JONES DAY

RECENT DEVELOPMENTS IN BANKRUPTCY AND RESTRUCTURING

VOLUME 10 ▪ NO. 6 ▪ NOVEMBER/DECEMBER 2011

BUSINESS RESTRUCTURING REVIEW

IN THIS ISSUE

1 European Perspective: Spanish Parliament Approves Law Amending the 2003 Insolvency Act

5 Newsworthy

7 WaMu Confirmation Denied: Interest Rates, Equitable Disallowance, and Insider Trading

10 Is Chapter 9 the Next Chapter in the Municipal Saga?

14 "Universal Rule": Trademark Licenses Not Assignable in Bankruptcy Absent Express Authorization

17 Another Blow to Triangular Setoff in Bankruptcy: "Synthetic Mutuality" No Substitute for the Real Thing

21 Second Circuit Settles the Meaning of Settlement Payments Under Section 546(e) of the Bankruptcy Code

25 First Impressions: Prepetition Severance Pay Entitled to Priority Under Section 507(a)(4)

27 The U.S. Federal Judiciary

28 Revised Bankruptcy Rule 2019 Effective

EUROPEAN PERSPECTIVE: SPANISH PARLIAMENT APPROVES LAW AMENDING THE 2003 INSOLVENCY ACT

Victor Casarrubios and Charo de los Mozos

Note from the Editors: This installment of our "European Perspective" feature was contributed by Victor Casarrubios and Charo de los Mozos, a partner and associate, respectively, in Jones Day's Madrid Office. They discuss recent amendments to Spain's landmark 2003 insolvency law, implemented in part to respond to the current European economic crisis.

On October 10, 2011, the Spanish Parliament approved Law n. 38/2011 (the "Amendment"), which amends the Spanish Insolvency Act of 2003 (the "Insolvency Act"). Except for certain of its provisions (which became effective on October 12, 2011), the Amendment will generally come into force on January 1, 2012.

The Insolvency Act, enacted in July 2003, was a milestone in the Spanish legal system, as it implemented a new unitary insolvency system for professionals and enterprises (both individuals and legal entities) governed by a single law and subject to the exclusive jurisdiction of specialized courts (the Mercantile Courts). However, eight years of experience and the current financial turmoil have highlighted certain defects that have prevented the Insolvency Act from achieving its main goal: preservation of an insolvent company as a business concern.

The Amendment does not radically change the legal principles of the Insolvency Act. However, it is a comprehensive update of Spanish insolvency regulations applying the Insolvency Act, implemented to respond to the current European Union economic situation. The main goals of the Amendment are:

(i) To avoid the liquidation of insolvent companies by exploring alternatives to an insolvency proceeding and offering a company a faster and less expensive solution to its financial crisis by means of refinancing agreements;

(ii) To encourage fresh-money infusions by granting priority to fresh credit over the claims of other creditors;

(iii) To offer certain kinds of creditors "insolvency credits," or claims, with full voting rights at the meeting of creditors after a company's declaration of insolvency;

(iv) To simplify insolvency proceedings and assist the overburdened Mercantile Courts;

(v) To improve the professional qualifications of insolvency trustees; and

(vi) To clarify the legal regime of insolvency proceedings by regulating, among other things, the order of payment among creditors in cases involving assets that are inadequate to satisfy the claims of all creditors in full.

The provisions in the Amendment addressing each of these six goals are discussed below.

REFINANCING AGREEMENTS

Under the Insolvency Act, any agreement signed by an insolvent company within two years prior to declaring insolvency is subject to a "claw-back" action (*acción de reintegración*) if the agreement caused "economic loss" to the company's assets. A loss is presumed (among other cases) in agreements where new "*in rem*" security was pledged by the company to secure preexisting debt.

However, a refinancing agreement between the insolvent company and its creditors executed within two years prior to a declaration of insolvency is protected from a claw-back action if: (i) the agreement effectuates a significant increase of the funds available to the company or an extension of the maturity or replacement of existing obligations; (ii) the agreement was supported by a feasibility plan aimed at enabling continuation of the business; and (iii) the following conditions are fulfilled prior to the commencement of insolvency proceedings:

(a) The agreement is signed by creditors holding at least 60 percent of the insolvent company's debt;

(b An independent expert designated by a mercantile registrar issues a technical opinion on the refinancing agreement stating that the information provided by the debtor is sufficient, the plan is reasonable and achievable, and that any new security granted as part of the refinancing is proportionate on the basis of market conditions at the time the agreement is executed. Under the Amendment, if a refinancing agreement applies to a group of companies, a joint opinion covering all related companies may be issued by the expert. If the opinion contains any reservations or limitations, the parties to the agreement must provide a detailed assessment of the relevance of any such caveats; and

(c) The agreement is formalized before a notary in a public deed, which should include all the evidence of compliance with the above-mentioned requirements.

Under the Amendment, it is now possible to obtain judicial approval (*homologación*) of a refinancing agreement prior to the commencement of insolvency proceedings if, *in addition to the requirements delineated above*, the following conditions are satisfied:

(a) The refinancing agreement has been executed by creditors holding 75 percent of the insolvent company's debt; and

An email version of the Business Restructuring Review *is now available. If you would like to receive the email version of the publication, please send an email to BRR@jonesday.com requesting to be added to the email distribution list. In addition, let us know whether you would prefer to discontinue receiving the print version of the publication.*

(b) The refinancing agreement does not represent, in the court's opinion, a disproportionate sacrifice by nonsignatory creditors.

Judicial approval of a refinancing agreement has the following advantages:

(a) Any standstill period under the refinancing agreement is extended to nonsignatory creditors, unless their claims are secured by "*in rem*" security, such as a mortgage. Affected creditors may object within 15 days of publication of judicial approval of the agreement in the *Spanish Official Bulletin* and the *Public Insolvency Register*. However, the grounds for objection are limited to: (i) failure to satisfy the required debt percentage threshold; and (ii) a challenge to the court's conclusion that dissenting creditors would not be disproportionately prejudiced by approval of the agreement. Any objections interposed are adjudicated and resolved in a single proceeding before the court, and the court's final decision is not subject to appellate review. Judicial approval becomes effective on the day following publication of the final decision on objections in the *Spanish Official Bulletin*.

(b) The court granting approval of a refinancing agreement may order the suspension of any foreclosure proceedings initiated by any creditor during the standstill period established under the refinancing agreement, which may not exceed three years. However, creditors retain their rights against those jointly obligated with the insolvent debtor as well as any guarantor of the debt; guarantors do not have recourse to the court to oppose payment on their guarantees.

Should the debtor not fulfill the terms of the refinancing agreement, any creditor may request a judicial declaration of breach from the same court that approved the agreement. Once this declaration is issued by the court, creditors may request a declaration of insolvency with respect to the debtor or initiate individual collection actions against it. The debtor may not petition for another judicial approval of a refinancing agreement during the year following its initial request for judicial approval.

The Insolvency Act provides that a debtor is obligated to initiate an insolvency proceeding no later than two months after it becomes, or should have become, aware that it is insolvent. In addition, a creditor may commence an insolvency proceeding against the debtor if the creditor becomes aware that the debtor has become insolvent. Under the Amendment, the two-month deadline is extended if the debtor has initiated negotiations to reach a refinancing agreement and the court is notified of the debtor's situation before the two-month term expires. However, the Amendment provides that the debtor must commence an insolvency proceeding if it is still insolvent three months after delivering the required extension notification to the court.

PRIORITY FOR FRESH MONEY

The Insolvency Act did not originally contain any specific protection or priorities for claims based upon fresh-money infusions into an insolvent company. In practice, fresh money was protected with specific additional security (for example, mortgages or pledges) granted in connection with a refinancing agreement. Pursuant to the Amendment (and with effect from October 12, 2011), 50 percent of "fresh money" (*i.e.*, new capital obtained by the company under a refinancing agreement that meets the requirements for protection described above) is conferred with priority in the form of a "credit," or claim (discussed below), against the assets of the insolvent debtor (*crédito contra la masa*). The remaining 50 percent is conferred with priority in the form of an insolvency credit with priority as a "general privilege."

Claims against the insolvent debtor's estate are satisfied from assets of the insolvent company that are not mortgaged, pledged, or otherwise used as collateral security for specific credits. The remaining assets of the insolvent company are used to pay, in descending order of priority, credits with general privilege, ordinary credits, and subordinate credits.

The new priorities for fresh money under the Amendment do not apply to new capital in the form of either equity or debt financing provided by existing shareholders or affiliated companies holding more than 10 percent in the share capital of the insolvent company or by company directors.

ACQUISITION OF INSOLVENCY CREDITS

Under the pre-Amendment version of the Insolvency Act, with certain exceptions, creditors that acquired claims after the initiation of an insolvency proceeding had no right to vote at the creditors' assembly convened to vote on the debtor's reorganization plan (*convenio de acreedores*). Pursuant to the Amendment (which applies to reorganization plans proposed after January 1, 2012), any creditor "subject to financial supervision" that acquires insolvency credits after the initiation of an insolvency proceeding will have the right to vote at the creditors' assembly. The Amendment does not define the phrase "subject to financial supervision," but Spanish law governing this issue provides that the Bank of Spain has control and supervisory authority over, among others, banks, savings banks, credit cooperatives, branches of foreign financial entities, and mutual guarantee companies.

SIMPLIFIED INSOLVENCY PROCEDURE

In connection with insolvency proceedings to be initiated beginning in 2012, the Amendment implements a simplified insolvency procedure if the court determines that an insolvency is not complex, in accordance with the following criteria:

(a) The list of creditors filed by the debtor with the court includes fewer than 50 creditors;

(b) The initial estimate of aggregate indebtedness is less than €5 million;

(c) The initial asset valuation is below €5 million; and

(d) The debtor files a proposed composition agreement providing for the merger, sale, spinoff, or transformation of the company in a transaction involving a transfer of substantially all of the debtor's assets and liabilities to another entity.

Under the Amendment, the court is obligated to apply the simplified procedure if the debtor submits, in a liquidation plan, a binding proposal by a third party to acquire an operating unit of the debtor or if the debtor has ceased doing business and its employment contracts are no longer in force. At any time, the court may convert the insolvency proceeding from an ordinary proceeding to a simplified proceeding and vice versa, on the basis of a change in circumstances relative to the criteria for eligibility.

INSOLVENCY TRUSTEES

The Amendment increases the scope of liability and qualifications required for insolvency trustees, who are entrusted with examining the bankruptcy estate and existing debts. In addition, the number of members sitting on the panel of insolvency trustees in any particular insolvency proceeding is reduced from three to one, although an ancillary trustee (*auxiliar delegado*) may be appointed, as discussed below. With certain exceptions, an insolvency trustee must:

(a) Be a practicing lawyer with at least five years of experience and an accredited education specializing in insolvency law; or

(b) Be an economist, chartered accountant, or auditor with at least five years of experience and accredited expertise in insolvency.

Organizations may also be appointed as trustees, provided they include a lawyer, economist, chartered accountant, or auditor who satisfies the requirements set forth above and that they guarantee due independence and dedication in performing their obligations as an insolvency trustee.

The Amendment imposes specific requirements on trustees in insolvency proceedings involving banks, insurance companies, and other regulated entities. Any expert rendering an opinion required for approval of a refinancing agreement is ineligible for appointment as a trustee in any ensuing insolvency proceeding commenced by or against the same debtor.

