JONES DAY

RECENT DEVELOPMENTS IN BANKRUPTCY AND RESTRUCTURING

VOLUME 10 ▪ NO. 5 ▪ SEPTEMBER/OCTOBER 2011

BUSINESS RESTRUCTURING REVIEW

IN THIS ISSUE

1 European Perspective: Roll Up! Roll Up! Schemes Roundup

4 Newsworthy

8 Seventh Circuit Rules That Secured Creditors Must Be Given the Right to Credit-Bid

11 Smack-Down of a Straitjacket

13 First Impressions: Fifth Circuit Rules That Noninsider Claims Can Be Recharacterized as Equity

16 First Impressions: Portion of Withdrawal Liability Entitled to Administrative Priority

19 History Matters: Historical Breaches May Undermine Assumption of Executory Contracts

22 Proposed Chapter 11 Venue Legislation Introduced

EUROPEAN PERSPECTIVE: ROLL UP! ROLL UP! SCHEMES ROUNDUP

Michael Rutstein

Note From the Editors: This installment of our "European Perspective" column has been contributed by Michael Rutstein, a partner in Jones Day's global Business Restructuring & Reorganization Practice. Based in London, Michael's practice focuses on corporate restructurings and insolvencies, which often include cross-border issues.

INTRODUCTION

In this article, we will review some of the recent developments in the way schemes of arrangement under English law have been used and some of the legal issues that have arisen.

Schemes of arrangement have been in the English statute books for well over 100 years. The current provisions are found in five short and terse sections of the UK Companies Act 2006 (the "Companies Act") (sections 895–899). The brevity of the sections belies their importance and complexity, and a body of case law has developed over time concerning the correct procedures and formalities that have to be complied with and the legal hurdles that have to be overcome in order for the court to approve the scheme.

Until relatively recently, schemes, in an insolvency context, have tended to be used by insurance companies as a means of settling long-term and contingent claims and distributing assets to policyholders. However, in the past few years, schemes have become a popular rescue procedure for a much wider audience and, in particular, for complex financial distressed-based restructurings involving one or more tiers of secured debt, filling the void left by the potentially more user-friendly company voluntary arrangement ("CVA"). A CVA cannot be used to compromise claims of a secured creditor without that creditor's expressed consent.

WHAT IS A SCHEME OF ARRANGEMENT?

A scheme of arrangement can be used in both solvent and insolvent contexts. It is a procedure that can be used by a company to implement a compromise or arrangement with either its creditors generally (or a class of them) or its members (or a class of them). A scheme is a court-driven process and involves the proponent of the scheme (invariably the debtor company) making two applications to court. At the first hearing, the company seeks an order of the court to convene the relevant creditor meetings to vote on the proposed compromise embodied in the scheme documentation.

It is at this stage that the court decides whether the company has correctly identified the classes of creditors to attend the meeting and vote on the scheme. The creditor meetings are then held. If the creditors approve the scheme, the company makes a second application to the court for "sanction" (*i.e.*, approval). The court at this stage is concerned with ensuring that the scheme is one which a creditor could reasonably have approved, that the majority has not unfairly coerced a minority to accept a position contrary to its interests, and that each creditor class has been fairly represented at the meeting. If the court gives sanction, the scheme becomes binding once the court order has been filed at the UK Companies Registry.

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A scheme is approved by creditors if a majority in number of the creditors of each relevant class and at least 75 percent in value of the claims of creditors in that class represented at the meeting have voted in favour of it.

RECENT DEVELOPMENTS IN SCHEMES OF ARRANGEMENT

By far the most significant development that has taken place in the past year relating to schemes has been their use by overseas companies. It may at first sight seem strange that a foreign company would want to make use of an English law procedure to compromise claims with creditors (few or none of whom may be English-based) and even odder when one considers that the EC Regulation on Insolvency Proceedings 2000 (the "Insolvency Regulation") has been in force for many years and provides for automatic recognition throughout the EU (except in Denmark) of a debtor's main insolvency proceedings initiated in the country where its centre of main interests ("COMI") is located.

The odd becomes the truly bizarre when one considers that an English scheme is not an insolvency procedure which falls within the ambit of the Insolvency Regulation and therefore has no legal status thereunder. So why are foreign companies coming here to propose schemes? Is it because they like the food or the weather? Alas, no. The more mundane reasons why schemes are proving popular with foreign companies are as follows:

- Schemes of arrangement (like CVAs) have at their heart a "cramdown" procedure whereby a dissenting minority of creditors can be bound by a compromise approved by a majority. Although cramdown is a well-established concept under both English and U.S. insolvency law, it is comparatively rare in civil-law countries. Where cramdown does not exist, a company must obtain the consent of each of its creditors if it is to implement successfully a restructuring. In practice, this 100 percent threshold often is unachievable. Therefore, where cramdown does not exist under local law or the law of its COMI, the debtor may find cramdown procedures in England worth a closer look.
- Even where cramdown procedures do exist under the law of the debtor's COMI, there may be little track record of the procedures' having been used successfully, and there may be a lack of experience in local courts in overseeing

them. The German *Insolvenzplan*, for example, is still an underused procedure even though it allows for cramdown.
- The English scheme is a trusted and well-understood mechanism with predictability of result.

England has already demonstrated its ability to attract debtor "immigrants" (both corporate and individual) to make use of its debtor- and creditor-friendly bankruptcy and insolvency procedures. For example, Wind Hellas in 2010 migrated its COMI to England from Luxembourg in order to enter into an English administration (as a "main proceeding" under the Insolvency Regulation) and to effect a prepackaged sale of its business. However, moving COMI is, to put it bluntly, a hassle at best and wholly impractical or impossible at worst (assuming the "command and control" test for COMI is not resurrected). The recent European experience is that, as far as corporate debtors are concerned, only a company with few or no employees or physical assets can readily move its COMI (and even then, there may be significant tax considerations which might mitigate against it). However, English insolvency lawyers and English courts do not give up the fight easily, and English schemes are another form of the wares we offer to the curious and financially distressed who choose to shop within our stores. This has been witnessed recently in *La Seda de Barcelona* (a partially reported decision) and a number of unreported decisions (*Tele Columbus Group* and *Rodenstock GmbH* (German), *Metrovacesa SA* (Spanish), and *Gallery Media* (Russian)).

CASE STUDIES

Let us take a closer look at the developing law relating to the ability of non-English companies to use English schemes of arrangement successfully.

La Seda

La Seda was a Spanish company with its COMI in Spain. The company entered into individual compromise agreements with bilateral lenders and trade creditors. Predictably, it could not obtain unanimous consent of the members of its secured bank syndicate to a restructuring of its facilities. The only option available to it in Spain was a formal insolvency. However, the negotiations with the bank syndicate had shown that a majority of the syndicate was in favour of a restructuring which, if exported to England, would be sufficient to approve a scheme. La Seda therefore came to England and proposed a scheme of arrangement among the members of the syndicate (which comprised one class of creditors). The requisite majority of creditors voted in favour. A number of interesting issues emerged from the case, but the one that concerns us for present purposes was the basis on which the English court held that it had jurisdiction to approve La Seda's scheme.

Section 895 of the Companies Act provides that "a company liable to be wound up under the [UK] Insolvency Act 1986 [(the 'Insolvency Act')]" may propose a scheme. Section 221 of the Insolvency Act allows an unregistered company (which includes a non-English company) to be wound up in England. Before the Insolvency Regulation came into force, the English courts had assumed a liberal and wide discretion to make winding-up orders over foreign companies (and hence, there was a wide window available for foreign companies to propose schemes). Under common law, a threefold test needs to be satisfied in order for an English court to exercise jurisdiction:

- The debtor must have a sufficient connection with England;
- There must be a reasonable possibility that if the company were to be wound up in England or a scheme were to be approved, someone would benefit from the winding-up order or scheme; and
- There is at least one person interested in the distribution of the assets in the winding-up or under the scheme who would be subject to the jurisdiction of the English courts.

It is not quite clear if all of these elements are mandatory or if (in the case of the last two) they merely go towards the court's exercise of its discretion whether to assume winding-up jurisdiction.

Two issues of interest arose in *La Seda*. First, did the company have a sufficient connection with England, and second, had the Insolvency Regulation displaced the common-law rules as to what constituted a company "liable to be wound up under the Insolvency Act"? As for the first issue, the court held that La Seda did have a sufficient connection. This was because the banking agreements between La Seda and the syndicate were governed by

NEWSWORTHY

Corinne Ball (New York and ***London)***, ***Paul D. Leake (New York)***, ***David G. Heiman (Cleveland)***, ***Brad B. Erens (Chicago)***, ***Heather Lennox (New York*** and ***Cleveland)***, ***Charles M. Oellermann (Columbus)***, ***Gregory M. Gordon (Dallas)***, ***Bennett L. Spiegel (Los Angeles)***, ***Richard L. Wynne (Los Angeles)***, ***Peter J. Benvenutti (San Francisco)***, ***Aldo L. LaFiandra (Atlanta)***, and ***Susan E. Siebert (Boston)*** were recognized in the field of Bankruptcy in the 2012 *Super Lawyers Business Edition*.

