Pratt's
Journal of Bankruptcy Law

AN A.S. PRATT & SONS PUBLICATION FEBRUARY/MARCH 2013

HEADNOTE: DECISIONS, DECISIONS
Steven A. Meyerowitz

HOTEL WHOSE CHAPTER 11 CASE WAS FILED IN BAD FAITH CAN "STAY" IN BANKRUPTCY
Lee Jason Goldberg

BANKRUPTCY COURT SURPRISES OBSERVERS AND TRANSFERS VENUE OF PATRIOT COAL CHAPTER 11 CASES TO MISSOURI
Eric M. English

FORECLOSURE LAW IN THE WAKE OF RECENT DECISIONS ON RESIDENTIAL MORTGAGE LOANS: THE SITUATION IN GEORGIA
Ashby Kent Fox, Shea Sullivan, and Amanda E. Wilson

TRUST ME—A SECURITY TRUSTEE'S DUTIES TO SUBORDINATED CREDITORS EXAMINED
Mathew Cox and Bevis Metcalfe

THE YEAR IN BANKRUPTCY: PART I
Charles M. Oellermann and Mark G. Douglas

RECENT DEVELOPMENTS IN BUSINESS BANKRUPTCY CASES
Jonathan M. Landers

GIORDANO'S COURT SENDS INAPPROPRIATE MESSAGE ON INVESTIGATION OF SOLICITATION ALLEGATIONS
Fielden Fleming

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ISSN 1931-6992

The Year in Bankruptcy: Part I

CHARLES M. OELLERMANN AND MARK G. DOUGLAS

In the first part of a two-part article, the authors discuss and analyze the past year's most significant bankruptcy law developments.

December 2012 marked the fifth anniversary of the beginning of the Great Recession, which officially began in December 2007 and ended in June 2009 (at least in the U.S.). Five years down the road, the U.S. economy is undeniably on the road to recovery, with unemployment down to 7.8 percent from a high of 10.2 percent in October 2009, a significant drop in mortgage-foreclosure rates, and a housing market strengthened by the lowest mortgage rates in history. Even so, the recovery is shaky. Much remains to be done to restore the world's largest economy to sustainable growth and a positive outlook.

Characteristically divisive U.S. lawmakers in the dysfunctional 112th Congress actually failed to reach a deal in 2012 to avoid hurling the nation over the "fiscal cliff." However, in a (post)-last-minute ploy to prevent automatic spending cuts, the largest tax increase in U.S. history, and a relapse into recession, Congress worked out a compromise on January 1, 2013, that, among other things, repeals most of the Bush-era tax cuts for wealthy Ameri-

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Published by A.S. Pratt in the February/March 2013 issue of *Pratt's Journal of Bankruptcy Law*.
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cans, avoids tax increases on middle-class families, temporarily defers deep military and other government spending cuts, restores financial aid to farmers, and extends unemployment benefits.

Now for the bad news. For the fourth year running, the U.S. ran a deficit in excess of $1 trillion for the fiscal year ("FY") ending September 30. Also, in a reprise of 2011, the U.S. reached its legal borrowing limit on December 31, giving Congress just four months (as extended pursuant to a deal reached in late January) before it must raise the debt ceiling (again), or (again) risk causing the government to default on its bills and financial obligations. In addition, the "sequestration" automatic spending cuts avoided on January 1 were only temporarily deferred. Stay tuned for Fiscal Cliff II.

U.S. unemployment remains stubbornly high, compared to the 4.9 percent unemployment rate in December 2007. At the end of 2012, 12.2 million Americans were unemployed (not counting the underemployed and those who have dropped out of the workforce). The U.S. Labor Department reported on January 4, 2013, that American employers added 155,000 jobs in December, leaving the unemployment rate unchanged at 7.8 percent, the level at which it has more or less remained since September. Overall, the country added 1.8 million jobs during 2012.

Food prices in the U.S. spiked at the end of 2012 and will continue to be higher in 2013, after the nation's worst drought in 50 years—2012 was the hottest year ever recorded in the contiguous United States—sent prices for corn, soybeans, feed, and related products (e.g., ethanol and meat) soaring.

A report released by the U.S. Education Department and the Consumer Financial Protection Bureau in July 2012 estimated that total outstanding student-loan debt in the U.S. for the first time exceeded $1 trillion (with an average loan balance of more than $23,000), surpassing the total U.S. credit-card balance ($693 billion) and the total U.S. auto-loan balance ($730 billion). Moreover, as the number of people taking out U.S. government-backed student loans has exploded, so has the number of those who have fallen at least 12 months behind in making payments—about 5.9 million people nationwide, up about a third in the last five years. In all, nearly one in every six borrowers with a student-loan balance is in default. Student-loan debt collection is a booming business. In FY 2011, the U.S. Department of Education alone paid more than $1.4 billion to collection agencies and other groups to

hunt down defaulters. On July 6, 2012, President Obama signed legislation freezing federally subsidized student-loan rates for a year, averting a doubling of interest rates. The change helped more than 7 million students.

The latest U.S. Census Bureau data shows that the number of impoverished Americans increased from 49 million in 2010 to 49.7 million in 2011. The report also states that nearly 20 percent of American children continue to live in poverty. In September 2012, the bureau reported that the income gap between the wealthiest 20 percent of American households and the rest of the country grew sharply, as an overwhelming majority of Americans saw no gains from a weak economic recovery. Median household income after inflation fell to $50,054, a level that was 8 percent lower than in 2007, the year before the recession took hold.

Fewer Americans filed for personal bankruptcy in 2012: 1.13 million individuals filed for bankruptcy last year, 14 percent fewer than in 2011, and the fewest since 2008, according to Epiq Systems, Inc.

Only 51 U.S. banks failed in 2012, compared to 92 in 2011, 157 in 2010 (more than in any year since the savings and loan crisis of the early 1990s), and 140 in 2009. The number of bank failures was the lowest since 2008, when 25 banks failed. Since 2008, a total of 465 banks with assets aggregating more than $680 billion have been closed by regulators. On the basis of recent trends, however, it appears that the U.S. banking system is slowly stabilizing as banks complete divestitures of toxic mortgage assets. At the close of FY 2012, the number of banks on the Federal Deposit Insurance Corporation's confidential "problem list" fell to 694—about 9.6 percent of all federally insured banks. At its peak in the first quarter of 2011, the number of troubled banks was 888, or 11.7 percent of all federally insured institutions.

Headlines in 2012 continued to herald the dire financial straits of U.S. states and municipalities. 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). The burden has been too great for some municipalities to bear. Some have

turned to Chapter 9 bankruptcy protection for relief.

California led the charge in 2012, with three of its municipalities filing for bankruptcy, including the largest U.S. city to file for Chapter 9 protection (the City of Stockton). In all, 15 municipalities (most of which were water and sanitary districts, hospital authorities, or state-run off-track betting enterprises) filed for bankruptcy protection in 2012, compared to 13 in 2011 and 7 in 2010.

BUSINESS BANKRUPTCY FILINGS

Business bankruptcy filings dropped off in both FY and calendar year 2012. However, public-company bankruptcy filings remained roughly the same. According to data released by the Administrative Office of the U.S. Courts, business bankruptcy filings in FY 2012 totaled 42,008, down 16 percent from the 49,895 business filings reported in FY 2011. Chapter 11 filings fell to 10,597, down 12 percent from the 11,979 Chapter 11 filings reported in FY 2011.

According to court data compiled by Epiq Systems, there were 7,760 business Chapter 11 filings in calendar year 2012, compared to 8,658 filings in 2011, a decline of approximately 10 percent. All told, commercial bankruptcy filings fell 22 percent in 2012 to 57,788. The drop-off can be attributed to a number of factors, including the continuation of an "amend and extend" (or "extend and pretend") mentality by many lenders loath to redeploy capital in a market with historically low interest rates.

