RECENT DEVELOPMENTS IN BANKRUPTCY AND RESTRUCTURING

VOLUME 10 ▪ NO. 4 ▪ JULY/AUGUST 2011

BUSINESS RESTRUCTURING REVIEW

IN THIS ISSUE

EUROPEAN PERSPECTIVE: ITALIAN SUPREME COURT RECOGNIZES THAT JUDICIARY HAS LIMITED POWERS TO REVIEW ARRANGEMENTS WITH CREDITORS

Francesco Squerzoni and Tommaso Cefis

Note From the Editors: The second installment of our "European Perspective" column has been contributed by Francesco Squerzoni and Tommaso Cefis. Francesco is a partner in Jones Day's Milan Office. His practice focuses on multijurisdictional transactions, including investment and development projects in acquisition and real estate financings, structured finance transactions, and debt restructurings. Tommaso is an associate in the Milan Office.

During the last few years, Italian bankruptcy law has been shifting from a traditional "procedural/judicial" model, based on the central role of courts called upon to safeguard the "public interest" involved in bankruptcy by actively directing the procedure and making the most important decisions, to a model that recognizes the private interests of creditors. Under the new paradigm, creditors are conferred with decisional powers, while courts maintain a principally supervisory role.

The turning point was in 2005, when the Italian legislature significantly reformed the fundamental statute on bankruptcy (Royal Decree No. 267 of March 16, 1942; the "Bankruptcy Law"), in an effort to achieve a more modern and flexible insolvency-law system based on private rather than judicial initiative (sometimes referred to as "deregulation" or "privatization" of the bankruptcy law), with creditors as the real engine of the insolvency proceedings. The reform, in particular, brought new life to "agreed" insolvency procedures as an alternative to bankruptcy. Previously, bankruptcy proceedings had been heavily regulated, burdened with strict legal requirements, and subject to the pervasive direction of the courts—and thus were rarely attractive and seldom used in comparison with other legal systems. The existing insolvency-procedure alternative to bankruptcy (an arrangement with creditors, or *concordato preventivo*) was revised beginning in 2005, and a new procedure (the restructuring agreement, or *accordo di ristrutturazione dei debiti*) was introduced, all in accordance with the principles of freedom of contract and private initiative.

Courts, however, have been reluctant to cede center stage to creditors. Since the reform, several decisions have been issued by lower courts in which the law has been interpreted to extend the authority of the judiciary to review private actions. The rationale underlying these rulings (*i.e.*, allowing courts to prevent abuse that "strong" creditors may commit) was to a certain extent appropriate. However, the reviewing authority of the judiciary in the wake of the reforms has, in the opinion of many, overstepped the intentions of legislators in enacting the reforms.

This "attitude" of the judiciary, however, may change, thanks to a recent decision of the Italian Supreme Court concerning *concordato preventivo* procedures. In *Industrial Lift Technology* (Decision No. 21860 of October 25, 2010), the Supreme Court recognized the predominance of private interests and limited the authority of the judiciary to review arrangements with creditors.

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ARRANGEMENTS WITH CREDITORS IN ITALY

To better explain the significance and possible consequences of *Industrial Lift Technology*, it may be useful to summarize the main features of the Italian *concordato preventivo*.

The *concordato preventivo* is one of the insolvency procedures made available to entrepreneurs in a state of financial crisis or insolvency by the Bankruptcy Law. The aim of the procedure is to avoid a declaration of bankruptcy, which may be detrimental to both the debtor and its creditors, by permitting the parties to reach an agreement on the rescue or liquidation of the business, with limited court supervision.

In summary, the procedure is structured as follows:

- A draft arrangement with creditors is prepared by the debtor. The draft has the form of a "take it or leave it" contractual proposal addressed to creditors. In practice, the terms of the proposal are informally negotiated with, at a minimum, the most important creditors (and may also be amended following requests made by the court or creditors after the original proposal has been filed). Unlike in a U.S. chapter 11 case, where the debtor has exclusivity for a limited time period, only the debtor is entitled to propose an arrangement.

- The proposed arrangement is based on a "plan" that may provide for any of the following: (i) restructuring of indebtedness and settlement of creditor claims by any means, including the sale of goods, the assumption of debt, or the transfer of stock, bonds, or other financial instruments to creditors; (ii) sale of the business to a third party; (iii) division of creditors with similar legal positions and economic interests into classes; and (iv) different treatment among classes.

- The feasibility of the arrangement plan is certified in a report by a professional (such as a chartered accountant) enrolled in the auditors' register.

NEWSWORTHY

Corinne Ball (New York) received a "Leading Lawyer" designation in the field of Corporate Restructuring in *The Legal 500 U.S.* for 2011.

Heather Lennox (New York/Cleveland) was featured in the June 14, 2011, "Practice Spotlight" column of *Business Law Currents*.

Paul D. Leake (New York), ***Richard L. Wynne (Los Angeles)***, ***Heather Lennox (New York/Cleveland)***, and ***Carl E. Black (Cleveland)*** were recommended in the field of Corporate Restructuring in *The Legal 500 U.S.* for 2011.

Jones Day's Frankfurt Office will host a client event on October 6 regarding a currently pending major reform of German insolvency legislation that will significantly facilitate the restructuring of insolvent businesses, enhance creditor influence on the choice of an insolvency administrator, and provide for more cases of self-administration. The speakers will include ***Volker Kammel (Frankfurt)*** and other professionals.

Paul M. Green (Dallas) and ***Thomas A. Howley (Houston)*** gave a presentation on June 24 in San Antonio at the State Bar of Texas Annual Meeting concerning "What All Lawyers Should Know About Bankruptcy and Recent Developments in Commercial Workouts."

Daniel P. Winikka (Dallas) moderated a panel discussion on June 11 entitled "Intercompany Claims and Issues in Complex Bankruptcies" at the Association of Insolvency & Restructuring Advisors' 27th Annual Bankruptcy and Restructuring Conference in Boston.

Thomas A. Howley (Houston) was named the 2011–2012 chair-elect of the Bankruptcy Law Section for the State Bar of Texas.

An article written by ***Charles M. Oellermann (Columbus)*** and ***Mark G. Douglas (New York)*** entitled "The Trouble With Ch. 11 for Nonprofits" appeared in the April 20, 2011, edition of *Bankruptcy Law360*.

An article written by ***Scott J. Friedman (New York)*** and ***Mark G. Douglas (New York)*** entitled "Bankruptcy Claims Traders Alert" was published in the June 2011 edition of *The Bankruptcy Strategist*.

An article written by ***Michael Rutstein (London)*** entitled "Roll Up! Roll Up! Schemes Round Up" will appear in the September 2011 issue of *Corporate Rescue and Insolvency*.

An article written by ***Laurent Assaya (Paris)*** entitled "Coeur Défense: The Application of the Safeguard Procedure" was published in May 2011 as a *Jones Day Commentary*.

Laurent Assaya (Paris) was quoted in an article entitled "La nouvelle sauvegarde de Belvédère interpelle les juristes" in the July 6, 2011, edition of *Agefi.fr*.

An interview with ***Laurent Assaya (Paris)*** concerning Ford Blanquefort appeared in the May 13, 2011, edition of *LesEchos.fr.*

Laurent Assaya (Paris) gave a presentation entitled "Restructuration financière et valorisation: les principaux dangers (Financial Restructuring and Valuation: The Main Dangers)" on March 24 at a conference sponsored by L'Association Droit & Affaires in Paris.

- A request for admission to the *concordato preventivo* procedure, accompanied by supporting documentation (including the professional's report on feasibility), is then submitted to the local court of first instance (*Tribunale*). The court reviews the documentation and, if all the requirements are met, admits the proposed arrangement and declares the procedure open.

- During the pendency of the procedure, precautionary or enforcement actions of creditors are stayed. The business is still managed by the debtor, but under the supervision of a court-appointed official and the superintendence of a delegated judge.

- Thereafter, the provisionally approved arrangement is submitted to creditors for approval. At a creditors' meeting, the arrangement is approved with a favorable vote by creditors representing the majority of the claims eligible to vote (and, if divided into classes, with a favorable vote by the majority of the classes). Dissenting creditors may file an objection with the court under limited circumstances.

- After having certified the voting procedures and ruled on objections by dissenting creditors, the court will approve the arrangement. At this juncture, the arrangement becomes effective and final and therefore binding upon the debtor and all creditors.

Beginning in 2005, the Italian legislature reformed the *concordato preventivo* with the intention of creating a flexible instrument that the parties involved may adapt to the actual circumstances of the case in order to safeguard their interests. The law, however, has reserved a supervisory role for the courts. In addition, as discussed below, a debate among judges and scholars has been growing during the last few years on the extent and significance of the courts' role.

REVIEWING POWERS OF THE COURTS: INTERPRETATION ISSUES

Since the 2005 reforms, one of the hot topics has been the extent of the reviewing powers of the courts with respect to the merits of a proposed arrangement plan certified by a professional and submitted by the debtor to the *Tribunale*, together with a request for admission to the *concordato preventivo* procedure.

The reformed Bankruptcy Law does not expressly grant the *Tribunale* the power to deny admission to the procedure if the arrangement (notwithstanding being certified by a professional) is deemed unfeasible by the court. The statutory provisions defining the court's reviewing powers, however, are rather obscure and open to different interpretations. Before *Industrial Lift Technology*, two conflicting interpretations had emerged.

Under the first interpretation, the court would be entitled to review the feasibility—and therefore the merits—of the arrangement plan proposed by the debtor, and to deny admission to the procedure, if the court deemed the plan infeasible. This interpretation has been endorsed by most of the lower courts and by certain commentators. It is premised upon the rationale that the courts are entrusted by law with the role of independent protectors of the "public interests" involved in insolvency procedures and, as such, must ensure that an arrangement plan is not used as an instrument by majority creditors, possibly in collusion with the debtor, to commit abuses against minority creditors, who may receive less in a *concordato preventivo* than in an "ordinary" bankruptcy.

Under the second interpretation, which is cited with approval by the majority of legal scholars, any evaluation of the feasibility of an arrangement is to be undertaken solely by creditors, and courts should limit their review to formal and procedural aspects. This approach emphasizes that the feasibility of an arrangement is certified by a professional expert who has extensively investigated the affairs of the business, whereas the judge, at that stage of the procedure, lacks necessary knowledge of the background to assess the feasibility of the plan. This approach is also consistent with the spirit of deregulation that inspired the 2005 reforms.

