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WHEN BANKRUPTCY AND EQUITY COLLIDE: HAS THE BANKRUPTCY CODE DE-FANGED THE CONSTRUCTIVE TRUST?

Charles M. Oellermann and Mark G. Douglas

The constructive trust, an equitable remedy designed to prevent unjust enrichment, is a vestige of a U.S. legal system that originally comprised separate courts of law and equity. The remedy survived the merger of courts of equity and law in the late 19th century and remains today an important part of the common law of restitution. However, its vitality in the bankruptcy context is unclear, fueling an enduring debate that has evolved since the Bankruptcy Code was enacted in 1978 to polarize and confuse courts and practitioners alike on the question. A ruling recently handed down by the Second Circuit Court of Appeals indicates that the controversy is far from over. In *Ades and Berg Group Investors v. Breeden (In re Ades and Berg Group Investors)*, the court of appeals affirmed a decision below refusing to impose a constructive trust on proceeds from a settlement of reinsurance claims that were paid to a chapter 11 debtor. According to the Second Circuit, "retention by the bankruptcy estate of assets that, absent bankruptcy, would go to a particular creditor is not inherently unjust."

CONSTRUCTIVE TRUSTS

A "constructive trust" is a relationship with respect to property that subjects the person who holds title to property to an equitable duty to convey it to another because the holder's acquisition or retention of the property would constitute unjust enrichment. Whether such a relationship exists is governed by state law. For example, New York law generally requires four elements for a constructive trust: (i) a confidential or fiduciary relationship; (ii) a promise, express or implied; (iii) a transfer of property made in reliance on that promise; and (iv) unjust enrichment. The fourth element is the most important because the purpose of a constructive trust is to prevent unjust enrichment. The standards applied in other states are substantially similar.

Even though bankruptcy courts have traditionally been courts of equity, it is unclear under the Bankruptcy Code how equitable interests, such as property rights created under common law when a constructive trust is imposed, are to be treated. Section 541(a) of the Bankruptcy Code broadly defines "property of the bankruptcy estate" to include "all legal or equitable interests of the debtor in property as of the commencement of the case." The expansive scope of the estate is tempered, however, by section 541(d), which states:

> Property in which the debtor holds, as of the commencement of the case, only legal title and not an equitable interest ... becomes property of the estate ... only to the extent of the debtor's legal title to such property, but not to the extent of any equitable interest in such property that the debtor does not hold.

The legislative history of section 541(d) indicates that the purpose of the provision was to ensure that the secondary mortgage market, where mortgage-servicing companies typically hold legal but not equitable title to mortgages, is shielded from the trustee's avoidance powers.

CONFUSION IN THE BANKRUPTCY COURTS

Most bankruptcy courts that recognize the enforceability of constructive trusts in the bankruptcy context rely upon the authority of section 541 in distinguishing between legal and equitable interests when determining whether assets should or should not be included in a debtor's bankruptcy estate. According to this view, sections 541(a) and (d) should be read to exclude from the estate property that the debtor holds in constructive trust for another. Adherents to this approach commonly require, in addition to the factors establishing the existence of a constructive trust relationship, that the property at issue be traceable in the hands of the debtor.

Many courts are divided over whether property subject to a constructive trust is subject to the trustees' strong-arm powers—in particular, the trustee's status under section 544(a)(3) of the Bankruptcy Code as a bona fide purchaser of real property. Courts disagree as to whether a bankruptcy court has the power, through the imposition of a constructive trust, to prevent the trustee from utilizing section 544(a) to avoid an unperfected security interest or unrecorded interest in real property. Some courts, including the Seventh and Ninth Circuits, have adopted the view that section 544(a)(3) trumps the affirmative defense of a constructive trust, reasoning that, as a hypothetical bona fide purchaser, the trustee has a defense that defeats the claimant's equitable interest. Other courts have deemed this interpretation untenable because it would mean that the trustee could defeat constructive trust claims to real but not personal property, as section 544(a)(3) is limited to the former. These courts, representing the minority view, find that the strong-arm powers of section 544(a)(3) cannot be utilized to avoid an equitable interest.

Some courts have concluded that the constructive trust is fundamentally at odds with basic principles incorporated in the Bankruptcy Code, such as equality of distribution to creditors. This approach was initially articulated in a landmark ruling handed down by the Sixth Circuit Court of Appeals in 1994. In *XL/Datacomp, Inc. v. Wilson (In re Omegas Group Inc.)*, the court of appeals emphasized that "[t]he equities of bankruptcy are not the equities of the common law," concluding that property subject to a claim of constructive trust is excluded from the bankruptcy estate only if such a trust has been imposed by a court "in a separate proceeding prepetition." Constructive trusts, the Sixth Circuit explained, "are anathema to the equities of bankruptcy since they take from the estate, and thus directly from competing creditors, not from the offending debtor." The court of appeals elaborated on this point as follows:

> The problem with the ... analyses of the vast majority of courts which have addressed bankruptcy claims based on constructive trust, is that a constructive trust is not really a trust. A constructive trust is a legal fiction, a common-law remedy in equity that may only exist by the grace of judicial action.

* * *

> [A] claim filed in bankruptcy court asserting rights to certain assets "held" in "constructive trust" for the claimant is nothing more than that: a claim. Unless a court has already impressed a constructive trust upon certain assets or a legislature has created a specific statutory right to have particular kinds of funds held as if in trust, the claimant cannot properly represent to the bankruptcy court that he was, at the time of the commencement of the case, a beneficiary of a constructive trust held by the debtor.

This approach to the constructive trust quandary has been adopted by some courts but it has been rejected by others, exacerbating the confusion and uncertainty clouding the issue. For example, in *CRS Steam, Inc. v. Engineering Resources, Inc. (In re CRS Steam, Inc.)*, a Massachusetts bankruptcy court held that the Bankruptcy Code's definition of "claim" is an express indication by Congress that courts must treat parties asserting constructive trust rights as nothing more than unsecured creditors, even if the constructive trust was imposed by a state court pre-petition. Thus, the *CRS Steam* court concluded, property returned to the court-imposed trust beneficiary by a debtor within 90 days of a bankruptcy filing was avoidable as a preference. The Second Circuit Court of Appeals has had several opportunities to weigh in on the question, the most recent of which came in *Ades and Berg*.

ADES AND BERG

Bennett Funding Group, Inc. ("BFG"), a leasing and funding company based in Syracuse, New York, was, until 2008, the perpetrator of the largest Ponzi scheme in U.S. history; it filed for chapter 11 protection in New York in 1996. The ensuing storm of litigation commenced by the chapter 11 trustee appointed in the bankruptcy cases included a suit against Sphere Drake Insurance PLC ("Sphere Drake") seeking to recover the proceeds due under a reinsurance policy issued to BFG and asserting a variety of tort claims for aiding and abetting fraud and breach of fiduciary duty. The complaint also sought a declaration that BFG, and not its investors, was the sole and rightful recipient of any policy proceeds. Certain investors counterclaimed against the trustee, seeking the imposition of a constructive trust over policy proceeds.

In December 2002, the trustee, Sphere Drake, and various other litigants, including the investors, finalized a settlement pursuant to which Sphere Drake agreed to pay approximately $28 million for the release of all claims asserted by the trustee and other litigants. A New York district court approved the settlement and remanded the litigation to the bankruptcy court to determine how the settlement proceeds should be distributed. In 2004, the bankruptcy court entered an order directing that a portion of the settlement proceeds be allocated to BFG creditors with Sphere Drake-related investments, with the remainder to be paid to BFG's general unsecured creditors. However, the court delayed distribution of the proceeds until such time that the investors' constructive trust counterclaim could be adjudicated.

Although the ruling pays lip service to underlying substantive law, its message is unequivocal: the bankruptcy policy of equality of distribution ordinarily trumps the equitable interest emanating from a constructive trust claim.