David G. Heiman (Cleveland), ***Brad B. Erens (Chicago)***, ***Mark A. Cody (Chicago)***, ***Jane Rue Wittstein (New York)***, ***Robert W. Hamilton (Columbus)***, and ***Timothy W. Hoffmann (Chicago)*** represented food specialty retailer Harry & David Holdings, Inc., in connection with the company's successful emergence on September 14, 2011, from six months in bankruptcy. On August 30, a Delaware bankruptcy court confirmed the company's chapter 11 plan. The foundation of the plan is a landmark settlement with the Pension Benefit Guaranty Corporation relating to the termination of the company's pension plan. The settlement was reached after a hotly contested three-day evidentiary trial in bankruptcy court on the company's (ultimately victorious) motion for authorization to terminate the pension plan.

Corinne Ball (New York and ***London)***, ***Peter J. Benvenutti (San Francisco)***, ***Carl E. Black (Cleveland)***, ***Brad B. Erens (Chicago)***, ***Gregory M. Gordon (Dallas)***, ***David G. Heiman (Cleveland)***, ***Aldo L. LaFiandra (Atlanta)***, ***Paul D. Leake (New York)***, ***Heather Lennox (New York*** and ***Cleveland)***, and ***Richard L. Wynne (Los Angeles)*** were recognized in *Best Lawyers in America* (2012) in the field of Bankruptcy and Creditor Debtor Rights/Insolvency and Reorganization Law.

On September 19, 2011, the Second Circuit Court of Appeals affirmed the ruling of a New York bankruptcy court ordering eight former Chrysler dealerships to abandon their efforts to force the new, postbankruptcy carmaker to reinstate the dealers' franchise agreements. The appeals court ruled that the dealers had missed their opportunity to appeal the bankruptcy court's order approving the 2009 sale of substantially all of the company's assets to New Chrysler, a joint venture with Italian carmaker Fiat SpA. New Chrysler's predecessor, Old Carco LLC, was represented by ***Kevyn D. Orr (Washington)*** and ***Jeffrey B. Ellman (Atlanta)***.

Daniel P. Winikka (Dallas) discoursed on "Bankruptcy Reorganization Plan Strategies: Debt Reinstatement and Indubitable Equivalent" at a Strafford Publications webinar on September 7.

David. G. Heiman (Cleveland) was recognized in *Best Lawyers in America* (2012) in the field of Equipment Finance Law.

NEWSWORTHY *(continued)*

An article written by ***Jeffrey B. Ellman (Atlanta)*** and ***Daniel J. Merrett (Atlanta)*** entitled “Pensions and Chapter 9: Can Municipalities Use Bankruptcy to Solve Their Pension Woes?” appeared in volume 27, issue 2 (Summer 2011), of the *Emory Bankruptcy Developments Journal*.

Corinne Ball (New York and ***London)***, ***Paul D. Leake (New York)***, ***Peter J. Benvenutti (San Francisco)***, and ***Carl E. Black (Cleveland)*** were recognized in *Best Lawyers in America* (2012) in the field of Litigation-Bankruptcy.

An article written by ***Pedro A. Jimenez (New York)*** and ***Mark G. Douglas (New York)*** entitled “Breaking New Ground (Again) in Chapter 15” was published in the October 2011 issue of *Pratt’s Journal of Bankruptcy Law*.

Kevyn D. Orr (Washington) sat on a panel discussing “Cross-Border Insolvencies: Current Issues and Trends” at the American Bar Association’s Annual Meeting in Toronto on August 6.

Kevyn D. Orr (Washington) and ***Dan T. Moss (Washington)*** were recognized in *Law360* in connection with Jones Day’s defense of HRB Tax Group, Inc., against claims of unfair competition and false advertisement in a lawsuit filed by Jackson Hewitt Inc. The Delaware bankruptcy judge lifted a stay that had been put in place to stop a Lanham Act false-advertising fight between the two tax preparers.

Thomas A. Howley (Houston) participated in a panel discussion on “The Great Amend and Pretend Period: Chapter 11/Where Will the Work Be?” at the State Bar of Texas Advanced Business Bankruptcy Conference on September 8 in Houston.

An article written by ***Daniel R. Culhane (New York)*** entitled “Substantive Consolidation and Nondebtor Entities: The Fight Continues” was published in the September 2011 edition of *Pratt’s Journal of Bankruptcy Law*.

An article written by ***Nancy J. Lu (New York)*** entitled “Section 503(b) Not Exclusive Authority for Payment of Creditor Fees and Expenses in Chapter 11” was published in the September 2011 edition of *Pratt’s Journal of Bankruptcy Law*.

An article written by ***Charles M. Oellermann (Columbus)*** and ***Mark G. Douglas (New York)*** entitled “Senior Class Gifting Is Not the End of the Story” appeared in the June 21, 2011, issue of *Bankruptcy Law360*.

English law and gave the English courts jurisdiction. It was also significant that La Seda had an English subsidiary and its own branch office in England.

As for the second issue, the Insolvency Regulation introduced a problem, perhaps unintentionally. Under the Insolvency Regulation, a company (wherever it is incorporated) cannot be wound up in England as a "main proceeding" unless its COMI is in England, and it cannot be wound up in England as a "nonmain" (secondary, or "territorial") proceeding unless the company has an "establishment" in England.

The court held that the Insolvency Regulation had not displaced the previous rules relating to what amounted to a company "liable to be wound up" in England. According to the court, since La Seda satisfied the threefold test referred to above, it was liable to be wound up in England, and that was the end of the matter.

So far, so good. However, would a scheme approved by the English court bind all the scheme creditors, particularly those who are in a position to initiate an insolvency in the home country, Spain? Because the Insolvency Regulation does not confer recognition on schemes in EU member states, it would be a matter for Spanish law as to whether the English scheme would be recognised in Spain. Evidence was adduced in *La Seda* that a Spanish court would recognise the English scheme because of the presence of the English governing law and jurisdiction clauses in the banking facility agreements. The scheme would be seen in Spain to be an amendment of creditors' rights under the La Seda facility agreements, and because that amendment would be binding under the law of the facility agreements (English law), a Spanish court would recognise the scheme.

Tele Columbus Group and *Rodenstock*

Hot on the heels of *La Seda*, the Tele Columbus Group and Rodenstock successfully implemented English schemes of arrangement. In both cases, the companies in question were German, and each had its COMI in Germany. Once again, the scheme purported to compromise the claims of secured creditors whose rights and obligations were governed by English-law loan agreements that contained English jurisdiction clauses. What emerges from these two cases as a practical pointer is that it is important to adduce evidence that an English scheme would be recognised in the home country (this could be provided by an academic, a retired judge, or an officeholder in the home country). The rationale for this requirement is not entirely clear, but it appears to go to the issue of fairness and reasonableness. If the scheme bound those creditors who were subject to the jurisdiction of the English courts, but not those creditors who were not, the former would be in an unfair position compared to the latter, and it would not be reasonable for a scheme to become binding in these circumstances.

In *Rodenstock*, the court was influenced by the fact that the scheme was being used to compromise creditor claims arising under a single facility agreement. What was important was not just that the rights between the company and the creditors were governed by that agreement, but that it also governed the rights between the creditors themselves. The position supporting jurisdiction would have been weaker if each creditor had entered into its own separate loan agreement with the company and there had been no overarching agreement that dealt with intercreditor issues.

Metrovacesa

Another Spanish company, Metrovacesa SA, also successfully proposed an English scheme of arrangement. Its banking arrangements were similarly governed by an English-law loan agreement. Additional testimony was given by a Spanish academic to the effect that the Spanish court would recognise the English scheme as a matter of policy because Spain was in the process of formulating its own cramdown rules.

It is interesting to note that the statutory requirement for the court order sanctioning a scheme to be filed at the UK Companies Registry in respect of English companies in order for the scheme to become binding appears not to apply in respect of foreign companies. This clearly makes practical sense where the foreign company is not registered in England as an overseas company, but the legal rationale for waiving the requirement remains obscure.

There are a few words of caution to offer regarding the attractiveness of English schemes for foreign companies. All of the cases we have considered above involve what was

essentially a compromise of rights under English law documents. It is far less clear as to whether an English scheme would be recognised in the country of the debtor's incorporation or (if different) the debtor's COMI if the scheme purported to compromise rights arising under a law other than English law. Interestingly, the regional appellate court in Celle, Germany, has refused to recognise the Equitable Life scheme of arrangement (although the decision is being appealed). The difference in that case is that the English scheme purported to compromise rights arising under German law documents.

CAN SCHEMES OF ARRANGEMENT BE USED TO COMPEL CREDITORS TO RELEASE CLAIMS AGAINST THIRD PARTIES?

The issue of third-party releases also arose in *La Seda*. An English subsidiary, Artenius UK Limited ("Artenius"), was a guarantor of La Seda's bank liabilities. Artenius had been placed into administration and had claims against La Seda and other group companies exceeding £80 million. The scheme contained a term that provided for the scheme creditors to release Artenius from all liabilities as guarantor. If the scheme were approved containing such a term, Artenius was prepared to release its intercompany claims. The question arose whether the court should decline to approve the scheme because it included a term under which creditors would be forced to give up their claims against a third party.

The court had little difficulty in coming to the view that the term in question did not prevent it from giving approval to the scheme. It was satisfied that there was a sufficient element of give and take on the part of the creditors and the beneficiary of the release, Artenius. The "take" on the part of the creditors was that the release would improve the balance-sheet position of La Seda and its subsidiaries. The court explained that the test for these sorts of clauses is that they are unobjectionable if the claims of the creditors against the released party: (i) are closely connected to the scheme creditors' rights against the company proposing the scheme; (ii) are personal and not in the nature of proprietary rights; and (iii) would, if exercised, result in a reduction of the creditors' claims against the debtor.

