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THE *VISTEON* DECISION: THIRD CIRCUIT EXPANDS SECTION 1114 PROTECTIONS TO TERMINABLE-AT-WILL RETIREE BENEFIT PLANS

Joseph M. Witalec

On July 13, 2010, the United States Court of Appeals for the Third Circuit issued an opinion in the chapter 11 case of Visteon Corporation ("Visteon"), holding that the procedures set forth in section 1114 of the Bankruptcy Code apply to all retiree benefit plans, even those plans that could have been terminated at will outside of bankruptcy. In so ruling, the Third Circuit reached the opposite conclusion on this issue from the majority of courts that have previously considered it. As a result, debtors in the Third Circuit will need to give more careful consideration to approaches to terminating or modifying their retiree benefit plans either before filing for or while in bankruptcy.

BACKGROUND

Visteon is one of the world's largest suppliers of automotive parts. Originally a division of Ford Motor Corporation, it was spun off as an independent entity in 2000. In connection with its operations, Visteon had provided certain health and life insurance benefits to its retirees. Pursuant to the relevant governing documents for these retiree benefit plans, Visteon retained the right to modify or terminate the plans at any time.

Visteon filed for chapter 11 protection on May 28, 2009, in Delaware. On June 26, 2009, Visteon moved the bankruptcy court for permission to terminate all of its domestic retiree benefit plans. Visteon did not ask for authority to terminate these plans pursuant to section 1114 of the Bankruptcy Code, which (as described below) requires extensive procedures to be followed in order to modify or terminate retiree benefits. Instead, Visteon asked for authorization under section 363 of the

Bankruptcy Code, which in essence requires only a showing of the debtor's reasonable exercise of business judgment.

Several groups of retirees and their unions objected to Visteon's motion to terminate benefits on the ground that Visteon needed to comply with the requirements of section 1114. The bankruptcy court overruled those objections, following the view of the majority of courts that have previously addressed the issue, and allowed Visteon to terminate the retiree benefit plans without following the procedures set forth in section 1114. The bankruptcy court reasoned that because the benefit plans could be terminated at will outside of bankruptcy, it would be "absurd" to expand retirees' rights inside bankruptcy by applying the procedures of section 1114 when there existed no legitimate bankruptcy purpose for doing so in the context of nonvested retiree benefits.

The retirees appealed the bankruptcy court's decision to the Delaware district court. The district court affirmed the decision, reasoning that if Visteon were required to follow the procedures set forth in section 1114 for a plan that it was free to terminate outside of bankruptcy, the situation would result in a "unique if not revolutionary interpretation of the Bankruptcy Code by improving prepetition, contractual rights of a third party constituent as a result of the filing of a bankruptcy case."

The retirees then further appealed the district court's decision to the Third Circuit.

THE THIRD CIRCUIT'S DECISION

On appeal, a three-judge panel of the Third Circuit reversed the lower courts' decisions and held that Visteon was required to follow the procedures set forth in section 1114 of the Bankruptcy Code to terminate its retiree benefit plans, even those that Visteon had the right to terminate at will outside of bankruptcy.

Plain Language of Section 1114

In beginning its analysis on the issue of whether section 1114 applied to Visteon's termination of its nonvested retiree benefit plans, the Third Circuit looked at the text of the statute itself. On its face, section 1114(e) of the Bankruptcy Code provides that a debtor "shall timely pay and shall not modify *any retiree benefits*" (emphasis added), except through the procedures set forth in the statute or by agreement with the affected retirees.

Retiree benefits covered by section 1114 include benefits to retired employees and their spouses and dependents for medical, surgical, or hospital-care benefits or for benefits in the event of sickness, accident, disability, or death under any plan maintained or established by the debtor prior to bankruptcy. The procedures in section 1114 require the debtor to provide certain information to, and negotiate with, the retirees regarding the modification or termination of benefits. If the debtor and the retirees are unable to reach agreement, then the debtor must make a showing to the court that the modification or termination of benefits is necessary for reorganization, treats all affected parties fairly and equitably, and is favored by the balance of equities.

> In the future, debtors (especially those in the Third Circuit) will need to be aware of this decision, including the requirement it imposes on debtors to go through the section 1114 process to modify or terminate retiree benefit plans, even those that are terminable at will.

The Third Circuit concluded that the language in section 1114 is plain and unambiguous and requires a debtor to follow the procedures for the modification or termination of *any* retiree benefits—even benefits that are terminable at will outside of bankruptcy. The court noted that there are no exceptions or limitations on section 1114's application, and benefits that are terminable at will fit into its broad definition.

The court rejected Visteon's argument that section 1114 is ambiguous when read in conjunction with section 1129(a)(13) of the Bankruptcy Code. Section 1129(a)(13), which was enacted at the same time as section 1114, states that in order to obtain confirmation of a chapter 11 plan, a debtor must continue to provide retiree benefits "for the duration of the period that the debtor has obligated itself to provide such benefits." Visteon, following the reasoning of other courts, argued that sections 1114 and 1129 are meant to be read together, and thus section 1114's application should

be limited to retiree benefits that the debtor is obligated to provide until such time that the debtor has the unilateral right to terminate the benefits. The Third Circuit found this argument unpersuasive and concluded instead that Congress meant to differentiate between the two provisions, such that section 1114 applies to *all* retiree benefits regardless of the duration of the obligation.

The Third Circuit panel also cited to a 2005 amendment to section 1114 as evidence of the broad scope of the statute. Specifically, section 1114(l) was added in 2005 to provide parties in interest with the right to seek a court order restoring retiree benefits that were terminated or modified by an insolvent debtor in the 180-day period prior to the bankruptcy filing. The Third Circuit noted that not only does section 1114(l) apply to *all* retiree benefits, with no limit for benefits that are terminable at will, but also that the provision would be virtually meaningless if it did not apply to those benefits that the debtor could unilaterally terminate or modify, because that is effectively the only way such a termination or modification could occur prior to a bankruptcy filing.

Legislative History

The Third Circuit also examined the legislative history of section 1114 to aid in its interpretation of the statute. Section 1114 and section 1129(a)(13) were the primary substantive components of the Retiree Benefits Bankruptcy Protection Act of 1988 ("RBBPA"). Congress enacted RBBPA in direct response to LTV Corporation's termination of health and life insurance benefits to 78,000 retirees during its chapter 11 bankruptcy case in the mid-1980s. According to the legislative history, while the principal objectives of chapter 11 after the enactment of this legislation would remain the facilitation of a debtor's reorganization and the protection of creditors' interests, the purpose of section 1114 is to protect the interests of retirees of chapter 11 debtors.

Visteon cited to certain statements in the legislative history of RBBPA to argue that Congress intended to protect only vested benefits that are "legal and contractual obligations" that could not be terminated at will. But the Third Circuit cited to numerous other comments in the legislative record to make the point that Congress intended to protect "legitimate expectations" of retirees for benefits, including those benefits that were otherwise terminable. The court concluded that Congress was well aware that many retiree benefits are terminable at will, but it nonetheless wanted to protect all such retiree benefits while a company is in bankruptcy by subjecting them to the requirements of section 1114. In the Third Circuit panel's view, Visteon fell woefully short of the "extraordinary showing of contrary intentions" in the legislative history to justify a departure from the unambiguous plain language of section 1114 and its application to *all* retiree benefits.

Not an "Absurd Result"

Finally, the Third Circuit addressed the argument by Visteon that giving retirees more rights in chapter 11 through the protections set forth in section 1114 than they had outside of bankruptcy is such an absurd result that Congress could not have intended so much. The Third Circuit concluded that giving retiree benefits extra protection in bankruptcy is not an absurd result at all, but rather a reasonable compromise that Congress could have reached to provide at least some procedural protections for retiree benefits when they are at their most vulnerable—during a company's bankruptcy.

