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KERP OR KEIP: FIREWORKS CONTINUE ON KEEPING KEY EMPLOYEES AT THE HELM IN CHAPTER 11

Heather Lennox and Mark G. Douglas

Changes made to the Bankruptcy Code in 2005 raised the bar considerably for providing "pay to stay" incentives that had been offered routinely to management and other key employees of a chapter 11 debtor, such as a severance or key employee retention plan ("KERP"). Sections 503(c)(1) and 503(c)(2) now place strict limitations on severance and KERP payments to "insiders." In addition, section 503(c)(3) of the Bankruptcy Code mandates that transfers or obligations outside the ordinary course of business to any person or entity, including officers, managers, or consultants hired post-petition, be "justified by the facts and circumstances of the case."

Several notable court rulings have been handed down already in 2012 concerning the propriety under section 503(c) of—or the application of that subsection to—payments to key employees. Many of these decisions concern the increasing frequency with which chapter 11 debtors have characterized proposed payments to personnel as a key employee *incentive* program ("KEIP") rather than a KERP. Bankruptcy courts, U.S. Trustee watchdogs, and creditor groups have collectively cast a critical eye on these efforts to ensure that payments to key employees do not run afoul of the purpose underlying section 503(c). Other issues that have recently come under scrutiny include the criteria applied under section 503(c)(3) to proposed payments and, further peeling back the onion, whether all KERPs or KEIPs proposed by a chapter 11 debtor are even subject to section 503(c). The latter was addressed by a Delaware bankruptcy court in *In re Blitz U.S.A., Inc.*, 475 B.R. 209 (Bankr. D. Del. 2012).

LIMITATIONS ON PAYMENTS TO KEY EMPLOYEES

Section 503(c) was intended to limit the scope of KERPs and similar plans designed to induce management personnel to remain with a company during its bankruptcy case. Prior to the 2005 amendments, key personnel were frequently given bonuses in addition to their regular compensation as part of a KERP, with the resulting obligations treated as administrative-expense priority claims under section 503 of the Bankruptcy Code.

Section 503(c) limits the allowance and payment of such administrative-expense claims, reflecting in part the growing disfavor of giving what some characterized as preferential treatment to a debtor's "insiders" (including, among others, directors, officers, and other controlling individuals or entities) at the expense of the bankruptcy estate. It provides that, notwithstanding the general rule stated in section 503(b) regarding the allowance of administrative expenses:

> there shall neither be allowed, nor paid—
>
> (1) a transfer made to, or an obligation incurred for the benefit of, an insider of the debtor for the purpose of inducing such person to remain with the debtor's business, absent a finding by the court based on evidence in the record that—
>
> (A) the transfer or obligation is essential to retention of the person because the individual has a bona fide job offer from another business at the same or greater rate of compensation;
>
> (B) the services provided by the person are essential to the survival of the business; and
>
> (C) either—
>
> (i) the amount of the transfer made to, or obligation incurred for the benefit of, the person is not greater than an amount equal to 10 times the amount of the mean transfer or obligation of a similar kind given to nonmanagement employees for any purpose during the calendar year in which the transfer is made or the obligation is incurred; or
>
> (ii) if no such similar transfers were made to, or obligations were incurred for the benefit of, such nonmanagement employees during such calendar year, the amount of the transfer or obligation is not greater than an amount equal to 25 percent of the amount of any similar transfer or obligation made to or incurred for the benefit of such insider for any purpose during the calendar year before the year in which such transfer is made or obligation is incurred;
>
> (2) a severance payment to an insider of the debtor, unless—
>
> (A) the payment is part of a program that is generally applicable to all full-time employees; and
>
> (B) the amount of the payment is not greater than 10 times the amount of the mean severance pay given to nonmanagement employees during the calendar year in which the payment is made; or
>
> (3) other transfers or obligations that are outside the ordinary course of business and not justified by the facts and circumstances of the case, including transfers made to, or obligations incurred for the benefit of, officers, managers, or consultants hired after the date of the filing of the petition.

Thus, sections 503(c)(1) and 503(c)(2) deal with retention and severance payments, whereas section 503(c)(3) imposes a general catchall limitation with respect to payments or obligations that are both outside the ordinary course of business and not justified by the facts and circumstances of the case.

However, unlike with respect to retention and severance payments covered by subsections (c)(1) and (c)(2), lawmakers omitted detailed criteria for payments encompassed by subsection (c)(3) and instead reserved for the bankruptcy courts the discretion to determine whether the provision's conjunctive requirements have been satisfied.

Blitz confirms many practitioners' views that not all employee incentive plans are subject to section 503(c). However, the ruling also demonstrates that a chapter 11 debtor or bankruptcy trustee should be prepared to justify a proposed plan under the business-judgment standard whether or not the plan is within the ordinary course of business.

In *In re Dana Corp.,* 358 B.R. 567 (Bankr. S.D.N.Y. 2006), the court ruled that the requirement in section 503(c)(3) for a transaction to be "justified by the facts and circumstances of the case" is the same as the "business judgment" standard applied under section 363(b) to a proposed use, sale, or lease of estate property outside the ordinary course of the debtor's business. According to the court, "[S]ection 503(c)(3) gives the court discretion as to bonus and incentive plans, which are not primarily motivated by retention or in the nature of severance." Other courts have similarly adopted the business-judgment standard as a litmus test for payments governed by section 503(c)(3). *See, e.g., In re Dewey & LeBoeuf LLP*, 2012 WL 3065275 (Bankr. S.D.N.Y. July 30, 2012); *In re Global Aviation Holdings Inc.*, 2012 WL 3018064 (Bankr. E.D.N.Y. July 24, 2012); *In re Velo Holdings Inc.*, 472 B.R. 201 (Bankr. S.D.N.Y. 2012); *In re Borders Group, Inc.*, 453 B.R. 459 (Bankr. S.D.N.Y. 2011); *In re Mesa Air Group, Inc.*, 2010 WL 3810899 (Bankr. S.D.N.Y. Sept. 24, 2010); *In re Nobex Corp.*, 2006 WL 4063024 (Bankr. D. Del. Jan. 19, 2006). *But see In re Pilgrim's Pride Corp.*, 401 B.R. 229 (Bankr. N.D. Tex. 2009) (payments under section 503(c)(3) may be granted administrative-expense priority only if the court finds, independent of the debtor's business justification, that the payment is in the best interest of the parties).

In *Dana*, the court listed several factors that courts typically consider when determining whether the structure of a compensation proposal and the process for its development satisfy the business-judgment test:

- Is there a reasonable relationship between the plan proposed and the results to be obtained, i.e., will the key employee stay for as long as it takes for the debtor to reorganize or market its assets, or, in the case of a performance incentive, *is the plan calculated to achieve the desired performance?*
- Is the cost of the plan reasonable in the context of the debtor's assets, liabilities and earning potential?
- Is the scope of the plan fair and reasonable; does it apply to all employees; does it discriminate unfairly?
- Is the plan or proposal consistent with industry standards?
- What were the due diligence efforts of the debtor in investigating the need for a plan; analyzing which key employees need to be incentivized; what is available; what is generally applicable in a particular industry?
- Did the debtor receive independent counsel in performing due diligence and in creating and authorizing the incentive compensation?

As noted, several courts have recently addressed whether payment programs denominated as "incentive" rather than "retention" plans should be approved under section 503(c). For example, in *In re Velo Holdings Inc.*, 472 B.R. 201 (Bankr. S.D.N.Y. 2012), the court concluded that the chapter 11 debtors' proposed KEIP established incentive targets which, although tied to the debtors' compliance with their debtor-in-possession budget, required key employees to "stretch" in order to qualify for plan payments, so as not to constitute a retention plan subject to the restrictions set forth in sections 503(c)(1) and (2). The court ruled that the debtors met their burden of proving that the proposed KEIP was primarily incentive-based as it related to key employees and was a valid exercise of sound business judgment under sections 363 and 503(c)(3).

Similarly, in *In re Borders Group, Inc.*, 453 B.R. 459 (Bankr. S.D.N.Y. 2011), the chapter 11 debtor-retailers sought court approval of both a KEIP and a KERP. The employees covered by the proposed KERP were not insiders, but the court determined that the KERP had to be analyzed under section 503(c)(3) because the plan was not an ordinary-course transaction. Applying the *Dana* factors, the court ruled that the debtors exercised sound business judgment in proposing both the KEIP and the KERP. The bankruptcy court also approved incentive payments under section 503(c)(3) as a sound exercise of the debtor's business judgment in *In re Mesa Air Group, Inc.*, 2010 WL 3810899 (Bankr. S.D.N.Y. Sept. 24, 2010).

The bankruptcy court in *Blitz* considered whether a chapter 11 debtor group's EBITDA-based employee bonus plan was subject to the strictures of section 503(c)(3).

BLITZ

Blitz U.S.A., Inc., manufactures consumer gasoline containers distributed through various retailers. On November 9, 2011, prompted by rapidly escalating product-liability defense costs, Blitz and several of its affiliates (collectively, "Blitz") filed for chapter 11 protection in Delaware.

In May 2012, Blitz sought court approval of an employee bonus plan for the 2012 fiscal year. The proposed bonus plan, which was substantially similar to bonus plans adopted by Blitz every year since 2008, was calculated on the basis of EBITDA (earnings before interest, taxes, depreciation, and amortization) targets. Prior to 2008, a bonus program based upon net-income targets was in place at Blitz. The EBITDA targets were adjusted by Blitz for the 2012 fiscal year before it filed for chapter 11 protection. Among other things, the adjustments involved lowering the thresholds for bonus payments due to Blitz's pre-bankruptcy spinoff of one of its non-gasoline container businesses.

