

# BUSINESS RESTRUCTURING REVIEW

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## SEVENTH CIRCUIT SUGGESTS THAT LONGER ASSUMPTION/ REJECTION DEADLINE SHOULD GOVERN INTEGRATED FRANCHISE AND COMMERCIAL LEASE AGREEMENTS

*Brad B. Erens and Mark G. Douglas*

It is broadly accepted that the abbreviated deadline for a bankruptcy trustee or chapter 11 debtor-in-possession (“DIP”) to assume or reject an unexpired lease of nonresidential real property with respect to which the debtor is the lessee does not apply to executory contracts or unexpired leases of residential real property or personal property. Less clear, however, is which deadline for assumption or rejection in the Bankruptcy Code applies to an “integrated” contract or group of “inseparable” agreements that includes both a commercial real estate lease and another type of contract or lease.

This was one of the thorny questions that the Seventh Circuit addressed, albeit obliquely, in *A&F Enters., Inc. II v. Int’l House of Pancakes Franchising LLC (In re A&F Enters., Inc. II)*, 2014 BL 34222 (7th Cir. Feb. 7, 2014). In *A&F Enterprises*, the court of appeals examined, among other things, a franchisee-lessee’s likelihood of success on a motion for a stay pending appeal of an order determining that its franchise agreement expired when a related nonresidential real property lease was deemed rejected pursuant to section 365(d)(4) of the Bankruptcy Code. In granting the stay, the Seventh Circuit wrote that “[t]here are powerful arguments in favor of” the franchisee’s argument that the longer assumption or rejection deadline stated in section 365(d)(2) should apply to the related contracts.

## **ASSUMPTION AND REJECTION OF EXECUTORY CONTRACTS AND UNEXPIRED LEASES**

Section 365(a) of the Bankruptcy Code authorizes a trustee or DIP, with court approval, to assume or reject most executory contracts and unexpired leases during the course of a bankruptcy case. If the debtor has defaulted under the contract or lease, assumption is subject to the conditions set forth in section 365(b) (e.g., cure of certain defaults and adequate assurance of future performance).

The general rule is that a trustee or DIP must assume or reject a contract or lease in its entirety. This rule prohibits the debtor from “cherry-picking,” or accepting the benefits of a contract or lease without also assuming its burdens. However, some courts have recognized arguably an exception to this principle by allowing assumption or rejection of only part of a lease or contract if the court concludes that the document actually constitutes multiple, severable agreements under applicable nonbankruptcy law based upon the intent of the parties. See, e.g., *In re Hawker Beechcraft, Inc.*, 2013 BL 156513 (Bankr. S.D.N.Y. June 13, 2013); *In re Contract Research Solutions, Inc.*, 2013 BL 117998 (Bankr. D. Del. May 1, 2013); *In re Buffets Holdings, Inc.*, 387 B.R. 115 (Bankr. D. Del. 2008). Courts have also ruled that related “inseparable” or “integrated” agreements must be assumed or rejected together rather than separately. See, e.g., *KFC Corp. v. Wagstaff Minn., Inc. (In re Wagstaff Minn., Inc.)*, 2012 BL 757, \*4 (D. Minn. Jan. 3, 2012) (“Two or more contracts that are ‘essentially inseparable’ should be viewed as a single indivisible agreement and assumed or rejected in their entirety.”); *In re Union Fin. Servs. Grp., Inc.*, 325 B.R. 816 (Bankr. E.D. Mo. 2004). Inseparability is similarly determined on the basis of the intent of the parties. *Id.*; accord *In re AbitibiBowater Inc.*, 418 B.R. 815 (Bankr. D. Del. 2009); *Philip Servs. Corp. v. Luntz (In re Philip Servs., Inc.)*, 284 B.R. 541 (Bankr. D. Del. 2002).

Section 365(d) governs the time frame for the assumption or rejection decision, depending upon the chapter of the Bankruptcy Code that applies and the nature of the contract or lease.

Pursuant to section 365(d)(2), the trustee or DIP in a chapter 9, 11, 12, or 13 case may assume or reject an executory contract or unexpired lease of residential real property or of

personal property at any time prior to confirmation of a plan, unless the court shortens the time upon the request of the nondebtor party to the agreement.

For unexpired nonresidential real property leases with respect to which the debtor in any bankruptcy case (except a chapter 15 case) is the lessee, section 365(d)(4) provides that a lease “shall be deemed rejected, and the trustee shall immediately surrender that nonresidential real property to the lessor,” if the trustee or DIP does not assume or reject the lease by the earlier of: (i) 120 days after the petition date; or (ii) confirmation of a plan. The court may extend the 120-day period by up to 90 days upon a showing of “cause,” but any additional extensions are not authorized unless the lessor consents in writing.

A franchise agreement is an executory contract subject to the assumption or rejection deadline set forth in section 365(d)(2). See *Dunkin’ Donuts Franchising LLC v. CDDC Acquisition Co. (In re FPSDA I, LLC)*, 470 B.R. 257, 262 (E.D.N.Y. 2012).

However, if a franchise agreement is part of an integrated agreement or series of contracts that also includes a lease of nonresidential real property, it may be unclear whether section 365(d)(2) or section 365(d)(4) controls the deadline for assumption or rejection. This was one of the questions addressed by the Seventh Circuit in *A&F Enterprises*.

### **A&F ENTERPRISES**

A&F Enterprises, Inc. II and various affiliates (collectively, “A&F”) managed and operated 19 separate franchised International House of Pancakes (“IHOP”) restaurants in Illinois. A&F filed for chapter 11 protection in Illinois on February 28, 2013.

At the time of the filing, A&F’s primary assets consisted of 19 IHOP franchise agreements and the corresponding building and equipment leases. For all but four of the restaurants, the franchise relationship at each location was memorialized in three separate contracts, all of which contained cross-default provisions.

A&F obtained court approval to reject the agreements with respect to two of the IHOP locations, but it neither assumed

the leases covering the remaining 17 locations within the 120-day period specified in section 365(d)(4) nor sought an extension of the time to assume or reject.

As franchisor, IHOP sought an order of the bankruptcy court declaring that the building leases for those locations were therefore automatically rejected and, by way of the cross-default provisions, that the corresponding franchise agreements and equipment leases expired. A&F countered that, because the building leases were just one component of the larger franchise arrangement with IHOP, section 365(d)(2)'s more generous time limit applied to the entire package of integrated contracts.

On August 5, 2013, the bankruptcy court ruled that the real property leases were deemed rejected as of June 28, 2013, by operation of section 365(d)(4). However, to give the parties additional time to brief the issue, the court deferred a ruling on whether the related franchise agreements and equipment leases expired on that date. After the additional briefing, the bankruptcy court ruled on September 23, 2013, that the franchise agreements and equipment leases expired as of the date the real property leases were deemed rejected.