In this context of conflicting approaches, *Industrial Lift Technology* strongly rejected the first interpretation and embraced the second.

INDUSTRIAL LIFT TECHNOLOGY: FACTS AND FIRST-INSTANCE DECISION

Industrial Lift Technology, an Italian limited liability company, filed an application for admission to a *concordato preventivo* procedure with the *Tribunale* of Macerata in May 2009. The arrangement plan, duly certified by a professional, provided for the sale to third parties of the company's assets (including receivables and inventories).

The court rejected the application, having reviewed the plan and the expert report and concluded that the arrangement, as proposed, was not feasible. The ruling was based on the court's view that, notwithstanding the certification of the feasibility of the arrangement plan, the report of the professional had failed to consider issues such as the actual existence of receivables, the degree of difficulty in collecting them, and the difficulty in liquidating the inventories in the market.

INDUSTRIAL LIFT TECHNOLOGY: THE SUPREME COURT'S DECISION

Industrial Lift Technology appealed the decision of the *Tribunale* directly, as provided by the Bankruptcy Law, to the *Corte di Cassazione* (Italian Supreme Court), arguing that by performing an assessment of the feasibility and merits of the plan, the *Tribunale* exceeded its statutory authority insofar as its duties were limited to verifying the correctness of the application.

Called upon for the first time to decide the issue, the Supreme Court reversed the decision of the *Tribunale*, holding that courts are not allowed to assess the feasibility of an arrangement plan submitted by the debtor and duly certified by a qualified professional.

In its opinion, the Supreme Court emphasized that the legislature in 2005 clearly intended to make the *concordato preventivo* a contractual and private procedure. The amended law, the Court explained, is clear that any decision concerning the appropriateness of convening a *concordato preventivo* is reserved for creditors, who express their views by voting for or against a proposed arrangement at the creditors' meeting. Because the law does not allow the court to undertake such a review, it cannot be entitled to evaluate the feasibility of the plan (which in any case is independently certified by a professional) when deciding on admission to the procedure. Should the court be permitted to deny admission to the procedure on the basis of the nonfeasibility of the plan, the Supreme Court explained, creditors would be de facto deprived of the opportunity to decide whether to accept or refuse the debtor's proposal.

INDUSTRIAL LIFT TECHNOLOGY: EXPECTED CONSEQUENCES

Industrial Lift Technology limits the power of the courts to review the contents of arrangements with creditors. Given the Supreme Court precedent (and despite the absence of *stare decisis* in Italian civil-law jurisprudence), lower courts called upon to decide on applications for *concordato preventivo* procedures will almost certainly be more careful in deciding whether to extend their review to matters that pertain to the merits of the arrangement. On the basis of *Industrial Lift Technology*, courts are now expected to be more inclined to limit their scrutiny to a principally formal review of the requirements for the commencement of the procedure, such as verification of the debtor's state of distress and the completeness of the filing documentation.

The decision will likely be welcomed by parties who have more to fear from any pervasive reviewing authority of the courts, such as "strong" creditors with large claims, and by parties more likely to exercise significant influence regarding the terms of a proposed arrangement plan, such as banks.

In addition to making progress toward a solution to the dispute over the extent of court scrutiny regarding a debtor's admission to a *concordato preventivo* procedure, *Industrial Lift Technology* is significant because the Supreme Court effectively endorses the philosophy underlying the Bankruptcy Law, which prioritizes private interests and grants a pivotal role in the procedure to the private parties involved. It is difficult to predict whether this decision will be followed by other courts (if not overruled, in a legal system where it is not uncommon to find different solutions to the same issues by different chambers of the Supreme Court). In any case, *Industrial Lift Technology* has moved the Italian bankruptcy system—at least temporarily—a little closer to "Anglo-Saxon" systems based on the predominance of private initiative.

STERN v. MARSHALL—SHAKING BANKRUPTCY JURISDICTION TO ITS CORE?

Benjamin Rosenblum and Scott J. Friedman

In *Stern v. Marshall*, 131 S. Ct. 2594 (2011), the estate of Vickie Lynn Marshall, a.k.a. Anna Nicole Smith, lost by a 5-4 margin Round 2 of its Supreme Court bout with the estate of E. Pierce Marshall in a contest over Vickie's rights to a portion of the fortune of her late husband, billionaire J. Howard Marshall II. The dollar figures in dispute, amounting to more than $400 million, and the celebrity status of the original (and now deceased) litigants may grab headlines. But the real story here is the Supreme Court's declaration that a portion of the Federal Judicial Code addressing the bankruptcy court's "core" jurisdiction is unconstitutional.

THE DISPUTE

In 1994, Vickie married 89-year-old oil tycoon J. Howard Marshall II. About one year after they were married, J. Howard passed away. Shortly before he passed, Vickie filed suit in a Texas probate court alleging that J. Howard's younger son, E. Pierce Marshall, fraudulently induced J. Howard to sign a living trust that did not include Vickie as a beneficiary, even though J. Howard meant to provide Vickie with half his fortune. Pierce denied wrongdoing and defended the trust and, eventually, J. Howard's "pour-over" will, which provided that all of J. Howard's assets not already included in the living trust were to be transferred to the trust upon his death.

After J. Howard's death, Vickie filed for chapter 11 relief in a California bankruptcy court. Pierce filed a defamation complaint in the bankruptcy case against Vickie, alleging she induced her lawyers to tell the media that Pierce had fraudulently controlled J. Howard's estate planning. The complaint, which was followed by Pierce's filing a proof of claim, sought a declaration that the defamation claim was nondischargeable in Vickie's bankruptcy. Vickie defended on the merits and, at the same time, asserted a counterclaim against Pierce for tortious interference with the gift she expected from J. Howard.

The California bankruptcy court granted Vickie's motion for summary judgment on Pierce's defamation complaint and later, after a bench trial, found in favor of Vickie on her counterclaim. After the bankruptcy court's ruling on these matters, the Texas probate court reached the opposite result—that is, after the completion of a jury trial on the merits, the Texas court entered a judgment for Pierce. On Pierce's appeal to the federal district court in California, the district court came to three notable conclusions. First, the bankruptcy court could not have appropriately exercised core jurisdiction and, as a result, the district court would treat the bankruptcy court's ruling on the counterclaim as a proposed, rather than final, judgment. Second, the Texas probate court's judgment was not entitled to preclusive effect. And third, applying its own independent review of the record, the district court found that Pierce had tortiously interfered with J. Howard's gift to Vickie.

On appeal, the Ninth Circuit reversed the district court on the ground that the "probate exception" to federal court jurisdiction precluded the federal courts from hearing Vickie's counterclaim. According to the circuit, the exception meant that the Texas probate court had exclusive *in rem* jurisdiction over all claims either against or on behalf of J. Howard's estate. As a result, the Ninth Circuit ruled, Vickie's victories in the federal courts below were not supported by appropriate federal jurisdiction and therefore had to be reversed.

The parties took their disputes to the U.S. Supreme Court. In a 2006 opinion, the Supreme Court reversed the circuit's decision, ruling that the circuit had applied an improperly broad approach to the "probate exception" and that the exception did not govern the circumstances presented. Round 1 in the Supreme Court thus went to Vickie. But this was not the end of the bout. In their 2006 opinion, the justices did not decide whether or not the bankruptcy court's exercise of jurisdiction over Vickie's counterclaim in the bankruptcy court was "core."

On remand to the Ninth Circuit, the circuit took up this question and held that the bankruptcy court could not in fact exercise "core" jurisdiction over Vickie's counterclaim against Pierce. The bankruptcy court's judgment was therefore a "proposed" judgment only, not a final one. Because the Texas probate court issued a final judgment prior to the district court in California, the Texas court's judgment was the earliest final judgment issued on the relevant matters. As the first final judgment, the Texas probate court's holding, according to the circuit, was entitled to preclusive effect.

The Supreme Court again granted certiorari.

BANKRUPTCY JURISDICTION

Article III, Section 1 of the U.S. Constitution provides that "[t]he judicial Power of the United States, shall be vested in one supreme Court, and in such inferior Courts as the Congress may from time to time ordain and establish." The Article states that such judges "shall hold their Offices during good Behaviour, and shall, at stated Times, receive for their Services, a Compensation, which shall not be diminished during their Continuance in Office."

The exercise of the "judicial Power of the United States" is vested in Article III judges. Bankruptcy judges, however, are not Article III judges. They do not have life tenure, and their salaries are subject to diminution. Instead, bankruptcy judges are technically authorized under Article I, which governs the legislative branch and authorizes the establishment of a uniform system of federal bankruptcy laws. Under principles of separation of powers, bankruptcy judges cannot exercise the judicial power reserved for Article III judges.

Twenty-nine years ago, in *Northern Pipeline Constr. Co. v. Marathon Pipe Line Co.*, 458 U.S. 50 (1982), the Supreme Court struck down the Bankruptcy Act of 1978 because it conferred Article III judicial power upon bankruptcy judges who lacked life tenure and protection against salary diminution. After several years of delay, Congress enacted the Bankruptcy Amendments and Federal Judgeship Act of 1984 to fix the *Marathon* issue. The 1984 jurisdictional scheme for bankruptcy courts continues in force today.

That scheme vests bankruptcy jurisdiction in the first instance in the district courts. District courts may—but need not—refer cases and matters within the scope of such jurisdiction to the bankruptcy courts (which are constituted as "units" of the district courts). Bankruptcy jurisdiction is divided into two categories: "core" and "related to" jurisdiction. One distinguishing feature of these two types of jurisdiction is that bankruptcy courts may enter final orders with respect to matters within the scope of their core jurisdiction. These final orders are subject to appellate review by the district courts or bankruptcy appellate panels. In contrast, absent consent of the litigants, bankruptcy courts cannot enter final orders when exercising "related to" jurisdiction. Instead, they may issue proposed orders only, which are reviewed *de novo* by the district courts. In addition, there are certain types of matters that the district courts may not refer to bankruptcy courts. Moreover, the district courts retain the ability to withdraw the reference of matters referred to the bankruptcy courts. In these ways, and because bankruptcy judges are appointed by the circuit courts, Article III judges have a degree of control over the bankruptcy process.

ROUND 2 IN THE SUPREME COURT

In *Stern v. Marshall*, the Supreme Court began by clarifying that: (i) "core proceedings are those that arise in a bankruptcy case or under Title 11 [*i.e.*, the Bankruptcy Code]"; (ii) there is no such thing as a "core" proceeding that does not arise under Title 11 or in a Title 11 case; and (iii) the list of core proceedings in section 157(b)(2) of Title 28 of the United States Code is illustrative. Section 157, among other examples, identifies "counterclaims by the estate against persons filing claims against the estate" as being within the bankruptcy court's core jurisdiction.

