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Erica M. Ryland and Mark G. Douglas

The devastating consequences of an enduring global recession for businesses and individuals alike have been writ large in headlines worldwide, as governments around the globe scramble to implement assistance programs designed to jump-start stalled economies. Less visible amid the carnage wrought among the financial institutions, automakers, airlines, retailers, newspapers, homebuilders, homeowners, and suddenly laid-off workers is the plight of the nation's cities, towns, and other municipalities. A reduction in the tax base, caused by plummeting real estate values, and a high incidence of mortgage foreclosures, questionable investments in derivatives, and escalating costs (including the higher cost of borrowing due to the meltdown of the bond mortgage industry and the demise of the market for auction-rate securities) have combined to create a maelstrom of woes for U.S. municipalities.

One option available to municipalities teetering on the brink of financial ruin is chapter 9 of the Bankruptcy Code, a relatively obscure legal framework that allows an eligible municipality to "adjust" its debts by means of a plan of adjustment that is in many respects similar to the plan of reorganization that a debtor devises in a chapter 11 case. However, due to constitutional concerns rooted in the Tenth Amendment's preservation of each state's individual sovereignty over its internal affairs, the resemblance between chapter 9 and chapter 11 is limited. One significant difference pertaining to a municipal debtor's ability to modify or terminate

labor contracts with unionized employees was the subject of an important ruling recently handed down by a California bankruptcy court. In *In re City of Vallejo*, the court ruled that section 1113 of the Bankruptcy Code, which delineates the circumstances under which a chapter 11 debtor can reject a collective bargaining agreement, does not apply in chapter 9, such that it would appear to be easier for a municipal debtor to reject a labor agreement.

MUNICIPAL BANKRUPTCY LAW

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.

The present-day legislative scheme for municipal debt reorganizations was implemented in the aftermath of New York City's financial crisis and state government bailout in 1975, but chapter 9 has proved to be of limited utility thus far. Few cities or counties have filed for chapter 9 protection. The vast majority of chapter 9 filings have involved 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 600 municipal bankruptcy petitions have been filed in the more than 60 years since Congress established a federal mechanism for the resolution of municipal debts.

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 the amount of claims in each class 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.

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*, 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."

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 prerequisites

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.

Section 921(c) states that "[a]fter 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 for dismissal ("may dismiss"), section 921(c) has been construed as requiring the dismissal of a petition filed by a debtor that is ineligible for relief under chapter 9. Dismissal of a chapter 9 case is the only option if the debtor is ineligible—the assets of a chapter 9 debtor cannot be liquidated involuntarily.

CONSTITUTIONAL COMPROMISES

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—and the significant limitation—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 under chapter 9 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 is not subject to the reporting requirement and other general duties of a chapter 11 debtor.

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.

As with chapter 11, the raison d'être of chapter 9 is the confirmation of a plan (either consensual or otherwise), but with one significant difference noted earlier—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.

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.

REJECTION OF LABOR CONTRACTS IN BANKRUPTCY

Section 365 of the Bankruptcy Code allows a bankruptcy trustee or chapter 11 debtor-in-possession to assume or reject most kinds of contracts or agreements that, as of the bankruptcy filing date, are "executory" in the sense that both parties to the contract have a continuing obligation to perform. For most kinds of contracts, the bankruptcy court will authorize assumption or rejection, provided it is

demonstrated that either course of action represents an exercise of sound business judgment.

Until 1984, courts struggled to determine whether the same standard or a more stringent one should govern the decision to reject a collective bargaining agreement. The U.S. Supreme Court answered that question in 1984, ruling in *NLRB v. Bildisco & Bildisco* that a labor agreement can be rejected under section 365 if it burdens the estate, the equities favor rejection, and the debtor made reasonable efforts to negotiate a voluntary modification without any likelihood of producing a prompt satisfactory solution. The court also held (by a five-to-four majority) that a bargaining agreement in bankruptcy is "no longer immediately enforceable, and may never be enforceable again."

Congress changed that later the same year, when it enacted section 1113 of the Bankruptcy Code in response to a groundswell of protest from labor interests. Section 1113 provides that the court "shall" approve an application to reject a bargaining agreement only if:

- The debtor makes a proposal to the authorized representative of the employees covered by the agreement;
- The authorized representative has refused to accept the debtor's proposal without good cause; and
- The balance of the equities clearly favors rejection of the agreement.

The provision ensures that a chapter 11 debtor-employer cannot unilaterally rid itself of its labor obligations and instead mandates good-faith negotiations with the union before rejection may be approved. To that end, section 1113 carefully spells out guidelines for any proposal presented by the debtor to the authorized labor representative. Underlying these guidelines is the premise that all parties must exercise their best efforts to negotiate in good faith to reach mutually satisfactory modifications to the bargaining agreement and that any modification proposal must treat all creditors, the debtor, and other stakeholders fairly. Each proposal must be based on the most complete and reliable information available and must "provide[] for those necessary modifications in the employees['] benefits and protections that are necessary to permit the reorganization of the debtor."

As the financial problems of municipalities continue to mount, there may be a significant surge in chapter 9 filings. The additional leverage afforded to municipal debtors with labor contracts by the court's ruling in *Vallejo* may make chapter 9 even more attractive.

SECTION 1113 INAPPLICABLE IN CHAPTER 9

Section 1113, however, does not apply in chapter 9 cases—it was conspicuously omitted from the list of Bankruptcy Code provisions incorporated into chapter 9 under section 901. Although the reason for the omission is unclear, commentators have suggested that Congress excluded the provision due to constitutional concerns, opting to leave to the states, when authorizing municipalities to resort to chapter 9, the decision as to whether and under what circumstances a collective bargaining agreement with a municipal debtor can be modified. In 1991, Congress considered adding a provision to chapter 9 that would have required a municipal debtor to exhaust state labor law procedures before rejecting a collective bargaining agreement. However, the proposed bill, denominated the Municipal Employee Protection Amendments of 1991, H.R. 3949, 102 Cong. (1991), died in committee and was never enacted into law. Thus, it was unclear which 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.

ORANGE COUNTY

The California bankruptcy court presiding over the chapter 9 case of Orange County, California, purported to answer that question in 1995. With a population exceeding 2.8 million, Orange County filed the largest chapter 9 case in U.S. history in 1994 after more than $1.6 billion in losses in its investment pools precipitated an acute and immediate financial crisis. Facing a projected budget shortfall of approximately $172 million, the management council appointed to devise cost-cutting measures recommended that many of the rights of county

employees under various memoranda of understanding specifying wages, hours and terms, and conditions of employment be eliminated. Ten county-employee organizations that had formed a coalition to oppose the resolution sued the county in state court to enforce the labor contracts. That litigation was later removed to the bankruptcy court, which conducted a hearing on the coalition's emergency request for an injunction preventing permanent employee layoffs.

The bankruptcy court granted the injunction. Orange County argued that the Supreme Court's ruling in *Bildisco* gives a municipal debtor the flexibility to make unilateral changes to its collective bargaining agreements because section 1113 does not apply in chapter 9 cases. The coalition countered that state rather than federal law should apply, consistent with the dictates of sections 903 and 904 of the Bankruptcy Code, and that California statutory and case law provide a mechanism by which municipalities and its employees are to negotiate and resolve their differences. The coalition argued that under the California Supreme Court's 1979 ruling in *Sonoma County Organization of Public Employees v. County of Sonoma*, a municipality must satisfy a four-part test before impairing employees' rights under a bargaining agreement on the basis of an emergency:

(1) a declared emergency must be based on an adequate factual foundation;

(2) the agency's action must be designed to protect a basic social interest and not benefit a particular individual;

(3) the law must be appropriate for the emergency and obligation; and

(4) the agency decision must be temporary, limited to the immediate exigency that caused the action.