Both the bankruptcy court and the district court denied A&F's motions for a stay pending appeal. Among other things, the district court, in assessing the likelihood that A&F would succeed on the merits of an appeal, rejected A&F's argument that every court which has reviewed the issue "has viewed the intersection of franchise agreements and nonresidential leases to be a unified issue and has applied § 365(d)(2)." See *In re A&F Enters., Inc. II*, 2013 BL 279511, \*2 (N.D. Ill. Oct. 8, 2013), *rev'd*, 2014 BL 34222 (7th Cir. Feb. 7, 2014). According to the district court, none of the cases cited by A&F was binding authority, and A&F, faced with uncertainty regarding the interplay between contracts governed by different statutory deadlines, should have sought an extension of the deadline to assume or reject the real property leases.

A&F appealed the district court's ruling to the Seventh Circuit.

### THE SEVENTH CIRCUIT'S RULING

A three-judge panel of the Seventh Circuit reversed. At the outset, the court of appeals noted that "[t]he sole issue for

us now is whether the bankruptcy court's orders should be stayed pending resolution of the appeals on the merits." Even so, the Seventh Circuit briefly addressed the merits in applying the standard for granting a stay pending appeal, which includes an assessment of the likelihood that the party seeking the stay will succeed on the merits of its appeal.

The court explained that although A&F and IHOP agreed on the effects of their contractual arrangement, they disputed whether the agreements should be viewed as a single integrated contract or as separate but related contracts that might be assumed or rejected individually. The Seventh Circuit found that the entire package of agreements would be worthless unless the agreements were all assumed together, due to the purpose and terms of the individual contracts, including various usage restrictions and cross-default provisions.

Because the real property leases, the franchise agreements, and the equipment leases were inseparable, the Seventh Circuit concluded that reference to the plain language of the Bankruptcy Code was unavailing—there is an irreconcilable conflict between sections 365(d)(2) and (d)(4), the court reasoned, because it is unclear which provision's deadline for assumption or rejection should apply to a hybrid contract. According to the court, "Creating an exception [to either provision for an integrated contract] is unavoidable, so we have no choice but to look beyond the text."

The Seventh Circuit explained that there are "powerful arguments" in support of A&F's argument that the longer deadline in section 365(d)(2) should apply, consistent with chapter 11's purpose in affording debtors a fair opportunity to reorganize. Two bankruptcy courts, the Seventh Circuit noted, have held on nearly identical facts that section 365(d)(4) "does not apply to a lease that is so tightly connected to a franchise arrangement." See *In re FPSDA I, LLC*, 450 B.R. 391 (E.D.N.Y. 2011), *leave to appeal denied*, 470 B.R. 257 (E.D.N.Y. 2012); *In re Harrison*, 117 B.R. 570 (Bank. C.D. Cal. 1990). "Though we are provisionally persuaded that A&F's position has substantial merit," the court wrote, "we emphasize that we aren't deciding the issue today."

Given the absence of a clear-cut answer on the legal issue, the Seventh Circuit based its decision whether to grant a stay pending appeal on the balance of potential harms. It

concluded that the potential harm to A&F from terminating its franchises and putting an end to its prospects for reorganization in chapter 11 outweighed any potential damage to the goodwill associated with IHOP's trademark by allowing A&F to continue operating the restaurants pending the outcome of the appeal. The Seventh Circuit accordingly reversed the district court's ruling and stayed execution of the bankruptcy-court order deeming the real property leases rejected and the franchise agreements and equipment leases terminated.

## OUTLOOK

Because of its procedural posture, *A&F Enterprises* does not provide any definitive guidance on the substantive legal question of whether section 365(d)(2) or section 365(d)(4) determines when an integrated group of disparate leases and contracts (i.e., including both nonresidential real property leases and other leases or contracts) must be assumed or rejected. Had the Seventh Circuit decided the issue on the merits, it would have been as a matter of first impression in the circuit courts of appeal. However, unless the parties reach a settlement, the Seventh Circuit may yet have an opportunity to weigh in on the issue.

Despite the nondispositive nature of its reasoning on the merits, the Seventh Circuit's analysis suggests that it sees a reasonably strong case for applying the longer assumption/rejection deadline contained in section 365(d)(2). According to the court, allowing a franchise agreement to expire by operation of a cross-default provision in a related commercial lease that is not timely assumed under the abbreviated deadline set forth in section 365(d)(4) does not comport with the goal of chapter 11 (i.e., to afford debtors an opportunity to reorganize).

This approach mirrors the reasoning articulated by the handful of other courts that have considered this issue. For example, in *FPSDA*, the bankruptcy court emphasized that if section 365(d)(4) were to apply to a combined franchise-lease agreement, the franchisor-landlord would be provided with a "superior power to determine the course and outcome of such debtor's bankruptcy case than intended," which would allow the franchisor-landlord to pressure the debtor to assume or reject the franchise agreement simply by refusing to extend the time to assume or reject the lease. See *FPSDA*, 450 B.R. at 401.

## "TRADE AWAY!"

# BANKRUPTCY COURT FOR THE SOUTHERN DISTRICT OF NEW YORK DECIDES THAT ORIGINAL ISSUE DISCOUNT FROM FAIR VALUE EXCHANGES IS ALLOWABLE IN BANKRUPTCY

*Richard L. Wynne and Lance Miller*

Debt exchanges have long been utilized by distressed companies to address liquidity concerns and to take advantage of beneficial market conditions. A company saddled with burdensome debt obligations, for example, may seek to exchange existing notes for new notes with the same outstanding principal but with borrower-favorable terms, like delayed payment or extended maturation dates (a "Face Value Exchange"). Or the company might seek to exchange existing notes for new notes with a lower face amount, motivated by discounted trading values for the existing notes (a "Fair Value Exchange"). Under either scenario, for tax and accounting purposes, a debt exchange will create "original issue discount" ("OID"), equal to the difference between the face amount of the new notes and the value generated by the exchange for the company (i.e., the fair market value of the old notes). For tax and accounting purposes, OID is treated as interest that is amortized over the life of the note, with the face amount scheduled to be paid on maturity. When a company files for bankruptcy relief, however, treating unaccrued OID as interest arguably should result in its complete disallowance, because the Bankruptcy Code has a general rule—section 502(b)(2)—disallowing "unmatured interest."

To the investors who agreed to participate in the company's debt exchange—and thereby supported prepetition efforts to avoid bankruptcy in the first place—disallowing unaccrued OID seems manifestly unfair, punishing cooperative creditors for assisting a struggling company in seeking to avoid bankruptcy. Both the Second and Fifth Circuit Courts of Appeal have respected these concerns, holding primarily on policy grounds that unaccrued OID from Face Value Exchanges should not be disallowed, in order to encourage out-of-court restructuring. See *In re Chateaugay Corp.*, 961 F.2d 378 (2d Cir. 1992); *In re Pengo Indus., Inc.*, 962 F.2d 543 (5th Cir. 1992). Until recently, however, no court had decided whether the same rule should apply to Fair Value Exchanges.