The court found that these three elements had been satisfied. What is not clear from the ruling is whether the claims against Artenius were secured (likely) and whether the claims that Artenius had against La Seda and its subsidiaries were subordinated such that they could not have been paid until the bank debt had been repaid in full (almost certainly). Neither of these factors appeared to be an impediment in satisfying the threefold test.

It is interesting to compare the position to releasing third parties under a CVA. If La Seda had proposed a CVA on identical terms, the result ought to have been the same. It is possible to compromise creditors' claims against third parties under a CVA, provided that no unfair prejudice has been suffered by a releasing creditor. In *La Seda*, all the scheme creditors had the same rights against Artenius and were receiving the same value for the release (*i.e.*, the cancellation of claims against the remainder of the group), and thus, there was a complete absence of discrimination between the creditors.

CONCLUSION

Schemes and the law associated with them are evolving to provide a very powerful tool in the restructuring process where debtors have complex capital structures involving one or more tiers of secured debt. This is evidenced by the fact that schemes in the insolvency context have developed from the rather narrow and specialist arena of providing for a distribution mechanism for insolvent insurance companies to what is now emerging as an effective and powerful restructuring process of choice for a broad range of companies (wherever their place of incorporation or the location of their COMI). This says much about their flexibility and popularity among corporate leaders and the welcome readiness of the English courts to assist companies in financial difficulty in providing a restructuring solution that avoids a formal insolvency.

A version of this article was published in the September 2011 issue of *Corporate Rescue and Insolvency*. It has been reprinted here with permission.

SEVENTH CIRCUIT RULES THAT SECURED CREDITORS MUST BE GIVEN THE RIGHT TO CREDIT-BID

George R. Howard and Mark G. Douglas

In a victory for secured creditors, the Seventh Circuit Court of Appeals recently held in *River Road Hotel Partners, LLC v. Amalgamated Bank* (*In re River Road Hotel Partners, LLC*), 2011 WL 2547615 (7th Cir. June 28, 2011), that a dissenting class of secured lenders cannot be deprived of the right to credit-bid its claims under a chapter 11 plan that proposes an auction sale of the lenders' collateral free and clear of liens. The decision is a welcome development for secured creditors on the heels of contrary rulings handed down by the Third Circuit in *In re Philadelphia Newspapers*, 599 F.3d 298 (3d Cir. 2010), and the Fifth Circuit in *In re Pacific Lumber Co.*, 584 F.3d 229 (5th Cir. 2009). The resulting circuit split, however, may be a compelling invitation for review by the U.S. Supreme Court.

THE BANKRUPTCY CODE'S CRAMDOWN REQUIREMENTS

Section 1129(b) of the Bankruptcy Code sets forth the requirements that must be met before a bankruptcy court can confirm a chapter 11 plan over the objections of a dissenting class of creditors whose rights are impaired by the plan. Among these "cramdown" requirements is the dictate in section 1129(b)(1) that a plan "not discriminate unfairly" and that it be "fair and equitable" with respect to a dissenting class of creditors.

Section 1129(b)(2) addresses the "fair and equitable" requirement for different types of claims. Section 1129(b)(2)(A) provides three alternative ways to achieve confirmation over the objection of a dissenting class of secured claims: (i) the secured claimants' retention of their liens and receipt of deferred cash payments equal to at least the value, as of the plan effective date, of their secured claims; (ii) the sale, "subject to section 363(k)," of the collateral free and clear of all liens, with attachment of the liens to the proceeds and treatment of the liens on proceeds under option (i) or (iii); or (iii) the realization by the secured creditors of the "indubitable equivalent" of their claims claim.

Section 363(k) of the Bankruptcy Code establishes the right of secured creditors to "credit-bid" by providing that when a debtor sells any property secured by a valid lien, unless the court orders otherwise "for cause," and if the holder of the secured claim purchases the property, "such holder may offset such claim against the purchase price of the property."

THE DISPUTE

Courts disagree as to whether a secured creditor must be afforded the right to credit-bid its claims in a sale of its collateral pursuant to a chapter 11 plan in all circumstances. In particular, if a plan proposes to satisfy the "fair and equitable" requirement by providing the "indubitable equivalent" under section 1129(b)(2)(A)(iii)—which, unlike section 1129(b)(2)(A)(ii), is not expressly made "subject to section 363(k)"—some courts have held that the secured creditors in the affected dissenting class do not have the right to credit-bid in connection with the sale.

In *Philadelphia Newspapers*, for example, the Third Circuit sent shock waves through the commercial lending industry by ruling that a dissenting class of secured creditors can be stripped of the right to credit-bid their claims under a chapter 11 plan that proposes an auction sale of the creditors' collateral free and clear of liens. According to the court, the "indubitable equivalent" prong of the "fair and equitable" requirement set forth in section 1129(b)(2)(A) does not itself require that a secured creditor be permitted to credit-bid its claim. Instead, the court held, the "indubitable equivalent" alternative requires a secured creditor to realize "the unquestionable value" of the creditor's secured interest in the collateral without the right to credit-bid.

Circuit judge Thomas L. Ambro wrote a vigorous 48-page dissent. Judge Ambro opined that section 1129(b)(2)(A) can reasonably be read as outlining the different requirements to satisfy the "fair and equitable" test, but that only one of the three requirements is applicable to any given class of secured creditors under a plan. The applicable requirement is determined by the treatment of the class of secured creditors. In addition, Judge Ambro would have applied the context of section 1111(b) and the legislative history of the provisions to conclude that "the Code requires cramdown plan sales free of liens to fall under the specific requirements

of § 1129(b)(2)(A)(ii) and not to the general requirement of subsection (iii)."

Philadelphia Newspapers came closely on the heels of the ruling in *In re Pacific Lumber Co.*, 584 F.3d 229 (5th Cir. 2009), in which the Fifth Circuit similarly considered whether section 1129(b)(2)(A)(ii) is the only avenue to confirmation of a plan under which the collateral securing the claims of a dissenting secured class is to be sold. That court of appeals ruled that section 1129(b)(2)(A)(ii) does not always provide the exclusive means by which to confirm a plan where the sale of a secured party's collateral is contemplated. Rather, the Fifth Circuit held that, where sale proceeds provide a secured creditor with the indubitable equivalent of its collateral, confirmation of a plan is possible under section 1129(b)(2)(A)(iii). In addition, consistent with its conclusion that the sale transaction in the chapter 11 plan accomplished that result, the court rejected an argument by noteholders that confirmation was improper because they had not been afforded the opportunity to credit-bid their claims for the assets.

Much is at stake for secured creditors in connection with this issue. Credit bidding and the option to elect fully secured status under section 1111(b) of the Bankruptcy Code are important rights designed to guard against judicial undervaluation of a secured creditor's collateral, particularly in circumstances where market conditions are not favorable to the realization of what the creditor views as a fair price for the property.

RIVER ROAD

River Road Hotel Partners, LLC, and its affiliates (the "debtors") built and operated the InterContinental Chicago O'Hare Hotel from 2007 to 2009 with construction financing totaling more than $155 million. The debtors filed for chapter 11 relief in Illinois in August 2009. The debtors proposed joint chapter 11 plans contemplating the sale of substantially all of their assets pursuant to an auction process. They concurrently filed a motion for court approval of bidding procedures.

The lenders objected to the bidding-procedures motion and the plans, arguing that the plans were unconfirmable and that the procedures should not be approved because they violated the requirement of section 1129(b)(2)(A)(ii) that secured creditors be given the right to credit-bid if assets are to be sold free and clear of liens pursuant to a plan. The debtors countered that the proposed plans provided the lenders with the "indubitable equivalent" of their claims under section 1129(b)(2)(A)(iii), which does not require that the lenders be permitted to credit-bid their claims in connection with an auction sale of their collateral.

Round 3 in the circuits goes to secured creditors, but the bout is far from over. On August 5, 2011, the debtors filed a petition for writ of certiorari, asking the U.S. Supreme Court to review the Seventh Circuit's decision in *River Road* and resolve the split among the circuit courts of appeal on this issue.

The bankruptcy court declined to approve the debtors' proposed bidding procedures because they denied secured creditors the right to credit-bid and, therefore, the debtors' proposed chapter 11 plans could never be confirmed. The debtors appealed and requested that the appeals be certified directly to the Seventh Circuit, which request was granted by the bankruptcy court.

THE SEVENTH CIRCUIT'S RULING

A three-judge panel of the Seventh Circuit affirmed the ruling below. The court began by analyzing whether the language of section 1129(b)(2)(A) has a "plain and unambiguous meaning."

According to the Seventh Circuit, the language of section 1129(b)(2)(A) is ambiguous for two reasons: (1) there is nothing in the provision indicating whether subsection (iii) should have global applicability or be limited to those situations that are not covered by subsections (i) and (ii); and (2) the term "indubitable equivalent" is itself ambiguous and is particularly problematic with respect to undersecured claims.

The Seventh Circuit rejected the Third Circuit's reasoning in *Philadelphia Newspapers* that the use of the disjunctive "or" after section 1129(b)(2)(A)(ii) is a clear indication that subsection (iii) was meant to have global applicability. According to

the court, Judge Ambro's dissent in *Philadelphia Newspapers* is more compelling on this point. The Seventh Circuit also rejected the debtors' argument that the proposed auction would determine the current market value of the assets to be sold and would thus deliver to the lenders the "indubitable equivalent" of their secured claims. Instead, the Seventh Circuit noted, "[T]here are a number of factors that create a substantial risk that assets sold in bankruptcy auctions will be undervalued," including:

(1) The speed and timing of bankruptcy sales;
(2) Lack of sufficient notice and an abbreviated marketing process;
(3) The inherent risk of self-dealing;
(4) Credit markets in a state of limited liquidity; and
(5) The costs of submitting a bid in a court-supervised bankruptcy auction process.

