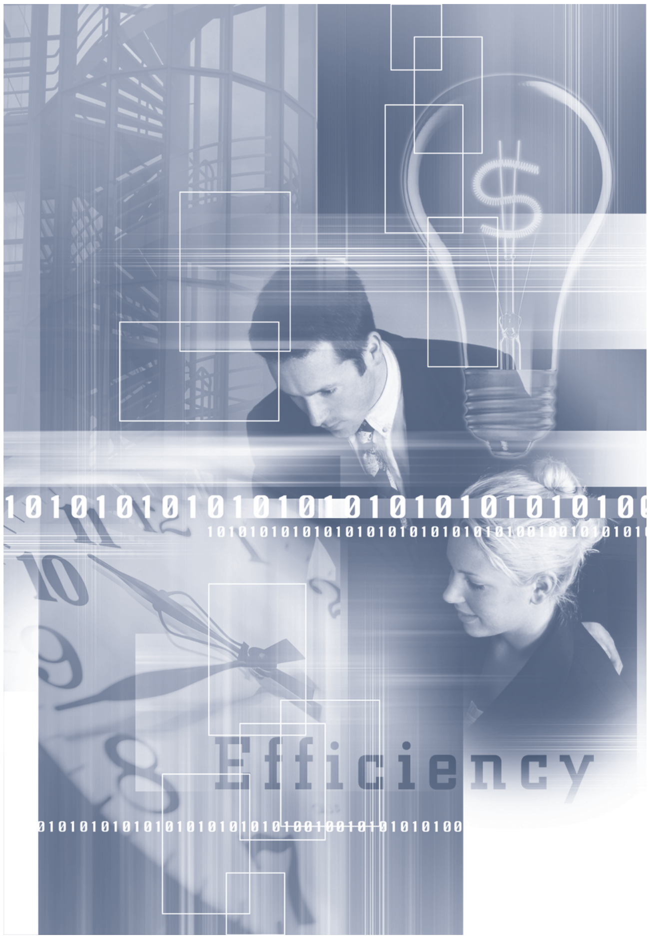
CREDITOR COMPOSITIONS

The rules and procedures governing creditor compositions were significantly reformed by the 2005–06 amendments. As part of a creditor composition, the debtor company may propose: (1) debt restructuring and satisfaction of creditor claims by any means, including asset transfers, assumption of liabilities, or other transactions; (2) a transfer of some or all of the company's assets to an *assuntore*, or contractual assignee; (3) classification of creditors into separate classes differentiated by legal status or priority; or (4) different treatment between and among creditors of different classes.

Under the 2005–06 reforms, a composition with creditors may be approved only if creditors representing the majority by value of all "admitted" claims vote in favor of the composition. The list of "admitted" claims is compiled by a judicial officer based on the company's financial records. When more than a single class of creditors exists, a majority of each class by value must vote to accept the composition. Even so, the court acts as the final arbiter of any proposed composition and retains the power to withhold approval of a fully consensual composition. In addition, the court may approve a composition despite the existence of one or more dissenting classes, so long as the composition satisfies certain statutory requirements similar in substance to the chapter 11 "cramdown" standards contained in the U.S. Bankruptcy Code.

The Corrective Decree implemented a number of important changes to these creditor composition rules:

- In a significant departure from previous practice, secured creditor claims need not necessarily be paid in full under certain circumstances.
- Cram-down of dissenting classes of creditors under the conditions specified in the legislation is no longer within the insolvency court's discretion, but automatic.
- A proposed composition involving several classes of creditors will be deemed approved by creditors despite the absence of unanimous class approval so long as a majority of all classes by value votes to accept it.



AFTER IMPLEMENTATION OF THE CORRECTIVE DECREE:

- Debt-restructuring agreements are binding only on accepting creditors. Dissenting minority creditors are not bound by the agreement.
- Once a debt-restructuring agreement has been filed with the insolvency court and published in the Register of Companies, the debtor company may benefit from an automatic stay of any enforcement proceedings against its assets for a period of 60 days.
- A debt-restructuring agreement may include a settlement between the debtor and taxing authorities concerning the debtor's tax liabilities.

Thus, with the enactment of the Corrective Decree, distressed Italian companies have greater flexibility in attempting to address their financial problems by means of court-approved creditor compositions or debt-restructuring agreements that, if successful, can ward off commencement of insolvency proceedings.

DEBT-RESTRUCTURING AGREEMENTS

Under Italian law, a distressed company can seek court authority to implement a debt-restructuring agreement, provided it has been approved by creditors holding at least 60 percent of the company's liabilities. When petitioning the insolvency court for approval, the debtor is required to file a report certified by an expert that sets forth the terms of the agreement and specifies how the claims of dissenting creditors will be treated. This procedure is more expedited than a creditor composition and enables the distressed company to avoid the more elaborate voting requirements governing compositions. Should the company subsequently become a debtor in an insolvency proceeding, payments and other transfers or dispositions effectuated as part of the debt restructuring (including liens or security interests) are not subject to avoidance or recovery.

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