In this regard, the court traced the history of the federal legislative treatment of retiree compensation, including the fact that the Employee Retirement Income Security Act ("ERISA") protects pension benefits for retirees, with elaborate vesting requirements for pension plans, but has no such vesting requirements for welfare benefit plans for retirees. While certain legislators would have preferred to amend ERISA to require vesting for retiree benefit plans, the court noted, Congress did not go that far. Rather, lawmakers agreed to install procedural safeguards for modifying or terminating benefits while a company is in bankruptcy. The Third Circuit reasoned that a chapter 11 case is a logical time to require such safeguards because bankruptcy can distort a company's normal decision-making process and expose retiree benefits to extra risk. For example, a company is less likely to modify retiree benefits during good financial times because such benefits help attract and retain employees. In bankruptcy, however, a debtor faces intense pressure to relieve itself of ongoing and future liabilities, and as a result, it may attempt to shed liabilities, such as retiree benefits, that it ordinarily would be inclined to stand behind.

Accordingly, the Third Circuit determined that it is not an "absurd" result that Congress wished to provide extra protection for retiree benefits when a company is in bankruptcy and those benefits are most vulnerable. Rather, the court concluded, such a result is a "measured middle-ground" that allows a company some flexibility in modifying retiree benefits, subject to procedural safeguards that provide at least some level of protection for those benefits when they are most needed.

FUTURE PLANNING

As described above, the Third Circuit's decision in *Visteon* goes against the majority of courts that have considered the application of section 1114 to retiree benefit plans that are terminable at will. Given its thorough analysis of the issue and legislative history, however, the opinion may be persuasive precedent for courts in other circuits.

In the future, debtors (especially those in the Third Circuit) will need to be aware of this decision, including the requirement it imposes on debtors to go through the section 1114 process to modify or terminate retiree benefit plans, even those that are terminable at will. Although it does not prohibit a debtor from modifying or terminating retiree benefits, section 1114 does require that the debtor negotiate with retirees and, absent agreement, make certain showings to the court as to why such modifications or terminations are needed. It bears adding, however—as the Third Circuit panel also made clear—that a debtor remains free to terminate benefits as permitted by its retiree welfare plan after the debtor emerges from bankruptcy.

At a minimum, though, the Third Circuit's *Visteon* decision will give retirees and their unions more leverage in chapter 11 cases and require debtors to give more consideration to these constituencies in the future.

IUE-CWA v. Visteon Corp. (In re Visteon Corp.), 612 F.3d 210 (3d Cir. 2010).

MUNICIPAL BANKRUPTCIES: A HORSE OF A DIFFERENT COLOR

Erica M. Ryland and Mark G. Douglas

The devastating consequences of the Great Recession for businesses and individuals alike continue to dominate U.S. and world news headlines, as governments around the globe struggle to implement or extend programs designed to jump-start stalled economies and attempt to gauge the health of financial institutions deemed "too big to fail" or otherwise critical to long-term prospects for recovery. Less visible yet increasingly prominent amid the carnage wrought among financial institutions, automakers, airlines, retailers, newspapers, homebuilders, homeowners, and the enduringly unemployed is the plight of U.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, underfunded pension plans and retiree benefits, and escalating costs (including the higher cost of borrowing due to the meltdown of the bond mortgage industry and the demise of the $200 billion market for auction-rate securities beginning in mid-2007) 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 pertains to a municipal debtor's ability to modify or terminate labor contracts with unionized employees. Another distinction lies in the absence of an "estate" consisting of a municipal debtor's assets that is subject to administration in a chapter 9 case. Both of these issues were highlighted in rulings recently handed down by a California district court and a New York bankruptcy court. In *In re City of Vallejo, California*, the district court affirmed a bankruptcy court ruling 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. In *In re New York City Off-Track Betting Corporation*, the bankruptcy court denied a creditor's motion to compel the immediate payment as an administrative expense of sums the municipal debtor was obligated to pay under applicable New York law, ruling that because there is no bankruptcy estate in a chapter 9 case, there can be no expenses of administering the estate allowed under section 503(b) of the Bankruptcy Code.

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. Fewer than 250 chapter 9 cases have been filed since the current version of the Bankruptcy Code was enacted in 1978.

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

- A state law or governmental entity empowered by state law must specifically authorize the municipality (in its capacity as such or by name) to file for relief under chapter 9;
- The municipality must be insolvent;
- The municipality must "desire[] to effect a plan" to adjust its debts; and
- The municipality must either: (a) have obtained the consent of creditors holding at least a majority in amount of the claims in each class that will be impaired under the municipality's intended 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* in 1995, courts construing the amended provision have concluded that state law must provide express written authority for a municipality to seek chapter 9 relief and that the authority must be "exact, plain, and direct, with well-defined limits, so that nothing is left to inference or implication."

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 prefiling negotiation prerequisites set forth in section 109(c)(5), all of which are unique to chapter 9. These requirements were inserted by Congress to prevent capricious chapter 9 filings.

Chapter 9 is also the only chapter of the Bankruptcy Code that expressly incorporates a good-faith filing requirement. 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." 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 judgment entered thereunder) prescribing a method of composition of indebtedness 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. Also, unlike in a case under chapter 7, 11, 12, or 13 of the Bankruptcy Code, a municipal debtor's assets do not become part of the debtor's bankruptcy estate upon the filing of a chapter 9 petition.

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 requirements 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 postpetition 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 discussed in more detail below, the incorporated provisions do not include section 1113, which spells out the circumstances under which a debtor can reject a collective bargaining agreement, or section 541, which provides that an estate consisting of all of the debtor's property is created upon the filing of a bankruptcy petition.

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 plan 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

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Corinne Ball (New York), ***Paul D. Leake (New York)***, ***David G. Heiman (Cleveland)***, ***Heather Lennox (Cleveland)***, ***Brad B. Erens (Chicago)***, ***Carl E. Black (Cleveland)***, ***Gregory M. Gordon (Dallas)***, ***Richard L. Wynne (Los Angeles)***, ***Peter J. Benvenutti (San Francisco)***, and ***Aldo L. LaFiandra (Atlanta)*** have been selected for inclusion in the 2011 edition of *Best Lawyers in America* in the field of Bankruptcy and Creditor-Debtor Rights Law.

Paul D. Leake (New York) received a "Leading Lawyer" designation in the field of Corporate Restructuring in *The Legal 500 U.S.* for 2010.

Corinne Ball (New York) was featured as a "Most Admired Bankruptcy Attorney" in the August 31, 2010, edition of *Bankruptcy Law360* for her achievements in connection with, among other things, the chapter 11 cases of Chrysler, LLC, and Dana Corporation.

On August 8, ***Kevyn D. Orr (Washington)*** sat on a panel discussing "FDIC Assisted Transactions—Managing Legal Issues for Acquirors and Owners of Troubled Banks" at the Annual Meeting of the American Bar Association in San Francisco.

Corinne Ball (New York), ***David G. Heiman (Cleveland)***, ***Kevyn D. Orr (Washington)***, ***Peter J. Benvenutti (San Francisco)***, ***Richard L. Wynne (Los Angeles)***, ***Adam Plainer (London)***, and ***Michael Rutstein (London)*** were named to *The International Who's Who of Insolvency & Restructuring Lawyers 2010*.

Craig F. Simon (Dallas) was a speaker on a nationally syndicated West LegalEdcenter webcast on August 24 regarding "The Impact of Bankruptcy on IP Litigation and Licensing."

Corinne Ball (New York) was designated as being among the "Most highly regarded individuals—global" in *The International Who's Who of Insolvency & Restructuring Lawyers 2010*. She was also cited in the September 6–19, 2010, edition of *The Deal* as an example of the relatively few women at the helm of prominent bankruptcy practices.

An article written by ***Mark G. Douglas (New York)*** entitled "South Beach—Death and Taxes Assured" was published in the September 2, 2010, edition of *Bankruptcy Law360*. His article entitled "Disenfranchising Strategic Investors in Chapter 11: 'Loan to Own' Acquisition Strategy May Result in Vote Designation" appeared in the July/August 2010 issue of *Pratt's Journal of Bankruptcy Law*.

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 required in that circumstance 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 material 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.

Taken together, *City of Vallejo* and *New York City OTB* are a primer on the limitations of chapter 9, and more specifically, the delicate constitutional compromise that lawmakers reached when enacting a municipal bankruptcy law in 1978.

