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The Year in Bankruptcy, Part II

CHARLES M. OELLERMANN AND MARK G. DOUGLAS

The authors review the past year's bankruptcy developments.

TOP 10 BANKRUPTCIES OF 2011

The Top 10 List in 2010 was dominated by bank or financial services companies that filed for bankruptcy protection as primarily shell corporations for the purpose of liquidating their negligible remaining assets. Not so in 2011. The Top 10 List for 2011 was populated principally with a wide variety of operating companies ranging from commodities brokers to airlines to booksellers to shipping companies, each of which checked into bankruptcy with more than $1 billion in assets (according to the calculation customarily performed in assessing the asset values of public-company bankruptcy cases, which looks to the most recent public financial statements filed by the companies before filing for bankruptcy).

Global financial derivatives and commodities broker *MF Global Holdings Ltd.* ("MF Global") rang the bell for 2011 when it filed for Chapter 11 protection on October 31, 2011, in New York with $40.5 billion in assets. The first U.S. financial casualty of the European debt crisis, MF Global bought up approximately $6.3 billion in European debt during late 2010 and 2011, gambling that issuing countries such as Italy, Portugal, Spain, and Ireland would soon recover or be bailed out by the EU. MF Global's descent into bankruptcy at the end of October came after a week when

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investors fled the company and credit-ratings agencies cut ratings on the firm to junk status.

The bankruptcy filing came just as U.S. regulators were considering how stringently to implement the Dodd-Frank Act's Volcker Rule and as Congress considered whether to revise the law's procedures for seizing and winding down failed firms. Although relatively small in comparison to the largest U.S. firms, MF Global will be a test case for dealing with what the law deems to be "systemically important financial institutions," or SIFIs. The bankruptcy filing was a humbling blow for MF Global's chief executive, Jon S. Corzine, who took the reins of the firm early in 2010 after a decade as a U.S. senator and New Jersey governor and was summoned to testify before the U.S. Congress concerning the whereabouts of as much as $1.2 billion in customer funds that may have been improperly rehypothecated and seized by commodities-contract counterparties. MF Global's bankruptcy filing is the eighth largest in U.S. history.

Cruising in at No. 2 on the Top 10 List for 2011 was *AMR Corporation*, the parent company of *American Airlines, Inc.* ("American"). A Fort Worth, Texas-based company with 78,250 employees that was founded in 1934, American was the last major U.S. airline to resist filing for Chapter 11 in an effort to shed a heavy debt load and reduce labor costs by renegotiating collective bargaining agreements.

American had been negotiating new contracts with its unions, but talks stalled early in November 2011, when American's pilots' union refused to send a proposal to its members for a vote. Long the biggest airline in the U.S., American began to lose ground in recent years as low-cost carriers such as Southwest Airlines grew in prominence.

As competition intensified, American responded by borrowing more and more, eventually pledging nearly all of its assets and leaving itself heavily indebted. American's principal competitors, including Delta Air Lines ("Delta") and UAL Corporation's United Airlines ("United"), filed for bankruptcy, shedding billions of dollars in costs and renegotiating labor contracts. Both also merged with competitors to gain scale, with Delta pairing off with Northwest and United with Continental. The deals allowed those airlines to regain profitability.

American filed for Chapter 11 protection in New York on November

29, 2011, with just over $25 billion in assets and nearly $30 billion in debt. American's bankruptcy is the 24th largest ever and the second-largest airline filing, behind that of United in 2002.

Dynegy Holdings, LLC ("Dynegy Holdings"), surged to the No. 3 position on the Top 10 List for 2011. Houston, Texas-based Dynegy Holdings engages in the production and wholesaling of electric energy, capacity, and ancillary services in the U.S. It also trades in natural-gas and coal positions. Dynegy Holdings' parent, Dynegy Inc. (which did not file for bankruptcy), is the third-largest independent U.S. power producer.
Dynegy Holdings reported a net loss of $234 million for 2010 after a continuing slump in the U.S. economy drove down electricity prices. The power company missed a $43.8 million interest payment on November 1, 2011, and later concluded a preliminary deal with bondholders to restructure approximately $4 billion in debt to be consummated pursuant to a prenegotiated Chapter 11 plan. Dynegy Holdings and four affiliates filed for Chapter 11 protection in New York on November 7, 2011, with $9.9 billion in assets.

PMI Group, Inc. ("PMI"), a Walnut Creek, California-based company that, through its subsidiary, PMI Mortgage Insurance Co., provides residential mortgage insurance products to mortgage lenders and investors in the U.S., filed the fourth-largest public bankruptcy case in 2011. The company was forced into bankruptcy when a judge upheld a takeover by Arizona state regulators of PMI's primary mortgage insurance divisions. PMI filed for Chapter 11 protection in Delaware on November 23, 2011, with $4.2 billion in assets (as reflected in its recent public securities filings), although the company listed no more than $100 million to $500 million in assets on its bankruptcy petition.

Spot No. 5 on the Top 10 List for 2011 belonged to Miamisburg, Ohio-based *NewPage Corporation* ("NewPage"), a leading producer of coated paper in North America, with 8,000 employees, 10 paper mills, and 20 paper machines in the U.S. and Canada. NewPage, its corporate parent NewPage Group, and 12 affiliates filed for Chapter 11 protection in Delaware on September 7, 2011, with $3.5 billion in assets.

Albuquerque, New Mexico-based *First State Bancorporation* ("First State") was deposited in the No. 6 position on the Top 10 List for 2011

when it filed a Chapter 7 petition on April 27, 2011, in New Mexico. Founded in 1922, First State operated as the holding company for *First Community Bank*, which operated 40 branch offices in New Mexico and Arizona until it was seized by federal regulators on January 28, 2011, and was later sold to U.S. Bank N.A. First State last publicly reported approximately $3.2 billion in assets, although it listed no more than $1.1 million in assets in its Chapter 7 filing.

Evansville, Indiana-based bank holding company *Integra Bank Corporation* ("IBC") cashed out in the No. 7 position for 2011 when it filed a Chapter 7 petition on July 30, 2011, in Indiana. The Chapter 7 filing followed the July 29, 2011, closure by the Office of the Comptroller of the Currency of IBC subsidiary Integra Bank N.A., which previously operated 67 banking centers and 116 ATMs at locations in Illinois, Indiana, Kentucky, and Ohio. IBC's assets were once pegged at $2.42 billion, although the Chapter 7 petition listed no more than $8.2 million in assets at the time of the bankruptcy filing.

General Maritime Corporation ("General Maritime") navigated its way to the No. 8 berth on the Top 10 List for 2011 when it filed for Chapter 11 protection in New York on November 17, 2011, with $1.78 billion in assets. A New York City-based company with 1,180 employees, General Maritime is a leading provider of international seaborne energy transportation services, owning and operating one of the largest crude-oil tanker fleets in the world, principally in the Caribbean, South and Central America, the U.S., western Africa, and the North Sea. The company sought bankruptcy protection from creditors amid low freight rates and a surplus of ships. General Maritime listed assets of $1.71 billion and debt of $1.41 billion in its Chapter 11 petition. The company joins other troubled shipping companies in bankruptcy, including Korea Line Corp., Korea's second-largest operator of dry-bulk ships, and time-chartered operators Britannia Bulk Plc, Armada (Singapore) Pte Ltd., and Transfield ER Cape.

Borders Group, Inc. ("Borders"), closed the book on the No. 9 spot on the Top 10 List for 2011 when it filed for Chapter 11 protection in New York on February 16, 2011, with $1.4 billion in assets after failing to secure agreements with publishers and other vendors to restructure its $1.3 billion in debt. At the time of the bankruptcy filing, Ann Arbor, Michigan-based

Borders had 642 stores across the U.S. and approximately 19,500 full- and part-time employees, principally in its Borders and Waldenbooks stores.

Borders began liquidating 226 of its stores in the U.S. shortly after filing for bankruptcy. Despite an offer from the private-equity firm Najafi Companies (which was later withdrawn), Borders was unable to find a buyer before its July 17, 2011, bidding deadline and consequently began liquidating its remaining retail outlets, with the last remaining stores closing their doors in September 2011. On October 14, 2011, the Borders.com Web site was automatically redirected to the Barnes & Noble Web site, effectively shutting down Borders.com entirely. The bankruptcy court confirmed a liquidating Chapter 11 plan for Borders on December 20, 2011. The pot plan will pay unsecured creditors from four to 10 cents on the dollar.

Satellite and terrestrial telecommunications company *TerreStar Corporation* ("TS Corp.") crash-landed into the final spot on the Top 10 List for 2011 when it filed for Chapter 11 protection in New York on February 16, 2011, with $1.4 billion in assets. Through its subsidiaries TerreStar Networks, Inc. ("TS Networks"), and TerreStar Global Ltd., TS Corp. was created to operate a wireless communications system to provide mobile coverage in the U.S. and Canada using integrated satellite terrestrial smartphones and to construct and operate a Pan-European integrated mobile satellite and terrestrial communications network to address public safety and disaster relief, as well as to provide rural broadband connectivity. TS Corp.'s TerreStar-1 satellite was launched on July 1, 2009. With a mass of 6,910 kg, it has been deemed the largest commercial telecommunications satellite ever launched.

TS Networks filed a prepackaged Chapter 11 case on October 19, 2010, and later obtained confirmation of a plan whereby the secured creditors exchanged $940 million of debt for approximately 97 percent of the company. TS Networks is now owned by Dish Network, which purchased the company from TS Corp. in August 2011 for $1.35 billion. A hearing to consider confirmation of TS Corp.'s Chapter 11 plan is currently scheduled for February 13, 2012.