The bankruptcy court in *County of Orange* concluded that "*Bildisco* applies in Chapter 9 since Congress has had numerous opportunities to limit its effect by incorporating § 1113 into Chapter 9."

Even so, the court emphasized, this does not mean that a municipality in bankruptcy can unilaterally breach a collective bargaining agreement with its unions without limitations. According to the bankruptcy court, "any unilateral action by a municipality to impair a contract with its employees must satisfy … [the *Sonoma*] factors if not as a legal matter, [then] certainly from an equitable standpoint." The court explained that *Bildisco* does not excuse a municipality from complying with applicable state law. Although unilateral action may be justified in an emergency, the court concluded, Orange County, having declared an emergency, was obligated to satisfy the *Sonoma* factors before taking steps to modify, breach, or terminate its collective bargaining agreements:

> Chapter 9 recognizes the interests of the state and a proper balance between state and federal interests. This balance requires that when modifying contractual rights under municipal collective-bargaining agreements, municipalities must view unilateral action as a last resort.

CITY OF VALLEJO

Bankruptcy Judge Michael S. McManus recently rejected this approach in *City of Vallejo*. Vallejo, a city located in Solano County, California, with 117,000 residents, filed for chapter 9 protection on May 23, 2008, after the deficit in its general operating fund ballooned to $17 million due to significantly decreased revenues from property taxes, sales taxes, assessments, and fees. Less than one month afterward, Vallejo moved to reject collective bargaining agreements with four groups of unionized employees: police officers, firefighters, electrical workers, and administrative and managerial personnel. The city and two of the affected unions ultimately reached a settlement, leaving rejection motions pending with respect to the bargaining agreements with the firefighters and electrical workers. According to the City of Vallejo, the standard for rejection articulated by the Supreme Court in *Bildisco* governs its request for relief because section 1113 does not apply in chapter 9 cases.

After closely examining the constitutional underpinnings and legislative history of chapter 9, Judge McManus ruled that "Section 1113 is not applicable in chapter 9 cases, and a chapter 9 debtor is not required to comply with it in order to reject an executory collective bargaining agreement." According to the judge, Congress enacted section 903 to harmonize two

competing interests—"reservation of powers to the states and the supremacy of federal bankruptcy law." Together with the Bankruptcy Code's provisions governing eligibility to be a debtor, he explained, section 903 permits states "to act as gatekeepers to their municipalities' access to relief under the Bankruptcy Code." When a state authorizes its municipalities to file for chapter 9 relief, Judge McManus emphasized, "it declares that the benefits of chapter 9 are more important than state control over its municipalities." This means that any state authorizing access to chapter 9 "must accept chapter 9 in its totality" rather than cherry-picking some provisions and discarding others. As such, the judge concluded, if a municipality is authorized by a state to file a chapter 9 petition, the municipality "is entitled to fully utilize 11 U.S.C. § 365 to accept or reject its executory contracts."

Judge McManus found that the California statute authorizing chapter 9 relief for California municipalities provides the "broadest possible state authorization for municipal bankruptcy proceedings." Moreover, he concluded that no California law imposes pre-filing limitations or post-filing restrictions requiring compliance with public-sector laws. Judge McManus ruled that a municipal debtor's decision to reject a collective bargaining agreement is governed not by California labor law but by section 365 of the Bankruptcy Code. Furthermore, he noted, any California law that purported to superimpose California labor laws onto section 365 would be unconstitutional by operation of the Bankruptcy Clause (Art. I, § 8, cl. 4), the Supremacy Clause (Art. VI, cl. 2), and the Contracts Clause (Art. VI) of the U.S. Constitution. Judge McManus flatly rejected the assertion that *Sonoma County* or any state labor law provides the standard controlling rejection of Vallejo's collective bargaining agreements, explaining that any such laws are preempted by section 365.

OUTLOOK

Despite his conclusion that neither section 1113 nor California labor law applies to Vallejo's motion to reject its two remaining bargaining agreements, Judge McManus deferred his ruling on the merits of the motion "to give the parties every reasonable opportunity" to reach a settlement and issued an order on April 27, 2009, directing the parties to mediate the dispute. Given the less stringent standard for rejection under section 365 and *Bildisco*, Vallejo's unions now have a powerful incentive to come to terms. However, the ruling is not a positive development in all respects for municipal debtors. In pre-section 1113 cases, courts recognized that rejection of a collective bargaining agreement under section 365 created an unsecured pre-petition claim for damages by operation of section 502(g). Courts applying section 1113 disagree as to whether rejection of a labor agreement gives rise to any claim for damages, principally because section 502(g) refers to contract rejection under section 365, but not under section 1113. Thus, while it may be easier for a municipality to reject a collective bargaining agreement under section 365, the consequences of rejection may be less palatable.

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 are a rarity compared to business 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 the negative impact, perceived or otherwise, on a municipality's future ability to raise capital in the debt markets. Also, chapter 9's insolvency requirement appears to discourage municipal bankruptcy filings.

Until Vallejo's chapter 9 filing in 2008, 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. When Vallejo filed its chapter 9 petition last year, 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 amid the worst housing slump in the U.S. in more than a quarter century. Orange County was the other prominent local government to have taken the plunge. Having filed the largest chapter 9 case in U.S. history and confirmed a plan in 1995, Orange County stands alone as the only large debtor to have navigated chapter 9 so far.

NEWSWORTHY

Corinne Ball (New York) and ***David G. Heiman (Cleveland)*** are heading up a team of Jones Day professionals counseling Chrysler Group LLC and 25 affiliates in connection with their voluntary chapter 11 filings in New York on April 30, 2009. Auburn Hills, Michigan-based Chrysler, which was founded in 1925 and is today the third-largest automaker in the U.S., with more than 55,000 employees, filed for chapter 11 protection to effectuate a sale of most of its operations under section 363 of the Bankruptcy Code to a new entity to be owned by Italian automaker Fiat SpA, as the lead investor, as well as a voluntary employee beneficiary association of Chrysler employees represented by the United Autoworkers and the U.S. and Canadian governments. After the bankruptcy court's June 1, 2009, order approving the sale was reviewed on an expedited basis and affirmed by the U.S. Court of Appeals for the Second Circuit, the U.S. Supreme Court denied requests for a stay of the bankruptcy court's order, and the sale transaction transferring Chrysler's business as a going concern to "New Chrysler" was consummated on June 10, 2009. The other practice attorneys involved in the representation are ***Jeffrey B. Ellman (Atlanta)***, ***Richard H. Engman (New York)***, ***Pedro A. Jimenez (New York)***, ***Brett P. Barragate (New York)***, ***Mark A. Cody (Chicago)***, ***Kevyn D. Orr (Washington)***, ***Robert W. Hamilton (Columbus)***, ***Veerle Roovers (New York)***, ***Nathan P. Lebioda (New York)***, ***Jason M. Cover (New York)***, ***Joseph M. Tiller (Chicago)***, ***Robert E. Krebs (Chicago)***, ***Timothy W. Hoffmann (Chicago)***, and ***Thomas A. Wilson (Cleveland)***.