The bankruptcy court ultimately dismissed the constructive trust counterclaim. Observing that "bankruptcy courts are generally reluctant to impose constructive trusts without a substantial reason to do so," the court ruled that the investors could not satisfy the criteria for a constructive trust under New York law because they could not establish unjust enrichment. According to the court, "[t]here is nothing inequitable or unconscionable" in allowing a chapter 11 trustee to act "in accordance with the Bankruptcy Code in marshaling and preserving assets." In doing so, the bankruptcy court relied upon the Second Circuit's 2004 decision in *Superintendent of Ins. v. Ochs (In re First Central Financial Corp.)*, where the court of appeals considered whether a constructive trust should be imposed on a tax refund issued to the trustee of a debtor that had been party to a tax allocation agreement for the consolidated filing of tax returns and the sharing of any resulting refunds. Concluding that a constructive trust was not warranted under New York law, the Second Circuit observed that a constructive trust creates "a separate allocation mechanism outside the scope of the bankruptcy system" and thus can "wreak … havoc with the priority system ordained by the Bankruptcy Code." Moreover, the court of appeals explained:

> [A]lthough we do not disturb the general rule that constructive trusts must be determined under state law, we believe it important to carefully note the difference between constructive trust claims arising in bankruptcy as opposed to those that do not, as the "equities of bankruptcy are not the equities of the common law."

The investors in *Ades and Berg* appealed the bankruptcy court's ruling. The district court affirmed in 2007, endorsing the bankruptcy court's approach to the constructive trust issue and characterizing *First Central* as "unquestioned, binding precedent." The investors then appealed to the Second Circuit.

THE SECOND CIRCUIT'S RULING

According to the investors, the U.S. Supreme Court's 2007 decision in *Travelers Casualty & Surety Co. of America v. Pacific Gas & Electric Co.* undermines the continued validity of *First Central*, including the Second Circuit's admonition that courts should "act very cautiously" in applying constructive trust law in the bankruptcy context. In *Travelers*, the Supreme Court reaffirmed the "basic federal rule" that state law governs the substance of claims in bankruptcy, emphasizing that "[u]nless some federal interest requires a different result, there is no reason why [property] interests should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding." After *Travelers*, the investors argued, it is erroneous to evaluate constructive trust claims in the bankruptcy context differently from those outside bankruptcy "because doing so undermines a system explicitly premised on applicable nonbankruptcy law to define property interests."

The Second Circuit rejected this argument, explaining that the investors misread both *Travelers* and *First Central*. Its ruling in *First Central*, the court of appeals explained, expressly acknowledged that the existence of a constructive trust relationship must be determined under state law, but it counseled courts to be cognizant that equitable principles in bankruptcy are not equivalent to those under applicable state law:

> Recognizing different equities in different contexts is not an impermissible transformation of the substantive law. It is simply a recognition that an equitable remedy is more or less appropriate when different interests are in play. Context-sensitivity is part and parcel of equity under New York law as much as it is under bankruptcy law.

Moreover, the Second Circuit explained, *First Central* premised "its bankruptcy-sensitive analysis of New York unjust enrichment law in the purposes of the Bankruptcy Code, giving its reasoning the tie to the Code that was utterly lacking in the … rule rejected by *Travelers*." According to the court of appeals, in both *First Central* and the case before it, the courts carefully adhered to substantive state law in light of the special equities of bankruptcy in concluding that "retention by the bankruptcy estate of assets that, absent bankruptcy, would go to a particular creditor is not inherently unjust." Emphasizing that the New York State Court of Appeals has recognized that "there is no inequity in treating [a constructive trust claimant] in the same manner as any other depositor/creditor who was unfortunate enough to have placed its money" with a debtor, the Second Circuit concluded that the lower courts did not err either in characterizing *First Central* as "unquestioned, binding precedent" or in refusing to impose a constructive trust.

OUTLOOK

The approach articulated in *Ades and Berg* sets the bar extremely—if not insurmountably—high for constructive trust claimants seeking to exclude property from a debtor's bankruptcy estate. The decision provides no guidance regarding any possible scenario that could allow a constructive trust claimant to establish unjust enrichment, an element essential to a constructive trust claim not only in New York, but in every jurisdiction. Although the ruling pays lip service to underlying substantive law, its message is unequivocal: the bankruptcy policy of equality of distribution ordinarily trumps the equitable interest emanating from a constructive trust claim. *Ades and Berg* and other recent rulings like it indicate that the continued validity of equitable ownership interests in property, such as the constructive trust, are questionable in modern bankruptcy jurisprudence.

Ades and Berg Group Investors v. Breeden (In re Ades and Berg Group Investors), 550 F.3d 240 (2d Cir. 2008).

Vineyard v. McKenzie (In re Quality Holstein Leasing), 752 F.2d 1009 (5th Cir. 1985).

Nat'l Bank of Alaska v. Erickson (In re Seaway Express Corp.), 912 F.2d 1125 (9th Cir. 1990).

Belisle v. Plunkett, 877 F.2d 512 (7th Cir. 1989).

XL/Datacomp, Inc. v. Wilson (In re Omegas Group Inc.), 16 F.3d 1443 (6th Cir. 1994).

CRS Steam, Inc. v. Engineering Resources, Inc. (In re CRS Steam, Inc.), 225 B.R. 833 (Bankr. D. Mass. 1998).

Superintendent of Ins. v. Ochs (In re First Central Financial Corp.), 377 F.3d 209 (2d Cir. 2004).

In re Flanagan, 503 F.3d 171 (2d Cir. 2007).

Travelers Casualty & Surety Co. of America v. Pacific Gas & Electric Co., 127 S. Ct. 1199 (2007).

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NEW CAYMAN ISLANDS CORPORATE INSOLVENCY LAW

As of March 1, 2009, the laws of the Cayman Islands dealing with corporate insolvency were updated by the implementation of amendments to the Cayman Islands Companies Law that were originally enacted in 2007 but lay dormant pending the promulgation of three new sets of procedural rules governing the conduct of insolvency matters and an amendment to the rules of the Cayman Islands Grand Court.

The new rules are the Companies Winding-Up Rules 2008, the Insolvency Practitioners' Regulations 2008, the Foreign Bankruptcy Proceedings (International Cooperation) Rules 2008, and the Grand Court (Amendment No. 2 Rules) 2008. Previously, insolvency procedures in the Cayman Islands have generally been regarded as haphazard and unsatisfactory.

The new rules and regulations, together with the replacement of Part V of the Companies Law (which deals with insolvency generally) and the introduction of Part XVI (which deals with international cooperation), represent a major milestone in the evolution of the Cayman Islands' legislative framework by providing the Caymans with a modernized and well-considered insolvency regime specifically tailored to address the needs of those who use the Cayman Islands as a major financial center.

Supplanting the U.K.'s Insolvency Rules 1986, the Companies Winding-Up Rules 2008 are the first procedural rules for insolvency matters specifically adopted for the Cayman Islands. The new rules apply to all insolvency proceedings commenced after March 1, 2009, as well as actions taken in proceedings pending as of that date. The insolvency law now focuses on the rights of creditors of all priorities. There are no formal "corporate rescue" or reorganization provisions similar to chapter 11 of the U.S. Bankruptcy Code or administration in the U.K. Secured creditors retain their rights to enforce their security outside the liquidation process. In addition, contractual setoff and netting provisions will remain enforceable against the liquidators of insolvent Cayman Islands companies. The new provisions also reaffirm the enforceability of multilateral setoff arrangements.

Among the provisions in the new rules is the express duty of official liquidators of Cayman Islands companies that are the subject of parallel insolvency proceedings in another jurisdiction, or whose assets overseas are subject to foreign bankruptcy or receivership proceedings, to consider whether it is advisable to enter into an international protocol for the purpose of coordinating the cross-border proceedings. Other provisions include the elimination of strict deadlines for the payment of distributions to creditors after expiration of the claim submission deadline and the implementation of a specific regime to govern the treatment of unclaimed dividends.

Under the Insolvency Practitioners' Regulations 2008, insolvency practitioners in the Cayman Islands will for the first time be required to meet defined criteria for appointment as official liquidators, including licensing, minimum experience, residency, conflict-of-interest, and insurance requirements (with certain grandfathering exceptions). New rules regarding remuneration of official liquidators are also covered by the regulations.

The Foreign Bankruptcy Proceedings (International Cooperation) Rules 2008 regulate applications made under the new Part XVI of the Companies Law, which: (i) delineates the procedure to be followed in connection with an application by a foreign representative for a declaration that he or she is entitled to act on behalf of a debtor; (ii) establishes procedures governing applications for ancillary orders such as injunctions, orders for stay of enforcement, or examination or surrender of assets; and (iii) obligates any Cayman Islands company and any foreign company registered in the Cayman Islands that becomes the subject of foreign bankruptcy proceedings to give notice of that fact to the Registrar and advertise it in the *Cayman Islands Gazette*.