In connection with an insolvency proceeding of "special significance," the Amendment provides that the court shall appoint, as an additional member of the panel of trustees, a creditor holding an ordinary insolvency credit or an unsecured insolvency credit with general privilege. According to the Amendment, insolvency proceedings have special significance if:

NEWSWORTHY

Jones Day's Business Restructuring & Reorganization Practice received a "National Tier 1" designation in the 2011–12 *U.S. News & World Report* and *Best Lawyers* "Best Law Firms" ranking in the field of Bankruptcy and Creditor Debtor Rights/Insolvency and Reorganization Law.

Corinne Ball (New York), ***David G. Heiman (Cleveland)***, ***Kevyn D. Orr (Washington)***, ***Richard L. Wynne (Los Angeles)***, and ***Michael Rutstein (London)*** were named to *The International Who's Who of Insolvency & Restructuring Lawyers 2011*.

David G. Heiman (Cleveland), ***William E. Bryson (Taipei*** and ***Beijing)***, ***Thomas T.M. Chen (Taipei)***, ***Jack J.T. Huang (Taipei)***, ***Chung-Ping Liu (Taipei)***, and ***Louis Y.S. Liu (Taipei)*** were designated as "leading lawyers" in the field of "restructuring and insolvency" in the *IFLR1000* for 2012.

Lisa G. Laukitis (New York) was one of 12 lawyers in the U.S. chosen by *Turnarounds & Workouts* as an Outstanding Young Restructuring Lawyer for 2011.

Kevyn D. Orr (Washington) sat on a panel at the National Conference of Bankruptcy Judges Annual Meeting in Tampa on October 13, discussing "Chapter 11 Plan of Reorganization Mediations" in conjunction with the ABA Business Bankruptcy Fall Committee Meeting.

Corinne Ball (New York) moderated a panel discussion entitled "Room Funding Distress Investing in EU/UK—Successes and Pitfalls" at the National Conference of Bankruptcy Judges Annual Meeting in Tampa on October 14 in conjunction with the ABA Business Bankruptcy Fall Committee Meeting.

An article written by ***Corinne Ball (New York)*** entitled "LLC Members Now Definitively Insiders" was published in the October 27, 2011, edition of the *New York Law Journal*.

Mark A. Cody (Chicago) sat on a panel discussing "To Infinity and Beyond—Where Have We Come From? Where are We Now? Where are We Going?" at the ABI Canadian/American Cross-Border Insolvency Symposium in Toronto on November 7.

Heather Lennox (New York and ***Cleveland)*** sat on a panel discussing "Shareholders Count Too: The Role of the Equity Committee in a Volatile Economy" at the National Conference of Bankruptcy Judges Annual Meeting in Tampa on October 14 in conjunction with the ABA Business Bankruptcy Fall Committee Meeting.

An article written by ***Charles M. Oellermann (Columbus)*** and ***Mark G. Douglas (New York)*** entitled "1st Impressions—*In re Marcal Paper Mills*" appeared in the September 7, 2011, edition of *Bankruptcy Law360*.

Lori Sinanyan (Los Angeles) moderated a panel entitled "Municipal Restructurings: Fact, Fiction and Future" at a meeting of the Turnaround Management Association on November 10 in Los Angeles.

An article written by ***Scott J. Friedman (New York)*** and ***Mark G. Douglas (New York)*** entitled "Recharacterization: It's Not All About Equity or Insiders" was published in the November 2011 edition of *The Bankruptcy Strategist*.

Thomas A. Howley (Houston) moderated a panel discussion entitled "Competing Plans in Chapter 11: Fleeting Fad or Permanent Fixture?" on October 26 at the annual meeting of the Turnaround Management Association in San Diego.

An article written by ***Lance E. Miller (New York)*** entitled " 'But I Already Paid You!' Arguments Under the Single-Satisfaction Defense" was published in the 2011 *Norton Annual Survey of Bankruptcy Law*.

(a) The annual turnover of the debtor was €100 million or more in any of the three fiscal years preceding the date of commencement of the insolvency proceeding;

(b) The aggregate indebtedness declared by the debtor exceeds €100 million;

(c) The number of creditors declared by the debtor exceeds 1,000; or

(d) The number of the debtor's employees exceeds 100 or did so in any of the three fiscal years prior to the insolvency-proceeding commencement date.

In addition, in cases involving a single insolvency trustee, the court, after convening a hearing on the issue and concluding that the existing trustee is not a legal entity (*i.e.*, an association, corporation, partnership, proprietorship, trust, or individual that has legal standing under the law), may appoint an additional, or ancillary, trustee. The appointment of an ancillary trustee is mandatory in certain cases specified in the Amendment.

PAYMENT OF CLAIMS AGAINST INSOLVENCY ASSETS (*CRÉDITOS CONTRA LA MASA*)

The Insolvency Law and the Amendment provide that certain claims (*e.g.*, claims for legal costs incurred in connection with insolvency proceedings, post-insolvency declaration claims arising from business operations, and salaries payable during the 30-day period prior to the declaration) shall be paid from unencumbered assets of the insolvent company. Eligible assets are therefore reserved or reduced (prior to the payment of any other claims) for the purpose of satisfying this special class of claims (*créditos contra la masa*). These claims are paid as they mature, but the Amendment gives the trustee(s) the power to alter the order of payment among different claims within this special class, provided the trustee(s) conclude that it is in the best interest of the proceedings and that there will be sufficient eligible assets to pay all claims in the class.

If at any time after the declaration of insolvency, the trustee(s) should determine that eligible assets are not sufficient to pay all the claims in this class, the Amendment provides that the insolvency proceeding will terminate, unless the court finds that the obligations are guaranteed by a third party. In the event of such a termination, claims in this class shall be paid in the following order:

(i) Claims for salaries earned during the final 30 days of employment in an amount not exceeding double the national minimum salary;

(ii) Claims for salaries and other compensation in an amount computed by multiplying triple the national minimum salary by the number of salary days for which payment is due;

(iii) Claims for judicial costs and expenses associated with the insolvency proceeding; and

(iv) Any other claims against the insolvency assets (including claims based upon fresh money).

PROPOSED CHAPTER 11 ATTORNEY-FEE GUIDELINES

In 1996, in accordance with 28 U.S.C. § 586, the United States Trustee Program ("USTP") promulgated Guidelines for Reviewing Applications for Compensation and Reimbursement of Expenses filed under 11 U.S.C. § 330 (the "1996 guidelines"). The USTP is revising the 1996 guidelines in phases and has drafted new proposed guidelines for reviewing applications for attorney compensation in larger chapter 11 cases (more than $50 million in combined assets and liabilities, aggregated for jointly administered cases). The USTP invites public review of and comment on these proposed guidelines by January 31, 2012; they can be viewed at http://www.justice.gov/ust/eo/rules_regulations/guidelines/proposed.htm.

WAMU CONFIRMATION DENIED: INTEREST RATES, EQUITABLE DISALLOWANCE, AND INSIDER TRADING

Benjamin Rosenblum

In *In re Washington Mutual, Inc.*, 2011 WL 4090757 (Bankr. D. Del. Sept. 13, 2011), Judge Mary F. Walrath of the U.S. Bankruptcy Court for the District of Delaware denied confirmation of the debtors' proposed chapter 11 plan and instead referred the litigants to mediation in order to move the case toward a confirmable resolution. The lengthy opinion denying confirmation covers issues ranging from the award of interest in a chapter 11 plan to equitable claims disallowance and insider trading. While some of the topics discussed in the opinion are relatively straightforward, other issues examined in the ruling have divided bankruptcy courts throughout the nation. As a consequence, the decision is a must-read for restructuring professionals, particularly those in the distressed investing field.

WASHINGTON MUTUAL'S CONFIRMATION PROCESS

Washington Mutual, Inc., was the bank holding company that formerly owned Washington Mutual Bank ("WaMu"). WaMu was the nation's largest savings and loan association. In 2007, as with many other large financial institutions at that time, WaMu's revenues and earnings began to decline. By September 2008, the rating agencies had significantly downgraded the credit ratings of both the bank and the holding company. A run on the bank ensued.

On September 25, 2008, the U.S. Office of Thrift Supervision seized WaMu and appointed the Federal Deposit Insurance Corporation (the "FDIC") as receiver. The takeover of WaMu by the FDIC represented the largest bank failure in this country's history. On the day of the takeover, the FDIC sold substantially all of WaMu's assets to JPMorgan Chase Bank, N.A. ("JPMorgan"). A day later, Washington Mutual, Inc., and affiliate WM Investment Corp. (the "debtors") filed for chapter 11 protection in Delaware.

On March 26, 2010, the debtors proposed a sixth amended chapter 11 plan, which was modified various times thereafter. The sixth amended plan incorporated a global settlement agreement among the debtors, JPMorgan, the FDIC, and certain other stakeholders regarding ownership of certain assets and various claims that the parties asserted against each other. In a January 7, 2011, opinion, the bankruptcy court approved the global settlement agreement but denied confirmation of the plan for other reasons.

The debtors subsequently revised the plan and again sought confirmation. The debtors, JPMorgan, the FDIC, the official committee of creditors, a group of senior noteholders, the indenture trustees for the debtors' senior notes and senior subordinated notes, and certain other parties in interest all supported confirmation of the revised plan. Others, including the official equity committee and certain putative holders of "trust preferred securities," opposed it.

CONFIRMATION ISSUES

As is common in many large chapter 11 cases, the plan objectors disputed the debtors' proffered valuation of the reorganized company. They argued that, as a result of this low valuation, creditors receiving stock in the reorganized company were receiving too much on account of the expense of their claims at equity. After hearing expert testimony from both sides, the court determined that, although the debtors' valuation was in fact too low, the plan objectors' competing valuation was too high. The court then valued the company at an amount between the two proposed valuations.

The plan opponents also attacked the global settlement agreement as unreasonable. In its prior decision denying confirmation, the court had already passed on the global settlement and determined that it met the applicable legal standards for approval. However, certain objectors argued that the court was not bound by its prior decision, some maintaining that subsequent case law justified a departure from the previous determination. The court rejected these arguments, ruling that it had already decided the issue and no intervening change in law or fact warranted reconsideration of its prior determination.

Next, the plan objectors argued that the plan's award of postbankruptcy interest was too rich. Typically, unsecured creditors may not recover postpetition interest on their claims. However, courts have awarded such interest in rare cases

where the estate is solvent. One rationale for doing so is based upon a combined reading of sections 726 and 1129(a)(7) of the Bankruptcy Code. Section 726 provides that, in a chapter 7 liquidation, postpetition interest at the "legal rate" shall be paid on unsecured claims before any distribution to equity holders. Courts have imported section 726's priority scheme into chapter 11 cases on the basis of the "best interests" test in section 1129(a)(7), which requires that in order to confirm a chapter 11 plan, a dissenting creditor or interest holder must receive at least as much under a chapter 11 plan as it would in a chapter 7 liquidation.

Distressed investors that regularly trade claims in bankruptcy cases would be well advised to consider the court's analysis of the insider-trading allegations in *Washington Mutual*.

Although most courts agree that interest should be awarded to unsecured creditors in a solvent estate, courts are split on the permissible rate of interest and the meaning of the term "legal rate" in section 726. In *Washington Mutual*, the court concluded that "legal rate" means the federal judgment rate at the time of the bankruptcy filing. In a prior decision in the case, the court noted authorities for the proposition that the term "legal rate" establishes a rebuttable presumption in favor of the contract rate, which can be overcome only by the equities of the case. Among these authorities was Judge Walrath's own earlier opinion in *In re Coram Healthcare Corp.*, 271 B.R. 228 (Bankr. D. Del. 2001), wherein the judge applied the federal judgment rate only after determining that the equities in that case did not favor application of the contract rate. Accordingly, *Washington Mutual* would appear to represent a shift in the court's position on this issue.