The Firm recently announced the expansion of its global Business Restructuring & Reorganization Practice with the arrival of seven lawyers from Kirkland & Ellis. ***Richard L. Wynne*** and ***Bennett L. Spiegel*** join as partners, and ***Lori Sinanyan*** and ***Erin N. Brady*** join as of counsel in the Firm's Los Angeles Office. Also joining are two associates in Los Angeles, ***Christopher M. Healey*** and ***Stacie D. Torres***, and one associate in New York, ***Lance Miller***. The Firm's U.S. West Coast practice is now one of the most substantial in California, with five partners, three of counsel, and two members of the American College of Bankruptcy.

Corinne Ball (New York), ***Peter J. Benvenutti (San Francisco)***, ***Jeffrey B. Ellman (Atlanta)***, ***Brad Erens (Chicago)***, ***Gregory M. Gordon (Dallas)***, ***David G. Heiman (Cleveland)***, ***Tobias S. Keller (San Francisco)***, ***Paul D. Leake (New York)***, ***Heather Lennox (Cleveland)***, and ***Charles M. Oellermann (Columbus)*** were recognized in *Chambers USA 2009* as being among "America's Leading Lawyers for Business" in the field of Bankruptcy/Restructuring.

Paul D. Leake (New York), ***David G. Heiman (Cleveland)***, and ***Erica M. Ryland (New York)*** were listed as leading individuals in the field of Corporate Restructuring in *The Legal 500 USA 2009*.

Corinne Ball (New York), ***Brad Erens (Chicago)***, and ***Peter J. Benvenutti (San Francisco)*** were identified in the Restructuring and Insolvency category as "Highly Recommended" lawyers in Practical Law Company's *Which lawyer? 2009*.

An article written by ***Erica M. Ryland (New York)*** and ***Mark G. Douglas (New York)*** entitled "Municipalities In Ch. 9: Rejecting Labor Agreements" appeared in the April 8 editions of *Bankruptcy Law360* and *Labor Law360*.

Bennett L. Spiegel (Los Angeles), ***Richard L. Wynne (Los Angeles)***, ***Lori Sinanyan (Los Angeles)***, and ***Erin N. Brady (Los Angeles)*** are coauthors of a book published by the American Bankruptcy Institute in June 2009 entitled *A Comparison Guide for 363 Sales*.

David G. Heiman (Cleveland) and ***Volker Kammel (Frankfurt)*** received the "Recommended" designation in the Restructuring and Insolvency category in Practical Law Company's *Which lawyer? 2009*.

Adam Plainer (London) was awarded the "Recognised" designation in the Restructuring and Insolvency category in Practical Law Company's *Which lawyer? 2009*.

Corinne Ball (New York), ***Peter J. Benvenutti (San Francisco)***, ***Brad Erens (Chicago)***, ***Gregory M. Gordon (Dallas)***, ***David G. Heiman (Cleveland)***, ***Paul D. Leake (New York)***, ***Heather Lennox (Cleveland)***, and ***Charles M. Oellermann (Columbus)*** were listed in *Super Lawyers*' 2009 "Corporate Counsel Edition" in the field of Bankruptcy & Creditor/Debtor Rights by Law & Politics.

Adam Plainer (London) and ***Volker Kammel (Frankfurt)*** were listed as leading individuals in the field of Corporate Restructuring and Insolvency in *The Legal 500 2009*.

Yuichiro Mori (Tokyo) was listed as a leading individual in the field of dispute resolution in *The Legal 500 2009*.

On May 7, ***Carl Black (Cleveland)*** gave a presentation in New Orleans to the MAPI Manufacturers Alliance's Strategic Planning and Development Council concerning "Distressed Asset Transactions: What Strategic Buyers Need to Know."

An article written by ***Michael Rutstein (London)*** entitled "Spoilt for Choice? Recognition in England of Overseas Bankruptcy Procedures" was published in the July edition of *Corporate Rescue and Insolvency*.

That may change soon. Jefferson County, Alabama, a county perched in the foothills of the Appalachian Mountains with 660,000 residents and home to the state's largest city (Birmingham), may supplant Orange County as the largest chapter 9 debtor (in dollar terms) in our nation's history. Jefferson County entered into a series of complex bond swap transactions over the past decade worth $5.4 billion after incurring a mountain of debt to finance a new sewer system. The county is now staggering under $3.2 billion in debt (or roughly $4,800 per resident) that it cannot pay. A combination of defaulted debt and the legacy of widespread municipal corruption in connection with the sewer project may soon propel the county into chapter 9, a course of action recommended on March 24, 2009, by county commissioners overseeing county finances, tax collection, and infrastructure. In the middle of May, Jefferson County officials reviewed plans to lay off up to 1,200 county employees, close satellite courthouses, and cancel hundreds of contracts to make up for the potential loss of the county's occupational tax, meaning that more than a third of the county's 3,000-plus employees would be out of work.

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 under chapter 9 to bind dissenting creditors without obtaining voter approval may make that option preferable. Thus, as the financial problems of municipalities continue to mount, there may be a significant surge in chapter 9 filings. The additional leverage afforded to municipal debtors with labor contracts by the court's ruling in *Vallejo* may make chapter 9 even more attractive.

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 is unlikely to be obtained at any favorable rate of interest. 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.

In re City of Vallejo, 403 B.R. 72 (Bankr. E.D. Cal. 2009).

In re County of Orange, 179 B.R. 177 (Bankr. C.D. Cal. 1995).

NLRB v. Bildisco & Bildisco, 465 U.S. 513 (1984).

Sonoma County Organization of Public Employees v. County of Sonoma, 591 P.2d 1 (1979).

A version of this article appeared in the April 8, 2009, editions of *Bankruptcy Law360* and *Labor Law360*. It has been reprinted here with permission.

DELAWARE BANKRUPTCY COURT REJECTS TRIANGULAR SETOFF

Jason M. Cover and Mark G. Douglas

In a recent decision, a Delaware bankruptcy court ruled on the permissibility of "triangular setoffs" pursuant to section 553 of the Bankruptcy Code. In *In re SemCrude, L.P.*, the court held that triangular setoffs do not meet the mutuality requirements of section 553, such that a creditor could not effect a triangular setoff of the amounts owed among it and three affiliated debtors, despite pre-petition contracts that expressly contemplated multiparty setoff.

SETOFF RIGHTS IN BANKRUPTCY

Section 553 of the Bankruptcy Code provides, subject to certain exceptions, that the Bankruptcy Code "does not affect any right of a creditor to offset a mutual debt owing by such creditor to the debtor that arose before the commencement of the case under this title against a claim of such creditor against the debtor that arose before the commencement of the case ... ." A creditor is precluded by the automatic stay from exercising its setoff rights without bankruptcy court approval. The stay, however, merely suspends the exercise of such a setoff pending an orderly examination of the respective rights of the debtor and the creditor by the court, which will generally permit the setoff if the requirements under applicable law are met, except under circumstances where it would be inequitable to do so.

As articulated by the U.S. Supreme Court as early as 1913, setoff avoids the "absurdity of making A pay B when B owes A." Debts are considered mutual when they are due to and from the same persons in the same capacity. An exception to this strict mutuality requirement may exist in cases involving "triangular setoff," the provenance of which is commonly traced (rightly or wrongly) to a 1964 ruling construing section 68(a) of the former Bankruptcy Act of 1898 by the Seventh Circuit Court of Appeals in *Inland Steel Co. v. Berger Steel Co. (In re Berger Steel Co.)*. In this situation, A might have a relationship with B and C, where B and C are related parties. Triangular setoff occurs when A owes B, and A attempts to set off such amount with amounts C owes to A. The validity of triangular setoff in the bankruptcy context, as distinguished from under state contract or common law, is subject to debate, given the lack of mutuality involved. A Delaware bankruptcy court had an opportunity to consider this controversial issue in *SemCrude*.