The Seventh Circuit reasoned that the right of secured creditors to credit-bid is "a crucial check against undervaluation." Because "[n]othing in the text of Section 1129(b)(2)(A) indicates that plans that *might* provide secured creditors with the indubitable equivalent of their claims" can be confirmed, the court of appeals ruled that the debtors could not rely on section 1129(b)(2)(A)(iii) to auction off their assets without allowing the lenders to exercise their right to credit-bid.

Having concluded that the meaning of section 1129(b)(2)(A) is ambiguous, the Seventh Circuit proceeded to use "well established principles of statutory interpretation" to determine that the most plausible reading of the statute requires secured creditors to be given the right to credit-bid whenever assets are to be sold free and clear of liens pursuant to a chapter 11 plan.

First, the Seventh Circuit noted that statutes are to be interpreted so that "every part of the statute is meaningful" and no provisions are "superfluous." The court found that the debtors' proposed interpretation of section 1129(b)(2)(A) "violates a cardinal rule of statutory construction" because it would "render the other subsections of the statute superfluous." According to the Seventh Circuit, it could not "conceive of a reason why Congress would state that a plan must meet certain requirements if it provides for the sale of assets in particular ways and then immediately abandon [those] requirements." Therefore, the court concluded that requiring secured creditors to be allowed to credit-bid anytime assets are to be sold free and clear of liens is the "infinitely more plausible interpretation of Section 1129(b)(2)(A)."

Second, the Seventh Circuit explained that denying secured creditors the right to credit-bid by relying on section 1129(b)(2)(A)(iii) "sharply conflicts with the way that [secured creditors] are treated in other parts of the [Bankruptcy] Code." Specifically, the Seventh Circuit noted that section 363(k) and section 1129(b)(2)(A)(ii) expressly provide secured creditors with the right to credit-bid, and section 1111(b) of the Bankruptcy Code provides a means for secured creditors to protect their interests when a debtor seeks to keep possession of assets. Moreover, the court emphasized, there do not appear to be provisions in the Bankruptcy Code "that recognize an auction sale where credit-bidding is unavailable."

Because in its view eliminating a secured creditor's right to credit-bid would (1) "nullify" section 1129(b)(2)(A)(ii) of the Bankruptcy Code and (2) "ignore the protections for secured creditors" in other provisions of the Bankruptcy Code, the Seventh Circuit concluded that any chapter 11 plan that contemplates selling collateral free and clear of liens must allow secured creditors to credit-bid at the sale of their collateral.

OUTLOOK

Round 3 in the circuits goes to secured creditors, but the bout is far from over. On August 5, 2011, the debtors filed a petition for writ of certiorari, asking the U.S. Supreme Court to review the Seventh Circuit's decision in *River Road* and resolve the split among the circuit courts of appeal on this issue. In early September, a group of seven law-school professors and the Loan Syndications and Trading Association separately filed briefs supporting the debtors' certiorari petition.

SMACK-DOWN OF A STRAITJACKET

Laird E. Nelson

Postconfirmation liquidation and litigation trusts have become an important mechanism in a chapter 11 bankruptcy estate's arsenal, allowing for the resolution of claims and interests without needlessly delaying confirmation in the interim. The specter of postconfirmation litigation may seem unremarkable. Section 1123(b)(3)(B) of the Bankruptcy Code states that a plan may provide for retention or enforcement by the reorganized debtor, the trustee, or a representative of the estate of any claim or interest belonging to the estate. However, the provision does not specify the manner in which the retention of any such claims or interests should be drafted and disclosed to other parties—leaving to the courts the question of the level of specificity and detail required. A recent decision handed down by a Texas bankruptcy court, *In re MPF Holdings US LLC*, 443 B.R. 736 (Bankr. S.D. Tex. 2011), suggested that in that district at least, the level of specificity and detail required is high. However, in *In re Matter of Texas Wyoming Drilling, Inc.*, 647 F.3d 547 (5th Cir. 2011), the Fifth Circuit issued an opinion clarifying that debtors in that circuit, which includes the Southern District of Texas, are not straitjacketed in this regard after all.

BACKGROUND: THE THREE APPROACHES

Decisions on this issue have been varied, with some courts requiring only broad, categorical language; others adopting a more nuanced, middle-of-the-road approach; and still others mandating a precise reservation provision. The first group of courts, exemplified by the Seventh Circuit's ruling in *P.A. Bergner & Co. v. Bank One* (*In re P.A. Bergner & Co.*), 140 F.3d 1111 (7th Cir. 1998), and, more recently, the court's decision in *In re Kimball Hill, Inc.*, 449 B.R. 767 (Bankr. N.D. Ill. 2011), requires only broad, categorical language. The second group, attempting to find a middle ground, focuses on the particular plan language and the history of the case itself. *See, e.g., Elk Horn Coal Co., LLC v. Conveyor Mfg. & Supply, Inc.* (*In re Pen Holdings, Inc.*), 316 B.R. 495 (Bankr. M.D. Tenn. 1994). In *Dynasty Oil & Gas, LLC v. Citizens Bank* (*In re United Operating, LLC*), 540 F.3d 351 (5th Cir. 2008), the Fifth Circuit placed itself in the third camp, requiring that the plan "expressly retain the right to pursue such causes of action" and that the language doing so be "specific and unequivocal."

RELAXATION OF THE FIFTH CIRCUIT STANDARD?

Since the *United Operating* ruling was handed down, bankruptcy courts in the Northern District of Texas have criticized the Fifth Circuit's bright-line test and concluded that seemingly broad reservation provisions were permissible under the "specific and unequivocal" standard. For example, in *Moglia v. Keith* (*In re Manchester, Inc.*), 2009 Bankr. Lexis 2003 (Bankr. N.D. Tex. 2009), the court was confronted with a confirmed plan stating that "all Causes of Action shall be transferred to the Litigation Trustee" and that the trustee shall "have the exclusive right to prosecute and enforce any rights to payment of claims or other rights that the Debtors or the Estates may hold against any Person (including Avoidance Actions)." The court determined that *United Operating* did not mandate the identification of specific individuals or entities which would be sued and that the categorical reservation of avoidance claims was sufficient. Accordingly, the court upheld the litigation trustee's standing to pursue certain preference actions after confirmation.

Likewise, in *Spicer v. Laguna Madre Oil & Gas, LLC* (*In re Tex. Wyo. Drilling, Inc.*), 422 B.R. 612 (Bankr. N.D. Tex. 2010), the bankruptcy court upheld standing to sue under similar plan provisions on the ground that *United Operating* does not require the "specific and unequivocal" language to include identification of specific claims and defendants. The clear import of these cases, therefore, was that debtors providing a generic reservation of the right to pursue preference or other avoidance claims could satisfy the bright-line test set forth in *United Operating*.

THE "STRAITJACKET" OF *MPF HOLDINGS*

In *MPF Holdings*, by contrast, a bankruptcy court in the Southern District of Texas adopted a different approach. Applying the standard set forth in *United Operating*, the court concluded that the phrase "specific and unequivocal" requires the plan's reservation provision expressly to state: (1) the name of the putative defendant; (2) the basis on which the putative defendant will be sued; and (3) that the putative defendant will definitely be sued after confirmation. According to the court, "the language must be so Shermanesque that anyone who reads the proposed plan knows that if the plan is confirmed, the putative defendant will unquestionably be sued post-confirmation under a particular legal theory or statute."

Specific

In considering whether the plan was sufficiently specific, the court reviewed the retention language of the plan itself. The court began its analysis by noting that the plan expressly identified putative defendants by reference to certain exhibits, which contained the names, addresses, and amounts paid to those putative defendants within 90 days of the petition date. Accordingly, the court judged the plan to be sufficiently specific.

> The Fifth Circuit's decision in *Texas Wyoming* partially bridges the sharp divide between the competing views on the degree of specificity in a chapter 11 plan necessary to preserve postconfirmation litigation claims. Although debtors in the Fifth Circuit would do well to remember that the claim-reservation language in a chapter 11 plan and disclosure statement must be "specific and unequivocal," the threat of a strict straitjacket no longer looms large.

Unequivocal

However, the plan failed in the court's estimation to satisfy the "unequivocal" prong of the test. The plan stated that the trustee would have the right to prosecute "all causes of action, including but not limited to, (i) any Avoidance Action that may exist." The inclusion of the word "may," the court reasoned, introduced ambiguity as to what causes of action were in fact reserved. The court also found ambiguity insofar as the plan provisions relied upon to establish "specificity" suggested that the basis of litigation was definitely preferential payments (based on the identified payments), but the plan's language suggested that those preference actions only *might* exist—leaving creditors unable to establish with certainty whether and on what grounds they would be sued.

The court also identified the plan language "excluding any Cause of Action released in connection with or under the Plan or by prior order of the Court" as a basis for concluding that the reservation provision was unclear and prevented creditors from discerning precisely who could and would be sued and the impact on future claims and liabilities. Finally, the court examined the disclosure statement filed in support of the plan. There, the court found further support for its conclusion that the causes of action were not "unequivocally preserved" because the disclosure statement provided that "neither the Debtors nor other parties have identified or fully investigated any potential Avoidance Actions." As a whole, therefore, the court determined that the reservation provisions could not be said to be "unequivocal," as the Fifth Circuit standard requires.