Blitz argued that the bonus plan was an ordinary-course transaction that did not require court approval. In the alternative, however, Blitz maintained that, even if the bonus plan was outside the ordinary course of its business, the plan should be approved because it satisfied the requirements of section 503(c)(3). The official unsecured creditors' committee objected and argued that the bonus plan was neither ordinary-course nor justified under the facts and circumstances of the case as required by section 503(c)(3). The office of the U.S. Trustee, a division of the U.S. Department of Justice responsible for overseeing the administration of bankruptcy cases and private trustees, also objected, taking issue with the amount of the payments designated for certain insiders.

Post-petition payment programs for key personnel (especially insiders), whether characterized as KEIPs, KERPs, or others, have increasingly come under the microscope since 2005, in keeping with lawmakers' efforts in the Bankruptcy Abuse Prevention and Consumer Protection Act to "trim the fat" from chapter 11.

The bankruptcy court conducted an evidentiary hearing after which it found, among other things, that: (i) the bonus-plan EBITDA targets were set by Blitz's compensation committee so that total employee-compensation levels would, on average, be competitive with the market if the targets were reached; (ii) all Blitz employees were eligible for the bonus plan; (iii) because EBITDA targets were met in 2008, 2009, and 2010, payments were made to employees under the plan amounting to $533,620, $1.60 million, and $1.75 million, respectively; (iv) no payments were made in 2011 due to the failure to meet EBITDA targets; (v) the 2012 targets were lowered due to the spinoff to reflect the loss in sales but account for greater efficiencies and better margins; (vi) if the 2012 targets were met, the total payout to employees would be approximately $427,000; and (vii) Blitz's debtor-in-possession lender did not oppose the bonus plan.

Applying the two-part test adopted by the Third Circuit in *In re Roth American, Inc.*, 975 F.2d 949 (3d Cir. 1992), as well as many other courts, the bankruptcy court in *Blitz* concluded that the bonus plan was an ordinary-course transaction because: (i) Blitz had implemented similar plans for the three years preceding its chapter 11 filing (therefore satisfying the "vertical" element of the test to determine whether a transaction is ordinary-course); and (ii) other manufacturers employed similar plans (satisfying the "horizontal" component). On the basis of its analysis, the court ruled that "the Bonus Plan is an ordinary course transaction that is not subject to the requirements of § 503(c)(3)."

Even so, the court considered whether the plan satisfied the business-judgment standard applied under section 363 of the Bankruptcy Code to proposed non-ordinary-course transactions. The court rejected the committee's arguments that: (i) the bonus-plan approval process was incomplete and the payments were too high; (ii) in light of subsequent projections, the EBITDA targets were "not a stretch and . . . designed only to reward certain insiders before the company is liquidated"; and (iii) the targets should have been revised upward once the bankruptcy filing stayed product-liability suits. The court ultimately ruled that "the Bonus Plan is an ordinary course transaction made with sound business judgment and in good faith," stating that "rewarding [employees] for hard work already done and encouraging them to fill existing orders until operations cease does not smack of bad faith or unsound business judgment."

OUTLOOK

Blitz confirms many practitioners' views that not all employee incentive plans are subject to section 503(c). However, the ruling also demonstrates that a chapter 11 debtor or bankruptcy trustee should be prepared to justify a proposed plan under the business-judgment standard whether or not the plan is within the ordinary course of business.

Post-petition payment programs for key personnel (especially insiders), whether characterized as KEIPs, KERPs, or others, have increasingly come under the microscope since 2005, in keeping with lawmakers' efforts in the Bankruptcy Abuse Prevention and Consumer Protection Act to "trim the fat" from chapter 11. As part of those efforts, the U.S. Trustee is making a concentrated effort to block companies from paying bonuses to the same executives who piloted their companies into chapter 11. For example, during July 2012, chapter 11 debtors Eastman Kodak Co., Hawker Beechcraft Inc., and Residential Capital LLC proposed incentive plans that the companies claim will motivate and reward their top executives and other employees to meet important goals in their restructurings, such as ensuring that creditors recover as much as possible. In each of these cases, the U.S. Trustee urged the bankruptcy court to block the plans on the basis that, rather than providing genuine incentives, the plans, which contain readily achievable goals, are masked ploys to induce insider management to remain on board during a time of great uncertainty—in other words, KERPs dressed up in KEIPs' clothing.

The U.S. Trustee's efforts have been gaining traction. In *In re Hawker Beechcraft, Inc.*, 2012 WL 3637251 (Bankr. S.D.N.Y. Aug. 24, 2012), the court recently denied without prejudice the debtor's motion to implement a KEIP that would have paid bonuses of up to $5.3 million to a "senior leadership team" and concluded that, although the KEIP included elements of incentive compensation, "when viewed as a whole, it set[] the minimum bonus bar too low to qualify as anything other than a retention program for insiders." In *In re Residential Capital, LLC*, 2012 WL 3670700 (Bankr. S.D.N.Y. Aug. 28, 2012), the bankruptcy court denied Residential Capital LLC's bid to pay more than $7 million in bonuses to 17 top executives and ruled that the plan had been improperly structured, to ensure that top management would not leave the company rather than to incentivize them to meet performance goals. "Ultimately, the Debtors have failed to carry their burden," the court wrote, pointing to a provision that 63 percent of the bonus money could be earned simply by the debtor's closing the sales of two loan portfolios that had been substantially negotiated pre-petition.

Bankruptcy professionals and industry commentators, however, are beginning to wonder whether the U.S. Trustee's watchdog mentality is doing more harm than good. A study published on August 8, 2012, entitled "Provision of Management Incentives in Bankrupt Firms," which was coauthored by Vidhan K. Goyal of the Hong Kong University of Science and Technology and Wei Wang of the Queen's School of Business at Queen's University in Kingston, Ontario, concludes that employee retention and incentive plans in bankrupt firms actually improve outcomes for creditors rather than enrich managers at the creditors' expense.

Professors Goyal and Wang assembled a database of 417 large public firms that had filed for chapter 11 protection between 1996 and 2007, 39 percent of which implemented KERPs. In addition to offering bonuses of 30 to 70 percent of employees' base salary, approximately half of the plans offered further incentives tied to resolving the bankruptcy expeditiously and to other specific goals. The study found that incentive plans (i.e., plans that tie bonuses to specific outcomes) "significantly improve outcomes for creditors." When incentive plans were tied to reorganization, the study reports, firms were more likely to reorganize. Conversely, when incentives were contingent upon asset sales, companies were more likely to liquidate. Incentive plans, the study concludes, also resulted in "significantly less time in bankruptcy" and a "significantly lower likelihood" of deviating from the absolute-priority rule.

The authors noted that it is important to distinguish between plans that offer retention bonuses only and plans that provide both retention and incentive bonuses. The study also found that "creditor control of bankruptcies [by means of an official creditors' committee] increases the likelihood that bankrupt firms offer retention and incentive bonuses to managers." Another significant finding was that chief executive officers were more likely to be paid bonuses if they were newly hired turnaround specialists rather than pre-existing managers. A complete copy of the study can be accessed at http://northernfinance.org/2012/openconf/modules/request.php?module=oc_program&action=view.php&id=330 (web sites herein last visited on October 4, 2012).

FIRST IMPRESSIONS: SHUTTING DOWN A CHAPTER 11 CASE DUE TO PATENT UNCONFIRMABILITY OF PLAN

Scott J. Friedman

Before soliciting votes on its bankruptcy plan, a chapter 11 debtor that has filed for bankruptcy typically must obtain court approval of its disclosure statement. As part of the disclosure-statement approval process, interested parties are afforded the opportunity to object. For example, a party may object on the grounds that the disclosure statement lacks sufficient information about the debtor. Sometimes, however, a party objects to the disclosure statement because the chapter 11 plan described by the statement cannot be confirmed. Although issues regarding a plan's compliance with the Bankruptcy Code's confirmation requirements are typically deferred until the confirmation hearing, some courts may resolve those issues at the disclosure-statement hearing if the plan is unconfirmable on its face, or "patently unconfirmable."

In *In re American Capital Equipment, LLC,* 688 F.3d 145 (3d Cir. 2012), the Third Circuit Court of Appeals held as a matter of first impression that a bankruptcy court may, in certain circumstances, resolve confirmation issues at the disclosure-statement hearing. The Third Circuit affirmed a bankruptcy court's ruling at the disclosure-statement stage that: (i) the chapter 11 plan did not satisfy the Bankruptcy Code's requirements that the plan be "feasible" and proposed in "good faith"; and (ii) on the basis of the plan's patent unconfirmability (and the debtors' inability to propose a confirmable plan), the debtors' chapter 11 cases would be converted to chapter 7 liquidations.

