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CHAPTER 15 PETITION DATE "ANCHORS" COMI ANALYSIS

Pedro A. Jimenez and Mark G. Douglas

October 17, 2013, will mark the eighth anniversary of the enactment of chapter 15 of the U.S. Bankruptcy Code as part of the comprehensive U.S. bankruptcy-law reforms implemented in 2005. Chapter 15, which governs cross-border bankruptcy and insolvency cases, is patterned after the Model Law on Cross-Border Insolvency (the "Model Law"), a framework of legal principles formulated by the United Nations Commission on International Trade Law ("UNCITRAL") in 1997 to deal with the rapidly expanding volume of international insolvency cases. The Model Law has now been adopted in one form or another by 20 nations or territories.

The jurisprudence of chapter 15 has evolved since 2005, and one issue that has received considerable attention is the determination of a foreign debtor's "center of main interests" ("COMI"). In *Morning Mist Holdings Ltd. v. Krys (In re Fairfield Sentry Ltd.)*, No. 11-4376, 2013 BL 102426 (2d Cir. Apr. 16, 2013), the U.S. Court of Appeals for the Second Circuit recently ruled that COMI must be determined on the basis of the debtor's "activities at or around the time the Chapter 15 petition is filed," rather than on the commencement date of the foreign proceeding.

In making such an inquiry, the Second Circuit cautioned, "a court may consider the period between the commencement of the foreign insolvency proceeding and the filing of the Chapter 15 petition to ensure that a debtor has not manipulated its COMI in bad faith." Factors that may be considered in determining COMI, the court explained, "are not limited and may include the debtor's liquidation activities."

Another important portion of the Second Circuit's decision was its analysis of the "public policy exception" to relief under chapter 15 contained in section 1506 of the Bankruptcy Code. The Second Circuit concluded that the exception is to be narrowly construed and that in the case of the foreign proceeding at issue in *Fairfield Sentry*, restricted access to documents in a British Virgin Islands liquidation proceeding "is no basis on which to hold that recognition of the BVI liquidation is manifestly contrary to U.S. public policy."

RECOGNITION UNDER CHAPTER 15

Under chapter 15, the "foreign representative" of a foreign debtor may file a petition in a U.S. bankruptcy court seeking "recognition" of a "foreign proceeding." "Foreign representative" is defined in section 101(24) of the Bankruptcy Code as "a person or body, including a person or body appointed on an interim basis, authorized in a foreign proceeding to administer the reorganization or the liquidation of the debtor's assets or affairs or to act as a representative of such foreign proceeding."

"Foreign proceeding" is defined by section 101(23) of the Bankruptcy Code as:

> a collective judicial or administrative proceeding in a foreign country, including an interim proceeding, under a law relating to insolvency or adjustment of debt in which proceeding the assets and affairs of the debtor are subject to control or supervision by a foreign court, for the purpose of reorganization or liquidation.

Because more than one bankruptcy or insolvency proceeding may be pending against the same foreign debtor in different countries, chapter 15 contemplates recognition in the U.S. of both a "main" proceeding—a case pending in the country that contains the debtor's COMI—and "nonmain" proceedings, which may have been commenced in countries where the debtor merely has an "establishment."

Section 1517(b) of the Bankruptcy Code provides that a "foreign proceeding shall be recognized . . . as a foreign main proceeding if it is pending in the country where the debtor has the center of its main interests." The Bankruptcy Code does not define "COMI." However, section 1516(c) provides that, "[in] the absence of evidence to the contrary, the debtor's registered office, or habitual residence in the case of an individual, is presumed to be" the debtor's COMI. According to the statute's legislative history, this presumption was included "for speed and convenience of proof where there is no serious controversy." *See* H.R. Rep. No. 109-31, pt. 1, at 112–13 (2005), U.S. Code Cong. & Admin. News 2005, pp. 88, 175. An "establishment" is defined in section 1502(2) as "any place of operations where the debtor carries out a nontransitory economic activity."

The Bankruptcy Code does not specify what evidence is required to rebut the presumption that COMI is the debtor's place of registration or incorporation. Various factors have been deemed relevant by courts and commentators in examining COMI, including the location of the debtor's headquarters, managers, employees, investors, primary assets, or creditors, and which jurisdiction's law would apply to most disputes. Chapter 15 expressly directs courts to look for guidance on the determination of COMI to interpretations by foreign jurisdictions of similar statutes, such as the European Union Regulation on Insolvency Proceedings, Council Regulation (EC) No. 1346/2000 of 29 May 2000 (the "EU Regulation"), which applies to all insolvency cases filed in the European Union (except for Denmark) on or after May 31, 2002, and the U.K. Cross-Border Insolvency Regulation of 2006, S.I. 2006/1030 (U.K.).

Additional guidance can be found in the Legislative Guide to Enactment of the Model Law adopted by UNCITRAL on June 25, 2004 (the "UNCITRAL Guide") and an extensive body of legal commentary developed during the 16 years since the Model Law was finalized in 1997 and in the wake of chapter 15's enactment in 2005. The UNCITRAL Guide explains that employing COMI as the basis for extending recognition of a main proceeding was modeled on the use of that concept in the EU Regulation. The EU Regulation provides that COMI "should correspond to the place where the debtor conducts the administration of his interests on a regular basis and is therefore ascertainable by third parties." The concept is roughly equivalent to the "principal place of business" under U.S. law.

If a U.S. court recognizes a foreign main proceeding under chapter 15, actions against the foreign debtor or its property located in the U.S. are stayed under section 362 of the Bankruptcy Code. Following recognition of a main or nonmain proceeding, a bankruptcy court may also provide "additional assistance" to a foreign representative. This can include injunctive relief or authority to distribute the proceeds of all or part of the debtor's U.S. assets, provided, however, that the court concludes, "consistent with the principles of comity," that such assistance will reasonably ensure, among other things, the just treatment of creditors and other stakeholders, the protection of U.S. creditors against prejudice and inconvenience in pursuing their claims in the foreign proceeding, and the prevention of fraudulent or preferential disposition of property.

Moreover, any relief under chapter 15, including recognition itself, is subject to the caveat contained in section 1506, which states that "[n]othing in this chapter prevents the court from refusing to take an action governed by this chapter if the action would be manifestly contrary to the public policy of the United States."

In *Fairfield Sentry*, the Second Circuit considered as matters of first impression: (i) whether the commencement date of a foreign insolvency proceeding or the date of the chapter 15 petition should be used to determine COMI in ruling on a petition for recognition of a foreign main proceeding under chapter 15; and (ii) whether the public policy exception warranted denial of chapter 15 recognition due to the confidential nature of a foreign bankruptcy proceeding.

FAIRFIELD SENTRY

Fairfield Sentry Limited and two affiliates (collectively, "Fairfield") were organized under the laws of the British Virgin Islands ("BVI") in 1990 as "feeder funds" for Bernard L. Madoff Investment Securities LLC ("BLMIS"). Pursuant to its organizational documents, Fairfield administered its business interests from the BVI, where its registered office, registered agent, registered secretary, and corporate documents were located. Fairfield's day-to-day operations were handled by an investment manager based in New York, where the company's three directors also resided.

On July 21, 2009, the High Court of Justice of the Eastern Caribbean Supreme Court (the "BVI Court") entered an order commencing liquidation proceedings for Fairfield under the Virgin Islands Insolvency Act of 2003. The BVI Court-appointed joint liquidators (the "liquidators") for Fairfield filed a petition on June 14, 2010, in the U.S. bankruptcy court seeking recognition of the BVI liquidation as a foreign "main proceeding" under chapter 15. As of that date, Fairfield's liquid assets consisted of approximately $73 million in Ireland, $22 million in the U.K., and $17 million in the BVI. Its remaining assets consisted of claims and causes of action, including a claim for approximately $6 billion in customer funds in BLMIS's U.S. liquidation proceeding under the Securities Investor Protection Act, $3 billion in claims against former BLMIS customers who profited from redemptions in New York, and $150 million in similar redemption claims in the BVI. These claims were being litigated in New York, the Netherlands, Ireland, and the BVI.

A New York bankruptcy court granted the liquidators' chapter 15 petition and formally recognized the BVI liquidation on July 22, 2010, as a foreign main proceeding. In determining Fairfield's COMI, the bankruptcy court examined the period between December 2008, when Fairfield stopped doing business, and June 2010, the chapter 15 petition date. The court concluded that Fairfield's "COMI for the purpose of recognition as a main proceeding is in the BVI, and not elsewhere."

The bankruptcy court's recognition order stayed a derivative action commenced in May 2009 in New York state court by Morning Mist Holdings Ltd. ("Morning Mist"), a Fairfield shareholder, alleging that Fairfield's directors, management, and service providers breached fiduciary duties.

Morning Mist appealed the recognition order to the district court, which affirmed, ruling that the bankruptcy court properly considered Fairfield's administrative activities in its COMI analysis and correctly considered Fairfield's COMI as of the chapter 15 petition date, as distinguished from other dates or periods throughout the course of its 18-year operational history. The district court rejected Morning Mist's argument that recognition would be manifestly contrary to U.S. public policy because the BVI liquidation was not an open proceeding, reasoning that the right of public access in the U.S. to court records is not absolute. Morning Mist appealed to the Second Circuit.

THE SECOND CIRCUIT'S RULING

A three-judge panel of the Second Circuit affirmed. Writing for the court, chief judge Dennis Jacobs first looked to the language of section 1517(b), which provides that a "foreign proceeding shall be recognized . . . as a foreign main proceeding if it *is pending* in the country where the debtor *has* the center of its main interests." (emphasis added). According to Judge Jacobs, the use of the present tense suggests that a court should examine a debtor's COMI at the time the chapter 15 petition is filed. In light of this plain language, the judge rejected Morning Mist's argument that a court should consider the debtor's entire operational history or base the COMI determination on the commencement date of the foreign proceeding. "Under the text of the statute," he wrote, "the filing date of the Chapter 15 petition should serve to anchor the COMI analysis."

This approach, Judge Jacobs explained, has been adopted by nearly every federal court that has addressed the question, including the Fifth Circuit Court of Appeals in *In re Ran*, 607 F.3d 1017 (5th Cir. 2010). In *Ran*, the Fifth Circuit rejected the argument that the COMI determination should be made with regard to the debtor's operational history. According to the court, "If Congress had, in fact, intended bankruptcy courts to view the COMI determination through a look-back period, it could have easily said so," and in fact it did so in another provision of the Bankruptcy Code—section 522(b)(3)(A), which contains a look-back period for the purpose of establishing domicile in connection with a debtor's claim of exemptions. The Fifth Circuit also emphasized that third parties (primarily creditors) should be able to ascertain a debtor's COMI. However, the Fifth Circuit, albeit in dicta, left open the possibility of looking at a broader time frame to frustrate possible bad-faith COMI manipulation.

Among the few dissenting courts, Judge Jacobs noted in *Fairfield Sentry*, are the bankruptcy and district courts in *In re Millennium Global Emerging Credit Master Fund Ltd.*, 458 B.R. 63 (Bankr. S.D.N.Y. 2011), *aff'd*, 474 B.R. 88 (S.D.N.Y. 2012). In *Millennium*, the bankruptcy court suggested substituting principal place of business for COMI, writing that "it is obvious that the date for determining an entity's place of business refers to the business of the entity before it was placed into liquidation." Judge Jacobs rejected this approach in *Fairfield Sentry*, noting that, according to the writings of one of chapter 15's drafters, "center of main interests" as it appears in the Model Law could have been supplanted by "principal place of business," as a phrase more familiar to U.S. judges and lawyers, but the drafters elected to retain COMI, believing that "such a crucial jurisdictional test should be uniform around the world."