The plan objectors also argued that the plan violated section 1129(a)(3) of the Bankruptcy Code because it was not proposed in good faith. The objectors complained of alleged misconduct on the part of certain of the noteholders that were party to the global settlement agreement (the "settlement noteholders"). In particular, the equity committee complained that the settlement noteholders "hijacked" the settlement-negotiation process and engaged in wrongful conduct, including insider trading.

In rejecting this argument, the court determined that the settlement noteholders' conduct neither negatively impacted the chapter 11 plan nor tainted negotiation of the global settlement. According to the court, the settlement noteholders' conduct appeared to have assisted in augmenting the debtors' estates by encouraging a more aggressive settlement with JPMorgan. The court therefore held that, although it was not suggesting that the settlement noteholders' conduct was commendable, any harm caused by their conduct could be remedied in other ways.

INSIDER TRADING AND THE DOCTRINE OF EQUITABLE DISALLOWANCE

Relatedly, after explaining that confirmation must be denied, the court granted a motion of the equity committee for standing to pursue equitable disallowance of the settlement noteholders' claims.

The continued vitality of the doctrine of equitable disallowance has been a controversial topic in recent years. Some courts have held that the doctrine did not survive the enactment of the Bankruptcy Code. Other courts, however, continue to recognize its existence. The *Washington Mutual* court aligned itself with the latter group.

The court next considered whether the equity committee had articulated a colorable claim for equitable disallowance based on alleged insider trading on the part of certain of the settlement noteholders. The court began by identifying two types of insider trading under section 10(b) of the Securities Exchange Act of 1934: the "classical theory" and the "misappropriation theory." The classical theory of insider trading applies where a corporate insider (i) trades in the securities of the corporation, (ii) on the basis of (iii) material nonpublic information, (iv) in violation of a fiduciary duty owed to shareholders.

The equity committee alleged that the classical theory of insider trading applied. According to the equity committee: (a) the settlement noteholders had knowledge of the global

settlement negotiations and the parties' position therein; (b) such knowledge constituted material nonpublic information; (c) the noteholders actively traded in the debtors' securities after the expiration of certain restriction periods; and (d) such noteholders became "temporary insiders" of the debtors when they were given material nonpublic information creating a fiduciary duty on their part to other creditors and shareholders.

With respect to the question of whether the information at issue was material, the settlement noteholders argued that their knowledge of the negotiations and the parties' positions during the negotiations could not be considered material because the parties neither reached an agreement in principle nor came close to reaching a deal. The court rejected this argument and concluded, on the basis of the evidence presented, that it appeared that the "settlement negotiations may have shifted towards the material end of the spectrum" and that the settlement noteholders may have traded on information that was nonpublic.

The court also determined that the settlement noteholders could have become "temporary insiders" or "non-statutory insiders" of the debtors. According to the court, the settlement noteholders could colorably be temporary insiders due to the fact that the debtors provided them with confidential information to allow them to participate in negotiating the global settlement agreement and plan. Also, the court explained, the settlement noteholders could be considered non-statutory insiders of the debtors because they held blocking positions in two classes of the debtors' debt structure. As such, the court concluded that it could find that these noteholders owed a duty to the other members of the affected classes.

The court also rejected the settlement noteholders' argument that they lacked the requisite "scienter" for insider trading. Specifically, the settlement noteholders argued that, even assuming the information obtained was material nonpublic information, they did not know this was the case because the debtors had agreed to disclose all material nonpublic information at the end of each confidentiality period. The equity committee responded that good-faith reliance on assurances of a third party to disclose all material information to the public cannot be a defense to insider trading. The bankruptcy court agreed.

Accordingly, the court determined that the equity committee stated a colorable claim for insider trading under the classical theory (and, for similar reasons, the misappropriation theory) and, hence, a claim for equitable disallowance. It therefore conferred derivative standing upon the equity committee to pursue the claim. However, the court stayed prosecution of the action pending mediation.

ANALYSIS

Washington Mutual covers a broad waterfront of issues pertinent to distressed investors and other bankruptcy stakeholders. The court's analysis of the valuation dispute and the proposed global settlement in the case addresses topics that frequently arise in contested chapter 11 plan cases.

The court also had occasion to address matters that arise less frequently, such as the appropriate interest rate payable under a chapter 11 plan on unsecured claims when a debtor is insolvent, as well as the vitality and contours of the doctrine of equitable disallowance of claims.

Finally, distressed investors that regularly trade claims in bankruptcy cases would be well advised to consider the court's analysis of the insider-trading allegations in *Washington Mutual*. Of particular note is the court's determination that the noteholders' participation in the settlement negotiations potentially provided them with material nonpublic information. In addition, the court made important rulings regarding the noteholders' blocking positions and the consequences thereof to the noteholders' insider status.

IS CHAPTER 9 THE NEXT CHAPTER IN THE MUNICIPAL SAGA?

Joseph M. Witalec and Mark G. Douglas

Fallout from the Great Recession continues to figure prominently in world headlines, as governments around the globe struggle to implement or extend programs designed to jump-start stalled economies and attempt to gauge the health of financial institutions deemed “too big to fail” or otherwise critical to long-term prospects for recovery. Amid the mayhem wrought in a broad spectrum ranging from sovereign states to the chronically unemployed, the plight of cities, towns, and other municipalities across the U.S. has received a significant amount of media exposure. A variety of factors—a reduction in the tax base caused by increased unemployment; plummeting real estate values and a high rate of mortgage foreclosures; questionable investments; underfunded pension plans and retiree benefits; decreased federal aid; and escalating costs (including the higher cost of borrowing due to the meltdown of the bond mortgage industry and the demise of the market for auction-rate securities)—have combined to create a maelstrom of woes for U.S. municipalities.

One option available to municipalities teetering on the brink of financial ruin is chapter 9 of the Bankruptcy Code, a once obscure legal framework that allows an eligible municipality to “adjust” its debts by means of a “plan of adjustment” that is in many respects similar to the plan of reorganization which a debtor can devise in a chapter 11 case. However, due to constitutional concerns rooted in the Tenth Amendment’s preservation of each state’s individual sovereignty over its internal affairs, the resemblance between chapter 9 and chapter 11 is limited. One significant difference pertains to the requirement that a municipal debtor be insolvent to be eligible for relief under chapter 9. This insolvency requirement was the subject of a ruling recently handed down by an Idaho bankruptcy court in *In re Boise County*, 2011 WL 3875639 (Bankr. D. Idaho Sept. 2, 2011).

MUNICIPAL BANKRUPTCY LAW

Ushered in during the Great Depression to fill a vacuum that previously existed in both federal and state law, federal municipal bankruptcy law suffered from a constitutional flaw that endures in certain respects to this day—the Tenth Amendment reserves to the states sovereignty over their internal affairs. This reservation of rights caused the U.S. Supreme Court to strike down the first federal municipal bankruptcy law as unconstitutional in 1936, and it accounts for the limited scope of chapter 9, as well as the severely restricted role the bankruptcy court plays in presiding over a chapter 9 case and in overseeing the affairs of a municipal debtor.

The present-day legislative scheme for municipal debt reorganizations was implemented in the aftermath of New York City’s financial crisis and bailout by the New York State government in 1975, but chapter 9 has proved to be of limited utility thus far. Few cities or counties have filed for chapter 9 protection. The vast majority of chapter 9 filings have involved municipal instrumentalities, such as irrigation districts, public-utility districts, waste-removal districts, and health-care or hospital districts. In fact, according to the Administrative Office of the U.S. Courts, fewer than 650 municipal bankruptcy petitions have been filed in the more than 70 years since Congress established a federal mechanism for the resolution of municipal debts. Fewer than 270 chapter 9 cases have been filed since the current version of the Bankruptcy Code was enacted in 1978—although the volume of chapter 9 cases has increased somewhat in recent years. By contrast, there were 13,500 chapter 11 cases filed in 2010 alone.

FILING REQUIREMENTS

Access to chapter 9 is limited to municipalities under section 109(c)(1) of the Bankruptcy Code. A “municipality” is defined by section 101(40) as a “political subdivision or public agency or instrumentality of a State.” Section 109(c)(2)–(c)(4) of the Bankruptcy Code sets forth three other mandatory prerequisites to relief under chapter 9:

- A state law or governmental entity empowered by state law must specifically authorize the municipality (in its capacity as such or by name) to file for relief under chapter 9;
- The municipality must be insolvent; and
- The municipality must “desire[] to effect a plan” to adjust its debts.

Finally, section 109(c)(5) provides that, prior to seeking chapter 9 relief, a municipality must either: (a) have obtained the consent of creditors holding at least a majority in amount of the claims in each class that will be impaired under the municipality's intended plan; (b) have failed to obtain such consent after negotiating with creditors in good faith; (c) be unable to negotiate with creditors because negotiation is "impracticable"; or (d) reasonably believe that "a creditor may attempt to obtain a transfer that is avoidable" as a preference.

A chapter 9 petitioner bears the burden of demonstrating compliance with each of the mandatory provisions of section 109(c)(1)–(4) and at least one of the disjunctive requirements set forth in section 109(c)(5). If the petitioner cannot do so, the bankruptcy court must dismiss the petition under section 921(c)—although that provision states that the court "may" dismiss the case of an ineligible petitioner, it has been construed by most courts to require dismissal.

No other chapter of the Bankruptcy Code includes insolvency among the criteria for relief. "Insolvency" in the context of chapter 9 eligibility, however, does not refer to balance-sheet insolvency. Instead, pursuant to section 101(32)(C) of the Bankruptcy Code, it requires a showing that, as of the filing date, the municipality is either: (i) generally not paying its undisputed debts as they become due; or (ii) unable to pay its debts as they become due. The bankruptcy court examined chapter 9's insolvency requirement in *Boise County*.

BOISE COUNTY

Boise County (the "County") is a rural mountain county in the State of Idaho with a population of approximately 7,000. Despite its name, the City of Boise, the capital of Idaho, is not located in the County. Rather, the County seat, Idaho City, is located approximately 40 miles northeast of the City of Boise. In January 2009, Alamar Ranch, LLC, and YTC, LLC (collectively, "Alamar"), which operated a residential treatment facility and private school for at-risk youth on property located in the County, sued the County, alleging that conditions imposed by it in connection with a conditional-use permit were illegal and discriminatory under the Fair Housing Act.

In December 2010, a federal district court entered a judgment against the County in Alamar's favor in the amount of $4 million. The County appealed the award to the Ninth Circuit Court of Appeals. Subsequent negotiations with Alamar regarding the terms of payment broke down, and Alamar communicated its intention to levy a writ of execution on the County's bank accounts. The County responded by filing a chapter 9 petition on March 1, 2011. In the filing, the County listed total assets of more than $27 million and total debt of approximately $7.3 million. The liabilities included the $4 million Alamar judgment, which was designated as undisputed, as well as a disputed $1.5 million debt for Alamar's legal fees in connection with the litigation and approximately $550,000 in contingent claims for medical-indigency payments asserted by several health-care providers.

The County filed a chapter 9 plan in June 2011. The plan proposed to pay Alamar $500,000 in respect of its judgment claim, relying on a limitation on damages contained in the Idaho Tort Claims Act. Alamar filed a motion to dismiss the chapter 9 case, claiming, among other things, that the County had failed to demonstrate that it was insolvent, as required by section 109(c)(3).