THE DISCLOSURE-STATEMENT AND CONFIRMATION HEARINGS

Confirmation and consummation of a bankruptcy plan are the culmination of a chapter 11 debtor's bankruptcy case. Creditors and interest holders whose rights are "impaired" (e.g., detrimentally affected vis-à-vis treatment outside bankruptcy) by a chapter 11 plan and who are to receive a distribution are entitled to vote on the plan. After a bankruptcy case is commenced and with limited exceptions, a debtor

NEWSWORTHY

Corinne Ball (New York), ***Bruce Bennett (Los Angeles)***, ***Peter J. Benvenutti (San Francisco)***, ***Carl E. Black (Cleveland)***, ***Brad B. Erens (Chicago)***, ***Gregory M. Gordon (Dallas)***, ***David G. Heiman (Cleveland)***, ***James O. Johnston (Los Angeles)***, ***Aldo L. LaFiandra (Atlanta)***, ***Paul D. Leake (New York)***, ***Heather Lennox (New York and Cleveland)***, ***Kevyn D. Orr (Washington)***, ***Richard L. Wynne (Los Angeles)***, and ***Sydney B. McDole (Dallas, Business and Tort Litigation)*** were recognized in *Best Lawyers in America* (2013) in the field of Bankruptcy and Creditor Debtor Rights/Insolvency and Reorganization Law.

Corinne Ball (New York), ***Bruce Bennett (Los Angeles)***, ***Peter J. Benvenutti (San Francisco)***, ***Carl E. Black (Cleveland)***, ***James O. Johnston (Los Angeles)***, ***Paul D. Leake (New York)***, and ***Sidney P. Levinson (Los Angeles)*** were recognized in *Best Lawyers in America* (2013) in the field of Litigation-Bankruptcy.

Corinne Ball (New York), ***Bruce Bennett (Los Angeles)***, ***Jeffrey B. Ellman (Atlanta)***, ***Brad B. Erens (Chicago)***, ***Gregory M. Gordon (Dallas)***, ***David G. Heiman (Cleveland)***, ***James O. Johnston (Los Angeles)***, ***Paul D. Leake (New York)***, ***Heather Lennox (New York and Cleveland)***, ***Sidney P. Levinson (Los Angeles)***, ***Charles M. Oellermann (Columbus)***, ***Susan E. Siebert (Boston)***, ***Bennett L. Spiegel (Los Angeles)***, and ***Richard L. Wynne (Los Angeles)*** were recognized in the field of Bankruptcy in the 2012 *Super Lawyers Business Edition*.

Jones Day's Cleveland and Columbus offices were each designated a "Top Law Firm" in the 2012 *Super Lawyers Business Edition*, according to the number of Firm attorneys who were selected to the 2011 *Super Lawyers* list in business practice areas, as well as a combination of metrics indicating the quality of those attorneys. Factors considered included the number of years selected to the list, inclusion on a top list, and average blue-ribbon panel score.

Gregory M. Gordon (Dallas) was named to the list of the top 100 Dallas lawyers by *Super Lawyers*.

Jones Day was recognized for the practice area "Finance-Corporate restructuring and insolvency" in *The Legal 500 United Kingdom 2012*.

Corinne Ball (New York) was named a "Most Highly Regarded Individual" in the field of Insolvency and Restructuring in *The International Who's Who of Insolvency & Restructuring Lawyers 2012*. Receiving honorable mention were ***Paul D. Leake (New York)***, ***Bruce Bennett (Los Angeles)***, ***David G. Heiman (Cleveland)***, ***Kevyn D. Orr (Washington)***, and ***Michael Rutstein (London)***.

Bruce Bennett (Los Angeles) was named one of the 100 most influential attorneys in California by the Los Angeles and San Francisco *Daily Journal* on September 12.

Corinne Ball (New York), ***Kay V. Morley (London)***, and ***Matthew S. French (London)*** were recognized in the field of "Finance-Corporate restructuring and insolvency" in *The Legal 500 United Kingdom 2012*.

Gregory M. Gordon (Dallas) gave a presentation entitled "The Other Chapters: Chapter 9 and Chapter 15" at the State Bar of Texas-sponsored 30th Annual Advanced Business Bankruptcy Course on September 13 in Houston.

An article cowritten by ***Paul M. Green (Dallas)*** entitled "Reinstatement of Debt: Having Your Cake and Eating It Too" was published in the July/August 2012 edition of *Pratt's Journal of Bankruptcy Law*.

Lori Sinanyan (Los Angeles) took part in a panel discussion entitled "Current Developments in Bankruptcy Law" on September 14 at the American Bankruptcy Institute's 20th Annual Southwest Bankruptcy Conference in Las Vegas.

An article written by ***Lauren M. Buonome (New York)*** and ***Mark G. Douglas (New York)*** entitled "Section 506(a): Why 'Wait-and-See' Won't Work to Value Secured Creditor Claims" appeared in the September 2012 issue of *Pratt's Journal of Bankruptcy Law*.

An article written by ***Dan T. Moss (Washington)*** entitled "Eleventh Circuit Rules 'No-Action' Clause Bars Noteholders' Fraudulent-Transfer Claims" was published in the September 2012 edition of *Pratt's Journal of Bankruptcy Law*.

(or other plan proponent) can solicit votes on the plan only if holders of claims or interests are provided with a "disclosure statement" which is approved, after notice and a hearing, by the bankruptcy court and which contains "adequate information." Thus, before soliciting votes, a chapter 11 debtor generally must obtain court approval of its disclosure statement, and interested parties must have the opportunity to challenge approval.

By agreeing with those courts that have enabled parties to prevail on confirmation objections at the disclosure-statement stage, the Third Circuit has confirmed in *American Capital Equipment* that bankruptcy courts can avoid the expense and delay of pursuing confirmation of a plan that is destined to fail.

Following approval of the disclosure statement, the debtor may solicit votes on its plan and thereafter seek confirmation of the plan. To be confirmed, the plan must satisfy certain statutory requirements found in section 1129 of the Bankruptcy Code, including the following: (i) the plan complies with the Bankruptcy Code; (ii) the plan has been proposed in good faith; (iii) the plan has been accepted by at least one class of impaired creditors (without taking into account plan acceptances of insiders), if any class of creditors is impaired; (iv) each class of creditors and interest holders has accepted the plan (or is deemed to have accepted by reason of nonimpairment), or the plan is "fair and equitable" with respect to each dissenting class; and (v) the plan is "feasible," in that confirmation is not likely to be followed by the debtor's liquidation or need for further financial reorganization (unless contemplated by the plan). Parties may object to confirmation of the plan if it fails to satisfy one of those requirements, and those objections generally are heard at the confirmation hearing.

In *American Capital Equipment*, the Third Circuit considered whether a bankruptcy court may resolve objections to confirmation of a plan at the hearing to consider approval of the disclosure statement, rather than at the confirmation hearing.

AMERICAN CAPITAL EQUIPMENT

Skinner Engine Company, founded in 1868, manufactured steamship engines and parts from the 1930s to the 1970s that allegedly contained asbestos. In 1998, American Capital Equipment, LLC (collectively with Skinner Engine Company, "Skinner"), acquired all of Skinner Engine Company's common stock. Both companies filed for chapter 11 protection in 2001 in Pennsylvania.

At that time, more than 29,000 asbestos claims were pending against Skinner. The asbestos cases were previously consolidated and, in 1996, were administratively dismissed by a maritime court without prejudice, as the claimants had not provided real medical or exposure history. These "asymptomatic cases" could be activated if the plaintiffs began to suffer impairment and could show evidence of asbestos-related injury as well as evidence of exposure to the defendants' products. After the dismissal, only a few dozen cases met the criteria for reinstatement, and none resulted in a judgment or settlement against Skinner.

Skinner maintained insurance to provide coverage for such claims. Litigation concerning the scope of the insurance coverage commenced in 2005. Under its policies, Skinner was obligated to cooperate in the defense of claims and obtain the insurers' consent to claim settlements. As will be seen, these policies were a factor in the Third Circuit's decision.

In June 2001, Skinner filed its first chapter 11 plan. Following various objections, Skinner amended that plan. However, creditors voted to reject Skinner's second chapter 11 plan. Thereafter, Skinner sold its assets and paid the proceeds (other than certain funds to cover processing of asbestos claims) to its secured lender.

Following the sale, Skinner filed yet another chapter 11 plan, its third. Under the plan, common stock of "Reorganized Skinner," insurance recoveries, and $35,000 in cash from Skinner's secured lender would fund a section 524(g) asbestos trust to provide for current and future asbestos claimants. Section 524(g) of the Bankruptcy Code establishes a procedure for dealing with future personal-injury asbestos claims against a chapter 11 debtor that entails the creation of a trust to pay future claims and the issuance of an injunction to prevent future claimants from suing the debtor. All claims based upon asbestos-related injuries are channeled to the trust.

As part of Skinner's third plan, asbestos claimants would need to show asbestos injuries and exposure to Skinner's products. Further, any cash from insurance actions and policies otherwise payable to asbestos claimants would be subject to a 10 percent "surcharge," which would be used to pay other creditors from a "Plan Payment Fund." Following bankruptcy-court approval of the disclosure statement in February 2005, Skinner's creditors voted to accept the plan.

A few months later, Skinner's insurers moved to dismiss its bankruptcy cases because Skinner allegedly was no longer proceeding in good faith. In denying that motion (a ruling that was affirmed on appeal by a district court and the Third Circuit), the bankruptcy court stated that it could not approve a section 524(g) trust because Skinner was not a going concern. Thereafter, Skinner filed a fourth chapter 11 plan, omitting the section 524(g) trust but providing for a 20 percent surcharge on insurance recoveries to pay nonasbestos creditors under the Plan Payment Fund and retaining a process for allowance of asbestos claims (including future claims). Although asbestos claimants could resort to tort litigation to seek recovery, claimants were enjoined under the plan from doing so until claims allowed in the bankruptcy cases were paid. After the bankruptcy court rejected the injunction and questioned the propriety of the surcharge, Skinner filed a fifth plan.