FOURTH CIRCUIT RESTORES BANKRUPTCY SAFE HARBOR PROTECTIONS FOR NATURAL GAS SUPPLY CONTRACTS THAT ARE "COMMODITY FORWARD AGREEMENTS"

Dickson C. Chin, Ben Rosenblum, and James E. Vallee

In reversing and remanding a bankruptcy court ruling that raised concerns among participants in the natural gas markets, the Fourth Circuit Court of Appeals in *Hutson v. E.I. du Pont de Nemours & Co. (In re National Gas Distributors, LLC)* held that natural gas supply contracts with end users are not precluded as a matter of law from constituting "swap agreements" under the Bankruptcy Code. A factual inquiry will be required to determine whether these natural gas supply contracts can be characterized as "swap agreements" and therefore entitled to the safe harbor protections from the automatic stay and avoidance powers of a bankruptcy trustee for preferences and fraudulent conveyances.

One way for a natural gas supply contract to constitute a "swap agreement" is for it to be found to be a "commodity forward agreement," which the Fourth Circuit states should include the following nonexclusive elements: (1) substantially all of the expected cost of performance must be attributable to an underlying commodity determined at the time of contracting; (2) payment must be for a commodity that is delivered more than two days after the date of the contract, at a price that is fixed at the time of contracting; (3) quantity and time of delivery must be fixed at the time of contracting; and (4) the agreement itself need not be assignable or tradable. Certain of these elements, such as the requirement that price, quantity, and time of delivery be "fixed" at the time of contracting, are not present in the Bankruptcy Code and may pose challenges in determining whether a given natural gas supply contract is in fact a "commodity forward agreement."

BACKGROUND

In 2006, Richard M. Hutson, II, trustee for National Gas Distributors, LLC (the "Trustee"), brought claims under sections 548(a) and 550(a) of the Bankruptcy Code against E.I. du Pont de Nemours and Company, the Smithfield Packing Company, and Stadler's Country Hams (collectively, the "Customers"), along with more than 20 other customers of

NEWSWORTHY

Corinne Ball (New York) and ***David G. Heiman (Cleveland)*** have been recognized as being among the "World's Leading Lawyers for Business" in *Chambers Global 2009*.

Corinne Ball (New York) was listed as a "Dealmaker of the Year" by *The American Lawyer*.

Heather Lennox (Cleveland) was inducted as a Fellow of the American College of Bankruptcy on March 27 in Washington, D.C.

Jones Day's Business Restructuring & Reorganization Practice was recognized by *Chambers Global 2009* as one of the best in the Restructuring/Insolvency practice area.

Simon Powell (Hong Kong) was recognized by *Chambers Asia* as one of the finest attorneys in the Restructuring/Insolvency practice area for 2009.

Adam Plainer (London), ***Sion Richards (London)***, and ***Michael Rutstein (London)*** were recognized by *Chambers UK* as three of the finest attorneys in the Restructuring/Insolvency practice area for 2009.

Heather Lennox (Cleveland) sat on a panel discussion entitled "Creating a Restructuring Process that Ensures a Successful Turnaround" at the American Conference Institute Distressed Debt Investing Summit on March 31 in New York City.

Adam Plainer (London) was awarded a "recognised" designation in the Practical Law Company's *Which Lawyer UK Restructuring and Insolvency* for 2009. He is listed as a leading individual for Insolvency and Corporate Recovery in *Legal Experts 2009*.

Brett J. Berlin (Atlanta) gave a presentation on March 4 at the Jones Day Atlanta CLE Academy entitled "Introduction to Bankruptcy: Things to Think About When the Companies You Do Business With End Up in Chapter 11 Bankruptcy." On March 5, he moderated a panel on "Hot Topics in Retail Bankruptcies" at the Emory Bankruptcy Developments Journal Symposium in Atlanta.

Laurent Assaya (Paris) gave a presentation at a conference sponsored by Rothschild & Co. in Paris on January 28 entitled "Creditors and the Reform of the Safeguard Law."

Adam Plainer (London), ***Paul Bromfield (London)***, ***Andrew L. Rotenberg (London)***, and ***Sion Richards (London)*** are listed as leading individuals for Corporate Restructuring and Insolvency in *Legal 500 UK 2008/9*.

An article written by ***Charles M. Oellermann (Columbus)*** and ***Mark G. Douglas (New York)*** entitled "When Bankruptcy and Equity Collide: Has the Bankruptcy Code De-fanged the Constructive Trust?" appeared in the March edition of *The Bankruptcy Strategist*.

An article written by ***Charles M. Oellermann (Columbus)*** and ***Mark G. Douglas (New York)*** entitled "2009 shaping up as another difficult year for US economy" was published in the spring 2009 edition of *Recovery*.

An article written by ***Pedro A. Jimenez (New York)*** and ***Mark G. Douglas (New York)*** entitled "Ch. 15 In Practice: *Fogerty v. Condor*" appeared in the March 26 edition of *Bankruptcy Law360*.

An article written by ***Mark G. Douglas (New York)*** entitled "2008: The Year in Bankruptcy" was reported on in news stories published in the March 3 editions of Reuters, *USA Today*, and the *New York Times DealBook*. It was also reported on in the March 6 edition of *The Journal Record* of Oklahoma City and an April 2 article in Reuters entitled "CEOs wait too long before filing bankruptcy."

National Gas Distributors, LLC ("National Gas"), a distributor of natural gas to predominately industrial customers. The Trustee's lawsuits sought to avoid payments made under certain natural gas supply contracts and recover "the cash value of the difference between the market prices when the customers took delivery and the prices they paid under the contracts, which the Trustee alleged [to be] over $4 million." The natural gas supply contracts at issue were entered into by National Gas within 12 months of the date its bankruptcy petition was filed. These contracts employed the "Base Contract for Sale and Purchase of Natural Gas," published by the North American Energy Standards Board, Inc., copyright 2002 ("NAESB Contracts"), and email confirmations between the parties that established (or "fixed") the prices for future natural gas deliveries by National Gas to its Customers' designated facilities. Under the NAESB Contracts, National Gas was obligated to sell natural gas to the Customers at these fixed prices, notwithstanding fluctuations in market prices, or pay the Customers the difference between the applicable market price and the contract price. This contractual requirement resulted in National Gas making sales to the Customers that were below the prevailing market price.

Under section 548(a), bankruptcy trustees may seek to avoid transfers of property that are made within two years of the filing of a bankruptcy petition when such transfers are "fraudulent," as defined in the Bankruptcy Code. Consequently, the Trustee claimed that the sales by National Gas below the prevailing market price were constructively fraudulent conveyances because National Gas was insolvent at the time of such sales. Alternatively, the Trustee claimed that National Gas's management engaged in actual fraudulent conveyances by intentionally using the NAESB Contracts to "hinder, delay or defraud" National Gas's creditors. In light of these alleged fraudulent transfers by National Gas, the Trustee argued that the NAESB Contracts should be avoided pursuant to section 548(a).

However, section 546(g) of the Bankruptcy Code provides a "safe harbor" from constructive fraud claims under section 548(a)(1)(B) for payments made to swap participants under "swap agreements." Further, sections 548(a)(1)(A) and 548(d)(2)(D) of the Bankruptcy Code provide a defense from both actual and constructive fraud claims to the extent the transferee provided value in good faith. Accordingly, the Customers filed motions to dismiss the Trustee's actions or, in the alternative, for summary judgment, arguing that the transfers of natural gas were made "in good faith" and "for value" and that " 'each Transfer was made by or to a swap participant under or in connection with a swap agreement' and was thus not avoidable [by Trustee] under 11 U.S.C. §§ 546(g) and 548(d)(2)(D)."

The bankruptcy court denied the Customers' motions, finding that the NAESB Contracts were "simply agreement[s] by a single end-user to purchase a commodity" and not "swap agreements" as defined in 11 U.S.C. section 101(53B) of the Bankruptcy Code. The bankruptcy court reasoned that since the NAESB Contracts were physically settled and not traded in any organized financial markets, these NAESB Contracts were not the type of agreements that Congress intended to exempt from the avoidance provisions of the Bankruptcy Code. Following additional motions by the Customers requesting a modification of the bankruptcy court's order with respect to conclusions it made regarding the NAESB Contracts that the Customers argued were factual in nature, the bankruptcy court ruled that "as a matter of law," the NAESB Contracts were not "swap agreements."