# NEWSWORTHY

U.S. News & World Report named **Jones Day** “Law Firm of the Year” for 2014 in the practice area Bankruptcy and Creditor Debtor Rights/Insolvency and Reorganization Law.

**Laurent Assaya (Paris), Juan Ferré (Madrid), David G. Heiman (Cleveland), Sion Richards (London), Paul D. Leake (New York), Bruce Bennett (Los Angeles), Heather Lennox (New York and Cleveland), Corinne Ball (New York), and Richard L. Wynne (Los Angeles)** have been recommended as “Leaders in Their Field” in the area of Restructuring/Insolvency and Bankruptcy by *Chambers Global* 2014.

**Jones Day** was recognized at the 2014 *M&A Advisor* Turnaround Awards for the following: (i) the Section 363 Sale of the Year (for transactions between \$10 million and \$50 million) for the transaction involving the sale of Rhythm & Hues, Inc., to 34x118 Holdings, LLC; (ii) the Distressed M&A Deal of the Year (for transactions exceeding \$1 billion) for the transactions involving the sale of Hostess Brands, Inc.; and (iii) the Out-of-Court Restructuring Deal of the Year (for transactions exceeding \$1 billion) for the restructuring of Travelport LLC.

**Philip J. Hoser (Sydney)** was named a “Leader in his Field” in the practice area of Restructuring/Insolvency and Bankruptcy in *Chambers Asia-Pacific* 2014.

**Ben Larkin** is joining Jones Day’s Business Restructuring & Reorganization Practice as a partner in the London Office. He previously led the Restructuring and Insolvency Practice at Berwin Leighton Paisner. During his time at BLP, Ben advised on such high-profile cases as TXU Energy, Le Méridien Hotel Group, and the Blue Bird Body Company (manufacturer of U.S. school buses). He is currently leading significant cross-border restructurings in the telecom, pharmaceutical, and energy sectors, and he acts for a wide variety of funds, investment banks, and corporations.

**Richard L. Wynne (Los Angeles)** participated in a panel discussion on March 11 entitled “Valuation: Is There Anything Else?” at the American Bankruptcy Institute’s Bankruptcy Battleground West in Los Angeles.

An article written by **Corinne Ball (New York)** entitled “*Philadelphia Newspapers* Footnote Survives *RadLAX*” was published in the February 27, 2014, edition of the *New York Law Journal*.

An article written by **Scott J. Greenberg (New York)** entitled “Online Gambling: Game Changer or Pocket Change?” appeared in the January/February 2014 edition of the *Journal of Corporate Renewal*.

An article written by **Pedro A. Jimenez (Miami)** and **Alex M. Sher (New York)** entitled “US Bankruptcy Courts May Advance the Global Scope of Cross-Border Insolvency Proceedings” appeared in the March 2014 issue of *Financier Worldwide*.



The wait is over. In a recent decision—*In re Residential Capital, LLC*, 501 B.R. 549 (Bankr. S.D.N.Y. 2013)—Judge Martin Glenn of the U.S. Bankruptcy Court for the Southern District of New York held that OID created from a prepetition Fair Value Exchange should be treated the same as OID arising from Face Value Exchanges, that is, as an allowed claim in bankruptcy despite section 502(b)(2)'s disallowance of claims for unmatured interest. If interpreted broadly and adopted by other courts, this decision will bring certainty to the markets that OID resulting from a debt-for-debt exchange will be allowed in bankruptcy, regardless of how the exchange is structured.

### **CHATEAUGAY AND FACE VALUE EXCHANGES**

The long-standing rule allowing claims for unaccrued OID in a bankruptcy case for Face Value Exchanges arose from the Second Circuit's decision in *Chateaugay*. *Chateaugay* involved a prepetition Face Value Exchange that exchanged old notes trading at a discount to par with new notes in the same principal amount but with restructured payment terms. Unfortunately, the exchange was not enough to stave off the debtors' financial troubles, and after the debtors filed for bankruptcy relief in New York, the bankruptcy court held that the OID created by the exchange was subject to disallowance under section 502(b)(2) as unmatured interest. The bankruptcy court reasoned:

In actuality, OID is nothing more or less than additional interest associated with a particular debenture. When purchasing debentures the "market" sets the appropriate rate of interest to compensate the purchaser for allowing the issuer to use the proceeds of the issue for a specified period of time, and for the various risks associated with [the] lending process such as expected inflation and the risk of nonpayment. If the proceeds from a particular issue are less than the face amount of the debentures, the "market" is telling the issuer that the stated rate of interest is too low, and the differential between consideration paid for the debenture and the amount received by the purchaser at maturity is intended to compensate the purchaser for buying a debenture with a stated interest rate below market levels.

*In re Chateaugay Corp.*, 109 B.R. 51, 55 (Bankr. S.D.N.Y. 1990), *aff'd*, 130 B.R. 403 (S.D.N.Y. 1991), *aff'd in part, rev'd in part*, 961 F.2d 378 (2d Cir. 1992). The U.S. District Court for the Southern District of New York affirmed the bankruptcy court's decision without substantive discussion.

On further appeal, the Second Circuit Court of Appeals reversed, due largely to policy concerns that disallowing unamortized OID would discourage "the speedy, inexpensive, negotiated resolution of disputes" out of court. The decision was perhaps also motivated by the prevailing belief that the lower courts' decision to disallow unaccrued OID (known as "LTV risk" because one of the debtors in *Chateaugay* was the LTV Corporation) had already increased bankruptcy filings that otherwise could have been avoided.

Shortly after the Second Circuit's decision in *Chateaugay*, the Fifth Circuit Court of Appeals in *Pengo* also endorsed the notion that, for policy reasons, the Bankruptcy Code's prohibition against unmatured interest should not apply to OID arising from a Face Value Exchange.

The decisions in *Chateaugay* and *Pengo* were expressly limited to OID arising from Face Value Exchanges. Both courts specifically left open the question of whether the same result should apply to OID arising from Fair Value Exchanges. In *Chateaugay*, the Second Circuit wrote in dicta that "[t]he bankruptcy court's decision might make sense in the context of a Fair Value exchange, where the corporation's overall debt obligations are reduced." The Fifth Circuit similarly noted in *Pengo* that "we express no opinion as to whether a Fair Value exchange creates OID not allowed under § 502(b)(2)." Parties were not quick to challenge this question, leaving markets in a relative state of uncertainty regarding Fair Value Exchanges. This question was answered recently by the bankruptcy court in *Residential Capital*.