The fifth chapter 11 plan omitted the injunction but retained the surcharge on insurance proceeds payable to asbestos claimants who opted into the plan's settlement process. The surcharge would be used to pay creditors through the Plan Payment Fund and to fund a claims-resolution process for asbestos claimants called the "Court Approved Distribution Procedures" (the "CADP"). Specifically, the CADP provided that:

> Each Asbestos Claimant shall maintain full and complete ownership of his or her Asbestos Claim, including, without limitation, the right to prosecute or settle any Asbestos Claim, but upon the Asbestos Claimant submitting his or her claim to the CADP, he or she shall thereby have agreed to pay the Surcharge Cash from any amounts paid on account of the Asbestos Claim under and through the CADP.

The CADP provided a basis for the plan trustee to evaluate asbestos claims and would have implemented claims-allowance criteria similar to those in the third and fourth plans. Insurers disagreeing with the plan trustee's determination of a claim could elect to seek a bankruptcy-court "determination" of that issue. However, a court determination was limited; the court was required to accept the amount proposed by either the trustee or the insurance company, and any decision would be binding and nonappealable by the insurers. Further, the plan's success depended on the surcharge to pay creditors and fund the CADP.

THE LOWER-COURT RULINGS AND APPEAL

At the disclosure-statement hearing, the bankruptcy court ruled that the fifth plan was "facially unconfirmable" because it failed to satisfy: (a) section 1129(a)(3) of the Bankruptcy Code, in that it was not proposed in good faith and was forbidden by law; and (b) section 1129(a)(11), because it was not feasible. The bankruptcy court also converted the cases to chapter 7, on the basis of its finding that Skinner would not be able to propose a confirmable plan. On appeal, the district court affirmed, and an appeal to the Third Circuit followed.

THE THIRD CIRCUIT'S DECISION

A three-judge panel of the Third Circuit addressed three primary issues on appeal.

First, the Third Circuit rejected Skinner's argument that the bankruptcy court erred by finding the plan unconfirmable absent a confirmation hearing. Agreeing with other courts that have addressed this issue, the Third Circuit ruled that a bankruptcy court can (subject to addressing due-process concerns) resolve confirmation issues at the disclosure-statement stage if the plan is patently unconfirmable. According to the court, a plan is patently unconfirmable if it has defects that cannot be overcome by the voting results and that concern matters for which all material facts are undisputed or have been developed at the disclosure-statement hearing.

Second, the Third Circuit agreed that the plan was not feasible and had not been proposed in good faith. As to feasibility, the court explained, a plan—including a liquidation plan—can be confirmed only if it is not likely to be followed by liquidation or further financial reorganization of the debtor or a successor under the plan, unless the liquidation or reorganization is proposed in the plan. Success need not be guaranteed; however, the plan must be reasonably likely to succeed. Thus, if the plan's success turns on uncertain and speculative litigation, it is not feasible, because success is only possible, not reasonably likely.

According to the Third Circuit, Skinner's plan was not feasible (i.e., it was not likely to succeed) because its sole source of funding was a surcharge on what the court characterized as "wholly speculative litigation proceeds." Not only did the plan depend on a sufficient number of claimants opting into the CADP rather than the court system, but even in that case, it could succeed only if enough claimants prevailed and contributed sufficient surcharge funds. Most of the claims, however, had been administratively dismissed and had so far been overwhelmingly unsuccessful. Because Skinner admitted that no plan would work absent a surcharge, the feasibility issue could not be cured. As there were no remaining disputed material facts, the Third Circuit concluded that the plan was patently unconfirmable on the grounds of unfeasibility.

In addressing the good-faith issue, the Third Circuit noted that what constitutes good faith depends on the context (and as a result, the Third Circuit's previous good-faith ruling in connection with the motion to dismiss did not dictate the results of the good-faith determination in the confirmation context). For purposes of plan confirmation, the court explained, the focus of the inquiry is the plan itself and whether the plan will achieve a result consistent with the objectives of the Bankruptcy Code. A debtor can pursue a valid bankruptcy goal (such as maximizing assets, thereby proceeding in good faith for purposes of determining whether the debtor's case should be dismissed), yet still propose a plan that is inconsistent with the Bankruptcy Code (and thus have a plan that has not been proposed in good faith).

The Third Circuit concluded that the plan was not proposed in good faith. The plan, the court explained, contained an inherent conflict of interest. On the one hand, Skinner could pay its creditors under the plan only if asbestos claimants obtained settlements and paid the surcharge. On the other hand, Skinner was obligated to cooperate in defending against the asbestos claims (thereby minimizing the amount of allowed claims as well as the surcharge). The Third Circuit agreed with the bankruptcy court's conclusion that the plan established a system under which Skinner would be "financially incentivized to sabotage its own defense."

At the same time, the Third Circuit emphasized, the claims process limited or eliminated the insurers' rights, including the right to take discovery and to appeal, without the protections of section 524(g). Finally, the plan trust was inconsistent with the asbestos-trust provisions of section 524(g). Under section 524(g), the court explained, a debtor is to fund the trust (at least partially) with its securities, and the trust, in turn, pays the asbestos claimants. Under Skinner's plan, however, the opposite would occur: contributions from participating asbestos claimants would be made to a fund that would be used to pay attorneys and other creditors.

While the Third Circuit did not rule that such provisions were per se impermissible, it found good faith lacking where: (i) Skinner's bankruptcy, which was due to cash-flow problems, was unrelated to the asbestos litigation, which involved mostly "asymptomatic" cases; (ii) the CADP, rather than being funded by the debtor (or its profits) to pay asbestos claimants, was funded by the asbestos claimants to pay creditors and attorneys; and (iii) the surcharge created an inherent conflict of interest, while the claims process deprived the insurers of their rights.

Finally, the Third Circuit affirmed the order converting Skinner's chapter 11 cases to chapter 7 liquidations.

CASE IMPLICATIONS

By agreeing with those courts that have enabled parties to prevail on confirmation objections at the disclosure-statement stage, the Third Circuit has confirmed in *American Capital Equipment* that bankruptcy courts can avoid the expense and delay of pursuing confirmation of a plan that is destined to fail.

TRADEMARK LICENSES IN BANKRUPTCY: THE SEVENTH CIRCUIT FIRES A SHOT ACROSS THE BOW OF *LUBRIZOL*

Charles M. Oellermann and Mark G. Douglas

In 1988, Congress added section 365(n) to the Bankruptcy Code, which grants some intellectual property licensees the right to continued use of licensed property notwithstanding rejection of the underlying executory license agreement by a debtor or bankruptcy trustee. The addition came three years after the Fourth Circuit Court of Appeals ruled in *Lubrizol Enters., Inc. v. Richmond Metal Finishers, Inc.*, 756 F.2d 1043 (4th Cir. 1985), that if a debtor rejects an executory intellectual property license, the licensee loses the right to use any licensed copyrights, trademarks, and patents. Despite the addition of section 365(n), the legacy of *Lubrizol* endures—by its terms, section 365(n) does not apply to trademark licenses and other kinds of "intellectual property" outside the Bankruptcy Code's definition of the term.

During the last few years, federal circuit courts of appeal have had an opportunity to confront *Lubrizol* by weighing in on how rejection in bankruptcy of a trademark license impacts the rights of the nondebtor licensee. In *In re Exide Technologies*, 607 F.3d 957 (3d Cir. 2010), the Third Circuit concluded, however, that the trademark license agreement at issue was not executory because the licensee had materially performed its obligations under the agreement at the time that the debtor filed for bankruptcy. Thus, the court never addressed whether rejection of the agreement (had it been found to be executory) would have terminated the licensee's right to use the debtor's trademark.

In July 2012, the Seventh Circuit took up the gauntlet, holding as a matter of first impression in *Sunbeam Products, Inc. v. Chicago American Manufacturing, LLC*, 686 F.3d 372 (7th Cir. 2012), that when a trademark license is rejected in bankruptcy, the licensee does not lose the ability to use any licensed intellectual property ("IP"). In doing so, the Seventh Circuit expressly rejected *Lubrizol*, providing a compelling invitation to U.S. Supreme Court review of this important issue to resolve the resulting split in the circuits.

LUBRIZOL AND BANKRUPTCY CODE SECTION 365(N)

In *Lubrizol*, the Fourth Circuit held that a debtor could reject an executory agreement pursuant to which it had licensed the exclusive right to use its IP, and upon rejection, the licensee lost the right to use that IP. Despite recognizing the "chilling effect" its holding might have on IP licensing agreements, the court saw no way around the plain language of the Bankruptcy Code as it existed at that time: the licensing agreement was an executory contract, the debtor rejected the executory contract, and it was "clear that the purpose of [section 365] is to provide only a damages remedy for the non-bankrupt party."

Section 365(g) of the Bankruptcy Code provides that rejection of an executory contract "constitutes a breach of such contract" effective "immediately before the date of the filing of the petition." According to the Fourth Circuit in *Lubrizol*:

> Under [section 365(g)], Lubrizol would be entitled to treat rejection as a breach and seek a money damages remedy; however, it could not seek to retain its contract rights in the technology by specific performance even if that remedy would ordinarily be available upon breach of this type of contract.