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 the debtor did not need to follow the contract modification procedures set forth in the National Labor Relations Act because, for purposes of that act, a collective 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."

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, Congress has not enacted legislation expressly dictating 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 provides 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 of the U.S. Bankruptcy Court for the Eastern District of California rejected this approach in *City of Vallejo* in 2009. 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* governed 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 prefiling limitations or postfiling 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, § 1, cl. 2), and the Contracts Clause (Art. VI) of the U.S. Constitution. Judge McManus flatly rejected the assertion that *Sonoma* 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.

Despite his conclusion that neither section 1113 nor California labor law applied 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 in April 2009 directing the parties to mediate the dispute. Following mediation, the union representing Vallejo's firefighters agreed to the rejection of its labor agreement, but no settlement was reached with the electrical workers' union. In August 2009, the bankruptcy court issued a formal ruling granting Vallejo's motion to reject its collective bargaining agreement with the electrical workers, who were represented by the International Brotherhood of Electrical Workers ("IBEW"). In the decision, Judge McManus reiterated his previous conclusions regarding the standard governing rejection of a bargaining agreement in a chapter 9 case. He also found that the evidence in the case before him satisfied the *Bildisco* standard. The IBEW appealed.

THE DISTRICT COURT'S DECISION IN *CITY OF VALLEJO*

The California district court denied the appeal and affirmed the bankruptcy court's August 2009 ruling. The legislative history of chapter 9 and the California statute authorizing municipalities to petition for bankruptcy, district judge John A. Mendez explained, "support [Vallejo's] argument that municipalities are intended to have broad authority to reject contracts and reorganize pursuant to Chapter 9, without regard to state labor laws." Judge Mendez flatly rejected the IBEW's contention that the bankruptcy court improperly concluded that Vallejo was authorized to reject the bargaining agreement without looking to state law standards for mid-term modification or termination of public employment contracts. State labor laws, he concluded, are preempted by federal bankruptcy law for the reasons articulated by the bankruptcy court.

Judge Mendez also declined to fault the bankruptcy court's conclusion that *Bildisco* establishes the standard for rejection due to the inapplicability of section 1113 in chapter 9 cases. "[I]t is Congress, not the Court," he wrote, "which should decide whether to incorporate a Section 1113-like provision into Chapter 9." In the absence of such legislation as well as any case law directly on point, Judge Mendez concluded that "the Court finds *Bildisco* and *In re County of Orange* to be persuasive authorities for analyzing and determining the appropriate standard for a municipality to reject a CBA during Chapter 9 bankruptcy."

Finally, Judge Mendez ruled that the bankruptcy court's evidentiary rulings and findings on the three prongs of the *Bildisco* test were not in error. Among other things, he determined that the bankruptcy court did not err by focusing its inquiry on the insolvent general fund, rather than Vallejo's finances as a whole, in concluding that the IBEW bargaining agreement burdened Vallejo's ability to reorganize. Judge Mendez also refused to second-guess the bankruptcy court's conclusion that the balance of equities favored rejection of the contract, given the court's findings that, among other things, plunging revenues threatened Vallejo's survival; little, if anything, remained for the city to cut from its labor expenses; and further reductions in the funding of services threatened Vallejo's ability to provide for the basic health and safety of its residents.

NEW YORK CITY OTB

Another important concept excluded from the scope of municipal bankruptcies—the estate—was a central element of the New York bankruptcy court's ruling in *New York City OTB*. New York City Off-Track Betting Corporation ("OTB") is a public benefit corporation, established and governed by the New York Racing, Pari-Mutuel Wagering and Breeding Law (the "Racing Law"), that operates an off-track parimutuel betting system within New York City. OTB was created in 1971 to earn money from horse-betting activities and halt illegal wagering and bookmaking on horse races. It is operated by a board of directors appointed by the Governor of New York State, which took over the company in 2008 after Mayor Michael Bloomberg threatened to shut it down because of losses to the city.

OTB has been beset by economic problems for many years. Part of its financial malaise is caused by the Racing Law, which obligates OTB to distribute certain percentages of the pool of total bets OTB receives on a race to the state, local governments, horse-breeding funds, and certain racetracks. These "commissions" are payable both for races on New York tracks within OTB's region as well as for other New York tracks and out-of-state races that are simulcast by OTB and for which it accepts bets. OTB has lobbied the New York State Legislature without success for five years to alter the Racing Law's mandatory distributions in a way that would allow the company to erase enormous annual operating deficits.

Although the Racing Law provides the formulae for calculating commissions, neither the statute nor applicable regulations issued by the Racing and Wagering Board specify when the payments must be made. Cash-flow problems prompted OTB to slow the pace of commission payments during the five-year period leading up to its bankruptcy filing. OTB filed a chapter 9 petition in December 2009 in New York. At the time of the filing, OTB was five months in arrears on the payment of "indirect commissions" to certain New York tracks for simulcast races outside of its region, although it was current in paying "direct commissions" to tracks for races within its region.

After the chapter 9 filing, OTB was able to pay both direct and indirect commissions with a one-month lag but stopped making indirect commission payments after three months and announced its intention to cease operating in April 2010 due to cash-flow problems. Instead of closing its doors, however, OTB elected to remain operating while the New York State Legislature debated a solution to its financial woes. It was able to do so by suspending the payment of indirect commissions.

Two of the tracks that were owed direct and indirect commissions aggregating approximately $8.5 million filed a motion seeking a court order obligating OTB to pay the outstanding amounts immediately, in part because indirect commissions payable after OTB's chapter 9 filing are "actual, necessary costs and expenses of preserving the estate" entitled to administrative-expense treatment under section 503(b) of the Bankruptcy Code. According to the racetracks, OTB was obligated to comply with applicable nonbankruptcy

law even though it was a chapter 9 debtor, and the commissions, which were vital to the tracks' ability to continue operating and for the New York State harness-racing industry as a whole, clearly qualified for administrative priority.

Bankruptcy judge Martin Glenn denied the motion. Explaining at the outset that sections 903 and 904 severely restrict a bankruptcy court's discretion to interfere with a chapter 9 debtor's operations or property, Judge Glenn rejected the track's contention that the court, notwithstanding these statutory restrictions, was authorized to rule on all of the issues raised by the dispute because OTB had implicitly given its consent. According to Judge Glenn, OTB had consented only to whether the indirect commissions were administrative expenses and whether they must be paid on the schedule requested by the tracks.

Judge Glenn then ruled that the commissions were not administrative expenses. He explained that section 503 of the Bankruptcy Code, which contemplates the creation of administrative expenses for "the actual, necessary costs and expenses of preserving the *estate*," applies to chapter 9 debtors by operation of section 901(a). However, chapter 9 does not incorporate section 541 of the Bankruptcy Code, which provides for the creation of a bankruptcy "estate." As such, Judge Glenn ruled:

> Because a chapter 9 debtor's property remains its own and does not inure into a bankruptcy estate as provided by section 541 of the Bankruptcy Code, there can be no administrative expenses "for the actual and necessary costs of preserving the estate" as contemplated by section 503(b)(1)(A) of the Bankruptcy Code.

According to Judge Glenn, this interpretation has been adopted by several other bankruptcy courts and is consistent with the views expressed by leading commentators. Moreover, he emphasized, it is supported by the policies inherent in chapter 9, which "is permeated with dual sovereignty concerns," including respect for the sovereignty of state entities that "substantially constrains the Court's powers when dealing with a chapter 9 debtor." Even a municipal debtor's consent to the court's determination of issues pertaining to the debtor's statutorily and constitutionally protected sovereignty over its operations is not sufficient to overcome these constraints. The court, Judge Glenn explained, simply has no discretion in this area.