Among the most notable bankruptcies failing to grace 2011's Top 10 List were the following:

- *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). Jefferson County recently supplanted Orange County, California, as the largest municipal debtor in U.S. history when it filed for Chapter 9 protection on November 9, 2011. The county had entered into a series of complex bond-swap transactions after incurring $3.2 billion in debt to finance a new sewer system.
- Privately owned *MSR Resort Golf Course LLC* (also known as PGA West & Citrus Club), the owner of the Grand Wailea Resort Hotel & Spa in Maui, Hawaii, and 30 other units linked to luxury hotels and golf courses, which filed for Chapter 11 protection on February 1, 2011, in New York with $2.2 billion in assets after lenders seized control of the resorts following a default.
- Newspaper publisher *Lee Enterprises, Inc.* ("Lee Enterprises"), which filed for Chapter 11 protection on December 12, 2011, in Delaware with $1.16 billion in assets. A Davenport, Iowa-based company with 6,200 employees, Lee Enterprises publishes 49 daily newspapers, including the *St. Louis Post-Dispatch*, and 300 weekly newspapers and specialty publications in 23 states. Founded in 1890 in Ottumwa, Iowa, by A.W. Lee, the company included on its staff Mark Twain, Willa Cather, and Thornton Wilder. Lee Enterprises is the third-largest newspaper publisher to file for bankruptcy, behind the MediaNews Group in 2010 and the Tribune Company in 2008, as readership and advertising revenue continue to dwindle across the industry.
- Denver, Colorado-based *Delta Petroleum Corp.*, an oil and natural-gas explorer and developer whose largest shareholder is billionaire investor Kirk Kerkorian. It filed for Chapter 11 protection on December 15, 2011, in Delaware with $1.024 billion in assets after failing to restructure its debts or find a buyer.
- *Harry & David Holdings, Inc.* ("Harry & David"), the Medford, Oregon-based multichannel specialty retailer and producer of branded premium gift-quality fruit, gourmet food products, and other gifts. Recession-weary shoppers, stiff competition from big-box retailers, and an overleveraged balance sheet prompted the company to reach

out to creditors and investors for help. The upshot was a prenegotiated Chapter 11 filing on March 28, 2011, in Delaware and confirmation on August 29, 2011, of a Chapter 11 plan converting all of Harry & David's approximately $200 million of outstanding public notes into equity of the reorganized company.

- *Solyndra LLC* ("Solyndra"), a privately held manufacturer of solar power systems that filed for Chapter 11 protection on September 6, 2011, in Delaware after ceasing operations and firing its 1,100 full- and part-time employees. As the impetus for the bankruptcy filing, Solyndra cited competitive challenges exacerbated by "a global over-supply of solar panels and a severe compression of prices that in part resulted from uncertainty in governmental incentive programs in Europe and the decline in credit markets that finance solar systems." An investigation was subsequently launched into the propriety of $535 million in loan guarantees given to Solyndra by the U.S. Department of Energy, allegedly at the behest of the Obama administration. Solyndra was one of four U.S. solar companies to file for bankruptcy in 2011 in response to increased global competition, massive oversupply in 2010 and 2011, and lower government subsidies in the U.S. and Europe. Among the other companies was *Evergreen Solar, Inc.*, which filed for Chapter 11 protection on August 15, 2011, in Delaware with nearly $490 million in debt to auction off its assets.
- Privately held Major League Baseball franchise *Los Angeles Dodgers LLC* (the "Dodgers"), which filed for Chapter 11 protection on June 27, 2011, in Delaware after baseball commissioner Bud Selig rejected a $3 billion television contract with News Corp.'s Fox Sports, purportedly due to concerns that the cash would be diverted to fund Dodgers owner Frank McCourt's "lavish" lifestyle. At the time of the filing, *Forbes* magazine valued the team at $800 million, the third-highest in baseball after the New York Yankees and the Boston Red Sox. The Dodgers was the 12th North American major-league team to file for Chapter 11 bankruptcy protection.
- The Dodgers team was joined in bankruptcy three months later by the National Hockey League's *Dallas Stars LP* (the "Dallas Stars"),

which filed for Chapter 11 protection on September 15, 2011, in Delaware. The bankruptcy court confirmed a prepackaged Chapter 11 plan for the hockey club on November 18, 2011, clearing the way for the sale of the Dallas Stars to Vancouver, British Columbia, businessman Tom Gaglardi for $265 million.

- *Sbarro, Inc.* ("Sbarro"), the "world's leading Italian quick service restaurant concept" and the "largest shopping mall-focused restaurant concept in the world," with a global base of 1,056 restaurants in 41 countries. Sbarro filed for Chapter 11 protection in New York on April 4, 2011, a victim of slashed mall traffic caused by the Great Recession and rising prices for its key ingredients, cheese and flour. On November 17, 2011, Sbarro obtained confirmation of a prenegotiated Chapter 11 plan that converts all of the company's preexisting second-lien debt and senior notes to equity, leaving the company with about $175 million in outstanding debt with extended maturities.
- *Jackson Hewitt Tax Service Inc.* ("Jackson Hewitt"), the second-largest U.S. tax-preparation firm (behind H&R Block), with a nationwide network of 5,800 offices. Jackson Hewitt filed for Chapter 11 protection in Delaware on May 24, 2011, after getting into trouble with lenders as it failed to secure full funding for tax-refund ("refund anticipation") loans, a key covenant in its credit agreement.
- *Friendly's Ice Cream Corp.* ("Friendly's"), an ice cream parlor chain founded in 1935 in Springfield, Massachusetts, which filed for Chapter 11 protection on October 5, 2011, in Delaware, as the sluggish U.S. economy and slow consumer spending claimed another casual-dining operator. Friendly's blamed rising prices for cream and high rents for its problems. It has struggled to cut prices to lure back recession-weary families who prefer cheaper counter-service chains. Friendly's announced plans to close 63 of its weaker restaurants, while the remaining 424 are to remain open. It also revealed that it intends to sell the business to an affiliate of its current owner, Sun Capital Partners Inc. Other regional or national restaurant-chain bankruptcies in 2011 included Chapter 11 filings by *Perkins & Marie Callender's Inc.* and *Real Mex Restaurants, Inc.*

- Secaucus, New Jersey-based retailer *Syms Corp.* ("Syms"), the parent company of *Filene's Basement, LLC* ("Filene's"), which made its final foray into bankruptcy when it filed for Chapter 11 protection on November 2, 2011, in Delaware to liquidate its assets through going-out-of-business sales conducted at the 25 Syms and 21 Filene's locations during the remainder of 2011 and into 2012. Syms acquired Filene's at a bankruptcy auction in 2009 during Filene's second Chapter 11 filing.

NOTABLE EXITS FROM BANKRUPTCY IN 2011

Company	Filing Date (Court)	Conf. Date Effective Date	Assets	Industry	Result
Lehman Brothers Holdings Inc.	09/15/2008 (S.D.N.Y.)	12/06/2011 CD	$691 billion	Financial Services	Liquidation
Motors Liquidation Company (former GM)	06/01/2009 (S.D.N.Y.)	03/29/2011 CD 03/31/2011 ED	$91 billion	Automobiles	Sale
Colonial BancGroup	08/25/2009 (M.D. Ala.)	06/02/2011 CD 06/03/2011 ED	$25.8 billion	Bank Holding Company	Liquidation
Capmark Financial Group Inc.	10/25/2009 (D. Del.)	08/23/2011 CD 09/30/2011 ED	$21 billion	Mortgage Banking	Reorganization
Guaranty Financial Group Inc.	08/27/2009 (N.D. Tex.)	05/11/2011 CD 05/13/2011 ED	$16.8 billion	Bank Holding Company	Liquidation

AmTrust Financial Corporation	11/30/2009 (N.D. Ohio)	11/03/2011 CD 11/30/2011 ED	$11.7 billion	Bank Holding Company	Liquidation
Corus Bankshares	06/15/2010 (N.D. Ill.)	09/27/2011 CD 10/27/2011 ED	$8 billion	Bank Holding Company	Reorganization
R&G Financial Corporation	05/14/2010 (D.P.R.)	12/21/2011 CD 01/03/2012 ED	$7.3 billion	Bank Holding Company	Liquidation
AMCORE Financial, Inc.	08/19/2010 (N.D. Ill.)	12/15/2010 CD 06/22/2011 ED	$3.8 billion	Bank Holding Company	Liquidation
Advanta Corp.	11/08/2009 (D. Del.)	02/11/2011 CD 02/28/2011 ED	$3.6 billion	Bank Holding Company	Liquidation
Midwest Banc Holdings, Inc.	08/20/2010 (N.D. Ill.)	05/31/2011 CD 06/03/2011 ED	$3.4 billion	Bank Holding Company	Liquidation
FairPoint Communications, Inc.	10/26/2009 (S.D.N.Y.)	01/13/2011 CD 01/24/2011 ED	$3.3 billion	Telecom	Reorganization

Tronox Incorporated	01/12/2009 (S.D.N.Y.)	11/30/2010 CD 02/14/2011 ED	$1.7 billion	Chemicals	Reorganization
Innkeepers USA Trust	07/19/2010 (S.D.N.Y.)	06/29/2011 CD 10/27/2011 ED	$1.5 billion	Hotels	Reorganization
Borders Group, Inc.	02/16/2011 (S.D.N.Y.)	12/20/2011 CD 01/12/2012 ED	$1.4 billion	Retail	Liquidation
Chesapeake Corporation	12/29/2008 (E.D. Va.)	03/29/2011 CD 04/18/2011 ED	$1.2 billion	Packaging Prods. Mfg.	Liquidation
Trico Marine Services, Inc. (2010)	08/25/2010 (D. Del.)	08/02/2011 CD 08/11/2011 ED	$1.1 billion	Shipping	Liquidation
Mesa Air Group, Inc.	01/05/2010 (S.D.N.Y.)	01/20/2011 CD 03/01/2011 ED	$959 million	Airline	Reorganization
Local Insight Media Holdings	11/17/2010 (D. Del.)	11/03/2011 CD 11/18/2011 ED	$812 million	Advertising	Reorganization
Sun-Times Media Group, Inc.	03/31/2009 (D. Del.)	08/18/2011 CD 10/01/2011 ED	$792 million	Media	Liquidation

Seahawk Drilling, Inc.	02/11/2011 (S.D. Tex.)	09/28/2011 CD 10/04/2011 ED	$625 million	Oil	Liquidation
RHI Entertainment, Inc.	12/10/2010 (S.D.N.Y.)	03/29/2011 CD 04/04/2011 ED	$587 million	Television	Reorganization
Sbarro, Inc.	04/04/2011 (S.D.N.Y.)	11/17/2011 CD 11/28/2011 ED	$490 million	Restaurant	Reorganization
Satélites Mexicanos, S.A. de C.V. (2010)	04/06/2011 (D. Del.)	05/11/2011 CD 05/26/2011 ED	$439 million	Satellite	Reorganization
Constar International, Inc. (2010)	01/11/2011 (D. Del.)	05/20/2011 CD 06/01/2011 ED	$418 million	Packaging	Reorganization
Perkins & Marie Callender's Inc.	06/13/2011 (D. Del.)	11/01/2011 CD 11/30/2011 ED	$292 million	Restaurant	Reorganization
Harry & David Holdings, Inc.	03/28/2011 (D. Del.)	08/29/2011 CD 09/14/2011 ED	$243 million	Retail	Reorganization

LEGISLATIVE/REGULATORY DEVELOPMENTS

Revised Bankruptcy Rule 2019

Highly anticipated changes to Rule 2019 of the Federal Rules of Bankruptcy Procedure became effective on December 1, 2011. As amended, Rule 2019, which mandates certain disclosures concerning the economic interests of creditors and interest holders in bankruptcy cases, provides:

> In 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."