SEMCRUDE

Energy-industry services company SemCrude, L.P. ("SemCrude"), and various direct and indirect subsidiaries (collectively, the "debtors"), including SemFuel, L.P. ("SemFuel"), and SemStream, L.P. ("SemStream"), filed voluntary petitions for chapter 11 protection in Delaware in 2008. Prior to the petition date, Chevron USA Inc. ("Chevron") entered into separate contracts with SemCrude, SemFuel, and SemStream, respectively. The contracts provided for the purchase of crude oil, gasoline, butane, isobutene, and propane. The three contracts contained or were governed by identical netting provisions that provided:

> In the event either party fails to make a timely payment of monies due and owing to the other party, or in the event either party fails to make timely delivery of product or crude oil due and owing to the other party, the other party may offset any deliveries or payments due under this or any other agreement between the parties and their affiliates.

On the petition date, Chevron owed a balance of $1.4 million to SemCrude, while SemFuel owed Chevron $10.2 million and SemStream owed Chevron $3.3 million. Chevron claimed that pursuant to the terms of the contracts, the amount it owed could be set off, and it sought relief from the automatic stay to effect the setoff. The debtors, the official committee of unsecured creditors, and a number of individual creditors objected, citing the requirement of section 553 of the Bankruptcy Code that debts must be "mutual" in order to be set off. Chevron countered that either its pre-petition contracts with the debtors satisfied the mutuality requirement or the Bankruptcy Code allowed the parties to contract around the mutuality requirement by providing for setoffs across affiliates.

In determining whether an agreement that contemplates triangular setoff can create mutuality under section 553, the bankruptcy court scrutinized the meaning of the term "mutual

debt." Finding that the nature of mutuality under section 553 is well settled, the court concluded that "debts are considered 'mutual' only when they are due to and from the same persons in the same capacity." "Put another way," the court explained, "mutuality requires that each party must own his claim in his own right severally, with the right to collect in his own name against the debtor in his own right and severally." In light of this definition, the court concluded that "mutuality cannot be supplied by a multi-party agreement contemplating a triangular setoff."

If followed, *SemCrude* would eliminate triangular setoff, at least where the contracts at issue are not subject to a Bankruptcy Code safe-harbor provision, such as those that apply to financial contracts.

The bankruptcy court rejected Chevron's contention that parties could contract around section 553's mutuality requirement. In its motion, Chevron cited a line of cases decided under both the Bankruptcy Code and the Bankruptcy Act of 1898 that appeared to support the proposition that section 553 could be circumvented by a pre-petition contract. Each case cited by Chevron to support triangular setoff could be traced either directly or indirectly to the Seventh Circuit's ruling in *Berger Steel*. In *Berger Steel*, a party sought to satisfy the mutuality requirement by means of an alleged oral agreement for triangular setoff. The court, upholding the bankruptcy referee's ruling that no agreement existed, rejected the setoff. Acknowledging that some previous cases allowed a triangular setoff to be taken pursuant to a valid contract, the court emphasized that each of these cases was decided under state law or the common law of equitable receivership, not under the restrictive language of the Bankruptcy Act. However, by factually distinguishing its ruling from other instances where triangular setoff was allowed, the Seventh Circuit invited later courts to cite *Berger Steel* as precedent for circumvention of section 553's mutuality requirement by contract.

In *SemCrude*, the court rejected *Berger Steel* as authority for the proposition that nonmutual setoff provisions in a contract can be enforced against a debtor. Addressing other decisions that rely on *Berger Steel*, the court noted that none of these cases actually upheld or enforced an agreement for a triangular setoff. Rather, the rulings simply recognized the possibility of an exception for pre-petition contracts contemplating triangular setoff in the course of denying setoff or finding mutuality.

Finding no actual precedent for enforcing nonmutual setoff, the court focused on the plain language of section 553(a), which in its view clearly and unambiguously requires mutuality. Furthermore, the court found that nonmutual setoff would be contrary "to the principle of equitable distribution that lies at the heart of the Code," because "one creditor or a handful of creditors could unfairly obtain payment from a debtor at the expense of the debtor's other creditors, thereby upsetting the priority scheme of the Code and reducing the amount available for distribution to all creditors."

The court distinguished setoff from a guarantee relationship, explaining that, unlike in a guarantee situation, setoff does not give rise to a debt that is due from one party to the other, nor a right to collect. When a setoff right is exercised, the court emphasized, the parties' receivables are merely reduced or eliminated as between the same parties. As such, the court concluded, although Chevron might retain privity of contract by reason of its agreements with SemCrude, SemFuel, and SemStream, the outstanding obligations under such contracts were not mutual for purposes of section 553.

OUTLOOK

According to *SemCrude*, absent piercing of the corporate veil or substantive consolidation of affiliated debtors' estates, the mutuality requirement precludes triangular setoffs in bankruptcy. However, the legitimacy of a triangular setoff even in cases of substantive consolidation or veil piercing is open to debate, at least in Delaware, given the Delaware district court's December 2008 ruling in *In re Garden Ridge Corp.* In *Garden Ridge*, the court affirmed a decision of the bankruptcy court refusing to permit a creditor to invoke a triangular-setoff right despite the prior substantive consolidation of affiliated debtors' bankruptcy estates, remarking that "substantive consolidation cannot create mutuality where it did not otherwise exist." Thus, parties seeking to avoid the setoff problem in transactions involving multiple related obligors may be better served by relying on cross-collateralization and/or guarantees.

If followed, *SemCrude* would eliminate triangular setoff, at least where the contracts at issue are not subject to a Bankruptcy Code safe-harbor provision, such as those that apply to financial contracts. The safe-harbor provisions of the Bankruptcy Code suggest that where triangular setoff is being exercised under a contract that is protected by the safe harbor, the mutuality requirement of section 553(a) does not apply. In fact, on January 20, 2009, Chevron asked the bankruptcy court to reconsider its order denying triangular setoff, arguing that the contracts at issue are "forward contacts" and/or "swap agreements" and are therefore entitled to the protections of the safe-harbor provisions of the Bankruptcy Code. On March 20, the bankruptcy court denied the motion to reconsider, based on Chevron's failure to raise the safe-harbor provisions in its initial moving papers. Chevron thereafter appealed the bankruptcy court's initial ruling. Thus, the fate of triangular setoff in bankruptcy may rest in the hands of the Delaware district court or perhaps even the Third Circuit Court of Appeals.

In re SemCrude, L.P., 399 B.R. 388 (Bankr. D. Del. 2009).

Studley v. Boylston Nat. Bank, 229 U.S. 523 (1913).

Inland Steel Co. v. Berger Steel Co. (In re Berger Steel Co.), 327 F.2d 401 (7th Cir. 1964).

In re Garden Ridge Corp., 399 B.R. 135 (D. Del. 2008).

CHAPTER 15 IN PRACTICE:

BANKRUPTCY COURT LACKS JURISDICTION TO ADJUDICATE AVOIDANCE ACTIONS IN CHAPTER 15 UNDER U.S. OR FOREIGN LAW

Pedro Jimenez and Mark G. Douglas

April 17, 2009, marked the three-and-one-half-year anniversary of the effective date of chapter 15 of the Bankruptcy Code, which was enacted as part of the comprehensive bankruptcy reforms implemented under the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005. Governing cross-border bankruptcy and insolvency cases, chapter 15 is patterned after the Model Law on Cross-Border Insolvency (the "Model Law"), a framework of legal principles formulated by the United Nations Commission on International Trade Law in 1997 to deal with the rapidly expanding volume of international insolvency cases. The Model Law has now been adopted in one form or another by 15 nations or territories.