By its terms, 28 U.S.C. § 157(b)(2) entitled the California bankruptcy court to enter a final order on Vickie's counterclaim for tortious interference against Pierce as a core proceeding because Pierce had filed a proof of claim in the bankruptcy. Notwithstanding the statute, however, the Supreme Court held that the bankruptcy court could not *constitutionally* enter a final order on such a counterclaim because that would trespass upon the judicial power granted to Article III courts.

Article III, according to the Supreme Court, can neither serve its purpose nor protect the integrity of the judiciary if the other branches of government could confer "judicial Power" on entities outside Article III. The Court observed that, consequently, it has long held that Congress generally may not withdraw from judicial cognizance suits at common law, in equity or in admiralty. Rather, traditional common-law actions within the scope of federal jurisdiction must be heard by Article III judges. Given these principles, the Court determined that the bankruptcy court improperly exercised the "judicial Power of the United States" (just as the court did in *Marathon*) because it purported to enter a final judgment on a state common-law claim.

This trespass was not cured by the "public rights" exception, which recognizes that a category of cases exists involving public rights that Congress may constitutionally assign to "legislative" courts for resolution. While the Court acknowledged that its treatment of the public rights exception has not been entirely consistent, it concluded that this case could not fit within any of the varied formulations of the doctrine. Specifically, Vickie's common-law counterclaim: (i) does not flow from a federal statutory scheme and is not "completely dependent" upon adjudication of a claim created by federal law; (ii) is not a matter that can be pursued only by the grace of the other branches; (iii) is not the type of matter that historically could have been determined only by those branches; and (iv) is not limited to a particularized area of the law, such as the examination and determination of a specialized class of questions of fact assigned to an administrative agency as an expert in dealing with such matters.

The Court also rejected Vickie's argument that the bankruptcy court had authority to adjudicate her counterclaim because Pierce filed a proof of claim. The Court distinguished the cases of *Katchen v. Landy*, 382 U.S. 323 (1966), and *Langenkamp v. Culp*, 498 U.S. 42 (1990), and held that, unlike in those cases, Vickie's counterclaim did not arise from the bankruptcy itself and that it was not necessary to resolve the counterclaim in the claims-allowance process. Elsewhere, the Court also noted that Pierce did not truly consent to resolution of Vickie's counterclaim in the bankruptcy and that Pierce had nowhere else to go if he wished to recover on his claim.

Next, the Court dismissed the notion that bankruptcy courts are adjuncts of the district courts because, when a court issues a final order, it "is no mere adjunct of anyone." The Court also rejected practical arguments made by Vickie and *amici* (including the United States) regarding delays and increased costs if bankruptcy courts are unable to finally resolve compulsory counterclaims in the claims process. An unconstitutional law, the Court explained, cannot be saved simply because it is convenient or efficient. Further, the Court was not convinced that the practical consequences were as significant as suggested and characterized the question before it as narrow. Despite the contention that its decision "does not change all that much," however, the Court explained that it was nevertheless important—even slight encroachments on judicial power may threaten the integrity of the judiciary.

Justice Scalia issued a concurring opinion regarding the scope of the public rights exception. Of potential note, the justice indicated that he took no view on whether historical practice permits non-Article III judges "to process claims" against the bankruptcy estate.

Justice Breyer issued a dissenting opinion, joined by three other justices. In the minority's view, the Court's prior precedent mandated a more pragmatic approach to Article III questions. Applying this approach, the dissenters concluded that bankruptcy courts could adjudicate compulsory counterclaims without violating any constitutional separation-of-powers principle in light of several factors: (i) the nature of the non-Article III tribunal; (ii) the control exercised over that tribunal by Article III judges; (iii) the fact that Pierce consented to the tribunal by filing a proof of claim; and (iv) the nature and importance of the legislative purpose served. The dissenting justices also contended that the practical problems associated with the majority's holding were more significant and, by contrast, that any intrusion on the judiciary could only be considered *de minimis*. Accordingly, the minority would have upheld the bankruptcy court's core jurisdiction to issue a final order on Vickie's counterclaim.

OUTLOOK

Stern v. Marshall raises several interesting questions. Is the minority's practical concern that the holding will cause inefficiencies well-founded? Or is the majority correct that the decision will not result in meaningful change in the courts' division of labor? Does the majority opinion—and Justice Scalia's concurrence—foreshadow additional litigation concerning the authority of the bankruptcy courts to enter final orders with respect to other matters that are statutorily core? If there is such litigation, will the Supreme Court's decision be limited to state-law counterclaims or will it have broader consequences for the scope of a bankruptcy court's authority? The answer to this last question may determine whether the majority or minority is correct as to the practical impact of the decision.

BREAKING NEW GROUND (AGAIN) IN CHAPTER 15

Pedro A. Jimenez and Mark G. Douglas

Two recent decisions from the United States Bankruptcy Court for the Southern District of New York (the "Bankruptcy Court") have further contributed to the rapidly expanding volume of chapter 15 jurisprudence. In *In re Fairfield Sentry Ltd.*, 2011 WL 1998374 (Bankr. S.D.N.Y. May 23, 2011), and *In re Fairfield Sentry Ltd.*, 2011 WL 1998376 (Bankr. S.D.N.Y. May 23, 2011), bankruptcy judge Burton R. Lifland rendered two decisions involving offshore "feeder funds" that invested in the massive Ponzi scheme associated with Bernard L. Madoff Investment Securities LLC ("BLMIS"). Judge Lifland ruled, in matters of apparent first impression, that: (i) the court would not remand or abstain from hearing actions commenced by the foreign representatives of a foreign debtor seeking recovery or avoidance of transfers made in connection with the Madoff Ponzi scheme; and (ii) the tolling provisions of the Bankruptcy Code apply in chapter 15, such that the foreign representatives would receive an extension of deadlines in connection with both pending and potential lawsuits.

REMOVAL OF LITIGATION TO THE BANKRUPTCY COURT

One of the benefits of filing for bankruptcy is that it suspends piecemeal litigation against the debtor and its assets in potentially hundreds of different courts and centralizes litigation in a single coordinated forum. To that end, the debtor and anyone who is involved in litigation with the debtor are permitted pursuant to 28 U.S.C. § 1452(a) to "remove" to the district court certain kinds of litigation pending in state or other federal courts. In most districts, such removed actions are then automatically referred to the bankruptcy court. In accordance with Rule 9027 of the Federal Rules of Bankruptcy Procedure ("Bankruptcy Rule 9027"), removal requires only that the litigant file a notice of removal with the district court, or the bankruptcy court in districts in which such matters are automatically referred to the bankruptcy court, within a prescribed period that varies according to whether the litigation was commenced prior or subsequent to the bankruptcy petition date.

The notice must contain a statement indicating whether, once removed, the action would be within the bankruptcy court's "core" jurisdiction and, if not, whether the removing litigant consents to the entry of final orders or judgment by the bankruptcy court. Court approval is not necessary. Certain actions, however, may not be removed to the district or bankruptcy court. These include noncivil actions (*e.g.*, criminal, administrative, and arbitration proceedings), tax court proceedings, certain governmental proceedings, and claims or causes of action over which the district court does not have jurisdiction.

REMAND AND ABSTENTION

Once litigation has been "removed" to the district or bankruptcy court, under certain circumstances, the court can "remand" such removed litigation to the court from which it came. Pursuant to 28 U.S.C. § 1452(b), the court may remand a removed "claim or cause of action on any equitable ground." Factors that courts consider in determining whether "equitable remand" is appropriate include: (1) the effect of the action on the administration of the bankruptcy estate; (2) the extent to which issues of state law predominate; (3) the complexity of applicable state law; (4) "comity," or the interest that a state has in developing its law and applying its law to its citizens; (5) the relatedness or remoteness of the action to the bankruptcy case; (6) the existence of a right to jury trial; and (7) prejudice to the party involuntarily removed from state court. A court's decision on a remand request is not subject to appellate review above the district court level.

A related concept—"abstention"—involves the bankruptcy court's determination not to hear a case because another forum is more appropriate. "Permissive abstention" from adjudicating particular controversies in a bankruptcy case is authorized by 28 U.S.C. § 1334(c)(1), which provides (with emphasis added):

> *Except with respect to a case under chapter 15 of title 11*, nothing in this section prevents a district court in the interest of justice, or in the interest of comity with State courts or respect for State law, from abstaining from hearing a particular proceeding arising under title 11 or arising in or related to a case under title 11.

Permissive abstention is allowed even in disputes involving the bankruptcy court's "core" jurisdiction, such as litigation to avoid preferential or fraudulent transfers, although bankruptcy courts seldom abstain from hearing these cases. The italicized reference to chapter 15 cases was added to section 1334(c)(1) when chapter 15 was enacted as part of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005.

In determining whether permissive abstention is appropriate, courts consider many of the same factors applied in connection with a remand request. Additional factors include: (1) the feasibility of severing state-law claims from core bankruptcy matters to allow judgments to be entered in state court with enforcement left to the bankruptcy court; (2) the burden on the court's docket; (3) whether commencement of the proceeding in a bankruptcy court involves forum shopping by one of the parties; and (4) the presence in the proceeding of nondebtor parties.

Pursuant to 28 U.S.C. § 1334(c)(2), a bankruptcy court is obligated to abstain from hearing certain types of cases that are "related to" a bankruptcy case, but not "arising under" the Bankruptcy Code or "arising in a case" under the Bankruptcy Code. "Mandatory abstention" is warranted "[u]pon timely motion of a party in a proceeding based upon a State law claim or State law cause of action, related to" a bankruptcy case with respect to which there is no other basis for federal court jurisdiction and the action can be timely adjudicated in state court. Other than the denial of a request for mandatory abstention, a ruling on an abstention motion under section 1334(c) is not reviewable on appeal above the district court level.

Abstention from adjudicating proceedings under section 1334(c) is distinct from the bankruptcy court's "abstention" powers under section 305 of the Bankruptcy Code. That provision authorizes the court to dismiss a bankruptcy *case* or suspend all proceedings in a bankruptcy case, if the interests of creditors or the debtor would be better served by dismissal or suspension, or if the purposes of chapter 15 would be best served by dismissal or suspension.