Proposed Chapter 11 Venue Legislation Introduced

On July 14, 2011, the Chapter 11 Bankruptcy Venue Reform Act of 2011 (H.R. 2533) was introduced to prevent what some lawmakers deem to be forum shopping in Chapter 11 cases. The proposed legislation would limit venue to: (i) the location of the debtor's principal place of business or principal assets in the U.S. during the year immediately preceding the commencement of the Chapter 11 case (or a portion of such one-year period exceeding that of any other district in which the debtor had such place of business or assets); or (ii) the district in which an affiliate of the debtor

that owns, controls, or holds with power to vote more than 50 percent of the outstanding voting securities of such debtor has its Chapter 11 case pending. If it were to become law, this proposed legislation would in many cases prevent a debtor from commencing a Chapter 11 case in its state of incorporation or from "piggybacking" on the filing of a subsidiary. On August 25, 2011, H.R. 2533 was referred to the House Subcommittee on Courts, Commercial and Administrative Law. Initial hearings were conducted before the subcommittee on September 8.

PBGC Regulation on Terminating Plans in Bankruptcy

On June 13, 2011, the Pension Benefit Guaranty Corporation ("PBGC") released a final rule that, in most cases, will reduce the amount of pension benefits guaranteed under the agency's single-employer insurance program when a pension plan is terminated in a bankruptcy case. The rule will also decrease the amount of pension benefits given priority in bankruptcy.

The rule (RIN: 1212-AA98) became effective on July 14, 2011. One consequence of the rule will be that a plan participant's guaranteed benefit can be no greater than the amount of the benefit on the sponsor's bankruptcy petition date. Previously, some employers continued to sponsor plans after filing for bankruptcy, and participants continued to accrue benefits after the petition date. Those post-bankruptcy accruals will no longer be guaranteed by PBGC. Another consequence of the final rule is that PBGC will guarantee only benefits that were "nonforfeitable" on the bankruptcy petition date.

Spanish Parliament Approves Law Amending the 2003 Insolvency Act

On October 10, 2011, the Spanish Parliament approved Law n. 38/2011, which amends the Spanish Insolvency Act of 2003 and applies, with certain exceptions, to insolvency cases commenced after January 1, 2012. The amendment is a comprehensive update of Spanish insolvency regulations applying the Insolvency Act and was implemented in the context of the current EU economic situation with a view toward, among other

things, avoiding the liquidation of insolvent companies by exploring alternatives to insolvency and offering such companies a faster and less expensive solution to their financial crises by means of refinancing agreements.

New German Insolvency Act

The German Parliament enacted a new Insolvency Act on October 26, 2011 (the "Act"). The Act (*das Gesetz zur weiteren Erleichterung der Sanierung von Unternehmen*, broadly translated as "the law for the further facilitation of the rehabilitation of companies") will significantly strengthen the rights of creditors and, to some extent, the rights of debtors in insolvency proceedings. The Act is expected to come into force early in 2012.

NOTABLE BUSINESS BANKRUPTCY DECISIONS OF 2011

Allowance/Disallowance/Priority/Discharge of Claims

When a company that has been designated a responsible party for environmental cleanup costs files for bankruptcy protection, the ramifications of the filing are not limited to a determination of whether the remediation costs are dischargeable claims. Another important issue are the circumstances under which contribution claims asserted by parties co-liable with the debtor will be allowed or disallowed in the bankruptcy case. This question was the subject of rulings handed down in *In re Lyondell Chemical Co.*, 442 B.R. 236 (Bankr. S.D.N.Y. 2011), and *In re Chemtura Corp.*, 443 B.R. 601 (Bankr. S.D.N.Y. 2011). In separate bench rulings, the court held that environmental contribution claims remain contingent, and must be disallowed, until the co-liable creditor actually pays for the cleanup or otherwise expends funds on account of the claim.

Until 2011, no federal circuit court of appeals had ever directly addressed whether a claim for multi-employer pension plan withdrawal liability incurred by a debtor-employer that continues to employ workers during a bankruptcy case is entitled (in whole or in part) to administrative expense status. That changed when the Third Circuit handed down

its ruling in *In re Marcal Paper Mills, Inc.*, 650 F.3d 311 (3d Cir. 2011). Addressing the issue as a matter of first impression, the court of appeals affirmed a district court's reversal of a bankruptcy court order denying administrative expense status to a withdrawal liability claim against a Chapter 11 debtor in possession ("DIP") that continued to participate in a multi-employer defined-benefit pension plan until it sold substantially all of its assets to a successor entity. According to the Third Circuit, because part of the withdrawal liability was attributable to the postpetition time period and the debtor clearly benefited from postpetition labor provided by its unionized employees, the portion of the claim relating to postpetition services constituted a priority administrative expense.

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

Restrictions on a borrower's ability to prepay secured debt are a common feature of bond indentures and credit agreements. Lenders often incorporate "no-call" provisions to prevent borrowers from refinancing or retiring debt prior to maturity. Alternatively, a loan agreement may allow prepayment at the borrower's option, but only upon payment of a "make-whole premium" (commonly referred to as a "prepayment penalty"). The purpose of these prepayment penalties is to compensate the lender for the loss of the remaining stream-of-interest payments it would have received had the borrower paid the debt through maturity.

Courts sometimes disallow lender claims for payment of make-whole premiums in the event of prepayment because those premiums are generally not due under the applicable loan documents during the no-call period. In *In re Trico Marine Services, Inc.*, 450 B.R. 474 (Bankr. D. Del. 2011), the court ruled in an apparent matter of first impression before it

that, following the "substantial majority of courts, a make-whole premium is in the nature of liquidated damages, not interest." This meant that the lenders ended up with an unsecured claim for the make-whole premium rather than a secured claim.

In most cases, when a "responsible" party under the Comprehensive Environmental Response, Compensation, and Liability Act or the Resource Conservation and Recovery Act files for bankruptcy, the cleanup costs incurred by the bankrupt responsible party are discharged. In *In re Mark IV Industries, Inc.*, 459 B.R. 173 (S.D.N.Y. 2011), the district court affirmed a bankruptcy court decision concluding that a state government's right to an injunction compelling a Chapter 11 debtor to conduct an environmental cleanup is not a "claim" subject to discharge under the Bankruptcy Code. The decision continues a trend in court rulings limiting the circumstances under which an environmental cleanup obligation will be treated as a dischargeable bankruptcy claim.

Avoidance Actions/Trustee's Avoidance and Strong-Arm Powers

Lenders can breathe a little easier — for now — in the wake of a Florida district court decision in 2011 quashing the much discussed *TOUSA* bankruptcy opinion. *See In re TOUSA, Inc.*, 422 B.R. 783 (Bankr. S.D. Fla. 2009), *quashed in part*, 444 B.R. 613 (S.D. Fla. 2011). In rejecting the bankruptcy court's analysis, the district court protected the lenders' right to accept payment of bona fide antecedent debt without undue concern that such payments would ultimately be disgorged as the spoils of a constructively fraudulent transfer. Among other things, the district court held that "the opportunity to avoid default, to facilitate the enterprise's rehabilitation, and to avoid bankruptcy, even if it proved to be short lived, may be considered in determining reasonable equivalent value." The venue for this continuing saga and its eagerly anticipated denouement has now shifted to the Eleventh Circuit.

In *In re Longview Aluminum, L.L.C.*, 657 F.3d 507 (7th Cir. 2011), the Seventh Circuit explained that, for purposes of avoidance litigation, there are two approaches to the determination of "insider" status: (i) the "similarity" approach; and (ii) the "closeness" approach. The similarity

approach compares the position held by a nonstatutory insider with the list of statutory insiders delineated in Section 101(31)(B) of the Bankruptcy Code and attempts to analogize the nonstatutory insider's position with statutory positions. If the court finds sufficient "similarity," the putative insider is viewed as a statutory insider. By contrast, according to the closeness approach, anyone with a sufficiently close relationship with the debtor such that his conduct is subject to closer scrutiny than those dealing at arm's length with the debtor will be deemed an insider.

The Seventh Circuit ruled that a bankruptcy court did not err in using the similarity approach to determine that a "member" of a limited liability company ("LLC") was similar to a statutory "director" and thus was an insider. According to the Seventh Circuit, the court did not err in choosing not to analyze whether the LLC member was a nonstatutory insider via control factors.

When a debtor that has operated or been the instrument of a Ponzi scheme files for bankruptcy, the bankruptcy trustee or DIP may later seek to avoid and recover payments made in furtherance of the scheme as fraudulent transfers. Defendants in these avoidance actions commonly seek to thwart such attempted "clawbacks" by contending that they received their returns from the debtor in good faith and without any knowledge of the Ponzi scheme and that they gave "value" to the debtor in the form of initial and subsequent investments.

In *Picard v. Katz*, 2011 WL 4448638 (S.D.N.Y. Sept. 27, 2011), the district court examined the extent to which the trustee could avoid certain transfers made with the actual intent to defraud creditors in connection with the Bernard Madoff Ponzi scheme. The availability of a good faith defense, the court explained, depends on whether the transfers sought to be recovered were the defendants' principal or profits. According to the court, the principal invested by the defendants conferred value upon the debtors, but the profits presumptively exceeded any value that might have been given. The court added the caveats that: (i) a trustee might be able to recover principal invested in a Ponzi scheme by demonstrating "willful blindness" by the investor; and (ii) a defendant could retain its profits if it could show that it gave value for the profits in excess of its principal.