### **RESIDENTIAL CAPITAL**

The debtors in *Residential Capital* initiated a prepetition Fair Value Exchange whereby they exchanged \$6 billion (face amount) in old unsecured notes for approximately \$4 billion (face amount) in new secured notes, plus \$500 million in cash. Specifically, participants in the exchange traded \$1,000 face principal amount of the old notes for \$800 face value of

the new notes, where the market value of the old notes was \$650 per \$1,000 face amount of each note.

In the debtors' bankruptcy, the official committee of unsecured creditors (the "committee") sought a determination that the unaccrued OID (totaling approximately \$377 million) should be disallowed as unmatured interest. The committee distinguished *Chateaugay* by arguing that disallowing the OID in this case would not chill future similar debt exchanges:

Here, among other things, the Exchange traded unsecured notes for a lower face amount of fundamentally different secured and structurally senior obligations. Holders were given ample incentives to tender, including almost certainly improved treatment in the event of a bankruptcy, even with OID treated as unmatured interest pursuant to Bankruptcy Code section 502(b)(2).

Plaintiffs' Phase I Post-Trial Brief, *Official Committee of Unsecured Creditors v. UMB Bank, N.A.*, Adv. No. 13-01277, at \*11 (Bankr. S.D.N.Y. Nov. 1, 2013) [Dkt. No. 186].

At the outset, the court held that a trial would be required to determine, as a matter of fact, whether the debt exchange in this case implicated the same policy considerations underlying *Chateaugay* and *Pengo*. At trial, the expert for the committee testified that the enhanced yield, security, and seniority of the new notes provided noteholders with "ample economic incentives to participate in the Exchange Offer regardless of OID in bankruptcy." Direct Testimony of John D. Finnerty, Ph.D., *Official Committee of Unsecured Creditors v. UMB Bank, N.A.*, Adv. No. 13-01277, at \*21 (Bankr. S.D.N.Y. Oct. 8, 2013) [Dkt. No. 127]. According to the committee's expert, as a result of these enhancements, "[t]he level of recoveries projected by the credit analysts, which was considerably less than 100%, suggests that the treatment of OID in bankruptcy would not have been a consideration for the note holders in deciding whether or not to participate in the Exchange Offer." *Id.* at \*24.

In contrast, the noteholders' expert noted that the offering memorandum for the debtors' debt exchange did not mention the risk that OID could be disallowed in a bankruptcy, and he testified that the market did not place "significant value"

on the new liens or guarantees provided under the exchange. Sworn Witness Statement of P. Eric Siegert, *Official Committee of Unsecured Creditors v. UMB Bank, N.A.*, Adv. No. 13-01277, at \*16 (Bankr. S.D.N.Y. Oct. 9, 2013) [Dkt. No. 138]. With respect to policy, the noteholders' expert also testified that:

[t]he market has functioned with substantial disregard to OID related to restructurings since the *Chateaugay* Decision. Any modification to the status quo would have widespread impact on the way in which debt is treated and traded and would be inconsistent with the realities of the market, making far more difficult the task of delevering over-leveraged companies. In fact, the mere assertion of the Committee's claim has already had such a real world effect on a multi-billion dollar exchange presently under negotiation where the bondholders have categorically refused to consider a Fair Value Exchange.

*Id.*

Following trial, the bankruptcy court determined that the OID arising from the debtors' Fair Value Exchange should be treated in the same fashion as OID arising from a Face Value Exchange. Specifically, the court found that "there is no meaningful basis upon which to distinguish between the two types of exchanges," pointing to admissions by the committee's expert that "distinguishing between face value and fair value exchanges is 'somewhat arbitrary' " because issuers consider the same factors in deciding whether to implement either type of exchange:

Dr. Finnerty acknowledged that nearly all of the features that companies consider in connection with a debt-for-debt exchange can be used in both face value and fair value exchanges: (1) granting of security in the issuer's collateral; (2) interest rate; (3) maturity date; (4) payment priorities; (5) affiliate guarantees; (6) other lending covenants; (7) redemption features; (8) adding or removing a sinking fund or conversion feature; and (9) offering stock with the new debt. . . . Other than changing the face value of the bond (which is not possible in face value exchanges), an issuer "could adjust every other factor" available to it.

*Id.* at 588. Accordingly, the court reasoned that since the Fair Value Exchange in this case was indistinguishable from Face Value Exchanges, the holding from *Chateaugay* should apply in both instances.

Although the court's reasoning was arguably based on the specific facts underlying the debtors' exchange, its holding was considerably broader: "The Court thus concludes that there is no commercial or business reason, or valid theory of corporate finance, to justify treating claims generated by face value and Fair Value Exchanges differently in bankruptcy." *Id.*

### KEY LESSONS

If the decision in *Residential Capital* is broadly adopted by other courts, it would provide much-needed certainty to the markets for distressed debt. Broad acceptance of the decision would provide issuers and bondholders alike with greater certainty that any OID arising from a debt-for-debt exchange will be treated as an allowed claim in the event of a bankruptcy filing. *Residential Capital* thus removes an important stumbling block to distressed companies seeking to retire or restructure burdensome debt through an exchange. It will likely also remove one reason why some holders in the past have refused to participate in exchanges. On the company side, it may also reduce pressure for a distressed company to provide significant credit enhancements to entice participation in a debt-for-debt exchange.

For those seeking to challenge allowance of unamortized OID in the future, *Residential Capital* will present a significant hurdle. Decisions from the U.S. Bankruptcy Court for the Southern District of New York are particularly influential regarding complex chapter 11 issues, and Judge Glenn's decision in *Residential Capital* is thoroughly reasoned. Notably, however, the decision was based in part on expert testimony that there is no meaningful difference between a Fair Value Exchange and a Face Value Exchange. Parties seeking a different result may attempt to bring forth credible experts with a different opinion or to distinguish the facts from those present in *Residential Capital*.

## DELAWARE COURT FINDS "CAUSE" TO LIMIT CREDIT-BID TO FACILITATE BANKRUPTCY AUCTION

*Ben Rosenblum*

In *In re Fisker Automotive Holdings, Inc.*, 2014 BL 13998 (Bankr. D. Del. Jan. 17, 2014), *leave to app. denied*, 2014 BL 33749 (D. Del. Feb. 7, 2014), *certification denied*, 2014 BL 37766 (D. Del. Feb. 12, 2014), a Delaware bankruptcy court limited a creditor's ability to credit bid its debt in connection with the sale of a hybrid car manufacturer's assets. Although the court limited the amount of the credit-bid to the distressed purchase price actually paid for the debt, the court's focus was on the prospect that the credit-bid would chill bidding and that the full scope of the underlying lien was as yet undetermined. The court also expressed concern as to the expedited nature of the sale, which in the court's view was never satisfactorily explained.

After the distressed debt buyer's credit-bid was limited by the court, an auction ensued and a third-party strategic purchaser prevailed over the distressed debt buyer. Given the importance of credit bidding as a distressed acquisition tool, and the court's ruling limiting the credit-bid to the amount paid for the debt, distressed debt purchasers are sure to focus on how subsequent courts interpret and apply *Fisker*.

