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IN THIS ISSUE

SALE "FREE AND CLEAR" DOES NOT EXTINGUISH SUBLESSEE'S RIGHT TO REMAIN IN POSSESSION

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The ability of a trustee or chapter 11 debtor in possession ("DIP") to sell bankruptcy estate assets "free and clear" of competing interests in the property has long been recognized as one of the most important advantages of a bankruptcy filing as a vehicle for restructuring a debtor's balance sheet and generating value. Still, section 363(f) of the Bankruptcy Code, which delineates the circumstances under which an asset can be sold free and clear of "any interest in such property," has generated a fair amount of controversy. This is so in part because the statute itself does not define "interest."

Although generally acknowledged to encompass liens and security interests, section 363(f)'s scope would appear to be much broader, taking into account both the language of the provision and its underlying purpose. Broadly applied, however, section 363(f) arguably conflicts with certain other provisions of the Bankruptcy Code.

One of those provisions is section 365(h)(1). Section 365(h)(1) provides that, if the trustee or DIP rejects an executory real property lease under which the debtor is the lessor, the nondebtor lessee (and any permitted successor or assign, pursuant to subsection (h)(1)(D)) has the option to retain its rights under the lease for the balance of the lease term. Courts disagree as to whether the rights of a lessee or sublessee under section 365(h)(1) are effectively extinguished if the leased real property (or the lease itself) is sold free and clear of any "interest" under section 363(f). This was the thorny question addressed by the bankruptcy court in *In re Zota Petroleums, LLC*, 2012 BL 259645 (Bankr. E.D. Va. Oct. 1, 2012).

SALES FREE AND CLEAR

Section 363(f) of the Bankruptcy Code authorizes a trustee to sell property "free and clear of any interest in such property of an entity other than the estate" under any one of five specified conditions. These include, among other things, if applicable nonbankruptcy law permits a sale free and clear, if the sale price exceeds the aggregate value of all liens encumbering the property, or if the interest is in bona fide dispute. A bankruptcy court's power to order sales free and clear of competing interests without the consent of the party asserting the interest has been recognized for more than a century. *See Ray v. Norseworthy*, 90 U.S. 128, 131–32 (1875); *Van Huffel v. Harkelrode*, 284 U.S. 225, 227 (1931). It promotes the expeditious liquidation of estate assets by avoiding delay attendant to sorting out disputes concerning the validity and extent of competing interests, which can later be resolved in a centralized forum. It also facilitates the estate's realization of the maximum value possible from an asset. A prospective buyer would discount its offer significantly if it faced the prospect of protracted litigation to obtain clear title to an asset. Pending the bankruptcy court's resolution of any disputes, section 363(e) of the Bankruptcy Code provides that the nondebtor is entitled to "adequate protection" of its interest. This most commonly takes the form of a replacement lien on the proceeds of the sale.

"ANY INTEREST" BROADLY CONSTRUED

Section 363(f) has been applied to a wide range of interests. Courts, however, have sometimes struggled to comprehend the precise scope of the term "interest," which is defined nowhere in the Bankruptcy Code or its accompanying legislative history. Most courts reject the narrow approach adopted by courts that find section 363(f) to be confined to *in rem* property interests or only those claims which have already been asserted at the time the property is sold. Instead, the majority construe the term broadly to encompass other obligations that may flow from ownership of property, including, for example, successor liability claims. *See, e.g.*, *In re Trans World Airlines, Inc.*, 322 F.3d 283 (3d Cir. 2003); *UMWA 1992 Benefit Plan v. Leckie Smokeless Coal Co. (In re Leckie Smokeless Coal Co.)*, 99 F.3d 573 (4th Cir. 1996). *But see Olson v. Frederico (In re Grumman Olson Indus., Inc.)*, 445 B.R. 243 (Bankr. S.D.N.Y. 2011) (section 363 sale order cannot exonerate purchasers from successor liability claims by claimants who, at the time of the sale, had not yet been injured and had no contact or relationship with the debtor or its products).

Section 363(f) is problematic if a debtor-lessor seeks to sell property free and clear of the possessory interests of tenants or subtenants. This is so because section 365(h)(1) specifically protects such interests. As noted previously, section 365(h)(1) provides that, if the trustee or DIP rejects an executory real property lease under which the debtor is the lessor, the nondebtor lessee (and any permitted successor or assign) has the option either: (i) to treat the lease as terminated and file a claim for breach; or (ii) to retain its rights under the lease for the balance of the lease term (including any renewal or extension periods). Section 365(h)(2) provides similar protections to the purchaser of a debtor's time-share interest.

In enacting section 365(h)(1), lawmakers sought to "codify a delicate balance between the rights of a debtor-lessor and the rights of its tenants" by preserving the parties' expectations in a real estate transaction. *In re Lee Road Partners, Ltd.*, 155 B.R. 55, 60 (Bankr. E.D.N.Y. 1993). The provision's legislative history indicates that lawmakers intended that rejection of a lease by a debtor-lessor should not deprive the tenant of its estate for the term for which it bargained. H.R. Rep. No. 95-595, 349–50 (1977); S. Rep. No. 95-989, 60 (1978).

The apparent conflict between sections 365(h)(1) and 363(f) was considered as a matter of first impression in the circuit courts of appeal by the Seventh Circuit in *Precision Industries, Inc. v. Qualitech Steel SBQ*, 327 F.3d 537 (7th Cir. 2003). In *Qualitech Steel*, a chapter 11 debtor sold substantially all of its assets (including a steel mill containing a warehouse leased to Precision Industries, Inc. ("Precision") for 10 years) to the mortgagee of the property. The order approving the sale provided that the assets were to be conveyed "free and clear of all liens, claims, encumbrances, and interests," except those specifically excepted. Precision was notified of the sale, yet chose not to object. Instead, it negotiated with the ultimate buyer of the property regarding the assumption of its (unrecorded) lease. Those negotiations proved futile, and Precision's lease agreement was deemed rejected in accordance with the terms of the debtor's chapter 11 plan.

Zota Petroleums is undeniably a positive development for both commercial and residential lessees and sublessees of landlords that file for bankruptcy protection. According to the court's reasoning, the protections provided in section 365(h)(1) cannot be nullified by structuring a transaction that includes, or effectively results in, rejection of a lease or sublease as part of a sale of the underlying real property or the debtor's leasehold interest "free and clear" under section 363(f).

Precision commenced litigation seeking a determination that it retained a possessory interest in the warehouse notwithstanding the sale of the property. The bankruptcy court ruled that, on the basis of the terms of both section 363(f) and the sale order, the new owner had obtained title to the property free and clear of Precision's leasehold interest. According to the court, that interest clearly qualified as "any interest" under the statute and was unequivocally "extinguished" by the terms of the sale order. It also implicitly rejected the idea that section 365(h)(1) somehow preserved Precision's rights.

Precision appealed to the district court, which reversed. Reasoning that the provisions of sections 363(f) and 365(h) are incongruous, the district court held that "the terms of section 365(h) prevail over those of section 363(f) as applied to the rights of lessees." It concluded that the more specific terms of section 365(h) must override the more general scope of section 363(f), observing that "[t]here is no statutory basis for allowing the debtor-lessor to terminate the lessee's position by selling the property out from under the lessee, and thus limiting a lessee's post-rejection rights solely to cases where the debtor-lessor remains in possession of its property." The new owner of the property appealed to the Seventh Circuit.

The Seventh Circuit reversed. Mindful of its obligation to construe the two statutory provisions in a way that avoids conflict if at all possible, the Seventh Circuit did precisely that. Despite the Bankruptcy Code's silence on the exact meaning of "any interest," the court emphasized, the term itself is sufficiently comprehensive to encompass a broad range of competing rights. Given the U.S. Supreme Court's observations in other contexts that "interest" is a broad term, the Seventh Circuit concluded that the right conferred by a leasehold upon the lessee "readily may be understood as an 'interest' in the property" within the meaning of section 363(f).