TOLLING UNDER SECTION 108

Section 108 of the Bankruptcy Code essentially establishes a two-year deadline from entry of the bankruptcy "order for relief" for a bankruptcy trustee (or a chapter 11 debtor in possession) to commence actions on behalf of the estate, provided that the applicable time period did not expire before the filing of the bankruptcy petition. Section 108(a) provides:

> If applicable nonbankruptcy law, an order entered in a nonbankruptcy proceeding, or an agreement fixes a period within which the debtor may commence an action, and such period has not expired before the date of the filing of the petition, the trustee may commence such action only before the later of—(1) the end of such period, including any suspension of such period occurring on or after the commencement of the case; or (2) two years after the order for relief.

Section 108(b) similarly provides a short extension of time for filing pleadings, curing defaults, and performing other acts on behalf of the debtor:

> Except as provided in subsection (a) of this section, if applicable nonbankruptcy law, an order entered in a nonbankruptcy proceeding, or an agreement fixes a period within which the debtor . . . may file any pleading, demand, notice, or proof of claim or loss, cure a default, or perform any other similar act, and such period has not expired before the date of the filing of the petition, the trustee may only file, cure, or perform, as the case may be, before the later of—(1) the end of such period, including any suspension of such period occurring on or after the commencement of the case; or (2) 60 days after the order for relief.

These provisions are made applicable to chapter 15 cases by section 103(a) of the Bankruptcy Code, which provides in relevant part that "chapters 1, 3, and 5 of this title apply in a case under chapter 7, 11, 12, or 13 of this title, *and this chapter*, sections 307, 362(n), 555 through 557, and 559 through 562 apply in a case under chapter 15" (emphasis added).

FAIRFIELD SENTRY

Fairfield Sentry Limited and two affiliates (collectively, "Fairfield") were organized under the laws of the British Virgin Islands ("BVI") as "feeder funds" for BLMIS. Shortly after it was revealed in December 2008 that disgraced former investment maven Bernard L. Madoff had orchestrated the largest Ponzi scheme in history, certain of Fairfield's shareholders and creditors commenced insolvency proceedings on behalf of Fairfield in the BVI.

The BVI court-appointed joint liquidators (the "liquidators") for Fairfield filed petitions on June 14, 2010, in the Bankruptcy Court seeking recognition of the BVI insolvency proceedings as foreign "main proceedings" under chapter 15 of the Bankruptcy Code. The Bankruptcy Court granted the petition and formally recognized the BVI insolvency proceedings on July 22, 2010.

The *Fairfield Sentry* rulings and the Fifth Circuit's "pioneer decision" in *Fogerty v. Petroquest Res., Inc. (In re Condor Ins. Ltd.)*, 601 F.3d 319 (5th Cir. 2010), in which the court recognized the power of a U.S. bankruptcy court to permit relief under foreign avoidance laws in chapter 15, along with other similar cases, illustrate the wide array of tools available to a foreign representative in a chapter 15 case.

Prior to filing for chapter 15 recognition, the liquidators, with the BVI court's approval, sued hundreds of Fairfield's subscribers in New York state courts, seeking the return of redemption payments allegedly made as part of the Ponzi scheme. Those actions asserted equitable and restitutionary common-law claims of unjust enrichment, "money had and received," mistaken payment, and constructive trust, as well as avoidance claims arising under the BVI Insolvency Act for "unfair preferences" and "undervalue transactions."

All of the state court actions were removed after entry of the recognition order to the Bankruptcy Court, where the liquidators commenced adversary proceedings against other subscribers seeking substantially the same relief. In all, more than 200 actions (the "redeemer actions") are currently pending in the Bankruptcy Court, seeking nearly $6 billion from the defendants.

The liquidators also sued Fairfield's former investment advisors in state court in May 2009, seeking in excess of $919 million in investment management and performance fees from Fairfield's BLMIS accounts. In addition, certain of Fairfield's shareholders commenced a derivative action on Fairfield's behalf in state court. Both actions were removed to the bankruptcy court following entry of the recognition order. Finally, the bankruptcy court is also presiding over litigation commenced against Fairfield by the trustee appointed under the Securities Investor Protection Act ("SIPA") to liquidate BLMIS (in addition to the SIPA liquidation proceeding commenced with respect to BLMIS). That adversary proceeding seeks recovery of more than $3 billion in fraudulent transfers and preferences.

Certain of the defendants in the redeemer actions petitioned for an order pursuant to 28 U.S.C. § 1452(b) remanding their actions to the courts in which they were originally filed or, in the alternative, for an order abstaining from hearing the actions under 28 U.S.C. § 1334(c). In addition, the liquidators sought an order from the Bankruptcy Court under, among other provisions, section 108 of the Bankruptcy Code, giving the liquidators extensions of time to assert causes of action and meet applicable deadlines on Fairfield's behalf with respect to currently pending and potential litigation.

THE BANKRUPTCY COURT'S RULINGS

Remand and Abstention

Having first found that the Bankruptcy Court had jurisdiction over the redeemer actions, Judge Lifland denied the defendants' requests for equitable remand and abstention. At the outset, he noted that discretionary abstention is not permitted in a chapter 15 case by operation of 28 U.S.C. § 1334(c)(1). He concluded that, even if it were, neither equitable remand nor discretionary abstention was warranted under the circumstances, given, among other things, the parties' acknowledgment that the actions should proceed as a whole, the Bankruptcy Court's familiarity with the legal issues involved, the risk of duplicative efforts and duplicative rulings, and the absence of prejudice to the defendants in having the actions adjudicated in the Bankruptcy Court. Because the actions fell within the court's core jurisdiction, Judge Lifland also held that mandatory abstention "is inapplicable on the face of the statute itself." Even if the actions were noncore, the judge noted, mandatory abstention would not be appropriate because, among other things, the actions as a whole are not "based upon a State law claim," but rather, "implicate foreign and U.S. insolvency law . . . and require adjudication of issues arising under the [Bankruptcy] Code."

Finally, Judge Lifland rejected the defendants' argument that the redeemer actions should be remanded because the liquidators' removal notices were not timely filed. The judge joined the majority of other courts in ruling that the 90-day deadline set forth in Bankruptcy Rule 9027(a)(2) applies in a chapter 15 case, rather than the 30-day deadline specified in 28 U.S.C. § 1446, which, together with 28 U.S.C. § 1441, governs removal in most other federal litigation. In a chapter 15 context, Judge Lifland held, the "order for relief" referred to in Bankruptcy Rule 9027(a)(2) refers to the recognition order in a chapter 15 case.

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In addition to section 108, the liquidators based their request for an extension of deadlines in connection with pending or prospective litigation on sections 103(a), 105(a), 1507(a), and 1521(a)(7) of the Bankruptcy Code. As noted, section 103(a) makes the entirety of chapter 1 of the Bankruptcy Code ("this chapter")—including section 108—applicable in a chapter 15 case. Section 105(a) gives a bankruptcy court broad equitable powers to "issue any order, process, or judgment that is necessary or appropriate to carry out the provisions" of the Bankruptcy Code.

Section 1507(a) authorizes the court, upon recognition of a foreign proceeding and subject to the specific limitations elsewhere in chapter 15, to "provide additional assistance to a foreign representative under this title or under other laws of the United States." Finally, section 1521(a)(7) provides that the relief which may be granted by the court upon recognition of a foreign proceeding under chapter 15 may include "granting any additional relief that may be available to a trustee, except for relief available under" sections 522 (delineating "exempt" property), 544 (granting the trustee "strong arm" powers), 545 (avoidance of statutory liens), 547 (avoidance of preferential transfers), 548 (avoidance of fraudulent transfers), 550 (liability of avoidance-action transferees), and 724(a) (avoidance of certain punitive-damage-based liens).

Judge Lifland acknowledged that "there is no dispositive case law addressing whether Section 108 is automatically applicable in these chapter 15 cases." Even so, he concluded that the question is "squarely addressed" by section 103(a), which "unambiguously" states that " 'this chapter'—chapter one—applies in its entirety." Moreover, he wrote, section 108 is a "general provision, which is not restricted to, or excluded from, cases under any specific chapter of the Code."

Judge Lifland also rejected the defendants' argument that section 1520(a)(3) of the Bankruptcy Code "provides the exclusive relief that can be transferred from 'trustees' to foreign representatives, without including Section 108." Section 1520(a)(3) gives a foreign representative in a recognized chapter 15 case the power to operate the debtor's business and to exercise the rights and powers of a bankruptcy trustee *under sections 363* (governing the use, sale, or lease of estate property) *and 552* (governing the enforceability of prepetition liens on property acquired by the estate or the debtor postpetition). "Simply put," Judge Lifland wrote, "inclusion of Section 108 relief in section 1520 would have been superfluous in light of the plain language of section 103(a) of the Code."

Judge Lifland similarly rejected the defendants' argument that the term "trustee" in a chapter 15 case does not include a foreign representative. Section 1502(6) of the Bankruptcy Code provides that "trustee" for the purposes of chapter 15 "includes a trustee, a debtor in possession in a case under any chapter of this title, or a debtor under chapter 9 of this title." The word "includes," the judge explained, indicates that the definition is not meant to be exclusive, and foreign representatives "are indistinguishable from trustees with respect to the purpose of Section 108 to provide the entity stepping into the shoes of the debtor additional time to evaluate and preserve a debtor's rights."

According to Judge Lifland, his conclusion is supported by: (i) the legislative history of section 1520, which confirms lawmakers' "awareness of the application of Section 108 in a chapter 15 proceeding"; (ii) *In re Condor Insurance Ltd.*, No. 07-51045, Dkt. No. 44 (Bankr. S.D. Miss. Oct. 10, 2007), where the court directed that "the application of section 108 of the Bankruptcy Code is relief available to a trustee and therefore can be granted to the Foreign Representatives under section 1521(a)(7)," without indicating any objection to the automatic availability of such relief or considering section 103(a); (iii) a comprehensive law journal article examining chapter 15 jurisprudence issued by the National Conference of Bankruptcy Judges in 2008; and (iv) the only other court ruling touching on the issue, *In re Bancredit Cayman Ltd.*, 2007 WL 3254369 (Bankr. S.D.N.Y. Nov. 2, 2007), *aff'd*, 2008 WL 919533 (S.D.N.Y. Mar. 31, 2008), where the bankruptcy court expressly declined to address the issue, stating that "[n]othing in this decision should be read to decide the ultimate issue: whether § 108 is available to foreign representatives."