### CREDIT BIDDING UNDER THE BANKRUPTCY CODE

Section 363(b) of the Bankruptcy Code allows for the sale of a debtor's assets outside the ordinary course of its business, including the sale of all or substantially all of those assets. Subject to certain requirements, section 363(f) of the Bankruptcy Code provides that such a sale may be made "free and clear" of all liens, claims, and encumbrances. That is, the sale can be consummated, notwithstanding the fact that a party other than the debtor asserts an interest in the property up for sale.

The Bankruptcy Code recognizes that a creditor with a lien on the assets for sale may "credit bid" its indebtedness in connection with such a sale, "unless the court for cause orders otherwise." This authorization applies to both a sale outside a chapter 11 plan and a sale pursuant to a noncon-



sensual plan. Specifically, section 363(k) of the Bankruptcy Code provides:

At a sale under subsection (b) of this section of property that is subject to a lien that secures an allowed claim, unless the court for cause orders otherwise the holder of such claim may bid at such sale, and, if the holder of such claim purchases such property, such holder may offset such claim against the purchase price of such property.

As set forth above, a credit-bid is nothing more than the offset of a claim against the property's purchase price. That is, rather than having (i) the creditor pay the purchase price to the debtor, and (ii) the debtor return the purchase price to the creditor as proceeds of its collateral, the creditor can make a bid that would simply cancel out the two obligations and short-cut the back-and-forth payment of cash. The U.S. Supreme Court recently explained in *RadLAX Gateway Hotel, LLC v. Amalgamated Bank*, 132 S. Ct. 2065, 2070 n.2 (2012), that “[t]he ability to credit-bid helps to protect a creditor against the risk that its collateral will be sold at a depressed price[.]” and “[i]t enables the creditor to purchase the collateral for what it considers the fair market price (up to the amount of its security interest) without committing additional cash to protect the loan.”

Section 363(k) of the Bankruptcy Code assumes a valid lien on the property being purchased—specifically, it refers to “property that is subject to a lien that secures an allowed claim.” However, even where a valid lien exists, the court may nonetheless prohibit credit bidding “for cause.”

The holding in *Fisker* provides some guidance regarding the meaning of “for cause” for purposes of section 363(k), in the context of that case.

### **FIKSKER**

Prior to filing for chapter 11 protection in 2013, Fisker Automotive (“Fisker”) manufactured hybrid electric cars in the U.S. In 2010, Fisker received a loan from the U.S. Department of Energy (“DOE”) in order to fund the development, commercial production, sale, and marketing, as well as all related engineering integration, of various of Fisker’s hybrid electric cars.

Business did not go well for Fisker, which had to deal with the bankruptcy filing of a key battery supplier, with product recalls, and with other adverse incidents. In 2012, Fisker was substantially impacted by the effects of Hurricane Sandy, losing a material portion of its existing unsold-vehicle inventory.

In October 2013, the DOE auctioned off Fisker’s senior indebtedness. At the auction, Hybrid Tech Holdings, LLC (“Hybrid”) was the prevailing bidder and purchased all of Fisker’s outstanding senior loan facility debt (\$168.5 million face amount) from the DOE for \$25 million—approximately 15 cents on the dollar.

On November 22, 2013, Fisker filed for bankruptcy relief in Delaware and initially sought to sell its assets to Hybrid by means of a private sale. As proposed, Hybrid would acquire substantially all of Fisker’s assets in exchange for \$75 million in the form of a credit-bid of the debt acquired from the DOE.

Pressing for an auction instead of a private sale, the official committee of unsecured creditors (the “committee”) opposed Fisker’s proposed deal with Hybrid and sought to limit Hybrid’s ability to credit bid its debt. The committee strongly endorsed an auction process in which at least one third-party strategic purchaser, Wanxiang America Corporation (“Wanxiang”), would participate.

For its part, Wanxiang had recently purchased certain assets of bankrupt A123 Systems, LLC, which produced a primary component of Fisker’s electric cars—namely, the lithium ion batteries. This made Wanxiang a potentially highly attractive auction participant. However, there was a catch—Wanxiang refused to participate in any auction process unless Hybrid’s ability to credit bid was capped at \$25 million.

### **MORE FISKER FACTS**

On January 10, 2014, the bankruptcy court held a hearing to consider Fisker’s motion to approve the proposed private sale of assets to Hybrid. Fisker and the committee stipulated to the relevant facts, which included the following:

- “[I]f at any auction Hybrid either would have no right to credit bid or its credit bidding were capped at \$25 million, there is a strong likelihood that there would be an auction

that has a material chance of creating material value for the estate over and above the present Hybrid bid.”

- “[I]f Hybrid’s ability to credit bid is not capped, it appears to both the Debtors and the Committee that there is no realistic possibility of an auction . . . .”
- “[The] limiting of Hybrid’s ability to credit bid . . . would likely foster and facilitate a competitive bidding environment . . . .”
- “[W]ithin th[e] entirety of the assets offered for sale are (i) material assets that . . . consist of properly perfected Hybrid collateral, (ii) material assets that are not subject to properly perfected liens in favor of Hybrid and (iii) material assets where there is a dispute as to whether Hybrid has a properly perfected lien . . . .”
- If “the Court rules that there is no basis to limit Hybrid’s ability to credit bid as proposed, the Committee will withdraw all of its oppositions to the Debtors’ present sale . . . .”

### THE BANKRUPTCY COURT’S RULING

The bankruptcy court, reciting the language of section 363(k), acknowledged that the Bankruptcy Code gives a secured creditor the right to credit bid its claim. However, the court also observed that the provision expressly gives it the power to limit that right “for cause.”

To determine what “cause” means in this context, the court turned to the Third Circuit’s ruling in *In re Philadelphia Newspapers, LLC*, 599 F.3d 298 (3d Cir. 2010). There, the Third Circuit held that the “right to credit bid is not absolute.” Further, in a footnote, the court of appeals observed that imposing a limit on credit bidding “for cause” does not require that the secured creditor “engage[] in inequitable conduct.” *Id.* at 315 n.14. On the contrary, according to the Third Circuit, “[a] court may deny a lender the right to credit bid in the interest of any policy advanced by the Code, such as to ensure the success of the reorganization or to foster a competitive bidding environment.” *Id.*

Picking up on this language, the court in *Fisker* held that the stipulated evidence showed that there would be *no* bidding

(not merely the *chilling* of bidding) if limits were not placed on Hybrid’s ability to credit bid.

The bankruptcy court further reasoned that the holder of a lien whose validity has yet to be determined may not credit bid a claim secured by such a lien. Emphasizing that the parties had stipulated that Hybrid had a valid lien on some Fisker assets, did not have a valid lien on other assets, and had a lien of uncertain status on the remainder, the court concluded that no one could know the scope of Hybrid’s collateral or what portion of Hybrid’s claim would ultimately be allowed as a secured claim.