THE BANKRUPTCY COURT'S RULING

The bankruptcy court concluded that: (i) the County qualified as a "municipality"; (ii) the County was authorized by state law to be a debtor in chapter 9; (iii) the County demonstrated a desire to implement a plan to adjust its debts; (iv) further negotiations with Alamar had become impracticable; and (v) the County had a reasonable belief that Alamar might attempt to obtain a transfer avoidable as a preference. However, the court ruled that the County had failed to demonstrate that it was insolvent at the time of the chapter 9 filing.

According to the County, the $550,000 in unpaid health-care-provider claims represented debts not paid when due, thus rendering the County insolvent under section 101(32)(C)(i). The bankruptcy court disagreed, ruling that "[t]he County's failure to process and pay a single category of claims, which represents only a small portion of its budgeted expenditures, from what appear to be adequate funds does not rise to the level of the general nonpayment contemplated

by § 101(32)(C)(i).” Moreover, the court noted, the evidence showed that the monies in the County’s indigent fund were more than sufficient to pay those claims and any similar claims projected for the remainder of the fiscal year. The court also found that the County had failed to show that the scheduled health-care-provider claims were in fact “due” for purposes of section 101(32)(C)(i).

The bankruptcy court similarly rejected the County’s claim that it was insolvent under section 101(32)(C)(ii) because it could not pay both the Alamar judgment and its other expenses for supporting County operations. The test for insolvency under section 101(32)(C)(ii), the court explained, focuses on cash flow during the current (or a projected) fiscal year, rather than a budget deficit. After carefully examining the County’s cash management rules and procedures (including the Idaho Constitution), the court concluded that the County was neither legally prohibited from nor incapable of paying the Alamar judgment without risking nonpayment of other essential County obligations. On the basis of its finding that the County failed to meet its burden of demonstrating insolvency, the bankruptcy court dismissed the chapter 9 case under section 921(c) of the Bankruptcy Code.

OUTLOOK

Boise County demonstrates one of the reasons that chapter 9 is not a panacea for every kind of financial problem burdening U.S. municipalities. Unlike other chapters of the Bankruptcy Code, chapter 9 is expressly reserved for debtors genuinely facing financial extremis in the form of insolvency. Like the court in *Boise County*, other bankruptcy courts can be expected to subject a municipal debtor’s claim of insolvency to exacting scrutiny, given the widespread perception that chapter 9 is a remedy of last recourse which should be invoked only under drastic circumstances. Indeed, the court’s rejection of Boise County’s chapter 9 case is not exceptional. Nearly one-third of all chapter 9 cases filed since 1980 have been dismissed shortly after the petition date.

Unfortunately, an increasing number of municipalities are passing the test that Boise County failed. More than 30 chapter 9 cases have been filed during the last four years—four in 2008, 12 in 2009, seven in 2010, and 11 thus far in 2011.

Jefferson County, Alabama

Jefferson County, Alabama, a county perched in the foothills of the Appalachian Mountains with 660,000 residents and home to the state’s largest city (Birmingham), recently supplanted Orange County, California, as the largest municipal debtor in our nation’s history when it filed for chapter 9 protection on November 9, 2011. Jefferson County entered into a series of complex bond-swap transactions after incurring a mountain of debt to finance a new sewer system. The county is staggering under $3.2 billion in debt (or roughly $4,800 per resident) from that project, which it cannot afford to pay.

On September 16, 2011, county commissioners voted to accept a restructuring agreement that, with the approval of the state legislature (among others) prior to a June 30, 2012, restructuring deadline, would have allowed the county to shed about $1 billion in debt and lower the interest rate on roughly $2 billion of new, 40-year debt that would have been issued to replace the current debt. However, Jefferson County’s governing board voted to file a chapter 9 petition after settlement talks broke down. The county’s chapter 9 case involves more than $4 billion in debt, dwarfing the $1.7 billion bankruptcy of Orange County, California, in 1994 that had been the largest municipal bankruptcy case on record.

Vallejo, California

Vallejo, California, a San Francisco Bay Area city with approximately 116,000 residents, kicked off the recent uptick in municipal bankruptcy filings when it filed for chapter 9 protection in May 2008 at the inception of the current financial recession. In the long term, Vallejo fell victim to the closing of a U.S. Navy base in the 1990s. Its more immediate cause for distress, however, was unsupportable public-employee labor and legacy costs.

Vallejo successfully used chapter 9 to clean up its balance sheet and either renegotiate or reject unfavorable labor contracts. A bankruptcy court confirmed the city’s plan of adjustment on August 4, 2011, after a three-year stay in chapter 9. Under the plan, Vallejo’s largest creditor, a bank holding more than $45 million in unpaid certificates of participation, will recover roughly half of its claims. The claims of Vallejo’s public employees will be paid in full over time, while unsecured creditors are to receive 30 cents on the dollar.

Central Falls, Rhode Island

Central Falls, Rhode Island, a tiny city of just over one square mile with 18,000 residents, filed for chapter 9 protection on August 1, 2011, to revamp its pension obligations after tax increases and austerity measures failed to restore the city to solvency. The filing came one year after the state took control of the city's finances. Central Falls, which was described as "impoverished" by *The New York Times*, was so crime-ridden in the mid-1980s after its textile industry collapsed that the city was crowned "Cocaine Capital of New England" by *Rolling Stone* magazine in 1986. At the time of its chapter 9 filing, Central Falls had $21 million in general debt, a structural budget deficit of $5.6 million, and an unfunded liability of nearly $80 million for retiree benefits and pensions.

Harrisburg, Pennsylvania

Facing a state takeover of the city's finances, the city council of Harrisburg, the capital of Pennsylvania, authorized a chapter 9 filing for the city on October 11, 2011. The city of 49,500 residents faces a debt burden five times larger than its general-fund budget because of an overhaul and expansion of a trash-to-energy incinerator that does not generate enough revenue to service the $310 million in debt incurred to fund the project. The chapter 9 filing came four months after the Pennsylvania legislature passed a law in June preventing Harrisburg from filing for bankruptcy until the following month of July, and two weeks after Pennsylvania's House of Representatives overwhelmingly approved a scheme that would have placed Harrisburg under the control of a state-appointed receiver if its city council did not approve a plan to handle the city's debt crisis.

State Legislative and Executive Actions

Confronted with an increasing volume of actual or prospective municipal failures, state legislatures and executives have been anything but idle, in many cases scrambling to implement an array of tools designed to offer viable alternatives to a chapter 9 filing. For example, in Michigan, Governor Rick Snyder signed legislation in March 2011 that expands the power of state-appointed emergency financial managers to include the right to terminate union contracts. The law, which offers struggling local governments and school districts assistance at an earlier stage, is intended to head off fiscal emergencies in order to prevent bankruptcy filings by troubled cities like Detroit, which currently faces a budget deficit of more than $155 million.

Nine days after Harrisburg filed for chapter 9 protection, Pennsylvania governor Tom Corbett signed into law the Municipalities Financial Recovery Act (SB 1151), which gave Harrisburg's mayor and the city council 30 days to come up with a recovery plan, subject to approval by the Secretary of the Pennsylvania Department of Community and Economic Development. Failing the implementation of such a plan, the act authorizes the governor to appoint a receiver to take over the state capital's finances. On October 14, Harrisburg's mayor and the state government asked a bankruptcy judge to dismiss the city's chapter 9 petition, claiming it was filed without authorization and in violation of state law as well as the Tenth Amendment to the U.S. Constitution.

On October 24, 2011, Governor Corbett declared a fiscal emergency in Harrisburg, citing the need to ensure that municipal services are maintained and the public safety protected in the financially distressed state capital despite its leaders' failure to enact a recovery plan. As a result of the governor's declaration, the Pennsylvania Department of Community and Economic Development had 10 days to develop an emergency action plan to ensure the public safety and to coordinate services that included police and firefighting, water and wastewater, trash collection, payroll, and pension and debt payments. On November 8, Harrisburg's city council agreed to sell the city's trash incinerator and lease downtown parking garages in an effort to stave off the state takeover. On November 23, Judge Mary D. France of the U.S. Bankruptcy Court for the Middle District of Pennsylvania dismissed Harrisburg's chapter 9 case, ruling that the city council was not authorized to file the chapter 9 petition on the city's behalf. The ruling clears the way for the state to place Harrisburg into receivership.

Lawmakers in Indiana—one of 21 states without any specific procedures for authorizing a municipal bankruptcy filing—have been more equivocal on the issue. A bill recently introduced before both houses of the state legislature would have permitted fiscally distressed municipalities to request the appointment of an emergency financial manager with

the authority to renegotiate contracts and slash spending. Under the Indiana Senate's version of the legislation, bankruptcy would have been an option if the financial manager failed to restore fiscal order. The Indiana House of Representatives, however, stripped the bankruptcy option from the bill. With lawmakers having failed to reach a consensus, the legislation died.

Three weeks before Central Falls filed for chapter 9 protection, Rhode Island governor Lincoln Chafee signed legislation providing that, in the event of a bankruptcy filing, lenders of a debtor municipality automatically receive a first-priority lien on both the municipality's general and property tax revenue. The bankruptcy-legislation package also includes a measure to indemnify fiscal overseers who take control of financially distressed cities or towns. It remains to be seen whether the new law will withstand challenge in the courts.

On October 10, 2011, California governor Jerry Brown gave his imprimatur to legislation designed to keep California cities, counties, special districts, and other public agencies from "rushing" into bankruptcy. The law, which takes effect in January 2012, bars local government agencies from filing for bankruptcy until they undergo mediation or hold a public hearing and declare a fiscal emergency threatening the health, safety, or well-being of residents.

CONCLUSION

The end result of these lessons from the past several years is that chapter 9 of the Bankruptcy Code is not a panacea for municipalities facing financial distress. Because Tenth Amendment restrictions ultimately place the power to allow chapter 9 filings with the individual states, a municipality must carefully examine applicable state laws, as well as assess the current political environment, to determine whether a chapter 9 filing is a realistic option for dealing with its financial situation.

"UNIVERSAL RULE": TRADEMARK LICENSES NOT ASSIGNABLE IN BANKRUPTCY ABSENT EXPRESS AUTHORIZATION

Joseph M. Tiller

Two fundamental goals of chapter 11 of the Bankruptcy Code are rehabilitating a debtor's business and maximizing the value of the debtor's estate for the benefit of various stakeholders. In serving these goals, section 365(a) of the Bankruptcy Code allows a bankruptcy trustee or chapter 11 debtor in possession ("DIP"), subject to certain exceptions and the prerequisite to cure defaults and to provide adequate assurance of future performance, to assume and/or assign beneficial executory contracts and unexpired leases and to reject burdensome contracts and leases. U.S. bankruptcy law has long provided for the assumption and assignment of many kinds of executory contracts and unexpired leases without the consent of the nondebtor contracting party, even if the agreement expressly prohibits such assignment.

Section 365(c)(1) of the Bankruptcy Code, however, provides an exception to the general ability of a DIP or trustee to assume and assign executory contracts by providing that such a contract may not be assigned if "applicable law" excuses the nondebtor contracting party from accepting performance from an entity other than the debtor. A ruling handed down earlier this year by the Court of Appeals for the Seventh Circuit in *In re XMH Corp.*, 647 F.3d 690 (7th Cir. 2011), relied on this "applicable law" exception in laying down a "universal rule" that a trademark license may not be assigned to a third party without the licensor's consent.

BACKGROUND

In 2009, clothing firm XMH Corp., formerly known as Hartmarx ("XMH"), filed for chapter 11 protection together with a number of its affiliates, including subsidiary Simply Blue, in Illinois. During the chapter 11 cases, XMH asked the bankruptcy court for permission to sell Simply Blue's assets to a number of different purchasers.