As in his ruling concerning the defendants' remand and abstention requests, Judge Lifland held that the chapter 15 recognition date is the date of the "order of relief" for purposes of section 108 and other provisions in or made applicable to chapter 15. Finally, the judge ruled that, even if section 108 were not "a self-executing statute" with respect to chapter 15 cases, a bankruptcy court has the power to grant such relief under sections 1507(a) and 1521(a)(7).

OUTLOOK

Chapter 15 of the Bankruptcy Code will mark the sixth anniversary of its effectiveness on October 17, 2011. Judge Lifland's groundbreaking rulings in *Fairfield Sentry* indicate that many of the nuances of this relatively new legislation are as yet unexplored and of uncertain application. The rulings also highlight the fundamental purpose of chapter 15 as a vehicle for harmonizing and coordinating cross-border insolvency proceedings. In addition, they bring into sharp focus the important role played by U.S. bankruptcy courts in centralizing disputes in the U.S. against a foreign debtor as a means of providing assistance to foreign insolvency proceedings and the duly appointed representatives entrusted with administering a foreign debtor's assets. The *Fairfield Sentry* rulings and the Fifth Circuit's "pioneer decision" in *Fogerty v. Petroquest Res., Inc. (In re Condor Ins. Ltd.)*, 601 F.3d 319 (5th Cir. 2010), in which the court recognized the power of a U.S. bankruptcy court to permit relief under foreign avoidance laws in chapter 15, along with other similar cases, illustrate the wide array of tools available to a foreign representative in a chapter 15 case.

SENIOR CLASS GIFTING IS NOT THE END OF THE STORY: SOME RECENT DEVELOPMENTS REGARDING THE ABSOLUTE PRIORITY RULE AND THE NEW VALUE EXCEPTION

Charles M. Oellermann and Mark G. Douglas

Much attention in the commercial bankruptcy world has been devoted recently to judicial pronouncements concerning whether the practice of senior creditor class "gifting" to junior classes under a chapter 11 plan violates the Bankruptcy Code's "absolute priority rule." Comparatively little scrutiny, by contrast, has been directed toward significant developments in ongoing controversies in the courts regarding the absolute priority rule outside the realm of senior class gifting—namely, in connection with the "new value" exception to the rule and whether the rule was written out of the Bankruptcy Code in individual debtor chapter 11 cases by the addition of section 1115 as part of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA"). This article examines these concepts as well as some recent court rulings addressing them.

CRAM-DOWN AND THE "FAIR AND EQUITABLE" REQUIREMENT

If a class of creditors or shareholders votes to reject a chapter 11 plan, it can be confirmed only if the plan satisfies the "cram-down" requirements of section 1129(b) of the Bankruptcy Code. Among these requirements is the mandate that a plan be "fair and equitable" with respect to dissenting classes of creditors and shareholders.

Section 1129(b)(2)(B) of the Bankruptcy Code provides that a plan is "fair and equitable" with respect to a dissenting impaired class of unsecured claims if the creditors in the class receive or retain property of a value equal to the allowed amount of their claims or, failing that, in cases not involving an individual debtor, if no creditor of lesser priority, or no equity holder, receives or retains any distribution under the plan "on account of" its junior claim or interest. This requirement is sometimes referred to as the "absolute priority rule."

HISTORY OF THE ABSOLUTE PRIORITY RULE

The U.S. Supreme Court first formally articulated the absolute priority rule, originally referred to as the "fixed principle," in *Northern Pacific Railway Co. v. Boyd*, 228 U.S. 482 (1913), which involved an equity receivership of a railroad. In *Boyd*, the old stockholders and bondholders agreed to a plan of reorganization in 1896 pursuant to which the company was to be sold to a new company in which the old stockholders had rights. Boyd asserted an unsecured claim against the predecessor company that resulted in a judgment in 1896 and was revived in 1906. However, because the old railroad's assets had been sold to the new company 10 years earlier, there were no longer any assets on which to levy an execution. Boyd accordingly sued to hold the new company responsible for the old company's debt to him. The Supreme Court ruled that the stockholders' receipt of property was invalid:

> [I]f purposely or unintentionally a single creditor was not paid, or provided for in the reorganization, he could assert his superior rights against the subordinate interests of the old stockholders in the property transferred to the new company. They were in the position of insolvent debtors who could not reserve an interest as against creditors. . . . Any device, whether by private contract or judicial sale under consent decree, whereby stockholders were preferred before the creditor, was invalid.
>
> *   *   *   *
>
> [I]n cases like this, the question must be decided according to a fixed principle, not leaving the rights of the creditors to depend upon the balancing of evidence as to whether, on the day of sale, the property was insufficient to pay prior encumbrances.

Thus was established the "fixed principle"—a concept that later came to be known as the "absolute priority rule." According to this precept, stockholders could not receive any distribution in a reorganization case unless creditor claims were first paid in full. The Supreme Court continued to apply this principle in equity receivership cases throughout the early 1900s, emphasizing that it should be strictly applied.

In 1934, Congress amended the former Bankruptcy Act to introduce the words "fair and equitable" to bankruptcy nomenclature. Section 77B(f) of the Act provided that a plan of reorganization could be confirmed only if the bankruptcy judge was satisfied that the plan was "fair and equitable and does not discriminate unfairly in favor of any class of creditors or stockholders and is feasible." The provenance of this restriction was none other than the "fixed principle." As later expressed by the Supreme Court in *Bank of America Nat. Trust and Sav. Ass'n v. 203 North LaSalle*, 526 U.S. 434 (1999), *reversing Matter of 203 North LaSalle Street Partnership*, 126 F.3d 955 (7th Cir. 1997), "[t]he reason for such a limitation was the danger inherent in any reorganization plan proposed by a debtor, then and now, that the plan will simply turn out to be too good a deal for the debtor's owners." The "fair and equitable" requirement endured as part of chapter X of the former Bankruptcy Act when Congress passed the Chandler Act in 1938. As applied, the absolute priority rule prohibited any distribution to the holders of junior interests if senior creditors were not paid in full. This was so even if senior creditors agreed to the arrangement.

Congress partially codified the absolute priority rule into section 1129(b)(2) of the Bankruptcy Code in 1978. Prior to the enactment of the Bankruptcy Code, the absolute priority rule prevented junior classes from receiving consideration at the expense of a senior creditor even if the majority of senior creditors agreed. Now, the rule applies only if the senior class does not vote to accept the plan. Thus, the rule would be an obstacle to confirmation only if a class of senior creditors is "impaired" by, for example, receiving less than full payment, the senior class votes to reject a chapter 11 plan, and the plan provides for some distribution to junior creditors or interest holders.

THE NEW VALUE EXCEPTION

In 1939, the Supreme Court made explicit the connection between old equity cases and bankruptcy practice by holding in *Case v. Los Angeles Lumber Prods. Co.*, 308 U.S. 106 (1939), that under section 77B(f) of the former Bankruptcy Act, the requirement of a "fair and equitable" plan of reorganization meant application of the absolute priority rule. In *Case*, the debtor's existing shareholders sought to retain an ownership interest in the company, even though senior creditors were not to be paid in full. The shareholders argued that retention of their interests was important to the company's future success, given their familiarity with business operations and the advantages of continuity in management. The Supreme Court ruled that continued shareholder participation in the ownership of an insolvent company may be acceptable under certain circumstances. From this pronouncement evolved the controversial "new value" corollary or exception to the absolute priority rule.

Under the new value exception, a junior stakeholder (*e.g.*, a shareholder) may retain its equity interest under a chapter 11 plan over the objection of a senior impaired creditor class, provided the shareholder contributes new capital to the restructured enterprise. According to some courts, that capital must be new, substantial, necessary for the success of the plan, reasonably equivalent to the value retained, and in the form of money or money's worth.

In *In re Bonner Mall Partnership*, 2 F.3d 899 (9th Cir. 1993), *motion to vacate denied*, *case dismissed sub nom. U.S. Bancorp Mortg. Co. v. Bonner Mall Partnership*, 513 U.S. 18 (1994), the Ninth Circuit held that "if a proposed plan satisfies all of these [five] requirements, i.e. the new value exception, it will not violate section 1129(b)(2)(B)(ii) of the Code and the absolute priority rule." Such a plan, the court wrote, "will not give old equity property 'on account of' prior interests, but instead will allow the former owners to participate in the reorganized debtor on account of a substantial, necessary, and fair new value contribution." Other courts have concluded that the new value exception did not survive the enactment of the Bankruptcy Code in 1978 because, among other things, the concept is not explicitly referred to in section 1129(b)(2) or elsewhere in the statute.

Since the enactment of the Bankruptcy Code, the U.S. Supreme Court has only obliquely addressed the viability of the new value exception. In its decision in *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197 (1988), the court held that, even if the new value exception to the absolute priority rule survived the enactment of the Bankruptcy Code in 1978, new value could not be satisfied by promised contributions of labor. The court was similarly reluctant to tackle the issue head on in the other two cases to date in which it had an opportunity to do so. In 1994, the court declined to vacate the Ninth Circuit's *Bonner Mall* opinion, and in 1999, it similarly declined to overrule the Seventh Circuit's interpretation of the corollary in *Matter of 203 North LaSalle Street Partnership*. Instead, the court held that one or two of the five elements of the new value corollary could not be satisfied when old equity retains the exclusive right to contribute the new value. The court expressly declined to define what "on account of" requires, except to hold that it cannot be satisfied when old equity has the exclusive right to propose a plan.

THE ABSOLUTE PRIORITY RULE IN INDIVIDUAL CHAPTER 11 CASES

"High-asset" individual debtors, such as business owners or owners of rental property or other significant business and personal assets, whose financial problems are too extensive to qualify for treatment under the wage-earner provisions in chapter 13, commonly seek protection under chapter 11 of the Bankruptcy Code. Such debtors are a prominent feature of commercial insolvency practice in California and certain other western states. Recent statistics indicate that the volume of individual chapter 11 cases has risen significantly since the October 17, 2005, effective date of BAPCPA.

BAPCPA amended section 1129(b)(2)(B)(ii) with respect to individual chapter 11 debtors. It now provides (with added language italicized) as follows:

> (ii) the holder of any claim or interest that is junior to the claims of such class will not receive or retain under the plan on account of such junior claim or interest any property, *except that in a case in which the debtor is an individual, the debtor may retain property included in the estate under section 1115, subject to the requirements of subsection (a)(14) of this section*.

The added language allows individual chapter 11 debtors to retain "property included in the estate under section 1115," even if a dissenting class of unsecured creditors could otherwise argue that retention of such property violates the absolute priority rule.