In response to *Lubrizol*, Congress added section 365(n) to the Bankruptcy Code to protect the rights of many (but not all) IP licensees. Section 365(n) gives such licensees two options when a debtor or trustee rejects an executory license agreement. The licensee may either: (i) treat the agreement as terminated (as in *Lubrizol*) and assert a claim for rejection damages; or (ii) retain the right to use the IP (with certain limitations). The legislative history of section 365(n) reveals that Congress intended to "make clear that the rights of an intellectual property licensee to use the licensed property cannot be unilaterally cut off as a result of the rejection of the license pursuant to Section 365 in the event of the licensor's bankruptcy."

But the story does not end there. "Intellectual property," as defined in section 101(35A) of the Bankruptcy Code, covers only certain types of IP, namely and only to the extent protected by applicable nonbankruptcy law: a trade secret; an invention, process, design, or plant protected under title 35 of the U.S. Code; a patent application; a plant variety; a work of authorship protected under title 17 of the U.S. Code; or a mask work protected under chapter 9 of title 17 of the U.S. Code.

Notably, trademarks, trade names, and service marks are not included in the definition of "intellectual property." Thus, the protections afforded IP licensees under section 365(n) do not apply to trademark licensees. Since section 365(n) was added to the Bankruptcy Code, courts have struggled to determine the proper treatment of trademark licenses in bankruptcy. For example, the Third Circuit 2010 ruling in *Exide Technologies* highlighted the uncertainty faced by trademark licensees when a debtor or trustee seeks to reject a trademark license agreement.

In *Exide Technologies*, the debtor, one of the world's largest producers of lead-acid batteries, licensed its trademark to another company for use in the industrial-battery business. After filing for chapter 11 protection in 2002, the debtor sought court approval to reject the trademark license agreement. The bankruptcy court held that the trademark license agreement was executory and that upon the debtor's rejection of the agreement, the rights of the licensee to use the debtor's trademarks were terminated because, among other things, the protections of section 365(n) do not apply to trademark licensees. According to the bankruptcy court, "Congress certainly could have included trademarks within the scope of § 365(n) . . . but saw fit not to protect them." The district court affirmed on appeal.

The Third Circuit reversed. The court concluded that the agreement was not executory because the nondebtor licensee had materially completed its performance under the contract prior to the debtor's bankruptcy filing. Thus, the court ruled, the agreement could not be assumed or rejected at all. As a consequence, the Third Circuit never addressed whether rejection of the agreement (had it been found to be executory) would have terminated the licensee's right to use the debtor's trademarks.

Resolution of this important issue has already been a long time coming for trademark licensees, who doubtless will keep close tabs on developments in *Sunbeam* as well as other cases that make their way through bankruptcy and appellate courts.

However, in a separate concurring opinion, circuit judge Thomas L. Ambro took issue with the bankruptcy court's conclusion that rejection of a trademark license agreement necessarily terminates the licensee's right to use the debtor's trademark. Congress's decision to leave treatment of trademark licenses to the courts, Judge Ambro argued, signals nothing more than Congress's inability, at the time it enacted section 365(n), to devote enough time to consideration of trademarks in the bankruptcy context; no negative inference should be drawn by the failure to include trademarks in the Bankruptcy Code's definition of "intellectual property." As Judge Ambro concluded, "[I]t is simply more freight than negative inference will bear to read rejection of a trademark license to effect the same result as termination of that license."

In *Sunbeam*, the Seventh Circuit picked up where Judge Ambro left off.

SUNBEAM

Lakewood Engineering and Manufacturing Co. ("Lakewood") entered into a supply contract with Chicago American Manufacturing ("CAM") in 2008 to produce Lakewood's box fans using motors manufactured by Lakewood. The contract included a nonexclusive license authorizing CAM to use Lakewood's patents and place Lakewood's trademarks on the fans. Because Lakewood was experiencing financial difficulty, CAM was reluctant to gear up its manufacturing operations with no assurance that Lakewood could pay for the 1.2 million fans that CAM was required to produce under the supply contract for the 2009 season. CAM accordingly bargained for the right to sell the 2009 run of box fans for its own account if Lakewood did not purchase them.

Three months into the contract, certain of Lakewood's creditors filed an involuntary chapter 7 petition against the company in Illinois. The chapter 7 trustee later sold the business, including Lakewood's patents and trademarks, to Sunbeam Products, Inc., which operates under the name "Jarden Consumer Solutions" ("Jarden"). Jarden wanted neither the fans in CAM's inventory nor CAM as a competitor in the box-fan market.

Although the bankruptcy trustee later rejected the supply contract, CAM continued to make and sell Lakewood-branded fans. Jarden and the trustee sued for infringement, seeking to prevent any further manufacturing or sale of the fans and claiming that, under the supply contract, CAM was obligated to stop making and selling fans once Lakewood stopped having requirements for them. The bankruptcy court, concluding that the supply contract was ambiguous, ultimately ruled that CAM was entitled to make as many fans as Lakewood estimated it would need in 2009 and to sell them bearing Lakewood's marks.

However, the bankruptcy court declined to address whether the trustee's rejection of the IP licenses precluded CAM from using Lakewood's trademarks. Agreeing with Judge Ambro's observation in *Exide* that sections 365(n) and 101(35A) leave open the question of whether rejection of an IP license ends the licensee's right to use trademarks, the bankruptcy court permitted CAM to continue using Lakewood's trademarks "on equitable grounds." Jarden's appeal was certified directly to the Seventh Circuit.

THE SEVENTH CIRCUIT'S RULING

Addressing the issue as a matter of first impression, the Seventh Circuit held that the rejection of a trademark license agreement does not abrogate the licensee's right to use the trademarks. The court of appeals faulted the bankruptcy court's reliance on equitable grounds for permitting continued use of Lakewood's trademarks as "untenable" but found that such reliance "does not necessarily require reversal."

Focusing on the impact of section 365(g), the Seventh Circuit explained that, outside bankruptcy, a licensor's breach does not terminate a licensee's right to use IP. Under the Uniform Commercial Code, CAM could have elected to treat the breach as ending its own obligations under the supply contract, or it could have opted to cover in the market by purchasing motors and billing Lakewood for the extra costs. CAM bargained for the right to sell Lakewood-branded fans for its own account if Lakewood defaulted. As such, the Seventh Circuit emphasized, "Lakewood could not have ended CAM's right to sell the box fans by failing to perform its own duties, any more than a borrower could end the lender's right to collect just by declaring that the debt will not be paid."

Section 365(g), the Seventh Circuit explained, does not alter these rights. "What § 365(g) does by classifying rejection as breach," the court wrote, "is establish that in bankruptcy, as outside of it, the other party's rights remain in place." The debtor's unfulfilled obligations under the contract are converted to damages, which, if the contract has not been assumed, are treated as a pre-petition obligation. "[N]othing about this process," the court remarked, "implies that any rights of the other contracting party have been vaporized." Instead, rejection "merely frees the estate from the obligation to perform and has no effect upon the contract's continued existence" (internal quotation marks and citation omitted).

The Seventh Circuit reasoned that lawmakers' failure to include trademark licenses within the ambit of section 365(n) should not be viewed as an endorsement of any particular approach to the ramifications to the licensee of rejection of a trademark license agreement. According to the court, "[A]n omission is just an omission." Moreover, the Seventh Circuit wrote, "[a]ccording to the Senate committee report on the bill that included §365(n), the omission was designed to allow more time for study, not to approve *Lubrizol*." *Lubrizol* itself, the court noted, devoted scant attention to the question of whether rejection cancels a contract, "worrying instead about the right way to identify executory contracts to which the rejection power applies." For this reason, the Seventh Circuit concluded, "*Lubrizol* does not persuade us."

OUTLOOK

The draft opinion in *Sunbeam* was circulated to all active judges on the Seventh Circuit before publication because of the split it creates between the Fourth Circuit and the Seventh Circuit. No judge favored a hearing en banc, and the issue has now been framed squarely for potential review by the U.S. Supreme Court (or perhaps legislative clarification). Resolution of this important issue has already been a long time coming for trademark licensees, who doubtless will keep close tabs on developments in *Sunbeam* as well as other cases that make their way through bankruptcy and appellate courts. Interestingly, the Eighth Circuit Court of Appeals recently had an opportunity to weigh in on the issue in *Lewis Brothers Bakeries Inc. and Chicago Baking Co. v. Interstate Brands Corp. (In re Interstate Bakeries Corp.)*, 2012 WL 3744504 (8th Cir. Aug. 30, 2012), but declined to do so, ruling that a trademark license was executory and therefore capable of being assumed or rejected, but not addressing what the ramifications of rejection would be for the non-debtor licensee.

In the meantime, trademark licensees (at least those in the Seventh Circuit) can be expected to invoke *Sunbeam* for the proposition that rejection of a trademark license agreement in bankruptcy does not terminate a licensee's ability to continue using a licensed trademark post-rejection. The same strategy may be employed by licensees of similar rights not necessarily encompassed by section 101(35A)'s definition of "intellectual property," such as patents and copyrights that are not protected under the U.S. Code.

FEDERAL-MOGUL GLOBAL: A VICTORY FOR BANKRUPTCY ASBESTOS TRUSTS

Benjamin Rosenblum

Affirming the bankruptcy and district courts below, the Third Circuit Court of Appeals, in *In re Federal-Mogul Global Inc.*, 684 F.3d 355 (3d Cir. 2012), held that a debtor could assign insurance policies to an asbestos trust established under section 524(g) of the Bankruptcy Code, notwithstanding anti-assignment provisions in the policies and applicable state law.