In *Perkins v. Haines*, 661 F.3d 623 (11th Cir. 2011), the Eleventh

Circuit reached a similar conclusion, albeit in a slightly different context — the initial investments in *Perkins* consisted of purchases of equity interests in limited partnerships, rather than direct investments of cash into a fund or other investment vehicle. Addressing the issue as a matter of apparent first impression, the court ruled that: (i) transfers made in furtherance of a Ponzi scheme are presumed to be actually fraudulent under Section 548 of the Bankruptcy Code; (ii) the general rule is that an investor defrauded in a Ponzi scheme is recognized as having given "value" to the extent of the principal invested for purposes of the Section 548(c) "good faith" affirmative defense; and (iii) amounts distributed to the investor in excess of the initial investment are deemed not to have been given for value and may be recovered. According to the Eleventh Circuit, the form of the investment — either as a payment giving rise to a debt claim or an equity investment — is irrelevant to application of the rule.

In *In re Dreier LLP*, 2011 WL 6327385 (Bankr. S.D.N.Y. Dec. 19, 2011), and *In re Dreier LLP*, 2011 WL 6337493 (Bankr. S.D.N.Y. Dec. 19, 2011), the bankruptcy court denied motions to dismiss counts in a complaint seeking to avoid as actual and constructive fraudulent transfers interest payments made to hedge funds that loaned money to a debtor operating a Ponzi scheme. In ruling that the Section 548(c) safe harbor was not available to the lenders, the court reaffirmed the general rule that the good faith defense in this context does not apply to payments other than principal and rejected the lenders' contention that a lender to a fraudulent business provides "value" in exchange for the interest it receives.

Automatic Stay

Section 362(a)(1) of the Bankruptcy Code automatically stays the commencement or continuation of a judicial proceeding against the debtor that was or could have been initiated before the filing of a bankruptcy petition. In *Chizzali v. Gindi (In re Gindi)*, 642 F.3d 865 (10th Cir. 2011), the Tenth Circuit interpreted Section 362(a)(1) to mean that "the automatic stay does not prevent a Chapter 11 debtor in possession from pursuing an appeal even if it is an appeal from a creditor's judgment against the debtor."

At least nine other circuit courts of appeals have disagreed with the Tenth Circuit's interpretation of Section 362(a)(1) in *Gindi*, holding that a bankruptcy filing automatically stays appellate proceedings if the debtor has filed an appeal from a judgment entered in a suit against the debtor. In *TW Telecom Holdings Inc. v. Carolina Internet Ltd.*, 661 F.3d 495 (10th Cir. 2011), the Tenth Circuit reversed its position on this issue. "From this date forward," the court wrote, "this Circuit will read 'section 362… to stay all appeals in proceedings that were *originally brought* against the debtor, regardless of whether the debtor is the appellant or appellee.'"

In *Palmdale Hills Property, LLC v. Lehman Commercial Paper, Inc.*, 654 F.3d 868 (9th Cir. 2011), the Ninth Circuit held that the automatic stay bars actions which would diminish the estate of a debtor in bankruptcy ("debtor 1"), and therefore, if another debtor ("debtor 2") in a separate bankruptcy case wants to seek equitable subordination of claims asserted by debtor 1 against debtor 2, debtor 2 must first obtain relief from the stay in debtor 1's bankruptcy case.

In *In re Nortel Networks, Inc.*, 2011 WL 6826412 (3d Cir. Dec. 29, 2011), the Third Circuit affirmed lower court rulings enforcing the automatic stay against the Trustee of Nortel Networks U.K. Pension Plan and the U.K. Board of the Pension Protection Fund ("PPF") with respect to their participation in U.K. pension proceedings initiated by the U.K. Pensions Regulator ("TPR") to determine the extent of the liability of Nortel Networks U.K. Limited and its affiliates, including two U.S. Chapter 11 debtors (Nortel Networks, Inc., and NN Caribbean and Latin American), for an underfunded defined-benefit pension scheme established and governed by U.K. law.

The Third Circuit ruled that the Trustee and PPF failed to demonstrate that the proceedings fell within the "police power" exception to the automatic stay contained in Section 362(b)(4) of the Bankruptcy Code. According to the court, neither the Trustee nor PPF was a "governmental unit" qualifying for the exception, and although TPR was a governmental unit, TPR was not a party to the bankruptcy proceedings and therefore could not assert the "police power" exception. In addition, the Third Circuit concluded that the U.K. proceedings were focused on the pecuniary interests of PPF and the members of the pension scheme, rather than the

protection of public health or safety.

In *In re Stone Resources, Inc.*, 458 B.R. 823 (E.D. Pa. 2011), the district court held that a bankruptcy court abused its discretion in denying a franchisor's motion for relief from the automatic stay when the franchisee's bankruptcy petition was filed after the franchisor had previously filed litigation against the franchisee to enforce a covenant not to compete. The ruling is significant because it found that the relief the franchisor sought — the enforcement of the covenant not to compete — could not be considered a "claim" that could be remedied by a claim for money damages in bankruptcy and thus was immune from the effects of the automatic stay.

Bankruptcy Asset Sales

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

In *In re Skyline Woods Country Club*, 636 F.3d 467 (8th Cir. 2011), the debtor had sold its golf course property "free and clear" of any interest under Section 363 of the Bankruptcy Code. After the buyer ceased operating, adjoining homeowners sued in state court to enforce a covenant restricting use of the property as a golf course. The buyer argued that the restrictive covenant was wiped out by Section 363(f). The state court ruled that the covenant was not an "interest" in property within the meaning of Section 363(f).

The buyer went back to bankruptcy court to reopen the case for the purpose of challenging the state court's determination. The bankruptcy court denied the request, a ruling that was upheld by a bankruptcy appel-

late panel. On further appeal, the Eighth Circuit held that the state court ruling was entitled to full faith and credit and that the ruling did not represent a collateral attack on the bankruptcy court order approving the sale that would otherwise have been impermissible under Section 363(m) of the Bankruptcy Code. According to the Eighth Circuit, the state court had merely interpreted the scope of the sale order's "free and clear" provision.

In *In re ASARCO, L.L.C.*, 650 F.3d 593 (5th Cir. 2011), the Fifth Circuit ruled that when a bidder seeks payment of sale-related expenses after a bankruptcy sale, with no mechanism for such reimbursement having been preapproved by the bankruptcy court, the standards governing the allowance and payment of administrative expenses in Section 503(b) of the Bankruptcy Code apply. However, when the bankruptcy court assesses the propriety of proposed bidder reimbursement procedures before the sale, the court should apply the business judgment standard that governs a proposed use, sale, or lease of estate property outside the ordinary course of business under Section 363(b).

Bankruptcy Court Powers/Jurisdiction

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

Although it has been described as an "extraordinary remedy," the ability of a bankruptcy court to order the substantive consolidation of related debtor entities in bankruptcy (if circumstances so dictate) is relatively uncontroversial, as an appropriate exercise of a bankruptcy court's broad (albeit nonstatutory) equitable powers. By contrast, considerable contro-

versy surrounds the far less common practice of ordering consolidation of a debtor in bankruptcy with a nondebtor.

In *Kapila v. S & G Fin. Servs., LLC (In re S & G Fin. Servs. of S. Fla., Inc.)*, 451 B.R. 573 (Bankr. S.D. Fla. 2011), the court ruled that "it is well within this Court's equitable powers to allow substantive consolidation of entities under appropriate circumstances, whether or not all of those entities are debtors in bankruptcy." It also held that "this Court has jurisdiction over non-debtor entities to determine the propriety of an action for substantive consolidation insofar as the outcome of such proceeding could have an impact on the bankruptcy case."

The ability of a bankruptcy court to reorder the priority of claims or interests by means of equitable subordination or recharacterization of debt as equity is generally recognized. Even so, the Bankruptcy Code itself expressly authorizes only the former of these two remedies. This has led to uncertainty in some courts concerning the extent of their power to recharacterize claims and the circumstances warranting recharacterization. In *Grossman v. Lothian Oil Inc. (In re Lothian Oil Inc.)*, 650 F.3d 539 (5th Cir. 2011), the Fifth Circuit ruled in a matter of first impression that a bankruptcy court's ability to recharacterize debt as equity is part of the court's authority to allow and disallow claims (rather than the court's broad equitable powers under Section 105 of the Bankruptcy Code), and the remedy is not limited to claims asserted by corporate insiders.

Bankruptcy Planning

The involuntary Chapter 11 case that senior noteholders successfully filed against a "bankruptcy remote" collateralized debt obligation ("CDO") entity in *In re Zais Investment Grade Limited VII*, 455 B.R. 839 (Bankr. D.N.J. 2011), surprised some investors. A New Jersey bankruptcy court ruled that, even though the CDO entity was structured as a foreign-registered special-purpose vehicle with no employees or assets in the U.S. other than collateral held in trust for the benefit of noteholders, it was eligible to be a Chapter 11 debtor under Section 109(a) of the Bankruptcy Code because it had a place of business and property in the U.S. According to the court, Chapter 11 provided an appropriate way to resolve the valuation dispute

between senior and junior secured noteholders. The decision illustrates that "bankruptcy remote" is not equivalent to "bankruptcy proof."

Bankruptcy Professionals/Litigation Issues

In *In re Tribune Co.*, 2011 WL 386827 (Bankr. D. Del. Feb. 3, 2011), the court ruled that, in the context of settlement negotiations that form the basis for a Chapter 11 plan, the "common-interest doctrine," which allows attorneys representing different clients with aligned legal interests to share information and documents without waiving the work-product doctrine or attorney-client privilege, applies once the parties have "agreed upon material terms of a settlement." "Once the [plan proponents] agreed upon [the] material terms of the settlement," the court wrote, "it is reasonable to conclude that the parties might share privileged information in furtherance of their common interest of obtaining approval of the settlement through confirmation of the plan."