The jurisprudence of chapter 15 has evolved rapidly since 2005, as courts have transitioned in relatively short order from considering the theoretical implications of a new legislative regime governing cross-border bankruptcy and insolvency cases to confronting the new law's real-world applications. An important step in that evolution was the subject of a ruling recently handed down by a Mississippi district court. In *Fogerty v. Condor Guaranty, Inc. (In re Condor Insurance Limited (In Official Liquidation))*, the court held that unless the representative of a foreign debtor seeking to avoid pre-bankruptcy asset transfers *under either U.S. or foreign law* first commences a case under chapter 7 or 11 of the U.S. Bankruptcy Code, a bankruptcy court lacks subject-matter jurisdiction to adjudicate the avoidance action.

PROCEDURES AND RELIEF UNDER CHAPTER 15

Under chapter 15, a duly accredited representative of a foreign debtor may file a petition in a U.S. bankruptcy court seeking "recognition" of a "foreign proceeding." "Foreign proceeding" is defined as:

> a collective judicial or administrative proceeding in a foreign country, including an interim proceeding, under a law relating to insolvency or adjustment of debt in which proceeding the assets and affairs of the debtor are subject to control or supervision by a foreign court, for the purpose of reorganization or liquidation.

Because more than one bankruptcy or insolvency proceeding may be pending against the same foreign debtor in different countries, chapter 15 contemplates recognition in the U.S. of both a "main" proceeding—a case pending in whatever country contains the debtor's "center of main interests"—and "nonmain" proceedings, which may have been commenced in countries where the debtor merely has an "establishment."

Upon recognition of a foreign "main" proceeding, certain provisions of the Bankruptcy Code automatically come into force, while others may be deployed in the bankruptcy court's discretion by way of "additional assistance" to the foreign bankruptcy case. Among these are the automatic stay (or an equivalent injunction) preventing creditor collection efforts with respect to the debtor or its assets located in the U.S. (section 362, subject to certain enumerated exceptions); the right of any entity asserting an interest in the debtor's U.S. assets to "adequate protection" of that interest (section 361); the power to avoid unauthorized post-recognition asset transfers (section 549); and restrictions on the debtor's ability to use, sell, or lease its U.S. property outside the ordinary course of its business (section 363). In contrast, if the foreign proceeding is recognized as a "nonmain" proceeding, then the bankruptcy court may, but is not required to, grant a broad range of provisional and other relief designed to preserve the foreign debtor's assets or otherwise provide assistance to a main proceeding pending elsewhere.

Once a foreign main proceeding is recognized by the bankruptcy court, the foreign representative is authorized to operate the debtor's business in much the same way as a chapter 11 debtor-in-possession. He can also commence a full-fledged bankruptcy case under any other chapter of the Bankruptcy Code, so long as the foreign debtor is eligible to file for bankruptcy in the U.S. and the debtor has U.S. assets.

The foreign representative in a recognized chapter 15 case may intervene in any court proceedings in the U.S. in which the foreign debtor is a party, and it can sue and be sued in the U.S. on the foreign debtor's behalf. The representative is also conferred with some of the powers given to a bankruptcy trustee under the Bankruptcy Code, although those powers do not include the ability to invalidate pre-bankruptcy preferential or fraudulent asset transfers or obligations, unless a case is pending with respect to the foreign debtor under another chapter of the Bankruptcy Code.

This limitation is spelled out in sections 1521 and 1523 of the Bankruptcy Code. Section 1521(a)(7) provides that upon recognition of a foreign proceeding, the court may grant "any appropriate relief," including "additional relief that may be available to a trustee, *except for relief available under sections 522, 544, 545, 547, 548, 550, 553, and 724(a).*" Section 1523 authorizes the bankruptcy court to order relief necessary to avoid acts that are "detrimental to creditors," providing that upon recognition of a foreign proceeding, a foreign representative has "standing in a case concerning the debtor *under another chapter of this title* to initiate actions under sections 522, 544, 545, 547, 548, 550, 553, and 724(a)." The referenced provisions of the Bankruptcy Code pertain generally to a bankruptcy trustee's powers to avoid pre-bankruptcy transfers that are either preferential or fraudulent.

The legislative history of sections 1521 and 1523 provide as follows:

> [Section 1521] follows article 21 of the Model Law, with detailed changes to conform to United States law. The exceptions in subsection (a)(7) relate to avoiding powers. The foreign representative's status as to such powers is governed by section 1523 below.
>
> * * * *
>
> [Section 1523] follows article 23 of the Model Law, with wording to fit it within procedure under this title. It confers standing on a recognized foreign representative to assert an avoidance action but only in a pending case under another chapter of this title.

> The Model Law is not clear about whether it would grant standing in a recognized foreign proceeding if no full case were pending. This limitation reflects concerns raised by the United States delegation during the UNCITRAL debates that a simple grant of standing to bring avoidance actions neglects to address very difficult choice of law and forum issues. This limited grant of standing in section 1523 does not create or establish any legal right of avoidance nor does it create or imply any legal rules with respect to the choice of applicable law as to the avoidance of any transfer of obligation. The courts will determine the nature and extent of any such action and what national law may be applicable to such action.

H.R. Rep. 109-31(I), at 178–79 (2005) (footnotes omitted). In *Condor Insurance*, the court considered whether sections 1521 and 1523 preclude a foreign representative in a chapter 15 proceeding from seeking to avoid transfers *under non-U.S. law* without first commencing a chapter 7 or 11 case with respect to the debtor.

CONDOR INSURANCE

Condor Insurance, Limited ("Condor"), is a corporation organized under the laws of the Federation of St. Kitts and Nevis that formerly operated an insurance and surety bond business. Condor became the subject of a winding-up petition under Nevis law in 2007. The company's court-appointed liquidators filed a petition the following year in the U.S. for recognition of the Nevis winding-up proceeding under chapter 15. After the Mississippi bankruptcy court entered an order recognizing the winding-up as a foreign main proceeding under chapter 15, the liquidators commenced an adversary proceeding in the bankruptcy court seeking to avoid as fraudulent transfers aggregating more than $313 million to Condor affiliates and principals. The defendants moved to dismiss, claiming that the bankruptcy court lacked jurisdiction to grant the relief requested. The bankruptcy court agreed.

On appeal to the district court, the liquidators argued that the language of sections 1521 and 1523 clearly indicates that foreign representatives are prohibited from utilizing certain sections of the U.S. Bankruptcy Code to avoid transfers but are not precluded from relying on foreign law to do so. The district court concluded that "the plain language of the statutes does not specifically address the use of avoidance powers under foreign law." Even so, the court emphasized, "the choice of law that is to be applied to a lawsuit is determined by a court having jurisdiction over the case, and the parties are not permitted to choose whatever law they wish when filing a lawsuit."

Condor Insurance is indicative of the kinds of challenges faced by U.S. courts in fleshing out the details of a relatively new and untested legislative framework. The ruling may also illustrate that despite the many years devoted by lawmakers, restructuring professionals, and international law experts to the arduous task of devising a workable framework of rules applying to cross-border bankruptcy cases, questions linger regarding how the rules are supposed to work.