The number of bankruptcy filings by "public companies" (defined as companies with publicly traded stock or debt) in 2012 was 87, according to data provided by New Generation Research, Inc. There were 86 public-company filings in 2011, whereas 106 public companies filed for bankruptcy in 2010, and 211 did so in 2009.

The year 2012 added 14 names to the billion-dollar public-company bankruptcy club, compared to 12 in 2011, 19 in 2010, and 52 in 2009. Counting private-company and municipal filings, the billion-dollar club gained 22 members in 2012.

The largest bankruptcy filing of 2012—Residential Capital, LLC, with $15.7 billion in assets—was the 35th-largest filing of all time, based upon asset value. Nineteen public and private companies with assets greater than $1

billion exited from bankruptcy in 2012. In a change from recent years, more of these companies reorganized than were liquidated or sold. Two of the most prominent names on the list were Lehman Brothers Holdings Inc., the largest bankruptcy filing ever (which returned a 100 percent recovery to brokerage customers), and Washington Mutual Inc., the second-largest bankruptcy of all time.

According to Standard & Poor's ("S&P"), the global number of corporate defaults in 2012 exceeded the number of defaults in 2010 and 2011. A total of 82 issuers defaulted in 2012, surpassing the 53 defaults in 2011 and the 81 defaults in 2010. However, the number of defaults in 2012 was significantly lower than the 264 defaults recorded in 2009. Forty-seven of 2012's defaults were based in the U.S., followed by 22 in emerging markets. Nine were based in Europe, while four were based in other developed regions. Missed interest or principal payments and bankruptcy filings were the top reasons for defaults in 2012, followed by distressed exchanges.

Completed distressed-debt and bankruptcy restructuring activity totaled $422.6 billion over the course of 2012, according to Thomson Reuters, a 102.6 percent increase compared to the $208.6 billion accrued during 2011. In total, 430 deals totaling $470.8 billion were announced in 2012—344 fewer deals compared to the same period in 2011. Activity was led by Greece's $263.1 billion debt-exchange transaction, the largest restructuring deal on record. U.S. deal activity totaled $61.6 billion in 2012, a 19.2 percent decrease from 2011. There were 129 announced U.S. restructuring transactions during 2012, 107 fewer than in the previous year.

WHERE DO WE GO FROM HERE?

The outlook for 2013 in the U.S. business bankruptcy world looks much as it did in each of the past two years. Low interest rates and freer credit markets mean that troubled companies (as well as their lenders) are less likely to opt for a reorganization strategy that incorporates a garden-variety bankruptcy filing. As in years past, prepackaged or prenegotiated Chapter 11 cases and quick-fix Section 363(b) sales are likely to be the norm. Bankruptcy prognosticators have highlighted the health care, real estate, retail, shipping, energy, and professional sports sectors as having companies deemed "most likely to fail."

The transformation of Chapter 11 bankruptcies during the 35 years since the Bankruptcy Code was enacted in 1978 has prompted calls for a hard look at reform. A variety of factors are driving the need for changes. These include: (i) increased use of secured credit throughout capital structures; (ii) an explosion in the growth of distressed-debt markets and claims trading that has made Chapter 11 a takeover strategy; (iii) owner and creditor agendas that go beyond traditional restructuring; (iv) a change from debtors engaged principally in manufacturing to service companies, such as retailers and technology-driven enterprises relying less on hard assets and more on financial contracts; and (v) the increasing prominence of cross-border bankruptcy cases with international-law implications. A commission established by the American Bankruptcy Institute to study Chapter 11 reform held five meetings in 2012 and expects to issue a report of its recommendations in April 2014.

EUROPE

The eye of the global financial storm stalled over Europe in 2012, where the tempest continues to threaten the 27-nation European Union, or at least the 17-member eurozone. Austerity measures implemented by Greece, Spain, Italy, Britain, and Portugal, among others, have proved to be both unpopular and unsuccessful. S&P downgraded the credit ratings of France, Italy, Spain, and six other European countries in 2012—a reminder that Europe's economic woes are far from over. The only eurozone nations retaining their top AAA ratings are Germany, the Netherlands, Finland, and Luxembourg.

According to Eurostat, the EU's statistics office, the 17 countries that use the euro ended 2012 at a record high unemployment rate of 11.8 percent (more than 26 million), the highest level since the euro was launched in 1999.

Greece reached an agreement with its private creditors in 2012 to secure the biggest sovereign restructuring in history, paving the way for a second bailout of the debt-ridden nation and averting an economic collapse. Under the terms of the $172 billion bailout, Greece will reduce its debt to about 120.5 percent of its gross domestic product by 2020, from about 160 percent in early 2012. Banks that hold Greek bonds, which had agreed in October

2011 to take a 50 percent loss on the face value of their bonds, agreed in February 2012 to take a 53.5 percent loss on the face value, the equivalent of an overall loss of around 75 percent.

On March 30, 2012, the Spanish government announced an annual budget that includes €17.8 billion ($24 billion) in fresh spending cuts for the central government, one day after it faced a nationwide general strike and said it would continue its increasingly unpopular austerity drive. Shortly afterward, Spain, which faces record unemployment of more than 25 percent, officially joined seven other eurozone nations in recession. Spain's credit rating was cut by S&P to just above "junk" status in June 2012, setting the stage for yet another eurozone rescue. Shortly afterward, Spain agreed to accept a bailout of up to €100 billion ($125 billion) for its cash-starved banks. Spanish and Portuguese workers coordinated a general strike in November to protest continued austerity measures.

On May 6, 2012, in a popular backlash against austerity measures, voters in France ousted the pro-austerity administration of Nicolas Sarkozy and elected François Hollande as the first Socialist president of France since 1995.

Official figures released by the British government at the end of April 2012 indicated that Britain fell into its first double-dip recession since the 1970s, raising more questions about whether government belt tightening in Europe has gone too far. Near the end of 2012, George Osborne, Britain's chancellor of the exchequer and the architect of the nation's austerity program, informed Parliament that the government missed one of its self-imposed debt-cutting goals and will have to extend the belt tightening into 2018, a year longer than previously promised.

In July 2012, the Italian government approved €4.5 billion ($5.6 billion) in spending cuts for 2012 aimed at slashing the size of Italy's bloated public sector and delaying a new tax increase until after the first half of 2013.

A positive development in the European debt crisis came on December 13, when EU leaders agreed to place eurozone banks under a single supervisory authority. The agreement would put between 100 and 200 major banks under the direct oversight of the European Central Bank, leaving thousands of smaller institutions to be overseen principally by national regulators. The new system is designed to strengthen oversight of a sector that, under the supervision of national regulators, failed to prevent banks from amassing debt

quantities that could endanger the finances of eurozone states and threaten the future of the currency. The supervision mechanism is to be fully operational by March 2014 and is subject to the approval of the European Parliament and national legislatures before it goes into effect.

ASIA

Short-term growth nearly ground to a halt in India during 2012, dampening hopes that India, along with China and other non-Western economies, might help revive the global economy, as happened after the 2008 financial crisis. India is now facing a political reckoning, as the country's elected leaders address difficult, politically unpopular decisions. India's currency (the rupee) is falling, investment is down, inflation is rising, and deficits are eroding government coffers.

Faced with a sharply slowing Chinese economy, weak exports, and faltering investment, China's central bank unexpectedly announced in June 2012 that it would cut interest rates by a quarter of a percentage point. The interest-rate cut was the first by the central bank since December 2008, the last time policymakers in China—the world's second-largest economy—were deeply worried that they might be behind in responding to an economy receding faster than expected.