Finally, Judge Glenn concluded that neither the Racing Law nor its accompanying regulations specified when commission payments were supposed to be disbursed. Given, among other things, the predominance of state law and policy in deciding that question, he accordingly determined that the circumstances called for the court to abstain from adjudicating the issue. The judge modified the automatic stay to allow the parties to commence a proceeding before the Racing and Wagering Board to resolve the issue. He also chastised that board, the Racing Commission, and the New York State Legislature for repeatedly failing to address the enduring problems in the racing industry, commenting that he had the discretion under section 930(a)(2) to dismiss OTB's chapter 9 case for cause, including "unreasonable delay by the debtor that is prejudicial to creditors."

OUTLOOK

Taken together, *City of Vallejo* and *New York City OTB* are a primer on the limitations of chapter 9 and, more specifically, the delicate constitutional compromise that lawmakers reached when enacting a municipal bankruptcy law in 1978. Chapter 9's very title—"Adjustment of Debts of a Municipality"—is a telling testament to the marked differences between chapter 9 and chapters 7, 11, 12, and 13 of the Bankruptcy Code, where the court and stakeholders in the case have a much greater degree of control over the debtor and its affairs and property.

Depending on the circumstances, *City of Vallejo* should not necessarily be viewed as a positive development in all respects for municipal debtors, although the ruling would appear to make it much easier to reject a bargaining agreement in chapter 9 than in chapter 11. In pre-section 1113 cases, courts recognized that rejection of a collective bargaining agreement under section 365 created an unsecured prepetition 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.

The ruling in *New York City OTB* is notable principally because it highlights another important distinction between chapter 9 and chapter 11. Those who provide goods and services to chapter 9 debtors should be aware that, although applicable nonbankruptcy law (*e.g.*, state law or perhaps 28 U.S.C. § 959) may be interpreted to require a municipal debtor to satisfy its postpetition obligations, the operating expenses of a municipal debtor are not entitled to administrative priority.

In re City of Vallejo, California, 403 B.R. 72 (Bankr. E.D. Cal. 2009), *aff'd*, 432 B.R. 262 (E.D. Cal. 2010).

In re New York City Off-Track Betting Corporation, 434 B.R. 131 (Bankr. S.D.N.Y. 2010).

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).

In re Valley Health Sys., 429 B.R. 692 (Bankr. C.D. Cal. 2010).

In re JZ L.C.C., 371 B.R. 412 (Bankr. 9th Cir. 2007).

FIFTH CIRCUIT ALLOWS DEBTOR TO AVOID INSIDER SEVERANCE PAYMENT AS A FRAUDULENT TRANSFER

John H. Chase and Mark G. Douglas

In keeping with the careful scrutiny that the Bankruptcy Code directs toward claims asserted by corporate insiders due to the heightened risk of overgenerosity or overreaching, severance payments made (or promised) to an executive terminated during the period leading up to a bankruptcy filing by the company may be challenged if the amount of the payment is later deemed to be excessive and/or unsupported by adequate consideration. Changes made to the Bankruptcy Code as part of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA") have made it easier for a bankruptcy trustee or chapter 11 debtor in possession ("DIP") to recover these payments or to avoid the underlying payment obligation. In such actions, which most commonly arise under section 548(a) of the Bankruptcy Code, the focus becomes the value of the concessions or other consideration that the executive granted in exchange for the severance payments and whether the value of such consideration is "reasonably equivalent" to the value of the severance payments. A three-judge panel of the Fifth Circuit Court of Appeals recently applied section 548(a) in this context. In *In re TransTexas Gas Corp.*, the court affirmed a ruling below authorizing a DIP to avoid prepetition severance payments made to an executive as fraudulent transfers.

AVOIDANCE OF FRAUDULENT TRANSFERS IN BANKRUPTCY

Among the powers conferred upon a bankruptcy trustee (or DIP) under the Bankruptcy Code is the ability to avoid asset transfers that are either actually or constructively fraudulent. Section 548(a)(1)(A) of the Bankruptcy Code provides that the trustee can avoid any transfer made, or obligation incurred, by the debtor in the two years preceding a bankruptcy filing if it is effected with the "actual intent to hinder, delay, or defraud" creditors. Section 548 also authorizes avoidance of transfers made or obligations incurred in the absence of fraudulent intent. Specifically, section 548(a)(1)(B) provides that the trustee may avoid any transfer made or obligation incurred by a debtor in the two years preceding bankruptcy if the debtor received "less than a reasonably equivalent value

in exchange" and: (a) was, or became as a result of the transaction, (i) insolvent, (ii) undercapitalized, or (iii) unable to pay its debts generally as they matured; or (b) regardless of solvency, made, or obligated itself to make, nonordinary-course payments to insiders under an employment agreement.

Fraudulent transfers may also be avoided under applicable state law by operation of section 544(b) of the Bankruptcy Code. Section 544(b) allows a DIP or trustee to "avoid any transfer of an interest of the debtor in property or any obligation incurred by the debtor that is voidable under applicable law by a creditor holding an unsecured claim" against the debtor. The primary advantage of this provision over section 548 is that section 548 bears a two-year reach-back period. By contrast, many state fraudulent conveyance laws (generally a version of the Uniform Fraudulent Transfer Act ("UFTA")) provide for a longer statutory reach-back period to avoid fraudulent transfers.

AMENDMENTS TO SECTION 548 IN BAPCPA

BAPCPA amended section 548 to enhance the trustee's ability to recover excessive prepetition compensation paid or promised to a debtor's insiders. Specifically, section 548(a) was amended to clarify that it permits a trustee to avoid transfers for "less than a reasonably equivalent value . . . to or for the benefit of an insider, under an employment contract and not in the ordinary course of business." According to the legislative history, the intent of the amendment was "to enhance the recovery of avoidable transfers and excessive [prebankruptcy] compensation, such as bonuses, paid to insiders of a debtor." The 2005 amendment removed the requirement that the debtor be insolvent at the time of any challenged transaction involving nonordinary-course payments under employment agreements to insiders. As a consequence, insiders are now precluded from claiming solvency as a defense, thereby significantly simplifying the trustee's ability to avoid a transfer or obligation to an insider under section 548.

CONSEQUENCES OF AVOIDANCE

If the trustee successfully avoids a severance payment as a fraudulent transfer, the recipient of the avoided transfer is required to return the funds actually received to the bankruptcy estate. However, if the DIP or trustee succeeds in avoiding the severance payment but does not seek to avoid the underlying payment obligation as reflected in the severance agreement, the insider may have a claim against the bankruptcy estate. That claim would most likely be an unsecured prepetition claim, possibly with partial priority under section 507(a)(4), provided the claim is not invalidated in whole or in part under section 502(b)(4), which disallows any insider claim for services to the extent the claim exceeds the "reasonable value" of such services, or section 502(b)(7), which caps employee claims for "damages resulting from the termination of an employment contract" at an amount equal to approximately one year's compensation.

The Fifth Circuit applied section 548 to insider severance claims in *TransTexas Gas*.

TRANSTEXAS GAS

TransTexas Gas Corporation ("TransTexas") was engaged in the exploration, production, and transmission of oil and natural gas. TransTexas filed the first of two chapter 11 petitions in April 1999 in Texas. The company's chapter 11 plan provided that the company's founder, John Stanley, Sr. ("Stanley"), would serve as chief executive officer of the company and as one of the five directors on the board.

As part of TransTexas' chapter 11 plan, Stanley and TransTexas entered into an employment agreement effective in 2000 providing that Stanley could be terminated beginning two years after its execution. At termination, Stanley could be entitled to severance pay, depending on the circumstances of his termination. If he were dismissed for reasons other than cause, he would receive $3 million. If terminated for cause, his payment would be $1.5 million. If he voluntarily resigned, he would not be entitled to any severance.

Despite confirmation of a chapter 11 plan in March 2000, TransTexas continued to struggle financially. On January 30, 2002, all five members of the board met. The four directors other than Stanley agreed that "the severance option" under Stanley's employment agreement should be invoked. There was no indication that the directors discussed whether Stanley would be terminated for cause or the effect that such a termination would have on the payment.

Between January and March 2002, Stanley remained with TransTexas as CEO and a member of the board as he negotiated the terms of his departure. In March 2002, Stanley and TransTexas agreed that he would resign. The board then executed a "separation agreement," which explicitly superseded Stanley's employment agreement. Under the separation agreement, Stanley was to be paid $3 million in installments, nearly $2.3 million of which Stanley received before the payments ceased.