THE FIFTH CIRCUIT WEIGHS IN (AGAIN)

Recently, however, the Fifth Circuit laid much of this debate to rest, affirming the ruling below in *Texas Wyoming* and distancing itself from the *MPF Holdings* "hard line" approach. At the outset of its opinion, the Fifth Circuit noted that the intent behind the specific and unequivocal requirement is to ensure that creditors are on notice, with all information necessary to cast an intelligent vote. Notice is not the end in itself, however—it is a means to the end of securing a prompt, effective administration of a debtor's estate. With that in mind, the court explored the implications of the "specific and unequivocal" standard that it previously articulated in *United Operating*.

Specific and Unequivocal

The Fifth Circuit noted that, consistent with *United Operating*, a debtor's chapter 11 plan and disclosure statement must preserve claims to be litigated postconfirmation. To meet this burden, the court explained, the plan and disclosure statement must identify the types of claims—not simply reserve "any and all." Language identifying the types of claims (*e.g.*, avoidance actions), the possible amount of recovery, and the basis for the claims as well as the fact that the reorganized debtor or its representative intends to pursue these actions is sufficient. Individual defendants, however, need not be named. Because the putative defendants in *Texas Wyoming* were identified by class ("certain prepetition shareholders"), the Fifth Circuit did not reach the issue of whether a plan that provides no identification would pass scrutiny.

POLICY CONCERNS

According to the *Manchester* and *Texas Wyoming* bankruptcy courts, the larger policy behind many of the Bankruptcy Code's provisions—maximization of creditor recoveries—could hardly be served by imposing onerous claim-reservation requirements on debtors, particularly where the consequence may well be to bring recovery on these claims down to zero.

Those courts, therefore, sought to dilute the *United Operating* standard to ensure that creditors would not suffer adverse consequences from strict application of section 1123(b)(3)(B), the terms of which are arguably quite general.

By contrast, the *MPH Holdings* court determined that the relevant policy judgment had already been made—by the Fifth Circuit in *United Operating*. Rather than emphasizing the preservation of claims for the benefit of the estate, the court in *MPH Holdings* reasoned that the Fifth Circuit in *United Operating* elected to focus on the need for complete, full disclosure to give voting creditors sufficient information to know whether they would—or would not—be sued. Suggesting that the lack of such disclosure comes at the expense of those creditors, the bankruptcy court concluded that the Fifth Circuit determined that it is appropriate to require debtors, rather than postconfirmation litigation trustees, to devote the time and resources necessary to investigate potential claims and identify the ones that will be pursued postbankruptcy.

The Fifth Circuit has clarified in *Texas Wyoming* the level of disclosure that is required. With this latest ruling, the Fifth Circuit has chosen to adopt a balanced, pragmatic approach that takes into account the interests of the bankruptcy estate and individual voting creditors.

CONCLUSION

The Fifth Circuit's decision in *Texas Wyoming* partially bridges the sharp divide between the competing views on the degree of specificity in a chapter 11 plan necessary to preserve postconfirmation litigation claims. Although debtors in the Fifth Circuit would do well to remember that the claim-reservation language in a chapter 11 plan and disclosure statement must be "specific and unequivocal," the threat of a strict straitjacket no longer looms large.

Interestingly, yet another Texas bankruptcy court addressed this issue in a ruling handed down the day after the Fifth Circuit issued its opinion in *Texas Wyoming*. In *In re Crescent Resources*, 2011 WL 3022567 (Bankr. W.D. Tex. July 22, 2011), the court held that the requirement for a plan to contain "specific and unequivocal" language reserving claims to be pursued postconfirmation allows the use of the "categorical approach," in which claims are described by category rather than by the specific defendants to be sued.

FIRST IMPRESSIONS: FIFTH CIRCUIT RULES THAT NONINSIDER CLAIMS CAN BE RECHARACTERIZED AS EQUITY

Scott J. Friedman and Mark G. Douglas

The ability of a bankruptcy court to reorder the priority of claims or interests by means of equitable subordination or recharacterization of debt as equity is generally recognized. Even so, the Bankruptcy Code itself expressly authorizes only the former of these two remedies. Although common law uniformly acknowledges the power of a court to recast a claim asserted by a creditor as an equity interest in an appropriate case, the Bankruptcy Code is silent upon the availability of the remedy in a bankruptcy case. This has led to uncertainty in some courts concerning the extent of their power to recharacterize claims and the circumstances warranting recharacterization. The Fifth Circuit Court of Appeals recently had an opportunity to weigh in on this issue as an apparent matter of first impression in that court. In *Grossman v. Lothian Oil Inc.* (*In re Lothian Oil Inc.*), 650 F.3d 539 (5th Cir. 2011), the court ruled that a bankruptcy court's ability to recharacterize debt as equity is part of the court's authority to allow and disallow claims, and the remedy is not limited to claims asserted by corporate insiders.

EQUITABLE SUBORDINATION AND RECHARACTERIZATION

Although the distinction between courts of equity and law has largely become irrelevant in modern times, courts of equity have traditionally been empowered to grant a broader spectrum of relief in keeping with fundamental notions of fairness, distinguished from principles of black-letter law. One of the tools available to a bankruptcy court in exercising its broad equitable mandate is "equitable subordination."

Equitable subordination is a remedy developed under common law prior to the enactment of the current Bankruptcy Code to remedy misconduct that results in injury to creditors or shareholders. It is expressly recognized in Bankruptcy Code section 510(c), which provides that the bankruptcy court may, "under principles of equitable subordination, subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim or all or part of

an allowed interest to all or part of another allowed interest." However, the statute explains neither the concept nor the standard that should be used to apply it.

This has been left to the courts. In *In re Mobile Steel Co.*, 563 F.2d 692 (5th Cir. 1977), the Fifth Circuit Court of Appeals articulated what has become the most commonly accepted standard for equitable subordination of a claim. Under the *Mobile Steel* standard, a claim can be subordinated if the claimant engaged in some type of inequitable conduct that resulted in injury to creditors (or conferred an unfair advantage on the claimant) and if equitable subordination of the claim is consistent with the provisions of the Bankruptcy Code. Courts have refined the test to account for special circumstances. For example, many make a distinction between insiders (*e.g.*, corporate fiduciaries) and noninsiders in assessing the level of misconduct necessary to warrant subordination.

A related but distinct remedy is "recharacterization." Like equitable subordination, the power to treat a debt as if it were actually an equity interest is derived from principles of equity. It emanates from the bankruptcy court's power to ignore the form of a transaction and give effect to its substance. However, because the Bankruptcy Code does not expressly empower a bankruptcy court to recharacterize debt as equity, some courts disagree as to whether they have the authority to do so and, if so, the source of such authority. According to some, because the statute authorizes subordination but is silent concerning recharacterization, Congress intended to deprive bankruptcy courts of the power to recharacterize a claim. *See*, *e.g.*, *In re Pac. Express, Inc.*, 69 B.R. 112 (B.A.P. 9th Cir. 1986).

However, other courts, including four federal circuit courts of appeal, have held that a bankruptcy court's power to recharacterize debt derives from the broad equitable powers set forth in section 105(a) of the Bankruptcy Code, which provides that "[t]he court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of [the Bankruptcy Code]." *See Committee of Unsecured Creditors for Dornier Aviation (North America), Inc.*, 453 F.3d 225 (4th Cir. 2006); *Cohen v. KB Mezzanine Fund II, LP* (*In re SubMicron Systems Corp.*), 432 F.3d 448 (3d Cir. 2006); *Sender v. Bronze Group, Ltd.* (*In re Hedged-Invs. Assocs., Inc.*), 380 F.3d 1292 (10th Cir. 2004); *Bayer Corp. v. Masco Tech, Inc.* (*In re AutoStyle Plastics, Inc.*), 269 F.3d 726 (6th Cir. 2001).

Courts consider various factors when determining whether a debt should be recharacterized. As articulated by the Sixth Circuit Court of Appeals in *Bayer Corp. v. Masco Tech, Inc.* (*In re AutoStyle Plastics, Inc.*), 269 F.3d 726 (6th Cir. 2001), these can include the labels given to the debt; the presence or absence of a fixed maturity date, interest rate, and schedule of payments; whether the borrower is adequately capitalized; any identity of interest between the creditor and the stockholder; whether the loan is secured; and the corporation's ability to obtain financing from outside lending institutions. No single factor is controlling. Instead, each one is considered in the particular circumstances of each case. In *SubMicron*, the Third Circuit rejected a factor-based inquiry as a "mechanistic scorecard," opting instead to focus on the parties' intent at the time of the transaction through a common-sense evaluation of the facts and circumstances.

Despite its departure from section 105(a) as the source of a bankruptcy court's power to recharacterize debt as equity, *Lothian Oil* is consistent with rulings to date by other circuits on this issue.

The effect of recharacterization may be similar to that of subordination—in both cases, the priority of the asserted claim is made subordinate to the claims of other creditors. However, there are important differences. For example, recharacterization turns on whether a debt actually exists, not on whether the claim should be reprioritized. By contrast, in an equitable-subordination analysis, the court reviews whether an otherwise legitimate creditor engaged in misconduct, in which case the remedy is subordination of the creditor's claim to the claims of other creditors, but only to the extent necessary to offset injury or damage suffered by the latter.