After three decades of torrid growth, China is encountering an unfamiliar problem with its newly struggling economy: a huge buildup of unsold goods that is cluttering shop floors, car dealerships, and factory warehouses. The glut of everything from steel and household appliances to cars and apartments is hampering China's efforts to emerge from a sharp economic slowdown. China is also confronting a major change in political leadership, with the election in November 2012 of Xi Jinping to the post of general secretary of the Communist Party.

The world's third-largest economy also found itself treading water in 2012. In February 2012, Japan posted a record trade deficit, as the yen's strength and weaker global demand eroded profits at manufacturers and slowed the nation's recovery from the earthquake and tsunami in 2011. The trade gap widened to ¥1.48 trillion ($19 billion), and shipments dropped 9.3 percent compared with 2011, as energy imports surged.

On February 27, 2012, Elpida Memory, Inc., the last Japanese maker of computer memory chips, sought bankruptcy protection, with liabilities of ¥448 billion ($5.5 billion). The company's failure to embrace the global consumer shift from computers to smartphones and tablets pushed the chipmaker into bankruptcy. This bankruptcy is the nation's largest since Japan Airlines Co. sought protection in January 2010 with ¥2.32 trillion in liabilities.

Sony Corporation more than doubled its projected net loss in 2012 to ¥520 billion, the worst ever, as additional tax expense hurt a company already battered by heavy losses in its television business, a strong yen, and natural disasters in Japan and overseas. It later announced a reduction in its global labor force of 10,000 employees (6 percent of its workers).

A GOOD YEAR IN THE MARKETS

Despite stalled U.S. economic growth, fiscal deadlock in Washington, an intensifying European debt crisis, and a slowdown in China, Japan, and India, stock markets had a surprisingly good year in 2012. In the U.S., the Dow Jones Industrial Average, the S&P 500, and the NASDAQ Composite Index all ended 2012 substantially higher, despite losing some ground in the final days of the year as concerns about the looming "fiscal cliff" mounted. Stocks staged a late-day rally in the final session of 2012, enabling the Dow Jones Industrial Average to post a 7.3 percent gain for the year, as hopeful investors wagered that politicians would come up with a last-minute resolution to avert the impending crisis. The Dow rose 166.03 points on December 31, or 1.3 percent, to 13,104.14, marking the largest gain on the final day of the year in its history. The S&P 500 Stock Index jumped 13 percent in 2012, and the technology-heavy NASDAQ soared 16 percent during the year.

In 2012, unlike in 2011, nearly all European and Asian markets finished the year significantly higher. In Asia, Japan's Nikkei 225 was up more than 26 percent, with the Hong Kong Hang Seng Index up more than 24 percent. In Europe, the Deutsche Börse AG German Stock Index ("DAX") soared over 27 percent for the year, the EURO STOXX 50 Price Index finished up more than 15 percent, and London's FTSE 100 Index was up more than 7 percent.

World markets were buoyed by the European Central Bank's announcement on September 6 of a sweeping new program for buying the bonds

of troubled eurozone countries, followed by the U.S. Federal Reserve's announcement on September 13 that the bank would start a third round of its "quantitative easing" bond-purchase program ("QE3") intended to push longer term interest rates lower and encourage borrowing and investment.

TOP 10 BANKRUPTCIES OF 2012

In 2012, unlike in many previous years, when bank holding and financial-services companies undone by the financial crisis dominated the Top 10 List for public-company bankruptcy filings, only a single financial services company and two banking entities made the year's Top 10. The remainder of the list was populated by companies in the imaging, energy, publishing, aircraft, and shipping industries. Each company on the Top 10 List checked into Chapter 11 with both assets and liabilities exceeding $1 billion.

Minneapolis, Minnesota-based real estate finance company **Residential Capital, LLC** ("ResCap") grabbed the brass ring for the largest public bankruptcy case in 2012 when it filed for Chapter 11 protection on May 14 in New York with $15.7 billion in assets and $15.3 billion in debt. ResCap is a wholly-owned subsidiary of GMAC Mortgage Group, LLC, which in turn is wholly-owned by Ally Financial Inc. ("Ally"), the former finance arm of General Motors Co. once known as GMAC. As one of the biggest subprime-mortgage lenders in the country, ResCap was hit especially hard by the financial crisis. The fallout from the crash swamped both ResCap and Ally with mortgage liabilities—to the extent that Ally is now 74 percent owned by the U.S. government after a series of bailouts and failed the most recent round of bank stress tests conducted by the U.S. Federal Reserve.

ResCap's long-awaited bankruptcy filing was intended to alleviate that pressure (and enhance the prospects for taxpayer recovery) by effecting a sale of the company's mortgage business and loan portfolio. On November 21, 2012, the bankruptcy court approved the sale of ResCap's mortgage business to Ocwen Financial Corp and Walter Investment Management Corp., which agreed to pay $3 billion in an auction. It also approved the sale of a ResCap loan portfolio to Warren Buffett's Berkshire Hathaway Inc., which agreed to pay $1.5 billion for a package of 50,000 loans. U.S. taxpayers are still owed nearly $12 billion from the Ally bailout.

Santa Ana, California-based coal, natural gas, and wind power producer **Edison Mission Energy** ("Edison Mission") surged into the No. 2 position on the Top 10 List for 2012 when it filed a prenegotiated Chapter 11 case in Illinois on December 17 with $8.3 billion in assets. Through its subsidiaries, Edison Mission sells or trades energy from coal-fired generating facilities, natural gas-fired generating facilities, and renewable energy facilities, including one of the largest portfolios of wind projects in the U.S. The company has suffered financial losses amid low energy prices, high fuel costs, relatively weak power demand, and low power generation at coal-fired plants run by Midwest Generation, an Illinois-based subsidiary. Edison Mission is a subsidiary of Edison International, which did not file for bankruptcy. Prior to the Chapter 11 filing, Edison International reached an agreement with Edison Mission and the majority of Edison Mission's noteholders whereby ownership of Edison Mission will be transferred to creditors, subject to bankruptcy-court approval.

The No. 3 spot on the Top 10 List for 2012 was captured by iconic imaging pioneer **Eastman Kodak Company** ("Kodak"), which filed for Chapter 11 protection in New York on January 19, 2012, with $6.24 billion in assets and $7.3 billion in debt. At the time of the filing, the Rochester, New York-based company was running short of cash and unable to sell 1,100 digital-imaging patents that could have forestalled a bankruptcy filing. Kodak, the company that invented the digital camera nearly 40 years ago and whose late 19th-century rise to prominence and later ubiquity were owing to the technical and marketing genius of founder George Eastman, never successfully transitioned from its reliance on the photographic-film business, despite the increasing dominance of newer imaging technologies. Kodak had 17,000 employees worldwide and 8,000 in the U.S. (principally in Rochester) at the time of the filing. At its peak in the early 1980s, the company employed 62,000 people in Rochester and 130,000 worldwide. On January 11, 2013, the bankruptcy court approved the sale of Kodak's 1,100 digital-imaging patents for $527 million to a consortium that included Apple Inc., Microsoft Corp., Google Inc., Adobe Systems Inc., Research In Motion Ltd., Samsung Electronics Co., Fujifilm Corp., and Facebook Inc. The sale is a key element of the company's plans to shift its focus to commercial packaging and printing from photography.