TransTexas Gas demonstrates the importance of proving reasonably equivalent value if an insider is to retain payments under or enforce a severance agreement.

TransTexas filed a second chapter 11 petition in November 2002. The Texas bankruptcy court confirmed a chapter 11 plan proposed by TransTexas' creditors in August 2003. The plan established a liquidating trust for TransTexas' remaining assets. The liquidating trustee sued Stanley, seeking to avoid the severance payments as preferential and fraudulent transfers under sections 547 and 548 of the Bankruptcy Code as well as the Texas UFTA. The bankruptcy court ruled in favor of the liquidating trustee on all counts, ordering Stanley to repay the $2.3 million he had received, plus attorneys' fees and costs. Among other things, the bankruptcy court found that Stanley used overreaching tactics, abusing his position of authority to obtain favorable terms in the separation agreement to which he was not entitled. The bankruptcy court also concluded that: (i) Stanley was an "insider" of TransTexas for the purpose of determining whether he was the recipient of a preferential transfer (such that the one-year reach-back period in section 547 applied); (ii) the severance payments to Stanley were both actually and constructively fraudulent under section 548; and (iii) TransTexas was insolvent at the time of the payments.

Stanley appealed to the district court, which affirmed the bankruptcy court's determination that the payments were voidable under section 548 and the UFTA but reversed the preference ruling on the basis of its conclusion that the bankruptcy court erred in holding that Stanley was an insider. Stanley then appealed to the Fifth Circuit Court of Appeals.

THE FIFTH CIRCUIT'S OPINION

A three-judge panel of the Fifth Circuit affirmed the ruling. Writing for the panel, circuit judge Leslie H. Southwick cited to the post-BAPCPA version of section 548, observing that "[t]wo elements [of section 548] are clearly satisfied" because "[t]he severance payments made to Stanley after his dismissal were obligations incurred by TransTexas within two years of its petition date." The judge then examined whether Stanley qualified as an "insider" of TransTexas within the meaning of section 548(a)(1). Under section 548, Judge Southwick wrote, "it is enough that Stanley was an insider either at the time of the transfer of the funds or at the time the company incurred such obligation." According to the judge, "[T]here is no textual limitation of insider status to the time in which the transfer is made."

Judge Southwick then addressed whether TransTexas received reasonably equivalent value in exchange for the severance payments made to Stanley. According to Stanley, he provided reasonably equivalent value because the payments were "a dollar-for-dollar satisfaction of a debt" that arose under his employment agreement and were merely memorialized in his separation agreement. He also contended that his employment agreement was specifically approved as part of the chapter 11 plan in TransTexas' first bankruptcy and that "there is a *res judicata* effect from the earlier bankruptcy court's approval of the contract itself, making the payment incontestable." Finally, Stanley suggested that by agreeing to "go quietly," he provided benefit to the company.

The Fifth Circuit rejected these arguments. Judge Southwick wrote that "[t]he problem factually for each court that has examined the early 2002 Separation Agreement is that at least for a year prior to the termination, there had been evidence of good cause for which Stanley could be terminated." Such a termination would have reduced by half the severance payment. Moreover, the judge explained, Stanley actually resigned, which under the employment agreement would have entitled the company to pay him nothing. Even under the most favorable circumstances, he emphasized, Stanley could have been entitled to no more than $1.5 million under the employment agreement, rather than the $2.3 million he was actually paid.

Stanley argued that the release and covenant not to sue that he signed as part of the separation agreement provided a benefit to the company, an argument that led the district court below to assign some value to Stanley's concessions, but not enough to prevent the payment from being avoided as a fraudulent transfer. The Fifth Circuit agreed with the district court, concluding that any such value paled in comparison to the severance payment and could not make up the $1.5 million difference between what TransTexas may have owed Stanley (assuming it owed him anything at all) and the amount actually paid.

Turning to the issue of whether TransTexas was insolvent or had become insolvent by virtue of the financial obligations incurred by the separation agreement, Judge Southwick concluded that "the insolvency issue only applies to preferential transfers under section 547(b)." Under post-BAPCPA section 548, she explained, a debtor either must have made a transfer that resulted in insolvency or when the debtor was insolvent, or must have made the transfer "to or for the benefit of an insider, or incurred such obligation to or for the benefit of an insider, under an employment contract and not in the ordinary course of business." According to the judge, "That latter provision applies," and Stanley was an insider at the time the obligation was incurred.

RAMIFICATIONS

TransTexas Gas represents the first time that the post-BAPCPA version of section 548 was applied in the federal circuit courts of appeal. Unfortunately, it would appear that the *pre*-BAPCPA version of the provision actually applied to the dispute. TransTexas filed both of its chapter 11 cases prior to the October 17, 2005, effective date of most BAPCPA provisions, as well as the April 20, 2005, effective date of the changes to section 548 regarding transfers or obligations to insiders under employment contracts, and the April 21, 2006, effective date of the expanded two-year look-back period. The Fifth Circuit's reliance on the post-BAPCPA version of section 548 may have been a consequence of the bankruptcy court's findings of fact and conclusions of law, which cite to a version of the provision that contains subsection 548(a)(1)(B)(IV), which was added as part of BAPCPA. In addition, one of the appellate briefs filed in the Fifth Circuit refers to the amended version of section 548. Interestingly, although Stanley asked the Fifth Circuit to reconsider its ruling on February 24, 2010, he did not raise this issue in his petition for rehearing, which the court denied on April 12, nor did he appeal the ruling to the U.S. Supreme Court.

Because the post-BAPCPA version of section 548 will apply to bankruptcy cases filed after the dates described above, *TransTexas Gas* demonstrates the importance of proving reasonably equivalent value if an insider is to retain payments under or enforce a severance agreement. The question then arises regarding what forms of reasonably equivalent value (under section 548) or "adequate consideration" (under the UFTA) the insider can provide. Unfortunately, the answer to that question is unclear.

Courts have determined, in the context of actions commenced under section 544(b) to avoid fraudulent transfers under the UFTA, that one form of adequate consideration involves an employee accepting an obligation of continuing performance in exchange for a future severance payment. This was the situation, for example, in the Eleventh Circuit's 1996 ruling in *In re Munford*, where several essential officers agreed to stay with the company during a leveraged buyout transaction in exchange for additional severance pay. The court found that the obligation of continued employment constituted adequate consideration and that the severance payments were therefore not fraudulent transfers.

An obligation of continuing performance may not help, however, if the debtor enters into a severance agreement simultaneously with an employee's termination, which is a common scenario in which a severance payment is later challenged by a trustee or DIP as being a fraudulent transfer. Also, as in *TransTexas Gas*, a contingent obligation to make a severance payment may result in a fraudulent transfer if the necessary contingency (*i.e.*, lack of cause for the termination) is not satisfied. In these cases, the insider may need to rely on the value of a release and covenant not to sue, a noncompete clause, or another ongoing obligation created by the severance agreement in order to establish the necessary value to withstand a challenge under section 544(b) or 548.

Unfortunately, case law provides little guidance on how to value releases, noncompete clauses, or similar obligations

created by severance agreements. Both the district court and the Fifth Circuit in *TransTexas Gas* agreed with Stanley that such releases provide some measure of value. Both also found, however, that the potential value was not reasonably equivalent to the challenged $3 million severance obligation. There was no analysis of how the courts reached that conclusion, nor was there any suggestion of how a court should calculate value in a similar situation. This uncertainty creates a potential minefield for executives who are terminated as part of the prebankruptcy process.

In re TransTexas Gas Corp., 597 F.3d 298 (5th Cir. 2010), *aff'g Stanley v. U.S. Bank Nat'l Assoc., as Liquidating Trustee*, Case No. 2:07-CV-00398 (S.D. Tex. Sept. 23, 2008).

In re Munford, Inc., 98 F.3d 604 (11th Cir. 1996).