ASBESTOS TRUSTS IN BANKRUPTCY

One of the mechanisms available to a company seeking to address its asbestos liabilities is the creation of an "asbestos trust" by means of confirmation of a chapter 11 plan of reorganization. Asbestos trusts are an innovation of the 1982 bankruptcy case of Johns-Manville Corporation, which was once the largest producer of asbestos-containing products. In 1994, Congress seized on this innovation and enacted section 524(g) of the Bankruptcy Code, which established a statutory procedure for dealing with future personal-injury asbestos claims against a bankrupt company.

This procedure entails the creation of a trust to pay future claims and the issuance of an injunction to prevent future claimants from suing the debtor. All claims based upon asbestos-related injuries are channeled to the trust. The statute contains detailed requirements governing the nature and scope of any injunction issued under section 524(g) in connection with the confirmation of a chapter 11 plan under which a trust is established to deal with asbestos claims. Almost every section 524(g) trust is funded at least in part by the proceeds of insurance policies that the debtor has in effect to cover asbestos or other personal-injury claims. The debtor's plan of reorganization typically provides for an assignment of both the policies and their proceeds to the trust. Such an assignment, however, may violate the express terms of the policies or applicable nonbankruptcy law.

THE ESTATE, THE PLAN, AND PRE-EMPTION

Section 541 of the Bankruptcy Code provides that the filing of a bankruptcy case creates an estate. With some exceptions, the estate comprises all legal or equitable interests of the debtor in property as of the commencement of the case. Specifically included within this estate are all "[p]roceeds . . . from property of the estate" and "[a]ny interest in property that the estate acquires after commencement of the case." The majority of courts have concluded that a debtor's insurance policies (as well as policy proceeds) are property of the bankruptcy estate.

Section 1123 of the Bankruptcy Code provides that "[n]otwithstanding any otherwise applicable nonbankruptcy law, a plan shall . . . provide adequate means for the plan's implementation, such as . . . [a] transfer of all or any part of the property of the estate to one or more entities, whether organized before or after the confirmation of such plan." Reading sections 541 and 1123 together, it would appear that despite any otherwise applicable nonbankruptcy law, a plan may provide for the transfer of property of the estate, such as an insurance policy, to an entity such as an asbestos trust established under section 524(g).

The Third Circuit Court of Appeals, in the earlier decision of *In re Combustion Engineering, Inc.*, 391 F.3d 190 (3d Cir. 2004), appeared to so hold. However, whether an assignment of an insurance policy to an asbestos trust could be made, notwithstanding state law, was not the focus of the appeal, which addressed, among other things, whether the bankruptcy court's equitable powers could be deployed to extend the scope of a channeling injunction to include claims against nondebtor affiliates.

Further, section 1142 of the Bankruptcy Code, which generally addresses "implementation" of a chapter 11 plan, provides that "[n]otwithstanding any otherwise applicable nonbankruptcy law, rule, or regulation *relating to financial condition*, the debtor and any entity organized or to be organized for the purpose of carrying out the plan shall carry out the plan and shall comply with any orders of the court" (emphasis added). Section 1142, which was implemented in 1978 together with the rest of the Bankruptcy Code, has been construed to pre-empt only nonbankruptcy laws relating to financial condition.

In *Pac. Gas & Elec. Co. v. California ex rel. California Dept. of Toxic Substances Control*, 350 F.3d 932 (9th Cir. 2003), the Ninth Circuit Court of Appeals interpreted section 1123's pre-emption to be coextensive with section 1142's pre-emption. To reach this result, the Ninth Circuit relied on two presumptions: first, Congress would not lightly pre-empt state law, particularly in areas of traditional state regulation, and second, absent a clear indication to the contrary, Congress would not intend to drastically change bankruptcy law and practice from the law and practice under the Bankruptcy Act—the predecessor statute to the modern Bankruptcy Code. The precursor to section 1123 under the former Bankruptcy Act did not contain any pre-emptive language, and the pre-emptive language in section 1123 was added in 1984 pursuant to what were termed "technical" rather than substantive amendments. Because of this statutory history and context, and due to a general presumption that Congress does not undertake lightly to pre-empt state law, the Ninth Circuit interpreted the pre-emptive text of section 1123 to be no more broad than the already existing "notwithstanding" clause of section 1142 of the Bankruptcy Code, which, as noted, pre-empts only nonbankruptcy laws, rules, or regulations "relating to financial condition." Under this approach, a state-law or contract provision prohibiting assignment of an insurance policy would not be pre-empted by contrary provisions in a chapter 11 plan.

FEDERAL-MOGUL

On October 1, 2001, Federal-Mogul Global Inc. and affiliated entities (collectively, "Federal-Mogul") filed for chapter 11 relief in Delaware. Prior to the bankruptcy filing, Federal-Mogul was one of the world's largest manufacturers of automobile parts. Like many other manufacturers before it, the company faced enormous asbestos-related liabilities.

By filing for bankruptcy protection, Federal-Mogul sought a mechanism to address its asbestos exposure through a section 524(g) trust. In its plan of reorganization, the company proposed to channel present and future asbestos claims to an asbestos trust. The trust would be funded with various assets, including Federal-Mogul's rights to recovery under its liability insurance policies. The plan contained an "insurance neutrality" provision, which preserved the insurers' rights to assert against the trust any defense to coverage that might exist. The one defense that was not preserved for the insurers was the defense that the transfer to the trust violated the policies' anti-assignment provisions.

The Third Circuit's ruling in *Federal-Mogul* is a favorable development for companies wishing to address their asbestos liabilities through a chapter 11 plan of reorganization by means of the trust mechanism contained in section 524(g).

The insurers objected to the plan. As is standard in the industry, the policies prohibited the insured company from assigning them (or the rights thereunder) without the insurance companies' consents. According to the insurance companies, the chapter 11 plan could not transfer the policies to the asbestos trust in contravention of these rights and state law. The bankruptcy and district courts ruled against the insurers.

THE THIRD CIRCUIT'S RULING

Like the courts below, a three-judge panel of the Third Circuit Court of Appeals rejected the insurance companies' argument that Federal-Mogul could not assign its insurance policies to the asbestos trust. In doing so, the court first set the table by discussing the purpose and history of asbestos trusts. It noted their importance and that they are "the only national statutory scheme extant to resolve asbestos litigation through a quasi-administrative process." According to the court, "[T]he trusts are similar to workers' compensation or other administrative remedies that employ valuation grids to compensate injuries, subject to individualized and judicial review." However, the court wrote, "unlike those schemes, the trusts place the authority to adjudicate claims in private rather than public hands."

The Third Circuit then examined the Bankruptcy Code provisions at issue and noted the well-established principle that the Supremacy Clause of the U.S. Constitution (Art. VI, Cl. 2) invalidates state laws that interfere with federal law. While acknowledging that there is a presumption against pre-emption, the court explained that this presumption is overcome where Congress's desire to pre-empt state law is clear.

Next, the court turned to the insurers' argument that this was a case of first impression. Not so, according to the Third Circuit. Like the courts below, the Third Circuit determined that it had already held in *Combustion Engineering* that section 1123 of the Bankruptcy Code pre-empts anti-assignment provisions that would otherwise bar the transfer of insurance rights to an asbestos trust. Although the Third Circuit determined that its prior decision controlled the result in this case, it went on to address the insurers' various arguments.

The Third Circuit rejected the argument that section 1123's pre-emption scope should be based on section 1142 of the Bankruptcy Code and the Ninth Circuit's *Pacific Gas* decision. The court saw no reason to read sections 1123 and 1142 coextensively. And, while it found *Pacific Gas* distinguishable, it was "unconvinced" that sections 1123 and 1142 are so similar that they must be read together.

The court also rejected the argument for narrow pre-emption based on prior practice under the Bankruptcy Act and the applicable legislative history. While the law under the Bankruptcy Act may have been different, the Third Circuit explained, those practices were not governed by a statute that said "[n]otwithstanding any otherwise applicable nonbankruptcy law" and thus were not informative. Further, the legislative history was too "thin" and "inconclusive" to override the statutory language of section 1123.

Lastly, the Third Circuit addressed various hypotheticals raised by the insurers to demonstrate that section 1123 should not have broad pre-emptive scope because numerous scenarios exist where a debtor might employ section 1123 to avoid the strictures of federal or state law, resulting in absurdity. For example, under a broad reading of section 1123, a debtor could unilaterally override environmental laws barring transfer of a contaminated property, or a debtor could transfer a nuclear power plant to a third party in contravention of applicable regulations. According to the insurers, the statute could not possibly be read that way, and thus section 1123's pre-emptive scope has to be narrow. The Third Circuit answered these hypotheticals by explaining that its decision does not mean that the scope of pre-emption under section 1123(a) is boundless. Rather, the court emphasized, there is a long-standing presumption against pre-emption of state police powers, as well as the laws and regulations rooted in health and public safety. As such, while the anti-assignment provisions at issue did not implicate public health, safety, and welfare, the court acknowledged that limiting section 1123(a)'s pre-emptive scope on these grounds is "sensible." Consequently, the Third Circuit concluded that reading section 1123 to pre-empt the anti-assignment provisions does not result in absurdity.