Overseas Shipholding Group Inc. ("OSG"), one of the world's largest publicly traded tanker owners, berthed in the No. 4 position on the Top 10 List for 2012 when it foundered into Chapter 11 in Delaware, along with 180 affiliates, on November 14, 2012, listing more than $4 billion in assets and $2.7 billion in debt. OSG owns or operates 111 vessels that transport oil, refined products, and natural gas worldwide. OSG and other crude oil shippers have been buffeted in recent years by slowing demand for oil, combined with a sharp fall in shipping rates for international crude and product vessels. In addition, OSG has ongoing tax problems that rendered its last three years of financial statements unreliable and created a potential for default under its loan agreements.

St. Louis, Missouri-based **Patriot Coal Corp.** ("Patriot") excavated its way into the No. 5 spot on the Top 10 List for 2012 when it filed for Chapter 11 protection on July 9, 2012, together with 98 affiliates in New York, listing $3.8 billion in assets and $3.1 billion in debt. Patriot produces and markets coal products in the eastern U.S., with operations and coal reserves in the Appalachian and Illinois Basin coal regions. The company struggled in recent years because of decreased demand for coal, due largely to an increase in natural gas and other energy sources. At the same time, Patriot's liabilities increased because of rising costs due to "more burdensome environmental and other regulations" as well as "unsustainable labor-related legacy liabilities." In addition, due to an adverse court ruling, Patriot is obligated to build water-treatment facilities that will cost hundreds of millions of dollars. On November 27, 2012, the bankruptcy court in New York ordered venue of Patriot's Chapter 11 cases to be transferred to Missouri, where Patriot's corporate headquarters and executive offices are located.

Houston, Texas-based **ATP Oil & Gas Corporation** ("ATP"), which acquires, develops, and produces oil and natural gas assets in the Gulf of Mexico, the North Sea, and the Mediterranean, drilled its way into the No. 6 position on the Top 10 List for 2012 when it filed for Chapter 11 protection in Texas on August 17, 2012, listing $3.4 billion in assets and $3.1 billion in debt. Prior to its bankruptcy filing, ATP had estimated net proved reserves of 118.9 million barrels of crude oil equivalent and 241.5 billion cubic feet of natural gas. ATP stated that it filed for Chapter 11 to manage debt it incurred because of the five-month moratorium on most U.S. offshore drilling after

the deadly 2010 Gulf of Mexico oil spill.

First Place Financial Corp. ("FPF"), the bank holding company for First Place Bank, was deposited into the No. 7 position on the Top 10 List for 2012 when it filed for Chapter 11 protection in Delaware on October 28, 2012. Based in Warren, Ohio, First Place Bank was a federally chartered stock savings association with more than 40 branches in Ohio, Michigan, Indiana, and Maryland. On October 26, 2012, FPF entered into an agreement to sell First Place Bank to Talmer Bancorp ("Talmer") as a means of complying with certain directives issued by the Office of the Comptroller of the Currency and the Office of Thrift Supervision ("OTS") (which merged on July 21, 2011). The bankruptcy court approved the sale of First Place Bank to Talmer on December 14, 2012. Although FPF's most recent public financial statements showed $3.2 billion in assets, the company listed only $175 million in assets and $64.5 million in debt in its bankruptcy filings.

Hawker Beechcraft, Inc. ("Hawker") crash-landed into the No. 8 spot on the Top 10 List for 2012 when it filed for Chapter 11 protection in New York on May 3, 2012, with $2.8 billion in assets and $3.7 billion in debt. Wichita, Kansas-based Hawker manufactures business, special mission, and trainer/attack aircraft as well as parts and aviation products. At the time of the filing, the company had 5,400 employees and 100 service centers supporting a fleet of 34,000 aircraft. Hawker was formed in 1994 when Raytheon Company merged its Beech Aircraft Corporation and Raytheon Corporate Jets units. In 2006, Raytheon sold Hawker to Goldman Sachs and Onex Corporation, leaving the company with a heavy debt burden that it struggled to support from the 2008 economic crisis onward. Hawker filed for Chapter 11 protection after defaulting on interest payments.

In July 2012, the Chinese company Superior Aviation Beijing offered to purchase Hawker for $1.79 billion, but the deal fell through in October 2012 due to a combination of regulatory concerns and labor issues. In early November 2012, Hawker announced that it would lay off more than 400 of its remaining workers, close various service facilities, and trim its business operations to concentrate on its core manufacturing and maintenance activities. Hawker later filed a Chapter 11 plan proposing a restructuring pursuant to which it would emerge from bankruptcy under a new name, Beechcraft Corporation, with significantly scaled-back operations and $525 million in exit financing.

Textbook publisher **Houghton Mifflin Harcourt Publishing Company** ("Houghton Mifflin") booked position No. 9 on the Top 10 List for 2012 when it and 20 affiliates filed prenegotiated Chapter 11 cases in New York on May 21, 2012, listing $2.7 billion in assets and $3.5 billion in debt. Boston-based Houghton Mifflin publishes textbooks used at all grade levels. It also publishes novels, nonfiction books, children's books, and reference works, including such classics as J.R.R. Tolkien's *The Lord of the Rings* and H.A. and Margret Rey's *Curious George* books for children. The company's educational software unit developed popular computer games such as "The Oregon Trail." Houghton Mifflin struggled financially for years, laden with debt taken on when Education Media and Publishing Group, an Irish private-equity concern, borrowed heavily to finance the acquisitions of Houghton Mifflin in 2006 and Harcourt in 2007. Venue of the Chapter 11 cases was transferred to Massachusetts, but only after the bankruptcy court in New York confirmed a Chapter 11 plan for Houghton Mifflin on June 21, 2012, effectively ending the company's 32-day stay in bankruptcy. Under the plan, Houghton Mifflin swapped its existing bank and bond debt for 100 percent of the equity in the restructured company.

The final spot on the Top 10 List for 2012 belongs to **United Western Bancorp, Inc.** ("UW Bancorp"), a Denver-based holding company that owned United Western Bank until January 21, 2011, when the Federal Deposit Insurance Corporation was appointed receiver for the bank by OTS and oversaw the sale of the bank's eight branches to First-Citizens Bank & Trust Company of Raleigh, North Carolina. UW Bancorp responded by suing OTS, claiming that the seizure was an abuse of power. UW Bancorp filed for Chapter 11 protection in Colorado on March 2, 2012. Although the company's most recent public financial statements listed $2.5 billion in assets, UW Bancorp scheduled assets valued at no more than $10 million in its bankruptcy filings.

Other notable debtors (public and private) in 2012 included:

- ***Hostess Brands, Inc.*** ("Hostess"), the iconic baker of Wonder Bread, Twinkies, and HoHos, which filed for Chapter 11 protection for the second time in a decade (Hostess was known as Interstate Bakeries at the time of its 2004 Chapter 11 filing) in New York on January 11, 2012,

citing soaring costs and weakened demand for its products. Founded in 1937 and based in Irving, Texas, privately held Hostess had 18,500 employees, 33 bakeries, 565 distribution centers, and nearly $1 billion in assets at the time of the filing. On November 16, 2012, one week after one of its biggest unions went on strike to protest a labor contract, 82-year-old Hostess announced plans to wind down operations and sell its portfolio of well-known brands.