The Seventh Circuit faulted the district court's reliance upon an apparent contradiction between the two provisions as a basis for reversing the bankruptcy court. First, the Seventh Circuit noted, the provisions themselves do not suggest that one supersedes or limits the other, whereas other subsections of both sections 363 and 365 contain specific cross-references to other provisions that have a limiting effect on their scope. The court then observed that the plain language of section 365(h) suggests that it is limited in scope. In particular, section 365(h) expressly applies only to situations where the trustee rejects a lease but retains possession of the property. In contrast, if the trustee does not reject the lease but sells the underlying property under section 363(f), the sale will be free and clear of the tenant's possessory interest (provided it meets one of the five conditions).

According to the Seventh Circuit, a lessee is not without recourse if its leasehold rights are extinguished in this way. Section 363(e) gives it the right to demand adequate protection of its interest in the property. This would most likely take the form of compensation for the value of its forfeited leasehold.

Qualitech Steel is the only circuit-court ruling to date addressing the interplay between sections 363(f) and 365(h)(1). A number of lower courts have reached the same conclusion as the Seventh Circuit for some or all of the same reasons. *See*, *e.g.*, *In re Downtown Athletic Club of New York City, Inc.*, 2000 WL 744126 (S.D.N.Y. June 9, 2000); *South Motor Co. v. Carter-Pritchett-Hodges, Inc. (In re MMH Automotive Group, LLC)*, 385 B.R. 347 (Bankr. S.D. Fla. 2008). Other courts have ruled to the contrary. *See*, *e.g.*, *In re Samaritan Alliance, LLC*, 2007

BL 156456, 2007 WL 4162918 (Bankr. E.D. Ky. Nov. 21, 2007); In re Haskell, L.P., 321 B.R. 1 (Bankr. D. Mass. 2005); *In re Churchill Properties III, Ltd. Partnership*, 197 B.R. 283 (Bankr. N.D. Ill. 1996). Thus, in *Zota Petroleums*, the bankruptcy court joined a fray in which the combatants have been roughly evenly divided.

Zota Petroleums is only one lower court's take on a divisive issue. Moreover, the only authority at the circuit level regarding this question is at least arguably to the contrary. Therefore, whether a nondebtor lessee or sublessee can rely on section 365(h)(1) to preserve its rights under a rejected lease or sublease in the section 363 sale context is very much an open question that may hinge on the venue of the debtor's bankruptcy case.

ZOTA PETROLEUMS

Zota Petroleums, LLC ("Zota") leased 16 gas stations and convenience stores in Virginia. One of those businesses was located on a parcel of real property leased from Kelmont, LLC ("Kelmont"), which Zota subleased to D&MRE, LLC ("D&MRE").

Zota filed for chapter 11 protection in Virginia on August 7, 2011. Shortly afterward, a chapter 11 trustee appointed in the case sought a court order authorizing an auction process for the sale of substantially all of Zota's assets as well as the assumption and assignment of leases and executory contracts, including the lease between Zota and Kelmont. The trustee later moved to reject the sublease between Zota and D&MRE.

The bankruptcy court approved the sale of Zota's assets to LAP Petroleum, LLC ("LAP") on November 30, 2011. The sale order provided that:

> [t]o the extent of applicable law, the sale of the Assets shall vest LAP with good title to the Assets, and the Assets shall be free and clear of any and all liens, encumbrances and any and all 'claims' as defined in § 101(5) of the Bankruptcy Code . . . other than as provided in the [asset purchase agreement].

The order further provided that the trustee was authorized to assume and assign the identified leases, including the Kelmont lease. The bankruptcy court authorized the trustee to reject the D&MRE sublease by separate order entered on the same date.

D&MRE later filed a motion seeking a determination that section 365(h)(1)(A) gave it, as sublessee, the ability to retain its rights under the rejected sublease. LAP objected, arguing, among other things, that section 365(h) does not apply because LAP acquired Zota's assets, including the Kelmont lease, free and clear of all interests under section 363(f).

THE BANKRUPTCY COURT'S RULING

The bankruptcy court ruled in favor of D&MRE. The rationale underlying decisions prohibiting the extinguishment of a sublessee's section 365(h) rights through a section 363 sale, the court explained, "has been based in part upon the statutory construction principle that the more specific provision should prevail over the general." According to this reasoning, because Congress decided that lessees should have the option under section 365(h)(1) to remain in possession, "it would make little sense to permit a general provision, such as Section 363(f), to override its purpose." In addition, the *Zota Petroleums* court emphasized that such cases generally rely upon the legislative history of section 365(h), which, as noted, reflects lawmakers' desire to protect the rights of a debtor's tenants.

The court concluded that LAP's reliance on *Qualitech Steel* was misplaced. That case, the bankruptcy court emphasized, is distinguishable because, among other things, the Seventh Circuit specifically noted that it was *not* addressing whether a section 363 sale could divest a tenant of its rights after the rejection of an unexpired lease.

Instead, the *Zota Petroleums* court was persuaded by the reasoning of the courts in *In re Samaritan Alliance, LLC*, 2007 BL 156456, 2007 WL 4162918 (Bankr. E.D. Ky. Nov. 21, 2007), and *In re Haskell, L.P.*, 321 B.R. 1 (Bankr. D. Mass. 2005), which are more factually apposite and, in the bankruptcy court's view, better construe the interplay between sections 363(f) and 365(h):

The court has evaluated the arguments contained in the *Qualitech* and *Haskell* lines of cases and, as did the court in *Samaritan Alliance*, agrees with the conclusion reached by the court in *Haskell*. The rights of the tenant may not be extinguished by a § 363 sale; to hold to the contrary would give open license to debtors to dispossess tenants by utilizing the § 363 sale mechanism. The court cannot countenance this result, especially under the facts of this case, when, as previously noted, 1) the transaction was titled as a sale free and clear and an assumption and assignment, and 2) all parties had notice therefore that the provisions of § 365 were thus implicated, 3) the [asset purchase agreement] itself contained an Exhibit listing the leases to be assumed and assigned and giving cure amounts, and 4) the sublease was specifically rejected pursuant to the provisions of § 365. The court also notes that there is no adequate protection proposed. This result will also be in accord with the legislative history of § 365, which indicates the desire of Congress to preserve the rights of a party to a real property lease that a lessor debtor has rejected.

OUTLOOK

Zota Petroleums is undeniably a positive development for both commercial and residential lessees and sublessees of landlords that file for bankruptcy protection. According to the court's reasoning, the protections provided in section 365(h)(1) cannot be nullified by structuring a transaction that includes, or effectively results in, rejection of a lease or sublease as part of a sale of the underlying real property or the debtor's leasehold interest "free and clear" under section 363(f).

However, *Zota Petroleums* is only one lower court's take on a divisive issue. Moreover, the only authority at the circuit level regarding this question is at least arguably to the contrary. Therefore, whether a nondebtor lessee or sublessee can rely on section 365(h)(1) to preserve its rights under a rejected lease or sublease in the section 363 sale context is very much an open question that may hinge on the venue of the debtor's bankruptcy case.