Among the Simply Blue assets to be sold was an executory contract with another clothing firm, Western Glove Works ("Western"). The Western contract with Simply Blue indicated

that Western was a licensee of the trademark "Jag Jeans." "Jag" is a federally registered trademark owned by Jag Licensing LLC for various items of women's clothing. The Western contract stated that Western granted Simply Blue a sublicense to sell women's jeanswear bearing the "Jag" trademark until December 31, 2002. Simply Blue agreed to pay Western a license fee of 12.5 percent of Simply Blue's net sales of the trademarked apparel during the period in which the contract was in effect. The contract did not prohibit or restrict assignment, nor did it permit it.

The duration of the trademark sublicense was initially only two weeks, as the contract had taken effect on December 17, 2002, but was extended to June 30, 2003. Thereafter, the relationship between the parties, pursuant to a series of agreements, converted to one whereby Simply Blue provided designing, sourcing, marketing, sales, merchandising, and customer services to Western in return for a fee.

Western objected to the assignment, arguing that the contract could not be assigned without its permission. According to Western, "applicable law" under section 365(c)(1) was trademark law because the contract stated that Western was a licensee of the Jag trademark.

Initially persuaded by Western, the bankruptcy court ruled that the sublicense could not be assigned to the purchasers because Western would not authorize the assignment. XMH appealed the decision to the district court. While the appeal was pending, XMH amended the sale agreement with the purchasers to provide that Simply Blue would retain title to the Western contract, but that the purchasers would assume all the obligations Simply Blue had owed to Western under the contract and would receive all the fees to which Simply Blue had been entitled thereunder.

The bankruptcy court approved the amendment to the sale agreement. Western appealed this decision. Meanwhile, the district court, addressing XMH's earlier appeal, granted a motion by the purchasers to be substituted for XMH and then reversed the bankruptcy court's order barring assignment of the contract between Western and Simply Blue, ruling that the trademark sublicense had expired by its terms on June 30, 2003, and remanding the case to the bankruptcy court for further deliberation. The ruling also disposed of the appeal by Western, which then appealed to the Seventh Circuit.

THE SEVENTH CIRCUIT'S DECISION

In its appeal to the Seventh Circuit, Western maintained that because its contract with Simply Blue included a sublicense to use the Jag trademark, the assignment to the purchasers was impermissible under section 365(c)(1) of the Bankruptcy Code. XMH countered that the sublicense had already expired at the time of the assignment and that section 365(c)(1) therefore did not bar XMH from assigning the agreement to the purchasers.

A three-judge panel of the Seventh Circuit ultimately affirmed the decision of the district court authorizing XMH to assign the Western contract to the purchasers over Western's objection. However, in doing so, the court expressly held that the universal rule with respect to trademarks is that "trademark licenses are not assignable in the absence of a clause expressly authorizing assignment." Specifically, the court explained, section 365(c)(1) prohibits assignment of an executory contract if "applicable law" authorizes the other party to the contract to refuse to accept performance from an assignee, whether or not the contract prohibits or restricts assignment. The Seventh Circuit noted that the term "applicable law" means any law applicable to a contract (other than bankruptcy law) and includes trademark law.

Circuit judge Richard A. Posner took great pains to explain why trademarks are an exception to the general rule that debtors may assume and assign beneficial executory contracts:

> The purpose of a trademark, after all, is to identify a good or service to the consumer, and identity implies consistency and a correlative duty to make sure that the good or service really is of consistent quality . . . . If the owner of the trademark has broken off business relations with a licensee, he cannot ensure the continued quality of the (ex-)licensee's operation . . . . That is why the licensee is not permitted to sublicense the trademark to a seller over whom the trademark owner, having no contract with the sublicensee, will have no control [citations and quotations omitted].

Because the trademark owner is concerned about the quality of the trademarked product, Judge Posner noted, it makes sense to follow a universal rule that a trademark license is not assignable without the owner's express permission.

Applying this universal rule, the Seventh Circuit explained that if the Western contract with Simply Blue still included a trademark sublicense when XMH attempted to assign the contract to the purchasers, the contract was not assignable in light of Western's refusal to consent to the assignment. However, the Seventh Circuit determined that the contract at issue was actually not a trademark sublicense at all, but merely a "service agreement" with a trademark license component, and that the trademark sublicense had expired prior to assignment of the contract.

OUTLOOK

XMH does not represent an abrupt turn in the area of assumption and assignment of trademark licenses under section 365 of the Bankruptcy Code. The ruling is consistent with several bankruptcy-court opinions following the "universal rule" that a trademark license cannot be assigned without the licensor's express consent. The decision is notable, however, as it is the first published opinion on the circuit level regarding the issue, although the Ninth Circuit previously affirmed a similar ruling by a lower court without a written opinion in *N.C.P. Marketing Group, Inc. v. BG Star Prods., Inc.* (*In re N.C.P. Marketing Group, Inc.*), 279 Fed. Appx. 561 (9th Cir. 2008).

XMH, therefore, may be viewed as a victory for trademark licensors intent upon preventing assignments without their consent. It remains to be seen how *XMH* will be viewed in other circuits. Regardless, drafters of trademark licenses are well advised to draft an agreement carefully to ensure that it explicitly and unequivocally expresses the parties' intentions and expectations on this point.

XMH is also noteworthy for what it did not address. One issue that did not come to the fore, but has been the subject of considerable controversy in the courts in connection with trademark licenses, is whether Simply Blue, in lieu of assigning the agreement, could have assumed and continued performance under the contract with Western as part of its reorganization. There is a split of authority in the courts on this point. Some courts (representing the minority view) apply an "actual test" to a proposed assumption under section 365(c)(1), construing the provision to permit a debtor to assume an executory trademark license if the debtor does not "actually" seek to assign the license to a third party. Other courts (representing the majority view) have adopted a "hypothetical test," interpreting section 365(c)(1) to prohibit a debtor from assuming an executory trademark license under any circumstances if nonbankruptcy law would prohibit assignment absent consent.

In 2009, the U.S. Supreme Court denied certiorari in a case in which the lower court applied the "hypothetical test" to prevent the assumption of a trademark license. However, in denying review, two Justices stated that "[t]he division in the courts over the meaning of § 365(c)(1) is an important one to resolve for Bankruptcy Courts and for businesses that seek reorganization," but "[t]his petition for certiorari . . . is not the most suitable case for our resolution of the conflict."

ANOTHER BLOW TO TRIANGULAR SETOFF IN BANKRUPTCY: "SYNTHETIC MUTUALITY" NO SUBSTITUTE FOR THE REAL THING

Charles M. Oellermann and Mark G. Douglas

On October 4, 2011, Judge James M. Peck of the U.S. Bankruptcy Court for the Southern District of New York ruled in *In re Lehman Bros. Inc.*, 2011 WL 4553015 (Bankr. S.D.N.Y. Oct. 4, 2011), that a "triangular setoff" does not satisfy the Bankruptcy Code's mutuality requirement and that the Bankruptcy Code's safe-harbor provisions do not eliminate that requirement in connection with setoffs under financial contracts. The ruling, which involved a broker-dealer liquidation proceeding under the Securities Investor Protection Act, confirmed speculation that multiparty setoffs under financial contracts would be deemed impermissible (at least in Delaware and New York) in the wake of rulings recently handed down in the chapter 11 cases of SemCrude, L.P., and Lehman Bros. Holdings Inc. The debate on triangular setoff, however, is almost certain to continue.

SETOFF RIGHTS IN BANKRUPTCY

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

As articulated by the U.S. Supreme Court in *Studley v. Boylston Nat. Bank*, 229 U.S. 523 (1913), setoff avoids the "absurdity of making A pay B when B owes A." Debts are considered mutual when they are due to and from the same persons or entities in the same capacity. An exception to this strict mutuality requirement may exist in cases involving "triangular setoff," the provenance of which is commonly traced (rightly or wrongly) to a 1964 ruling construing section 68(a) of the former Bankruptcy Act of 1898 by the Seventh Circuit Court of Appeals in *Inland Steel Co. v. Berger Steel Co.* (*In re Berger Steel Co.*), 327 F.2d 401 (7th Cir. 1964). In this situation, A might have a relationship with B and C, where B and C are related parties. Triangular setoff occurs when A owes B, and A attempts to set off such amount against amounts C owes to A. The validity of triangular setoff in the bankruptcy context, as distinguished from under state contract or common law, is subject to debate, given the lack of mutuality involved.

SEMCRUDE

In 2009, a Delaware bankruptcy court ruled in *In re SemCrude, L.P.*, 399 B.R. 388 (Bankr. D. Del. 2009), that triangular setoff is not permitted in bankruptcy due to the absence of mutuality. *SemCrude* involved contracts between Chevron USA Inc. ("Chevron") and three affiliated debtors providing for the purchase of crude oil, gasoline, butane, isobutene, and propane. The contracts contained or were governed by identical netting provisions that provided:

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

The bankruptcy court ruled that, for the purpose of exercising a right of setoff under section 553 of the Bankruptcy Code, "mutuality cannot be supplied by a multi-party agreement contemplating a triangular setoff." The court rejected the contention that parties can contract around section 553's mutuality requirement. The court also rejected *Berger Steel* as authority for the proposition that nonmutual setoff provisions in a contract can be enforced against a debtor. In doing so, the court emphasized that none of the court rulings proffered in support of the practice actually upheld or enforced an agreement for a triangular setoff, but rather simply recognized the possibility of an exception for prepetition contracts contemplating triangular setoff in the course of denying setoff or finding mutuality.

A Delaware district court affirmed the bankruptcy court's ruling in *In re SemCrude, L.P.*, 428 B.R. 590 (D. Del. 2010). However, as with the ruling below, the appellate decision does not address whether the result would be different for derivatives and other financial contracts that fall under the "safe-harbor" provisions of the Bankruptcy Code.

THE BANKRUPTCY CODE'S SAFE-HARBOR PROVISIONS FOR FINANCIAL CONTRACTS

Although one of the Bankruptcy Code's primary policies is to provide for the equitable distribution of a debtor's assets among its creditors, Congress recognized the potentially devastating consequences that might ensue if the bankruptcy or insolvency of one financial firm were allowed to spread to other market participants, thereby threatening the stability of entire markets. Beginning in 1982, lawmakers formulated a series of changes to the Bankruptcy Code to create certain safe harbors to protect rights of termination and setoff under "securities contracts," "commodities contracts," and "forward contracts." Those changes were subsequently refined and expanded to cover "swap agreements," "repurchase agreements," and "master netting agreements" as part of a series of legislative developments, including the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 and the Financial Netting Improvements Act of 2006.

For example, section 561(a) of the Bankruptcy Code provides in relevant part that:

> [T]he exercise of any contractual right . . . to offset or net termination values, payment amounts, or other transfer obligations arising under or in connection with one or more . . . swap agreements . . . shall not be stayed, avoided, or otherwise limited by operation of any provision of this title or by any order of a court or administrative agency in any proceeding under this title.

In addition, section 362(b)(17) of the Bankruptcy Code provides a limited exception to the automatic stay for the exercise of setoffs of termination values, payment amounts, or other transfer obligations arising under or in connection with one or more swap agreements.

These safe-harbor provisions could be construed to suggest that where a triangular setoff is being exercised under a contract that is protected by the safe harbor, the mutuality requirement of section 553(a) would not apply. This issue was raised by Chevron before the bankruptcy court in *SemCrude*, but belatedly, such that it was never addressed by either the bankruptcy or district court.