- ***LightSquared Inc.*** (f.k.a. SkyTerra Communications), a privately owned telecommunications company that filed for Chapter 11 protection in New York on May 14, 2012, listing $4.5 billion in assets after its plan to deliver high-speed wireless to as many as 260 million people ran afoul of U.S. regulators.
- Houston, Texas-based ***Dynegy Inc.***, a privately owned company whose subsidiaries produce electric energy from 16 coal- and gas-fired power facilities located in six states, which filed for Chapter 11 protection on July 6, 2012, in New York, listing $4.1 billion in assets. The filing was part of a settlement agreement with creditors involving a merger of Dynegy, Inc., with its largest subsidiary, Dynegy Holdings (which had filed for Chapter 11 on November 7, 2011), and the sale of Dynegy, Inc.'s remaining assets to satisfy creditor claims.
- ***Arcapita Bank BSC*** (f.k.a. First Islamic Investment Bank) ("Arcapita"), a Bahrain-based privately owned manager of Islamic-compliant (Shari'ah-compliant) investments with $7 billion under management, which filed for Chapter 11 protection in New York, listing $3 billion in assets and $2.6 billion in debt after failing to reach an agreement with creditors on the refinancing of a $1.1 billion syndicated Shari'ah-compliant loan. In December 2012, the bankruptcy court overseeing Arcapita's Chapter 11 case authorized the first-ever Shari'ah-compliant debtor-in-possession financing.
- ***Pinnacle Airlines Corp.***, a Memphis-based regional air carrier that operates a jet and turboprop fleet under agreements with Delta Air Lines, Inc., United Continental Holdings, Inc., and US Airways Group, Inc., which filed for Chapter 11 protection on April 1, 2012, in New York, listing $1.5 billion in assets and $1.4 billion in debt.

- ***The City of Stockton, California***, which became the largest city in U.S. history to seek bankruptcy protection when it filed a Chapter 9 petition on June 28, 2012, in California to manage a $26 million budget deficit. The filing came after a breakdown in negotiations with creditors in compliance with A.B. 506, a newly effective California law that allows municipalities in financial distress to negotiate with creditors to restructure debts and agreements to avoid filing for bankruptcy. In its bankruptcy filings, Stockton listed assets of more than $1 billion and liabilities of more than $500 million.
- ***The City of San Bernardino, California***, 65 miles east of Los Angeles and home to about 210,000 residents, which became the third California city to file for bankruptcy protection in 2012 when it filed a Chapter 9 petition on August 1, listing assets and liabilities in excess of $1 billion. In late July, San Bernardino reported that it had $56 million in debt payable from its general fund, including payments on a $50 million pension bond. The city also had $195 million in unfunded pension obligations, $61 million in unfunded retiree health care, and $40 million in workers' compensation and general liabilities.
- ***A123 Systems Inc.*** ("A123"), a manufacturer of electric-car batteries and the recipient of nearly $250 million in U.S. government grants, which filed for Chapter 11 protection on October 16, 2012, in Delaware, listing $626 million in assets, with a plan to sell its auto-business assets to auto-parts maker Johnson Controls Inc. ("Johnson"). However, previous suitor Wanxiang America Corp., the U.S. arm of Chinese auto-parts conglomerate Wanxiang Group, outbid Johnson, offering $257 million for the assets—more than doubling Johnson's initial offer. The bankruptcy court approved the sale to Wanxiang on December 11, but Johnson appealed. A123's defense-related business assets will be sold separately for $2.25 million to Navitas Systems.
- ***Dewey & LeBoeuf*** ("Dewey"), a private law firm crippled by financial miscues and partner defections, which filed for Chapter 11 protection on March 28, 2012, in New York, punctuating the largest law-firm collapse in U.S. history. Dewey unraveled after lower-than-expected profits—and debt mountainous by law-firm standards—forced it to slash partners'

salaries. Already owed millions from previous years, the partners became concerned about Dewey's finances and eventually began a mass exodus that destroyed the firm. At its peak, Dewey employed more than 2,500 people, including roughly 1,400 lawyers in 26 offices across the globe.

LEGISLATIVE/REGULATORY DEVELOPMENTS

Commission to Study Proposed Changes to Chapter 11

On April 19, 2012, a commission established by the American Bankruptcy Institute (the "ABI Commission") to study the reform of Chapter 11 of the Bankruptcy Code held its first public meeting in Washington, D.C. On July 2, the ABI Commission released the names of nearly 130 corporate restructuring experts to serve on one of 13 advisory committees. The ABI Commission expects to issue a report of its recommendations in April 2014. It convened five public hearings in 2012 and anticipates holding as many as seven field hearings in 2013, with topics for discussion to include: (i) employee benefits; (ii) labor and management and the treatment of collective bargaining agreements; (iii) valuations; (iv) unsecured trade credit; (v) safe harbors for derivatives; (vi) changes from the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 and their effect on trade credit, landlords, and others; (vii) governance of troubled companies; and (viii) entrenched management.

Bankruptcy-Fee Guidelines Proposed

On November 2, 2012, the U.S. Trustee, a unit of the U.S. Justice Department entrusted with overseeing bankruptcy cases, proposed new guidelines for attorneys' fees in large Chapter 11 cases (defined as debtors with at least $50 million in assets and $50 million in liabilities). A previous proposal from 2011 was roundly criticized by bankruptcy attorneys, some of whom deemed it overreaching and out of touch. The new proposal, to take effect in the summer of 2013, incorporates some changes suggested by professionals, such as narrowing which Chapter 11 cases are affected, but includes other provisions deemed objectionable, including a provision that would call for

attorneys to submit budgets estimating the cost and type of work they intend to perform. The guidelines are not binding law but are likely to act as a benchmark.

Amended Bankruptcy Rules

On April 23, 2012, the U.S. Supreme Court approved amendments to the Federal Rules of Bankruptcy Procedure (the "Bankruptcy Rules") that became effective on December 1, 2012. Several of the amendments involve technical and conforming changes to eliminate inconsistencies within the existing Bankruptcy Rules, as well as changes designed to make the Bankruptcy Rules consistent with the Federal Rules of Civil Procedure and the Federal Rules of Appellate Procedure.

Additional amendments to the Bankruptcy Rules were proposed in August 2012 by the Committee on Rules of Practice and Procedure of the U.S. Judicial Conference, including a rule that would require parties in all bankruptcy cases to consent to judgments issued by bankruptcy courts to help eliminate confusion over court authority in light of the U.S. Supreme Court's landmark 2011 decision in *Stern v. Marshall*, 132 S. Ct. 56 (2011). The proposed amendments would become effective December 1, 2014 (with certain exceptions).

Stern v. Marshall Prompts New Court Rules/Orders

Several federal district courts have amended their standing orders referring bankruptcy cases to bankruptcy courts in response to *Stern*. Local-court rules have also been altered to account for the decision. For example, the U.S. District Court for the Southern District of New York issued an amended standing order of reference on January 31, 2012, and the Local Rules Committee for the district proposed new Local Bankruptcy Rules in response to *Stern*. Both require litigants to state expressly whether or not they consent to entry of final orders by bankruptcy courts in core proceedings if the court is deemed to lack constitutional authority to enter a final judgment or order. The U.S. District Court for the District of Delaware similarly amended its standing order of reference on February 29, 2012.

EC Insolvency Regulation Reform

On December 12, 2012, the European Commission ("EC") proposed reforms to the EC Insolvency Regulation (Council Regulation (EC) No 1346/2000) (the "EC Regulation") designed to modernize the rules governing cross-border insolvency proceedings. The preamble to the proposal states that "the new rules will shift focus away from liquidation and develop a new approach to helping businesses overcome financial difficulties, all the while protecting creditors' right to get their money back."

Key elements of the proposed reforms include: (i) broadening the scope of the EC Regulation by revising the definition of "insolvency proceedings" to include hybrid and pre-insolvency proceedings, as well as debt-discharge proceedings and other insolvency proceedings for natural persons; (ii) more efficient administration of insolvency proceedings by: (a) giving courts the discretion to deny a petition to commence a secondary (nonmain) proceeding if it is deemed unnecessary to protect the interests of local creditors, (b) abolishing the requirement that secondary proceedings be winding-up proceedings, and (c) improving coordination between main and secondary proceedings; and (iii) enhanced public access to court decisions in cross-border insolvency cases and standardization of creditor claim forms.