Judge Jacobs also found that the *Millennium* court's reliance on chapter 15's predecessor—section 304 of the Bankruptcy Code (repealed in 2005)—was misplaced. Although the definition of "foreign proceeding" for purposes of section 304 was determined by reference to the location of the debtor's domicile, residence, "principal place of business," or principal assets as of the "commencement" of the foreign insolvency case, he wrote, "Congress abandoned that provision in enacting Chapter 15."

Judge Jacobs noted section 1508 of the Bankruptcy Code's instruction that "[i]n interpreting [chapter 15], the court shall consider its international origin and the need to promote an application of this chapter that is consistent with the application of similar statutes adopted by foreign jurisdictions." Accordingly, he examined international sources bearing on the issue of COMI. Overall, the judge concluded, "international sources are of limited use in resolving whether U.S. courts should determine COMI at the time of the Chapter 15 petition or in some other way."

Judge Jacobs first consulted the UNCITRAL Guide, which does not define "COMI" but states that the concept was drawn from the EU Regulation. Like chapter 15, he explained, the EU Regulation employs the present tense, but its reference to the debtor's administration "on a regular basis" in defining "COMI" could suggest a potentially broader time frame. However, the judge determined that "the EU Regulation does not operate as an analog to chapter 15" because, under the regulation, a main insolvency proceeding filed in one EU member state is automatically recognized by all other EU member states, making a recognition petition, such as the petition required under chapter 15, unnecessary.

Next, Judge Jacobs examined relevant European case law interpreting COMI, which generally focuses on whether a debtor's COMI is "regular and ascertainable" and therefore

not easily subject to tactical removal. *See*, *e.g.*, *In re Eurofood IFSC Ltd.*, Case No. C-341/04, 2006 E.C.R. I-3813, 2006 WL 1142304 (E.C.J. 2006); *In re Stanford International Bank Ltd.*, Case Nos. A3/2009/1565 & 1643, 2010 EWCA Civ. 137, 2010 WL 605796 (Ct. of Appeal 2010).

On the basis of these considerations, Judge Jacobs adopted a hybrid approach:

> We therefore hold that a debtor's COMI should be determined based on its activities at or around the time the Chapter 15 petition is filed, as the statutory text suggests. But given the EU Regulation and other international interpretations, which focus on the regularity and ascertainability of a debtor's COMI, a court may consider the period between the commencement of the foreign insolvency proceeding and the filing of the Chapter 15 petition to ensure that a debtor has not manipulated its COMI in bad faith.

The judge found no fault with the bankruptcy court's conclusion that Fairfield's COMI was located in the BVI during the relevant time period. He also ruled that the evidence did not support a finding that Fairfield manipulated its COMI in bad faith between the initiation of the BVI liquidation and the chapter 15 petition date. Among other things, Judge Jacobs wrote that "any relevant activities, including liquidation activities and administrative functions, may be considered in the COMI analysis."

Finally, Judge Jacobs rejected Morning Mist's argument that the public policy exception should have been invoked to preclude recognition because the BVI liquidation was "cloaked in secrecy." He emphasized that section 1506 must be narrowly construed in keeping with its limited scope to preclude chapter 15 relief only in cases where such relief is "manifestly contrary" to U.S. public policy—as opposed to merely *conflicting* with public policy. According to the judge, the "confidentiality of BVI bankruptcy proceedings does not offend U.S. public policy" because, even in the U.S., the right of access to judicial records, although important, is not absolute and "can easily give way to 'privacy interests' or other considerations."

OUTLOOK

The Second Circuit's ruling resolves a split among lower courts in the circuit on the issue and aligns itself generally with the approach taken by the Fifth Circuit in *Ran*. Under this hybrid approach, COMI is to be determined as of the chapter 15 petition date, but the court can examine the debtor's activities during the period preceding that date to prevent bad-faith COMI manipulation.

Although this approach comports with the express language of chapter 15, its focus on the chapter 15 petition date has been criticized as an invitation to forum shopping by corporate debtors seeking to liquidate in countries that have favorable laws but have little or no connection to the debtors' prefiling activities. According to some commentators, *Millennium*'s "principal place of business" interpretation is more consistent with the intent of UNCITRAL and U.S. lawmakers that a foreign proceeding be recognized under chapter 15 as a foreign main proceeding only if there is a sufficient nexus between the debtor and the venue of the proceeding.

In fact, an UNCITRAL working group considering various proposed changes to the Model Law adopted a proposal in 2012 to amend the Model Law to clarify, among other things, that the date of commencement of a foreign insolvency proceeding should be used to determine both COMI and the related concept "establishment." *See* UNCITRAL, Report of Working Group V (Insolvency Law) on the work of its 41st session, U.N. Pub. Sales No. A/CN.9/742 at ¶ 4; UNCITRAL, Report of Working Group V (Insolvency Law) on the work of its 42nd session, U.N. Pub. Sales No. A/CN.9/763 at ¶¶ 50–52. If this approach were adopted, it would mean that liquidation activities and administrative functions following the filing of a foreign insolvency proceeding—factors that were clearly relevant to the Second Circuit's analysis in *Fairfield Sentry*—would not be relevant to the COMI determination. It remains to be seen whether these proposals will be adopted and, if so, what bearing the change would have on rulings under chapter 15.

Even nearly eight years on, chapter 15 continues to be fertile ground for first impressions and new departures in U.S. bankruptcy and appellate courts. In addition to the Second Circuit in *Fairfield Sentry*, the court in *In re Kemsley*, 2013 BL

77005 (Bankr. S.D.N.Y. Mar. 22, 2013), recently ruled on "the first contested matter involving recognition of an individual's foreign insolvency case to be decided in the Southern District of New York." In *Kemsley*, the foreign representative of debtor Paul Kemsley sought recognition under chapter 15 of Kemsley's U.K. bankruptcy case. The petition was filed after the principal creditor in Kemsley's U.K. case sued Kemsley in two U.S. state courts to recover £5 million.

Kemsley, however, had lived in the U.S. for several years at the time the chapter 15 petition was filed on August 21, 2012, although he maintained ties to the U.K., where his children were then living with their mother in London. Interestingly, the court decided that Kemsley's COMI should be determined as of the date of commencement of his U.K. bankruptcy proceeding (January 13, 2012), rather than the chapter 15 petition date, because it was a fixed, verifiable date.

The court ruled that, because Kemsley was living in the U.S. with his children at the time he commenced the U.K. proceeding, his COMI was in the U.S. at that time. The court acknowledged that the result may well have been otherwise if COMI had been tested as of the chapter 15 petition date. It accordingly refused to recognize Kemsley's U.K. bankruptcy case as a foreign main proceeding under chapter 15. In addition, on the basis of its conclusion that Kemsley did not even have a "place of operations" in the U.K. for carrying out nontransitory economic activity, the court denied the petition for recognition of the U.K. bankruptcy case as a foreign nonmain proceeding.

PUBLIC RIGHT TO FULL DISCLOSURE IN BANKRUPTCY EXTENDS TO RULE 2019 STATEMENTS

Gregory M. Gordon and Mark G. Douglas

One of the hallmarks of the U.S. bankruptcy system is ready access to information concerning any entity that files for bankruptcy protection. The integrity of that system is premised upon the presumption that not only creditors and other interested parties in a bankruptcy case, but also the public at large, should have the ability to examine any document filed with the bankruptcy court. Rooted in the common-law right of access to public documents, full disclosure promotes the legitimacy of the bankruptcy court as an institution entrusted with impartially applying the nation's bankruptcy laws and administering debtors' estates for the benefit of all interested parties. Unrestricted access to judicial records also fosters confidence among creditors regarding the fairness of the bankruptcy system.

However, the right of public access is a qualified one—it has exceptions. Thus, a bankruptcy court has the power under the Bankruptcy Code to implement appropriate protective measures where: (i) disclosure of information would result in the revelation of trade secrets or confidential commercial information; (ii) information in a court filing is scandalous or defamatory; or (iii) disclosure of information would create undue risk of identity theft or other unlawful injury to an individual or to his or her property. More generally, "privacy interests" sometimes lead courts to direct that access to certain court documents be restricted (e.g., by filing documents under seal). *See Morning Mist Holdings Ltd. v. Krys (In re Fairfield Sentry Ltd.)*, No. 11-4376, 2013 BL 102426 (2d Cir. Apr. 16, 2013) ("Important as public access to court documents may be, it is not an exceptional and fundamental value. It is a qualified right; and many proceedings move forward in U.S. courtrooms with some documents filed under seal . . . .").

Absent one of these particular circumstances, however, the deep-rooted policy of full disclosure in bankruptcy is difficult to overcome. A ruling recently handed down by a Delaware district court illustrates the presumption favoring public access to information in a bankruptcy case. In *In re*

NEWSWORTHY

Jones Day opened an office in Miami, the Firm's first office in Florida, its 16th in the U.S., and its 40th in the world. ***Pedro A. Jimenez (Miami)***, a Miami native and a partner in the Firm's Business Restructuring & Reorganization Practice, will serve as Partner-in-Charge.

Michael Rutstein (London) and ***Laurent Assaya (Paris)*** have been recommended as "Leaders in their Field" by *Chambers Europe* 2013 in the practice area of Restructuring/Insolvency.

Jane Rue Wittstein (New York) joined the Honorable Robert D. Drain in a panel discussion on "Recent Developments in Jurisdiction, Venue, Abstention, Remand, Removal, Withdrawal of the Reference, Jury Trials and Appeals" at the Practising Law Institute's seminar "Bankruptcy & Reorganizations 2013: Current Developments," held in New York City on April 29. She also coauthored the updated PLI chapter of the same name with ***Daniel R. Culhane (New York)***, ***Jordan M. Schneider (New York)***, and ***Laura L. Swanson (New York)***.

Volker Kammel (Frankfurt) has been recommended in the field of "Insolvency and restructuring—Restructuring" in *The Legal 500 Europe*, *Middle East & Africa* 2013.

Gregory M. Gordon (Dallas) participated in a panel discussion entitled "And Now that the Auction Is Over, Let the Bidding Begin" at the American Bankruptcy Institute's 31st Annual Spring Meeting, held in National Harbor, Maryland, on April 20.

Brett J. Berlin (Atlanta) was reelected in April to a second one-year term as a board member of the Bankruptcy Law Section of the Atlanta Bar Association. On April 24, he delivered a guest lecture entitled "Chapter 11 Overview" at the John Marshall Law School in Atlanta.

Scott J. Greenberg (New York) participated in a panel discussion entitled "The Power to Veto Bankruptcy Sales: Sports Leagues and Other Franchisors" at the American Bankruptcy Institute's 31st Annual Spring Meeting, held in National Harbor, Maryland, on April 19.

Amy Edgy Ferber (Atlanta) participated in a panel discussion entitled "What Every Business Lawyer Should Know About Bankruptcy" at the American Bar Association's Business Law Section 2013 Spring Meeting, held in Washington, D.C., on April 6.

An article written by ***David G. Marks (New York)*** entitled "Recession Not 'Extraordinary' Enough For Revising Ch. 11" was published in the April 2, 2013, edition of *Bankruptcy Law360*.

Volker Kammel (Frankfurt) moderated a panel discussion entitled "Cross-Border Approaches to the Valuation of Distressed Enterprises" at INSOL's Ninth International World Congress, held in The Hague on May 20.

Lisa G. Laukitis (New York) was named a "Rising Star" for 2013 by the *New York Law Journal*. She was also named a "New York Metro Super Lawyer" for 2013.