THE BANKRUPTCY CODE'S "COUNTERVAILING POLICY OF PROTECTING FINANCIAL MARKETS"

Although one of the Bankruptcy Code's primary policies is to provide for the equitable distribution of a debtor's assets among its creditors, Congress recognized the potentially devastating consequences that could occur if the insolvency of one firm were allowed to spread to other market participants, thereby threatening the stability of entire markets. Beginning in 1982, Congress engaged in formulating a series of changes to the Bankruptcy Code to create certain "safe harbors" to protect rights of termination and setoff under "securities contracts," "commodities contracts," and "forward contracts." The "safe harbor protections" provided to these types of contracts include exemption from several avoidance provisions in the Bankruptcy Code—notably, an exemption from a bankruptcy trustee's ability to avoid contract payments that are "fraudulent conveyances."

These amendments to the Bankruptcy Code were augmented and refined in the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA") and in the Financial Netting Improvements Act of 2006, in which, among other things, the safe harbor protections were expanded to permit cross-product netting among protected transactions (*i.e.*, swap agreements, forward contracts, commodity contracts, repurchase agreements, and securities contracts). The definitions relating to swap and other protected transactions were also broadened to provide "sufficient flexibility to avoid the need to amend the definition as the nature and uses of swap transactions matured."

Although the Fourth Circuit's decision seems to be consistent with Congress's stated desire to mitigate systemic market risk that may arise in connection with a given market participant's bankruptcy, the "nonexclusive guidance" provided by the Fourth Circuit may offer challenges in interpretation and application of this precedent to future contractual situations.

As part of these amendments, the term "commodity forward agreement" was added to the definition of "swap agreement" under the Bankruptcy Code. However, Congress did not define the term "commodity forward agreement" in the Bankruptcy Code, and no court has yet sought to provide a definition. The Fourth Circuit acknowledged the bankruptcy court's "staunch effort" to analyze section 101(53B), which resulted in the bankruptcy court's conclusion that "a 'commodity forward agreement' has to be traded in a financial market and cannot involve the physical delivery of the commodity to an end user," but ultimately the Fourth Circuit disagreed with the bankruptcy court's conclusion.

"COMMODITY FORWARD AGREEMENTS" NEED NOT BE TRADED IN FINANCIAL MARKETS

In its opinion, the Fourth Circuit decided to look to the definition of "forward contract" under the Bankruptcy Code to determine whether a "commodity forward agreement" must necessarily be traded in a financial market or on an exchange because the broad term "forward agreement" must include the more narrow "forward contracts." The Fourth Circuit reasoned that there is statutory authority supporting the proposition that "forward contracts" need not be traded in a market or on an exchange by virtue of the exclusion of "commodity contracts"—which are contracts "on, or subject to the rules of, a contract market or board of trade"—from the definition of "forward contracts." The Fourth Circuit also noted that no court has required "forward contracts" to be traded in a market or on an exchange, but that some courts have held that "forward contracts" may in fact be directly negotiated by the parties and nonassignable. Consequently, the Fourth Circuit rejected the bankruptcy court's assumption that "all of the agreements in §101(53B)(A)(i) [which include "commodity forward agreements"] must be 'found in the financial markets.' "

"COMMODITY FORWARD AGREEMENTS" MAY INVOLVE THE PHYSICAL DELIVERY OF NATURAL GAS

The Fourth Circuit found the bankruptcy court's assumption that the NAESB Contracts were "simple supply contracts" because they involved the physical delivery of natural gas to be an oversimplification of the NAESB Contracts' intended purpose. Notwithstanding the fact that the NAESB Contracts involved the physical delivery of natural gas, the Fourth Circuit concluded that the bankruptcy court overlooked the fact that the NAESB Contracts contained financial hedging elements by which "the customers hedged their risk of future fluctuations in the price of natural gas":

> The [NAESB Contracts] obliged the customers to buy, and National Gas to sell, gas on a future date at a price fixed at the time of contracting, regardless of fluctuations in the market price. And if either party did not perform, that party was required to pay the difference between the contract price and the market price.

Thus, the Court reasoned that these "simple supply contracts" could influence and create risk for broader markets and their participants. The Fourth Circuit acknowledged that this was precisely the type of systemic risk that Congress intended to address with the amendments to the Bankruptcy Code set forth in the BAPCPA.

Moreover, the Fourth Circuit stated that there was nothing in the Bankruptcy Code that prohibited the physical delivery of a commodity. To the contrary, many courts have held that "forward contracts" may be settled by physical delivery of the underlying commodity, and therefore, "commodity forward agreements" may also be physically settled. Further, the Fourth Circuit observed that the Bankruptcy Code's inclusion of "spot" commodity transactions in the definition of "swap agreements" was also contrary to the bankruptcy court's conclusion because "spot agreements" are agreements in which the subject commodity is "available for immediate delivery after sale." Therefore, the Fourth Circuit held that Congress did not intend to prohibit the physical delivery of natural gas pursuant to a "commodity forward agreement."

ELEMENTS OF "COMMODITY FORWARD AGREEMENTS"

The Fourth Circuit declined the opportunity to fashion a definition for "commodity forward agreements." However, the court did set forth several "nonexclusive elements" as guidance for what it believes the statutory language requires for a "commodity forward agreement":

1. "The subject to a 'commodity forward agreement' must be a commodity." That is, "substantially all of the expected costs of performance must be attributable to the expected cost of the underlying commodity, determined at the time of contracting."
2. A "commodity forward agreement" must "require a payment for the commodity at a price fixed at the time of contracting for delivery [that is] more than two days after the date the contract is entered into."
3. In addition to price, "the quantity and time elements must [also] be fixed at the time of contracting."
4. "Commodity forward agreements" do not necessarily need to be assignable and, therefore, tradable.

CHALLENGES IN INTERPRETATION

In describing these contours of a "commodity forward agreement," the Fourth Circuit sought to "point to certain non-exclusive elements that the statutory language appears to require." Certain of these elements, such as the requirement that price, quantity, and time of delivery be "fixed" at the time of contracting, are not present in the Bankruptcy Code. The definition of "forward contract" under the Bankruptcy Code does not include any reference to price or quantity, and the only reference to delivery is the requirement for a "maturity date more than two days after the date the contract is entered into" without any further specifics on timing. Although the Fourth Circuit reasoned that "[b]ecause the term 'agreement' is broader than the term 'contract,' ... a forward contract must also be a forward agreement (although it does not follow that every forward agreement is a forward contract)," there is no defined term for "commodity forward agreement" and therefore no statutory guidance on the requirement that price, quantity, and time of delivery be "fixed" at the time of contracting. This lack of guidance may pose challenges in interpretation. Various agreements that are used for hedging purposes in the natural gas markets have price, quantity, and delivery provisions that, while variable in cost, amount, and timing, are expressly determined at the time of contracting by reference to specified extrinsic factors. Consequently, there may be uncertainty in applying these particular elements of a "commodity forward agreement" to these types of agreements.

CONCLUSION

Nat'l Gas Distributors has been very closely followed by participants in the U.S. natural gas industry—both by energy-industry participants and by their creditors. The dispute drew amicus briefs from the International Swaps and Derivatives Association, Inc. (a global financial trade association that seeks to identify and reduce risk in the derivatives and risk management industry), BP Energy Co. (one of the largest marketers of natural gas in the United States), and First Citizens Bank & Trust Co. Although the Fourth Circuit's decision seems to be consistent with Congress's stated desire to mitigate systemic market risk that may arise in connection with a given market participant's bankruptcy, the "nonexclusive guidance" provided by the Fourth Circuit may offer challenges in interpretation and application of this precedent to future contractual situations.

Hutson v. E.I. du Pont de Nemours & Co. (In re National Gas Distributors, LLC), 556 F.3d 247 (4th Cir. 2009).

CREDITOR THAT USED DEBTOR AS MERE INSTRUMENTALITY QUALIFIES AS NON-STATUTORY INSIDER IN PREFERENCE LITIGATION

Mark G. Douglas

Transactions between companies and the individuals or entities that control them, are affiliated with them, or wield considerable influence over their decisions are examined closely due to a heightened risk of overreaching caused by the closeness of the relationship. The degree of scrutiny increases if the company files for bankruptcy. A debtor's transactions with such "insiders" will be examined by the bankruptcy trustee, the chapter 11 debtor-in-possession, official committees, and even individual creditors or shareholders to determine whether pre-bankruptcy transfers made by the debtor may be avoided because they are preferential or fraudulent, whether claims asserted by insiders may be subject to equitable subordination, and whether the estate can assert causes of action based upon fiduciary infractions or other tort or lender liability claims.