STOCKTON, CALIFORNIA, RULING: BANKRUPTCY COURT POWERLESS TO PREVENT RETIREE BENEFIT REDUCTIONS BY MUNICIPAL DEBTOR

Jeffrey B. Ellman and Mark G. Douglas

Amid the economic hardships brought upon us by the Great Recession, the plight of cities, towns, and other municipalities across the U.S. has received a significant amount of media exposure. The media has been particularly interested in the spate of recent chapter 9 bankruptcy filings by Vallejo, Stockton, San Bernardino, and Mammoth Lakes, California; Jefferson County, Alabama; Harrisburg, Pennsylvania; and Central Falls, Rhode Island. A variety of factors have combined to create a virtual maelstrom of woes for U.S. municipalities—a reduction in the tax base caused by increased unemployment; plummeting real estate values and a high rate of mortgage foreclosures; questionable investments; underfunded pension plans and retiree benefits; decreased federal aid; and escalating costs (including the higher cost of borrowing due to the meltdown of the bond mortgage industry and the demise of the market for auction-rate securities). Addressing any one of these issues is a challenge for a municipality. Together, the burden has been too great for some municipalities to bear.

One option available to certain municipalities facing potential financial catastrophe is to seek relief under chapter 9 of the Bankruptcy Code. Chapter 9 for a long time was an obscure and little used legal framework, but it has grown more prominent in recent years as an option for struggling municipalities. Chapter 9 allows an eligible municipality to "adjust" its debts by means of a "plan of adjustment," similar in many respects to a plan of reorganization in a chapter 11 bankruptcy 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.

This inherent constitutional tension was the subject of a ruling recently handed down by a California bankruptcy court. In *In re City of Stockton, California*, 478 B.R. 8 (Bankr. E.D. Cal. 2012), the court held that: (i) the debtor city could unilaterally reduce the benefits of its retirees without offending the Contracts Clause of the U.S. Constitution (even where those benefits otherwise may be considered contractual in nature under state law); and (ii) the court was not permitted to enjoin the debtor from implementing the benefit reductions due to the express limitations on a bankruptcy court's jurisdictional mandate in chapter 9 cases. The court also affirmed the jurisdiction of bankruptcy courts to make such determinations and declined a request to cede jurisdiction of this dispute to state courts in California.

MUNICIPAL BANKRUPTCY LAW

Ushered in during the Great Depression to fill a vacuum that previously existed in both federal and state law, federal municipal bankruptcy law has been plagued by a potential constitutional flaw that endures in certain respects to this day—the Tenth Amendment reserves to the states sovereignty over their internal affairs. This reservation of rights caused the U.S. Supreme Court to strike down the first federal municipal bankruptcy law as unconstitutional in *Ashton v. Cameron County Water Improvement Dist. No. 1*, 298 U.S. 513 (1936), and it accounts for the limited scope of chapter 9, as well as the severely restricted role the bankruptcy court plays in presiding over a chapter 9 case and in overseeing the affairs of a municipal debtor.

The Supreme Court later validated a revised municipal bankruptcy statute in United States v. Bekins, 304 U.S. 27 (1938), concluding that revisions to the law designed to reduce the opportunity for excessive federal control over state sovereignty struck a constitutionally permissible balance. The present-day legislative scheme for municipal debt reorganizations was implemented in the aftermath of New York City's financial crisis and bailout by the New York State government in 1975, but chapter 9 has proved to be of limited utility. Historically, relatively few cities or counties have filed for chapter 9 protection. The vast majority of chapter 9 filings have involved municipal instrumentalities, such as irrigation districts, public-utility districts, waste-removal districts, and health-care or hospital districts. In fact, according to the Administrative Office of the U.S. Courts, fewer than 650 municipal bankruptcy petitions have been filed in the 75 years since Congress established a federal mechanism for the resolution of municipal debts in 1937. Fewer than 280 chapter 9 cases have been filed since the current version of the Bankruptcy Code was enacted in 1978—although the volume of chapter 9 cases has increased somewhat in recent years. By contrast, there were 1,529 chapter 11 cases filed in 2011 alone.

CONSTITUTIONAL COMPROMISES

Access to chapter 9 is limited to municipalities under section 109(c)(1) of the Bankruptcy Code. A "municipality" is defined by section 101(40) of the Bankruptcy Code as a "political subdivision or public agency or instrumentality of a State." Section 109(c) of the Bankruptcy Code identifies other mandatory prerequisites to relief under chapter 9, including the requirement that the municipality be "specifically authorized, in its capacity as a municipality or by name, to be a debtor under [chapter 9] by State law, or by a governmental officer or organization empowered by State law to authorize such entity to be a debtor under [chapter 9]."

More than half of the states have no statute specifically authorizing municipalities to file for chapter 9 relief, meaning that a municipality in these states cannot file for bankruptcy unless a statute is enacted specifically authorizing a filing. Elsewhere, the nature of state authorizing statutes varies greatly. Some states generally authorize *any* municipality to file for chapter 9 relief, while many other states restrict municipal bankruptcy filings to certain limited circumstances or require certain prior approvals and consents. In either case, once the conditions to a filing have been achieved and the filing occurs, the entirety of chapter 9 applies. Even so, chapter 9 establishes a framework of debt adjustment that is constrained by the U.S. Constitution. Various provisions of chapter 9 establish strict limitations to preserve the delicate constitutional balance between state sovereignty and federal bankruptcy power. Several key examples are described below.

First, section 903 of the Bankruptcy Code expressly reserves to the states the power "to control, by legislation or otherwise," municipalities that file for chapter 9 protection, with the caveat—and the significant limitation—that any state law (or judgment entered thereunder) prescribing a method of composition of indebtedness among a municipality's creditors is not binding on dissenters.

NEWSWORTHY

Jones Day's Business Restructuring & Reorganization Practice received a "Tier 1" national ranking in the 2013 "Best Law Firms" survey published jointly by *U.S. News & World Report* and *Best Lawyers*.

Mark A. Cody (Chicago), ***Brad B. Erens (Chicago)***, ***Timothy W. Hoffmann (Chicago)***, and ***Robert E. Krebs (Chicago)*** received a 2012 TMA Turnaround and Transaction of the Year Award for their efforts in connection with the pre-arranged chapter 11 case of Harry & David.

Corinne Ball (New York) was named one of the "Top 50 Women Attorneys in New York" for 2012 by *The New York Times*.

Amy Edgy Ferber (Atlanta) gave a presentation entitled "Creditor Representation—Issues, Strategies, Litigation Solutions and Ethical Concerns" on November 2 at the Georgia State Bar's Institute of Continuing Legal Education in Atlanta.

John H. Chase (Dallas) coauthored an article entitled "When Business Efficiency and Bankruptcy Collide: Resolving Intercompany Claims" in the September 2012 issue of the *Norton Journal of Bankruptcy Law and Practice*.

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

Corinne Ball (New York) was the recipient of a 2012 Woman of the Year Award from the International Women's Insolvency & Restructuring Confederation. The awards are presented to women who have made significant contributions in the insolvency fields.

Sion Richards (London) was named a "leading lawyer" in the 2012 edition of *The Legal 500 United Kingdom* in the field of "Crime, fraud and licensing—Fraud."

Michael Rutstein (London) and ***Sion Richards (London)*** were named "leading lawyers" in the field of Restructuring/Insolvency in the 2013 edition of *Chambers UK: A Client's Guide to the UK Legal Profession*.

Corinne Ball (New York) was named one of the "Top 50 Women New York Super Lawyers" for 2012 by *Super Lawyers*.

Mark A. Cody (Chicago) moderated a round-table discussion on October 17 concerning bankruptcy-remote structures at the 2012 Legal & Compliance Council Meeting of the National Association of Real Estate Investment Managers (NAREIM) in Chicago.