Peter J. Benvenutti (San Francisco) participated in a panel discussion entitled "Workout Strategies for Secured Creditors and Investors in Chapter 11 and Other Insolvency Proceedings" as part of the American Law Institute's "Commercial Lending Today" continuing legal education program, held in San Francisco on May 3.

Peter J. Benvenutti (San Francisco), ***Tobias S. Keller (San Francisco)***, ***Carl E. Black (Cleveland)***, ***Thomas A. Howley (Houston)***, ***Corinne Ball (New York)***, ***Paul D. Leake (New York)***, ***David G. Heiman (Cleveland)***, ***Brad B. Erens (Chicago)***, ***Heather Lennox (New York and Cleveland)***, ***Charles M. Oellermann (Columbus)***, ***Gregory M. Gordon (Dallas)***, ***Bennett L. Spiegel (Los Angeles)***, ***Richard L. Wynne (Los Angeles)***, ***Bruce Bennett (Los Angeles)***, ***James O. Johnston (Los Angeles)***, and ***Sidney P. Levinson (Los Angeles)*** were designated "Leaders in their Field" in the area of Bankruptcy/Restructuring by *Chambers USA* 2013.

Motions for Access of Garlock Sealing Technologies LLC, 488 B.R. 281 (D. Del. 2013), the court reversed lower-court rulings denying a chapter 11 debtor access to exhibits accompanying statements filed under Rule 2019 of the Federal Rules of Bankruptcy Procedure ("Rule 2019") by attorneys representing multiple asbestos claimants in 12 separate bankruptcy cases. According to the court, "As the 2019 Exhibits are judicial records that were filed with the Bankruptcy Court, there is a presumptive right of public access to them," and the appellees failed to rebut that presumption. The ruling also reflects a growing trend promoting transparency regarding claims: (i) asserted in asbestos-related bankruptcy cases; and (ii) submitted to trusts established at the completion of such cases.

PUBLIC ACCESS TO COURT DOCUMENTS

The public's general right to inspect and copy public documents, including judicial records, has long been part of common law. The existence of such rights, which are based upon the public's interest in monitoring the workings of the judicial system, are universally regarded as fundamental to a democratic state. They are closely allied to the presumption in the First Amendment of the U.S. Constitution that court proceedings should ordinarily be open to the press and the public.

Section 107(a) of the Bankruptcy Code recognizes the right of public access in a bankruptcy case. It provides that "[e]xcept as provided in subsection (b) and (c) [of this section] and subject to section 112, a paper filed in a case under this title and the dockets of a bankruptcy court are public records and open to examination by an entity at reasonable times without charge." The scope of the provision extends to nearly all documents filed with the court.

Even so, the common-law right of access to public documents is not absolute. Confidentiality may be justified if access to information is sought for an improper purpose or if the information has been categorically designated as off-limits by Congress. In bankruptcy cases, this caveat is reflected in sections 107(b) and (c) of the Bankruptcy Code. Section 107(b) provides as follows:

> On request of a party in interest, the bankruptcy court shall, and on the bankruptcy court's own motion, the bankruptcy court may—
>
> (1) protect an entity with respect to a trade secret or confidential research, development, or commercial information; or
>
> (2) protect a person with respect to scandalous or defamatory matter contained in a paper filed in a case under this title.

Section 107(c) authorizes the bankruptcy court to protect individuals against disclosure of information that would create undue risk of identity theft or other unlawful personal injury or injury to property. Section 112 of the Bankruptcy Code similarly establishes limitations on disclosure of the names of an individual debtor's minor children.

In *Garlock Sealing*, the district court considered whether the right of public access to information filed in a bankruptcy case extends to exhibits accompanying statements filed under Rule 2019.

GARLOCK SEALING

Garlock Sealing Technologies LLC ("Garlock"), a manufacturer of sealing products, filed for chapter 11 protection in 2010 in North Carolina to deal with current and future asbestos liabilities by means of a trust established pursuant to section 524(g) of the Bankruptcy Code. In connection with its efforts to estimate its liability for mesothelioma claims, Garlock sought access to information filed in 12 other asbestos-related bankruptcies.

Specifically, Garlock sought information contained in exhibits (the "2019 Exhibits") referred to in, but not annexed to, Rule 2019 statements filed in these bankruptcy cases by various attorneys representing multiple asbestos claimants. Under the version of Rule 2019 in effect at the time, any entity representing more than one creditor in a chapter 11 bankruptcy case, other than an official committee, was obligated to file a verified statement with the court disclosing, among other things: (i) the name and address of each creditor; (ii) the nature and amount of each represented creditor's claim; (iii) the circumstances and terms under which the representative entity was employed; and (iv) the acquisition date of each claim owned by the representative and the amount paid for each such claim.

Beginning in 2004, the bankruptcy courts entered orders in the 12 asbestos-chapter 11 cases—all of which were presided over by the same bankruptcy judge sitting in different districts—requiring all law firms that represented multiple asbestos personal-injury claimants to comply with Rule 2019 by filing verified statements and submitting to the clerk of the court compact discs containing the 2019 Exhibits, i.e., the individual claimant information required by the rule. The Rule 2019 statements were publicly available, but the 2019 Exhibits were not. Instead, although the 2019 Exhibits were not formally sealed, the bankruptcy judge ordered that they be made available to third parties only upon court order. That "procedural framework" was upheld on appeal by two district courts and the Third Circuit Court of Appeals. *See In re Kaiser Aluminum Corp.*, 327 B.R. 554 (D. Del. 2005); *In re Pittsburgh Corning Corp.*, 2005 WL 6128987 (W.D. Pa. Sept. 27, 2005), *aff'd*, 260 F. App'x 463 (3d Cir. Jan. 10, 2008).

In addition to seeking discovery of information included in the 2019 Exhibits in connection with litigation in its own chapter 11 case, Garlock filed motions in January 2011 seeking access to the 2019 Exhibits filed in these other asbestos-bankruptcy cases. According to Garlock, by comparing the 2019 Exhibits filed in other asbestos-bankruptcy cases with the discovery that Garlock obtained in connection with its own tort litigation, it could verify whether lawyers and claimants are being untruthful about exposure to Garlock's products and the injuries sustained through such exposure—in other words, as evidence of "fraud in the tort system."

The bankruptcy judge denied Garlock's requests in October 2011. Among other things, the judge concluded that: (i) Garlock had neither standing to intervene, Article III standing, nor "prudential" standing to seek access to the 2019 Exhibits in the other asbestos cases; and (ii) Garlock's expressed desire to use the 2019 Exhibits in pending and potential litigation "improperly" attempted to use Rule 2019 for purposes for which it was not intended. According to the judge, "Rule 2019 is not a discovery tool but is to ensure that plans are negotiated and voted on by those authorized to act on behalf of real parties in interest in a case." Addressing the right of public access to judicial records, the bankruptcy judge wrote that restriction of access to an individual claimant's personal details "is not inconsistent with the public's right of access." Garlock appealed to the district court, which consolidated all of the matters in a single proceeding.

THE DISTRICT COURT'S RULING

The district court reversed. At the outset, the court concluded that Garlock had standing both to seek access to the 2019 Exhibits, as a member of the public confronting an obstacle preventing access to a judicial record, and to appeal the bankruptcy judge's October 2011 order, because Garlock was "aggrieved" by the denial of access. The district court also determined that Garlock was not precluded from pursuing the appeal under the doctrines of collateral estoppel or res judicata because, among other things, no previous order or final judgment decided the issue of Garlock's right as a member of the public to access the 2019 Exhibits.

Addressing the merits of the appeal, the district court first concluded that the 2019 Exhibits were "judicial records" because they had been filed with the clerk of the court, even if not publicly available without a court order.

Next, the court explained that, because the 2019 Exhibits are public records, there is a presumptive right of public access to them in accordance with the Third Circuit's ruling in *Goldstein v. Forbes (In re Cedant Corp.)*, 260 F.3d 183 (3d Cir. 2001), as well as section 107 of the Bankruptcy Code.

Finally, the district court in *Garlock Sealing* ruled that the presumption of public access had not been rebutted. It acknowledged the appellees' concerns about possible misuse of asbestos claimants' personal information but concluded that "they fail to show any clearly defined and serious injury," particularly given the restrictions which the court intended to place on Garlock's use of the 2019 Exhibits.

The court similarly rejected the argument that Rule 2019 was not intended as a vehicle for obtaining discovery. "[J]ust because Garlock might have another mechanism for obtaining the information it seeks here," the court wrote, "does not, in the circumstances presented here, diminish Garlock's right to pursue access through the process it is pursuing in this court." Emphasizing that balancing the factors for and against access is an exercise committed to the discretion of the court, the district court ruled that Garlock should have access to the 2019 Exhibits.

Alternatively, the court ruled, even if the 2019 Exhibits were not judicial records, it would still grant Garlock access to them. The court explained that the Rule 2019 orders operated to a certain extent as confidentiality orders. Applying the balancing test articulated by the Third Circuit Court of Appeals in *Pansy v. Borough of Stroudsburg*, 23 F.3d 772 (3d Cir. 1994), the court ruled that Garlock had demonstrated good cause to modify the orders to give it access to the 2019 Exhibits, subject to certain restrictions. The court wrote that "Garlock's purpose in seeking access to the 2019 Exhibits—to permit its expert in its own bankruptcy to develop or rebut an opinion as to an estimate of Garlock's aggregate liability for asbestos claims . . . — is a proper purpose for seeking access."

However, the court determined that Garlock's access to the 2019 Exhibits should be subject to certain restrictions to prevent identity theft and other potential damage which the bankruptcy judge envisioned might ensue from unfettered access. Specifically, the court directed that: (i) access is to be provided solely for the purpose of using the 2019 Exhibits in connection with Garlock's asbestos claims-estimation hearings; (ii) Garlock may not publicly disclose information in the exhibits except in an aggregate format that does not identify individuals; (iii) Garlock is obligated to propose a form of protective order to the bankruptcy court presiding over its chapter 11 case before disclosing any information obtained from the 2019 Exhibits; and (iv) Garlock shall not be granted access to any attorney-retention agreements.

OUTLOOK

Part of *Garlock Sealing*'s import is explained by its context—large asbestos-bankruptcy cases—where companies seek a permanent resolution of thousands of existing and future claims. In such cases, the debtor's legitimate efforts, through discovery and other means, to develop an accurate estimate of its aggregate liability for current and future asbestos claims, as well as to rebut competing estimates, for the purpose of funding a section 524(g) trust must be balanced against the privacy interests of asbestos claimants (and their counsel).

The ruling reaffirms the importance of the right, albeit qualified, of public access to documents filed in a bankruptcy case. According to *Garlock Sealing*, statements and accompanying exhibits filed under Rule 2019 do not enjoy any special immunity from disclosure.

Garlock Sealing is emblematic of a growing movement promoting transparency regarding the assertion of claims in asbestos-related bankruptcy cases, including the submission to, and treatment by, asbestos trusts established at the conclusion of such cases. In granting Garlock's motion for access to the 2019 Exhibits, the court took judicial notice of recently proposed legislation at the state and federal levels designed to address a perceived lack of transparency in the asbestos-bankruptcy claim and trust system created by chapter 11 plans, plan confirmation orders, sealing orders, and other orders limiting public access to information. This lack of transparency has fueled widespread concerns of potential fraud in asbestos litigation.