Designation as a debtor's "insider" means, among other things, that the "lookback" period for preference litigation is expanded from 90 days to one year, claims asserted by the entity may be subject to greater risk of subordination or recharacterization as equity, and the entity's vote in favor of a cram-down chapter 11 plan may not be counted. The Bankruptcy Code contains a definition of "insider." However, as demonstrated by a ruling recently handed down by the Third Circuit Court of Appeals, the statutory definition is not exclusive. In *In re Winstar Communications, Inc.*, the court of appeals, in a matter of first impression, ruled that a creditor that used the debtor as a "mere instrumentality" to inflate its own revenues was a "non-statutory" insider for purposes of preference litigation.

STATUTORY AND NON-STATUTORY INSIDERS

"Insider" is defined in section 101(31) of the Bankruptcy Code, which provides that, if the debtor is a corporation, the term "includes" the following:

(i) director of the debtor;

(ii) officer of the debtor;

(iii) person in control of the debtor;

(iv) partnership in which the debtor is a general partner;

(v) general partner of the debtor; or

(vi) relative of a general partner, director, officer, or person in control of the debtor.

However, because the Bankruptcy Code's definition of the term is nonexclusive, courts have identified a category of "non-statutory insiders" consisting generally of those individuals or entities whose relationship with the debtor is so close that their conduct should be subject to closer scrutiny than that of those dealing with the debtor at arm's length. In determining whether a person or entity qualifies as a non-statutory insider, some courts consider: (i) the closeness of the relationship between the debtor and the alleged insider; and (ii) whether transactions between the debtor and the alleged insider were conducted at arm's length. As noted by the court in *Friedman v. Sheila Plotsky Brokers, Inc. (In re Friedman)*, the relationship must be "close enough to gain an advantage attributable simply to affinity rather than to the course of business dealings between the parties." The alleged insider's degree of control over the debtor is relevant but not dispositive. Under the Third Circuit's ruling in *Winstar Communications*, when a creditor is able to control a debtor's actions to such an extent that the debtor becomes a "mere instrumentality," the creditor qualifies as a non-statutory insider.

WINSTAR COMMUNICATIONS

Prior to filing for chapter 11 protection in April 2001 in Delaware, telecommunications provider Winstar Communications, Inc. ("Winstar"), and its wholly owned subsidiary Winstar Wireless, Inc. ("Wireless"), entered into a "strategic partnership" with Lucent Technologies Inc. ("Lucent") whereby Lucent essentially agreed to help finance and construct Winstar's global broadband telecommunications network. The two entered into a secured credit agreement in 1998 under which Lucent provided a $2 billion line of credit to be used for the purchase of certain products and services in exchange for a lien on substantially all of Winstar's assets. They also entered into a supply agreement under which Lucent assumed primary responsibility for constructing Winstar's network and which obligated Lucent to provide

Winstar with state-of-the-art equipment, failing which Lucent was obligated to finance equipment or services provided by third parties. The supply agreement required that if Winstar did not buy a certain percentage of services and equipment from Lucent, Winstar would incur escalating surcharges of up to $3 million per year.

Because Lucent did not yet have the ability to provide all of the required services, Lucent and Wireless entered into a temporary subcontracting agreement in 1999 under which Wireless acted as Lucent's subcontractor to build the network until Lucent could transition to assume that role. In 2000, certain banks provided Winstar with a secured $1.15 billion revolving credit and term loan. At the time, Winstar had raised nearly $1 billion in equity and floated $1.6 billion in public debt. Winstar used the bank loan proceeds to pay off the $1.2 billion it had borrowed from Lucent.

Lucent, however, continued its lending relationship with Winstar, providing the company in May 2000 with a $2 billion line of credit. Lucent's second credit facility was not secured by a lien on all of Winstar's assets but included covenants that limited Winstar's total cash expenditures, gave Lucent the right to serve a refinance notice on Winstar if its outstanding loans exceeded $500 million, and obligated Winstar to use any increase in the senior bank debt to repay Lucent.

In November 2000, Siemens, a competitor of Lucent in the manufacture of equipment, agreed to join the senior bank facility and lend $200 million to Winstar for "general corporate purposes." Winstar sought permission from Lucent to keep at least some of the Siemens loan proceeds, notwithstanding the requirements of the second credit agreement. Lucent refused and, among other things, threatened to cease lending under the second credit agreement absent surrender of the Siemens loan proceeds. Winstar acquiesced and wired net proceeds of the loan amounting to approximately $188 million to Lucent in December 2000, four months prior to Winstar's bankruptcy filing.

The Winstar bankruptcy cases were converted to chapter 7 liquidations in January 2002. Prior to the conversion, Winstar sued Lucent, alleging that by breaching its pre-petition contracts with Winstar, Lucent forced Winstar into bankruptcy. Lucent asserted secured and unsecured claims against Winstar aggregating $1 billion based upon the contracts. Post-conversion, the chapter 7 trustee filed an amended complaint in which she asserted various causes of action against Lucent, including claims for breach of subcontract, avoidance of the $188 million payment as a preference, and equitable subordination of Lucent's claims.

The bankruptcy court ruled that Lucent used Winstar as a mere instrumentality to inflate Lucent's own revenues, concluding that what began as a "strategic partnership" to benefit both parties quickly degenerated into a relationship in which the much larger company, Lucent, bullied and threatened the smaller Winstar into taking actions that were designed to benefit Lucent. The court found that Lucent controlled many of Winstar's decisions relating to the build-out of its network, forced the "purchase" of its goods well before the equipment was needed (if needed at all), treated Winstar as a captive buyer for Lucent's goods, and controlled many of Winstar's employees. The bankruptcy court held that the $188 million payment was preferential, despite having been made more than 90 days before Winstar filed for bankruptcy, because Lucent was an "insider" as "a person in control" of Winstar and qualified as a "non-statutory insider." The court also directed that Lucent's claims against Winstar be equitably subordinated under section 510(c) of the Bankruptcy Code to the claims of other creditors as well as stockholder interests.

THE THIRD CIRCUIT'S RULING: ACTUAL CONTROL OF DEBTOR UNNECESSARY

The district court and the Third Circuit, in a matter of first impression, affirmed the ruling in part on appeal. According to the court of appeals, a person may be an insider of a debtor either as: (i) a "person in control" of the debtor, or (ii) a non-statutory insider. To be an insider under category (i), actual control (or its close equivalent) is necessary. Actual control of the debtor is not necessary, however, to establish that a creditor is a non-statutory insider. A creditor's ability to coerce a debtor into transactions not in the debtor's interest can establish the creditor as a non-statutory insider. While mere aggressive enforcement of a debt does not ordinarily establish insider status, when a creditor is able to dominate a debtor and require the debtor to affirmatively engage in new, non-arm's length transactions that benefit the creditor and not the debtor, insider status can be established.

Even in the absence of actual control, a significant degree of influence over a prospective debtor's affairs and conduct, coupled with non-arm's length dealings, can lead to an "insider" designation for a creditor in connection with preference litigation or estate causes of action challenging the priority or validity of a creditor's claims.

To hold otherwise, the Third Circuit emphasized, would render meaningless Congress's decision to provide a nonexhaustive list of insiders in section 101(31)(B) because the "person in control" category would function as a determinative test. The court agreed with Lucent's assertion that "to avoid turning the catch-all 'non-statutory' category into an end-run around Congress's intent—making superfluous the specific, narrow categories Congress identified—that catch-all category must be reserved for persons and entities that are functionally equivalent to the types of insider enumerated in the statute." Concluding, however, that it is not necessary for a non-statutory insider to have actual control, the Third Circuit explained that the question is whether there is a close relationship between the debtor and the creditor and "anything other than closeness to suggest that any transactions were not conducted at arm's length." Finding no fault with the bankruptcy court's factual findings concerning Lucent's control of Winstar and Lucent's abusive conduct, the court of appeals affirmed the court's ruling with respect to Lucent's insider status. However, it modified the bankruptcy court's ruling insofar as it directed subordination of Lucent's claims to shareholder interests, holding that "§ 510(c)'s language plainly provides that a creditor's claim can be subordinated only to the claims of other creditors, not equity interests."