Second, section 904 of the Bankruptcy Code provides that unless the debtor consents or the plan so provides, the court may not "interfere" with any of the debtor's "political or governmental powers," any of the debtor's property or revenues, or the use or enjoyment of its income-producing property. Thus, unlike a chapter 11 debtor, a municipal debtor is not restricted in its ability to use, sell, or lease its property (e.g., section 363 does not apply in a chapter 9 case), and the court may not become involved in the debtor's day-to-day operations. Also, unlike in a case under chapter 7, 11, 12, or 13 of the Bankruptcy Code, a municipal debtor's assets do not become part of the debtor's bankruptcy estate upon the filing of a chapter 9 petition.

Stockton is an important ruling, although it remains to be seen whether the decision will be upheld on appeal. In addition to illustrating the limitations on a bankruptcy court's jurisdiction in municipal bankruptcy cases, the decision potentially opens the door in other chapter 9 cases to the impairment of vested contractual rights under retiree benefit plans without complying with the protections for retirees applicable in chapter 11 cases under section 1114 of the Bankruptcy Code.

In addition, control of a municipal debtor is not subject to defeasance in the form of a bankruptcy trustee (although state laws commonly provide a mechanism for transferring control of the affairs of a distressed municipality). A trustee, however, may be appointed to pursue avoidance actions (other than preferential transfers to or for the benefit of bondholders) on behalf of the estate if the debtor refuses to do so. A municipal debtor is not subject to the reporting requirements and other general duties of a chapter 11 debtor.

A chapter 9 debtor enjoys many of the rights of a chapter 11 debtor in possession but is subject to few of the obligations. Pursuant to section 901, many (but not all) of the provisions contained elsewhere in the Bankruptcy Code are expressly made applicable to chapter 9 cases. These include, among others, the provisions with respect to the automatic stay; adequate protection; secured post-petition financing; executory contracts; administrative expenses; a bankruptcy trustee's "strong arm" and avoidance powers; financial contracts; the formation of official committees; and most, but not all, of the provisions governing vote solicitation, disclosure, and confirmation of a chapter 11 plan. Among other sections, the incorporated provisions omit the following: (i) section 1113, which establishes the circumstances and procedures under which a debtor can reject a collective bargaining agreement; (ii) section 1114, which governs the payment of retiree benefits during bankruptcy; or (iii) section 541, which provides that an estate consisting of all of the debtor's property is created upon the filing of a bankruptcy petition.

Limitations on a bankruptcy court's power to control a municipal debtor's affairs were addressed by the court in *Stockton*, and these limitations were fundamental to its decision.

STOCKTON BANKRUPTCY FILING

Stockton is the 13th-largest city in the State of California, with a population of nearly 300,000. On June 28, 2012, it became the largest city to file for chapter 9 protection in U.S. history. Burdened by a $26 million budget shortfall, the city council adopted a budget for the fiscal year commencing July 1, 2012, which by state law was required to be balanced. To achieve a balanced budget, the city council imposed significant cost cutting, including a unilateral reduction in retiree health benefits.

A group of Stockton's retirees responded by filing a class-action adversary proceeding in the chapter 9 case seeking, among other things, injunctive relief preventing Stockton from unilaterally cutting benefits or, in the alternative, modification of the automatic stay to seek such relief in state court. The retirees contended that they had vested contractual rights protected from impairment by the Contracts Clause of the U.S. Constitution, a similar clause in the California Constitution, and other provisions of state law. The complaint, however, made no reference to section 904 of the Bankruptcy Code, an omission that the court later directed must be remedied by means of briefing by the retirees on the issue and a statement by Stockton as to whether it consented to the court's resolution of the health benefit payment dispute. Stockton did not consent.

THE BANKRUPTCY COURT'S RULING

Supremacy of the Bankruptcy Clause

The bankruptcy court denied the request for injunctive relief and dismissed the adversary proceeding. At the outset, the court examined the Contracts Clause of the U.S. Constitution (Art. I, § 10, cl. 1), which provides that "[n]o State shall . . . pass any . . . Law impairing the Obligations of Contracts." The court emphasized that this constitutional provision bans a *state* from making a law impairing a contractual obligation, but "it does not ban [the U.S.] *Congress* from making a law impairing the obligation of a contract." In short, the court explained, "the shield of the Contracts clause crumbles in the bankruptcy arena." According to the court, Congress is expressly vested by the Bankruptcy Clause of the U.S. Constitution (Art. I, § 8, cl. 4) with the power to establish uniform bankruptcy laws, and it, unlike the states, is not prohibited from passing laws impairing contracts:

> The goal of the Bankruptcy Code is adjusting the debtor-creditor relationship. Every discharge impairs contracts. While bankruptcy law endeavors to provide a system of orderly, predictable rules for treatment of parties whose contracts are impaired, that does not change the starring role of contract impairment in bankruptcy.

By operation of the Supremacy Clause of the U.S. Constitution (Art. VI, cl. 2), the court determined that the same analysis applies to the contracts clause in California's state constitution. Moreover, by authorizing a municipality to file for relief under chapter 9, a state invites the intervention of federal bankruptcy law to impair contractual relationships.

State Sovereignty Prevails in Chapter 9

The court prefaced its discussion regarding the retirees' request for injunctive relief with the observation that "[a] delicate state-federal relationship of mutual sovereigns in which the Tenth Amendment looms large provides the framework for municipal bankruptcy and gives context to this dispute." Sections 903 and 904, the court explained, honor the state-federal balance "by reserving certain state powers and by correlatively limiting the powers of the federal government."

The court focused primarily on section 904, including a careful examination of its provenance reaching back to 1934, which entailed several iterations of the present-day provision. That history, the court explained, reflects lawmakers' "sedulous" efforts "to avoid unnecessary intrusions of state sovereignty in order to obviate the risk of invalidation by the Supreme Court." Addressing the relief sought by Stockton's retirees, the court wrote that "[t]he message derived from this history . . . compels the conclusion that § 904 prevents any federal court from doing what the plaintiffs request, regardless of whether the City's action is fair or unfair."

Overall, the court emphasized, section 904 "performs the role of the clean-up hitter in baseball." The court wrote that the language of the provision

> is so comprehensive that it can only mean that a federal court can use no tool in its toolkit—no inherent authority power, no implied equitable power, no Bankruptcy Code § 105 power, no writ, no stay, no order—to interfere with a municipality regarding political or government powers, property or revenues, or use or enjoyment of income-producing property.

As a practical matter, the court concluded, "the § 904 restriction functions as an anti-injunction statute—and more."

The court rejected the retirees' arguments that section 904 does not apply because: (i) their challenge was limited to the role of Stockton as employer, rather than government regulator; and (ii) injunctive relief "would be an innocuous preservation of the status quo that would not directly interfere with City property or revenues," given the retirees' fixed and immutable rights to health benefits. According to the court, section 904(2) is dispositive on these points. "Coercively preserving a status quo that entails payment of money from the City treasury," the court wrote, "interferes with the City's choice to suspend such payments." The court accordingly ruled that the relief sought by the retirees is barred by section 904(2) as an interference with Stockton's "property or revenues."

The court rejected the retirees' argument that some equivalent of section 1114 be implemented to prevent Stockton from unilaterally reducing retiree benefits, even though section 1114 is not among the provisions of the Bankruptcy Code made applicable in chapter 9 cases by section 901(a). Whether the omission was by design or oversight is irrelevant, the court explained. "The delicate constitutional balance that has loomed large over municipal bankruptcy ever since *Ashton*," the court wrote, "further cautions against taking liberties to cure perceived legislative mistakes." According to the court, the retirees' remedy for Stockton's actions lies in participating in the claims-resolution process (i.e., filing a proof of claim for breach-of-contract damages), as well as the city's process of formulating a chapter 9 plan of adjustment.