For example, a pending federal bill, the Furthering Asbestos Claim Transparency Act of 2013 (the "FACT Act"), proposes amending the Bankruptcy Code to require all section 524(g) trusts to file publicly available reports on a quarterly basis, disclosing the details of payment demands and disbursements, including the names and exposure histories of claimants, except as provided in a protective order or as necessary to prevent disclosure of confidential medical records or protect against identity theft. As proposed, the FACT Act would apply retroactively to bankruptcy cases commenced and bankruptcy trusts established before its passage.

The *Garlock Sealing* court agreed to take judicial notice of the proposed legislation, noting that "these legislative proposals have arguable relevance to issues in this appeal, including at least whether there is public interest in transparency in asbestos litigation," a factor (in accordance with *Pansy*) the court deemed relevant in assessing whether a third party should have standing to challenge protective and confidentiality orders in an effort to obtain access to information or judicial proceedings. By providing Garlock with access—albeit restricted—to information that has been closely guarded by attorneys for asbestos claimants, the court appears to agree that transparency is the better course of action.

Jones Day represented Kaiser Aluminum Corp. and USG Corp., two of the reorganized debtors as to which Garlock is seeking access to the 2019 Exhibits.

DRIVING THE WEDGE DEEPER: FIFTH AND NINTH CIRCUITS UNITE IN REFUSING TO CONDEMN "ARTIFICIAL IMPAIRMENT" IN CRAMDOWN CHAPTER 11 PLANS

Charles M. Oellermann and Mark G. Douglas

One of the prerequisites to confirmation of a cramdown (nonconsensual) chapter 11 plan is that at least one "impaired" class of creditors must vote in favor of the plan. This requirement reflects the basic principle that a plan may not be imposed on a dissident body of stakeholders of which no class has given approval. However, it is sometimes an invitation to creative machinations designed to muster the requisite votes for confirmation of the plan.

"Strategic" classification can entail, among other things, 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 "block" the class's approval of a plan. This controversial practice, which most commonly arises in a single-asset real estate case involving an undersecured creditor holding a substantial deficiency claim, is sometimes referred to as class "gerrymandering" and has been held to be invalid by many courts, including the Fifth Circuit in *Phoenix Mut. Life Ins. Co. v. Greystone III Joint Venture (In re Greystone III Joint Venture)*, 995 F.2d 1274 (5th Cir. 1991), and the Fourth Circuit in *Travellers Ins. Co. v. Bryson Props., XVIII (In re Bryson Props., XVIII)*, 961 F.2d 496 (4th Cir. 1992).

Strategic classification can also take the form of "manufacturing" an impaired class even though impairment is unnecessary. For example, the plan could pay creditor claims nearly, but not entirely, in full or modify the rights of the creditors in the class in some incidental way—in either case, with such minimal effect that creditors are still willing to vote to accept the plan despite slight impairment of their claims. Sometimes referred to as "artificial impairment," this practice is also controversial. *See In re Swartville, LLC*, 2012 BL 211034, *2 (Bankr. E.D.N.C. Aug. 17, 2012) ("artificial impairment" refers to a scenario where a debtor "deliberately impairs a de minimis claim solely for the purpose of achieving a forced confirmation over the objection of a creditor"). So much so, in fact, that there is a split in the federal circuit courts of appeal concerning its legitimacy.

That rift recently widened when the U.S. Court of Appeals for the Fifth Circuit handed down its ruling in *Western Real Estate Equities, LLC v. Village at Camp Bowie I, LP (In re Village at Camp Bowie I, LP)*, 2013 BL 50530 (5th Cir. Feb. 26, 2013). In *Camp Bowie*, the Fifth Circuit joined the Ninth Circuit in holding that section 1129(a)(10) of the Bankruptcy Code, which contains the impaired-class acceptance requirement, "does not distinguish between discretionary and economically driven impairment." However, the court held that artificial impairment may be relevant in assessing whether a chapter 11 plan has been proposed in bad faith.

VOTING AND PLAN CONFIRMATION IN CHAPTER 11

Confirmation of a chapter 11 plan is possible under two circumstances: (i) the requisite majorities of creditors and equity interest holders in every "class" (explained below) vote in favor of the plan (or are deemed to have done so by reason of being "unimpaired"); or (ii) despite the absence of acceptance by all classes, the plan meets certain minimum standards spelled out in the nonconsensual confirmation, or "cramdown," provisions of the Bankruptcy Code.

Voting in chapter 11 is tabulated by classes rather than individual creditors or shareholders. This means that a dissenting individual creditor or shareholder can be outvoted if the remaining class members hold enough of the claims or interests in the class to achieve the voting majorities specified in the Bankruptcy Code for class acceptance. As such, how a claim or interest is classified can have a significant impact on the debtor's prospects for confirming a chapter 11 plan. For example, as noted, a creditor whose claim is substantial enough to give it voting control of a class may be able to block confirmation.

Confirmation is possible only if at least one "impaired" class of creditors or shareholders under the plan votes to accept it (without counting insider votes). This requirement, which appears in section 1129(a)(10) of the Bankruptcy Code, operates as one of several statutory gatekeepers to cramdown. Cramdown is a powerful remedy—it imposes a binding reor-

ganization (or liquidation) scheme upon a body of dissenting creditors and other stakeholders predicated upon sometimes complicated judicial determinations concerning asset and claim valuation, feasibility, and other important issues. Section 1129(a)(10) is premised on the policy that, before compelling stakeholders to bear the consequences associated with cramdown, at least one class whose members are not being paid in full (or whose claims or interests are otherwise "impaired") is willing to go along with the chapter 11 plan.

CRAMDOWN REQUIREMENTS

Section 1129(b) of the Bankruptcy Code sets forth the requirements that must be met before a bankruptcy court can confirm a chapter 11 plan over the objections of a dissenting class of creditors whose rights are impaired by the plan. Among these cramdown requirements is the dictate in section 1129(b)(1) that a plan "not discriminate unfairly" and that it be "fair and equitable" with respect to a dissenting class of creditors.

A plan discriminates unfairly if it treats a dissenting class of creditors less favorably than other classes of creditors that are similarly situated in terms of their legal rights to payment.

Section 1129(b)(2) addresses the "fair and equitable" requirement for different types of claims. Section 1129(b)(2)(A) provides three alternative ways to achieve confirmation over the objection of a dissenting class of secured claims: (i) the secured claimants' retention of their liens and receipt of deferred cash payments equal to at least the value, as of the plan's effective date, of their secured claims; (ii) the sale, subject to a secured creditor's right to credit-bid its claim, of the collateral free and clear of all liens, with attachment of the liens to the proceeds and treatment of the liens on proceeds under option (i) or (iii); or (iii) the realization by the secured creditors of the "indubitable equivalent" of their claims.

Section 1129(b)(2)(B) of the Bankruptcy Code provides that a plan is "fair and equitable" with respect to a dissenting impaired class of unsecured claims if the creditors in the class receive or retain property of a value equal to the allowed amount of their claims or, failing that, in cases not involving an individual debtor, if no creditor of lesser priority, or no equity holder, receives or retains any distribution under the plan "on account of" its junior claim or interest. This requirement is sometimes referred to as the "absolute priority rule."

IMPAIRMENT

Section 1123(b)(1) of the Bankruptcy Code provides that a chapter 11 plan may "impair or leave unimpaired any class of claims, secured or unsecured, or of interests." Section 1124 defines "impairment" as follows:

> Except as provided in section 1123(a)(4) of this title, a class of claims or interests is impaired under a plan unless, with respect to each claim or interest of such class, the plan—
>
> (1) *leaves unaltered the legal, equitable, and contractual rights to which such claim or interest entitles the holder of such claim or interest* [emphasis added]; or
>
> (2) notwithstanding any contractual provision or applicable law that entitles the holder of such claim or interest to demand or receive accelerated payment of such claim or interest after the occurrence of a default—
>
> (A) cures any such default that occurred before or after the commencement of the case under this title, other than a default of a kind specified in section 365(b)(2) of this title or of a kind that section 365(b)(2) expressly does not require to be cured;
>
> (B) reinstates the maturity of such claim or interest as such maturity existed before such default;
>
> (C) compensates the holder of such claim or interest for any damages incurred as a result of any reasonable reliance by such holder on such contractual provision or such applicable law;
>
> (D) if such claim or such interest arises from any failure to perform a nonmonetary obli-

gation, other than a default arising from failure to operate a nonresidential real property lease subject to section 365(b)(1)(A), compensates the holder of such claim or such interest (other than the debtor or an insider) for any actual pecuniary loss incurred by such holder as a result of such failure; and

(E) does not otherwise alter the legal, equitable, or contractual rights to which such claim or interest entitles the holder of such claim or interest.

Section 1123(a)(4) states that a plan must provide the same treatment for creditors or interest holders in the same class "unless the holder of a particular claim or interest agrees to a less favorable treatment" of its claim or interest.

Section 1124 is derived from section 107 of chapter X of the former Bankruptcy Act of 1898 (11 U.S.C. § 507; repealed in 1978), which provided that "creditors" or "any class thereof" would be "affected" for purposes of a plan—and therefore entitled to vote—"only if their or its interest shall be materially and adversely affected thereby." When section 1124 (and the remainder of the Bankruptcy Code) was enacted in 1978, the legislative history indicates that floor leaders for the final version of the bill stated that the provision "defines the new concept of 'impairment' of claims or interests; the concept differs significantly from the concept of 'materially and adversely affected' under the Bankruptcy Act." 124 Cong. Rec. H11,103 (daily ed. Sept. 28, 1978); 124 Cong. Rec. S17,419–17,420 (daily ed. Oct. 6, 1978).

Section 1124 originally included a third option for rendering a claim unimpaired: by providing the claimant with cash equal to the allowed amount of its claim. This option was removed by the Bankruptcy Reform Act of 1994. The amendment overruled a bankruptcy court's decision in *In re New Valley Corp.*, 168 B.R. 73 (Bankr. D.N.J. 1984). In *New Valley*, the court ruled that unsecured creditors of a solvent debtor who are to be paid in full in cash under a chapter 11 plan are unimpaired even though the plan does not provide for the payment of postpetition interest on their claims.

The 1994 amendment permits creditors slated not to receive postpetition interest under a plan involving a solvent debtor to vote against the plan. (Pursuant to sections 1126(a), (f), and (g) of the Bankruptcy Code, only the holders of impaired claims or interests are permitted to vote.) Assuming that the class of creditors rejects the plan, it can be confirmed only if the plan satisfies the cramdown standards in section 1129(b). Also, because their claims are impaired, these creditors are entitled to the protection of the "best interests of creditors" test in section 1129(a)(7), which requires that they receive or retain at least as much under a chapter 11 plan as they would receive in a chapter 7 liquidation. Since 1994, most courts considering the issue have held that payment in full in cash with postpetition interest at an appropriate rate constitutes unimpairment under section 1124(1).

ARTIFICIAL IMPAIRMENT

Courts disagree over the question of whether section 1129(a)(10) draws a distinction between "artificial" and "economically driven" impairment. For example, in *Matter of Windsor on the River Associates, Ltd.*, 7 F.3d 127 (8th Cir. 1993), the Eighth Circuit ruled that "a claim is not impaired [for purposes of section 1129(b)] if the alteration of the rights in question arises solely from the debtor's exercise of discretion." According to this approach, section 1129(a)(10) recognizes impairment only to the extent that it is caused by economic "need."