OUTLOOK

Winstar Communications is a significant development and a warning to creditors that have close relationships with financially troubled companies. Even in the absence of actual control, a significant degree of influence over a prospective debtor's affairs and conduct, coupled with non-arm's length dealings, can lead to an "insider" designation for a creditor in connection with preference litigation or estate causes of action challenging the priority or validity of a creditor's claims.

Schubert v. Lucent Technologies Inc. (In re Winstar Communications, Inc.), 554 F.3d 382 (3d Cir. 2009).

Hirsch v. Va. Tarricone (In re A. Tarricone, Inc.), 286 B.R. 256 (S.D.N.Y. 2002).

Friedman v. Sheila Plotsky Brokers, Inc. (In re Friedman), 126 B.R. 63 (Bankr. 9th Cir. 1991).

Wilson v. Huffman (In re Missionary Baptist Foundation, Inc.), 712 F.2d 206 (5th Cir. 1983).

In re South Beach Securities, Inc., 376 B.R. 881 (Bankr. N.D. Ill. 2007).

In re Eccles, 393 B.R. 845 (Bankr. W.D. Mo. 2008).

SECTION 1146 REDUX: *PICCADILLY CAFETERIAS* NOT THE LAST WORD AFTER ALL ON CHAPTER 11 TRANSFER TAX EXEMPTION

Mark G. Douglas

The ability to sell assets during the course of a chapter 11 case without incurring the transfer taxes customarily levied on such transactions outside bankruptcy often figures prominently in a potential debtor's strategic bankruptcy planning. However, the circumstances under which a sale and related transactions (*e.g.*, mortgage recordation) qualify for the tax exemption have been a focal point of vigorous dispute in bankruptcy and appellate courts for more than a quarter century, resulting in a split on the issue among the federal circuit courts of appeal and, finally, the U.S. Supreme Court's decision late in 2007 to consider the question.

The Supreme Court resolved that conflict when it handed down its long-awaited ruling on June 16, 2008. By a 7-2 majority, the Court ruled in *State of Florida Dept. of Rev. v. Piccadilly Cafeterias, Inc. (In re Piccadilly Cafeterias, Inc.)*, that section 1146(a) of the Bankruptcy Code establishes "a simple, bright-line rule" limiting the scope of the transfer tax exemption to "transfers made pursuant to a Chapter 11 plan that has been confirmed." Still, judging by a decision recently handed down by a New York bankruptcy court, the Supreme Court's ruling in *Piccadilly* did not end the debate on chapter 11's transfer tax exemption. In *In re New 118th Inc.*, the court ruled that the sale of a chapter 11 debtor's rental properties that had been approved prior to confirmation of a plan but would not close until after confirmation was exempt from transfer tax under section 1146(a) because the sale was necessary to the plan's consummation, as administrative claims could not have been paid without the sale proceeds.

TAX-FREE TRANSFERS UNDER THE BANKRUPTCY CODE

Section 1146(a) of the Bankruptcy Code provides that "[t]he issuance, transfer, or exchange of a security, or the making or delivery of an instrument of transfer under a plan confirmed under section 1129 of [the Bankruptcy Code], may not be taxed under any law imposing a stamp tax or similar tax." A "transfer" includes a sale of property or the grant of a mortgage lien. To qualify for the exemption, the transfer must satisfy a three-pronged test: (i) the tax must be a "stamp or similar" tax; (ii) the tax must be imposed upon the "issuance, transfer, or exchange of a security" or the "making or delivery of an instrument of transfer"; and (iii) the transfer must be "under a plan confirmed" pursuant to section 1129 of the Bankruptcy Code.

Section 1146(a) of the Bankruptcy Code (changed from section 1146(c) as part of the 2005 bankruptcy amendments) serves the dual purpose of providing chapter 11 debtors and prospective purchasers with some measure of tax relief while concurrently facilitating asset sales in bankruptcy and enhancing a chapter 11 debtor's prospects for a successful reorganization. Several areas of controversy have arisen concerning the scope of the section 1146(a) tax exemption. One area of debate concerns whether, to be exempt from taxes, asset transfers must be made as part of a confirmed chapter 11 plan, or whether the exemption may apply to sale transactions occurring at some other time during a bankruptcy case (particularly if the sale is important to the eventual confirmation of a plan).

Chapter 11 of the Bankruptcy Code contemplates the sale of a debtor's assets under two circumstances. First, a plan of reorganization (or liquidation) may provide for the sale of individual assets or even the debtor's entire business. Approval of a sale pursuant to a plan is subject to all of the requirements governing plan confirmation. This means, for example, that creditors whose claims are "impaired" (adversely affected, such as by receiving less than full payment) have the opportunity to veto the sale if they vote in sufficient numbers to reject the plan as a whole and are otherwise successful in preventing it from being confirmed. Selling assets under a plan thus requires higher procedural hurdles and would occur only at the end of the case, when all of the terms of a chapter 11 plan have been developed.

Circumstances may dictate that waiting to sell assets until confirmation of a plan at the end of a chapter 11 case is impossible or imprudent. Accordingly, assets can also be sold at any time during a bankruptcy case under section 363(b) of the Bankruptcy Code. That provision authorizes a trustee or chapter 11 debtor-in-possession, subject to court approval, to "use, sell, or lease, other than in the ordinary course of business, property of the estate." A bankruptcy court will generally approve a proposed asset sale under section 363(b) if the business justification supporting the sale is sound. Section 363(b) sales are an invaluable tool for generating value for a bankruptcy estate that can be used to fund a plan of reorganization or pay creditor claims. Moreover, because assets can be sold free and clear of liens, claims, or other encumbrances under the circumstances delineated in section 363(f), value can be generated quickly (taking advantage of market opportunities) and without the need to resolve most disputes involving the property until sometime later in the case.

Still, courts are sometimes reluctant to use section 363 as a vehicle for selling all, or a substantial portion, of a debtor's assets outside the plan process. The reluctance arises because an asset sale involving substantially all of the assets of the estate is a critical (probably *the* critical) aspect of the debtor's overall reorganization (or liquidation) strategy. While creditors have the right to object to a section 363(b) sale, they do not enjoy the more substantial protections of the chapter 11 plan-confirmation process, even though the transaction may be tantamount to, or dictate certain terms of, a chapter 11 plan.

The interplay between section 363(b) and section 1146 has been a magnet for controversy. The phrase "under a plan confirmed" in section 1146(a) is ambiguous enough to invite competing interpretations concerning the types of sales that qualify for the tax exemption. Before the U.S. Supreme Court examined the issue, four federal circuit courts of appeal had an opportunity to weigh in on whether section 363(b) sales outside the context of a plan qualify for the section 1146 exemption. The remaining decision at the circuit level concerning section 1146 addressed whether transactions involving nondebtors may be exempt.

THE CIRCUITS WEIGH IN

The Second Circuit first addressed this issue more than 20 years ago in *City of New York v. Jacoby-Bender*, articulating the general rule that a sale need not take place as part of confirmation, so long as "consummation" of the plan depends on the sale transaction. Many lower courts have interpreted *Jacoby-Bender* to sanction tax-exempt, pre-confirmation asset sales under section 363(b). Fourteen years later, the Fourth Circuit applied a restrictive approach to tax-exempt asset transfers in chapter 11, concluding in *In re NVR LP* that the term "under" should be construed as "[w]ith the authorization of" a chapter 11 plan. Explaining that the ordinary definition of "under" is "inferior" or "subordinate," the court observed that "we cannot say that a transfer made prior to the date of plan confirmation could be subordinate to, or authorized by, something that did not exist at the date of transfer—a plan confirmed by the court." The Fourth Circuit accordingly ruled that more than 5,000 real property transfers made by NVR during the course of its 18-month-long chapter 11 case did not qualify for the exemption.

In 2003, the Third Circuit Court of Appeals was the next to take up the gauntlet, and it effectively sided with the Fourth Circuit in taking a restrictive view of the section 1146 exemption in *Baltimore County v. Hechinger Liquidation Trust (In re Hechinger Investment Company of Delaware, Inc.)*. Rejecting the expansive interpretation adopted by many lower courts in determining what constitutes a transfer "under" a confirmed plan of reorganization, the court of appeals held that real estate transactions consummated during the debtor's chapter 11 case were not exempt from transfer and recording taxes because the bankruptcy court authorized the sales under section 363, and they occurred prior to confirmation of a plan of reorganization.