Italian Insolvency Act Amendments

Italian law decree No. 83 of June 22, 2012 (the "Decree") introduced significant amendments to several provisions of the Italian Insolvency Act governing: (a) a debt-restructuring agreement (*accordo di ristrutturazione dei debiti*) pursuant to Article 182-*bis* ("Art. 182-*bis* Agreement"); and (b) an arrangement with creditors (*concordato preventivo*) pursuant to Article 160 ("Arrangement with Creditors"). Among other things, the Decree provides: (i) easier access to an Arrangement with Creditors consistent with the key principles underlying the Chapter 11 process in the U.S. Bankruptcy Code; (ii) a new form of Arrangement with Creditors aimed at ensuring the continuity of an insolvent debtor as a going concern (*concordato con continuità aziendale*); (iii) enhanced protection of new financing granted in connection with restructuring proceedings; and (iv) certain amendments to provisions regulating the payment of dissenting creditors under an Art. 182-*bis* Agreement.

French Insolvency Law Amendments

On September 20, 2012, the French government issued a 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 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. With the changes, an SFA may now 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 150-employee or €20 million-turnover thresholds. Thus, an SFA, which will facilitate financial restructurings in distressed leveraged-buyout scenarios, is now available to most holding companies.

Russian Bankruptcy Law Amendments

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, which took effect in November 2012, amends regulations governing interim administrations of financial and banking entities that have forfeited their operational licenses. It also revises the powers of the Russian federal deposit insurance agency.

NOTABLE BUSINESS BANKRUPTCY DECISIONS OF 2012

Allowance/Disallowance/Priority/Discharge of Claims

"Key employee" retention plans proposed by bankrupt companies have been subject to rigorous scrutiny since Congress amended the Bankruptcy Code in 2005 to add Section 503(c), which makes it much more difficult to

implement such programs. Several notable court rulings were handed down in 2012 concerning the propriety under Section 503(c) of 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"), which is generally governed by the less stringent requirements of Section 503(c)(3), rather than as a key employee retention plan ("KERP"), which is strictly regulated by Section 503(c)(1).

During 2012, several courts adopted the "business judgment" standard applied to a proposed nonordinary-course use, sale, or lease of estate property pursuant to Section 363(b) of the Bankruptcy Code 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.*, 478 B.R. 142 (Bankr. E.D.N.Y. 2012); *In re Velo Holdings Inc.*, 472 B.R. 201 (Bankr. S.D.N.Y. 2012).

In *Velo Holdings*, the court concluded that the Chapter 11 debtors' proposed KEIP established incentive targets that, although tied to the debtors' compliance with a 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 that implementation of the plan was a valid exercise of sound business judgment under Sections 363 and 503(c)(3).

In *In re Hawker Beechcraft, Inc.*, 479 B.R. 308 (Bankr. S.D.N.Y. 2012), the court denied 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*, 478 B.R. 154 (Bankr. S.D.N.Y. 2012), the court denied the debtors' 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 debtors' closing the sales of two loan portfolios that had been substantially negotiated prepetition. However, the court later approved the payments after the debtors made changes to the KEIP designed to make it more incentivizing.

In *In re Blitz U.S.A., Inc.*, 475 B.R. 209 (Bankr. D. Del. 2012), the court concluded that a bonus plan proposed by the debtor was an ordinary-course transaction, and therefore not subject to Section 503(c), because the debtor had implemented similar plans for the three years preceding its Chapter 11 filing and because other manufacturers had employed similar plans.

In keeping with courts' narrow construction of what constitutes "substantial contribution" in a Chapter 11 case within the meaning of Section 503(b)(3)(D) of the Bankruptcy Code, the bankruptcy court in *In re AmFin Financial Corp.*, 468 B.R. 827 (Bankr. N.D. Ohio 2012), denied administrative-expense priority to the fees and expenses of senior noteholders, noting, among other things, that "the efforts by the Senior Noteholders to settle their own claims [were] not properly characterized as a substantial contribution to the case."

In *Machne Menachem, Inc. v. Spritzer (In re Machne Menachem)*, 2012 WL 8570 (3d Cir. Jan. 3, 2012), the Third Circuit, addressing the power of a court to recharacterize debt as equity, affirmed a bankruptcy court's ruling that certain advances made by a purported lender to a not-for-profit debtor were not loans. The bankruptcy court had looked to the intent of the parties as it existed at the time of the transaction; analyzed the parties' intent in keeping with the Third Circuit's earlier ruling in *Cohen v. K.B. Mezzanine Fund II (In re SubMicron Sys. Corp.)*, 432 F.3d 448 (3d Cir. 2006); and held that the advances were donations. The Third Circuit ruled that the bankruptcy court's determination was not clearly erroneous because: (i) "there [was] no written instrument for the court to analyze and determine whether the terms suggest[ed] an expectation of repayment," even though some of the checks had "loan" written on them; and (ii) there was "no evidence of intent on behalf of [the debtor] to accept or authorize the purported loans, such as a resolution from the board of directors, or evidence that the board was aware of the loans."

In *Wright v. Owens Corning*, 679 F.3d 101 (3d Cir. 2012), the Third Cir-

cuit held that, although it had previously reversed the rule stated in *Avellino & Bienes v. M. Frenville Co. (In re M. Frenville Co.)*, 744 F.2d 332 (3d Cir. 1984), governing when a "claim" arises for purposes of discharge in bankruptcy, due-process considerations mandated that the claims of certain unknown defective-product claimants not be discharged—thereby resuscitating *Frenville*'s results in certain circumstances and adding another layer of complexity to the analysis of discharged claims.

In *In re Heritage Highgate, Inc.*, 679 F.3d 132 (3d Cir. 2012), the Third Circuit ruled that, in a Chapter 11 reorganization, the term "value," as applied to Section 506(a), should mean the fair market value of collateral as of plan confirmation. In so ruling, the court of appeals rejected the market-based, or "wait and see," approach recommended by a group of secured creditors, whose subordinated claims would be rendered unsecured unless the court included projected revenues from the debtor's Chapter 11 plan in the valuation analysis. Applying the fair-market-value approach to calculate the amount of a creditor's secured claim, the Third Circuit held, does not constitute impermissible lien stripping. In addition, the court adopted a burden-shifting approach to the question of who bears the burden of demonstrating value.

In *Statek Corp. v. Dev. Specialists, Inc. (In re Coudert Bros. LLP)*, 673 F.3d 180 (2d Cir. 2012), the Second Circuit considered as a matter of first impression which choice-of-law rules should apply when a bankruptcy court sitting in one state is resolving a bankruptcy claim arising from a state-law action previously filed in another state. The court ruled that: (i) where a claim is wholly derived from another legal claim pending in a parallel nonbankruptcy proceeding in another state; and (ii) where the pending original claim was filed in a court prebankruptcy, the bankruptcy court must apply the choice-of-law rules of the state where the underlying prepetition claim was filed (in this case, Connecticut).

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

In *Senior Transeastern Lenders v. Official Committee of Unsecured Creditors (In re TOUSA, Inc.)*, 680 F.3d 1298 (11th Cir. 2012), the Eleventh Circuit ruled that the bankruptcy court's findings that subsidiaries of residential

construction company TOUSA, Inc., did not receive reasonably equivalent value in exchange for liens they granted to secure financing to fund the parent company's settlement with its joint-venture lenders were not clearly erroneous. Accordingly, the Eleventh Circuit held, those findings supported the bankruptcy court's determination that the transaction was a fraudulent transfer under Section 548(a)(1)(B) of the Bankruptcy Code. The *TOUSA* litigation has been closely followed by the loan market because of the significant implications for both lenders and borrowers when structuring loan transactions with comparable structural features, such as upstream guarantees with standard "savings clauses."