In reaching this conclusion, the bankruptcy court expressly distinguished the Third Circuit’s decision in *In re Submicron Systems Corp.*, 432 F.3d 448 (3d Cir. 2006), explaining that the issue there was one of value, not of validity. In other words, it is one thing to allow credit bidding where the collateral’s *value* is undetermined—indeed, one of the principal benefits of credit bidding is that it protects a creditor against the risk that collateral will be sold at a depressed price. It is another thing, however, to allow credit bidding where the validity of the lien is at issue, because the statute itself contemplates that a valid lien exists.

On the basis of this reasoning, the bankruptcy court in *Fisker* allowed Hybrid to credit bid but held that cause existed to limit its credit-bid to the \$25 million it paid for the distressed debt. The court, however, did not explain why it selected \$25 million as the amount of the limitation.

### THE AFTER STORY

After the adverse ruling, Hybrid sought leave to appeal to the district court as well as certification of a direct appeal to the Third Circuit. The district court denied both requests. In doing so, it determined that the bankruptcy court’s order limiting the credit-bid was not a final order. While not strictly tasked with deciding the merits, the district court by its opinions generally reinforced the view that, under *Philadelphia Newspapers*, bankruptcy judges have the authority to limit credit bidding in order to foster a competitive bidding environment.

After Hybrid’s ability to credit bid was limited to \$25 million, a competitive auction between Hybrid and Wanxiang

ensued. Wanxiang prevailed, the aggregate value of its bid reported at \$149.2 million. Now the battle has shifted to the portion of the sales proceeds to which Hybrid, as secured creditor, is entitled.

### THE TAKEAWAY

At least in Delaware, *Fisker* helps to clarify what can constitute “cause” for purposes of limiting a party’s right to credit bid its secured claims. The lede touting this ruling—namely, “court limits credit bid to distressed debt price”—is undoubtedly troubling to some distressed debt investors. However, it is far from clear how subsequent courts will interpret and apply the case.

For one thing, *Fisker* is an unpublished ruling that arguably has limited precedential effect. Moreover, although the court explains in some detail why imposing a limit on credit bidding was appropriate under the circumstances, it is unclear why the court chose \$25 million—Hybrid’s debt acquisition price—as the appropriate cap. One might argue that the \$25 million cap was driven by the parties’ stipulation that limiting the credit-bid to that amount would foster bidding and, therefore, the amount of the cap approved by the court was unrelated to the purchase price of the debt. It seems more than coincidental, however, that the \$25 million was equal to the debt purchase price. In either event, the principal focus of the decision was whether the court could limit credit bidding under the specific circumstances presented. The bankruptcy court answered that question with a resounding “yes.”

The *Fisker* bankruptcy court expressed its displeasure with what it perceived as the rushed nature of the sale process. In the opinion, the court complained that the schedule proposed by Fisker afforded only 24 business days for the parties to challenge the sale and that Fisker failed to provide satisfactory reasons why the private sale of a nonoperating debtor required such speed. The court further cautioned against the creation of artificial deadlines that put unnecessary pressure on bankruptcy judges and creditors. Accordingly, *Fisker* also acts as a reminder from the Delaware bankruptcy court that, while there are appropriate circumstances to conduct expedited section 363 sales in bankruptcy, the reasons for doing so must be clearly articulated to the court.

## MANDATORY SUBORDINATION UNDER SECTION 510(b) EXTENDS TO CLAIMS ARISING FROM PURCHASE OR SALE OF AFFILIATE’S SECURITIES

Charles M. Oellermann and Mark G. Douglas

Section 510(b) of the Bankruptcy Code provides a mechanism designed to preserve the creditor/shareholder risk allocation paradigm by categorically subordinating most types of claims asserted against a debtor by equity holders in respect of their equity holdings. However, courts do not always agree on the scope of this provision in undertaking to implement its underlying policy objectives. A New York bankruptcy court recently addressed this issue in *In re Lehman Brothers Inc.*, 2014 BL 21201 (Bankr. S.D.N.Y. Jan. 27, 2014). Concluding that the provision is unambiguous, the court ruled that claims asserted against a debtor arising from securities issued by the debtor’s corporate parent are subject to subordination under section 510(b).



## SUBORDINATION IN BANKRUPTCY

The concept of claim or debt subordination is well recognized under federal bankruptcy law. A bankruptcy court's ability to reorder the relative priority of claims or debts under appropriate circumstances is part and parcel of its broad powers as a court of equity. The statutory vehicle for applying these powers in a bankruptcy case is section 510 of the Bankruptcy Code.

Section 510(a) makes a valid contractual subordination agreement enforceable in a bankruptcy case to the same extent that it would be enforceable outside bankruptcy.

Section 510(b) addresses mandatory, or "statutory," subordination of shareholder claims (also sometimes referred to as "categorical" subordination). Section 510(b) automatically subordinates to the claims of ordinary creditors any claim: (i) arising from the rescission of a purchase or sale of a security of the debtor or an affiliate; (ii) for damages arising from the purchase or sale of such a security; or (iii) for reimbursement or contribution on account of such a claim.

Finally, misconduct that results in injury to creditors can warrant the "equitable" subordination of a claim under section 510(c).

### SUBORDINATION OF SHAREHOLDER CLAIMS UNDER SECTION 510(b)

The purpose of section 510(b) is to prevent the bootstrapping of equity interests into claims that are on a par with other creditor claims, consistent with the Bankruptcy Code's "absolute priority" rule. According to this rule, unless creditors are paid in full or agree otherwise, shareholders cannot receive any distribution from a bankruptcy estate.

Shareholders have resorted to a wide array of devices and/or legal arguments in an effort to overcome this basic legal premise, including contractual provisions purporting to entitle them to damages upon the issuer's breach of a stock purchase agreement and alternative theories of recovery, such as unjust enrichment and constructive trust. See *generally Stucki v. Orwig*, 2013 BL 98362 (N.D. Tex. Apr. 12, 2013) (discussing case law).

Many courts have decided cases under section 510(b) by reviewing the traditional allocation of risk between a company's shareholders and its creditors. Under this policy-based analysis, shareholders are deemed to expect more risk in exchange for the potential to participate in the profits of the company, whereas creditors can expect only repayment of their fixed debts. Accordingly, shareholders, and not creditors, assume the risk of a wrongful or unlawful purchase or sale of securities (this risk allocation model is sometimes referred to as the "Slain/Kripke theory of risk allocation"). Because of the parties' differing expectations for risk and return, it is perceived as unfair to allow a shareholder to recover from the limited assets of a debtor as a creditor by "converting" its equity stake into a claim through the prosecution of a successful securities lawsuit. The method by which such a conversion is thwarted is mandatory subordination of the shareholder's claim under section 510(b).