The Eleventh Circuit addressed the scope of the section 1146 tax exemption in two rulings, both of which were handed down in the last five years. In the first of those decisions, *In re T.H. Orlando Ltd.*, the court of appeals adopted an expansive approach to section 1146 in examining whether a transfer must involve the debtor and estate property to qualify for the section 1146 safe harbor. Examining the language of section 1146, the Eleventh Circuit concluded that a transfer "under a plan" refers to a transfer "authorized by a confirmed Chapter 11 plan," and a plan "authorizes any transfer that is necessary to the confirmation of the plan." It accordingly ruled that a refinancing transaction that did not involve the debtor or property of its estate, but without which the debtor would not have been able to obtain funds necessary to confirm a plan, was exempt from Florida's stamp tax under section 1146, "irrespective of whether the transfer involved the debtor or property of the estate."

PICCADILLY CAFETERIAS

The Eleventh Circuit had a second opportunity to examine the scope of section 1146 in 2007. In *State of Florida Dept. of Rev. v. Piccadilly Cafeterias, Inc. (In re Piccadilly Cafeterias, Inc.)*, the court of appeals considered whether the tax exemption applies to a sale transaction under section 363(b) of the Bankruptcy Code. Piccadilly Cafeterias, Inc. ("Piccadilly"), a 60-year-old company that was once one of the nation's most successful cafeteria chains, filed a chapter 11 case in 2003 for the purpose of consummating a sale of substantially all of its assets under section 363(b) to Piccadilly Acquisition Corporation ("PAC").

In conjunction with its section 363(b) motion, Piccadilly requested a determination that the sale transaction was exempt from taxes under section 1146. The Florida Department of Revenue ("FDOR"), one of the relevant taxing authorities, opposed both the sale and the transfer tax exemption. Piccadilly also sought approval of a global settlement reached with the unsecured creditors' committee and a committee of its senior noteholders. The settlement resolved the priority of distribution among Piccadilly's creditors and, according to Piccadilly, was in many ways "analogous to confirmation of a plan."

New 118th Inc. indicates that *Piccadilly Cafeterias* was not the last word on the scope of section 1146. The controversy concerning chapter 11's transfer tax exemption endures.

The bankruptcy court approved the sale of Piccadilly's assets to PAC for $80 million and held that the sale was exempt from stamp taxes under section 1146. It also approved the global settlement. Shortly after the sale order became final, Piccadilly filed a liquidating chapter 11 plan, which the bankruptcy court ultimately confirmed over FDOR's objection. FDOR also commenced an adversary proceeding against Piccadilly seeking a declaration that the $39,200 in stamp taxes otherwise payable in connection with the sale was not covered by section 1146. Both Piccadilly and FDOR sought summary judgment.

The bankruptcy court granted summary judgment to Piccadilly, ruling that the asset sale was exempt from stamp taxes under section 1146. The court reasoned that the sale of substantially all of Piccadilly's assets was a transfer "under" its confirmed chapter 11 plan because the sale was necessary to consummate the plan. The district court upheld that determination on appeal. However, it noted in its decision that the parties had addressed their arguments to whether, in general, section 1146 exempts stand-alone sale transactions under section 363(b) from tax, rather than whether the tax exemption applied specifically to the sale of Piccadilly's assets. Thus, the district court concluded that specific application of the exemption to the sale of Piccadilly's assets was an issue not properly before it. Even so, the court expressly affirmed the bankruptcy court's implicit conclusion that section 1146 may apply "where a transfer is made preconfirmation."

FDOR fared no better on appeal to the Eleventh Circuit. Noting that "[t]his court has yet to squarely address whether the [section 1146] tax exemption may apply to preconfirmation transfers," the court of appeals concluded that "the better reasoned approach" is found in *Jacoby-Bender* and *T.H. Orlando*, which looks "not to the timing of the transfers, but to the necessity of the transfers to the consummation of a confirmed plan of reorganization." According to the Eleventh Circuit, the language of section 1146 can plausibly be read to support either of the competing interpretations proffered by the parties. Even so, given the statutory ambiguity, lawmakers' intentions under section 1146 can be divined by reference to other provisions of the Bankruptcy Code that expressly and unambiguously create temporal restrictions, while section 1146 does not. If Congress includes specific language in one part of a statute "but omits it in another section of the same Act," the Eleventh Circuit emphasized, "it is generally presumed that Congress acts intentionally and purposely in the disparate inclusion or exclusion."

Finally, the court of appeals observed, "the strict temporal construction of [section 1146] articulated by the Third and Fourth Circuits ignores the practical realities of Chapter 11 reorganization cases." Even transfers expressly contemplated in a plan, the Eleventh Circuit explained, "will not qualify for the tax exemption unless they occur after the order confirming the plan is entered." According to the court, it is just as likely that a debtor may be required to close on a sale transaction as a condition precedent to the parties' willingness to proceed with confirmation. Rejecting the restrictive approach taken by the Third and Fourth Circuits, the Eleventh Circuit held that the section 1146 tax exemption "may apply to those pre-confirmation transfers that are necessary to the consummation of a confirmed plan of reorganization, which, at the very least, requires that there be some nexus between the pre-confirmation sale and the confirmed plan." The Supreme Court granted FDOR's certiorari petition in December 2007 and issued its ruling in June 2008.

THE SUPREME COURT'S RULING

Writing for the 7-2 majority, Justice Clarence Thomas observed, "While both sides present credible interpretations of § 1146(a), [FDOR] has the better one." He acknowledged that Congress could have used more precise language in the statute to remove any ambiguity concerning its scope. Even so, Justice Thomas characterized the interpretation espoused by Piccadilly (and adopted by the Eleventh Circuit) as less plausible because it "places greater strain on the statutory text than the simpler construction advanced by [FDOR] and adopted by the Third and Fourth Circuits."

Even assuming that the language of section 1146(a) is sufficiently ambiguous to warrant further inquiry, Justice Thomas wrote, the ambiguity must be resolved in FDOR's favor. He rejected Piccadilly's argument that if Congress had intended to limit section 1146(a) to post-confirmation transfers, it would have made its intent plain by including an express temporal limitation in the language of the provision, as it has done elsewhere in the statute. He similarly found unavailing Piccadilly's contention that, based upon other provisions in the Bankruptcy Code, the term "under" preceding "a plan confirmed" in section 1146(a) should be read broadly to mean "in accordance with" rather than "authorized by." It was unnecessary for Congress to include more specific temporal language in section 1146(a), Justice Thomas wrote, "because the phrase 'under a plan confirmed' is most naturally read to require that there be a confirmed plan at the time of the transfer."

The justice also emphasized that even if the Court were to adopt Piccadilly's broad construction of "under" in section 1146(a), it would be unavailing because Piccadilly had not even submitted a chapter 11 plan to the bankruptcy court at the time its assets were sold under section 363(b). Adopting Piccadilly's approach, Justice Thomas observed, would make the tax exemption depend on "whether a debtor-in-possession's actions are consistent with a legal instrument that does not exist—and indeed may not even be conceived of—at the time of the sale." According to Justice Thomas, even reading section 1146(a) in context with other provisions of the statute, "we find nothing justifying such a curious interpretation of what is a straightforward exemption." Contextually speaking, he explained, section 1146(a)'s placement in a subchapter of the Bankruptcy Code entitled "postconfirmation matters" further undermines Piccadilly's argument that the provision was intended to cover pre-confirmation asset transfers.

Justice Thomas then turned to various arguments made by FDOR based upon traditional canons of statutory construction, including the following: (i) Congress's failure to clarify section 1146, despite having amended the Bankruptcy Code several times since 1979 (most recently in 2005, after the rulings in *NVR* and *Hechinger*), indicates that lawmakers saw no reason to modify the provision, as interpreted by the Fourth and Third Circuits; and (ii) federal interference with the administration of a state's taxation scheme is discouraged, such that, consistent with the "federalism canon," articulated by the Supreme Court in *California State Board of Equalization v. Sierra Summit, Inc.*, courts should proceed carefully when asked to recognize an exemption from state taxation that Congress has not clearly expressed. He found the latter to be "decisive" in determining how section 1146(a) should be applied.