Reconciling discordant orders issued in the same Chapter 11 case, a Delaware bankruptcy court ruled in *Industrial Enterprises of America v. Burtis (In re Pitt Penn Holding Co., Inc.)*, 2012 WL 204095 (Bankr. D. Del. Jan. 24, 2012), that the two-year statutory "look-back" period during which a fraudulent transfer may be avoided pursuant to Section 548 of the Bankruptcy Code cannot be "equitably tolled."

Bankruptcy-Court Powers/Jurisdiction

Putting it mildly, the U.S. Supreme Court's 2011 ruling in *Stern v. Marshall*, 132 S. Ct. 56 (2011), cast a wrench into the day-to-day operation of bankruptcy courts scrambling to deal with a deluge of challenges—strategic or otherwise—to the scope of their "core" authority to issue final orders and judgments on a wide range of disputes. In *Stern*, the Court ruled that, to the extent that 28 U.S.C. § 157(b)(2)(C) purports to confer authority on a bankruptcy court to finally adjudicate a state-law counterclaim against a creditor that filed a proof of claim, the provision is constitutionally invalid. The mayhem among bankruptcy and appellate courts continued throughout 2012.

In *Onkyo Electronics v. Global Technovations Inc. (In re Global Technovations Inc.)*, 694 F.3d 705 (6th Cir. 2012), the Sixth Circuit became the first court of appeals to consider whether, in the aftermath of *Stern*, a bankruptcy court has authority to enter a final judgment in an action seeking to avoid a fraudulent transfer. The Sixth Circuit held that the bankruptcy court did have authority to do so because the creditor had filed a proof of claim.

According to the court, it was "crystal clear that the bankruptcy court had constitutional jurisdiction under *Stern* to adjudicate whether the sale [to the debtor of a subsidiary of Onkyo] was a fraudulent transfer" because Onkyo's proof of claim could not be resolved without addressing the fraudulent-transfer question. Thus, the Sixth Circuit wrote, this "case is fundamentally unlike [*Granfinanciera, S.A. v. Nordberg*, 492 U.S. 33 (1989)], where the bankruptcy estate reached out to file a fraudulent-transfer claim against a party who had filed no claim against the estate."

However, the Sixth Circuit also stated that "[w]hat is not crystal clear is whether the bankruptcy court had jurisdiction under *Stern* to make the additional finding that Onkyo was a 'good-faith transferee' and a 'good-faith obligee' under [the Florida Uniform Fraudulent Transfer Act]." The bankruptcy court never reached the issue below because it disallowed Onkyo's claim for the balance of the purchase price in its entirety. The Sixth Circuit held that even though a good-faith-transferee determination was not necessary to resolve Onkyo's proof of claim, the bankruptcy court nonetheless had authority to make the determination. According to the Sixth Circuit, it did not read *Stern* to require a court "to determine, in advance, which facts will ultimately prove strictly necessary to resolve a creditor's proof of claim." Thus, the mere possibility that a claim dispute will be resolved in a way that requires the bankruptcy court to address unrelated matters does not deprive the court of authority to issue a final ruling.

The Sixth Circuit reprised its role as interpreter of *Stern* in *Waldman v. Stone*, 698 F.3d 910 (6th Cir. 2012). In a surprising ruling that reinvigorated the ongoing debate about *Stern*'s scope, the Sixth Circuit adopted a broad view of the case, holding that the limitations imposed on bankruptcy courts by Article III of the Constitution cannot be waived by a party's failure to object at the trial-court level. In addition to rejecting the waiver principle as a basis for bankruptcy courts to issue final judgments in certain proceedings, the Sixth Circuit suggested that a "statutory gap" in 28 U.S.C. § 157 may prevent a bankruptcy court from issuing proposed findings of fact and conclusions of law in core matters. The decision renewed uncertainty regarding the constitutional limits of a bankruptcy court to adjudicate both core and noncore claims.

In *Executive Benefits Insurance Agency, Inc. v. Arkison (In re Bellingham*

Insurance Agency, Inc.), 2012 WL 6013836 (9th Cir. Dec. 4, 2012), the Ninth Circuit ruled that, even though federal law empowers bankruptcy judges to enter final judgments in fraudulent-conveyance actions against a "nonclaimant" (i.e., someone who has not filed a proof of claim), the U.S. Constitution forbids entry of a final order because those claims do not fall within the "public rights exception." However, the court explained, defendants in such avoidance proceedings may (and in this case did) consent to the entry of a final judgment by the bankruptcy court, even if that consent was implied from the defendant's failure to assert its right to entry of final judgment by an Article III court. In addition, the Ninth Circuit emphasized that a bankruptcy court may still hear and make recommendations regarding any statutorily "core" proceedings in which the court lacks the authority to enter a final judgment.

In *KHI Liquidation Trust v. Wisenbaker Builder Servs., Inc. (In re Kimball Hill, Inc.)*, 480 B.R. 894 (Bankr. N.D. Ill. 2012), the court suggested that bankruptcy courts do have the authority to enter final judgments in both fraudulent-transfer and preference litigation, whether or not: (i) the defendant filed a proof of claim; (ii) the fraudulent-transfer and preference claims are related to those initial claims; and (iii) the parties consented to final adjudication by the bankruptcy court. The court concluded that the vast majority of the Supreme Court's decision in *Stern* (and the ruling in *Ortiz v. Aurora Health Care, Inc. (In re Ortiz)*, 665 F.3d 906 (7th Cir. 2011), by which the *Kimball Hill* court was bound), was mere *dicta* and therefore not controlling authority for cases differing from the unique set of facts in *Stern*.

According to the *Kimball Hill* court, the proceeding before it did not involve counterclaims and was in no way "steeped in state law." Furthermore, the court wrote, it "[did] not share anything in common with the proceedings that *Stern* and *Ortiz* held [were] unconstitutional other than that they are all adversary proceedings in a bankruptcy case," a commonality that was "not sufficient to expand [*Stern*'s] explicitly narrow holding." The court remarked that "[a]s the right to avoid a fraudulent transfer is steeped in bankruptcy law, the bankruptcy court's entering final orders on the proceeding does not chip away at the authority that the Constitution vested to the Article III courts."

A Florida bankruptcy court ruled in *In re Pearlman*, 462 B.R. 849 (Bankr. M.D. Fla. 2012), that "substantive consolidation"—the merging of the assets, liabilities, and creditors of related entities—is purely a bankruptcy remedy

and that a bankruptcy court does not have the power to consolidate the estate of a debtor in bankruptcy with the assets and affairs of a nondebtor. In doing so, the court staked out a position on a contentious issue that has created a widening rift among bankruptcy and appellate courts regarding the scope of a bankruptcy court's jurisdiction over nondebtor entities. For example, in *In re LLS America, LLC*, 2012 WL 2042503 (B.A.P. 9th Cir. June 5, 2012), a bankruptcy appellate panel affirmed a bankruptcy-court order substantively consolidating the estates of debtor and nondebtor entities without comment regarding the power of the court to order the remedy.

In *Continental Ins. Co. v. Thorpe Insulation Co. (In re Thorpe Insulation Co.)*, 671 F.3d 1011 (9th Cir. 2012), the Ninth Circuit ruled that a bankruptcy court has discretion, even in a "core" proceeding, to decline to enforce an otherwise valid and applicable arbitration provision, but only if arbitration would conflict with the underlying purposes of the Bankruptcy Code.