Section 107 of the Bankruptcy Code provides a public right to access to papers filed in a bankruptcy case. However, the provision protects, among other things, "scandalous or defamatory" information from disclosure. Because the Bankruptcy Code does not define these terms, bankruptcy courts look to other sources, including the ordinary, dictionary meaning of "scandalous," in determining whether information should be protected from disclosure. In *In re Roman Catholic Archbishop of Portland*, 661 F.3d 417 (9th Cir. 2011), the Ninth Circuit ruled that, in a tort action against a debtor diocese, no good cause justified continuing a protective order to bar disclosure of personnel records containing allegations that a nonretired, nonparty priest had sexually abused children because the priest's private interest in nondisclosure was outweighed by the significant public interests in protecting public safety and identifying abusers of children. It also held that the bankruptcy court erred in unsealing documents containing allegations that two nonparty priests had sexually abused children, as those documents met the statutory exception in Section 107(b) to the general right of public access to bankruptcy filings for scandalous or defamatory matter.

Chapter 11 Plans

Notwithstanding the "absolute priority rule" stated in Section 1129(b)(2)(B) of the Bankruptcy Code, in order to foster plan confirmation or pursue other goals, a senior creditor, as part of a deal, may try to bypass an intermediate class of creditors by providing, from value that absent the deal would have gone to the senior creditor, a "gift" distribution to a junior class that would not otherwise be entitled to anything under a Chapter 11 plan. Although the Third Circuit limited the use of gifting in that circuit in *In re Armstrong World Indus., Inc.*, 432 F.3d 507 (3d Cir. 2005), gifting retained viability as a tool to achieve certain goals in other circuits. However, in *Dish Network Corp. v. DBSD N. Am., Inc. (In re DBSD N. Am., Inc.)*, 634 F.3d 79 (2d Cir. 2011), the Second Circuit rejected gifting as inconsistent with the absolute priority rule requirements for "cramdown," or involuntary, confirmation of a Chapter 11 plan.

Another requirement for involuntary plan confirmation is Section 1129(b)(1)'s dictate that a plan be "fair and equitable" with respect to a dissenting class of creditors. For secured claims, Section 1129(b)(2)(A) provides three alternative ways to satisfy this requirement: (i) the secured claimants' retention of their liens and receipt of deferred cash payments equal to at least the value, as of the plan effective date, of their secured claims; (ii) the sale, "subject to section 363(k)," of the collateral free and clear of all liens, with attachment of the liens to the proceeds and treatment of the liens on proceeds under option (i) or (iii); or (iii) the realization by the secured creditors of the "indubitable equivalent" of their claims.

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

In *River Road Hotel Partners, LLC v. Amalgamated Bank (In re River Road Hotel Partners, LLC)*, 651 F.3d 642 (7th Cir. 2011), the Seventh Circuit held that a dissenting class of secured lenders cannot be deprived of the right to credit bid its claims under a Chapter 11 plan that proposes an auction sale of the lenders' collateral free and clear of liens. The decision is a welcome development for secured creditors on the heels of contrary rul-

ings handed down by the Third Circuit in *In re Philadelphia Newspapers*, 599 F.3d 298 (3d Cir. 2010), and the Fifth Circuit in *In re Pacific Lumber Co.*, 584 F.3d 229 (5th Cir. 2009). The resulting circuit split, however, was a compelling invitation for review by the U.S. Supreme Court, which agreed to review the *River Road* ruling when it issued a writ of certiorari on December 12, 2011.

Compared to the attention devoted to the legitimacy of senior-class "gifting" to junior classes under a Chapter 11 plan, relatively little scrutiny has been directed toward significant developments in ongoing controversies in the courts during 2011 regarding the absolute priority rule in other contexts — namely, in connection with the "new value" exception to the rule developed under the former Bankruptcy Act of 1898 and whether the rule was written out of the Bankruptcy Code for individual Chapter 11 debtors by the addition of Section 1115 as part of the 2005 bankruptcy amendments.

Under the new value exception, a junior stakeholder (*e.g.*, a shareholder) may retain its junior claim or equity interest under a Chapter 11 plan over the objection of a senior impaired creditor class, provided the shareholder contributes new capital to the restructured enterprise. According to some courts, that capital must be new, substantial, necessary for the success of the plan, reasonably equivalent to the value retained, and in the form of money or money's worth. Other courts have concluded that the new value exception did not survive the enactment of the Bankruptcy Code in 1978 because, among other things, the concept is not explicitly referred to in Section 1129(b)(2) or elsewhere in the statute. Several bankruptcy courts weighed in on this issue in 2011, most finding that the exception remains viable, but some concluding that its requirements were not satisfied. *See*, *e.g.*, *In re Multiut Corp.*, 449 B.R. 323 (Bankr. N.D. Ill. 2011); *In re Red Mountain Machinery Co.*, 448 B.R. 1 (Bankr. D. Ariz. 2011); *In re Greenwood Point, LP*, 445 B.R. 885 (Bankr. S.D. Ind. 2011).

"High-asset" individual debtors, such as business owners or owners of rental property or other significant business and personal assets, whose financial problems are too extensive to qualify for treatment under the wage earner provisions in Chapter 13, commonly seek protection under Chapter 11 of the Bankruptcy Code. In 2005, Congress amended Section 1129(b)

(2)(B)(ii) with respect to individual Chapter 11 debtors to provide that "in a case in which the debtor is an individual, the debtor may retain property included in the estate under section 1115," even if a dissenting class of unsecured creditors could otherwise argue that retention of such property violates the absolute priority rule. Lawmakers also added Section 1115 to the Bankruptcy Code. Section 1115 provides that, in an individual Chapter 11 case, "property of the estate includes, in addition to the property specified in section 541 — (1) all property of the kind specified in section 541 that the debtor acquires after the commencement of the case…; and (2) earnings from services performed by the debtor after the commencement of the case."

A dispute has arisen in the courts as to whether the carve-out added to Section 1129(b)(2)(B)(ii) for property retained by individual debtors might extend to property other than postpetition earnings — in effect, abrogating the absolute priority rule in individual Chapter 11 cases. Some courts, representing the minority view, have construed Section 1115 broadly. These courts interpret Section 1115 to mean that Section 1129(b)(2)(B)(ii)'s exception from the reach of the absolute priority rule extends to all property of the estate, including, for example, prepetition ownership interests in nonexempt property and an individual debtor's ownership interests in a business. Other courts, representing a growing majority, subscribe to a narrower construction of Section 1115 and confine the exemption from absolute priority to postpetition earnings. *See*, *e.g.*, *In re Kamell*, 451 B.R. 505 (Bankr. C.D. Cal. 2011); *In re Draiman*, 450 B.R. 777 (Bankr. N.D. Ill. 2011); *In re Maharaj*, 449 B.R. 484 (Bankr. E.D. Va. 2011); *In re Walsh*, 447 B.R. 445 (Bankr. D. Mass. 2011); *In re Stephens*, 445 B.R. 816 (Bankr. S.D. Tex. 2011).

In *Ala. Dep't of Econ. & Comm. Affairs v. Ball Healthcare-Dallas, LLC (In re Lett)*, 632 F.3d 1216 (11th Cir. 2011), the Eleventh Circuit was presented with an opportunity to weigh in on the absolute priority rule in individual debtor Chapter 11 cases as well as the new value exception. However, Section 1115 did not apply in that case because the Chapter 11 filing preceded the October 17, 2005, effective date of the provision, and the court expressly declined "further discussion of this exception to the absolute priority rule, as it is not at issue in this case." On remand, however, the district

court ruled in *In re Lett*, 2011 WL 2413484 (S.D. Ala. June 13, 2011), that the debtor's plan violated the absolute priority rule because certain property would revest in the debtor upon confirmation without paying senior creditor classes in full and that the plan failed to satisfy the new value exception because the debtor contributed no new value to the estate.

In *Lett*, the Eleventh Circuit also ruled that objections to a bankruptcy court's approval of a cramdown Chapter 11 plan on the basis of noncompliance with the absolute priority rule may be raised for the first time on appeal. According to the court, "A bankruptcy court has an independent obligation to ensure that a proposed plan complies with [the] absolute priority rule before 'cramming' that plan down upon dissenting creditor classes," whether or not stakeholders "formally" object on that basis.

Section 1124 of the Bankruptcy Code delineates the requirements for rendering a class of claims or interests unimpaired in a Chapter 11 plan. In *In re General Growth Properties, Inc.*, 451 B.R. 323 (Bankr. S.D.N.Y. 2011), the bankruptcy court ruled that, under Section 1124(2), where a solvent debtor proposes a plan that reinstates the creditor's claim, the creditor is entitled to postpetition interest on its claim at the contract default rate for the period from the bankruptcy petition date to the effective date of the plan.

In *In re Washington Mutual, Inc.*, 2011 WL 57111 (Bankr. D. Del. Jan. 7, 2011), the bankruptcy court greatly limited debtors' ability to release parties under a Chapter 11 plan. The court approved a global settlement agreement resolving litigation stemming from the failure of Washington Mutual Bank in 2008 that was the basis for the debtors' sixth amended joint Chapter 11 plan. Despite finding that the global settlement was fair and reasonable, the court denied confirmation of the plan because it found the releases granted by the debtors to certain parties under the plan to be excessively broad and impermissible under applicable law.

In *In re Washington Mutual, Inc.*, 2011 WL 4090757 (Bankr. D. Del. Sept. 13, 2011), the court once again denied confirmation of the debtors' Chapter 11 plan and instead referred the litigants to mediation in order to move the case toward a confirmable resolution. Among other things, the court ruled that the equity committee in the cases had stated a colorable claim for equitable disallowance of noteholder claims on the ground that noteholders had traded on insider information obtained in settlement ne-

gotiations with the debtors and the buyer of the assets of an affiliate of the debtors. Such a ruling was required for the court to grant the committee standing to prosecute the claim on the basis of the debtors' alleged unjustifiable refusal to do so.

In *In re Tribune Co.*, 2011 WL 5142420 (Bankr. D. Del. Oct. 31, 2011), the bankruptcy court denied confirmation of competing joint Chapter 11 plans for 111 affiliated debtors. Among other things, the court ruled that neither plan satisfied Section 1129(a)(10) of the Bankruptcy Code, which provides that "[i]f a class of claims is impaired under the plan, at least one class of claims that is impaired under the plan has accepted the plan, determined without including any acceptance of the plan by any insider." According to the court, in the absence of substantive consolidation, the failure to have an accepting impaired class with respect to each of the 111 debtors precluded confirmation under Section 1129(a)(10). In other words, the court held that Section 1129(a)(10) must be satisfied on a "per debtor" basis, rather than a "per plan" basis.