Section 1115 was also added in 2005 by BAPCPA. It provides in relevant part as follows:

> (a) In a case in which the debtor is an individual, property of the estate includes, in addition to the property specified in section 541—(1) all property of the kind specified in section 541 that the debtor acquires after the commencement of the case . . . ; and (2) earnings from services performed by the debtor after the commencement of the case . . . .

Thus, the bankruptcy estate in an individual chapter 11 case is more expansive than the estate in a case involving a nonindividual debtor because section 1115 specifies that the estate in an individual chapter 11 case "includes" all property covered by section 541 as well as certain property expressly excluded from nonindividual debtor cases under section 541(a)(6)—*i.e.*, an individual debtor's postpetition earnings from services. However, because, among other things, the term "includes" is "not limiting" pursuant to section 102(3) of the Bankruptcy Code, a dispute has arisen as to whether the carve-out added by BAPCPA to section 1129(b)(2)(B)(ii) for property retained by individual debtors might extend to property other than postpetition earnings—in effect, abrogating the absolute priority rule in individual chapter 11 cases.

If "included in the estate under section 1115" in section 1129(b)(2)(B)(ii) means only property that is added by section 1115, it has a very narrow meaning, referring only to postpetition earnings and not to property originally specified in section 541. Conversely, if "included in the estate under section 1115" means that section 1115 entirely supplants section 541, assuming that property of the estate in an individual chapter 11 case is defined only by section 1115, it has a very broad meaning, essentially exempting individuals from the absolute priority rule as to unsecured creditors.

Some courts, representing the minority view as of this writing, have construed section 1115 broadly. These courts interpret the phrase "in addition to the property specified in section 541" to mean that section 1115 absorbs and then supersedes section 541 for individual chapter 11 cases. From this construction is derived the approach that, in individual chapter 11 cases, section 1129(b)(2)(B)(ii)'s exception from the reach of the absolute priority rule extends to all property of the estate, including, for example, prepetition ownership interests in nonexempt property and an individual debtor's ownership interests in a business. According to some courts, this approach comports with the underlying purpose of most of the changes effected by BAPCPA in adapting various provisions of chapter 13—which has no absolute priority rule—to fit in the chapter 11 context.

Other courts, representing a growing majority, subscribe to a narrow construction of section 1115 and confine the exemption from absolute priority to postpetition earnings. At least five bankruptcy courts have taken this position in reported or electronically available opinions thus far in 2011.

SOME RECENT CASES ON ABSOLUTE PRIORITY AND THE NEW VALUE EXCEPTION

2011 has already seen a wealth of court rulings addressing the new value exception and section 1115. In *In re Red Mountain Machinery Co.*, 2011 WL 1428266 (Bankr. D. Ariz. Apr. 14, 2011), the court confirmed a chapter 11 plan proposing to give equity in the reorganized company to the debtor's principals (and sole shareholders) notwithstanding less than full payment of a lender's unsecured deficiency claim. The court found that new value to be contributed by old equity for new equity interests in the reorganized entity in the amount of up to $1.2 million was "necessary for a successful reorganization" because the Bankruptcy Code unequivocally requires that administrative expenses be paid in full, in cash, on the effective date of the plan, and the debtor's cash position, without such a contribution from old equity, was insufficient to permit such payment. It also concluded that the new value the old equity would contribute under the chapter 11 plan was "reasonably equivalent" to the value of the equity interest they would receive, where exclusivity had expired, such that there was no option value to old equity in having the right to propose a plan, and the amount of the contribution was greatly in excess of the value of the equity interests based on either a pro forma balance sheet of the reorganized debtor or capitalization of the reorganized debtor's projected income.

In *In re Multiut Corp.*, 2011 WL 1486035 (Bankr. N.D. Ill. Apr. 19, 2011), the bankruptcy court denied confirmation of a chapter 11 plan proposing that the debtor's existing shareholder would retain 100 percent of his equity interest in exchange for a cash contribution of $100,000 under the "new value" exception. According to the court, although the money "to be contributed to the Plan is new, necessary for the success of the Plan, and in the form of money or money's worth," and "[w]ithout that contribution, there likely would not be enough funds with which to pay administrative claimants in full on the Effective Date of the Plan," the plan proponent failed to demonstrate that "the $100,000 contribution is reasonably equivalent to [the shareholder's] one hundred percent ownership interest."

Comparatively little scrutiny . . . has been directed toward significant developments in ongoing controversies in the courts regarding the absolute priority rule outside the realm of senior class gifting—namely, in connection with the "new value" exception to the rule and whether the rule was written out of the Bankruptcy Code in individual debtor chapter 11 cases by the addition of section 1115 as part of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005.

In *In re Greenwood Point, LP*, 445 B.R. 885 (Bankr. S.D. Ind. 2011), the court held that a chapter 11 plan proposing to distribute new equity to the wife of the debtor's principal, rather than the principal himself, in exchange for a $100,000 contribution, did not violate the absolute priority rule. Furthermore, the court held, even assuming that the absolute priority rule was implicated by equity provisions in the plan, the $100,000 contribution, when no lender was willing to provide such financing upon comparable terms, was sufficient to permit confirmation of the plan, despite nonpayment in full of senior creditor claims, under the new value exception.

The bankruptcy court adopted the narrow view of the impact of section 1115 in *In re Draiman*, 2011 WL 1486128 (Bankr. N.D. Ill. Apr. 19, 2011). In that case, an individual debtor's chapter 11 plan provided for less than full payment of senior creditor claims but proposed that the debtor would retain certain nonexempt assets, including office equipment, furnishings, supplies, and certain management agreements of his management and consulting firm as well as personal household items and an automobile. The court ruled that, although the debtor was entitled to postpetition income from the management company under section 1115, his attempt to keep nonexempt assets of the bankruptcy estate that are not specifically addressed by section 1115 violated the absolute priority rule. However, the debtor also argued that his contribution of $100,000 for the retained assets was sufficient for the new value exception to apply. The court agreed, concluding that the contribution, which was to be made by a business associate, was "new"; "necessary" to the plan because it would serve as the initial funding for a liquidation and litigation trust to be created by the plan; "reasonably equivalent to the value" of the retained assets (which were valued at no more than $30,000); and, being in cash, in "money or money's worth."

In *In re Kamell*, 2011 WL 1760282 (Bankr. C.D. Cal. May 4, 2011), the court similarly adopted the narrow view of BAPCPA and section 1115's impact on the absolute priority rule in individual chapter 11 cases. According to the court, "there is no good reason to conclude that Congress intended to abrogate this long-standing and important centerpiece of Chapter 11 jurisprudence based on the ambiguous language of the BAPCPA amendments." The court found the narrow view more persuasive than the "broad view," which reads into the language of sections 1129(b)(2)(B)(ii) and 1115 an intent to abrogate the absolute priority rule entirely, as in chapter 13. The court accordingly ruled that the debtor's plan could not be confirmed because it proposed to allow the debtor to retain substantial prepetition property without paying dissenting unsecured creditors in full. Other decisions thus far in 2011 adopting the narrow view have included *In re Maharaj*, 2011 WL 1753795 (Bankr. E.D. Va. May 9, 2011); *In re Walsh*, 447 B.R. 445 (Bankr. D. Mass. 2011); and *In re Stephens*, 445 B.R. 816 (Bankr. S.D. Tex. 2011).

OUTLOOK

The appellate courts have yet to address the impact of section 1115 on the absolute priority rule, and only a handful of courts (and none at the circuit level or above) have examined the new value exception in any published opinion in five years or more. That may soon change, especially with respect to section 1115. The number of individual chapter 11 filings has risen considerably in the last two years, and the continued existence (or not) of the absolute priority rule will determine whether plans are confirmable in many of those cases. The issue is an important one that needs resolution in many individual chapter 11 cases. Disputes regarding these issues are likely to percolate upward through the appellate processes in the not too distant future. Perhaps the circuit courts of appeal and even the U.S. Supreme Court will soon have an opportunity to rule on both the impact of section 1115 and the viability of the new value exception.

Interestingly, in *Ala. Dep't of Econ. & Comm. Affairs v. Ball Healthcare-Dallas, LLC (In re Lett)*, 632 F.3d 1216 (5th Cir. 2011), the Fifth Circuit Court of Appeals was presented with an opportunity earlier this year to weigh in on the absolute priority rule in individual debtor chapter 11 cases as well as the new value exception. However, section 1115 did not apply in that case because the chapter 11 filing preceded the October 17, 2005, effective date of the provision, and the court expressly declined "further discussion of this exception to the absolute priority rule, as it is not at issue in this case." On remand, however, the district court ruled in *In re Lett*, 2011 WL 2413484 (S.D. Ala. June 13, 2011), that the debtor's plan violated the absolute priority rule because certain property would revest in the debtor upon confirmation without paying senior creditor classes in full and that the plan failed to satisfy the new value exception because the debtor contributed no new value to the estate.

DCF ANALYSIS: A "COMMERCIALLY REASONABLE DETERMINANT" OF VALUE FOR LIQUIDATION OF MORTGAGE LOANS IN REPO TRANSACTION

Benjamin Rosenblum

In a case of first impression, the Third Circuit Court of Appeals in *In re American Home Mortg. Holdings, Inc.*, 637 F.3d 246 (3d Cir. 2011), held that, for purposes of section 562 of the Bankruptcy Code, a discounted cash flow analysis was a "commercially reasonable determinant" of value for the liquidation of mortgage loans in a repurchase transaction.

Repurchase, or "repo," agreements have long been an important mechanism for investing in U.S. government and agency securities, mortgage-related instruments, commodities, and money market instruments. Though these transactions can be complicated, the basic structure of a repo agreement is simple: one party sells assets to a purchaser in exchange for cash, and the purchaser promises to sell those assets back at an agreed-upon time or upon demand.

REPURCHASE AGREEMENTS IN BANKRUPTCY

Repurchase transactions are potentially beneficial to both parties. On the one hand, the party supplying the funds can invest its idle cash, and one attractive feature of many repos is that the party supplying the funds can make such an investment in a manner that is sufficiently short and flexible to meet its cash flow needs. On the other, the party receiving the funds uses the transaction as a form of financing. In fact, certain types of large institutions typically rely on repo transactions as an essential means of financing their securities or other portfolios. As a result of these benefits, the total amounts invested in repo transactions are staggering.