In *Lothian Oil*, the Fifth Circuit considered for the first time whether a bankruptcy court has the power to recharacterize debt as equity.

LOTHIAN OIL

In April and May 2005, Texas-based Lothian Oil Inc. and its affiliates ("Lothian") entered into a series of "loan" agreements with Israel Grossman ("Grossman"), whereby Grossman agreed to lend Lothian $200,000 in exchange for a 1 percent royalty on Lothian's oil production in New Mexico and Lothian's undertaking to repay the principal amount from the proceeds of an anticipated equity offering. No maturity date or interest rate was specified in the agreements, which provided that the loan obligation was subordinate to Lothian's debt under a bank credit agreement.

Lothian filed for chapter 11 protection in Texas in June 2007 and objected to Grossman's claims on the basis of the loan agreements, contending that the underlying obligations should be recharacterized as equity. The bankruptcy court agreed, ruling that the claims "assert common equity interests at best and that insufficient evidence of the value of the interests was presented." On appeal, the district court, "declin[ing] to extend the concept of debt recharacterization to a non-insider creditor," reversed this determination.

THE FIFTH CIRCUIT'S RULING

Addressing the question as a matter of first impression before it, a three-judge panel of the Fifth Circuit Court of Appeals reversed the district-court ruling. "We conclude," the court wrote, "that recharacterization extends beyond insiders and is part of the bankruptcy courts' authority to allow and disallow claims under 11 U.S.C. § 502."

The Fifth Circuit explained that the U.S. Supreme Court's ruling in *Butner v. United States*, 440 U.S. 48 (1979), makes clear that when a bankruptcy court is called upon to rule on an objection to a claim under section 502(b), state law determines whether, and to what extent, a claim is "unenforceable against the debtor and property of the debtor, under any agreement or applicable law." "Taken together," the court reasoned, "*Butner* and § 502(b) support the bankruptcy courts' authority to recharacterize claims." Thus, if an asserted interest would be classified as equity rather than debt under applicable state law—here, the law of Texas—a bankruptcy court would be empowered to recharacterize, rather than disallow, the claim.

The Fifth Circuit distanced itself from sister circuits that predicate the power to recharacterize debt as equity upon the bankruptcy courts' equitable authority under section 105(a). According to the court, given its interpretation of section 502(b), "resort to § 105(a) is unnecessary." "We agree with sister circuits' results," the Fifth Circuit wrote, "but not necessarily their reasoning."

The Fifth Circuit faulted the district court's imposition of a per se rule confining recharacterization to claims filed by corporate insiders. "Unless state law makes insider status relevant to characterizing equity versus debt," the court emphasized, "that status is irrelevant in federal bankruptcy proceedings."

Explaining that Texas courts applying Texas law have imported a multifactor test from federal tax law to distinguish between debt and equity, the Fifth Circuit concluded that the bankruptcy court committed no error in finding that Grossman's claims "assert common equity interests at best." Among the factors considered by the bankruptcy court were the fact that Grossman would be paid from royalties and equity placements as well as the lack of a specified interest rate, term of repayment, and maturity date. "Because Texas law would not have recognized Grossman's claims as asserting a debt interest," the Fifth Circuit wrote, "the bankruptcy court correctly disallowed them as debt and recharacterized the claims as equity interests."

OUTLOOK

Despite its departure from section 105(a) as the source of a bankruptcy court's power to recharacterize debt as equity, *Lothian Oil* is consistent with rulings to date by other circuits on this issue. Many courts find the distinction between equitable subordination and recharacterization to be confusing. The different standards applied in connection with the former remedy to situations involving insiders and noninsiders only compound the uncertainty. *Lothian Oil* attempts to clear the haze by explaining that the remedies are distinct and making it clear that recharacterization is not limited to claims asserted by corporate insiders. By focusing on the nature of the obligation rather than the conduct of the alleged claimant, the ruling implies that the identity of the claimant (including insider status) is irrelevant.

Finally, the Fifth Circuit's conclusion in *Lothian Oil* that resorting to section 105(a) is *unnecessary* in invoking the power to recharacterize debt as equity arguably falls short of an unequivocal pronouncement that the provision cannot be a basis for the remedy in an appropriate case. As such, courts—outside and within the Fifth Circuit—may deem recharacterization to be among the broad equitable powers granted under section 105.

FIRST IMPRESSIONS: PORTION OF WITHDRAWAL LIABILITY ENTITLED TO ADMINISTRATIVE PRIORITY

Charles M. Oellermann and Mark G. Douglas

Until 2011, no federal circuit court of appeals had ever directly addressed whether multi-employer pension plan withdrawal liability incurred by a debtor-employer that continues to employ workers during a bankruptcy case is entitled (in whole or in part) to administrative-expense status. That changed on June 16, when the Third Circuit handed down its ruling in *In re Marcal Paper Mills, Inc.*, 650 F.3d 311 (3d Cir. 2011). Addressing the issue as a matter of first impression, the court of appeals affirmed a district court's reversal of a bankruptcy-court order denying administrative-expense status to a withdrawal-liability claim against a chapter 11 debtor in possession ("DIP") that continued to participate in a multi-employer defined-benefit pension plan until it sold substantially all of its assets to a successor entity. According to the Third Circuit, because part of the withdrawal liability was attributable to the postpetition time period and the debtor clearly benefited from postpetition labor provided by its unionized employees, the portion of the claim relating to postpetition services constituted a priority administrative expense.

DEFINED-BENEFIT PENSION PLAN WITHDRAWAL LIABILITY

The Employee Retirement Income Security Act of 1974 ("ERISA"), as amended by the Multiemployer Pension Plan Amendments Act of 1980 ("MPPAA"), imposes "withdrawal liability" on participating employers that withdraw from a multi-employer defined-benefit pension plan insured by the Pension Benefit Guaranty Corporation ("PBGC") for the employer's proportionate share of the pension plan's "unfunded vested benefits" at the time of withdrawal. In *PBGC v. R.A. Gray & Co.*, 467 U.S. 717 (1984), the U.S. Supreme Court explained that unfunded vested benefits are "calculated as the difference between the present value of vested benefits and the current value of the plan's assets."

The MPPAA imposed withdrawal liability in response to a shortcoming in the original ERISA statute that allowed employers to withdraw from defined-benefit plans and shirk their obligations to provide benefits, effectively crippling the

plan and harming covered employees. An employer triggers a "complete withdrawal" from a plan when it no longer has any obligation to contribute to the plan, including by terminating all employees under the plan. Withdrawal liability is generally calculated as if the withdrawal occurred on the last day of the plan year preceding withdrawal. Although the details of the calculation are complex, withdrawal liability is generally calculated on the basis of the employer's contributions to the plan during the preceding five years.

WITHDRAWAL LIABILITY ENTITLED TO ADMINISTRATIVE STATUS IN BANKRUPTCY?

If a complete withdrawal occurs after the employer files for bankruptcy, the handful of courts that have addressed the issue to date disagree as to whether the claim based upon withdrawal liability should be classified (in whole or in part) as an administrative claim or a general unsecured claim. Section 507(a)(2) of the Bankruptcy Code provides that administrative expenses allowed under section 503(b) are entitled to priority over general unsecured claims. Section 503(b)(1)(A) defines "administrative expenses" to include "the actual, necessary costs and expenses of preserving the estate, including . . . wages, salaries, and commissions for services rendered after the commencement of the case."

In *In re McFarlin's, Inc.*, 789 F.2d 98 (2d Cir. 1986), the Second Circuit Court of Appeals suggested (but did not rule) that postpetition withdrawal liability to a multi-employer pension plan could be entitled to priority as an administrative expense. The court ultimately declined to classify the withdrawal-liability claim in the case before it as an administrative expense because the claim was based on "a period pre-dating the McFarlin's Chapter 11 proceeding and cannot therefore be treated as an administrative expense." Other (albeit lower) courts, however, have ruled that, to the extent that withdrawal liability is attributable to *postpetition* employment, the resulting claim is entitled to administrative status. *See*, *e.g.*, *In re Great Northeastern Lumber & Millwork Corp.*, 64 B.R. 426 (Bankr. E.D. Pa. 1986); *In re Cott Corp.*, 47 B.R. 487 (Bankr. D. Conn. 1984).

In *United Mine Workers of Amer. v. Lexington Coal Co., LLC* (*In re HNRC Dissolution Co.*), 396 B.R. 461 (Bankr. 6th Cir. 2008), a bankruptcy appellate panel for the Sixth Circuit ruled that withdrawal-liability claims against debtor-employers that withdrew from a multi-employer pension plan two years after filing for chapter 11 protection lacked the causal relationship to the work performed by the debtors' employees necessary for the claims to be treated as an administrative expense. According to the court, unlike other cases that have applied the narrow exception stated in *Reading Co. v. Brown*, 391 U.S. 471 (1968), for conferring administrative status in the absence of benefit to the estate, the withdrawal-liability claims did not stem from tortious or deliberate misconduct by the debtors.

Until *Marcal Paper*, *McFarlin's* was the only decision at the circuit level to consider the issue.

Marcal Paper is an important development and, for some debtor-employers, an unwelcome one. Withdrawal-liability claims can be very large. The possibility that a portion of such claims could be entitled to administrative priority if a DIP or trustee continues to employ workers covered by a multi-employer PBGC-guaranteed pension fund should figure prominently in a prospective debtor's strategic planning.