Finally, the bankruptcy court denied the retirees' request for an order modifying the automatic stay to permit them to seek redress in a forum that purportedly does have the power to grant them relief (i.e., California state court). It reasoned that resolution of the dispute between Stockton and the retiree-creditors is "central to the debtor-creditor relationship to be dealt with, along with every unhappy creditor, in the collective chapter 9 proceeding."

OUTLOOK

Stockton is an important ruling, although it remains to be seen whether the decision will be upheld on appeal. In addition to illustrating the limitations on a bankruptcy court's jurisdiction in municipal bankruptcy cases, the decision potentially opens the door in other chapter 9 cases to the impairment of vested contractual rights under retiree benefit plans without complying with the protections for retirees applicable in chapter 11 cases under section 1114 of the Bankruptcy Code. It is an additional blow to the rights of municipal employees and retirees in the wake of the ruling in *In re City of Vallejo, California*, 432 B.R. 262 (E.D. Cal. 2010). In *Vallejo*, the district court affirmed a bankruptcy-court ruling that section 1113 of the Bankruptcy Code does not apply in chapter 9, potentially making it easier for a municipal debtor to reject a collective bargaining agreement.

It is also possible that the court's reasoning could be extended to permit the impairment of other kinds of municipal obligations, including municipal bond debt, beyond the impairment already permitted in connection with the confirmation of a chapter 9 plan of adjustment. However, given the increased future borrowing costs to a defaulting municipality resulting from the impairment of the claims of municipal bondholders, the threat of impairment may be of only limited utility as a bargaining chip to obtain concessions.

IN RE CHARTER COMMUNICATIONS: DRIVING THE EQUITABLE MOOTNESS WEDGE DEEPER?

Jane Rue Wittstein and Justin F. Carroll

On the heels of the Third and Ninth Circuits' equitable mootness rulings in *In re Philadelphia Newspapers, LLC*, 690 F.3d 161 (3d Cir. 2012), and *In re Thorpe Insulation Co.*, 671 F.3d 980 (9th Cir. 2012), *amended and superseded on denial of rehearing en banc*, 677 F.3d 869 (9th Cir. 2012), the Second Circuit issued its own decision in *In re Charter Communications, Inc.*, 691 F.3d 476 (2d Cir. 2012), which deepens a split among the circuit courts of appeal with respect to the standard of review and burden of proof to be applied in equitable mootness cases. In so ruling, the Second Circuit put itself at odds with several recent equitable mootness decisions from other circuits and made a number of equitable mootness issues ripe for review by the Supreme Court.

EQUITABLE MOOTNESS

"Equitable mootness" is a judge-made doctrine under which an appellate court may dismiss an appeal, even when effective relief could conceivably be fashioned, if it finds that implementation of that relief would be inequitable. In bankruptcy, equitable mootness issues often arise in appeals from orders confirming chapter 11 plans, where plan proponents attempt to preclude appellate review by arguing that the relief sought by the appellant would upset a "substantially consummated" plan and lead to an unraveling of a debtor's restructuring. In these cases, appellate courts have sought to strike the proper balance between the importance of finality in bankruptcy proceedings and a litigant's right to appellate review of, and relief from, a bankruptcy-court order.

The threshold inquiry in applying the equitable mootness doctrine is whether a chapter 11 plan has been "substantially consummated." Pursuant to section 1101(2) of the Bankruptcy Code, substantial consummation occurs when substantially all of the proposed transfers in a plan are consummated, the successor company has assumed control of the debtors' business or property, and the distributions called for by the plan have commenced. Once a plan has been substantially consummated, it often becomes difficult for an appeal to withstand dismissal on equitable mootness grounds.

Several circuit courts have adopted multifactored tests to determine whether the doctrine of equitable mootness should apply in appeals of confirmation orders. These factors typically include an examination of whether: (i) the appellant sought to stay the execution of the objectionable order; (ii) the plan has been substantially consummated; (iii) the court can still order some effective relief; (iv) parties who would be adversely affected by the relief sought in the appeal have notice of the appeal and an opportunity to participate in the proceedings; and (v) the relief would require the unraveling of complex transactions and/or affect the re-emergence of the debtor as a reorganized entity. *See*, *e.g.*, *Charter Communications*, 691 F.3d at 482; *Thorpe Insulation*, 677 F.3d at 881; *Nordhoff Invs., Inc. v. Zenith Elecs. Corp.*, 258 F.3d 180 (3d Cir. 2001); *TNB Fin., Inc. v. James F. Parker Interests (In re Grimland, Inc.)*, 243 F.3d 228 (5th Cir. 2001). The circuits differ, however, with respect to the weight placed on these factors. *Compare Charter Communications*, 691 F.3d at 582 (appeal presumed moot where plan has been substantially consummated) *with In re Philadelphia Newspapers, LLC*, 690 F.3d 161, 168–69 (3d Cir. 2012) (foremost consideration is "whether allowing appeal to go forward will undermine the plan, and not merely whether the plan has been substantially consummated") *and In re Pacific Lumber Co.*, 584 F.3d 229 (5th Cir. 2009) (no mootness where there would be no significant adverse consequences to the reorganization from appellate review).

Prior to *Charter Communications*, the circuit courts of appeal uniformly required the party asserting equitable mootness to bear the burden of proof on appeal. *See Thorpe Insulation*, 677 F.3d at 880; *Search Market Direct, Inc. v. Jubber (In re Paige)*, 584 F.3d 1327, 1339–40 (10th Cir. 2009); *accord Ala. Dep't of Econ. & Cmty. Affairs v. Ball Healthcare-Dallas, LLC (In re Lett)*, 632 F.3d 1216, 1226 (11th Cir. 2011); *Gillman v. Cont'l Airlines (In re Cont'l Airlines)*, 203 F.3d 203, 210 (3d. Cir. 2000). With respect to the standard of review, however, the circuit courts have been split between applying a *de novo* or an abuse-of-discretion standard. In one of the earliest circuit-court cases addressing this issue, the Third Circuit in *Continental Airlines* adopted the abuse-of-discretion standard in reviewing a district court's equitable mootness decision. The Tenth Circuit later adopted the same approach in *Paige*.

In a dissenting opinion in *Continental Airlines*, however, then-circuit judge Samuel Alito "strongly disagree[d]" with the majority's adoption of the abuse-of-discretion standard, arguing that courts of appeal and district courts are equally fit to decide the mootness issue because they share the appellate function in bankruptcy cases. The Sixth Circuit later adopted Judge Alito's reasoning, and at least three other circuits also review equitable mootness dismissals under a *de novo* standard of review. *See Curreys of Neb., Inc. v. United Producers, Inc. (In re United Producers, Inc.)*, 526 F.3d 942, 946–47 (6th Cir. 2008); *Thorpe Insulation*, 677 F.3d at 880; *Liquidity Solutions, Inc. v. Winn-Dixie Stores, Inc. (In re Winn-Dixie Stores, Inc.)*, 286 F. App'x 619, 622 & n.2 (11th Cir. 2008); *United States v. GWI PCS 1 Inc. (In re GWI PCS 1 Inc.)*, 230 F.3d 788, 799–800 (5th Cir. 2000).

Charter Communications deepens a split among the circuit courts of appeal with respect to the standard of review and burden of proof to be applied in equitable mootness cases. In so ruling, the Second Circuit put itself at odds with several recent equitable mootness decisions from other circuits and made a number of equitable mootness issues ripe for review by the Supreme Court.

CHARTER COMMUNICATIONS

In March 2009, Charter Communications, Inc., and its affiliates (collectively, "Charter"), the nation's fourth-largest cable television company and a leading provider of cable and broadband service, filed a pre-negotiated chapter 11 case in New York with more than $24 billion in debt. The effort to develop a plan of reorganization for Charter was led by a group of junior bondholders and Paul Allen, a major investor whose ownership stake gave him control of the company.