Notwithstanding this argument, in *In re Lehman Bros. Holdings Inc.*, 433 B.R. 101 (Bankr. S.D.N.Y. 2010) ("*Swedbank*"), Judge Peck held that the safe-harbor provisions of the Bankruptcy Code do not override the mutuality requirement for setoff, which, he wrote, is "baked into the very definition of setoff." According to Judge Peck, although the safe harbors permit the exercise of a contractual right of offset in connection with swap agreements, notwithstanding the operation of any provision of the Bankruptcy Code that could operate to stay, avoid, or otherwise limit that right, "that right must exist in the first place."

Taken together, *Lehman Bros.*, *Swedbank*, and *SemCrude* mark a clear trend against the availability of triangular setoffs in bankruptcy. In the absence of further developments in the appellate courts or subsequent case law at the bankruptcy-court level, cross-affiliate setoff without mutuality would appear to be impermissible in the two most popular business bankruptcy jurisdictions in the U.S.—the Southern District of New York and the District of Delaware.

Swedbank was upheld on appeal by a New York district court early this year. *See In re Lehman Bros. Holdings Inc.*, 445 B.R. 130 (S.D.N.Y. 2011). That case, however, involved not a multiparty setoff, but a setoff of prepetition claims against funds collected by the debtor postpetition. Even so, many commentators speculated that, taken together, *Swedbank* and the rulings in *SemCrude* suggested that multiparty setoffs likely would not withstand challenge in bankruptcy.

THE LATEST SALVO

Judge Peck recently reprised his role as spoiler in this context in *In re Lehman Bros. Inc.*, 2011 WL 4553015 (Bankr. S.D.N.Y. Oct. 4, 2011). Lehman Brothers Inc. ("LBI") was the primary brokerage subsidiary of Lehman Brothers Holdings Inc. ("Lehman Holdings"). On September 19, 2008, four days after Lehman Holdings was forced to file the largest chapter 11 case in history, the Securities Investor Protection Corporation sought an order from a New York district court for a protective decree for LBI under the Securities Investor Protection Act of 1970 ("SIPA"), in the largest broker-dealer liquidation ever attempted. The district court issued the protective decree, appointed a trustee to oversee LBI's liquidation, and referred the case to the bankruptcy court.

A SIPA case proceeds in the bankruptcy court very much like a chapter 7 liquidation, with certain exceptions. SIPA expressly provides that to the extent consistent with SIPA's provisions, "a liquidation proceeding shall be conducted in accordance with, and as though it were being conducted under chapters 1, 3, and 5 and subchapters I and II of chapter 7 of title 11." Thus, the Bankruptcy Code's automatic-stay, setoff, and financial-contract provisions apply in a SIPA case.

LBI and global wealth management giant UBS AG ("UBS") had entered into a swap agreement in 2004. The swap agreement and related documents (the "Agreement") required the parties to post collateral to secure their respective obligations. The Agreement also provided as follows:

> [U]pon the designation of any Early Termination Date, in addition to and not in limitation of any other right or remedy . . . under applicable law the Non-defaulting Party or Non-affected Party (in either case, "X") may without prior notice to any person set off any sum or obligation (whether or not arising under this Agreement . . .) owed by the Defaulting Party or Affected Party (in either case, "Y") to X or any Affiliate of X against any sum or obligation (whether or not arising under this Agreement . . .) owed by X or any Affiliate of X to Y. . . .

Prior to the commencement of LBI's SIPA case, UBS delivered to LBI a notice of termination of the Agreement, designating September 16, 2008—the day after Lehman Holdings filed for chapter 11 protection—as the Early Termination Date and citing as cause for termination, among other things, a cross-default traceable to swap agreements between UBS and certain LBI affiliates.

The protective decree issued under SIPA for LBI on September 18, 2008, included a directive that the automatic stay precluded "any act to obtain possession of property of the estate or property from the estate" and stayed and enjoined all entities from directly or indirectly retaining or setting off or interfering with any assets or property owned by LBI. UBS subsequently delivered to LBI a valuation notice in which, among other things, it asserted a right to set off amounts allegedly due from LBI to UBS Securities and UBS Financial Services, two UBS affiliates, against the obligation of UBS under the Agreement to return certain excess collateral held by it to LBI. The SIPA trustee disputed the validity of any alleged setoff right under the Agreement and sought an order of the bankruptcy court enforcing the automatic stay and directing UBS to surrender approximately $23 million in excess collateral in its possession.

THE BANKRUPTCY COURT'S RULING

Judge Peck held in favor of the trustee, ruling that "[s]o-called triangular setoff that lacks mutuality . . . is not authorized under the Bankruptcy Code." The judge explained at the inception of his discussion that "[t]he question of central importance [in this case] . . . is whether the extension of the right of setoff [under the Agreement] to 'any Affiliate' is enforceable in bankruptcy."

UBS argued that: (i) because the setoff right in the Agreement, which is valid and enforceable under New York law, is one that was created by contract (and not a right at common law), the mutuality requirement in section 553 does not apply; and (ii) even if the court were to conclude otherwise, the setoff provision should be enforced because (a) triangular setoff does not violate the Bankruptcy Code (or SIPA) and (b) its contractual setoff right is protected by the safe-harbor provisions of the Bankruptcy Code.

Judge Peck rejected each of these arguments. He acknowledged that parties are entitled to agree to whatever they choose, so long as it is legal and not contrary to public policy. Even so, Judge Peck wrote, the attempt to override the independent status of the UBS affiliates in the Agreement

> disregards a consistent pattern of authority prescribing that, even where a setoff right exists under applicable law, the Bankruptcy Code imposes its own strict requirements—namely, that the debtor owes a pre-petition debt to the creditor, the creditor has a pre-petition claim against the debtor, and the debt and claim are mutual.

UBS's argument fails, Judge Peck concluded, because "the allegedly mutual debts flunk the test that they must be 'in the same right and between the same parties, standing in the same capacity.' "

Judge Peck gave short shrift to UBS's contention that *SemCrude* interpreted mutuality too narrowly and that it failed to credit the "numerous decisions" in which courts "did not enforce alleged contractual triangular setoffs because they found as a factual matter that there was no such contract." This argument, the judge wrote, "does not withstand careful examination," and the court in *SemCrude* correctly determined that triangular setoff was never permitted under the Bankruptcy Code. Courts that have predicated the legitimacy of triangular setoff on *Berger Steel*, Judge Peck explained, have done nothing more than engage in a misguided game of "whisper down the lane."

Given his ruling in *Swedbank* (by then affirmed by the district court), Judge Peck concluded that UBS's reliance on the safe-harbor protections of the Bankruptcy Code as authority for triangular setoff was misplaced. The safe harbors speak to rights that actually exist under other provisions of the Bankruptcy Code, he emphasized. Moreover, Judge Peck noted, in its affirmance in *Swedbank*, the district court found it "significant" that "there is no mention in the legislative history that the Safe Harbor Provisions were intended to eliminate the mutuality requirement." It is for Congress, not the bankruptcy court, "to clearly delineate any exception to strict mutuality in the case of triangular setoff," the judge concluded, and "Congress has not yet done so."

OUTLOOK

Taken together, *Lehman Bros.*, *Swedbank*, and *SemCrude* mark a clear trend against the availability of triangular setoffs in bankruptcy. In the absence of further developments in the appellate courts or subsequent case law at the bankruptcy-court level, cross-affiliate setoff without mutuality would appear to be impermissible in the two most popular business bankruptcy jurisdictions in the U.S.—the Southern District of New York and the District of Delaware. As such, financial-contract participants seeking multilateral netting would be well advised to consider cross-collateralization under master netting agreements or other alternatives to contractual triangular-setoff provisions.

A version of this article appeared in the October 26, 2011, edition of *Bankruptcy Law360*. It has been reprinted here with permission.

SECOND CIRCUIT SETTLES THE MEANING OF SETTLEMENT PAYMENTS UNDER SECTION 546(e) OF THE BANKRUPTCY CODE

Daniel J. Merrett and John H. Chase

The powers and protections granted to a bankruptcy trustee or chapter 11 debtor in possession under the Bankruptcy Code are numerous and far-reaching. From the automatic stay of creditor collection actions afforded by section 362 of the Bankruptcy Code to the unilateral power to assume or reject contracts under section 365 to the avoidance powers of chapter 5, the filing of a petition for relief under the Bankruptcy Code shifts the balance of power in many respects to the debtor.

Concerned by the potential for systemic risk to financial markets, however, Congress enacted a number of curbs on these key bankruptcy powers to the extent they might otherwise affect transactions involving certain financial instruments and securities. One of these "safe harbors" relating to (among other things) certain settlement payments under securities contracts can be found in section 546(e) of the Bankruptcy Code. The scope of protection afforded by section 546(e) has been the subject of considerable discussion and debate in the courts. In particular, some courts have attempted to reconcile a conflict between the apparently plain meaning of section 546(e) and Congress's stated intent in enacting it, yielding divergent results. Implicitly overruling a recent New York bankruptcy court's decision in *In re MacMenamin's Grill Ltd.*, 450 B.R. 414 (Bankr. S.D.N.Y. 2011), the Second Circuit Court of Appeals in *In re Enron Creditors Recovery Corp. v. Alfa, S.A.B. de C.V.*, 651 F.3d 329 (2d Cir. 2011), ruled that section 546(e) does, in fact, mean what it says.

THE SAFE HARBOR OF SECTION 546(e) OF THE BANKRUPTCY CODE

Section 546 of the Bankruptcy Code imposes several limitations on a trustee's avoidance powers. Several subsections of section 546, including section 546(e), provide safe-harbor protections against avoidance of transfers related to securities transactions that are complementary to the safe-harbor provisions found elsewhere in the Bankruptcy Code. Section 546(e) provides in part that:

> the trustee may not avoid a transfer that is a . . . settlement payment as defined in section 101 or 741 of this title, made by or to (or for the benefit of) a . . . financial institution . . . or that is a transfer made by or to (or for the benefit of) a . . . financial institution . . . in connection with a securities contract, as defined in section 741(7), . . . that is made before the commencement of the case, except under section 548(a)(1)(A) of this title.

Thus, under section 546(e), the trustee may not avoid, among other things, transfers to or by financial institutions, if such transfers are settlement payments made in connection with a securities contract, unless the transfer was made with actual fraudulent intent to hinder, delay, or defraud creditors under section 548(a)(1)(A) of the Bankruptcy Code.

The term "settlement payment" is defined in both sections 101 and 741 of the Bankruptcy Code, with only minor variations between the definitions. A "settlement payment" is defined in section 741(8), somewhat circularly, as "a preliminary settlement payment, a partial settlement payment, an interim settlement payment, a settlement payment on account, a final settlement payment, or any other similar payment commonly used in the securities trade." The definition of the term in section 101(51A) varies slightly by adding the phrase "net settlement payment" and substituting "forward contract trade" for "securities trade." Section 741(7) of the Bankruptcy Code defines a "securities contract" as, among other things, "a contract for the purchase, sale, or loan of a security," and section 101(49) defines "security" to include "stock."

Although the plain language of section 546(e) and its defined terms do not clearly restrict application of the safe harbor to publicly traded securities, the legislative history of section 546(e) appears to tell a different story. Section 546(e) was enacted in 1982 (originally as subsection 546(d)) and altered by, among other amendments, the Financial Netting Improvements Act of 2006 ("FNIA"), to include within its protections transfers made in connection with securities contracts. The legislative history of section 546(e) indicates that it was enacted "to minimize the displacement caused in the commodities and securities markets in the event [of] a major bankruptcy affecting those industries" and "to prevent the

'ripple effect' created by the insolvency of one commodity or security firm from spreading to other firms and possibly threatening the collapse of the affected industry.' " Some tension therefore exists between the broad coverage of section 546(e), which appears to include within its safe harbor all forms of settlement payments in connection with securities contracts, and congressional intent underlying the enactment of the provision, which can be interpreted to limit the scope of the protections to transactions that could imperil the stability of financial markets.