According to the district court, section 1521 speaks to the "types of powers and relief" that are available to a foreign representative, and lawmakers arguably referred to specific provisions of the Bankruptcy Code merely "to specify the types of powers that foreign representatives do not have." Given its conclusion that the express language of the provisions is ambiguous, the district court examined their legislative history. On the basis of that inquiry, the court concluded that sections 1521(a)(7) and 1523 "are intended to exclude all of the avoidance powers specified, under either United States or foreign law, unless a Chapter 7 or 11 bankruptcy proceeding is instituted." A contrary determination, the court explained, "would conflict with Congress' expressed desire that courts make the choice of law determination in a full bankruptcy proceeding." It accordingly affirmed the ruling below.

OUTLOOK

Condor Insurance is indicative of the kinds of challenges faced by U.S. courts in fleshing out the details of a relatively new and untested legislative framework. The ruling may also illustrate that despite the many years devoted by lawmakers,

restructuring professionals, and international law experts to the arduous task of devising a workable framework of rules applying to cross-border bankruptcy cases, questions linger regarding how the rules are supposed to work. For example, notwithstanding the district court's reasoning in *Condor Insurance*, it is not clear, based upon the express language of chapter 15 and its brief legislative history, whether lawmakers intended to preclude actions to avoid pre-bankruptcy transfers under *foreign law* in the absence of a chapter 7 or 11 filing by the debtor.

The bankruptcy or insolvency laws of several other nations (*e.g.*, Germany, the U.K., and Japan) provide that transfers that either are fraudulent or unfairly prefer creditors may be voided by the functional equivalent of a bankruptcy trustee. In ancillary proceedings commenced under former section 304 of the Bankruptcy Code, some courts disagreed as to whether the representative of a foreign debtor could, simply by filing a section 304 petition in the U.S., legitimately assert avoidance powers arising under non-U.S. law to recover assets located in the U.S. The prevailing view on that question was that avoidance powers were not available in an ancillary proceeding but could be used in a plenary case under chapter 7 or 11. According to the court in *Condor Insurance*, chapter 15 continues that practice—sections 1521 and 1523 preclude the assertion of avoidance actions arising under domestic or foreign law in the absence of a filing under another chapter of the Bankruptcy Code. However, with the exception of section 544 (discussed below), sections 1521(a)(7) and 1523(b) expressly reference only transfers that can be avoided under other provisions of the U.S. Bankruptcy Code. The legislative history certainly suggests that lawmakers intended the limitation to encompass avoidance causes of action under non-U.S. law due to difficult choice-of-law and forum questions, but the provisions do not on their face express this intention.

Finally, one avenue of inquiry on this issue apparently overlooked by the court in *Condor Insurance* is the impact of section 544 (which is among the provisions referenced in sections 1521 and 1523). Section 544(b) provides that a bankruptcy trustee may avoid any transfer "that is voidable under applicable law" by an unsecured creditor of the debtor. If "applicable law" were interpreted to include foreign law, the bar to asserting avoidance powers under non-U.S. law in stand-alone chapter 15 cases would be less equivocal.

Condor Insurance does not represent the first time that a U.S. bankruptcy court has been asked to decide whether a foreign representative in a chapter 15 proceeding can seek to avoid transfers under non-U.S. law. In *In re Loy*, the court ruled that a foreign representative could not sell the debtor's real property free and clear of a lien that was purportedly void or voidable under English law and section 549 of the Bankruptcy Code because the lien was recorded after the property became part of the debtor's bankruptcy estate. The court acknowledged that relief under the Bankruptcy Code's pre-bankruptcy transfer avoidance and recovery provisions can be granted only if the debtor is the subject of a case under another chapter of the Bankruptcy Code, while relief under section 549 regarding post-bankruptcy transfers can be granted in a chapter 15 proceeding. Even so, the *Loy* court ruled that avoidance under section 549 (regardless of the underlying substantive law) cannot be granted in the context of a motion under section 363(f) to sell property free and clear because the Bankruptcy Code requires that such relief be sought in an adversary proceeding.

Fogerty v. Condor Guaranty, Inc. (In re Condor Insurance Limited (In Official Liquidation)), 2009 WL 321627 (S.D. Miss. Feb. 9, 2009).

In re Loy, 2008 WL 906503 (Bankr. E.D. Va. Apr. 3, 2008).

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SECOND CIRCUIT ADOPTS "TOTALITY OF THE CIRCUMSTANCES" TEST FOR PRE-APPROVAL OF PROFESSIONAL RETENTIONS UNDER SECTION 328(a) OF THE BANKRUPTCY CODE

Daniel J. Merrett and Mark G. Douglas

The circumstances under which a bankruptcy professional's fee arrangement pre-approved by the court will or will not be subject to subsequent court review were addressed as a matter of first impression in a ruling recently handed down by the Second Circuit Court of Appeals. In affirming a U.S. district court decision that a debtor's fee arrangement with its special litigation counsel was pre-approved and not subject to modification, the Second Circuit in *Riker, Danzig, Scherer, Hyland & Perretti v. Official Comm. of Unsecured Creditors (In re Smart World Technologies, LLC)* adopted a "totality of the circumstances" standard for determining whether a professional retention has been pre-approved pursuant to section 328(a) of the Bankruptcy Code.

RETENTION OF PROFESSIONALS IN BANKRUPTCY CASES

A bankruptcy trustee, chapter 11 debtor-in-possession ("DIP"), or statutory committee is permitted to retain a wide variety of professionals, including lawyers, accountants, auctioneers, and investment bankers, to represent its interests during a bankruptcy case. In most cases, professionals are engaged pursuant to sections 327(a) and 1103 of the Bankruptcy Code, which authorize DIPs and statutory committees, respectively, subject to bankruptcy court approval, to employ "disinterested" professionals to represent them during the course of the bankruptcy. A trustee or DIP may also retain a lawyer that has previously represented the debtor for a "special purpose" other than acting as general bankruptcy counsel under section 327(e) (*e.g.*, in connection with discrete litigation, real estate, or labor matters).

Professionals retained under sections 327 and 1103 are paid in accordance with the interim and final compensation procedures delineated in sections 330 and 331 of the Bankruptcy Code. Those procedures contemplate court scrutiny of services for which compensation is sought and the discretion to reduce, or in some cases augment, the allowed amount of fees and reimbursable expenses, based upon the court's determination of what is reasonable and necessary under the circumstances.

Alternatively, section 328(a) of the Bankruptcy Code provides for the retention and compensation of professionals "on any reasonable terms and conditions of employment, including on a retainer [basis], on an hourly basis, on a fixed or percentage fee basis, or on a contingent fee basis." If a bankruptcy court approves a fee arrangement under section 328, it retains the discretion to revisit that decision and modify the compensation to be paid, but only if the terms specified in the retention order "prove to have been improvident in light of developments not capable of being anticipated at the time of the fixing of such terms and conditions." Approval of a fee arrangement under section 328 provides professionals with some reassurance that only in exceptional circumstances will a bankruptcy court tamper with their fee arrangements. Accordingly, any dispute over whether or not a retention was indeed pre-approved under section 328 is likely to be hotly contested, particularly where one party stands to receive an unexpected windfall under the arrangement.