ANALYSIS

The Third Circuit's ruling in *Federal-Mogul* is a favorable development for companies wishing to address their asbestos liabilities through a chapter 11 plan of reorganization by means of the trust mechanism contained in section 524(g). *Federal-Mogul* holds unequivocally that insurance policies associated with these liabilities may be transferred to these specialized trusts notwithstanding state-law anti-assignment clauses to the contrary. By promoting the transferability of such insurance policies, the holding may contribute to increased recoveries for asbestos claimants. The obvious losers in this case, by contrast, are the debtors' pre-petition insurers.

Although the Third Circuit's reasoning focused primarily on the plain language of the statute, the court's interpretation of such language is not free from controversy. Under *Federal-Mogul*'s interpretation of section 1123, any applicable nonbankruptcy law—at least any applicable nonbankruptcy law that does not address public health, safety, and welfare—would arguably be pre-empted, while under the Ninth Circuit's view, only nonbankruptcy law relating to financial condition is pre-empted. Given these conflicting authorities, the debate concerning the scope of section 1123 will undoubtedly continue. It also remains to be seen how courts will interpret the Third Circuit's suggestion that section 1123 may not pre-empt laws relating to public health, safety, and welfare.

WRIGHT v. OWENS CORNING—DEBTORS REMAIN IN THE "SHADOW OF *FRENVILLE*"

Paul M. Green and Amanda Suzuki

In 1984, the Third Circuit was the first court of appeals to examine the Bankruptcy Code's new definition of "claim" in *Avellino & Bienes v. M. Frenville Co. (In re M. Frenville Co.)*, 744 F.2d 332 (3d Cir. 1984). Focusing on the "right to payment" language in that definition, the court decided that a claim arises when a claimant's right to payment accrues under applicable nonbankruptcy law. This "accrual" test was widely criticized by other circuit courts as contradicting the broad definition of "claim" envisioned by Congress and the Bankruptcy Code.

In June 2010, responding to the nearly unanimous criticism of its opinion in *Frenville*, the Third Circuit decided *JELD-WEN, Inc. v. Van Brunt (In re Grossman's Inc.)*, 607 F.3d 114 (3d Cir. 2010), and specifically overruled *Frenville* (as well as the 26 intervening years of precedent). In its en banc decision, the court adopted the "exposure" test, a version of the "conduct" test used by other courts. However, *Grossman's* was fairly narrowly decided and failed to provide much guidance outside the asbestos context. Additionally, the court stressed that regardless of the applicable definition of "claim," due-process considerations remained an important part of the determination of whether a claim had been discharged, and consequently it remanded the due-process analysis to the bankruptcy court.

Earlier this year, the Third Circuit addressed the effect of *Grossman's* in *Wright v. Owens Corning*, 679 F.3d 101 (3d Cir. 2012), in an effort to clarify the impact its modified approach to the "claim" definition should have on the dischargeability of claims in a bankruptcy case that was filed before *Grossman's* was decided. In *Owens Corning*, the court held that, although *Grossman's* applies retroactively, due-process considerations mandated that the claims of certain unknown claimants not be discharged. The due-process determination hinged upon the definition of "claim" in effect at the time of the bankruptcy case, thereby resuscitating *Frenville*'s rule in certain circumstances and adding another layer of complexity to the analysis of discharged claims.

BACKGROUND

In October 2000, Owens Corning and certain of its affiliates filed for chapter 11 protection in Delaware. In November 2001, the bankruptcy court set a claims bar date of April 15, 2002, requiring all claimants to file proofs of claim on or before that date. The court also approved a bar date notice, which was published in *The New York Times, The Wall Street Journal*, and *USA Today*, among other publications. The notice directed claimants to file proofs of claim that arose prior to the filing of the debtors' bankruptcy cases. It specifically identified claims pertaining to "the sale, manufacture, distribution, installation and/or marketing of products by any of the Debtors, including without limitation . . . roofing shingles." The bankruptcy court confirmed a plan of reorganization for Owens Corning in September 2006.

In late 1998 or early 1999, Patricia Wright hired a contractor who installed shingles manufactured by Owens Corning. In 2005, Kevin West likewise hired a contractor who installed Owens Corning shingles on his roof. In 2009, both Wright and West discovered leaks and determined that the shingles had cracked. In an attempt to recover for the alleged defects in the shingles, Wright filed a class action against Owens Corning in November 2009, and West was later added as a plaintiff.

At the time the plaintiffs filed their class action, *Grossman's* had not been decided, and therefore *Frenville* applied. Under *Frenville*'s accrual approach, neither plaintiff had a "claim" subject to discharge because the claims did not accrue under applicable state law until the defects in the roofing shingles were manifested in 2009. Following the Third Circuit's 2010 ruling in *Grossman's*, however, Owens Corning filed a motion for summary judgment, arguing that the plaintiffs possessed pre-petition claims that had been discharged under the plan and confirmation order.

In response, the plaintiffs argued that: (i) the *Grossman's* holding should be limited to asbestos cases; (ii) *Grossman's* was not intended to apply retroactively; and (iii) the plaintiffs were not afforded due process because the notice in the bankruptcy case had been insufficient. The district court rejected these arguments and held that the plaintiffs' claims had been discharged.

On appeal, the plaintiffs revised their argument and asserted that the test set out in *Grossman's* was "unworkable" because, for a claim to exist under the test, the debtor and the claimant were required to anticipate a future tort action at the time of the bankruptcy case. The plaintiffs also continued to assert that they had not been afforded due process.

WHEN A CLAIM ARISES

After deciding that the plaintiffs had not waived their argument regarding the workability of *Grossman's* by failing to assert it in the district court, a three-judge panel of the Third Circuit determined that *Grossman's* applies retroactively and that Wright therefore held a "claim." The court explained that the test in *Grossman's* requires potential claimants to recognize that by being exposed to a debtor's product or conduct, they might hold claims even if no injury was evident at the time of the bankruptcy. As to West, the court determined that, even though his exposure had occurred post-petition (but pre-confirmation), he also had a claim. The court noted that limiting the *Grossman's* test to pre-petition exposure would "unnecessarily restrict" the Bankruptcy Code's expansive treatment of claims and would "separate artificially individuals who are affected . . . prepetition from those who are affected after the debtor's filing . . . but before confirmation of a plan." The court therefore extended the test under *Grossman's* to post-petition but pre-confirmation exposure.

The *Owens Corning* court's decision raises additional questions going forward. It now appears to be the case that the result unanimously criticized in *Frenville*, and seemingly disposed of in *Grossman's*, has been resurrected in part.

DUE-PROCESS CONSIDERATIONS

Despite its determination that both plaintiffs had claims, the Third Circuit held that neither of the claims was dischargeable because each plaintiff had received inadequate notice in violation of his or her due-process rights. After conceding that, generally, notice by publication is sufficient for unknown claimants like the plaintiffs, the court went on to explain that, although the notice might have been sufficient to most unknown claimants, it was insufficient as to the plaintiffs because *Frenville* was still the governing law at the time publication notice was issued. In other words, if the plaintiffs had reviewed the publication notice, they could not have known that their rights would be affected in any way by the bankruptcy case. The court noted, "Due process affords a re-do in these special situations to be sure all claimants have equal rights."

The Third Circuit held that "for persons who have 'claims' under the Bankruptcy Code based solely on the retroactive effect of the rule announced in *Grossman's*, those claims are not discharged when the notice given to those persons was with the understanding that they did not hold claims." In other words, the Third Circuit ruled that debtors could not use *Grossman's* to discharge claims retroactively that may have failed to exist under *Frenville*'s more narrow definition of "claim." Specifically with regard to the Wright class-action plaintiffs, the court held that neither plaintiff received due process and that such claims were therefore not discharged.

IMPLICATIONS OF THE THIRD CIRCUIT'S DECISION

The *Owens Corning* court's decision raises additional questions going forward. It now appears to be the case that the result unanimously criticized in *Frenville*, and seemingly disposed of in *Grossman's*, has been resurrected in part. Now, although pre-*Grossman's* claimants in the Third Circuit will technically be deemed to have claims, those claims will not be dischargeable, and the result for reorganized debtors that confirmed plans prior to June 2, 2010, will remain the same as that under *Frenville*.

It is difficult to predict how courts in the Third Circuit will rule when confronted with *Owens Corning*-like situations in the future—that is, situations in which the claimant had no reason to believe that it had a claim at the time of the bankruptcy and in which it seeks post-confirmation relief. Indeed, both *Grossman's* and *Owens Corning* suggest that courts should take a case-specific approach to due process, which will provide them with significant flexibility but may leave debtors with difficulty assessing which claims, if any, could pass through to a reorganized company or its successors.

In addition, the ramifications of *Owens Corning* regarding the sufficiency of publication notice to unknown creditors as a matter of due process remain to be seen. In a footnote, the Third Circuit specifically declined to address the issue:

> Given our reliance on the exceptional circumstances created by the retroactive application of *Grossman's*, we express no opinion on the broader issue of whether discharging unknown future claims comports with due process. . . . In this vein and consistent with our statements that whether due process has been provided depends on the circumstances of a particular case, our holding is not a bright-line rule that all persons with unknown future claims once governed by *Frenville* could not have been provided due process regardless of the adequacy of notice to those future claimants.