IN RE MACMENAMIN'S GRILL

New Rochelle, New York, bar and grill MacMenamin's Grill (the "Debtor") was the target of what the bankruptcy court later described as "a classic LBO, although writ small." In 2007, the Debtor's three shareholders, each holding 31 percent of the Debtor's issued and outstanding common stock, entered into an agreement to sell their stock to the Debtor. To finance the purchase, the Debtor borrowed $1.15 million from a bank, granting the bank a security interest in substantially all of its assets. At the closing of the transaction, the lender bank wire-transferred each shareholder's share of the loan proceeds directly to the shareholder's bank account.

The Debtor filed a chapter 11 petition in New York in November 2008. Thereafter, a chapter 11 trustee appointed in the case commenced an adversary proceeding against the shareholders and the bank seeking to avoid, among other things, the stock purchase as a constructively fraudulent transfer under section 548 of the Bankruptcy Code and the New York Debtor and Creditor Law, as incorporated by section 544 of the Bankruptcy Code. The shareholders and the bank moved for summary judgment on the ground that the transaction was protected from avoidance by section 546(e) of the Bankruptcy Code.

The trustee made several concessions with respect to the availability of section 546(e)'s safe harbor. The trustee did not dispute that the banks involved were "financial institutions" within the meaning of that subsection and that, generally, an agreement to purchase stock is a "securities contract," whether or not the stock is publicly traded. The trustee also acknowledged that a payment on account of such a purchase is a "settlement payment" notwithstanding the Bankruptcy Code's "frustratingly self-referential" definition of the term. The issue thus presented to the court was whether the safe harbor of section 546(e) would protect an otherwise qualifying private sale of stock in the absence of evidence that avoidance of the transfer would affect securities markets in any way.

As a threshold matter, the court disagreed with a number of courts that have held that the addition of the phrase "or any other similar payment commonly used in the securities trade" to section 741(8)'s definition of "settlement payment" by the FNIA somehow restricts the definition of "settlement payment" to payments involving the securities trade. To the contrary, the court found that the amendment was added to broaden, and not restrict, the scope of the "settlement payment" definition.

The court concluded that the plain meaning of the terms of section 546(e)—as amended by the FNIA—provided no basis to limit the scope of the safe harbor to those transactions that have at least some prospect of impacting financial markets. The court thus proceeded to consider those arguments for applying one or more exceptions to the "plain meaning" rule of statutory interpretation.

The court acknowledged several Southern District of New York decisions identifying multiple factors that may be relevant to whether a transaction should be denied the protections of section 546(e) of the Bankruptcy Code, notwithstanding its plain meaning. At the same time, the court recognized that a number of courts, including several circuit courts of appeal (other than the Second Circuit), had concluded that they were constrained by the plain meaning of section 546(e) to enforce it according to its terms.

Ultimately, the bankruptcy court was unable to ignore what it considered to be Congress's clear intent against unrestricted access to the safe harbor for purely private transactions. Quoting the U.S. Supreme Court's decision in *United States v. Ron Pair Enterprises*, 489 U.S. 235 (1989), the court concluded that it was authorized to stray beyond the language of section 546(e) because literal application of its plain terms would " 'produce a result demonstrably at odds with the intention of its drafters.' "

The court determined that the textual context of key defined terms upon which section 546(e) relies opened the door to consultation of the relevant (and, in its view, dispositive) legislative history. The court noted that section 546(e) draws its definitions from sections 741 and 761 of the Bankruptcy Code, provisions that deal with the liquidation of stockbrokers and commodity brokers, respectively. Given the context of these definitions and, in some cases, their ambiguity in isolation, the court deemed it appropriate to refer to the legislative history of section 546(e) as a means of divining congressional intent.

Once the court decided to consult the legislative history behind section 546(e), its holding became somewhat predictable. The court denied the former shareholders the protections of section 546(e)'s safe harbor because of the "clear and consistent" legislative history to the effect that the purpose of section 546(e)'s safe harbor is to protect financial markets. The shareholders' private stock transaction posed no risk to the financial markets and therefore did not qualify for section 546(e)'s safe harbor.

ENRON CREDITORS RECOVERY CORP.

Barely two months afterward, the Second Circuit Court of Appeals issued an opinion in *Enron Creditors Recovery Corp. v. Alfa, S.A.B. de C.V.* (*In re Enron Creditors Recovery Corp.*), 651 F.3d 329 (2d Cir. 2011), that has had the effect of overruling *MacMenamin's Grill*.

Prior to filing for chapter 11 on December 2, 2001, in New York, Enron paid more than $1.1 billion to retire certain of its unmatured, unsecured, and uncertified commercial paper at an accrued par value (original purchase price plus interest) significantly higher than its actual market value. Enron later sought to avoid the redemption payments in bankruptcy court as preferential transfers under section 547(b) of the Bankruptcy Code and constructive fraudulent transfers under section 548(a)(1)(B) of the Bankruptcy Code.

The transferees of the payments filed for summary judgment, arguing that the payments were protected by section 546(e)'s safe harbor. The bankruptcy court denied the motion, concluding that the definition of "settlement payments" in section 741(8) of the Bankruptcy Code includes only payments made to buy or sell securities and not payments to retire debt and that Enron's payments were therefore not protected by the safe harbor. The district court reversed, and Enron appealed to the Second Circuit Court of Appeals.

The Second Circuit's Ruling

Enron argued that the redemption payments were not "settlement payments" under section 546(e) of the Bankruptcy Code because: (i) the payments were not "commonly used in the securities trade," as required by the definition of "settlement payment" in section 741(8) of the Bankruptcy Code; (ii) the redemption payments were made to retire debt and not to acquire title to commercial paper, meaning no title to the securities changed hands, as required for a transaction to be considered a "settlement payment"; and (iii) the payments did not involve a financial intermediary that took title to the securities, and therefore they did not create the risks to the financial markets that prompted Congress to enact the safe-harbor provisions. Broadly interpreting the plain language of section 546(e), a three-judge panel of the Second Circuit rejected each of Enron's arguments and held that the redemption payments were "settlement payments" entitled to the protection of the safe-harbor provision.

Consistent with *MacMenamin's Grill*, the Second Circuit rejected Enron's argument that the phrase "commonly used in the securities trade" in subsection 741(8)'s definition of "settlement payment" applied to each preceding term, thus limiting the definition of "settlement payment" to transactions that are commonly performed in the securities trade. Applying the "last antecedent" rule of construction, the court held that the phrase "commonly used in the securities trade" modifies only the term immediately preceding it, *i.e.*, "any other similar payment." The phrase, therefore, was intended to be a catchall underscoring the breadth of section 546(e), and not a limitation. The court also expressed concern that adopting Enron's reasoning would require courts in future safe-harbor cases to make factual determinations regarding the commonness of any given transaction, causing uncertainty and unpredictability.

The Second Circuit found no other basis for restricting the scope of section 546(e)'s protections. In particular, the Second Circuit found no support for the requirement that title

to securities must change hands for a payment to qualify as a "settlement payment," and the court refused to read such a requirement into the statute.

In addition, the Second Circuit rejected Enron's argument that the payments at issue were not "settlement payments" because the transaction lacked a financial intermediary that took a beneficial interest in the securities. Citing the legislative history of section 546(e), Enron argued that, absent such a financial intermediary, the transaction did not pose any systemic risk to financial markets and therefore should not benefit from the protections of the safe harbor.

The Second Circuit disagreed, citing to opinions in several other circuits where similar arguments in the context of leveraged buyout transactions were rejected because, regardless of whether a financial intermediary took a beneficial interest in the exchanged securities, undoing settled leveraged buyouts would have a substantial impact on the stability of financial markets. The Second Circuit found that avoiding Enron's debt-retirement payments would have a similarly negative effect on the financial markets. As a result, applying the safe harbor to these payments, the court concluded, would further congressional intent regarding section 546(e).

Dissent

District judge John G. Koeltl, sitting by designation, dissented. In his dissent, Judge Koeltl argued that the majority's expansive reading of the term "settlement payment" and its accompanying legislative intent would bring virtually every transaction involving a debt instrument within the safe harbor of 546(e). Indeed, his prognostication may have hit the mark. One month after *Enron* was decided, a New York bankruptcy court, in *In re Quebecor World (USA) Inc.*, 453 B.R. 201 (Bankr. S.D.N.Y. 2011), examined the application of section 546(e) in the context of a debtor's repurchase and subsequent cancellation of privately placed notes. Relying heavily on *Enron*, the bankruptcy court concluded that courts no longer need: (i) to consider conflicting evidence about usage of the term "settlement payment" within the private-placement sector of the securities industry; or (ii) to decide whether prepetition transfers of value to the defendants should be characterized as a redemption of private-placement notes rather than a repurchase. Instead, the court ruled, any transaction involving a transfer of cash to complete a securities transaction is a "settlement payment" and thus cannot be avoided.

OUTLOOK

Enron and *MacMenamin's Grill* demonstrate the exacting scrutiny with which courts are increasingly called upon to construe the Bankruptcy Code's financial-contract provisions in an innovative and quickly evolving global financial-products industry. The quick pace of industry change can be expected to continue.

In *Enron*, the Second Circuit joined the Third, Sixth, and Eighth Circuits in ruling that section 546(e) and the Bankruptcy Code's definition of "settlement payment" should be broadly interpreted to cover a wide array of financial transactions. *See In re Plassein Int'l Corp.*, 590 F.3d 252 (3rd Cir. 2009); *In re QSI Holdings, Inc.*, 571 F.3d 545 (6th Cir. 2009); *Contemporary Indus. Corp. v. Frost*, 564 F.3d 981 (8th Cir. 2009). Thus, the ruling does much to clarify the scope of section 546(e)'s protections by resolving the tension between the plain language of the provision and the related legislative history.

As predicted by the dissent in *Enron* and demonstrated in *Quebecor*, *Enron* may make it substantially more difficult for plaintiffs to maintain a viable cause of action for avoidance of many transactions involving the prepetition transfer of a security. Still, although *Enron* construes the safe harbor in section 546(e) to protect transactions involving a far-reaching list of debt and equity instruments, the ruling's impact is hardly unlimited. For example, the decision should have no effect on preference litigation involving trade creditors because, by definition, the term "security" excludes "debt or evidence of indebtedness for goods sold and delivered or services rendered."

FIRST IMPRESSIONS: PREPETITION SEVERANCE PAY ENTITLED TO PRIORITY UNDER SECTION 507(a)(4)

David G. Marks

In the first circuit-level opinion on the issue, the Fourth Circuit Court of Appeals in *Matson v. Alarcon*, 651 F.3d 404 (4th Cir. 2011), held that, for purposes of establishing priority under section 507(a)(4) of the Bankruptcy Code, an employee's severance pay was "earned" entirely upon termination of employment, even though the severance amount was determined by the employee's length of service with the employer.

SECTION 507(a)(4)

Section 507 sets forth the categories of claims that are entitled to priority treatment under the Bankruptcy Code. Under section 507(a)(4), a fourth priority is given (with emphasis added) to "allowed unsecured claims, but only to the extent of [$11,725] for each individual . . . *earned within 180 days* before the date of the filing of the petition . . . for . . . wages, salaries, or commissions, including vacation, severance, and sick leave pay *earned* by an individual."