A number of circuit courts have developed tests for determining whether a bankruptcy court pre-approved the retention of a professional pursuant to section 328 of the Bankruptcy Code. In holding that an accounting firm's retention was not pre-approved, the Third Circuit in its 1995 ruling in *Zolfo, Cooper & Co. v. Sunbeam-Oster Co.* stated that "the burden should rest on the applicant to ensure that the court notes explicitly [in the retention order] the terms and conditions if the applicant expects them to be established at that early point." In 2002, the Ninth Circuit held in *In re Circle K Corp.* that an investment banking firm's fee application was reviewable for reasonableness. The court held that section 328 did not govern review of the fee application because the professional failed to invoke section 328 in its retention application, and provisions of the retention application and order stated that the retention remained subject to review by the court. A third test emanates from the Sixth Circuit's 2004 ruling in *Nischwitz v. Miskovic (In re Airspect Air, Inc.)*, in which the court of appeals stated that "whether a court 'pre-approves' a fee arrangement under § 328 should be judged by the totality of the circumstances." The Sixth Circuit elaborated that factors

relevant to the determination may include whether the debtor's motion specifically requested pre-approval of fees, whether the court's order assessed the reasonableness of the fee, and whether either the motion or the order expressly invoked section 328(a) of the Bankruptcy Code.

THE SECOND CIRCUIT'S RULING IN *SMART WORLD*

In *Smart World*, the Second Circuit Court of Appeals adopted the Sixth Circuit's "totality of the circumstances" test to determine whether a professional retention was pre-approved under section 328(a) of the Bankruptcy Code.

From 1996 to 2000, Smart World Technologies, LLC, and its affiliates (collectively, "Smart World") failed to generate a profit providing free dial-up internet service to subscribers. In 2000, Smart World agreed to sell its most valuable asset, its subscriber list, to Juno Online Services, Inc. ("Juno"). Juno required Smart World to file for bankruptcy as a condition of the sale. The ultimate sale price was to be determined with reference to the number of Smart World subscribers who transferred their internet service to Juno. A dispute arose when Smart World accused Juno of obscuring the true number of subscribers that had switched to Juno in an alleged effort to depress the sale price.

Smart World sought an order from Judge Cornelius Blackshear of the United States Bankruptcy Court for the Southern District of New York approving the retention of Riker, Danzig, Scherer, Hyland & Perretti LLP ("Riker Danzig") as special litigation counsel to pursue resolution or litigation of the dispute with Juno. On November 16, 2000, the bankruptcy court issued an order approving Smart World's retention of Riker Danzig "pursuant to 11 U.S.C. §§ 327 and 328." According to the terms of retention, Riker Danzig was to receive a percentage of any monies obtained from Juno in addition to payment of Riker Danzig's expenses. Riker Danzig's percentage entitlement varied in specific amounts according to the amount of any award or settlement and the duration of the dispute.

Smart World's largest creditor, WorldCom, continued negotiating with Juno, and 18 months after the retention of Riker Danzig, WorldCom requested approval of a proposed settlement whereby Juno would pay $5.5 million to WorldCom, of which $1.5 million would be returned to the Smart World estate. Riker Danzig objected to the settlement on behalf of Smart World, in part on the ground that WorldCom lacked standing to settle the proceeding. The bankruptcy court approved the settlement over Smart World's objection, but the Second Circuit reversed on the standing issue. Smart World's exclusive right to propose and solicit acceptances for a chapter 11 plan having expired, however, its unsecured creditors' committee attempted to impose a settlement on Smart World by filing a plan of liquidation that included a proposed settlement with Juno in the amount of $6.5 million. Once again, Riker Danzig contested the settlement, this time on the ground that Juno was undervaluing the claim, but the bankruptcy court disagreed and confirmed the plan.

> The *Smart World* decision should provide comfort to parties seeking section 328 pre-approval of professional retentions in the Second Circuit. The court of appeals adopted the least restrictive test for determining whether a professional's retention was pre-approved pursuant to section 328. In addition, the court confirmed that a section 328 retention may be disturbed only in circumstances incapable of being anticipated, as opposed to those that were merely unanticipated.

Riker Danzig applied for a fee award in excess of $2 million plus expenses, consistent with the terms of its retention agreement. In the bankruptcy court, Judge James Peck (who succeeded Judge Blackshear, the judge presiding when Riker Danzig was retained) found that Judge Blackshear preapproved the terms and conditions of Riker Danzig's retention under section 328 of the Bankruptcy Code but that four events were not capable of being anticipated at the time of the approval. The four occurrences were that: (a) the positions of Smart World and its creditors diverged with respect to the Juno matter; (b) Riker Danzig took instruction directly

from the officers and majority shareholders of Smart World; (c) the litigation was unusually prolonged; and (d) Riker Danzig was an obstacle, not an asset, to approval of the settlement. Judge Peck accordingly disallowed approximately one-half of the fees requested by Riker Danzig.

On appeal, the district court agreed that the retention had been pre-approved under section 328. Without opining as to which test for pre-approval it preferred, the district court noted that Riker Danzig's retention appeared to pass each of the various tests employed throughout the circuits. The district court reversed the bankruptcy court with respect to the reduction in fees, concluding that the four developments identified by the bankruptcy court may have been unforeseen but were not incapable of being anticipated.

The Second Circuit affirmed the judgment of the district court and adopted the Sixth Circuit's test for determining whether a retention has been pre-approved pursuant to section 328. According to the Second Circuit, the Bankruptcy Code does not "mandate that the application specifically mention §328 or that the court's approval order expressly and unambiguously state specific terms and conditions." Rather, the court emphasized, "pre-approval of a fee agreement under 11 U.S.C. section 328(a) depends on the totality of the circumstances, including whether the professional's application, or the court's order, referenced section 328(a), and whether the court evaluated the propriety of the fee arrangement before granting final, and not merely preliminary, approval." The Second Circuit concluded that the retention met the "totality of the circumstances" standard because the retention application expressly invoked section 328(a) of the Bankruptcy Code, and the retention order expressly incorporated this language.

In addition, the court agreed that the bankruptcy court erred in disturbing the pre-approval of Riker Danzig's retention because, although each of the events recited by the bankruptcy court may not have been anticipated, they were not *incapable* of being anticipated.

OUTLOOK

Apparently agreeing with the Sixth Circuit that the formalistic requirements imposed on professionals seeking payment of fees under section 328 of the Bankruptcy Code by several circuit courts were "too restrictive," the Second Circuit, in addressing the question for the first time in *Smart World*, adopted a "totality of the circumstances" test for section 328 pre-approval. As demonstrated in the *Smart World* ruling, however, consideration of the factors required by other tests—express invocation of section 328 in the retention application or order, express approval of the terms of retention in the order, and an absence of conditional language in the papers—may prove dispositive in applying the "totality of the circumstances" standard.

The *Smart World* decision should provide comfort to parties seeking section 328 pre-approval of professional retentions in the Second Circuit. The court of appeals adopted the least restrictive test for determining whether a professional's retention was pre-approved pursuant to section 328. In addition, the court confirmed that a section 328 retention may be disturbed only in circumstances incapable of being anticipated, as opposed to those that were merely unanticipated. Nevertheless, although the "totality of the circumstances" test may be less restrictive than its counterparts, as suggested by the *Smart World* court, to ensure that its terms are satisfied, the best practice will be to continue satisfying the bright-line requirements of other tests.

Riker, Danzig, Scherer, Hyland & Perretti v. Official Comm. of Unsecured Creditors (In re Smart World Technologies, LLC), 552 F.3d 228 (2d Cir. 2009).

Zolfo, Cooper & Co. v. Sunbeam-Oster Co., 50 F.3d 253 (3d Cir. 1995).

In re Circle K Corp., 279 F.3d 669 (9th Cir. 2002).

Nischwitz v. Miskovic (In re Airspect Air, Inc.), 385 F.3d 915 (6th Cir. 2004).