The reorganization strategy was driven by the goal of reinstating Charter's senior credit facility with J.P. Morgan, which required Charter to cure any of its defaults to ensure that J.P. Morgan would be classified as an unimpaired creditor. In order to avoid triggering a default under Charter's credit agreement with J.P. Morgan, however, Allen had to retain his voting power in the company despite the fact that most of his investment would be wiped out.

To induce Allen's participation in the plan, Charter and the junior bondholders agreed to a settlement with Allen (the "Allen Settlement"), whereby Allen agreed to retain his voting interests in Charter in exchange for $375 million and release of all liability. In contrast, Charter's other noteholders stood to recover only 32.7 percent of their claims under the proposed plan, and equity holders (other than Allen) would receive nothing. The bankruptcy court confirmed Charter's chapter 11 plan in November 2009.

Both the bankruptcy court and a district court later denied motions for a stay of the confirmation order pending appeal, and the plan became effective on November 30, 2009. Charter immediately took actions contemplated by the plan, including cancelling the existing equity, issuing shares in the reorganized company, converting pre-petition notes into new notes, and issuing new warrants.

Charter Communications represents a departure from equitable mootness rulings by other circuits. By requiring satisfaction of all five *Chateaugay* factors and shifting the burden of proof from the plan proponents to the appellants, the Second Circuit appears to have broadened the scope of the equitable mootness doctrine and created substantial obstacles to obtaining relief from a confirmation order following substantial consummation of a chapter 11 plan.

The indenture trustee for certain of Charter's notes and one of Charter's equity holders separately appealed the confirmation order, including the provision approving the Allen Settlement, on the grounds that the plan violated the absolute-priority rule and included an impermissible third-party release for Allen. The appellants claimed that the court could award monetary damages without undoing the Allen Settlement or the bankruptcy case and that the third-party releases could be excised from the Allen Settlement and the chapter 11 plan. The district court disagreed, however, and dismissed the appeals as equitably moot.

THE SECOND CIRCUIT'S RULING

The Second Circuit upheld the district court's rulings on equitable mootness, but in so doing, it may have created a difficult standard for governing attempted appeals of orders confirming chapter 11 plans that have been substantially consummated. First, the Second Circuit held that once a chapter 11 plan has been substantially consummated, an appeal is presumed to be equitably moot unless the appellant can demonstrate that it has met all five of the criteria delineated in its previous ruling in *Frito-Lay, Inc. v. LTV Steel Co. (In re Chateaugay Corp.)*, 10 F.3d 944 (2d Cir. 1993). To avoid dismissal on the basis of equitable mootness under Chateaugay, an appellant must demonstrate that:

(a) the court can still order some effective relief;

(b) such relief will not affect the re-emergence of the debtor as a revitalized corporate entity;

(c) such relief will not unravel intricate transactions so as to knock the props out from under the authorization for every transaction that has taken place and create an unmanageable, uncontrollable situation for the Bankruptcy Court;

(d) the parties who would be adversely affected by the modification have notice of the appeal and an opportunity to participate in the proceedings; and

(e) the appellant pursued with diligence all available remedies to obtain a stay of execution of the objectionable order if the failure to do so creates a situation rendering it inequitable to reverse the orders appealed from.

Id. at 952–53 (internal quotation marks omitted).

The Second Circuit found that the appellants had satisfied several, but not all, of the *Chateaugay* factors. The court concluded that the appellants had diligently pursued a stay of the confirmation order and that it was possible to order some effective relief without harming innocent parties. The Second Circuit also determined that all of the parties that would be affected by the relief sought in the appeal—namely, Charter itself, Allen, and Charter's creditors—were either parties to the appeals or active participants in the bankruptcy case. In upholding the decision below, however, the Second Circuit ruled that the district court did not abuse its discretion in determining that the relief sought by the appellants would "seriously threaten[ ] Charter's ability to re-emerge successfully from bankruptcy." According to the Second Circuit, the appellees had established a factual record sufficient to demonstrate that Allen's compensation and the third-party releases were "critical to the bargain" and that altering such provisions could lead to Allen's reneging on the Allen Settlement, thus leaving Charter's future uncertain. *Compare with In re Pacific Lumber*, 584 F.3d at 252 (striking third-party releases in a plan and declining to adopt the "more lenient approach to non-debtor releases taken by other courts," including the Second Circuit); *In re Hilal*, 534 F.3d 498 (5th Cir. 2008) (appellate review of nondebtor release not equitably moot where there would be no potential adverse effect on the plan or third parties from hearing the appeal).

The appellants moved for a rehearing en banc, challenging the Second Circuit's determination that the requested relief would require an unwinding of the chapter 11 plan. Among other things, the appellants cited the Second Circuit's own statements that requiring Allen or reorganized Charter to make a monetary payment "would not impact reorganized Charter's financial health" or "send it spiraling back into bankruptcy." Also, the appellants argued, the Second Circuit itself noted with respect to the third-party releases that the Allen Settlement "expressly provided that the debtors' failure to secure the releases as part of the approved Plan would not breach the Allen Settlement." Other than broad statements that revisiting the terms of the Allen Settlement could "throw into doubt the viability of Charter's chapter 11 plan," the appellants claimed, the Second Circuit panel did not explain how such facts and provisions in the Allen Settlement could be reconciled with the court's determination that the requested relief would somehow scuttle the Allen Settlement. The Second Circuit denied the petition for rehearing.

OUTLOOK

Charter Communications represents a departure from equitable mootness rulings by other circuits. By requiring satisfaction of all five *Chateaugay* factors and shifting the burden of proof from the plan proponents to the appellants, the Second Circuit appears to have broadened the scope of the equitable mootness doctrine and created substantial obstacles to obtaining relief from a confirmation order following substantial consummation of a chapter 11 plan. This doctrinal expansion seems to be at odds, however, with the court's acknowledged duty to "carefully balance the importance of finality in bankruptcy proceedings against the appellant's right to review and relief." By appearing to abandon the balancing approach employed by other circuits in this context, the Second Circuit now stands alone in presuming that an appeal is equitably moot following substantial consummation of a chapter 11 plan. Given the complexity of plans in most large chapter 11 cases, it is likely that *Charter Communications* will erect a significant hurdle for future litigants seeking to appeal the confirmation of a substantially consummated chapter 11 plan in the Second Circuit.

Additionally, *Charter Communications* deepens the divide between the circuits with respect to the appropriate standard of review for equitable mootness. This deepening rift may be a compelling invitation to review by the U.S. Supreme Court.

One important issue that is not addressed in any of the equitable mootness cases before the circuits is a litigant's ability to seek a direct appeal to the relevant circuit court of appeal from a bankruptcy court's confirmation order under the circumstances specified in 28 U.S.C. § 158(d)(2)(A). In light of the rapidity with which chapter 11 plans may be substantially consummated following plan confirmation—and the substantial risk that a stay pending appeal of a confirmation order may be denied—appellants seeking to avoid an equitable mootness ruling on the basis of substantial consummation may be well served by asking the bankruptcy court to certify a direct appeal.

IN BRIEF: RECENT RULINGS ON SOVEREIGN DEBT RESTRUCTURINGS

On October 26, 2012, the Court of Appeals for the Second Circuit, in a ruling that may impact sovereign debt restructurings, upheld a lower-court order enjoining Argentina from making payments on restructured defaulted debt without making comparable payments to bondholders who did not participate in the restructurings. On November 21, the U.S. District Court for the Southern District of New York ordered Argentina to pay nonparticipating bondholders $1.3 billion in past-due obligations no later than December 15, 2012.