Postconfirmation liquidation and litigation trusts have become an important mechanism in a Chapter 11 bankruptcy estate's arsenal, allowing for the resolution of claims and interests without needlessly delaying confirmation in the interim. Section 1123(b)(3)(B) of the Bankruptcy Code states that a plan may provide for retention or enforcement by the reorganized debtor, the trustee, or a representative of the estate of any claim or interest belonging to the estate. The provision does not specify, however, the manner in which the retention of any such claim or interest must be drafted and disclosed to other parties — leaving to the courts the question of the level of specificity and detail required.

In *In re MPF Holdings US LLC*, 443 B.R. 736 (Bankr. S.D. Tex. 2011), the bankruptcy court suggested that, in the Southern District of Texas at least, the level of specificity and detail required is high. However, in *In re Matter of Texas Wyoming Drilling, Inc.*, 647 F.3d 547 (5th Cir. 2011), the Fifth Circuit issued an opinion clarifying that debtors in that circuit, which includes the Southern District of Texas, are not straitjacketed in this regard after all. According to the Fifth Circuit, to meet the "specific and unequivocal" burden necessary to preserve postconfirmation litigation claims, a plan must identify the types of claims — not simply reserve

"any and all." Language identifying the types of claims (*e.g.*, avoidance actions), the possible amount of recovery, and the basis for the claims as well as the fact that the reorganized debtor or its representative intends to pursue those actions is sufficient. Individual defendants, however, need not be named.

Another Texas bankruptcy court addressed this issue in *In re Crescent Resources*, 2011 WL 3022567 (Bankr. W.D. Tex. July 22, 2011). Following *Texas Wyoming*, the court held that the requirement for a plan to contain "specific and unequivocal" language reserving claims to be pursued postconfirmation allows the use of the "categorical approach," in which claims are described by category rather than by the specific defendants to be sued.

Claims/Debt Trading

In *Regan Capital I, Inc. v. UAL Corp. (In re UAL Corp.)*, 635 F.3d 312 (7th Cir. 2011), the Seventh Circuit affirmed a ruling below that the purchaser of a claim based upon an executory contract which was ultimately rejected by a DIP is not entitled to cure amounts as part of its allowed claim.

In re Mesa Air Group, Inc., 2011 WL 320466 (Bankr. S.D.N.Y. Jan. 20, 2011), highlighted the importance of complying with court established procedures for acquiring claims and properly documenting claims transfers. The court had entered an order restricting the trading of large claims to protect the debtor's ability to use its net operating losses. It later ruled that a creditor which had acquired its claims in violation of the trading order lacked standing to object to confirmation of the debtors' Chapter 11 plan.

Creditor Standing and Rights

In a ruling that has been described as "very important" and the "first decision of its kind," the bankruptcy court held in *In re Innkeepers USA Trust*, 448 B.R. 131 (Bankr. S.D.N.Y. 2011), that a certificate holder with a beneficial interest in a securitized trust established by the Chapter 11 debtors' prepetition lenders was not a "party in interest" and therefore lacked standing to object to bidding procedures proposed by the debtors for the

sale of their assets outside the ordinary course of business. The court explained that this conclusion comports with the Second Circuit's holding in *In re Refco Inc.*, 505 F.3d 109 (2d Cir. 2007), that a "creditor of a creditor is not a 'party in interest' within the meaning of section 1109(b) of the Bankruptcy Code."

In *In re Global Industrial Technologies, Inc.*, 645 F.3d 201 (3d Cir. 2011), the Third Circuit ruled that, even if a Chapter 11 debtor's liability insurers' ultimate liability was contingent, the insurers were "parties in interest" and thus had standing to challenge confirmation of a Chapter 11 plan calling for them to fund a settlement trust created to satisfy the debtor's liability on silica-related claims.

In *In re Heating Oil Partners, LP*, 2011 WL 1838720 (2d Cir. May 16, 2011), the Second Circuit held that, although Section 1109(b) of the Bankruptcy Code states that "[a] party in interest…may raise and may appear and be heard on any issue in a case under [Chapter 11]," the provision does not abrogate constitutional standing requirements. A party in interest must still demonstrate that it meets the general requirements of the standing doctrine under the U.S. Constitution, including whether it has alleged a personal stake in the outcome of the proceedings and whether it is asserting its own legal rights and remedies.

In *Official Committee of Unsecured Creditors v. Baldwin* (*In re Lemington Home for the Aged)*, 659 F.3d 282 (3d Cir. 2011), the Third Circuit reversed a grant of summary judgment in favor of defendant directors and officers, holding, among other things, that the "deepening insolvency" cause of action, which the court previously recognized in *Official Committee of Unsecured Creditors v. R.F. Lafferty & Co.*, 267 F.3d 340 (3d Cir. 2001), remains an independent cause of action under Pennsylvania law.

Subordination agreements are generally enforceable in bankruptcy cases pursuant to Section 510(a) of the Bankruptcy Code. In *In re SW Boston Hotel Venture, LLC*, 2011 WL 5520928 (Bankr. D. Mass. Nov. 14, 2011), a junior creditor that was a signatory to an intercreditor and subordination agreement which provided senior creditors with the sole right to vote on any Chapter 11 plan for the debtor nevertheless submitted a ballot on its own behalf. The senior creditor moved to enforce the terms of the agreement. The bankruptcy court ruled that, to the extent a provision

in a subordination agreement attempts to alter a substantive right under the Bankruptcy Code — here, Section 1126(a), which provides that "[t]he holder of a claim or interest allowed under section 502 of this title may accept or reject a plan" — such a provision is invalid. Bankruptcy courts are evenly divided on this issue, which promises to remain controversial.

Mortgage loans have been increasingly packaged into mortgage-backed securities and securitization trusts known as "collateralized debt obligations." To avoid the need to rerecord a mortgage each time it is transferred, major mortgage lenders decided it would be more efficient for a single entity to be named as the "mortgagee of record" or "nominee" on a mortgage encompassed in such arrangements. A mortgage could then be transferred without having to be rerecorded because, assuming that the transferee agrees that the "mortgagee of record" or "nominee" will retain its status in that capacity notwithstanding future transfers, rerecording is not necessary because the mortgage remains recorded in the name of the mortgagee of record or nominee.

Mortgage Electronic Registration Systems Inc. ("MERS") was devised for this purpose. MERS is an electronic registry launched in 2004 for monitoring mortgage holders and servicing rights for mortgage lenders and servicers who become MERS members. MERS, rather than an individual lender, is named as mortgagee of record or nominee on its members' mortgages. A mortgage is recorded in local real property records in MERS's name and can be transferred among MERS members without the need for rerecording the mortgage upon each transfer. By some recent estimates, MERS is mortgagee of record or nominee on approximately 50 percent of all residential U.S. mortgages.

The MERS system, however, has been the subject of heated controversy in the recent foreclosure documentation saga. Foreclosure laws generally require, as a condition to foreclosure, both the note and the mortgage to be held by the same entity or an agent of such entity. It is unclear whether MERS, as the mortgagee of record or nominee, is an agent for the entity that would have been the mortgagee (the lender) under the traditional mortgage-recordation system. If MERS were not deemed to be an agent for the lender, MERS's recordation of the mortgage would split it from the note, and the resulting bifurcation would preclude the lender from foreclosing on the mort-

gage and leave the lender with an unsecured claim.

This dispute has played out prominently during 2011 not only in state courts but in U.S. bankruptcy and appellate courts as well, with courts lining up on both sides of the divide. Some courts have concluded that MERS is not an agent of the lender under applicable non-bankruptcy law. *See*, *e.g.*, *In re Gorman*, 2011 WL 5117846 (Bankr. E.D.N.Y. Oct. 27, 2011); *In re Salazar*, 448 B.R. 814 (Bankr. S.D. Cal. 2011); *In re Agard*, 444 B.R. 231 (Bankr. E.D.N.Y. 2011). Other courts have reached the opposite conclusion. *See*, *e.g.*, *Culhane v. Aurora Loan Services of Nebraska*, 2011 WL 5925525 (D. Mass. Nov. 28, 2011); *Nielsen v. Aegis Wholesale Corp.*, 2011 WL 1675178 (D. Utah May 4, 2011); *In re Martinez*, 455 B.R. 755 (Bankr. D. Kan. 2011).

In *In re J.H. Inv. Services, Inc.*, 2011 WL 5903523 (11th Cir. Nov. 22, 2011), the Eleventh Circuit ruled that an undersecured creditor must take an affirmative step to pursue an unsecured claim and that an undersecured creditor does not automatically assert a deficiency claim by operation of Section 506(a)(1) of the Bankruptcy Code. According to the court, "No creditor — even an undersecured creditor — is required to pursue a claim in bankruptcy or file a proof-of-claim form," and an "undersecured creditor is not required to pursue a deficiency claim." If a creditor fills out a proof-of-claim form in a manner which indicates the creditor believes that it is fully secured, the court wrote, "it has waived any unsecured claim."

In *CompuCredit Holdings Corporation v. Akanthos Capital Management, LLC*, 661 F.3d 1312 (11th Cir. 2011), the Eleventh Circuit reaffirmed the extent to which holders of debt may engage in coordinated behavior with respect to a common issuer without running afoul of antitrust laws. The court affirmed a judgment on the pleadings for a group of hedge funds in an antitrust case challenging the funds' actions under the Sherman Act. The court rejected the issuer's assertion that the funds had violated Section 1 of the Sherman Act by coordinating to force the issuer to pay above-market prices for the early redemption of its notes. In ruling for the funds, the court followed previous decisions by the Second and Seventh Circuits. *See United Airlines v. U.S. Bank, N.A.*, 406 F.3d 918 (7th Cir. 2005); *Sharon Steel Corp. v. Chase Manhattan Bank, N.A.*, 691 F.2d 1039 (2d Cir. 1982).

Cross-Border Bankruptcy Cases

October 17, 2011, marked the six-year anniversary of the effective date of Chapter 15 of the Bankruptcy Code. Governing cross-border bankruptcy and insolvency cases, Chapter 15 is patterned after the Model Law on Cross-Border Insolvency (the "Model Law"), a framework of legal principles formulated by the United Nations Commission on International Trade Law in 1997 to deal with the rapidly expanding volume of international insolvency cases. The Model Law has now been adopted in one form or another by 19 nations or territories.