NEW BANKRUPTCY RULES PROPOSED

In August 2012, the Advisory Committee on Bankruptcy Rules of the Judicial Conference of the United States (the "Advisory Committee") announced proposed amendments to the Federal Rules of Bankruptcy Procedure (the "Bankruptcy Rules") and the Official Bankruptcy Forms. Changes have been proposed to Bankruptcy Rules 1014, 7004, 7008, 7012, 7016, 7054, 8001–8028, 9023, 9024, 9027, and 9033, and Official Forms 3A, 3B, 6I, 6J, 22A-1, 22A-2, 22B, 22C-1, and 22C-2, which include the "means test" forms. Changes have also been proposed to Appellate Rule 6, concerning appeals to the federal circuit courts of appeal in bankruptcy cases.

Among the proposed amendments are changes to Bankruptcy Rules 7008, 7012, 7016, 9027, and 9033 in response to the U.S. Supreme Court's ruling in *Stern v. Marshall*, 564 U.S. 2 (2011). In *Stern*, the Supreme Court held that a non-Article III bankruptcy judge is constitutionally prohibited from entering a final judgment on a debtor's common-law counterclaim against a creditor, even though 28 U.S.C. § 157(b)(2)(C) specifically designates "counterclaims by the estate against persons filing claims against the estate" as being within a bankruptcy court's "core" jurisdiction. Under the proposed amendments: (i) the terms "core" and "non-core" will be removed from Rules 7008, 7012, 9027, and 9033 (governing, respectively, pleadings, defenses and objections, removal, and proposed findings and conclusions in noncore proceedings) to avoid possible confusion in light of *Stern*; (ii) parties in all adversary proceedings will be required to state whether they consent to entry of final orders or judgment by the bankruptcy judge; and (iii) Rule 7016, which governs pre-trial procedures, will be amended to direct bankruptcy courts to decide which course of action to pursue in adversary proceedings (e.g., to enter a final judgment or submit proposed findings of fact and conclusions of law).

According to the Advisory Committee, the amendments are not intended to take a position on the question of whether party consent is adequate to permit a bankruptcy judge to enter a final judgment in a proceeding that would otherwise fall outside the scope of the judge's adjudicatory authority. The proposed changes, the Advisory Committee wrote, are "designed to frame the question of adjudicatory authority and allow the bankruptcy judge to determine the appropriate course of action. The court must decide whether to hear and finally adjudicate the proceeding, whether to hear it and issue proposed findings and conclusions, or whether to take some other action."

The proposed rule amendments would become effective December 1, 2014, if: (i) they are approved, with or without revision, by the relevant advisory committee, the Committee on Rules of Practice and Procedure, the Judicial Conference, and the Supreme Court; and (ii) Congress does not act to defer, modify, or reject them. The revisions to the Official Bankruptcy Forms would become effective December 1, 2013, if they are approved by the rules committee and the Judicial Conference. The proposed amendments, the rules committee reports explaining the proposed changes, and other information are posted on the Judiciary's web site at http://www.uscourts.gov/uscourts/rules/rules-published-comment.pdf.

All comments to the proposed changes must be submitted no later than February 15, 2013. Comments may be submitted electronically to rules_comments@ao.uscourts.gov or to the Committee on Rules of Practice and Procedure, Administrative Office of the United States Courts, Suite 7-240, Washington, D.C. 20544.

EUROPEAN PERSPECTIVE IN BRIEF

Europe has struggled mightily during the last several years to triage a long series of critical blows to the economies of the 27 countries that comprise the European Union as well as the collective viability of euro-zone economies. Here we provide a snapshot of some recent developments relating to insolvency and restructuring in the EU.

The U.K.—On July 26, 2012, the U.K. Pensions Regulator issued a statement on financial support directions ("FSDs") with the intention of providing further guidance regarding the circumstances under which it will issue an FSD after a company has been placed into administration under the U.K. Insolvency Act 1986, as amended by the U.K. Enterprise Act 2002. Following the October 2011 rulings issued in connection with Lehman Brothers and Nortel Networks (*Bloom v. The Pensions Regulator* [2011] EWCA CIB 1124), an FSD issued before a company goes into administration will rank as a general unsecured debt, whereas an FSD issued post-administration will rank as an expense of administration. An FSD issued after administration will therefore be discharged from floating-charge (as opposed to fixed-charge) realizations and will rank above payment of the administrator's own remuneration. The priority of FSDs over floating-charge holders could have a material impact on returns to secured creditors, particularly where there are few or no fixed-charge assets.

The current ranking of FSDs issued after administration is of great concern to insolvency practitioners and lenders. In response to these concerns, the Pensions Regulator has stated that it has no intention of deliberately delaying the issuance of an FSD until a company goes into administration (and therefore taking advantage of the post-insolvency priority ranking). In addition, the Pensions Regulator has stated that, in most circumstances, it will not object to an application made by an administrator to reorder the statutory priorities so that a claim for payment of the administrator's reasonable remuneration will rank ahead of an FSD. The Pensions Regulator also advised that in the forthcoming appeal to the U.K. Supreme Court arising from the Lehman Brothers and Nortel Networks matters (scheduled to be heard on May 14, 2013), it will argue that an FSD issued after the commencement of an administration proceeding should rank in priority as a general unsecured debt rather than an expense of administration. Although welcome, the statement is unlikely to provide the certainty hoped for by stakeholders from the U.K. Supreme Court in connection with the appeal.

Other recent European developments can be tracked in Jones Day's *EuroResource*.

AMENDMENTS TO RUSSIAN BANKRUPTCY AND FINANCIAL LAWS

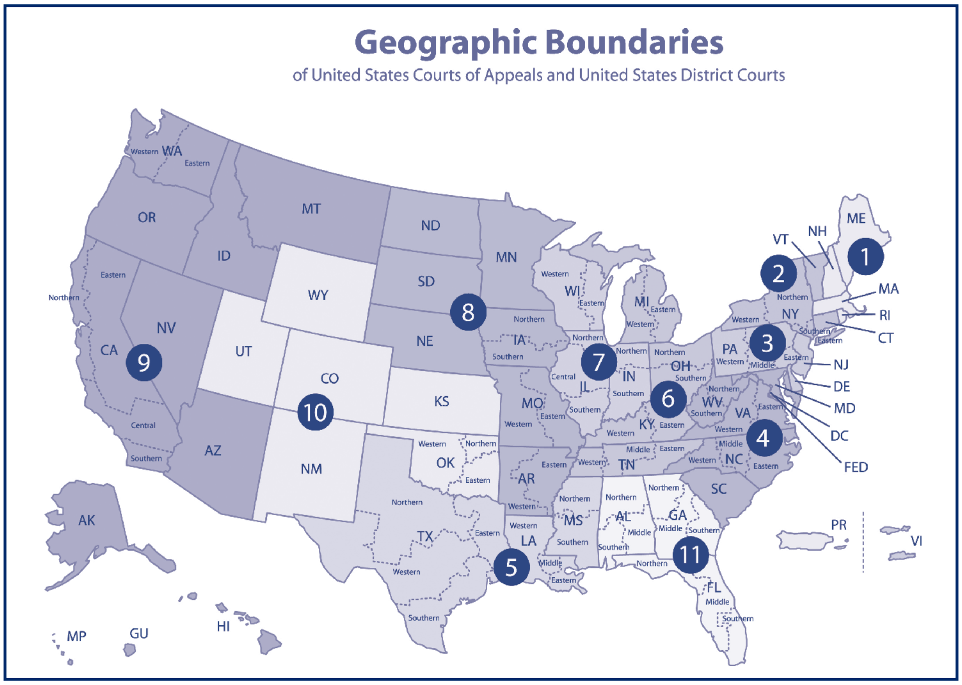
On July 28, 2012, Russian president Vladimir Putin gave his imprimatur to Federal Law No. 144-FZ, which amends Russian bankruptcy, financial, and banking legislation with the goal of improving regulations governing asset returns and interim management of insolvent banks. Among other things, the amendments change Russian insolvency law to remove executive compensation and bonuses from the list of priority claims in cases involving insolvent companies. The new law amends regulations governing interim administrations of financial and banking entities that have forfeited their operational licenses, and it also revises the powers of the Russian federal deposit insurance agency.

The new legislation amends Articles 5, 20.7, 61.2, 99, 110–111, 115, 126, 129–130, 132, 134, 136, 139, and 143 of Federal Law No. 127-FZ on insolvency (bankruptcy) dated October 26, 2002 (the "Bankruptcy Law"). The amendments alter provisions in the Bankruptcy Law governing creditor claims, interim management during insolvency proceedings, the return of client assets, and evaluation of a banking entity's assets during insolvency.

The new law also adds a provision to Federal Law No. 40-FZ (February 25, 1999), which governs insolvency proceedings of credit entities. New Article 22.2 sets forth regulations for interim administration of insolvent banks. Article 20 of Federal Law No. 17-FZ (February 3, 1996) was also amended to add provisions designed to ensure, in proceedings involving insolvent banks, the return to clients of securities and other assets acquired by the banks on behalf of clients in accordance with trust management and brokerage contracts. In addition, Article 40.1 of Federal Law No. 17-FZ was amended to set forth requirements designed to ensure the safety of records and databases of insolvent banks.

The new law was adopted on July 13 by the State Duma, the lower house of parliament, and on July 18 by the Federation Council, the upper house of parliament. It takes effect 90 days after its official publication on August 1, 2012.

THE U.S. FEDERAL JUDICIARY



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

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

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

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

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