Recognizing the importance and interrelatedness of repo transactions, in the 1980s Congress began to express concerns that the bankruptcy of a major financial player could cause a chain reaction in the markets. The fear in the repo market, which was fueled in part by a decision in the *Lombard-Wall* bankruptcy, was that the bankrupt entity's automatic stay would prohibit the other party from closing out its repo position, thereby exposing the nondebtor party to open-ended market risk. In response to these concerns, Congress added certain provisions to the Bankruptcy Code to address repo transactions. Since the 1980s, these provisions were amended and refined, and provisions dealing with other types of financial contracts, such as swap agreements, were added as well.

Among the provisions dealing with repo transactions is section 559 of the Bankruptcy Code, which allows a nondebtor party to exercise its contractual right to terminate, liquidate, or accelerate a repurchase agreement based on a so-called *ipso facto* clause, notwithstanding the automatic stay. This provision, which was enacted in 1984 and subsequently amended, was designed to address the *Lombard-Wall* problem. That is, a counterparty could cut off the feared open-ended market risk by promptly liquidating the contract upon bankruptcy.

In the interest of fairness to the debtor's estate, however, section 559 of the Bankruptcy Code provides that, upon liquidation, "any excess of the market prices received on liquidation of such assets . . . over the sum of the stated repurchase prices and all expenses in connection with the liquidation of such repurchase agreements shall be deemed property of the estate." In other words, if the counterparty liquidates the assets in the repo transaction, the counterparty must return to the debtor any excess over the market prices received.

Another provision relevant to repo agreements is section 562 of the Bankruptcy Code, which was enacted in 2005. That section addresses the appropriate date or dates for measuring damages arising from a debtor's or trustee's rejection or a counterparty's liquidation, termination, or acceleration of repo and derivatives instruments. Section 562 sets forth the rule that damages for such contracts are generally measured as of the earlier of either: (a) the date of termination, liquidation, or acceleration of the contract; or (b) the date of the rejection of the contract, pursuant to section 365 of the Bankruptcy Code. That general rule, however, gives way where a party can prove that on the applicable date there were no "commercially reasonable determinants" of value. Under those circumstances, damages are then measured as of the earliest subsequent date or dates on which commercially reasonable determinants exist.

AMERICAN HOME

With the onset of the mortgage and housing-market crisis, many lenders were forced to seek the refuge of bankruptcy court protection. In August 2007, American Home Mortgage Investment Corp. ("American Home"), one of the largest home lenders at the time, filed for chapter 11 in Delaware. Prior to filing, American Home's business primarily involved the origination, servicing, and sale of mortgage loans, as well as investments in mortgage loans and mortgage-backed securities. To fund the origination of mortgage loans, American Home was party to a repurchase agreement.

Under the agreement, when American Home originated a mortgage loan, it would immediately transfer the loan to a repo purchaser. American Home would then undertake to dispose finally of the loan to a private investor or securitization vehicle. Once it made arrangements to dispose of the loan, American Home would repurchase the mortgage from the repo purchaser. The repo purchaser received a spread based on the number of days it held the loan, and American Home received funds that enabled it to keep originating mortgages.

Around the time of the bankruptcy, Calyon New York Branch ("Calyon"), as administrative agent under a repurchase agreement, served American Home with a notice of default and accelerated the repo. As a result of the notice, American Home was obligated to repurchase the mortgage loans. On the basis of this repurchase obligation, Calyon filed claims in the bankruptcy that alleged a deficiency between the value of the mortgages transferred to Calyon and the repurchase obligation owed to it by American Home. In other words, Calyon alleged it was undercollateralized and sought an unsecured deficiency claim against the debtor. American Home objected to the claims, arguing that Calyon's valuation was incorrect and seeking to disallow or reduce the claims under section 562 of the Bankruptcy Code.

BANKRUPTCY COURT DECISION

In the bankruptcy court, American Home argued that the appropriate date for measuring damages in connection with the Calyon repurchase agreement was the date of acceleration, while Calyon argued that a later date should apply. Both parties agreed that the secondary market for mortgage loans was dysfunctional on the acceleration date because of the onset of the housing and mortgage crisis. The parties disagreed over the significance of that fact, however.

Calyon argued that a market or sale value of the mortgage loans was the *only* appropriate valuation methodology. According to Calyon, because the markets were admittedly dysfunctional on the acceleration date, such values could not be appropriately used, and consequently, section 562 mandated the application of a different date for measuring damages—that is, the date when the markets became functional again. In contrast, American Home argued that, though use of a market value was inappropriate because of the dysfunction of the markets on the acceleration date, other commercially reasonable determinants of value existed on that date. In particular, American Home asserted that the court could appropriately measure damages under section 562 by relying on a discounted cash flow analysis or certain market analyses that Calyon had obtained outside the context of the litigation.

[P]recious few courts have discussed either the repurchase provisions or section 562 of the Bankruptcy Code at all. Accordingly, how that body of case law will develop remains to be seen. However, at least for those courts within the Third Circuit, the phrase "commercially reasonable determinants" encompasses more methodologies than market price alone.

The bankruptcy court resolved the dispute in favor of American Home in *In re American Home Mortg. Holdings, Inc.*, 411 B.R. 181 (Bankr. D. Del. 2009), ruling that the discounted cash flow analysis (but not the market analyses) was a commercially reasonable determinant of value on the acceleration date. The court determined that section 562 was ambiguous in this regard, partly on the basis of a conflict with section 559. It then observed that the repo provisions of the Bankruptcy Code were designed to preserve liquidity in repo assets and that section 562 was designed to "align the risks and rewards associated with an investment in those assets." Section 562, according to the court, prevented the "moral hazard" that would result if damages were measured on a date other than the date of termination, acceleration, or liquidation. For example, by measuring damages as of a later date, the nondebtor could capture the benefits of price increases (up to the amount of the repurchase obligation), while being compensated for any price decreases in the form of a larger deficiency claim.

The court also observed, "There is nothing in section 562 that would imply a limitation on any methodology used to determine value, provided it is commercially reasonable." Indeed, the court continued, "the use of the word *determinants* suggests just the opposite—that *any* commercially reasonable valuation may be used." Also pertinent to the court's ruling was the finding that American Home's expert witness was credible and that Calyon's expert was not. Further, the court found that, even if Calyon's evidence were credited, it would not change the analysis because such testimony might have impacted the loan portfolio's sale price but was not relevant since Calyon intended to hold the loans.

Applying the discounted cash flow analysis, the court determined that the value of the mortgage loans exceeded the repurchase obligation and that Calyon therefore had no deficiency claim.

THIRD CIRCUIT DECISION

On direct appeal, the Third Circuit Court of Appeals affirmed the bankruptcy court's decision. But it did not agree with the bankruptcy court's reasoning in full. Specifically, the court of appeals rejected the lower court's suggestion that section 562 was ambiguous in light of a perceived conflict with section 559. The Third Circuit explained that these provisions address different circumstances: "Section 559 applies only in the event that a repurchase agreement is liquidated, and the liquidation results in excess proceeds . . . [, while section 562] applies when the contract is liquidated, terminated, or accelerated, and results in *damages* rather than excess proceeds."

The appellate court agreed, however, with the bankruptcy court's conclusion that market price is not the only commercially reasonable determinant of value under section 562. The Third Circuit noted the bankruptcy court's finding that Calyon had no intention of selling the loans, as well as the testimony below that a discounted cash flow was particularly appropriate where the owner holds the mortgage loans and is receiving the cash flows. The court of appeals also found persuasive the bankruptcy court's analysis that market price should be used when the market is functioning well and that a court should look to other determinants only when the market is dysfunctional.

Accordingly, the Third Circuit found the bankruptcy court's findings and conclusions persuasive and supported by the evidence, and it rejected Calyon's argument that only market price should be considered. Circuit judge Rendell concurred in the court's opinion and succinctly noted three reasons why the result was correct in her view: First, the statute uses the plural—"determinants." Second, the phrase "commercially reasonable" implicates a fact-intensive inquiry that depends on the totality of the circumstances (which may not include a sale of the assets). Third, Calyon retained the mortgage loans instead of selling them and thus received the cash flows.

OUTLOOK

The *American Home* decision appears to be the first opinion to address these issues at the circuit level. Indeed, precious few courts have discussed either the repurchase provisions or section 562 of the Bankruptcy Code at all. Accordingly, how that body of case law will develop remains to be seen. However, at least for those courts within the Third Circuit, the phrase "commercially reasonable determinants" encompasses more methodologies than market price alone.

IN BRIEF: PBGC ISSUES FINAL PPA REGULATION ON TERMINATING PLANS IN BANKRUPTCY

On June 13, the Pension Benefit Guaranty Corporation ("PBGC") released a final rule that, in most cases, will reduce the amount of pension benefits guaranteed under the agency's single-employer insurance program when a pension plan is terminated in a bankruptcy case. The rule will also decrease the amount of pension benefits given priority in bankruptcy.

The rule (RIN: 1212-AA98) became effective on July 14. Under the final rule, the date on which a plan sponsor's bankruptcy petition is filed will be treated by PBGC as the plan's termination date for purposes of determining certain benefits guaranteed by PBGC. Pension plan benefits earned by participants after the bankruptcy petition date will not be guaranteed. The final rule also establishes the benefits entitled to "priority category 3" status in statutory procedures for allocating the assets of terminated plans. The final rule implements Sections 4022 and 4044(a)(3) of Title IV of the Employee Retirement Income Security Act, as amended by Section 404 of the Pension Protection Act of 2006.

One consequence of the rule will be that a plan participant's guaranteed benefit can be no greater than the amount of the benefit on the sponsor's bankruptcy petition date. Previously, some employers continued to sponsor plans after filing for bankruptcy and participants continued to accrue benefits after the petition date. Those postbankruptcy accruals will no longer be guaranteed by PBGC.

Another consequence of the final rule is that PBGC will guarantee only benefits that were "nonforfeitable" on the bankruptcy petition date. For a plan that has five-year "cliff" vesting, a participant with fewer than five years of service on the petition date will receive no guaranteed benefit, even if the benefit "becomes vested by the section 4048 termination date." Similarly, if a participant becomes entitled to a disability retirement benefit or an early retirement subsidy after the sponsor's bankruptcy petition date, but prior to the plan termination date, that disability benefit or subsidy will not be guaranteed.