CAVEAT VENDOR: ELEVENTH CIRCUIT RULES THAT UNAUTHORIZED PAYMENTS BY DIP USING CASH COLLATERAL MUST BE DISGORGED

Charles M. Oellermann and Fan B. He

When a company files for chapter 11 protection, it typically obtains either debtor-in-possession ("DIP") financing or permission to use cash collateral, or a combination of both, to keep the business operational. In today's restricted credit market, DIP financing has been difficult to obtain. As a consequence, chapter 11 debtors are increasingly relying on the use of cash collateral to finance the journey through the bankruptcy process. A ruling recently handed down by the U.S. Court of Appeals for the Eleventh Circuit highlights the principle that a debtor's use of cash collateral is subject to later court review. In *In re Delco Oil, Inc.*, a three-judge panel of the court of appeals put vendors who trade with a debtor postpetition on notice that unauthorized payments by a DIP using cash collateral can be avoided and recovered by the estate.

CASH COLLATERAL

Section 363(a) of the Bankruptcy Code defines "cash collateral" as "cash, negotiable instruments, documents of title, securities, deposit accounts, or other cash equivalents whenever acquired in which the estate and an entity other than the estate have an interest." Cash collateral also includes "the proceeds, products, offspring, rents, or profits of property . . . subject to a security interest." The Bankruptcy Code defines "security interest" as a "lien created by an agreement."

Generally, cash collateral is thought of as an asset that can dissipate or be consumed quickly, easily, and undetectably. And once gone, cash collateral is difficult to trace and recover. Because of this transient characteristic, Congress has codified special provisions in the Bankruptcy Code to account for cash collateral and restrict the use of it, to protect the rights of the creditor that holds a security interest in the cash collateral.

Under section 363(c)(4) of the Bankruptcy Code, a DIP is required to segregate and account for any cash collateral in its possession, custody, or control. This requirement applies to both cash collateral the debtor has on hand before the

commencement of the bankruptcy case and any cash collateral the DIP acquires thereafter. Because the DIP has a duty to protect and maintain the collateral for the benefit of the one or more secured creditors who have an interest in the collateral, it is especially important to identify each secured creditor that has an interest in it.

Under section 363(c)(2) of the Bankruptcy Code, a DIP may not use, sell, or lease cash collateral without either (i) the consent of each secured creditor with an interest in the collateral or (ii) the court's authorization. Often, a secured creditor will allow the DIP to use cash collateral for specific purposes to keep the business operational, under certain terms and conditions. This type of agreement benefits the secured creditor because it maintains the DIP as a going concern, thereby preserving the value of the secured creditor's interest in the collateral.

If the secured creditor and the DIP cannot agree on a proposed use of cash collateral, the court may grant such permission, provided that the secured creditor's interest in the collateral is adequately protected. The DIP bears the burden of proving that it can adequately protect the secured creditor's interest in the cash collateral. Even though section 363(c)(2) requires notice and a hearing before the court can grant permission to use cash collateral, the court may, and often does, hear motions to use cash collateral on an expedited basis—particularly at the inception of a bankruptcy case. The court may conduct a preliminary hearing on the first day of the bankruptcy case to authorize the use of cash collateral for certain urgent and vital uses on an interim basis to prevent immediate and irreparable harm to the debtor's estate. The court typically convenes a later final hearing on the use of cash collateral.

AVOIDING UNAUTHORIZED POSTPETITION TRANSFERS

Section 549(a) of the Bankruptcy Code gives a bankruptcy trustee or DIP the power to avoid unauthorized postpetition transfers of estate property. It provides that, with certain exceptions, "the trustee may avoid a transfer of property of the estate—(1) that occurs after the commencement of the case; and (2)(A) that is authorized only under section 303(f) or 542(c) of this title; or (B) that is not authorized under this title or by the court." The exceptions involve transfers occurring during the involuntary bankruptcy petition "gap period" and certain transfers by or to parties who act in good faith without knowledge of the debtor's bankruptcy filing.

In *Delco Oil*, the Eleventh Circuit addressed whether a chapter 7 trustee may use section 549(a) to remedy a debtor's impermissible use of cash collateral.

DELCO OIL

Delco Oil, Inc. ("Delco"), was a distributor of gasoline. Before its bankruptcy filing, Delco entered into a purchase agreement with Marathon Petroleum Company, LLC ("Marathon"), for petroleum products and a financing agreement with CapitalSource Finance ("CapitalSource"), whereby CapitalSource provided financing to Delco in exchange for a security interest in all of Delco's personal property, including collections, cash payments, and inventory.

Delco filed for chapter 11 protection in October 2006 in Florida. On the petition date, it filed an emergency motion for court permission to use CapitalSource's cash collateral, a request opposed by CapitalSource. The court denied Delco's motion three weeks later. During the gap period between the filing of the motion and the court's ruling—although it did not have court approval or CapitalSource's consent to use cash collateral—Delco paid Marathon more than $1.9 million in cash for petroleum products delivered postpetition.

The bankruptcy case was converted to a chapter 7 liquidation in December 2006. The chapter 7 trustee filed an adversary proceeding to avoid and recover the transfers to Marathon. On summary judgment, the bankruptcy court ruled in favor of the chapter 7 trustee, holding that Delco lacked authority to use CapitalSource's cash collateral to pay Marathon. The district court affirmed the bankruptcy court's ruling, and Marathon appealed to the Eleventh Circuit.

THE ELEVENTH CIRCUIT'S DECISION

Marathon argued before the Eleventh Circuit that the lower courts erred in granting summary judgment because there was a material issue of fact regarding whether the funds it received from Delco were CapitalSource's cash collateral.

According to Marathon, under Florida's version of the Uniform Commercial Code, when Marathon received the funds from Delco's deposit account, Marathon took the funds free and clear of any security interest attached to them.

By ordering disgorgement of payments to Marathon, the Eleventh Circuit has written a cautionary tale for postpetition vendors.

The Eleventh Circuit did not dispute Marathon's interpretation of the Florida statute but instead found that the statute was inapposite. Under federal bankruptcy law, the court of appeals explained, the appropriate time to determine whether the funds were cash collateral was when they were in Delco's possession prior to the transfers. At that time, CapitalSource held a perfected security interest in all of Delco's personal property, and the funds Delco transferred to Marathon were cash proceeds of the personal property. Thus, the Eleventh Circuit ruled, the funds were cash collateral as defined under section 363(a) of the Bankruptcy Code, and Delco was prohibited from transferring the funds to Marathon without CapitalSource's permission or a court order.

NO "HARMLESS" EXCEPTION TO SECTION 549

Marathon also argued that, even if the funds were cash collateral, the chapter 7 trustee could not avoid the transfers because CapitalSource was not harmed by the transfers; the petroleum products Marathon sold to Delco postpetition in exchange for the payments of cash collateral constituted inventory subject to CapitalSource's lien in an amount allegedly equal to the amount of the cash transfers. Thus, the value of the assets covered by CapitalSource's lien arguably was not reduced by the unauthorized postpetition transfers of funds. The Eleventh Circuit dismissed this argument, holding that section 549(a) of the Bankruptcy Code does not have an exception for "harmless" transfers. Section 549(a), the court explained, broadly grants power to the chapter 7 trustee to avoid any unauthorized postpetition transfers of property of the estate.

NO ORDINARY-COURSE TRANSFER OR "INNOCENT VENDOR" DEFENSE

Finally, Marathon asserted that based on public policy, section 549 provides implicit defenses for ordinary-course transfers and for innocent vendors who trade with the debtor. The Eleventh Circuit rejected this argument as well. It reasoned that Congress, by specifically carving out the use of cash collateral from section 363(c)(1)—which permits the debtor to enter into ordinary-course-of-business transfers without notice or a hearing—intended that cash collateral not be used even in the ordinary course of business without secured creditor or court permission. Similarly, the Eleventh Circuit noted that there is no indication from the text of sections 549(a) and 550(a) that Congress intended to create an "innocent vendor" defense based upon the transferee's status and culpability. Consequently, the court ruled, no such implied defense exists under section 549(a) of the Bankruptcy Code.