In 1994, Argentina began issuing bonds with a governing instrument that contained a "*pari passu*," or "equal treatment," clause, providing that the bonds would constitute "direct, unconditional, unsecured and unsubordinated obligations of the Republic . . . [ranking] at all times . . . pari passu without any preference among themselves" and that "[t]he payment obligations of the Republic under the Securities shall at all times rank at least equally with all its other present and future unsecured and unsubordinated External Indebtedness."

Following a 2001 default on the bonds, Argentina offered bondholders new exchange bonds in 2005 and again in 2010. Argentina continued to make payments to holders of the exchange bonds, but pursuant to a "temporary moratorium" renewed each year since December 2001, it has not made payments to bondholders who did not participate in the exchange. The old bondholders sued Argentina in federal district court in New York (the old bond instrument being governed by New York law) to collect $1.33 billion in unpaid principal and interest. In February 2012, the district court, holding that Argentina's conduct violated the *pari passu* clause, enjoined further payments to exchange bondholders without corresponding payments to old bondholders.

The Second Circuit Court of Appeals upheld that ruling in *NML Capital, Ltd. v. Republic of Argentina*, 2012 BL 283459 (2d Cir. Oct. 26, 2012). The court was careful to predicate its ruling on the totality of Argentina's conduct, which included enacting unusual legislation rendering the defaulted bonds (and judgments obtained on them) unenforceable in Argentina. Even so, broadly speaking, the decision reflects judicial dissatisfaction with a sovereign debtor that for many years has flouted judgments entered by U.S. courts, notwithstanding the debtor's possession of resources sufficient to pay such judgments in whole or in part. It is expected that Argentina will seek to appeal the ruling to the U.S. Supreme Court. The full text of the opinion can be accessed at http://law.justia.com/cases/federal/appellate-courts/ca2/12-105/12-105-2012-10-26.html (web sites herein last visited November 30, 2012).

The Second Circuit remanded the case to the district court for the purpose of clarifying how the injunction was to operate. On November 21, 2012, U.S. district court judge Thomas Griesa did just that, ordering Argentina to pay holders of the original defaulted bonds in full—approximately $1.33 billion—on December 15, when interest payments are due to holders of Argentina's restructured debt. "It is hardly an injustice to have legal rulings which, at long last, mean that Argentina must pay the debts which it owes," Judge Griesa concluded. "After 10 years of litigation, this is a just result." If Argentina refuses to pay, the judge noted, the Bank of New York, which processes Argentina's bond payments, will also find itself in violation should it decline to withhold payments to other bondholders. Argentina's Economy Minister, Hernán Lorenzino, announced at a news conference on November 22 that Argentina will appeal the ruling.

Argentina received at least a temporary reprieve of its obligation to make payments to old bondholders pursuant to Judge Griesa's order on November 28, 2012, when the Second Circuit Court of Appeals stayed the ruling until it has an opportunity to hear the merits of Argentina's appeal, which has been scheduled for argument on February 27, 2013. The emergency stay quelled investor fears of a default by Argentina on December 15, when some $3.3 billion in debt repayments are due. On December 4, 2012, the Second Circuit denied an emergency motion by old bondholders to modify the stay by requiring Argentina to post $250 million in security in order to maintain it.

IN BRIEF: CLAIMS-TRADING HOBGOBLINS REDUX?

In the July/August 2012 edition of the *Business Restructuring Review*, we reported on a Delaware bankruptcy-court ruling that reignited the debate concerning whether sold or assigned claims can be subject to disallowance under section 502(d) of the Bankruptcy Code on the basis of the seller's receipt of a voidable transfer. In *In re KB Toys, Inc.*, 470 B.R. 331 (Bankr. D. Del. 2012), the court rejected as unworkable the distinction between a sale and an assignment of a claim for purposes of disallowance that was drawn by the district court in *Enron Corp. v. Springfield Associates, L.L.C. (In re Enron Corp.)*, 379 B.R. 425 (S.D.N.Y. 2007) ("*Enron II*"), *vacating Enron Corp. v. Springfield Associates, L.L.C. (In re Enron Corp.)*, 2005 WL 3873893 (Bankr. S.D.N.Y. Nov. 28, 2005), and *Enron Corp. v. Avenue Special Situations Fund II, LP (In re Enron Corp.)*, 340 B.R. 180 (Bankr. S.D.N.Y. 2006).

In *KB Toys*, the bankruptcy court ruled that several transferred-trade claims should be disallowed under section 502(d) because the transferors had received voidable preferences. According to the court, "[T]he plain language, legislative history, and decisional law support the view that a claim in the hands of a transferee has the same rights and disabilities as the claim had in the hands of the original claimant. Disabilities attach to and travel with the claim." The court also wrote that "the assertion that subjecting transferred claims to § 502(d) disallowance would cause disruption in the claims trading market is a hobgoblin without a house to haunt." As expected, the ruling was appealed immediately. Oral arguments before the Delaware district court are scheduled for January 2013.

On September 14, 2012, the Second Circuit Court of Appeals handed down an unpublished ruling that might have addressed the claims-trading section 502(d) controversy head on but did not. In *Longacre Master Fund, Ltd. v. ATS Automation Tooling Systems Inc.*, 2012 WL 4040176 (2d Cir. Sept. 14, 2012), the court vacated a decision declining to enforce a repurchase obligation in a claims-assignment agreement triggered by the debtor's objection to the traded claim under section 502(d).

The "Assignment of Claim" (the "agreement") provided that the assignor would be obligated to "repurchase" the claim if the claim was "impaired." "Impairment" was defined to occur when "all or any part of the Claim is . . . objected to . . . for any reason whatsoever, pursuant to an order of the Bankruptcy Court" and the objection is not resolved within 180 days. The assignor also warranted in the agreement that "to the best of [the assignor's] knowledge, the Claim is not subject to any defense, claim or right of setoff, reduction, impairment, avoidance, disallowance, subordination or preference action."

Longacre should reassure the claims-trading market and reduce uncertainty regarding the enforceability of common risk-allocation provisions in claims-assignment agreements.

The debtor filed an omnibus objection to the traded claim (among others) under section 502(d) shortly before the court-imposed deadline for doing so expired, for the purpose of preserving its ability to prosecute preference actions associated with the claims. The assignor and the debtor ultimately settled the preference litigation, which the court later dismissed with prejudice, and the debtor withdrew its objection to the claim—13 months after the objection was filed.

The assignee of the claim sued to enforce the repurchase provisions in the agreement. According to the assignee, the assignor's failure to resolve the objection fully within 180 days triggered the obligation under the agreement that the assignor refund the purchase amount, with interest, pending resolution of the objection. The assignee acknowledged that it later would have had to return the refunded purchase amount once the objection was resolved. Even so, the assignee sought recovery of the interest due on that amount from the date of the agreement to the date the claim was fully resolved.

A federal district court (the litigation having been removed from state court) ruled against the assignee in August 2011, reasoning that the debtor's objection under section 502(d) did not amount to "impairment" under the agreement because it merely preserved the debtor's right to object, rather than being "substantive." Moreover, the district court wrote, "because the Agreement [e]ffected a sale and not a pure assignment of the Claim, for the reasons stated in [*Enron II*], no section 502(d) objection (even if one were to have been made) would have constituted an Impairment in the first instance." The court also determined that the assignor had not breached its representations and warranties regarding the absence of potential preference actions because it had no knowledge of such actions.

The Second Circuit vacated the judgment, ruling that "nothing in the language of [the agreement] requires that the objection be meritorious" to constitute impairment triggering the repurchase obligation. The court also faulted the district court's decision regarding the absence of any breach of warranty, finding that a disputed material issue of fact existed as to the assignor's knowledge of a possible preference action and related objection.