Priority for wages earned prepetition has been a feature of U.S. bankruptcy law since the Bankruptcy Act's original enactment in 1898. This priority protects workers from hardship imposed by an employer's bankruptcy filing and encourages employees to remain working for a company despite its financial distress. With these same concerns in mind, courts often grant debtors' "first day" motions to pay prepetition wage claims at the inception of a chapter 11 case. Although there is no explicit statutory authority for paying such claims prior to the confirmation of a chapter 11 plan, some courts, invoking the "doctrine of necessity" or otherwise, have justified the payments in light of the priority afforded to the underlying claims by section 507(a)(4).

MATSON V. ALARCON

In 2004, LandAmerica Financial Group, Inc. ("LandAmerica"), which was at one time the third-largest title insurance group in the U.S., established a "severance benefits plan" for its employees. An employee would become a participant in the plan, which was amended in 2008, if he or she was terminated without cause after having signed a severance agreement and, upon termination, a release. However, an employee would not qualify as a participant if the employee was rehired within 30 days or offered an equivalent position with the company within a 50-mile radius, or if the termination was due to the employee's death or resignation.

A participant in the severance benefits plan was entitled to compensation equal to the employee's weekly salary for a specified number of weeks. The number of weeks was calculated on the basis of the employee's length of employment with LandAmerica. Thus, for example, an eligible participant who worked for more than one year but fewer than two years would receive two weeks of pay as severance, while an employee who worked more than eight years but fewer than 10 years would receive six weeks of pay. LandAmerica's board of directors retained the unilateral right to modify or eliminate the severance benefits plan at any time prior to an employee's termination.

Between August and November 2008, more than 100 employees were terminated by LandAmerica and became participants in the severance benefits plan (the "Claimants"). On November 26, 2008, LandAmerica filed for chapter 11 protection in Virginia. The Claimants filed proofs of claim for their severance compensation, taking the position that their claims were entitled to priority treatment under section 507(a)(4) because the underlying severance benefits were "earned" when the employees were terminated in the months leading up to the bankruptcy.

LandAmerica's chapter 11 plan created a liquidating trust. The liquidating trustee acknowledged that the Claimants were owed the amounts claimed as severance, but it argued that the Claimants "earned" their severance compensation over the entire course of their employment and were therefore entitled to priority status for only the (relatively small) portion of their Claims "earned" within the 180 days before the bankruptcy. To calculate the amount entitled to priority, the trustee prorated each employee's severance benefits across all the days of his or her employment. Then, the trustee multiplied that daily rate by the number of days the employee worked within the 180 days prior to the bankruptcy. According to the trustee, only this smaller portion of the total severance benefits was entitled to priority status because only that portion was "earned" within the 180-day period.

THE BANKRUPTCY COURT'S DECISION

The bankruptcy court rejected the trustee's proposed calculation, holding instead that the severance involved was "earned" in its entirety at the moment the employees were terminated and became eligible participants in the severance benefits plan. In reaching this conclusion, the court focused on what it characterized as the "absurd result" of the trustee's proposed calculation: "The result of [the trustee's] calculation is that terminated employees who worked many years at the company will receive a much smaller percentage of their severance package as a priority payment than will employees who worked for only a short period of time." According to the court, Congress could not have intended the "inequitable result" of punishing long-term employees because they worked for a longer time period.

The bankruptcy court then examined the purpose of severance pay, explaining that severance is "earned" on the day the employee "shows up to work and is terminated by the company without cause." The purpose of severance pay, the court noted, is to compensate employees for the economic disruption following termination of employment. An employee's length of service is simply a useful tool for measuring the scope of that disruption. According to the bankruptcy court, "It does not matter what factors go into an employee's severance package, only what the severance package is during that 180-day period."

Finally, the bankruptcy court decided that case law regarding the administrative priority of postpetition severance payments under section 503(b)(1)(A) is not relevant because the purpose and language of the provision differ significantly from those of section 507(a)(4). Section 503(b)(1)(A), the court explained, grants administrative-expense priority to claims for "services rendered" postpetition and is traditionally construed narrowly. By contrast, the court said, section 507(a)(4) covers severance benefits "earned" prepetition and is traditionally construed liberally.

Because the issue was an unsettled one of first impression in the circuit, the bankruptcy court certified a direct appeal to the Fourth Circuit Court of Appeals.

THE FOURTH CIRCUIT'S DECISION

A three-judge panel of the Fourth Circuit affirmed the ruling below. In doing so, however, the court focused on different facts in reaching the same conclusion. Initially, the court pointed out that the triggering event permitting employees to "earn" severance benefits was entirely outside the employees' control. Unlike traditional wages, the entitlement to severance pay was triggered by the *employer's* decision to terminate the employment relationship, not by the employee's rendering of services. Since LandAmerica's decision to terminate the Claimants' employment occurred within the applicable 180-day window, the Fourth Circuit reasoned, the severance pay was "earned" in its entirety within the time period entitled to priority.

The Fourth Circuit found further support for its position in the fact that the board of directors could unilaterally eliminate the severance plan before the employees became entitled to payments. Under the trustee's "accrual" position, employees "earned" their severance benefits over the course of their employment. Yet, if the board had decided to eliminate the severance plan before the employees were terminated, the employees would have been "earning" severance benefits to which they would ultimately have no entitlement. The Fourth Circuit found this interpretation to be untenable.

Finally, the Fourth Circuit agreed with the bankruptcy court's reasoning that none of the cases regarding administrative priority under section 503(b)(1)(A) was relevant in analyzing section 507(a)(4). Just as the bankruptcy court had pointed out, the Fourth Circuit contrasted section 507(a)(4)'s reference to "earned" severance payments with the reference to "services provided" in section 503(b)(1)(A). On the basis of this difference, the court of appeals concluded that case law from other circuits holding that severance compensation based on length of employment has administrative priority only to the extent the compensation was based on services provided postpetition does not apply to section 507(a)(4).

OUTLOOK

Matson clarifies the application of section 507(a)(4) to severance benefits earned as a result of a prepetition termination. Any ramifications of the reasoning articulated by the Fourth Circuit on whether severance payments should be entitled to priority when a termination occurs postpetition remain to be seen.

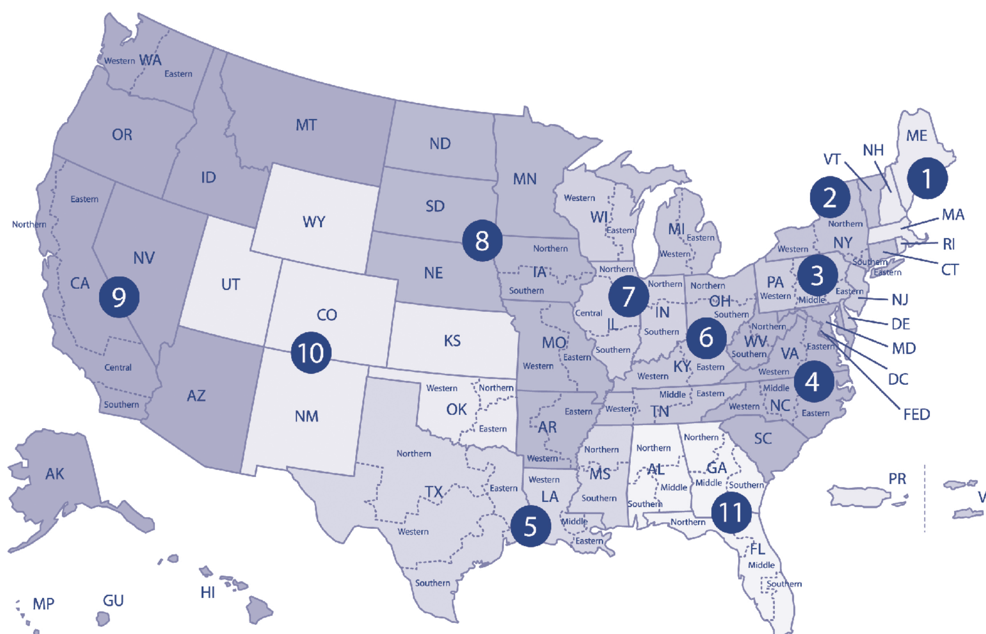
THE U.S. FEDERAL JUDICIARY

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

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

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

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



REVISED BANKRUPTCY RULE 2019 EFFECTIVE

Highly anticipated changes to Rule 2019 of the Federal Rules of Bankruptcy Procedure became effective on December 1, 2011. Rule 2019 mandates certain disclosures concerning the economic interests of creditors and interest holders in bankruptcy cases. Whether these disclosure requirements apply to ad hoc, or informal, creditor groups has been the subject of vigorous dispute in the bankruptcy courts during the last four years, with courts lining up on both sides of the divide in roughly equal numbers. These disputes prompted the Advisory Committee on Bankruptcy Rules to conduct a review of proposed revisions to the Rule (including extensive public commentary).

The Rules Committee ultimately recommended a substantially amended Rule 2019 on May 27, 2010, designed to accommodate the evolving constituencies and controversies in modern bankruptcy cases by, among other things, expanding the scope of the disclosure requirements to encompass more parties and types of information. The Advisory Committee's recommendations were approved by the Standing Committee on Rules of Practice and Procedure and the Judicial Conference later in 2010. The U.S. Supreme Court approved amended Rule 2019 on April 26, 2011. In the absence of congressional action, revised Rule 2019 became effective on December 1, 2011.

Amended Rule 2019 provides that:

> [i]n a chapter 9 or 11 case, a verified statement setting forth the information specified in subdivision (c) of this rule shall be filed by every group or committee that consists of or represents, and every entity that represents, multiple creditors or equity security holders that are (A) acting in concert to advance their common interests, and (B) not composed entirely of affiliates or insiders of one another.

Among other things, subdivision (c) of Rule 2019 requires that name and address information must be provided with respect to each "entity" and "each member of a group or committee," along with "the nature and amount of each disclosable economic interest held in relation to the debtor as of the date the entity was employed or the group or committee was formed." Amended Rule 2019 defines "disclosable economic interest" as "any claim, interest, pledge, lien, option, participation, derivative instrument, or any other right or derivative right granting the holder an economic interest that is affected by the value, acquisition, or disposition of a claim or interest."

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

If you would like to receive a complimentary subscription to *Business Restructuring Review*, send your name and address to:

Jones Day
222 East 41st Street
New York, New York
10017-6702
Attn.: Mark G. Douglas, Esq.

Alternatively, you may call (212) 326-3847 or contact us by email at mgdouglas@jonesday.com.

Three-ring binders are also available to readers of *Business Restructuring Review*. To obtain a binder free of charge, send an email message requesting one to mgdouglas@jonesday.com.

Business Restructuring Review provides general information that should not be viewed or utilized as legal advice to be applied to fact-specific situations.

JONES DAY HAS OFFICES IN:

ATLANTA
BEIJING
BOSTON
BRUSSELS
CHICAGO
CLEVELAND
COLUMBUS
DALLAS
DUBAI
FRANKFURT
HONG KONG
HOUSTON
IRVINE
LONDON
LOS ANGELES
MADRID
MEXICO CITY
MILAN
MOSCOW
MUNICH
NEW DELHI
NEW YORK
PARIS
PITTSBURGH
RIYADH
SAN DIEGO
SAN FRANCISCO
SÃO PAULO
SHANGHAI
SILICON VALLEY
SINGAPORE
SYDNEY
TAIPEI
TOKYO
WASHINGTON

© Jones Day 2011. All rights reserved.