Many courts have applied *Windsor* to deny confirmation of a chapter 11 plan impairing the *de minimis* claims of some creditors for the purpose of contriving a class to accept the plan. *See*, *e.g.*, *In re Combustion Engineering*, *Inc.*, 391 F.3d 190, 243–44 (3d Cir. 2003); *In re All Land Investments, LLC*, 468 B.R. 676, 690 (Bankr. D. Del. 2012); *In re Daly*, 167 B.R. 734, 737 (Bankr. D. Mass. 1994); *see also In re Deming Hospitality, LLC*, 2013 BL 93045, *6 (Bankr. D.N.M. Apr. 5, 2013) (stating that "[i]f there is no economic justification for failing to pay Class 6 in full after confirmation rather than the proposed 75%, then the impairment of the class likely would be 'artificial' and impermissible"). These courts reason that allowing manipulation of this kind undermines the policy of consensual reorganization expressed in section 1129(a)(10).

Other courts have concluded that artificial impairment does not violate section 1129(a)(10). In *L & J Anaheim Assocs. v.*

Kawasaki Leasing Intl., Inc. (In re L & J Anaheim Assocs.), 995 F.2d 940 (9th Cir. 1993), for example, the Ninth Circuit ruled that section 1129(a)(10) does not distinguish between discretionary and economically driven impairment. According to the court, "the plain language of section 1124 says that a creditor's claim is 'impaired' unless its rights are left 'unaltered' by the plan," and "[t]here is no suggestion here that only alterations of a particular kind or degree can constitute impairment." *Accord In re Greate Bay Hotel & Casino, Inc.*, 251 B.R. 213 (Bankr. D.N.J. 2000); *In re Duval Manor Assocs.*, 191 B.R. 622 (Bankr. E.D. Pa. 1996).

Many of these courts have reasoned, however, that artificial impairment is relevant to the issue of the debtor's good faith in proposing a chapter 11 plan. Section 1129(a)(3) of the Bankruptcy Code provides that a plan may be confirmed only if "proposed in good faith and not by any means forbidden by law." Even if artificial impairment is not impermissible per se, these courts have held, contriving an impaired class may constitute bad faith. *See, e.g.*, *FNMA v. Village Green I, GP*, 483 B.R. 807 (W.D. Tenn. 2012) (refusing to reject artificial impairment outright but holding that, under either section 1129(a)(3) or 1129(a)(10), the debtor must demonstrate some economic justification for delaying payment to *de minimis* creditors); *In re The Beare Co.*, 177 B.R. 886 (Bankr. W.D. Tenn. 1994).

The Fifth Circuit weighed in on the issue of artificial impairment in *Camp Bowie*.

CAMP BOWIE

Village at Camp Bowie I, LLC ("VCB") owns real property in Fort Worth, Texas, that includes several buildings leased out by VCB for retail and office space. In 2010, VCB defaulted on loans secured by the real estate. The day before a scheduled foreclosure sale of the property, VCB filed for chapter 11 protection in Texas.

At the time of the filing, VCB owed approximately $32 million to the mortgagee, Western Real Estate Equities, L.L.C. ("Western"), which acquired the debt with the intention of displacing VCB as the owner of the property. VCB's other debts consisted of approximately $60,000 in miscellaneous claims held by 38 trade creditors.

Western sought relief from the automatic stay, arguing that VCB lacked both equity in the property and any prospect of proposing a confirmable chapter 11 plan. The bankruptcy court ultimately found that the real property was worth $34 million, such that Western was oversecured and VCB had equity in the property.

VCB filed a series of proposed chapter 11 plans, the latest of which designated two impaired-creditor classes. The first class consisted of Western's secured claim, as to which VCB proposed to give Western a new five-year balloon note accruing interest at 6.4 percent secured by the real estate. The other class included all unsecured claims, which VCB proposed to pay in full within three months of the effective date of the plan, without interest. Finally, the plan provided that VCB's prebankruptcy owners and certain related parties would receive 100 percent of the equity in the reorganized VCB in exchange for a cash infusion of $1.5 million.

The unsecured class unanimously voted to accept the plan. Western voted against the plan and argued at the confirmation hearing that the plan violated section 1129(a)(10) because it impaired the trade claims solely to create an accepting impaired class. According to Western, VCB had the cash flow to pay off the trade claims in full at confirmation. Western also claimed that VCB's tactics constituted an abuse of the bankruptcy process in violation of the good-faith requirement of section 1129(a)(3).

The bankruptcy court confirmed VCB's plan. It rejected Western's theory that section 1129(a)(10) distinguishes between artificial and economically driven impairment. It also concluded that, although artificial impairment is a factor to consider in determining whether a plan proponent has complied with section 1129(a)(3), "in the usual case, artificial impairment does not amount per se to a failure of good faith." The court certified an appeal of its ruling directly to the Fifth Circuit, on the basis that the opinion addressed questions of law as to which there was no controlling Fifth Circuit or U.S. Supreme Court precedent and that an immediate appeal might materially advance progress of the case.

THE FIFTH CIRCUIT'S RULING

A three-judge panel of the Fifth Circuit affirmed. At the outset of its analysis, the court noted that "this Circuit has yet to stake out a clear position in the debate over artificial impairment." The panel discussed prior Fifth Circuit case law on the issue. In *Brite v. Sun Country Development, Inc. (In re Sun Country Development, Inc.)*, 764 F.2d 406 (5th Cir. 1985), the debtor, to satisfy section 1129(a)(10), modified its treatment of unsecured creditors under a chapter 11 plan from payment in full to a distribution of nonnegotiable 90-day notes. The court ruled that the plan did not violate section 1129(a)(3) because, among other things, the bankruptcy court found that the change was "necessary," as the debtor's cash flow was insufficient to pay creditors in full on confirmation.

In *Sandy Ridge Development Corp. v. Louisiana Nat'l Bank (In re Sandy Ridge Development Corp.)*, 881 F.2d 1346 (5th Cir. 1989), the Fifth Circuit remanded a case to the bankruptcy court for, among other things, a determination as to whether artificial impairment under a chapter 11 plan to create an accepting impaired class satisfies the good-faith requirement of section 1129(a)(3).

With this preamble, the Fifth Circuit in *Camp Bowie* staked out its position on the issue—this time unequivocally:

> Today, we expressly reject *Windsor* and join the Ninth Circuit in holding that § 1129(a)(10) does not distinguish between discretionary and economically driven impairment. As the *Windsor* court itself acknowledged, § 1124 provides that "any alteration of a creditor's rights, no matter how minor, constitutes 'impairment.' " . . . By shoehorning a motive inquiry and materiality requirement into § 1129(a)(10), *Windsor* warps the text of the Code, requiring a court to "deem" a claim unimpaired for purposes of § 1129(a)(10) even though it plainly qualifies as impaired under § 1124. . . . *Windsor*'s motive inquiry is also inconsistent with § 1123(b)(1), which provides that a plan proponent "*may* impair or leave unimpaired any class of claims," and does not contain any indication that impairment must be driven by economic motives. . . .

According to the Fifth Circuit, the *Windsor* court based its "strained reading" of sections 1129(a)(10) and 1124 on the premise that lawmakers enacted section 1129(a)(10) "to provide some indicia of support [for a cramdown plan] by affected creditors," and it reasoned that literal application of section 1124 would "vitiate this congressional purpose." That approach, the Fifth Circuit emphasized, is flawed because "the Bankruptcy Code *must* be read literally, and congressional intent is relevant only when the statutory language is ambiguous." Moreover, the court explained, the scant legislative history of section 1129(a)(10) "provides no insight as to the provision's intended use," and Congress, when it enacted section 1124, "considered and rejected precisely the sort of materiality requirement that *Windsor* has imposed by judicial fiat."

The Fifth Circuit also faulted *Windsor*'s reasoning that condoning artificial impairment would "reduce [section 1129(a)(10)] to a nullity." The Eighth Circuit's logic in *Windsor*, the Fifth Circuit explained, is premised on "the unsupported assumption that Congress intended § 1129(a)(10) to implicitly mandate a materiality requirement and a motive inquiry." According to the court, such an approach ignores the determinative role the provision plays in the typical single-asset bankruptcy, where the debtor has negative equity and the secured creditor has an unsecured-deficiency claim that allows it to control the unsecured class. "In such circumstances," the Fifth Circuit wrote, "secured creditors routinely invoke § 1129(a)(10) to block confirmation, . . . aided rather than impeded by the Code's broad definition of impairment."

The Fifth Circuit rejected Western's argument that the Fifth Circuit's 1991 condemnation of gerrymandering in *Greystone* "enunciate[s] a broad, extraordinary, extrastatutory policy against 'voting manipulation' " and that "prohibiting artificial impairment is merely the next logical extension of this policy." This contention, the court wrote, "brushes over the fact that *Greystone*'s anti-gerrymandering principle resolves an ambiguity left open by the classification rules set forth in § 1122." *Greystone*, the Fifth Circuit observed, "does not stand for the proposition that a court can ride roughshod over affirmative language in the Bankruptcy Code to enforce some Platonic ideal of a fair voting process."

Having concluded that a plan proponent's motives and methods for satisfying section 1129(a)(10) must be scrutinized, "if at all, under the rubric of § 1129(a)(3)," the Fifth Circuit examined the bankruptcy court's finding that VCB had proposed its chapter 11 plan in good faith. The court of appeals found no clear error in this determination. VCB, the Fifth Circuit wrote, "proposed a feasible cramdown plan for the legitimate purposes of reorganizing its debts, continuing its real estate venture, and preserving its non-trivial equity in its properties." According to the court, "A single-asset debtor's desire to protect its equity can be a legitimate Chapter 11 objective."

However, the Fifth Circuit cautioned that, "though we reject the concept of artificial impairment as developed in *Windsor*, we do not suggest that a debtor's methods for achieving literal compliance with § 1129(a)(10) enjoy a free pass from scrutiny under § 1129(a)(3)." According to the court, had the case involved the creation of "an impaired accepting class out of whole cloth" in a "sham" lending transaction with related parties, rather than independent trade creditors who extended prepetition credit to VCB in the ordinary course of business, "[a]n inference of bad faith might be stronger."

OUTLOOK

Camp Bowie can be viewed as a positive development for single-asset debtors with an oversecured creditor. By refusing to invalidate artificial impairment outright, the Fifth Circuit made it easier for a debtor to obtain confirmation of a nonconsensual chapter 11 plan that impairs the claim of an oversecured creditor by modifying its credit terms. Whether the possibility of such adverse treatment may make it more difficult for single-asset entities to obtain financing (at least in the Fifth Circuit) remains to be seen.

An oversecured creditor in a single-asset bankruptcy case is far from the norm. The more common scenario involves an undersecured creditor and strategic classification—gerrymandering—to isolate the unsecured-deficiency claim in a separate class and thereby prevent the creditor from blocking confirmation. The Fifth Circuit was careful to distinguish between artificial impairment and gerrymandering.

Finding an accepting impaired class of creditors can also be challenging in non-single-asset chapter 11 cases, where a debtor typically wants to preserve its trade creditor and employee relationships, while restructuring long-term debt and other obligations. *Camp Bowie* will provide debtors in the Fifth Circuit greater flexibility to technically impair "friendly" classes of creditors to create an accepting impaired class under a nonconsensual plan.

DELAWARE BANKRUPTCY COURT CONFIRMS THE VALIDITY OF PLAN SUPPORT AGREEMENTS

George R. Howard and Mark G. Douglas

Chapter 11 debtors and sophisticated creditor and/or shareholder constituencies are increasingly using postpetition plan support agreements (sometimes referred to as "lockup" agreements) to set forth prenegotiated terms of a chapter 11 plan prior to the filing of a disclosure statement and a plan with the bankruptcy court. Under such lockup agreements, if the debtor ultimately proposes a chapter 11 plan that includes prenegotiated terms, signatories are typically obligated to vote in favor of the plan. As a result, the outcome of voting on a chapter 11 plan is often largely determined even before the bankruptcy court approves the disclosure statement, if sufficient stakeholder constituencies are parties to a lockup agreement.