AUSTRALIAN VOLUNTARY WINDING-UP RECOGNIZED UNDER CHAPTER 15 OF THE BANKRUPTCY CODE

Steven Fleming

On February 9, 2009, the U.S. Bankruptcy Court for the District of Nevada issued an order in *In re Betcorp Ltd.* recognizing the voluntary winding-up proceeding of an Australian company as a "foreign main proceeding" under chapter 15 of the Bankruptcy Code. The ruling is of broader interest in the present economic environment because it provides guidance on several important cross-border insolvency issues that may arise in the U.S. and other countries that have adopted the UNCITRAL Model Law on Cross-Border Insolvency (the "Model Law"), after which chapter 15 of the U.S. Bankruptcy Code is patterned.

HOW DID THE PROCEEDING ARISE?

Betcorp Limited (In Liquidation) ("Betcorp") is an online gambling company that commenced operations in Australia in 1998. It later expanded its operations to the U.S., and those operations became central to Betcorp's overall operations. The enactment of the Unlawful Internet Gambling Enforcement Act (2006 – USC), which prevented Betcorp from receiving fund transfers related to gaming activities from U.S. consumers, was a major impediment to the ongoing viability of Betcorp's U.S. operations and eventually forced Betcorp to cease all of its U.S. operations. At a meeting in September 2007, shareholders in Australia voted to put Betcorp into a voluntary winding-up pursuant to Part 5 of Australia's Corporations Act 2001 (Cth) (the "Act"), and liquidators were appointed.

Subsequently, 1st Technology, an American technology company, filed proceedings against Betcorp in a U.S. district court claiming that Betcorp had infringed one of its patents. In response, the Australian liquidators of Betcorp filed a chapter 15 petition in the U.S. seeking to have the Australian winding-up process recognized as a "foreign main proceeding" under chapter 15 of the Bankruptcy Code. Recognition under chapter 15 would force 1st Technology to pursue its patent infringement claim in an Australian court because all U.S. litigation against Betcorp would be stayed.

THE ISSUES BEFORE THE BANKRUPTCY COURT

Bankruptcy Judge Markell determined two main issues in ruling on the application for recognition:

1. Whether Betcorp's voluntary winding-up constitutes a "foreign proceeding" for the purposes of the Bankruptcy Code; and

2. If so, whether Betcorp's winding-up proceeding is a "foreign main proceeding."

WHAT IS A "FOREIGN PROCEEDING"?

In relation to the first issue, 1st Technology submitted that the voluntary winding-up of Betcorp under Part 5 of the Act was not a "foreign proceeding" under chapter 15 because, as a voluntary process, it did not involve the making of an application to a court. The term "foreign proceeding" is defined in section 101(23) of the Bankruptcy Code as:

> a collective judicial or administrative proceeding in a foreign country, including an interim proceeding, under a law relating to insolvency or adjustment of debt *in which proceeding the assets and affairs of the debtor are subject to control or supervision by a foreign court*, for the purpose of reorganization or liquidation.

Judge Markell, consistent with the purpose of chapter 15 and the Model Law (upon which chapter 15 is based), held that "proceeding" was to be broadly interpreted to include "a statutory framework that constrains a company's actions and that regulates the final distribution of a company's assets." In this case, he concluded, "that framework is provided by the [Act]." Accordingly, the voluntary winding-up, having been undertaken in accordance with the provisions of the Act, was a "foreign proceeding" for the purposes of chapter 15, regardless of the fact that no application to a court was necessary to initiate the winding-up.

WAS THE PROCEEDING A "FOREIGN MAIN PROCEEDING"?

The next question for the court was whether the proceeding to voluntarily wind up Betcorp was a "foreign main proceeding" under chapter 15. Because more than one bankruptcy or insol-

vency proceeding may be pending against the same foreign debtor in different countries, chapter 15 contemplates recognition in the U.S. of both a foreign "main" proceeding—a case pending in whatever country contains the debtor's "center of main interests" ("COMI")—and foreign "nonmain" proceedings, which may have been commenced in countries where the debtor merely has an "establishment."

The conclusion of the court that a voluntary winding-up process (which does not involve any court supervision) is a "proceeding" for the purposes of the Bankruptcy Code (and, by extension, the Model Law) provides authority for the proposition that other forms of non-court-sanctioned external administration of a company qualify as "proceedings," so long as the process at issue is undertaken in accordance with a statutory framework.

Neither the Bankruptcy Code nor the Model Law defines "COMI." However, section 1516(c) of the Bankruptcy Code provides that the debtor's registered office or habitual residence, in the case of an individual, is presumed to be the debtor's COMI. According to the statute's legislative history, this presumption was included "for speed and convenience of proof where there is no serious controversy." An "establishment" is defined to be "any place of operations where the debtor carries out a nontransitory economic activity."

In determining Betcorp's COMI, Judge Markell applied the approach utilized by the U.S. district court in its May 2008 ruling in *In re Bear Stearns High-Grade Structured Credit Strategies Master Fund, Ltd.* In affirming the bankruptcy court's decision in *Bear Stearns*, the district court listed several factors relevant to the determination of the COMI: namely, the location of the debtor's headquarters, the location of those who actually manage the debtor (which conceivably could be the headquarters of a holding company), the location of the majority of the debtor's creditors or of a majority of the creditors who would be affected by the case, and/or the jurisdiction whose law would apply to most disputes.

Of these factors, the only one suggesting that Betcorp's COMI may have been located somewhere other than Australia was the fact that Betcorp's main creditors were located in the U.K. and the U.S. Although this was sufficient to rebut the presumption with respect to the location of the COMI, it was not enough to outweigh the factors, described below, that prompted the *Betcorp* court to conclude that Betcorp's COMI was located in Australia:

- Betcorp's registered office and headquarters were in Australia;
- Australia was the place where the winding-up was being administered pursuant to Australian law, and those laws would determine any disputes;
- The company's liquidators were located in Australia;
- Betcorp's management was, by and large, conducted from Australia; and
- Betcorp's only asset was cash held in an Australian bank account.

On the basis of this evidence, the court held that Betcorp's COMI was located in Australia and that the voluntary liquidation process should be recognized as a "foreign main proceeding" under chapter 15. Upon recognition of Betcorp's winding-up under chapter 15, 1st Technology's district court litigation was stayed by operation of section 1520 of the Bankruptcy Code, which provides that the automatic stay imposed by section 362 applies to a debtor and its assets upon recognition of a foreign main proceeding.

THE SIGNIFICANCE OF THE *BETCORP* DECISION

The *Betcorp* decision provides some useful guidance on the meaning of "foreign proceeding" and "COMI," which terms are relevant not only to applications under chapter 15 of the U.S. Bankruptcy Code, but also to applications under other versions of the Model Law enacted by other nations (including Australia, which implemented the Model Law when it enacted the Cross-Border Insolvency Act in 2008).

The conclusion of the court that a voluntary winding-up process (which does not involve any court supervision) is a "proceeding" for the purposes of the Bankruptcy Code (and, by extension, the Model Law) provides authority for the proposition that other forms of non-court-sanctioned external administration of a company qualify as "proceedings," so long as the process at issue is undertaken in accordance with a statutory framework. Most relevant in the Australian context, this means that the voluntary administration process (a largely extrajudicial rough equivalent of chapter 11 of the Bankruptcy Code) is likely to be a "proceeding" for the purposes of chapter 15. In addition, the court's analysis of Betcorp's COMI adds to a growing body of jurisprudence that sheds light on how this issue is to be determined.

In re Betcorp Ltd., 400 B.R. 266 (Bankr. D. Nev. 2009).

In re Bear Stearns High-Grade Structured Credit Strategies Master Fund, Ltd., 389 B.R. 325 (S.D.N.Y. 2008).

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