OUTLOOK

The Eleventh Circuit's decision in *Delco Oil* is consistent with courts' strict enforcement of section 363(c)(2) of the Bankruptcy Code and the protection of secured creditors' interests in cash collateral. Under the Eleventh Circuit's ruling, section 363(c)(2)'s reach is broad, extending to payments to vendors who trade postpetition with the debtor, even in the ordinary course of business.

By ordering disgorgement of payments to Marathon, the Eleventh Circuit has written a cautionary tale for postpetition vendors. Any vendor that receives postpetition payments from a DIP is well advised to ensure that the DIP has the requisite creditor consent or court authority to make the payments. Furthermore, under this decision, postpetition vendors apparently will not qualify for the good-faith transferee "safe harbor" in section 550(b). Absent such an assurance, vendors may refuse to deal with a DIP whose assets are substantially encumbered. Alternatively, such vendors may be forced to rely on an administrative-priority claim for the value of any goods or services provided to a DIP, which claim may be of little practical value in a chapter 11 case on the brink of administrative insolvency and/or conversion to chapter 7.

In re Delco Oil, Inc., 599 F.3d 1255 (11th Cir. 2010).

NO UNWAIVABLE RIGHT TO FILE AN INVOLUNTARY BANKRUPTCY PETITION

Mark G. Douglas

The ability to file for bankruptcy protection and receive a discharge of debts is sometimes perceived, rightly or wrongly, as a fundamental (if not constitutional) entitlement under U.S. law in keeping with the congressional mandate in Article I, Section 8, Clause 4 of the U.S. Constitution to establish "uniform Laws on the subject of Bankruptcies throughout the United States." For this reason, the general rule is that a debtor may not waive the right to file for bankruptcy protection, and a voluntary bankruptcy filing is prohibited only under the narrowly defined circumstances contained in the Bankruptcy Code.

A creditor's right to file an involuntary bankruptcy petition against a debtor, however, is less inviolable. A ruling recently handed down by the Second Circuit Court of Appeals illustrates that, under appropriate circumstances, creditors can be enjoined from filing an involuntary bankruptcy case against a debtor. In *Securities and Exchange Commission v. Byers*, the court of appeals affirmed a district court order denying a request to dissolve an anti-litigation injunction barring nonparties from filing involuntary bankruptcy petitions against entities whose property was subject to a Securities and Exchange Commission ("SEC") receivership. "Simply put," the Second Circuit ruled, "there is no unwaivable right to file an involuntary bankruptcy petition, and, even if there were, the receivership accomplishes what a bankruptcy would."

LIMITATIONS ON THE RIGHT TO FILE BANKRUPTCY PETITIONS

A debtor's ability to file for bankruptcy protection is a fundamental privilege. For this reason, any agreement purporting to waive that right is almost always unenforceable as a matter of public policy. Even so, the right to file a bankruptcy petition is not absolute. It may be abridged or limited by statute. For example, section 109 of the Bankruptcy Code, which governs eligibility for bankruptcy filings under all chapters (except chapter 15), prohibits certain entities, such as railroads, insurance companies, and banks, from being a debtor under certain chapters. Also, section 109(g) of the Bankruptcy Code, which was added to the Bankruptcy Code in 1984 to deter repetitious filings, provides that no individual or family farmer who has been a debtor in a case pending at any time during the preceding 180 days may be a debtor in a bankruptcy case under any chapter if the case was dismissed for willful failure of the debtor to abide by court orders or prosecute the case, or if the debtor requested and obtained voluntary dismissal of the case following a request for relief from the automatic stay.

Section 349(a) of the Bankruptcy Code, which provides that the dismissal of a bankruptcy case does not bar the issuance of a discharge of debts in a later case or "prejudice the debtor with regard to the filing of a subsequent petition . . . except as provided in section 109(g)," has also been interpreted by some courts as authority for barring future filings. There is, however, a conflict among the circuits as to the scope or validity of that empowerment. In addition, some courts have interpreted the broad equitable mandate contained in section 105(a) of the Bankruptcy Code, which provides that the "court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title," to preclude an entity from legitimately filing for bankruptcy in certain circumstances. However, this approach has been criticized as being contrary to the understanding of section 105(a)'s limitation of scope to areas that are not otherwise expressly addressed by other sections of the statute.

Section 303 of the Bankruptcy Code provides that an involuntary chapter 7 or chapter 11 case may be filed by creditors asserting unsecured claims of specified minimum amounts that are neither contingent nor subject to bona fide dispute against "a person, except a farmer, family farmer, or a corporation that is not a moneyed, business, or commercial corporation," so long as the "person" is otherwise eligible to be a debtor under the conditions specified in section 109. Other than section 303, no provision of the Bankruptcy Code expressly precludes a creditor from filing an involuntary bankruptcy petition against a debtor.

However, under certain limited circumstances, a handful of courts have ruled that voluntary or involuntary bankruptcy filings may be prohibited on grounds other than those expressly (or at least impliedly) contemplated by the

Bankruptcy Code. As demonstrated in the Second Circuit's ruling in *S.E.C. v. Byers*, these circumstances have almost always been limited to situations involving debtors that have been placed into federal receivership, such that their assets are already subject to federal court administration.

S.E.C. v. BYERS

On August 11, 2008, the SEC filed a complaint against Steven Byers and various other affiliated defendants, alleging a massive Ponzi scheme that operated in the U.S., the Middle East, and Africa and that reportedly defrauded investors of approximately $255 million. On the same day that it filed the complaint, the SEC obtained emergency relief, including a temporary restraining order freezing the assets of the defendants and appointing a receiver to ascertain the defendants' financial condition and to determine whether any or all of them should file for bankruptcy protection. The receiver order issued by the district court also contained the following anti-litigation provision:

> No person or entity, including any creditor or claimant against any of the Defendants, or any person acting on behalf of such creditor or claimant, shall take any action to interfere with the taking control, possession, or management of the assets, including, but not limited to, the filing of any lawsuits, liens, or encumbrances, or bankruptcy cases to impact the property and assets subject to this order.

One month later, the district court modified its previous order to provide as follows:

> If in accordance with this order the Receiver determines that any of the [defendants] and entities they own or control should undertake a bankruptcy filing, the Receiver be, and he hereby is, authorized to commence cases under title 11 of the United States Code for such entities in this district, and in such cases the Receiver shall prosecute the bankruptcy petitions in accordance with title 11 subject to the same parameters and objectives as a chapter 11 trustee and shall remain in possession, custody, and control of the title 11 estates subject to the rights of any party in interest to challenge such possession, custody, and control under 11 U.S.C. § 543 or to request a determination by this Court as to whether the Receiver should be deemed a debtor in possession or trustee, at a hearing, on due notice to all parties in interest, before the undersigned.

On October 24, 2008, on the consent of all parties, the district court issued a preliminary injunction that incorporated the provisional remedies quoted above. Shortly afterward, two ad hoc creditors' committees requested that the court modify its orders to remove the bankruptcy-filing prohibition and the provision that authorized the receiver to prosecute a bankruptcy case as a chapter 11 trustee. The district court denied the relief requested but modified its injunction order to: (i) permit any party or nonparty to seek court permission to file a bankruptcy case against any of the defendants on three days' notice, based upon a showing that such a petition would be appropriate and benefit the receivership estate; and (ii) allow the bankruptcy court to decide in the first instance any challenge to the receiver's continuing to serve as a debtor in possession. The committees appealed the order to the Second Circuit.

THE SECOND CIRCUIT'S RULING

A three-judge panel of the Second Circuit affirmed on appeal. Writing for the court, circuit judge Rosemary S. Pooler rejected the committees' argument that section 303 of the Bankruptcy Code grants them an absolute right, as creditors, to commence an involuntary bankruptcy case against a debtor. "[W]hile it is a power to be exercised cautiously," Judge Pooler remarked, "district courts may issue anti-litigation injunctions barring bankruptcy filings as part of their broad equitable powers in the context of an SEC receivership."