MARCAL PAPER

New Jersey-based paper products manufacturer Marcal Paper Mills, Inc. ("Marcal"), operated a fleet of trucks to distribute its wares. The truck drivers employed by Marcal were members of a teamsters' union ("Local 560") that acted as the collective bargaining representative for those employees. Pursuant to collective bargaining agreements with Local 560, Marcal participated in a multi-employer defined-benefit pension fund known as the Trucking Employees of North Jersey/Welfare Pension Fund (the "Pension Fund").

On November 30, 2006, Marcal filed for chapter 11 protection in New Jersey. After the bankruptcy filing, but before the bargaining agreements with Local 560 were due to expire in August 2007, Marcal and Local 560 agreed to continue to abide by the terms of the bargaining agreements until a new contract was executed (which never ultimately occurred). Due to this extension, covered employees continued to accrue pension benefits and Marcal continued to make contributions to the Pension Fund.

Marcal stopped making such contributions, however, on May 30, 2008, when Marcal Paper Mills, LLC ("Marcal LLC"), purchased substantially all of the company's assets, in addition to assuming Marcal's liabilities. Marcal LLC never employed the Local 560 truck drivers formerly employed by Marcal.

After the sale, the Pension Fund concluded that Marcal had made a "complete withdrawal" from the fund for the purposes of ERISA and MPPAA. It accordingly assessed Marcal with $5.9 million in total withdrawal liability and filed an administrative claim in Marcal's chapter 11 case for that amount. Marcal objected to the claim on the basis that it should be classified as a general unsecured claim. The Pension Fund responded by requesting administrative status for only the portion of the withdrawal liability attributable to postpetition services provided to Marcal by the covered employees.

The bankruptcy court ruled in favor of Marcal, directing that the withdrawal-liability claim be classified and treated as a general unsecured claim. The district court reversed on appeal, holding that the portion of the withdrawal liability attributable to the postpetition period was entitled to administrative priority. It remanded the case below to determine the appropriate apportionment. Marcal appealed to the Third Circuit Court of Appeals.

THE THIRD CIRCUIT'S RULING

Addressing the issue as a matter of first impression, a three-judge panel of the Third Circuit affirmed the district court's ruling, holding that the withdrawal liability should be apportioned between the pre- and postpetition periods and that the postpetition portion should be classified as an administrative expense.

On the basis of its previous ruling in *In re O'Brien Environmental Energy, Inc.*, 181 F.3d 527 (3d Cir. 1999), the Third Circuit explained that to qualify for administrative status, an expense must: (i) arise from a postpetition transaction; (ii) be beneficial to the operation of the debtor's business; and (iii) be actual and necessary. Therefore, the court examined whether any part of Marcal's withdrawal liability represented a postpetition expense incurred for services that were actual, necessary, and beneficial to Marcal's business.

According to the Third Circuit, the work performed by Marcal's employees conferred a benefit on the estate, and under the collective bargaining agreements, Marcal was obligated to provide certain pension benefits on account of that postpetition labor. Thus, the Third Circuit concluded that allowing the portion of the withdrawal liability relating to postpetition labor as an administrative expense is consistent with the criteria for administrative-expense status under section 503(b). Whereas this conclusion seems at first blush to cut against *McFarlin's*, the Third Circuit explicitly reconciled its holding with the Second Circuit's ruling in that case, observing that "[the Second Circuit's] analysis clearly supports a conclusion that post-petition withdrawal liability can be considered an administrative expense."

The Third Circuit expressly rejected the reasoning articulated in *HNRC Dissolution*, explaining that its holding in *Marcal Paper* is entirely consistent with and harmonizes the purposes of both the Bankruptcy Code and ERISA, as amended by MPPAA:

> [T]he narrowly tailored definition of administrative expense contained in the Bankruptcy Code is designed to balance two goals: the continued functioning of the debtor-in-possession and preservation of the estate for downstream creditors. By allowing only that portion of withdrawal liability attributable to the post-petition work to be classified as an administrative expense, we ensure that workers are provided the full benefit of the bargain promised to them in the continued-CBA, incentivizing their work for the DIP and ensuring its continued functioning. At the same time, by limiting what constitutes an administrative expense to only that portion of the withdrawal liability which can be fairly allocated to the post-petition period, we help preserve the estate and prevent it from being devoured by the entire withdrawal liability claim. . . . Perhaps even more importantly, by permitting the post-petition portion of the withdrawal liability to be classified as an administrative expense, Congress' objectives in passing the MPPAA are fulfilled. If withdrawal liability in its entirety were automatically classified as a general unsecured claim, it would greatly undercut the purpose of the MPPAA to secure the finances of pension funds and prevent an

employer's withdrawal from negatively affecting the plan and its employee beneficiaries.

The Third Circuit rejected Marcal LLC's arguments that withdrawal liability could not qualify as an administrative expense because, among other things, such liability: (i) was not based solely on postpetition work; (ii) was not designed to benefit employees who provided postpetition services; and (iii) could not be accurately apportioned between the pre- and postpetition periods. Other courts, the Third Circuit observed, have similarly classified postpetition withdrawal liability as an administrative expense, and it has itself apportioned benefits between pre- and postpetition periods for purposes of administrative priority in other contexts. *See*, *e.g.*, *In re Hechinger Inv. Co. of Del.*, 298 F.3d 219 (3d Cir. 2002) ("stay-on benefits" to entice employees to continue working while the employer liquidated its assets); *In re Roth American, Inc.*, 975 F.2d 949 (3d Cir. 1992) (vacation and severance benefits based on the length of employment).

OUTLOOK

Marcal Paper is an important development and, for some debtor-employers, an unwelcome one. Withdrawal-liability claims can be very large. The possibility that a portion of such claims could be entitled to administrative priority if a DIP or trustee continues to employ workers covered by a multi-employer PBGC-guaranteed pension fund should figure prominently in a prospective debtor's strategic planning.

It remains to be seen at this juncture whether other courts will adopt the *Marcal Paper* approach to this issue. In light of the rulings by the Third Circuit in *Marcal Paper* and the Second Circuit in *McFarlin's*, courts in those circuits at a minimum are likely to follow suit.

Finally, few courts have developed a methodology to allocate withdrawal-liability claims between pre- and postpetition components. It will be instructive to see the particular method employed by the bankruptcy court on remand in *Marcal Paper*.

A version of this article was published in the September 7, 2011, edition of *Bankruptcy Law360*. It has been reprinted here with permission.

HISTORY MATTERS: HISTORICAL BREACHES MAY UNDERMINE ASSUMPTION OF EXECUTORY CONTRACTS

Lance E. Miller

One of the primary fights underlying assumption of an unexpired lease or executory contract has long been over whether any debtor breaches under the agreement are "curable." Before the 2005 amendments to the Bankruptcy Code, courts were split over whether historic nonmonetary breaches (such as a failure to maintain cash reserves or prescribed hours of operation) undermined a debtor's ability to assume the lease or contract. By the 2005 amendments, however, Congress apparently took the position that—at least for contracts other than nonresidential real property leases—historic nonmonetary breaches do in fact generally preclude assumption of an executory contract or unexpired lease. A recent case from the Fifth Circuit Court of Appeals implicitly confirms that interpretation.

NONMONETARY BREACHES BEFORE THE 2005 AMENDMENTS

Section 365(a) of the Bankruptcy Code generally permits a debtor to assume an executory contract or unexpired lease. If the contract or lease is subject to prepetition defaults, section 365(b)(1) requires the debtor to first "cure" those defaults. A breach caused by a failure to pay money is "cured" by paying the unpaid amount owed. A breach of nonmonetary covenants, however, may not be as simple. Some terms require performance at a specific time period or interval, so performance at some point in the future may not remedy the past breach.

When dealing with these nonmonetary provisions, courts generally hold that the default is not curable as a matter of law. For example, courts have prohibited assumption where breaches related to, among other things, requirements to maintain continuous operations, promises not to use leased equipment for work with parties other than the lessor, promises not to place licensed software on third-party computers, and obligations to consummate a transaction by a specified closing date.

The cure requirements under section 365(b)(1) are somewhat moderated by section 365(b)(2), which enumerates a series of exceptions to the requirement for curing prepetition defaults. Prior to the 2005 amendments to the Bankruptcy Code, section 365(b)(2) provided:

> Paragraph (1) of this subsection [requiring cure of any defaults] does not apply to a default that is a breach of a provision relating to—
>
> (A) the insolvency or financial condition of the debtor at any time before the closing of the case;
>
> (B) the commencement of a case under this title;
>
> (C) the appointment of or taking possession by a trustee in a case under this title or a custodian before such commencement; or
>
> (D) the satisfaction of any penalty rate or provision relating to a default arising from any failure by the debtor to perform nonmonetary obligations under the executory contract or unexpired lease.

Notably, the first three enumerated exceptions to the cure requirements under the preamendment version of section 365(b)(2) relate to "*ipso facto*" clauses that trigger default upon a bankruptcy event. Subsection (b)(2)(D), however, addressed something other than *ipso facto* clauses, referring to "penalty rate[s] or provision[s] relating to . . . nonmonetary obligations." Before the 2005 amendments, courts were divided over whether this exception applied to penalty provisions only, or whether the reference to "provision[s] relating to . . . nonmonetary obligations" was a catchall that relieved a debtor from having to cure all nonmonetary breaches.