In *In re Fairfield Sentry Ltd.*, 452 B.R. 52 (Bankr. S.D.N.Y. 2011), and *In re Fairfield Sentry Ltd.*, 452 B.R. 64 (Bankr. S.D.N.Y. 2011) ("*Fairfield II*"), the bankruptcy court rendered two decisions involving offshore "feeder funds" that invested in the massive Ponzi scheme associated with Bernard L. Madoff Investment Securities LLC. In matters of apparent first impression, the court ruled that: (i) it would not remand or abstain from hearing actions commenced by the foreign representatives of a foreign debtor seeking recovery or avoidance of transfers made in connection with the Madoff Ponzi scheme; and (ii) the tolling provisions of the Bankruptcy Code apply in Chapter 15, such that the foreign representatives would receive an extension of deadlines in connection with both pending and potential lawsuits.

A New York district court later reversed *Fairfield II* on appeal in *In re Fairfield Sentry Ltd. Litigation*, 458 B.R. 665 (S.D.N.Y. 2011). According to the district court, because, among other things, the assets sought to be recovered were not located in the U.S. and the avoidance proceedings could be adjudicated by a foreign court, the proceedings were not "core" and thus could not be adjudicated by the bankruptcy court without the consent of the defendants under the U.S. Supreme Court's ruling in *Stern v. Marshall*, 131 S. Ct. 2594 (2011).

In *In re Daewoo Logistics Corp.*, 2011 WL 4706197 (Bankr. S.D.N.Y. Oct. 5, 2011), the bankruptcy court ruled that, in light of the ancillary nature of Chapter 15, absent exigent circumstances, a stay imposed pursuant to Chapter 15 is normally coterminous with the stay in the corresponding foreign proceeding and, accordingly, the stay terminates at the close of the foreign proceeding.

In a matter of apparent first impression, *In re Qimonda AG*, 2011 WL 5149831 (Bankr. E.D. Va. Oct. 28, 2011), the bankruptcy court held that the protections of Section 365(n) of the Bankruptcy Code are available to licensees of U.S. patents in a Chapter 15 case, even when those protections are not available under the foreign law applicable to the foreign debtor. The court found that a refusal to apply Section 365(n) was "manifestly contrary to the public policy of the United States" within the meaning of Section 1506 of the Bankruptcy Code and resulted in the licensees not being "sufficiently protected."

Executory Contracts and Unexpired Leases

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

The Fifth Circuit's unpublished ruling in *In re Escarent Entities, L.P.*, 2011 WL 1659512 (5th Cir. Apr. 28, 2011), implicitly confirms that interpretation. The court held that a debtor's failure to consummate a sale under a prepetition executory land purchase agreement on the closing date was "not only a material default, but effectively an incurable one, as the parties are unable to return to January 12, 2009, when [the debtor's] performance was originally due."

Section 365(c)(1) of the Bankruptcy Code 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. In *In re XMH Corp.,* 647 F.3d 690 (7th Cir. 2011), the Seventh Circuit relied on this "applicable law" excep-

tion in laying down a "universal rule" that a trademark license may not be assigned to a third party without the licensor's consent.

The *XMH* decision is notable because 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, 2008 WL 2192094 (9th Cir. 2008).

In *In re FPSDA I, LLC*, 450 B.R. 392 (Bankr. E.D.N.Y. 2011), the court held that where an unexpired lease is part of an integrated deal, a DIP cannot assume and cure the lease without assuming and curing defaults under other executory contracts that pertain to the integrated deal (here, a franchise). However, the court ruled, where there is an integrated deal involving both commercial real estate leases and other contracts not subject to the 120-day deadline in Section 365(d)(4) of the Bankruptcy Code for assumption or rejection, the time limits of Section 365(d)(4) do not apply, and the DIP has until confirmation to decide whether to assume or reject.

Financial Contracts/Setoffs

"Safe harbors" in the Bankruptcy Code designed to insulate nondebtor parties to financial contracts from the consequences of a bankruptcy filing by the contract counterparty have been the focus of a considerable amount of scrutiny during the last three years.

In 2009, a Delaware bankruptcy court ruled in *In re SemCrude, L.P.*, 399 B.R. 388 (Bankr. D. Del. 2009), that "triangular," or multiparty, setoff is not permitted in bankruptcy due to the absence of 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, neither court's decision addressed 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 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 before the bankruptcy court in *SemCrude*, but belatedly, such that it was never addressed by either the

bankruptcy or the district court.

Notwithstanding this argument, in *In re Lehman Bros. Holdings Inc.*, 433 B.R. 101 (Bankr. S.D.N.Y. 2010) ("*Swedbank*"), the court held that the safe harbor provisions of the Bankruptcy Code do not override the mutuality requirement for setoff, which, the court wrote, is "baked into the very definition of setoff." According to the court, 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 which could operate to stay, avoid, or otherwise limit that right, "that right must exist in the first place."

Swedbank was upheld on appeal in *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* suggest that multiparty setoffs likely would not withstand challenge in bankruptcy.

The bankruptcy court reprised its role as spoiler in this context, later ruling in *In re Lehman Bros. Inc.*, 458 B.R. 134 (Bankr. S.D.N.Y. 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 the rulings in *SemCrude* and *Swedbank*.

Repurchase, or "repo," agreements have long been an important mechanism for investing in U.S. government and agency securities, mortgage-related instruments, commodities, and money market instruments. Section 562 of the Bankruptcy Code, which was enacted in 2005 to complement the Bankruptcy Code's broad array of protections for financial contracts, addresses the appropriate date or dates for measuring damages arising from the rejection by a DIP or trustee, or a counterparty's liquidation, termination, or acceleration of repo and derivatives instruments. In a case of first impression, the Third Circuit in *In re American Home Mortg. Holdings, Inc.*, 637

F.3d 246 (3d Cir. 2011), held that, for purposes of Section 562, a discounted cash flow analysis was a "commercially reasonable determinant" of value for the liquidation of mortgage loans in a repurchase transaction.

The scope of protection afforded by the safe harbor for financial contracts in Section 546(e) has been the subject of considerable discussion and dispute in the courts. Some courts have attempted to reconcile a conflict between the apparently plain meaning of Section 546(e) and Congress's clearly stated intent in enacting it, yielding divergent results. The Second Circuit weighed in on this issue in *In re Enron Creditors Recovery Corp. v. Alfa, S.A.B. de C.V.*, 651 F.3d 329 (2d Cir. 2011). The court held that more than $1.1 billion in prepetition "redemption payments" made by the debtor to retire certain of its commercial paper could not be avoided as being preferential or constructively fraudulent because the redemption payments qualified as "settlement payments" entitled to the protection of the safe harbor provision.

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 (3d 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.

In a dissenting opinion, district judge John G. Koeltl, sitting by designation, 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 Section 546(e). Indeed, his prognostication may have hit the mark. Shortly 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 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 indus-

try; 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.

Enron effectively overruled a New York bankruptcy court's earlier ruling in *In re MacMenamin's Grill Ltd.*, 450 B.R. 414 (Bankr. S.D.N.Y. 2011), where the court held that the selling shareholders in a private leveraged buyout transaction were not entitled to the protections of Section 546(e). Notwithstanding the plain meaning of the provision, the court read the legislative history of Section 546(e) to mean that the safe harbor was intended to shield from avoidance as constructively fraudulent transfers only those transactions that, if avoided, would disrupt the financial markets.

Municipal Debtors

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

An important distinction between Chapter 9 and Chapter 11 is Chapter 9's requirement that a municipality be insolvent to qualify for relief. In *In re Boise County*, 2011 WL 3875639 (Bankr. D. Idaho Sept. 2, 2011), the bankruptcy court dismissed Boise County, Idaho's Chapter 9 filing due to the county's failure to demonstrate that it was insolvent. According to the court, the county's budget deficit and failure to pay a single outstanding judgment debt were not adequate to support a showing of insolvency under Section 101(32)(C) of the Bankruptcy Code. The ruling illustrates that Chapter 9 of the Bankruptcy Code is not a panacea for the woes of towns, cities, and other municipalities across the country in the enduring aftermath of the Great Recession.

In *In re New York City Off-Track Betting Corp.*, 2011 WL 309594 (Bankr. S.D.N.Y. Jan. 25, 2011), the bankruptcy court dismissed the debtor's Chapter 9 case, finding that the debtor had no prospect of reorganizing after the state legislature failed to act to amend the law governing the way the debtor's operations were funded, and the debtor ceased operating. Dismissal was also the remedy ordered by the bankruptcy courts in *In re Suffolk Regional Off-Track Betting Corp.*, 2011 WL 6010673 (Bankr. E.D.N.Y. Dec. 2, 2011), and *In re City of Harrisburg, Pennsylvania*, 2011 WL 6026287 (Bankr. M.D. Pa. Dec. 5, 2011). In *Suffolk*, the court ruled that the county resolution authorizing the debtor to file for Chapter 9 relief exceeded the scope of the county legislature's authority, such that the debtor was not properly authorized to file a Chapter 9 petition, as required by Section 109(c)(2) of the Bankruptcy Code. Lack of due authorization under Section 109(c)(2) similarly motivated the *Harrisburg* bankruptcy court, which held that the debtor was not "specifically authorized" by state law to seek Chapter 9 protection and was in fact prohibited from doing so under a law passed by the Pennsylvania legislature after the debtor was designated as a "distressed" municipality.

If a Chapter 9 debtor is a healthcare business, Section 333(a)(1), which was added to the Bankruptcy Code in 2005, mandates the appointment of a "patient care ombudsman" not later than 30 days after commencement of the case to monitor the quality of patient care and to represent the interests of the debtor's patients, "unless the court finds that appointment of such ombudsman is not necessary for the protection of patients under the specific facts of the case."

In *In re Barnwell County Hosp.*, 2011 WL 5443025 (Bankr. D.S.C. Nov. 8, 2011), the bankruptcy court ruled that the appointment of an ombudsman was unnecessary because, among other things, the debtor sought relief under Chapter 9 due to a shortfall of revenue, not due to any allegations of deficient patient care; the debtor was already subject to state and federal monitoring; and the debtor had adopted internal procedures to ensure a high level of patient care and to resolve complaints expeditiously. In *In re Barnwell County Hosp.*, 2011 WL 5117073 (Bankr. D.S.C. Oct. 27, 2011), the same court previously held that a citizens' group lacked standing to object to the debtor's Chapter 9 filing on the basis of ineligibility,

although the court ruled that it would rule on the issue *sua sponte*.