Such were the circumstances in a recent bankruptcy case in Delaware. In *In re Indianapolis Downs, LLC*, 486 B.R. 286 (Bankr. D. Del. 2013), certain of the debtor's equity holders attempted to thwart confirmation of a prenegotiated chapter 11 plan by arguing that a postpetition lockup agreement among the debtors and a large group of secured creditors violated the plan solicitation requirements of the Bankruptcy Code and that the votes of the signatory creditors should therefore be disallowed, or "designated." The bankruptcy court rejected the argument in an important ruling that may put to rest any lingering doubts about the validity of postpetition lockup agreements.

LOCKUP AGREEMENTS

Lockup agreements are a common feature of out-of-court workouts. They ensure that signatories remain committed, at least contractually, to a negotiated proposal potentially involving many competing creditor or shareholder groups. Without that commitment, the time and resources of workout participants may be wasted if a creditor or a creditor group reneges on an agreement in principle necessary to the success of the workout.

Many successful restructurings begin outside court but ultimately end up as "prepackaged" or "prenegotiated" bankruptcy cases. This is typically the case where the company is able to reach an agreement with some or perhaps even all of its creditors concerning the terms of a restructuring but needs the benefits of the Bankruptcy Code to implement the necessary adjustments to its balance sheet and capital structure. For instance, if a company reaches an agreement with some but not all of its creditors, a bankruptcy filing may be necessary to bind the holdouts to the terms of a proposed restructuring incorporated in a plan of reorganization confirmed by the bankruptcy court. Also, the Bankruptcy Code under certain circumstances allows a reorganizing debtor to issue new securities without complying with the registration requirements imposed by federal securities laws.

If the company strikes a deal with requisite majorities of its creditor constituencies and decides to file for bankruptcy to complete the workout, it can file a prepackaged bankruptcy case. This kind of case involves the solicitation of creditor votes for a restructuring proposal prior to filing a chapter 11 case, as well as bankruptcy-court authorization to have those votes counted in favor of a chapter 11 plan of reorganization. Where such consensus is impossible, but the company is able to get most of its significant creditors on board, it can file a prenegotiated chapter 11 case. In the latter circumstance, the company will attempt to obtain the participating stakeholders' commitment to support a plan of reorganization with certain specified terms. That commitment most often takes the form of a lockup, or plan support, agreement.

CONFLICT WITH BANKRUPTCY DISCLOSURE AND SOLICITATION RULES

The relationship between lockup agreements and bankruptcy law is an uneasy one. This is so because the Bankruptcy Code contains rigorous disclosure requirements that must be complied with as part of the plan confirmation process.

Pursuant to section 1125(g) of the Bankruptcy Code, which was added to the Bankruptcy Code in 2005, votes in favor of or against a chapter 11 plan that were obtained prior to the bankruptcy filing will be valid if "solicitation" of the vote complies with applicable nonbankruptcy law. By contrast, section 1125(b) provides that *postpetition* votes in favor of a plan can be solicited only after the creditor or shareholder receives a court-approved disclosure document containing "adequate information," a concept defined in section 1125(a).

If the court determines that a vote was solicited without disclosure of adequate information or under circumstances that are otherwise improper, it has the power under section 1126(e) to "designate," or invalidate, the vote.

Precisely what constitutes "solicitation" of a vote on a plan and, more specifically, whether negotiations accompanying a lockup agreement qualify as solicitation, are unclear. In keeping with a series of court decisions beginning with the bankruptcy court's ruling in *Trans World Airlines, Inc. v. Texaco, Inc. (In re Texaco, Inc.)*, 81 B.R. 813 (Bankr. S.D.N.Y. 1988), these kinds of agreements have generally not been deemed to run afoul of the Bankruptcy Code's solicitation requirements. *See*, *e.g.*, *In re Heritage Organization, L.L.C.*, 376 B.R. 783 (Bankr. N.D. Tex. 2007); *In re Kellogg Square Partnership*, 160 B.R. 336 (Bankr. D. Minn. 1993). Among other reasons, courts have noted that lockup agreements typically contain provisions allowing signatories to back out of their commitments where their fiduciary obligations require it or the plan actually proposed by the debtor is materially different from what was agreed upon.

However, in a pair of unpublished bench rulings handed down in 2002, Delaware bankruptcy judge Mary F. Walrath held that postpetition lockup agreements violate section 1125(b), and she consequently designated the votes of the signatories under section 1126(e). *See In re Station Holdings Company, Inc.*, No. 02-10882 (MFW) (Bankr. D. Del. Sept. 30, 2002) [document no. 177]; *In re NII Holdings, Inc.*, No. 02-11505 (MFW) (Bankr. D. Del. Oct. 22, 2002) [document no. 367]. Both cases involved prepackaged chapter 11 plans, but certain supporting creditors signed lockup agreements postpetition. Although the summary rulings do not contain any legal analysis, the transcripts of the proceedings indicate that Judge Walrath laid particular emphasis on the absence of any provision in the lockup agreements allowing the signatories the right to change their votes if the information contained in the disclosure statement turned out to be different from what they had received previously. The judge stated, "I never want to see another lockup agreement like this cited to me as being appropriate."

Another Delaware bankruptcy judge (Brendan L. Shannon) recently revisited this issue in *Indianapolis Downs*.

INDIANAPOLIS DOWNS

Indianapolis Downs, LLC, and Indiana Capital Corp. (collectively, the "debtors") operate a combined horse-racing track and casino—a "racino"—in Shelbyville, Indiana. The debtors filed for chapter 11 protection in April 2011 in Delaware after their out-of-court restructuring efforts failed. After months of negotiations during the bankruptcy cases, the debtors and two major secured creditor groups agreed to proceed on a dual-track path, seeking to explore a sale of the debtors' assets for an amount sufficient to muster the support of major creditors, while at the same time pursuing a recapitalization plan if the sale efforts failed.

This strategy was memorialized in a restructuring support agreement (the "RSA"). The RSA included, among other things: (i) specific terms of a dual-track chapter 11 plan, including the financial terms of, and creditor treatment under, potential sale or recapitalization transactions; (ii) the requirement that the debtors propose a chapter 11 plan within a specified time frame; (iii) a prohibition upon any party to the RSA proposing, supporting, or voting for a competing plan; and (iv) the requirement (enforceable by an order of specific performance) that signatories vote "yes" for a plan which complied with the RSA. By its terms, the RSA was binding upon execution by its nondebtor signatories but became binding upon the debtors only upon approval by the court of a disclosure statement. The RSA also expressly stated that it was not intended to be a solicitation of a plan for purposes of section 1125 of the Bankruptcy Code.

The debtors filed the RSA with the bankruptcy court and, on the same day, filed their proposed disclosure statement and accompanying plan. The court approved the disclosure statement, and the debtors solicited the votes of all eligible stakeholders on a proposed plan, which conformed to the terms of the RSA and contemplated a sale of substantially all of the debtors' assets for approximately $500 million.

Senior management and certain holders of the debtors' equity and debt instruments (the "Equity Objectors") objected to the debtors' proposed plan. The Equity Objectors argued that negotiation and execution of the RSA amounted to an improper postpetition solicitation of votes in contravention of section 1125(b) of the Bankruptcy Code and that such

improper solicitation warranted designating the votes of the signatory creditors pursuant to section 1126(e). The Equity Objectors did not argue, however, that votes in favor of the plan had been procured in bad faith or that the RSA had been negotiated in bad faith.

The bankruptcy court rejected the Equity Objectors' argument, adopting a narrow interpretation of "solicitation" in section 1125(b). In accordance with the ruling of the Third Circuit Court of Appeals in *Century Glove, Inc. v. First Am. Bank of New York*, 860 F.2d 94 (3d Cir. 1988), the bankruptcy court held that the term "solicitation" in section 1125(b) must be interpreted narrowly to avoid interference with negotiations during a bankruptcy case. The court also cited favorably to *Heritage Organization*, where the court concluded that the votes of creditors who had signed a term sheet embodying key economic terms of a chapter 11 plan should not be designated because "the term 'solicitation' should be construed very narrowly, in deference to a clear legislative policy encouraging negotiations among creditors and stakeholders in Chapter 11 cases." Finally, the bankruptcy court cited to *Kellogg Square* for the proposition that "solicitation" occurs only when a plan, disclosure statement, and ballot are actually presented. Relying on this narrow interpretation of "solicitation," the bankruptcy court in *Indianapolis Downs* concluded that the RSA was not an improper solicitation because it required creditors to vote in favor of a plan only if and when a plan conforming to the terms of the RSA was proposed in accordance with section 1125(b).

The bankruptcy court also articulated three broad policy considerations that warranted rejecting the arguments made by the Equity Objectors. First, the court noted that "creditor suffrage is a bedrock component of Chapter 11" and that it would be inconsistent with this principle to discount or ignore the votes of significant creditor constituencies in favor of a heavily negotiated chapter 11 plan in the absence of any showing of bad faith.

Second, the bankruptcy court explained that the requirements of section 1125 are designed to prevent a debtor from seeking approval of a plan before the parties in interest have sufficient information to make an informed decision. In the instance of the parties to the RSA, all of whom were sophisticated financial parties represented by experienced professionals, there was no such concern.

The court flatly rejected the Equity Objectors' assertion that provisions in the RSA requiring the signatories to vote in favor of a conforming plan and providing for the remedy of specific performance amounted to solicitation. According to the court, the specific performance provision in the RSA was appropriate because the parties "were entitled to demand and rely upon assurances that accepting votes would be cast."

Lastly, the court emphasized that the right of creditors to vote on a plan is a critical feature of chapter 11 that should be infringed upon only in exceptional circumstances. Given the lack of any showing of bad faith, the bankruptcy court concluded that the Equity Objectors failed to satisfy the heavy burden of proof required to designate the votes of the RSA's signatory creditors.

The bankruptcy court also distinguished *Station Holdings* and *NII Holdings*. According to the court, "These two prepackaged cases present a markedly different factual and procedural context than the case at bar, . . . [and] the two-page orders entered in those cases do not contain any legal analysis . . . [such that], consistent with this Court's practice, [they] are of only the most limited (if any) precedential value." The court also wrote that "[a]t a minimum, there was no question in those cases that the act in question was a 'solicitation' of a specific ballot relating to a filed plan."

The bankruptcy court denied the motion to designate RSA signatory votes, writing:

> In summary, the Court observes that the filing of a Chapter 11 petition is an invitation to negotiate. Congress has carefully calibrated the Chapter 11 process—using the automatic stay, exclusivity, the right of secured creditors to adequate protection and a host of other statutory provisions—to provide stakeholders with leverage or bargaining chips to advance their respective agendas. The purpose, at bottom, is to permit parties to have a voice and to make their own economic decisions. Each case requires an analysis into its particular

facts and circumstances to permit a court to determine whether there is material risk to the important interests sought to be protected by the Bankruptcy Code's disclosure requirements. But consistent with the holding in *Century Glove*, courts must be chary of construing those disclosure and solicitation provisions in a way that chills or hamstrings the negotiation process that is at the heart of Chapter 11. When a deal is negotiated in good faith between a debtor and sophisticated parties, and that arrangement is memorialized [as] a written commitment and promptly disclosed, § 1126 will not automatically require designation of the votes of the participants.