In *Lehman Brothers*, the bankruptcy court considered, among other things, whether section 510(b) should be applied to subordinate claims against a debtor for damages arising from the debtor's breach of a contract involving the purchase or sale of a security not of the debtor, but of the debtor's corporate parent.

### LEHMAN BROTHERS

Lehman Brothers Inc. ("LBI") was the primary brokerage subsidiary of Lehman Brothers Holdings Inc. ("LBHI"). Claren Road Credit Master Fund, Ltd. ("Claren Road") opened a prime brokerage account with LBI in December 2005.

LBI also served as underwriter with several co-underwriters in connection with various LBHI securities offerings. In December 2005, LBI and certain co-underwriters entered into a master agreement providing, among other things, that each underwriter was obligated to contribute toward losses or liabilities incurred by other signatory underwriters arising from allegations that any relevant offering materials contained misstatements or omissions.

On September 12, 2008, Claren Road and LBI entered into a transaction whereby LBI agreed to purchase from Claren Road approximately €10 million in notes issued by LBHI.

Three days later, LBHI filed for bankruptcy, and LBI never performed its obligation under the contract.

On September 19, 2008, four days after LBHI was forced to file the largest chapter 11 case in history, the Securities Investor Protection Corporation sought an order from a New York district court for a protective decree for LBI under the Securities Investor Protection Act of 1970 (“SIPA”), in the largest broker-dealer liquidation ever. The district court issued the protective decree, appointed a trustee to oversee LBI’s liquidation, and referred the case to the bankruptcy court.

A SIPA case proceeds in the bankruptcy court very much like a chapter 7 liquidation, with certain exceptions. SIPA expressly provides that to the extent consistent with SIPA’s provisions, “a liquidation proceeding shall be conducted in accordance with, and as though it were being conducted under chapters 1, 3, and 5 and subchapters I and II of chapter 7 of title 11.” Thus, among other things, the Bankruptcy Code’s claims resolution (i.e., allowance and disallowance) provisions—including section 510(b)—generally apply in a SIPA case.

Claren Road timely filed a claim in LBI’s SIPA case for damages arising from the breach of the securities contract. After the collapse of LBHI and LBI, numerous investors sued the co-underwriters, alleging that LBHI’s offering documents contained material misstatements and omissions. The co-underwriters filed claims against LBI seeking contribution under the master agreement for millions of dollars in defense costs and settlement payments incurred in connection with the litigation.

LBI’s SIPA trustee objected to the claims of both Claren Road and the co-underwriters, arguing that all of the claims should be subordinated in accordance with the plain language of section 510(b).

### THE BANKRUPTCY COURT’S RULING

Noting that “[t]he Court of Appeals for the Second Circuit along with the bankruptcy courts within the Second Circuit have uniformly applied a ‘broad interpretation of section 510(b),’ ” the bankruptcy court ruled that the Claren Road and co-underwriter claims must be subordinated (citing *Rombro v. Dufayne (In re Med Diversified, Inc.)*, 461 F.3d 251 (2d Cir. 2006), and *KIT Digital, Inc. v. Invigor Group Ltd. (In re KIT Digital, Inc.)*, 497 B.R. 181 (Bankr. S.D.N.Y. 2013)).

The bankruptcy court explained that the language of section 510(b) is plain and, enforced in accordance with its unambiguous meaning, mandates subordination of the claims. The court rejected Claren Road’s efforts to characterize its claim as one for breach of contract due to LBI’s failure to acquire the LBHI bonds. According to the court, Claren Road’s claim was “unmistakably . . . a claim ‘for damages arising from the purchase or sale’ of the LBHI Bonds.”

The bankruptcy court also rejected Claren Road’s argument that section 510(b) is ambiguous when applied to a claim arising from the purchase or sale of a security of a debtor’s affiliate. Claren Road’s claim, the court observed, “fits comfortably within that portion of section 510(b) which mandates subordination because it is a claim ‘for damages arising from the purchase or sale’ of a security of the debtor or of an affiliate.”

The court acknowledged that Claren Road’s contention that claims “represented by” the LBHI bonds may not be subordinated because the LBHI bonds have no claim against the LBI estate “calls for a closer examination of section 510(b).” Even so, the bankruptcy court characterized as “too narrow” Claren Road’s suggestion that subordination must “relate to the capital structure” that includes the securities—here, the capital structure of LBHI—because it “fails to recognize the common meaning of words used in the statute.”

A more reasonable construction of the language of section 510(b), the court explained, is that the “ ‘claim . . . represented by [the LBHI Bonds]’ is not directed to a recovery from LBI on account of the LBHI Bonds but extends to the breach of contract claim asserted by Claren Road against LBI with respect to these bonds.” According to the court, interpreting the phrase “claim or interest represented by such security” in this fashion is a “common sense interpretation” of section 510(b):

If a claim “represented by such security” were to be restricted to a recovery from the issuer for amounts outstanding under the security, then no claim arising from the purchase or sale of *affiliate* securities would ever fit within the regime for subordination. Such a result would contradict express provisions of the statute which direct that such claims shall be subordinated.



The court found support for its approach in *In re VF Brands, Inc.*, 275 B.R. 725 (Bankr. D. Del. 2002), and *Liquidating Trust Comm. of the Del Biaggio Liquidating Trust v. Freeman (In re Del Biaggio)*, 2013 BL 319638 (N.D. Cal. Nov. 18, 2013). The courts in both of those cases, which involved comparable facts, concluded that claims based upon damages arising from the purchase of securities of an affiliate of the debtors must be subordinated under section 510(b) to the claims of the general unsecured creditors of the debtors.

Claren Road argued in *Lehman Brothers* that section 510(b)'s legislative history warrants a different result because lawmakers did not intend to subordinate the type of claim asserted by Claren Road. The bankruptcy court rejected this argument. References to legislative history, the court wrote, "are unpersuasive in the current setting where the statute can be understood without reference to background sources."

Finally, for substantially the same reasons articulated in connection with Claren Road's claim, the court ruled that the co-underwriters' contribution and indemnity claims must be subordinated in accordance with the plain meaning of section 510(b). Dismissing the co-underwriters' "strained argument" that "focuses myopically" on what it means for a claim to be "represented by" the securities of an affiliate of the debtor, the bankruptcy court wrote that "a claim made by the Co-Underwriters for reimbursement or contribution is a claim represented by LBHI securities and not necessarily a claim to recover amounts invested in these securities."

## OUTLOOK

*Lehman Brothers* is consistent with the case law trend within the Second Circuit (and elsewhere) of broad interpretation of section 510(b). By subordinating claims arising from the purchase or sale of securities issued by an affiliate of the debtor, the bankruptcy court's ruling undeniably comports with what the court concluded was the plain language of the provision.

Even so, this approach is not universally endorsed in this context, especially if literal application of the statute is inconsistent with its perceived policy objectives—i.e., preserving the risk allocation model between creditors and equity holders.