The Second Circuit briefly discussed whether the agreement constituted a sale rather than an assignment. However, it did not rule on this issue, nor did it address the district court's observations regarding *Enron II* and the purported protection from disallowance under section 502(d) of claims that have been sold rather than assigned. Still, although *Longacre* skirts this issue, the ruling should reassure the claims-trading market and reduce uncertainty regarding the enforceability of common risk-allocation provisions in claims-assignment agreements.

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 eurozone economies. Here we provide a snapshot of some recent developments relating to insolvency and restructuring in the EU.

The United Kingdom—On October 24, 2012, the English Supreme Court handed down judgments in *Rubin v. Eurofinance SA* [2012] UKSC 46 and *New Cap Re v. AE Grant* [2012] UKSC 46, two unrelated cases, in both of which insolvency practitioners were seeking to enforce foreign (non-EU) court judgments arising from insolvency proceedings in their jurisdictions (the U.S. and Australia) against English defendants in English courts. The majority held that *Cambridge Gas Transportation Corporation v. Official Committee of Unsecured Creditors of Navigator Holdings Plc* [2007] 1 AC 508, the previously leading case, which promoted the idea of universality of recognition in insolvency proceedings, was wrongly decided. Instead, the Supreme Court held that insolvency judgments are subject to standard common-law principles relating to recognition and enforcement. Specifically, the Supreme Court held that a foreign judgment cannot be enforced under either the Cross-Border Insolvency Regulations 2006 (enacting the UNCITRAL Model Law on Cross-Border Insolvency in the U.K.) or s426 of the Insolvency Act because, in the court's view, neither expressly provides for the enforcement of judgments.

In light of this decision, English courts will not afford "special treatment" to judgments arising from insolvency proceedings. Instead, parties wishing to enforce insolvency judgments in

England through English courts must rely on the traditional common-law body of cases and, where appropriate, the EC Regulation on Insolvency Proceedings, which is not affected by this judgment and which makes foreign judgments falling within the ambit of the EC Regulation enforceable automatically in the U.K. The decision is likely to have significant consequences for cross-border insolvencies. At a minimum, it will make it more difficult to enforce foreign insolvency judgments in England and may lead to an increase in the volume of parallel insolvency proceedings filed in English courts in cross-border bankruptcy cases (e.g., "nonmain" proceedings under the Model Law) for the purpose of obtaining recognition of (and enforcing) such judgments.

The ruling can be accessed in its entirety at http://www.supremecourt.gov.uk/decided-cases/docs/UKSC_2010_0184_Judgment.pdf.

Spain—On August 31, 2012, the Spanish government approved Royal Decree-Law 24/2012 ("RDL 24/2012"), providing for the restructuring and resolution of "credit entities." Although the law became effective immediately, RDL 24/2012 has not yet been ratified by the Spanish parliament, where the ruling party (*Partido Popular*) holds the majority. RDL 24/2012 implements a new framework for the restructuring and resolution of financial institutions, which will become an essential tool to manage the banking crisis in Spain. To that end, RDL 24/2012 reinforces the role of supervisors, available instruments, and administrative procedures. The ultimate objective of the legislation is to safeguard the stability of the Spanish financial system as a whole, rather than any given entity, and to minimize the expense borne by taxpayers.

With the publication of RDL 24/2012, the Spanish government fulfilled commitments made on July 20, 2012, to the Eurogroup under the program of financial assistance to Spain for the recapitalization of the banking sector, which were included in the memorandum of understanding between Spain and the European Commission.

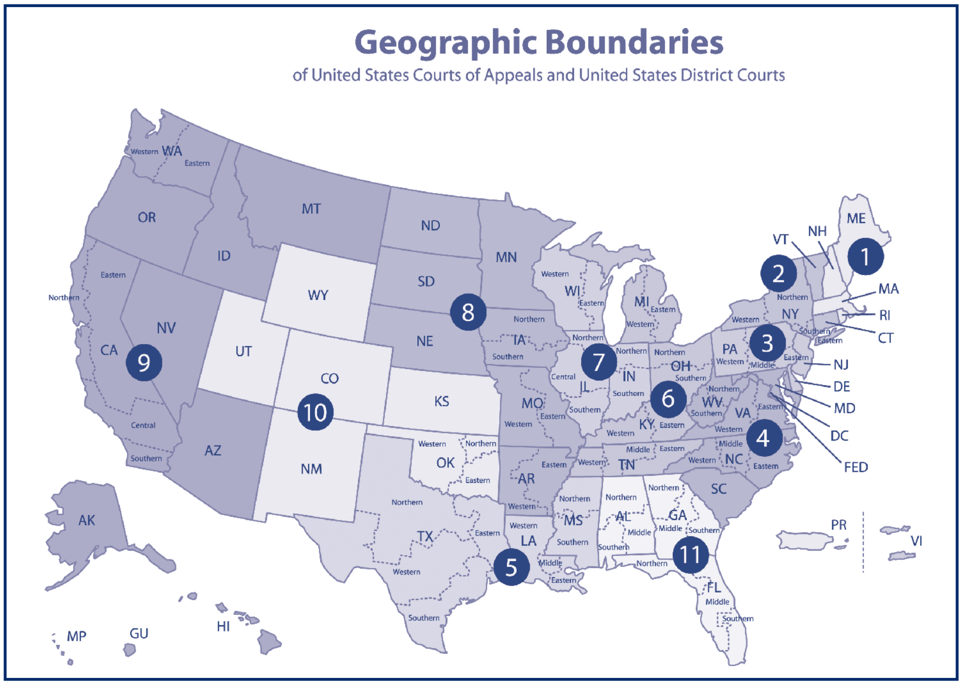
Among other things, RDL 24/2012 provides for: (i) a new framework for early intervention, restructuring, and orderly resolution of credit entities; (ii) the establishment of an asset management company (*sociedad de gestión de activos*) as a repository for distressed real estate assets, or a "bad bank"; (iii) management of hybrid instruments until June 2013; (iv) reinforcement of the administrative powers of the Fund for Orderly Bank Restructuring (*Fondo de Reestructuración Ordenada Bancaria*); (v) augmented capital requirements for financial institutions; and (vi) delegation of powers by the Ministry of Economy to the Bank of Spain.

France—On September 20, 2012, the French government issued a decree (the "Decree") amending the requirements for the commencement of an accelerated financial safeguard proceeding (*procédure de sauvegarde financière accélérée* ("SFA")). An SFA combines the elements of a "conciliation" (an out-of-court pre-insolvency proceeding involving a court-appointed mediator that is widely used to restructure distressed businesses in France) and a "safeguard" proceeding, which is a court-supervised proceeding culminating in the implementation of a plan restructuring a company's debt over a period of up to 10 years. An SFA is a pre-packaged financial restructuring that can be approved by the court with the consent of a 66-2/3 percent majority of the creditors. The court can impose the restructuring plan on dissenting creditors within a maximum of two months following the commencement of an SFA.

Prior to the Decree, an SFA was available only to solvent companies having more than 150 employees or turnover in excess of €20 million. Accordingly, an SFA could not be filed by a holding company, which typically has neither the required number of employees nor adequate turnover. Since the issuance of the Decree, an SFA may also be commenced by a solvent company with either: (i) a balance-sheet surplus exceeding €25 million; or (ii) a balance-sheet surplus exceeding €10 million, provided it controls a company satisfying the 150-employee or €20 million-turnover thresholds. Thus, an SFA will now be available to most holding companies. Because LBO transactions are typically structured with acquisition debt at the holding-company level, the Decree will clearly facilitate financial restructurings in distressed-LBO scenarios.

Other recent European developments can be tracked in Jones Day's *EuroResource*, available at http://www.jonesday.com/euroresource_september_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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