CONCLUSION AND IMPLICATIONS

Indianapolis Downs is consistent with the approach taken by most courts outside Delaware. By embracing a narrow interpretation of "solicitation," particularly in large, complex chapter 11 cases involving sophisticated and well-represented parties, these courts promote dialogue, negotiation and, in many cases, consensus among the debtor and its various stakeholders concerning the terms of a chapter 11 plan. Without such flexibility, the chapter 11 process can be more protracted, costly, and difficult. *Indianapolis Downs* has therefore been hailed as a positive development in both Delaware and other districts.

IN RE MDC SYSTEMS, INC.: 502(b)(6) "SURRENDERED" TO COMMON SENSE

Jordan M. Schneider

Section 502(b)(6) of the Bankruptcy Code caps the amount of a lessor's claim against a debtor-lessee for damages arising from the termination of a real property lease. The statutory cap is calculated according to a formula that considers, among other things, the date on which the lessor "repossessed" or the debtor-lessee "surrendered" the leased property. Because those terms are not defined in the Bankruptcy Code, however, courts disagree as to whether state or federal law should determine their meanings for the purpose of calculating the allowed amount of the lessor's claims.

A Pennsylvania bankruptcy court recently weighed in on this issue in *In re MDC Systems, Inc.*, 488 B.R. 74 (Bankr. E.D. Pa. 2013). The court rejected the majority view, ruling that state-law definitions of "surrender" and "repossession" should not determine the amount of a lessor's claim for future rent under section 502(b)(6).

STATUTORY CAP ON LANDLORD CLAIMS IN BANKRUPTCY

Section 502(b)(6) provides that, upon the filing of a timely objection, a claim filed in a bankruptcy case shall be disallowed to the extent that:

> if such claim is the claim of a lessor for damages resulting from the termination of a lease of real property, such claim exceeds—
>
> (A) the rent reserved by such lease, without acceleration, for the greater of one year, or 15 percent, not to exceed three years, of the remaining term of such lease, following the earlier of—
>
> (i) the date of the filing of the petition; and
>
> (ii) the date on which such lessor repossessed, or the lessee surrendered, the leased property; plus
>
> (B) any unpaid rent due under such lease, without acceleration, on the earlier of such dates . . . .

Section 502(b)(6) thus imposes a ceiling, or "cap," on the allowed amount of a landlord's claim for damages resulting from the termination of a lease of real property. The purpose of the rent cap is to balance the interests of landlords and other unsecured creditors by allowing a landlord "to receive compensation for losses suffered from a lease termination while not permitting a claim so large as to prevent general unsecured creditors from recovering from the estate." *See Solow v. PPI Enterprises, Inc. (In re PPI Enterprises (U.S.), Inc.)*, 324 F.3d 197 (3d Cir. 2003).

Section 502(b)(6) mandates that a lessor's claim for damages resulting from the termination of a lease must be compared to the sum of two amounts: (i) an amount based on "rent reserved" plus (ii) "unpaid rent." If the claim that otherwise would be allowable under applicable nonbankruptcy law exceeds these two amounts, the allowed claim is reduced accordingly.

The "rent reserved" means the amount of future rent under the lease, calculated from the earlier of the date of filing of the bankruptcy petition or the date on which the lessor "repossessed" or the lessee "surrendered" the leased property (such earlier date being referred to as the "Rent Cap Date"). Once the Rent Cap Date is determined, the rent-reserved component of the cap formula is computed by calculating the greater of: (i) the rent under the lease for one year from the Rent Cap Date; or (ii) 15 percent of the rent under the remaining term of the lease from the Rent Cap Date, but not to exceed three years.

"Unpaid rent" refers to the amount of rent that was due but not paid on the Rent Cap Date. Section 502(b)(6) does not limit claims for unpaid rent.

As noted, "repossessed" and "surrendered" are not defined in the Bankruptcy Code. Most courts, representing the majority view, look to state law for a definition of the terms. Even so, as illustrated by the bankruptcy court's ruling in *MDC Systems*, some state-law definitions arguably run at cross-purposes with the policy underlying section 502(b)(6).

MDC SYSTEMS

In 2002, MDC Systems, Inc. ("MDC") entered into a 10-year lease agreement whereby it leased commercial property from Brandywine Operating Partnership, L.P. ("Brandywine"). In 2004 or 2005, MDC allowed a related business entity, MDC Systems Corp. LLC ("LLC"), to take possession of the leased property. However, Brandywine never approved any assignment of the lease to LLC.

In July 2005, Brandywine notified MDC that it was in default for failing to pay rent under the lease and sued MDC in Pennsylvania state court for damages resulting from the breach. In November 2007, the Pennsylvania state court entered a judgment in favor of Brandywine for $1,071,024.53.

Shortly before the judgment was issued, Brandywine initiated an ejectment action in state court against LLC in which it alleged that LLC was an illegal occupant or subtenant of the property. In December 2007, before any judgment was issued in the ejectment action, LLC returned the keys to Brandywine and vacated the premises. MDC filed a chapter 7 petition in Pennsylvania on July 23, 2008.

Brandywine filed a proof of claim in MDC's chapter 7 case in the amount of $1,071,024.53. One of MDC's unsecured creditors, Graf & Graf, P.C. ("Graf"), objected to the claim, contending that the claim should be disallowed in its entirety or, alternatively, capped at $196,510.32 pursuant to section 502(b)(6) of the Bankruptcy Code. Brandywine conceded that section 502(b)(6) applied, but it argued that the claim should be allowed in the amount of $562,703.72.

THE BANKRUPTCY COURT'S RULING

As a threshold issue, the court held that, because a claim objection pursuant to section 502(b)(6) is in the nature of an affirmative defense, Graf bore the burden of proof with respect to all issues under the provision.

The primary driver behind the parties' differing claim calculations was a disagreement as to when the Rent Cap Date should be. Graf argued that the Rent Cap Date should be December 29, 2007, the date on which LLC delivered the keys to Brandywine. Brandywine countered that the Rent Cap Date should be July 23, 2008, the date on which MDC filed its bankruptcy petition. As explained previously, under section 502(b)(6), the Rent Cap Date is the earlier of the date of the filing of the bankruptcy petition or the date of "surrender"

or "repossession" of the leased premises. Thus, the specific issue presented was whether a "surrender" or "repossession" of the property occurred on December 29, 2007.

Both Brandywine and Graf assumed that applicable state law should determine whether an act of "surrender" or "repossession" occurred for purposes of section 502(b)(6). Under Pennsylvania law, surrender requires "mutual agreement of the parties." Thus, for a surrender to occur under Pennsylvania law, the landlord must accept the surrender.

The court acknowledged that this assumption was not unreasonable on the basis of the approach adopted by most courts, but it declined to follow the majority view. Instead, the court wrote that "the text, structure and purpose of § 502(b)(6) mandate that the term be given the more ordinary, dictionary-like definition: 'The act of yielding to another's power or control.' " (citing BLACK'S LAW DICTIONARY 1484 (8th ed. 2004)).

In other words, the court held, determining when a surrender occurs under section 502(b)(6) is a matter of federal law, and a surrender occurs when a tenant vacates and the landlord takes possession of the leased premises, regardless of how state law defines "surrender." The court adopted this interpretation primarily on the basis of the reasoning articulated in *In re Main, Inc.*, 1997 WL 626544 (Bankr. E.D. Pa. Oct. 7, 1997), *aff'd*, 226 B.R. 140 (E.D. Pa. 1998), *aff'd in part, rev'd in part on other grounds*, 192 F.3d 88 (3d Cir. 1999), and a law-journal article, Eric D. Winston & Nathan A. Schultz, *Sizing Up the "Cap" Commercial Lease Rejection Claims in Bankruptcy*, 27 CAL. BANKR. J. 209 (2004) ("Winston & Schultz").

In *Main*, the court held that Pennsylvania state law should not be used to determine when a "surrender" or "repossession" occurs under section 502(b)(6):

> Section 502(b)(6) presumes that "rent reserved" exists. Were there no "rent reserved," the landlord would have no claim for rent at all. Therefore, a § 502(b)(6) calculation presumes that the landlord's claim for rent has *not* been eliminated. However, the Pennsylvania law referenced [in the district-court order remanding the issue to the bankruptcy court in *Main*] considered the issues of "surrender" and "repossession" solely in the context of whether the tenant's entire liability for rent *was* eliminated.
>
> As a result, it appears not only unlikely but impossible that the Pennsylvania state law concept of "surrender" or "repossession" and the [§ 502(b)(6)(A)(ii)] concept of these terms could be identical. Whenever rent is due, . . . [a contrary approach would mean that] there will be no "surrender" or "repossession" to stop the running of the rent due pursuant to § 502(b)(6)(A)(ii). Under this reasoning, the only event which could trigger cessation of "rent reserved" is the filing of a bankruptcy petition, bringing § 502(b)(6)(A)(i) into play. In effect, § 502(b)(6)(A)(ii) would never be applicable.
>
> We therefore submit that the only logical reading of § 502(b)(6)(A)(ii) requires a conclusion that an event which is *insufficient* to eliminate the landlord's future rent claim may give rise to a § 502(b)(6)(A)(ii) date. In no sense should the state law determination of whether a "surrender" or "repossession" occurred such as would eliminate any future claim for rent reserved control the § 502(b)(6)(A)(ii) determination.

In Winston & Schultz, the authors similarly argue that state law should not control the meaning of "surrender" and "repossession" for several reasons based on their textual analysis of section 502(b)(6) and related sections of the Bankruptcy Code. First, the language of section 502(b)(6), under which the "lessee surrendered" or the "lessor repossessed," indicates that Congress intended for "future rent" claims to be measured from the surrender date, as determined by the lessee's acts, or the date of repossession, as determined by the lessor's acts. Thus, if Pennsylvania law were applied and required the term "surrender" to encompass the lessor's acceptance, that would be inconsistent with the language of section 502(b)(6) requiring only that the "lessee surrendered."

Second, in Winston & Schultz, the authors argue that because courts apply federal law, rather than state law, when interpreting the term "surrender" in section 365(d)(4) of the Bankruptcy Code, courts should apply federal law when interpreting "surrender" in section 502(b)(6) as well. Section 365(d)(4) requires

a trustee to surrender leased nonresidential real property that is the subject of a rejected lease "immediately" to the lessor. Applying the state-law definition of "surrender"—which typically requires both abandonment and a lessor's acceptance—under section 365(d)(4) would produce absurd results, since a trustee could not comply with section 365(d)(4) if the landlord did not accept the surrender.

In addition, the *MDC Systems* court explained, the use of the dictionary definition of the term "surrender" is "consistent with the purpose of § 502(b)(6), which is to reduce a landlord's claim for the period of time in which a valid state law claim for rent exists, but after the leased premises ceases to provide any benefit to the debtor or the bankruptcy estate."

Applying its chosen meaning of the term, the court held that MDC surrendered the premises to Brandywine on December 29, 2007, when LLC delivered the keys to Brandywine. Therefore, the court concluded, December 29, 2007, was the Rent Cap Date for purposes of determining the rent reserved under the lease.

The court rejected Graf's argument that Brandywine's filing of an ejectment action against the LLC in December 2007 terminated the lease under Pennsylvania law and eliminated MDC's obligation to pay any ongoing, future rent such that there was no "rent reserved" for purposes of section 502(b)(6). According to the court, even if the filing of an ejectment action against a *tenant* terminates a lease under Pennsylvania law, an attempt to eject an unapproved third-party occupant of property does not affect the ongoing viability of the lease.