In *In re Connector 2000 Ass'n, Inc.*, 447 B.R. 752 (Bankr. D.S.C. 2011), the bankruptcy court confirmed a Chapter 9 plan of adjustment that released third parties which were providing substantial consideration to the reorganization or substantially compromising their claims. According to the court, the release was appropriate and necessary because: (i) the debtor, a nonprofit corporation organized under South Carolina law to assist the South Carolina Department of Transportation ("SCDOT") in the financing, acquisition, construction, and operation of turnpikes, highway projects, and other transportation facilities, had an identity of interest with SCDOT, the beneficiary of the release; (ii) the releasee provided substantial consideration critical to effectuate the plan; and (iii) all of the impacted classes of creditors overwhelmingly supported the plan.

Nonprofit Debtors

One of the many challenges confronted by nonprofits in Chapter 11 cases concerns a workable exit strategy, especially if plan funding depends upon donor contributions. This obstacle was addressed in a ruling handed down by the Fifth Circuit in *In re Save Our Springs (S.O.S.) Alliance Inc.*, 632 F.3d 168 (5th Cir. 2011). The court affirmed a decision below denying confirmation of a Chapter 11 plan, ruling that "voluntary pledges [from donors] alone are too speculative to provide evidence of [plan] feasibility." In *Behrmann v. National Heritage Foundation*, 653 F.3d 704 (4th Cir. 2011), the Fourth Circuit considered whether a nonprofit charity could properly release nondebtor third parties under its Chapter 11 plan. The court ruled that such releases were unwarranted in the absence of any specific findings by the bankruptcy court explaining its determinations that the release provisions: (i) were essential to the charity's reorganization and implementation of its plan; (ii) were appropriate in light of the charity's unique circumstances; (iii) were an integral element of transactions contemplated in the plan; (iv) conferred some material benefit on the charity, its bankruptcy estate, or its creditors; and (v) were consistent with the applicable provisions of the Bankruptcy Code.

FROM THE TOP

The U.S. Supreme Court's October 2010 Term (which extended from October 2010 to October 2011) officially got underway on October 4, 2010, three days after Elena Kagan was formally sworn in as the Court's 112th justice and one of three female justices sitting on the Court.

Only two bankruptcy-related cases were handed down by the Supreme Court in 2011. On January 11, 2011, the Court ruled in *Ransom v. FIA Card Services, N.A.*, 131 S. Ct. 716 (2011), that a Chapter 13 debtor, in calculating his or her projected "disposable income" during the Chapter 13 plan period, cannot deduct automobile "ownership costs" specified in charts produced by the Internal Revenue Service, even though the debtor's vehicle is completely paid for. The circuits were split 3-1 on this issue, which arises from ambiguities introduced into the relevant provisions of the Bankruptcy Code in 2005.

On June 23, 2011, the Court handed down its bombshell ruling in *Stern v. Marshall*, 131 S. Ct. 2594 (2011). In *Stern*, the Court considered, among other things, whether a bankruptcy court created under Article I of the U.S. Constitution (rather than Article III, which governs the judiciary branch) can properly exercise "core" jurisdiction to adjudicate a state law tort claim asserted as a counterclaim to a claim for defamation filed in a bankruptcy case.

In its 5-4 ruling, the Court began by clarifying that: (i) "core proceedings are those that arise in a bankruptcy case or under Title 11 [*i.e.*, the Bankruptcy Code]"; (ii) there is no such thing as a "core" proceeding that does not arise under Title 11 or in a Title 11 case; and (iii) the list of core proceedings in 28 U.S.C. § 157(b)(2) is illustrative. Section 157(b)(2), among other examples, identifies "counterclaims by the estate against persons filing claims against the estate" as being within the bankruptcy court's core jurisdiction.

By its terms, the Court explained, 28 U.S.C. § 157(b)(2) entitled the bankruptcy court as a matter of statute to enter a final order on the counterclaim for tortious interference as a core proceeding because the creditor filed a proof of claim in the bankruptcy case. Notwithstanding the statute, however, the Court held that the bankruptcy court could not *constitution-*

ally enter a final order on such a counterclaim because that would trespass upon the judicial power granted to Article III courts.

This trespass, the Court emphasized, was not cured by the "public rights" exception, which recognizes a category of cases involving public rights that Congress may constitutionally assign to "legislative" courts for resolution. While the Court acknowledged that its treatment of the public rights exception has not been entirely consistent, it concluded that this case could not fit within any of the varied formulations of the doctrine.

The Court also rejected the argument that the bankruptcy court had authority to adjudicate the counterclaim because the creditor filed a proof of claim in the bankruptcy case. The Court distinguished the cases of *Katchen v. Landy*, 382 U.S. 323 (1966), and *Langenkamp v. Culp*, 498 U.S. 42 (1990), and held that, unlike in those cases, the counterclaim did not arise from the bankruptcy itself and that it was not necessary to resolve the counterclaim in the claims allowance process.

Justice Breyer issued a dissenting opinion, joined by three other justices. In the minority's view, the Court's prior precedent mandated a more pragmatic approach to Article III questions. Applying this approach, the dissenters concluded that bankruptcy courts could adjudicate compulsory counterclaims without violating any constitutional separation-of-powers principle in light of several factors delineated in the dissenting opinion. The dissenting justices also contended that the practical problems associated with the majority's holding were more significant and, by contrast, that any intrusion on the judiciary could only be considered *de minimis*.

The reverberations of *Stern* have been earthshaking (at least in the bankruptcy world) and are likely to continue for some time. The volume of jurisdictional challenges (strategic or otherwise) has skyrocketed in *Stern*'s aftermath, with (by some counts) as many as 150 court rulings on the issue in 2011 alone. *See*, *e.g.*, *In re Ortiz*, 2011 WL 6880651 (7th Cir. Dec. 30, 2011) (based on *Stern*, bankruptcy court lacked jurisdiction to grant summary judgment on state law counterclaims absent consent of the litigants); *In re Schmidt*, 453 B.R. 346 (B.A.P. 8th Cir. 2011) (based on *Stern*, replevin actions that had been removed from the state court to the bankruptcy court were outside the bankruptcy court's core jurisdiction; the inability of a bankruptcy judge after *Stern* to make final rulings on state law may take away

power to enjoin suits against nonbankrupts); *In re McClelland*, 2011 WL 6117275 (Bankr. S.D.N.Y. Dec. 9, 2011) (adversary proceeding involving allegations that real estate appraiser retained and compensated in Chapter 11 case with bankruptcy court approval committed gross negligence was core; state law counterclaim to fee application could not be finally adjudicated by court under *Stern*); *In re Refco Inc.*, 2011 WL 5974532 (Bankr. S.D.N.Y. Nov. 30, 2011) (*Stern* does not preclude court's issuance of final judgment on fraudulent transfer complaint where defendant has not filed a proof of claim); *In re Black Diamond Min. Co., LLC*, 2011 WL 4433624 (Bankr. E.D. Ky. Sept. 21, 2011) (based on *Stern*, court doubts that it would have supplemental jurisdiction over claims entirely unrelated to bankruptcy merely because those claims related to the same case or controversy as a cause of action pending before the court); *In re LLS America, LLC*, 2011 WL 4005447 (Bankr. E.D. Wash. Sept. 8, 2011) (substantive consolidation motion is core matter with respect to which bankruptcy court can issue final judgment under *Stern*); *In re AFY, Inc.*, 2011 WL 3800041 (Bankr. D. Neb. Aug. 18, 2011) (court lacked core jurisdiction under *Stern* over debt collection suit mischaracterized as turnover proceeding under Section 542).

LARGEST PUBLIC-COMPANY BANKRUPTCY FILINGS SINCE 1980

Company	Filing Date	Industry	Assets
Lehman Brothers Holdings Inc.	09/15/2008	Investment Banking	$691 billion
Washington Mutual, Inc.	09/26/2008	Banking	$328 billion
WorldCom, Inc.	07/21/2002	Telecommunications	$104 billion
General Motors Corporation	06/01/2009	Automobiles	$91 billion
CIT Group Inc.	11/01/2009	Banking and Leasing	$80 billion

Enron Corp.	12/02/2001	Energy Trading	$66 billion
Conseco, Inc.	12/17/2002	Financial Services	$61 billion
MF Global Holdings Ltd.	10/31/2011	Commodities	$40.5 billion
Chrysler LLC	04/30/2009	Automobiles	$39 billion
Thornburg Mortgage, Inc.	05/01/2009	Mortgage Lending	$36.5 billion
Pacific Gas and Electric Company	04/06/2001	Utilities	$36 billion
Texaco, Inc.	04/12/1987	Oil and Gas	$35 billion
Financial Corp. of America	09/09/1988	Financial Services	$33.8 billion
Refco Inc.	10/17/2005	Brokerage	$33.3 billion
IndyMac Bancorp, Inc.	07/31/2008	Banking	$32.7 billion
Global Crossing, Ltd.	01/28/2002	Telecommuni-cations	$30.1 billion
Bank of New England Corp.	01/07/1991	Banking	$29.7 billion
General Growth Properties, Inc.	04/16/2009	Real Estate	$29.6 billion
Lyondell Chemical Company	01/06/2009	Chemicals	$27.4 billion
Calpine Corporation	12/20/2005	Utilities	$27.2 billion
New Century Financial Corp.	04/02/2007	Financial Services	$26.1 billion
Colonial BancGroup, Inc.	08/25/2009	Banking	$25.8 billion
UAL Corporation	12/09/2002	Aviation	$25.2 billion
AMR Corporation	11/29/2011	Aviation	$25 billion
Delta Air Lines, Inc.	09/14/2005	Aviation	$21.9 billion
Adelphia Communica-tions Corp.	06/25/2002	Cable Television	$21.5 billion

Capmark Financial Group, Inc.	10/25/2009	Financial Services	$20.6 billion
MCorp	03/31/1989	Banking	$20.2 billion
Mirant Corporation	07/14/2003	Energy	$19.4 billion
Ambac Financial Group, Inc.	11/08/2010	Financial Insurance	$18.9 billion