Judge Pooler also rejected the committees' contention that such injunctions cannot apply to bankruptcy petitions because the ability to file a bankruptcy petition is a right guaranteed by the Bankruptcy Code. The judge explained that the Sixth and Ninth Circuits have also approved the issuance of anti-litigation injunctions in federal receivership cases, albeit they did not expressly bar bankruptcy filings. Debtors, she wrote, "do not have an absolute right to file a bankruptcy petition," and creditors may waive the right to file an involuntary bankruptcy petition:

> Simply put, there is no unwaivable right to file an involuntary bankruptcy petition, and, even if there were, the receivership accomplishes what a bankruptcy would. The receivership protects the assets of the estate, just as a stay would in bankruptcy.
>
> An anti-litigation injunction is simply one of the tools available to courts to help further the goals of the receivership. While such injunctions are to be used sparingly, there are situations in which they are entirely appropriate. In this litigation the receivership must manage hundreds of [defendants] that sprawl across the Middle East, Africa and the United States, many of which may have co-mingled assets. This is precisely the situation in which an anti-litigation injunction may assist the district court and receiver who will want to maintain maximum control over the assets. The current injunction prevents small groups of creditors from placing some entities into bankruptcy, thereby removing assets from the receivership estate to the potential detriment of all. We are persuaded that the powers afforded the receiver and the district court allow it to adequately protect the assets of the estate.

Finally, Judge Pooler found no merit in the committees' argument that the district court's order includes an improper de facto designation of the receiver as a debtor in possession or trustee in the event of a bankruptcy filing, principally because section 105(b) of the Bankruptcy Code prohibits courts from appointing a receiver in bankruptcy cases. According to the judge, nothing in the order conflicts with the Bankruptcy Code because the "order merely acknowledges that the receiver automatically becomes debtor-in-possession by operation of law." Moreover, she emphasized, the receiver's status can be challenged under section 543, or the parties can move to appoint a chapter 11 trustee under section 1104. There is no reason, Judge Pooler wrote, that "a district court cannot, pre-petition, appoint a manager for the entities, and there is nothing in the Bankruptcy Code that prevents that manager from continuing after the bankruptcy filing, subject to challenge by others."

OUTLOOK

The ability to file an involuntary bankruptcy petition against a debtor that is not paying its obligations is an important remedy given to creditors under the Bankruptcy Code. In certain situations (*e.g.*, when a company's management is incompetent, there is dissension among the general partners of a partnership, or a potential debtor is transferring assets in anticipation of creditor collection proceedings), the filing of an involuntary case is a beneficial, and sometimes optimal, strategy for creditors. *S.E.C. v. Byers* illustrates that a creditor's right to file an involuntary bankruptcy, like a debtor's right to file for bankruptcy voluntarily, is protected but not absolutely inviolate. According to the Second Circuit, creditors can be enjoined from filing an involuntary bankruptcy petition in cases where the debtor is in federal receivership.

S.E.C. v. Byers illustrates that a creditor's right to file an involuntary bankruptcy, like a debtor's right to file for bankruptcy voluntarily, is protected but not absolutely inviolate.

As a statutory matter, why the pendency of a federal receivership should be a legitimate basis for banning a voluntary or involuntary bankruptcy filing with respect to the debtor is unclear. Section 543 of the Bankruptcy Code expressly contemplates that a bankruptcy filing will supersede any pending receivership by directing a "custodian," which is defined in section 101(11) to include a "receiver or trustee of any property of the debtor, appointed in a case or proceeding not under [the Bankruptcy Code]," to deliver to the bankruptcy trustee any property of the debtor in its possession as of the commencement of the debtor's bankruptcy case. A receiver in a federal receivership proceeding would appear to fall within the definition of "custodian." Although it does not expressly say so, perhaps the Second Circuit's decision draws a distinction between federal and state law receiverships. Courts have uniformly ruled that voluntary or involuntary bankruptcy filings may not be barred in cases involving debtors that are subject to receiverships under *state* law. The Supremacy Clause of the U.S. Constitution (Art. VI, § 1, cl. 2), however, can be interpreted in such a way that the Bankruptcy Code prevails in cases involving state,

but not federal, receiverships. Moreover, bankruptcy courts do not represent an independent arm of the judicial branch but are merely units of the federal district courts. Thus, judicial economy and efficient use of resources arguably would dictate that a bankruptcy filing by or against a debtor that is already subject to federal receivership overseen by a district court would be wasteful and needlessly duplicative.

Securities and Exchange Commission v. Byers, 609 F.3d 87 (2d Cir. 2010).

Frieouf v. United States (In re Frieouf), 938 F.2d 1099 (10th Cir. 1991).

Liberte Capital Group, LLC v. Capwill, 462 F.3d 543 (6th Cir. 2006).

Securities and Exchange Commission v Wencke, 622 F.2d 1363 (9th Cir. 1980).

U.S. v. Vulpis, 961 F.2d 368 (2d Cir. 1992).

In re Casse, 198 F.3d 327 (2d Cir. 1999).

Colonial Auto Ctr. v. Tomlin (In re Tomlin), 105 F.3d 933 (4th Cir. 1997).

In re Cusano, 2010 WL 2593921 (Bankr. 6th Cir. June 25, 2010).

Giaimo v. Detrano (In re Detrano), 222 B.R. 685 (Bankr. E.D.N.Y. 1998).

In re Global Ship Systems, LLC, 391 B.R. 193 (Bankr. S.D. Ga. 2007).

In re McCullough and Co., 199 B.R. 179 (Bankr. W.D. Mo. 1996).

In re S & S Liquor Mart, Inc., 52 B.R. 226 (Bankr. D.R.I. 1985).

In re Newport Offshore Ltd., 219 B.R. 341 (Bankr. D.R.I. 1998).

In re Rite-Cap, Inc., 1 B.R. 740 (Bankr. D.R.I. 1979).

In re Segno Communications, Inc., 264 B.R. 501 (Bankr. N.D. Ill. 2001).

THE U.S. FEDERAL JUDICIARY

U.S. federal courts have frequently been referred to as the "guardians of the Constitution." Under Article III of the Constitution, federal judges are appointed for life by the U.S. president with the approval of the Senate. They can be removed from office only through impeachment and conviction by Congress. The first bill considered by the U.S. Senate—the Judiciary Act of 1789—divided the U.S. into what eventually became 12 judicial "circuits." In addition, the court system is divided geographically into 94 "districts" throughout the U.S. Within each district is a single court of appeals, regional district courts, bankruptcy appellate panels (in some districts), and bankruptcy courts.

As stipulated by Article III of the Constitution, the Chief Justice and the eight Associate Justices of the Supreme Court hear and decide cases involving important questions regarding the interpretation and fair application of the Constitution and federal law. A U.S. court of appeals sits in each of the 12 regional circuits. These circuit courts hear appeals of decisions of the district courts located within their respective circuits and appeals of decisions of federal regulatory agencies. Located in the District of Columbia, the Court of Appeals for the Federal Circuit has nationwide jurisdiction and hears specialized cases such as patent and international trade cases. The 94 district courts, located within the 12 regional circuits, hear nearly all cases involving federal civil and criminal laws. Decisions of the district courts are most commonly appealed to the district's court of appeals.

Bankruptcy courts are units of the federal district courts. Unlike that of other federal judges, the power of bankruptcy judges is derived principally from Article I of the Constitution, although bankruptcy judges serve as judicial officers of the district courts established under Article III. Bankruptcy judges are appointed for a term of 14 years (subject to extension or reappointment) by the federal circuit courts after considering the recommendations of the Judicial Conference of the U.S. Appeals from bankruptcy court rulings are most commonly lodged either with the district court of which the bankruptcy court is a unit or with bankruptcy appellate panels, which presently exist in five circuits. Under certain circumstances, appeals from bankruptcy rulings may be made directly to the court of appeals.

Two special courts—the U.S. Court of International Trade and the U.S. Court of Federal Claims—have nationwide jurisdiction over special types of cases. Other special federal courts include the U.S. Court of Appeals for Veterans' Claims and the U.S. Court of Appeals for the Armed Forces.

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