The bankruptcy court denied Brandywine's bid to include as part of its allowed claim the costs it incurred to relet the premises, less the rent it received from the new occupants following the Rent Cap Date. According to this approach, "any mitigation of damages secured by reletting the premises will offset only the landlord's overall potential recovery, and does not affect the § 502(b)(6) cap." However, the court held that the attorneys' fees and costs included in Brandywine's state-court judgment against MDC were not subject to the cap of section 502(b)(6) and would be allowed in their entirety because the attorneys' fees and costs are not "rent."

Factoring all of these adjustments into the calculation of Brandywine's claim (as capped by section 502(b)(6)), the court ruled that Brandywine had an allowed claim in the amount of $400,171.94.

OUTLOOK

The court's ruling in *MDC Systems* would appear to be unusual in the sense that applicable nonbankruptcy law ordinarily determines the amount of a claim. In general, property interests are created and defined by state law. *See Butner v. United States*, 440 U.S. 48 (1979). However, certain provisions of the Bankruptcy Code were expressly designed as a matter of policy to limit claims otherwise allowable under state law. Section 502(b)(6) is one such provision. As *MDC Systems* demonstrates, if applying a particular state law would frustrate the purpose of section 502(b)(6) or render a portion of it superfluous, the courts will likely find a way to rule in a manner such that the language and intent of the Bankruptcy Code are respected to the greatest extent possible.

FROM THE TOP IN BRIEF

The U.S. Supreme Court handed down its first bankruptcy decision of 2013 on May 13. In a unanimous ruling, the court held in *Bullock v. BankChampaign N.A.*, 2013 BL 125909 (U.S. May 13, 2013), that the term "defalcation" for purposes of denying discharge of a debt under section 523(a)(4) of the Bankruptcy Code includes a "culpable state of mind" requirement involving knowledge of, or gross recklessness with respect to, the improper nature of a fiduciary's behavior.

Section 523(a)(4) bars from discharge any debt of an individual debtor "for fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny." In *Bullock*, the bankruptcy court held that a debtor who had acted as trustee for his father's insurance trust was guilty of defalcation for making loans to himself during the time he controlled the trust. That ruling was upheld on appeal by a district court and the Eleventh Circuit Court of Appeals, which reasoned that "defalcation requires a known breach of fiduciary duty, such that the conduct can be characterized as objectively reckless." The Eleventh Circuit thereby aligned itself with the Fifth, Sixth, and Seventh Circuits. The Supreme Court agreed to review the case on October 29, 2012.

In its unanimous ruling, the Supreme Court vacated the decision and remanded the matter below for additional deliberations. Writing for the court, Justice Stephen Breyer stated that "where the conduct at issue does not involve bad faith, moral turpitude, or other immoral conduct, the term requires an intentional wrong." Justice Breyer explained as follows:

> We include as intentional not only conduct that the fiduciary knows is improper but also reckless conduct of the kind that the criminal law often treats as the equivalent. Thus, we include reckless conduct of the kind set forth in the Model Penal Code. Where actual knowledge of wrongdoing is lacking, we consider conduct as equivalent if the fiduciary "consciously disregards" (or is willfully blind to) "a substantial and unjustifiable risk" that his conduct will turn out to violate a fiduciary duty. That risk "must be of such a nature and degree that, considering the nature and purpose of the actor's conduct and the circumstances known to him, its disregard involves a gross deviation from the standard of conduct that a law-abiding person would observe in the actor's situation." (citations omitted).

Because the Eleventh Circuit applied a standard of "objective recklessness," the Supreme Court instructed it to determine on remand "whether further proceedings are needed and, if so, to apply the heightened standard that we have set forth."

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 U.K.—On May 9, 2013, the U.K. Supreme Court handed down its highly anticipated ruling in *BNY Corporate Trustee Services Limited v Eurosail and others* [2013] UKSC 28, in which the court for the first time interpreted the balance-sheet test for insolvency in section 123(2) of the Insolvency Act 1986. In its ruling, the Supreme Court also provided useful guidance concerning the correct application of the cash-flow test for insolvency in section 123(1)(e). These issues are highly significant, as "insolvency" must be proved for many purposes under English insolvency law.

The Supreme Court agreed with determinations by both the High Court and the Court of Appeal that Eurosail, a special-purpose securitization vehicle, was not balance sheet–insolvent. Even so, the Supreme Court's reasoning differed slightly from that of the lower courts. Key elements of the court's judgment include the following:

- The cash-flow test (i.e., whether a debtor can pay its liabilities as and when they fall due) not only considers debts presently due, but also can include liabilities maturing in the "reasonably near future," depending on such factors as the nature of the company's business and whether it will continue trading. Consideration of liabilities accruing beyond the "reasonably near future" would require speculation, and in these circumstances, a comparison of present assets with present future liabilities (with adjustments for contingencies) might be the only sensible test for insolvency.

- The balance-sheet test requires the court to evaluate whether a company has sufficient assets to substantiate a reasonable expectation that it can expect to satisfy all of its liabilities, including prospective and contingent liabilities. This evaluation must be undertaken on the basis of available evidence and the particular circumstances of the case, with the caveat that relying on more distant liabilities (i.e., those which are not presently payable) will make the balance-sheet test for insolvency less easy to satisfy.

- The "point of no return" test adopted by the Court of Appeal as a formulation for the balance-sheet test for insolvency was rejected. The Supreme Court determined that the test interpreted the scope of the balance-sheet test too narrowly.

Europe, the U.S., and Canada—On May 7, 2013, the U.S. Bankruptcy Court for the District of Delaware denied a motion by European creditors of Nortel Networks Corp. ("Nortel") to certify a direct appeal to the U.S. Court of Appeals for the Third Circuit of the bankruptcy court's April 3, 2013, ruling (*In re Nortel Networks, Inc.*, Case No. 09-10138 (KG), 2013 BL 92666 (Bankr. D. Del. Apr. 3, 2013), denying a request to submit to arbitration a dispute over the allocation among creditors of $7.3 billion in cash raised in Nortel's liquidation. According to the court, the appeal was "frivolous" because "the agreement at issue plainly did not call for arbitration and . . . the circumstances dictate that the underlying dispute proceed" before it rather than an international arbitrator. By finding the appeal frivolous, the court defeated arguments that it lacked jurisdiction over the liquidation proceeds pending a ruling from the court of appeals.

In refusing to certify the appeal, the bankruptcy court sided with Nortel bondholders—principally U.S. hedge funds—and against advocates for Nortel's European creditors, a group that includes retirees and disabled former workers. Bondholders, whose claims are against Nortel U.S. and Nortel Canada, are seeking an expedited trial in the U.S. and Canada to decide the proper allocation of the liquidation proceeds. European creditors argue that international arbitration, with limited appellate rights, is the better and faster alternative for resolving the dispute. The decision means that Nortel's belligerent international creditors will likely join issue in a January 2014 trial. Nortel, the Toronto-based former technology icon, filed for bankruptcy protection in a number of countries in January 2009.

Nortel U.S. fired the first volley in the fray on May 14 when it filed objections in the U.S. bankruptcy court seeking to eradicate billions of dollars' worth of claims filed by European entities, contending that the parties are trying to appropriate funds which should rightfully go to creditors of the defunct telecom's U.S. unit. Nortel's British retirees responded on May 21 by asking the court to strike the objections, contending that they do not properly address any of the pension fund's allegations.

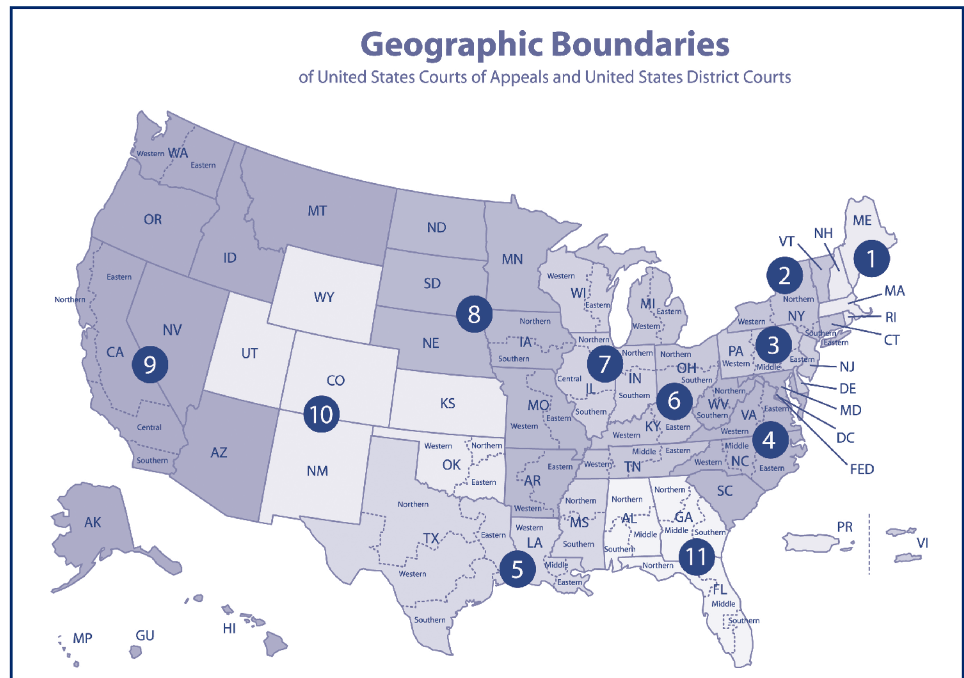
The U.K.—On March 27, 2013, the English High Court handed down a ruling in *In the Matter of Simon Carves Limited and In the Matter of the Insolvency Act 1986*, [2013] EWHC 685 (Ch), that illustrates the limitations of letters of support. In that case, Carillion Construction Limited ("CCL") sought leave to make an application under section 423 of the Insolvency Act 1986 (the "1986 Act") against Simon Carves Limited (in liquidation) ("SCL") and its ultimate parent company, Punj Lloyd Limited ("PLL"). CCL was an unsecured creditor of SCL when SCL went into administration in 2011. After SCL entered administration, its business and assets were sold to a sister company by way of a prepackaged transaction. Unsecured creditors received a nominal dividend return.

By its application, CCL sought to compel PLL to honor three separate letters of support issued by PLL to CCL's board of directors from 2008 to 2010. It was partly on the basis of those letters that SCL continued to trade after March 2008 until July 7, 2011 (when the administration order was made), despite posting significant losses during that period. CCL claimed that the letters of support constituted enforceable obligations. It also claimed that the dividend payable to unsecured creditors was nominal only because the failure by SCL to enforce the letters of support diminished the proceeds available for distribution to SCL's creditors. According to CCL, the failure to enforce those obligations constituted a transaction defrauding creditors for the purposes of section 423 of the 1986 Act.

The court ruled that the letters of support were not binding on PLL. Because the letters of support issued by PLL were addressed to SCL's directors in connection with the preparation of annual accounts, the court explained, the letters were relevant only to enable the directors to consider whether it was appropriate for the financial statements for the year to be prepared on a going-concern basis. According to the court, there was no evidence that SCL and PLL had agreed that the letters would be binding. The court held that "the letters do not even purport to be a contract with SCL" and that "there is no indication in the letters of what the consideration was (if any) passing from SCL (or, for that matter, from the Board of Directors) in return for PLL's financial support." The court also found there was no agreement between SCL and PLL that the letters of support would not be enforced, and so there was no "transaction" for the purposes of section 423 of the 1986 Act.

Other recent European developments can be tracked in Jones Day's *EuroResource*, available at http://www.jonesday.com/euroresource__may__2013.

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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