BANKRUPTCY ASSET SALE NOT SO "FREE AND CLEAR" AFTER ALL

Lauren M. Buonome

The ability to sell an asset in bankruptcy free and clear of liens and any other competing "interest" is a well-recognized tool available to a trustee or chapter 11 debtor in possession ("DIP"). Whether the category of "interests" encompassed by that power extends to potential successor liability claims, however, has been the subject of considerable debate in the courts. A New York bankruptcy court recently addressed this controversial issue in *Olson v. Frederico (In re Grumman Olson Indus., Inc.)*, 445 B.R. 243 (Bankr. S.D.N.Y. 2011). In *Grumman Olson*, the court ruled that a section 363 sale order cannot exonerate purchasers from successor liability claims by claimants who, at the time of the sale, had not yet been injured and had no contact or relationship with the debtor or its products.

FREE AND CLEAR SALES IN BANKRUPTCY

Section 363(b) of the Bankruptcy Code provides that a trustee or DIP may use, sell, or lease estate property outside the ordinary course of the debtor's business with bankruptcy court approval. In addition, under section 363(f), the sale may be "free and clear of any interest in such property of an entity other than the estate," provided it satisfies any one of certain specified conditions. These include, among other things, if applicable nonbankruptcy law permits a sale free and clear, if the sale price exceeds the amount of all liens encumbering the property, and if the interest is in bona fide dispute.

A bankruptcy court's power to order sales free and clear of a competing interest without the consent of the party asserting the interest has been recognized for more than a century. It promotes the expeditious liquidation of estate assets by avoiding delay attendant upon sorting out disputes concerning the validity and extent of competing interests, which can later be resolved in a centralized forum. It also facilitates the estate's realization of the maximum value possible from an asset. A prospective buyer would discount its offer significantly if it faced the prospect of protracted litigation to obtain clear title to an asset.

Meanwhile, holders of competing interests are also provided with protections by the Bankruptcy Code. Pending the bankruptcy court's resolution of any disputes, the interest holder is entitled to "adequate protection" of its interest. This most commonly takes the form of a replacement lien on the proceeds of the sale.

"ANY INTEREST" BROADLY CONSTRUED

Section 363(f) has been applied to a wide range of "interests," but courts have sometimes struggled to grasp the scope of the term, which is defined nowhere in the Bankruptcy Code or its accompanying legislative history. For example, courts have disagreed as to whether a successor liability claim constitutes an "interest" in property that can be extinguished by means of a sale free and clear. Some courts have narrowly construed the term "interest" to include only *in rem* interests (*e.g.*, liens and security interests that attach to specific property). These courts typically have ruled that product liability claims and tort actions against the seller are unaffected by a bankruptcy sale and can be asserted against the buyer. Other courts have construed the term broadly to hold that certain liabilities (*e.g.*, certain environmental remediation costs and employment discrimination claims) do not follow assets sold free and clear under section 363(f).

Grumman Olson suggests that sweeping "free and clear" language in a sale order purporting to extinguish a purchaser's liability for potential future tort claims may not necessarily achieve that objective in all cases.

Special circumstances have led to the development of case-specific rules. For example, some bankruptcy courts have expanded the scope of traditional successor liability where there is an overriding need to protect federal rights or effectuate federal policies. These courts have allowed actions against a purchaser of a debtor's business if the successor had notice of the claim before the acquisition and there is substantial continuity in the operation of the business before and after the sale.

Courts have also struggled to develop an appropriate way to deal with "future claims" (*i.e.*, claims that do not arise until after the bankruptcy proceedings have concluded). Some have adopted a blanket rule that future claims cannot be discharged in a debtor's bankruptcy case. Other courts have adopted a more practical approach in dealing with future claims. Instead of denying discharge of all future claims, these courts have examined whether the debtor notified as many potential claimants as possible of the sale, whether the debtor sought court approval to preclude successor liability, and whether the debtor made arrangements for future claimants so that they are able to look to some source for recovery.

GRUMMAN OLSON

Grumman Olson Industries, Inc. ("Grumman" or the "Debtor"), a manufacturer of truck body parts, filed a chapter 11 petition in New York in December 2002. On July 1, 2003, the bankruptcy court entered an order (the "Sale Order") approving the sale of certain of the Debtor's assets to a predecessor of Morgan Olson, LLC ("Morgan"). The Sale Order purported to exonerate Morgan from potential liability from certain tort claims, providing in pertinent part that "[t]he sale . . . of assets to be purchased . . . shall be free and clear of all . . . claims . . . and other interests . . . whether arising prior to or subsequent to the commencement of this Chapter 11 case." The Sale Order further provided that Morgan would "have no liability or responsibility for any liability or other obligation of the Debtor arising under or related to [the asset sale] . . . including, but not limited to, claims for successor or vicarious liability."

After the sale was consummated, Denise Frederico was injured when the Grumman-manufactured truck that she was driving crashed into a telephone pole. In October 2009, Frederico and her husband (together, the "Fredericos") commenced a personal injury action against Morgan in the Superior Court of New Jersey. The complaint alleged that the truck was defective and that Morgan was liable for the injuries under New Jersey's successor liability laws. Specifically, the Fredericos asserted that Morgan continued to use Grumman's product line, thereby holding itself "out to potential customers as continuing to manufacture the same product line of Grumman trucks."

In March 2010, Morgan commenced an adversary proceeding in the bankruptcy court seeking declaratory and injunctive relief to preclude the Fredericos from bringing their successor liability action. Morgan contended that the Sale Order and the accompanying asset purchase agreement exonerated it from any liability, including liabilities under state successor liability laws, arising from defective products manufactured by the Debtors and sold prior to the consummation of the Sale Order. Both Morgan and the Fredericos moved for summary judgment.

THE BANKRUPTCY COURT'S RULING

At the outset, the bankruptcy court concluded that it had subject matter jurisdiction over the dispute despite confirmation of the Debtor's chapter 11 plan. Among other bases for this conclusion, the court explained that "[i]t is well-settled that a bankruptcy court retains jurisdiction to interpret and enforce its prior orders, especially where, as here, the bankruptcy court expressly retains jurisdiction to do so."

Addressing the merits, the court held that a sale under section 363(f) does not exonerate a buyer from successor liability claims by parties who, at the time of the sale, had not yet been injured and had no identifiable connection as potential creditors to the debtor or its products. Because the Fredericos did not hold a claim at the time the Sale Order was entered, the court ruled that the order did not preclude the Fredericos from suing Morgan in state court. The court expressed no view as to whether Morgan was actually liable under New Jersey successor liability law for the underlying injury.

Future Tort Claims

The Sale Order expressly exonerated Morgan from any "claims," including those for successor liability. Section 101(5)(A) of the Bankruptcy Code defines "claim" in the broadest possible fashion to mean "right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured." Even so, the court acknowledged that, at least with respect to future tort claims, the term "claim" has an outer boundary. The court distinguished between two types of future tort claims. In the first, the tort claimant had prepetition exposure to the debtor's product but had not yet manifested symptoms or discovered an injury. In the second, the tort claimant was injured after consummation of an asset sale or confirmation of a plan as a result of a defective product manufactured and sold by the debtor prepetition. The court placed the Fredericos in the latter group.

Fair-Contemplation Test

The Second Circuit, the bankruptcy court explained, has adopted a "fair contemplation" test to differentiate between contingent or unmatured claims, which qualify as "claims" under section 101(5), and potential future tort claims, which do not. Under this test, set forth in *United States v. LTV Corp. (In re Chateaugay Corp.)*, 944 F.2d 997 (2d Cir. 1991), "a contingent or unmatured claim is a 'claim' if the occurrence of the contingency or future event that would trigger liability" may have conceivably been considered by the parties at the inception of the original relationship between the parties. *Chateaugay* involved environmental claims, not tort claims. Nevertheless, the court in *Grumman Olson* found the hypothetical posited in *Chateaugay* to be instructive:

> Consider, for example, a company that builds bridges around the world. It can estimate that of 10,000 bridges it builds, one will fail, causing 10 deaths. Having built 10,000 bridges, it becomes insolvent and files a petition in bankruptcy. Is there a "claim" on behalf of the 10 people who will be killed when they drive across the one bridge that will fail someday in the future? If the only test is whether the ultimate right to payment will arise out of the debtor's pre-petition conduct, the future victims have a "claim." Yet it must be obvious that enormous practical and perhaps constitutional problems would arise from recognition of such a claim. The potential victims are not only unidentified, but there is no way to identify them. . . . What notice is to be given to these potential "claimants"? Or would it suffice to designate a representative for future victims and authorize the representative to negotiate terms of a binding reorganization plan?

The bankruptcy court also considered a "modified version" of the "fair contemplation" test articulated by the Eleventh Circuit in *Epstein v. Official Committee of Unsecured Creditors (In re Piper Aircraft Corp.)*, 58 F.3d 1573 (11th Cir. 1995). In *Piper*, the court applied a two-part test to determine when a person holds a "claim" against a debtor manufacturer and thus may be barred from pursuing a successor buyer: (i) the events occurring prepetition must have created a relationship; and (ii) the basis for liability must be the debtor's prepetition conduct in designing, manufacturing, and selling the allegedly defective or dangerous product.

In *Grumman Olson*, the court concluded that the Fredericos' claim failed the *Piper* test and fell "squarely within the *Chateaugay* hypothetical." The Fredericos, the court explained, had no prepetition relationship with Grumman. In fact, the only connection the Fredericos had with Grumman was through Denise Frederico's employer, who purchased the truck that she drove. As such, the court ruled that the Fredericos did not hold a "claim" against the Debtor's estate at the time of the section 363 sale.

The court also noted due-process concerns with respect to a sale order under section 363(f) that purports to cleanse assets sold to a purchaser "free and clear of any interest in such property." A sale order, the court emphasized, does not bind parties that have not received adequate notice. Because the Fredericos could not have been identified as potential claimants prior to the sale or received adequate notice of the bankruptcy case, the sale, confirmation of Grumman's plan, or the deadline for filing a proof of claim, the Fredericos did not receive adequate notice to satisfy due-process concerns.

OUTLOOK

Grumman Olson should alert bankruptcy practitioners that purchasers of assets in a section 363 sale may face future liability from potential tort claimants. *Grumman Olson* suggests that sweeping "free and clear" language in a sale order purporting to extinguish a purchaser's liability for potential future tort claims may not necessarily achieve that objective in all cases. Purchasers would be well advised to consider such risks.

BUSINESS RESTRUCTURING REVIEW

Business Restructuring Review is a publication of the Business Restructuring & Reorganization Practice of Jones Day.

Executive Editor: Charles M. Oellermann
Managing Editor: Mark G. Douglas
Contributing Editor: Scott J. Friedman

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