Piccadilly's effort to evade the federalism canon, Justice Thomas wrote, "falls well short of the mark because reading § 1146(a) in the manner Piccadilly proposes would require us to do exactly what the canon counsels against." Moreover, he emphasized, Piccadilly premised its entire argument on the idea that section 1146(a) is ambiguous, a foundation that the federalism canon expressly renders inadequate to support any finding that Congress has clearly expressed its intention to provide a transfer tax exemption for pre-confirmation transfers.

Justice Thomas also rejected Piccadilly's contention that section 1146(a) should be interpreted "liberally" in keeping with: (i) chapter 11's twin objectives of preserving going concerns and maximizing property available to satisfy creditors; and (ii) the "remedial" nature of chapter 11 and the Bankruptcy Code as a whole. Far from having a single remedial purpose, Justice Thomas wrote, "Chapter 11 strikes a balance between a debtor's interest in reorganizing and restructuring its debts and the creditors' interest in maximizing the value of the bankruptcy estate." According to Justice Thomas, the Bankruptcy Code also accommodates state interests in regulating property transfers by generally leaving the determination of property rights in estate assets to state law. "Such interests often do not coincide," he observed, concluding that in this case, "[w]e therefore decline to construe the exemption granted by § 1146(a) to the detriment of the State."

Finally, Justice Thomas addressed Piccadilly's argument that construing section 1146(a) to exempt only post-confirmation transfers would amount to an "absurd" policy and ignore the practical realities of chapter 11 cases that increasingly involve pre-confirmation sales as part of a reorganization strategy. Agreeing with the Fourth Circuit's reasoning in *NVR* that Congress struck a reasonable balance in section 1146(a) by making the tax exemption available only in cases where the debtor has successfully confirmed a plan, Justice Thomas wrote, "[W]e see no absurdity in reading § 1146(a) as setting forth a simple, bright-line rule instead of the complex, after-the-fact inquiry Piccadilly envisions." Furthermore, he concluded that "it is incumbent upon the Legislature, and not the Judiciary, to determine whether § 1146(a) is in need of revision." The 7-2 majority of the court accordingly reversed the Eleventh Circuit's judgment and remanded the case below for further proceedings consistent with its ruling. Chief Justice Roberts and Justices Scalia, Kennedy, Souter, Ginsburg, and Alito joined in the majority opinion. Justice Breyer, joined by Justice Stevens, filed a dissenting opinion.

NEW 118TH INC.

According to the bankruptcy court in *New 118th Inc.*, the "bright-line" rule adopted by the Supreme Court in *Piccadilly Cafeterias* does not automatically disqualify pre-confirmation section 363 sales from being tax-exempt under section 1146(a).

In 2007, certain creditors of New 118th Inc. ("New 118"), which owned 21 rental apartment buildings in New York City, filed involuntary chapter 11 petitions against the company and 17 of its affiliates. After entering an order for relief in the cases, the bankruptcy court appointed a chapter 11 trustee to administer the joint estates of New 118 and its affiliated debtors. In April 2008, the trustee entered into an agreement to sell the rental properties for $54 million, subject to higher and better offers, and sought court authority to sell the properties under section 363(b). At the time, the trustee had not yet filed a chapter 11 plan. The trustee explained in his motion for approval of the sale under section 363(b) that he intended to file a liquidating plan but needed to dispose of the properties as quickly as possible and that the transaction was the "linchpin" of the anticipated plan because the sales proceeds would be used to fund the plan.

Contending that the sale was integral to the consummation of the anticipated plan, the trustee maintained that the transaction should be exempt from transfer taxes under section 1146(a). The New York City Department of Finance ("DOF") objected, arguing that the transfer tax exemption did not apply. The bankruptcy court approved the sale motion in June 2008. The trustee filed a liquidating chapter 11 plan the following month. The plan expressly reaffirmed the importance of the sale, which had not yet closed, as an "integral part" of the plan's implementation, stating that the sale "shall be exempt pursuant to section 1146(a) of the Bankruptcy Code from the imposition of any New York state or local deed recording taxes and other similar taxes." DOF objected to confirmation of the plan, arguing that: (i) the Supreme Court's ruling in *Piccadilly Cafeterias* establishes a bright-line test under which the exemption does not apply to a section 363 pre-confirmation sale, even if the sale closes post-confirmation; (ii) the trustee cannot convert a pre-confirmation sale into an exempt post-confirmation sale by filing a plan that incorporates the sale terms and postpones the closing until after confirmation; and (iii) the tax exemption applies only to "reorganization" plans, not plans of liquidation. The bankruptcy court confirmed the plan in

August 2008, reserving decision on the tax exemption issue. The closing on the rental property sale transaction was completed the following month.

The bankruptcy court ultimately ruled that the sale transaction qualified for the section 1146(a) exemption. Explaining that "*Piccadilly* did not address whether the exemption could apply to a pre-confirmation sale that closed post-confirmation," the court ruled that post-confirmation delivery of a deed—a post-confirmation "transfer"—satisfies the Supreme Court's "simple, bright-line rule" regardless of pre-confirmation approval of the sale transaction, because the transfer was not only necessary but essential to consummation of the plan. Without the sale proceeds, the court emphasized, professional fees and other administrative claims could not have been paid in full, precluding confirmation of the trustee's plan under section 1129(a)(9)(A). Thus, the court concluded, the transfers were made "under a plan confirmed" and were exempt from the payment of transfer taxes under section 1146(a).

The bankruptcy court rejected DOF's contention that the exemption can never apply to a pre-confirmation sale under section 363, noting that "*Piccadilly* did not adopt such a rule and nothing in § 1146(a) requires the 'sale' to occur post-confirmation." Finally, the court dismissed DOF's argument that section 1146(a) applies only to plans of reorganization. This argument, the court observed, "confuses 'reorganization,' which includes 'liquidation,' with the separate and distinct concept of 'rehabilitation.' " The court explained that the Bankruptcy Code expressly contemplates a chapter 11 plan providing for "the sale of all or substantially all of the property of the estate, and the distribution of the proceeds of such sale." As such, the court emphasized, a liquidating chapter 11 plan is a permissible form of "reorganization."

OUTLOOK

Chief Bankruptcy Judge Stuart M. Bernstein's ruling in *New 118th Inc.* provides a quantum of solace to chapter 11 debtors in the aftermath of the Supreme Court's landmark ruling in *Piccadilly Cafeterias*, which has been read by many courts, commentators, and practitioners to preclude any transfer tax exemption for pre-confirmation sale transactions under section 363(b). Given the prevalence of pre-confirmation section 363(b) asset sales in chapter 11 cases as a means of generating value for the estate and creditors, *Piccadilly Cafeterias* was decidedly unwelcome news. If obtaining a section 1146 tax exemption is important, the ruling may force debtors to defer major asset divestitures to the end of the case and/or to formulate and seek confirmation of a chapter 11 plan on a much-accelerated basis.

The message borne by *New 118th Inc.* is a positive one for debtors. The ruling provides asset sales that are approved pre-confirmation with the benefit of the tax exemption, so long as the sales transactions do not close until after confirmation of a chapter 11 plan and are necessary to the plan's consummation. In addition, the ruling makes it clear that asset sales that are necessary to consummate a liquidating plan, rather than a plan of reorganization, are eligible for the tax exemption.

New 118th Inc. indicates that *Piccadilly Cafeterias* was not the last word on the scope of section 1146. The controversy concerning chapter 11's transfer tax exemption endures.

State of Florida Dept. of Rev. v. Piccadilly Cafeterias, Inc. (In re Piccadilly Cafeterias, Inc.), 128 S. Ct. 2326 (2008).

In re New 118th Inc., 398 B.R. 791 (Bankr. S.D.N.Y. 2009).

City of New York v. Jacoby-Bender, 758 F.2d 840 (2d Cir. 1985).

In re NVR LP, 189 F.3d 442 (4th Cir. 1999).

Baltimore County v. Hechinger Liquidation Trust (In re Hechinger Investment Company of Delaware, Inc.), 335 F.3d 243 (3d Cir. 2003).

State of Florida v. T.H. Orlando Ltd. (In re T.H. Orlando Ltd.), 391 F.3d 1287 (11th Cir. 2004).

California State Board of Equalization v. Sierra Summit, Inc., 490 U.S. 844 (1989).

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