Chapter 11 Plans

In *RadLAX Gateway Hotel, LLC v. Amalgamated Bank*, 132 S. Ct. 2065 (2012), a unanimous U.S. Supreme Court upheld a ruling by the Seventh Circuit denying confirmation of a "cramdown" Chapter 11 plan that contemplated the sale of encumbered assets free and clear of all liens without giving a secured creditor the right to credit-bid its claim in connection with the sale. By its ruling, the Supreme Court resolved a circuit split on the proper application of the "indubitable equivalent" prong of Section 1129(b)(2)(A) of the Bankruptcy Code.

In a prelude (and a corollary) to the highly anticipated ruling in *RadLAX*, the Seventh Circuit in *In re River East Plaza, LLC*, 669 F.3d 826 (7th Cir. 2012), affirmed a bankruptcy court's ruling that a debtor could not "cram down" a Chapter 11 plan over the objection of an undersecured creditor which had made a Section 1111(b) election by substituting a lien on 30-year U.S. Treasury bonds as the "indubitable equivalent" of the creditor's mortgage lien on the property.

"Mootness" is a doctrine that precludes a reviewing court from reaching the underlying merits of a controversy. In federal courts, an appeal can be either constitutionally or equitably moot. Constitutional mootness is derived

from Article III of the U.S. Constitution, which limits the jurisdiction of federal courts to actual cases or controversies and, in furtherance of the goal of conserving judicial resources, precludes adjudication of cases that are hypothetical or merely advisory. In contrast, "equitable mootness" bars adjudication of an appeal when a comprehensive change of circumstances occurs such that it would be inequitable for a reviewing court to address the merits of the appeal. In bankruptcy cases, equitable mootness is often invoked in an effort to preclude appellate review of an order confirming a Chapter 11 plan.

In *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 Ninth Circuit, in a matter of first impression, held that an appeal by certain nonsettling asbestos insurers of an order confirming a Chapter 11 case was not equitably moot. According to the Ninth Circuit, the insurers used due diligence in seeking a stay, the plan had not been substantially consummated (as defined in Section 1101 of the Bankruptcy Code), remedies short of reversing confirmation would not inequitably affect the interests of third-party asbestos claimants or a lender that had extended credit to the reorganized debtor, and a remedy could be fashioned for the insurers by a multitude of options other than complete plan reversal.

In *In re Philadelphia Newspapers, LLC*, 690 F.3d 161 (3d Cir. 2012), the Third Circuit held that the foremost consideration in ruling on a challenge to plan confirmation on the basis of equitable mootness is "whether allowing the appeal to go forward will undermine the plan, and not merely whether the plan has been substantially consummated." According to the Third Circuit, the district court erred by: (i) finding equitable mootness relying only on the plan's substantial consummation under the Bankruptcy Code's definition; (ii) failing to perform an analysis of whether a ruling favorable to the appellants would upset the confirmed plan; and (iii) faulting the appellants for not seeking a stay, without explaining whether a stay was critical, given the progression of the debtors' bankruptcy cases.

In *In re Charter Communications, Inc.*, 691 F.3d 476 (2d Cir. 2012), the Second Circuit deepened a split between the circuits with respect to the standard of review and burden of proof to be applied in equitable-mootness cases. The court 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). 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. This deepening rift may be a compelling invitation to review by the U.S. Supreme Court.

The strategic importance of classifying claims and interests under a Chapter 11 plan is sometimes an invitation for creative machinations designed to muster adequate support for confirmation of the plan. A prominent bone of contention in the ongoing plan-classification dispute concerns the legitimacy of separately classifying similar, but arguably distinct, kinds of claims in an effort to create an accepting impaired class or to prevent a dissenting creditor from dominating a class because its claim is so substantial that the creditor can ensure that the class votes to reject a plan. Sometimes referred to as class "gerrymandering," this practice was the subject of a ruling handed down by a bankruptcy appellate panel in *In re Loop 76, LLC*, 465 B.R. 525 (B.A.P. 9th Cir. 2012). The panel affirmed a bankruptcy-court ruling that an unsecured-deficiency claim should be classified separately from the claims of other unsecured creditors because the undersecured creditor had recourse to a guarantee for payment of its deficiency claim, such that the claims were not substantially similar.

In *In re 18 RVC, LLC*, 2012 WL 5336733 (Bankr. E.D.N.Y. Oct. 22, 2012), the court ruled that the existence of a personal guarantee for an unsecured claim of a partially secured lender is insufficient to support separate classification of that claim under Section 1122(a) of the Bankruptcy Code as one that is not "substantially similar" to all other unsecured claims. The ruling was the first outside the Ninth Circuit to decline to follow *Loop*. In doing so, the *18 RVC* court agreed with the reasoning articulated in *In re 4th Street East Investors, Inc.*, 2012 WL 1745500 (Bankr. C.D. Cal. May 15, 2012), the first decision rejecting *Loop*, where the bankruptcy court held that the existence of a nondebtor guarantee is an insufficient basis to separately classify unsecured claims.

In *Federal National Mortgage Assoc. v. Village Green I GP*, 2012 WL 6045896 (W.D. Tenn. Dec. 5, 2012), the district court ruled that a bank-

ruptcy court improperly rejected outright the "doctrine of artificial impairment," which refers to the manipulation of classes of claims in order to artificially create an accepting class of impaired claims. Reversing and remanding the decision below, the district court concluded that the determining factor should be not whether the impairment was artificial, but whether the impairment was *without justification*. The court rejected the majority view that artificial impairment "runs afoul" of the requirements for Chapter 11 confirmation, including Sections 1129(a)(3) and 1129(a)(10).

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

In *In re Federal-Mogul Global Inc.*, 684 F.3d 355 (3d Cir. 2012), the Third Circuit 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. Like the courts below, the Third Circuit determined that it had already held in *In re Combustion Engineering, Inc.*, 391 F.3d 190 (3d Cir. 2004), that Section 1123 of the Bankruptcy Code preempts anti-assignment provisions which would otherwise bar the transfer of insurance rights to an asbestos trust. The Third Circuit rejected the argument that Section 1123's preemption scope should be based on Section 1142 of the Bankruptcy Code (providing that the debtor shall implement the plan "[n]otwithstanding any otherwise applicable non-bankruptcy law, rule, or regulation relating to financial condition") and the Ninth Circuit's ruling in *Pac. Gas & Elec. Co. v. California ex rel. California Dept. of Toxic Substances Control*, 350 F.3d 932 (9th Cir. 2003). The court saw no reason to read Sections 1123 and 1142 coextensively. In addition to finding *Pacific Gas* distinguishable, the Third Circuit was "unconvinced" that Sections 1123 and 1142 are so similar that they must be read together.

In *In re Caviata Attached Homes, LLC*, 481 B.R. 34 (B.A.P. 9th Cir. 2012), the court considered as a matter of first impression whether unfore-

seen circumstances prevented a Chapter 11 debtor from complying with the terms of a Chapter 11 plan confirmed in a previous Chapter 11 case. Section 1127(b) of the Bankruptcy Code prohibits the modification of a substantially consummated plan. Even so, some courts have held that serial Chapter 11 filings are not *per se* impermissible and that a second plan may modify the first plan where there has been an unforeseeable or unanticipated change in circumstances.

In *Caviata*, the court considered an appeal from a bankruptcy-court order dismissing a serial Chapter 11 filing 15 months after confirmation of a plan in the debtor's previous Chapter 11 case. The appellate panel cautioned that "[e]ven extraordinary and unforeseeable changes will not support a new Chapter 11, if these changes do not substantially impair the debtor's performance under the confirmed plan." It left undisturbed the bankruptcy court's finding that a decline in the U.S. economy between 2010 and 2011 was not an unforeseeable changed circumstance that substantially impaired the debtor's ability to perform under its confirmed Chapter 11 plan.