Under one view, exemplified by the Ninth Circuit Court of Appeals' ruling in *In re Claremont Acquisition Corp., Inc.*, 113 F.3d 1029 (9th Cir. 1997), subsection (b)(2)(D) related only to penalty provisions, such that a prepetition breach of a material nonmonetary obligation could preclude any attempted assumption of the contract or lease. For example, in *In re Williams*, 299 B.R. 684 (Bankr. S.D. Ga. 2003), the court ruled that an unexpired truck lease was unassumable where the debtor had violated prepetition a covenant under the lease to refrain from using the vehicle to do work for any company other than the lessor. Opposite this view, other courts, including the First Circuit Court of Appeals in *In re Bankvest Capital Corp.*, 360 F.3d 291 (1st Cir. 2004), held that section 365(b)(2)(D) spoke to two different types of default provisions—penalty provisions as well as a more general provision providing for default upon a failure to perform nonmonetary obligations. Under this interpretation, nonmonetary defaults were generally not grounds to thwart assumption of an executory contract or unexpired lease.

Consider a debtor who, before filing for bankruptcy relief, breached a material covenant in a franchise agreement that required the debtor to operate its business continuously without interruption. Under the view advocated by the Ninth Circuit before the 2005 amendments, the franchise agreement would be considered unassumable because the breach of a "going dark" clause would be considered a nonmonetary default not subject to any exception enumerated under section 365(b)(2). Under the view advocated by the First Circuit, however, the agreement would be assumable without regard to the debtor's prepetition closure of business operations, because nonmonetary breaches would be deemed irrelevant to the debtor's cure obligations pursuant to section 365(b)(2)(D).

THE 2005 AMENDMENTS

As part of the 2005 amendments to the Bankruptcy Code, Congress amended section 365(b)(2)(D) to provide that a debtor's cure obligations do not apply to "the satisfaction of any penalty rate or *penalty* provision relating to a default arising from any failure by the debtor to perform nonmonetary obligations under the executory contract or unexpired lease" (emphasis added). Lawmakers also amended section 365(b)(1)(A) to treat unexpired leases of nonresidential real property differently; for such leases, any breach "that arises from a failure to operate in accordance with . . . [the] lease" may be cured "by performance at and after the time of assumption in accordance with such lease, and pecuniary losses resulting from such default shall be compensated in accordance with the provisions of this paragraph."

In amending section 365(b)(2)(D), Congress appeared to take the position that historic and material nonmonetary breaches relating to nonpenalty provisions should generally be a bar to assumption for contracts and leases other than unexpired leases of nonresidential real property. The import of the changes to section 365(b)(2)(D) remain relatively untested, but a recent unreported decision from the Fifth Circuit Court of Appeals implicitly acknowledges that Congress effectively resolved the previously competing interpretations.

Although the Fifth Circuit did not cite section 365(b)(2)(D) specifically, *Escarent Entities* seems to confirm that, at least in that circuit, any fight over interpreting the provision is over. Courts in the future may adopt the Fifth Circuit's view that prior nonmonetary breaches of executory contracts and unexpired leases (other than nonresidential real property leases) must be "cured" before they can be assumed. In some cases, this "cure" requirement will simply preclude assumption as a matter of law.

ESCARENT ENTITIES

In re Escarent Entities, L.P., 2011 WL 1659512 (5th Cir. Apr. 28, 2011), involved a single-asset real estate debtor that entered into a prepetition contract to sell its ranch property to Quantum Diversified Holdings, Inc. ("Quantum"), subject to partial seller financing. The debtor filed for chapter 11 relief in Texas in January 2009, seven days before the closing date established in the purchase contract. It then filed a motion requesting authority to seek better sale terms through an auction process. The debtor proposed that, if it was unable to obtain a better purchase offer, it would assume the purchase contract and force Quantum to close on the original terms of sale, with a rescheduled closing date. The bankruptcy court approved the assumption motion over Quantum's objection and, when the debtor failed to locate another bidder for the property, ordered that the transaction be closed "after a reasonable time."

On appeal to the district court, Quantum argued that the purchase agreement could not be assumed because the debtor's failure to consummate the sale by the original closing date was a material nonmonetary default that could not be cured by future performance. The district court affirmed the order approving the debtor's assumption of the purchase agreement, and Quantum pursued its arguments before the Fifth Circuit Court of Appeals. Curiously, whereas Quantum's arguments mirrored the terminology underlying section 362(b)(2)(D), neither party actually cited that provision in its briefing before the district court or the Fifth Circuit.

THE FIFTH CIRCUIT'S RULING

Without actually citing section 362(b)(2)(D), the Fifth Circuit reversed the decisions of the courts below, reasoning that the debtor's failure to consummate the sale on the closing date was "not only a material default, but effectively an incurable one, as the parties are unable to return to January 12, 2009, when Escarent's performance was originally due." In so holding, the Fifth Circuit appears to have implicitly confirmed the prevailing view among commentators and practitioners—that following the 2005 amendments, contracts other than nonresidential property leases which are the subject of material, nonmonetary breaches may simply be unassumable.

OUTLOOK

Although the Fifth Circuit did not cite section 365(b)(2)(D) specifically, *Escarent Entities* seems to confirm that, at least in that circuit, any fight over interpreting the provision is over. Courts in the future may adopt the Fifth Circuit's view that prior nonmonetary breaches of executory contracts and unexpired leases (other than nonresidential real property leases) must be "cured" before they can be assumed. In some cases, this "cure" requirement will simply preclude assumption as a matter of law.

PROPOSED CHAPTER 11 VENUE LEGISLATION INTRODUCED

A significant consideration in a prospective chapter 11 debtor's strategic prebankruptcy planning is the most favorable venue for the bankruptcy filing. Given varying interpretations among different bankruptcy courts of certain important legal issues (*e.g.*, a debtor's ability to pay the claims of "critical" vendors at the inception of a chapter 11 case, to include nondebtor releases in a chapter 11 plan, or to reject collective bargaining agreements) and the reputation, deserved or otherwise, of certain courts or judges as more "debtor-friendly" than others, choice of venue (if a choice exists) can have a marked impact on the progress and outcome of a chapter 11 case.

The Southern District of New York and the District of Delaware have long been the preferred forums for large chapter 11 cases. Given New York's recognized status as the financial capital of the U.S. (and arguably the world), the fact that its bankruptcy courts regularly preside over a significantly greater proportion of complex chapter 11 restructurings than courts located elsewhere is not surprising. Delaware's courts have similarly developed considerable experience, expertise, and filing procedures in complex chapter 11 cases, but the district's prominence as a frequent venue for chapter 11 "mega-cases" also is based in part on the statutory venue requirements that apply to bankruptcy filings.

The rules that determine which particular venue(s) is (are) appropriate for a bankruptcy filing permit a debtor to file for bankruptcy protection in the bankruptcy court located in the debtor's state of incorporation, which for a significant percentage of corporations is Delaware. Specifically, 28 U.S.C. § 1408 provides that a debtor may commence a bankruptcy case in a district where: (i) the debtor is domiciled, resides, has a principal place of business, or has principal assets, generally within 180 days immediately preceding the commencement of the case; or (ii) there is another bankruptcy case pending with respect to an affiliate, general partner, or partnership of the debtor.

Because a large number of companies do not conduct business or own assets in the state in which they are incorporated, the state of incorporation as a basis for venue has been criticized by some members of Congress (while being defended by others) as providing a pretext for "forum shopping," which permits a chapter 11 debtor to sort out its financial problems far removed from creditors and other parties with a stake in the outcome of the case.

On July 14, 2011, the chairman of the House Judiciary Committee, Lamar Smith (R-Texas), and ranking member John Conyers, Jr. (D-Michigan),

introduced the Chapter 11 Bankruptcy Venue Reform Act of 2011 (H.R. 2533) to prevent what they deem to be forum shopping in chapter 11 cases. The proposed legislation would modify 28 U.S.C. § 408 by limiting venue to: (i) the location of the debtor's principal place of business or principal assets in the U.S. during the year immediately preceding the commencement of the chapter 11 case (or the portion of such one-year period exceeding that of any other district in which the debtor had such place of business or assets); or (ii) the district in which an affiliate of the debtor that owns, controls, or holds with power to vote more than 50 percent of the outstanding voting securities of such debtor has its chapter 11 case pending. If it were to become law, this proposed legislation would in many cases prevent a debtor from commencing a chapter 11 case in its state of incorporation or from "piggybacking" on the filing of a subsidiary.

As reflected by the press release issued by the House Committee on the Judiciary, the rationale underlying the proposed legislation appears to be its sponsors' frustration that certain mega-cases have been filed in the Southern District of New York, a venue they perceive to be "management-friendly," although most creditors and employees of the debtors in question were located elsewhere. According to the bill's sponsors, permitting corporations to file for chapter 11 far from home leaves employees, creditors, and other stakeholders "without a voice in the negotiations." They contend that the proposed legislation would level the playing field between employees and management.

Some restructuring professionals have criticized the proposed legislation. The Committee on Bankruptcy and Corporate Reorganization of the Association of the Bar of the City of New York condemned the legislation as unnecessary and premised on the unsubstantiated view that the current venue rules are flawed, lead to abuse and improper forum shopping, and compromise the independence of bankruptcy judges. According to the Committee, among other things, even if the current venue rules do in fact permit improper forum shopping, courts already have a mechanism—28 U.S.C. § 1412—to transfer venue to another jurisdiction if they determine that the venue was initially selected improperly or that the existing forum is inconvenient for the stakeholders involved.

On August 25, 2011, H.R. 2533 was referred to the House Subcommittee on Courts, Commercial and Administrative Law. Initial hearings were conducted before the Subcommittee on September 8.

BUSINESS RESTRUCTURING REVIEW

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

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