For example, every circuit court that has examined the "arising from" language in section 510(b) has found it to be ambiguous. See *In re SeaQuest Diving, LP*, 579 F.3d 411 (5th Cir. 2009); *In re American Wagering, Inc.*, 493 F.3d 1067 (9th Cir. 2007); *Med Diversified*, 461 F.3d at 258–59; *In re Geneva Steel Co.*, 281 F.3d 1173 (10th Cir. 2002); *In re Telegroup, Inc.*, 281 F.3d 133 (3d Cir. 2002); *In re Betacom of Phoenix, Inc.*, 240 F.3d 823 (9th Cir. 2001). Due to this ambiguity, these courts of appeal, and many other like-minded courts, have deemed it appropriate to examine the provision's legislative history and, having done so, have reached varying conclusions regarding the scope of mandatory subordination under section 510(b). Moreover, on the basis of the legislative history and section 510(b)'s underlying policy considerations, some commentators have posited that claims subject to subordination should be limited to: (i) those seeking to recover the decrease in value of investments in a debtor's securities; and (ii) those whose claimants are seeking to transform residual equity interests into general unsecured claims. See N. Theodore Zink, Jr., and Christy Rivera, *Are There Any Limits to Mandatory Subordination Under Section 510(b) of the Bankruptcy Code?*, PRATT'S J. BANKR. L. (March 2007).

The *Lehman Brothers* court found no ambiguity in section 510(b) and accordingly declined to examine either its legislative history or, with one exception discussed below, its policy objectives vis-à-vis the specific factual context involved. As a consequence, the court was not receptive to the argument that a breach-of-contract claim against a broker for failure to execute a trade is simply not the kind of claim that section 510(b) is intended to address.

The court did acknowledge that "there is a level of difficulty added in applying subordination under section 510(b) when the debtor is a broker-dealer, especially one as large and active as LBI," due to the large number of transactions involving securities of both affiliates and nonaffiliates. It accordingly distinguished between claims arising from the purchase or sale of LBI-affiliated securities, which must be subordinated under section 510(b), and claims arising from the purchase or sale of securities issued by unaffiliated parties, which are not subject to categorical subordination.

## GETTING FEES PAID BY THE CHAPTER 11 ESTATE WITHOUT PROVING SUBSTANTIAL CONTRIBUTION?

*Bennett L. Spiegel and Lori Sinanyan*

Section 503(b) of the Bankruptcy Code provides that the allowed administrative expenses of a bankruptcy estate shall include fees and expenses incurred by creditors, indenture trustees, and certain non-estate-retained professionals who make a “substantial contribution” in a chapter 9 or chapter 11 case. This is certainly the most frequently used provision under which such compensation is sought, but is it the exclusive method for such payment?

Despite vociferous objections from the United States Trustee (the “UST”) in the Southern District of New York, courts have recognized an alternative method for obtaining payment from the debtor’s estate of certain fees. Unlike under the more onerous “substantial contribution” test of section 503(b), an applicant may be awarded fees under a plan subject only to a “reasonableness” test set forth in section 1129(a)(4) of the Bankruptcy Code. Indeed, courts have concluded that sections 503(b) and 1129(a)(4) provide alternative methods for obtaining such relief and are not mutually exclusive.

### THE BATTLE BETWEEN SECTIONS 503(b) AND 1129(a)(4) OF THE BANKRUPTCY CODE

Whether a party has made a “substantial contribution” is a question of fact that imposes the burden of proof on the applicant to show by a preponderance of the evidence that the services it rendered provided a substantial benefit to the estate. *In re Hooker Invs., Inc.*, 188 B.R. 117, 120 (S.D.N.Y. 1995); *In re Best Prods. Co.*, 173 B.R. 862, 865 (Bankr. S.D.N.Y. 1994). Active participation alone is insufficient; there must be a substantial net benefit. *In re Granite Partners, L.P.*, 213 B.R. 440, 445–46 (Bankr. S.D.N.Y. 1997). Substantial contribution provisions are narrowly construed. *Id.* at 445 (need to “discourage mushrooming expenses” and “do not change the basic rule that the attorney must look to his own client for payment”). Creditors face an especially difficult burden in passing the substantial contribution test since “they are presumed to act primarily for their own interests.” *In re Dana Corp.*, 390 B.R. 100, 108 (Bankr. S.D.N.Y. 2008); *Granite Partners*, 213 B.R. at

446. Moreover, “[e]fforts undertaken by creditors solely to further their own self interest are not compensable under section 503(b)” and “services calculated primarily to benefit the client do not justify an award even if they also confer an indirect benefit on the estate.” *Id.* In the majority of cases where courts have allowed creditors substantial contribution claims under section 503(b)(3), courts have found that the creditor played a *leadership role* that normally would be expected of an estate-compensated professional, *but was not so performed*. See, e.g., *Granite Partners*, 213 B.R. at 446–47.

An applicant may, however, be able to recover certain fees and expenses from the estate without establishing that it provided a “substantial contribution.” Section 1123(b) of the Bankruptcy Code provides that a plan “may” include certain types of provisions. The list of provisions in section 1123(b) is voluntary, and a plan proponent has discretion to tailor a plan to the specific needs of the case. In particular, section 1123(b)(6) provides that a plan may “include any other appropriate provision not inconsistent with the applicable provisions of [the Bankruptcy Code].”

Section 1129(a)(4) of the Bankruptcy Code establishes a “reasonableness” standard for payments that are made pursuant to a chapter 11 plan. It provides that the bankruptcy court “shall” confirm a plan only if the following requirement is satisfied:

Any payment made or to be made by the proponent [or] by the debtor . . . for services or for costs and expenses in or in connection with the case, or in connection with the plan and incident to the case, has been approved by, or is subject to the approval of, the court as reasonable.

Taken together, sections 1123(b)(6) and 1129(a)(4) authorize a plan proponent to include in its plan a provision for the payment of fees and expenses of certain parties and authorize the court to approve the payments as part of the plan, provided that they are “reasonable.”

### CURRENT STATUS OF THE CASE LAW

The only published opinions addressing the payment of fees relying on sections 1123(b)(6) and 1129(a)(4) have been issued

by bankruptcy courts in the Southern District of New York. In each case, the UST objected to payment of fees under any provision of the Bankruptcy Code other than section 503(b). The arguments posited by the UST can be summarized as follows: (i) as a matter of statutory construction, the specific provisions of section 503(b) supersede the more general provisions of section 1129(a)(4); otherwise, section 503(b) would be superfluous; and (ii) compensation under the reasonableness standard of section 1129(a)(4) without satisfying the elements of section 503(b) is “inconsistent” with the limitations of section 503, which would render section 1123(b)(6) inapplicable by its own terms.

In each of the *Adelphia*, *Lehman*, and *American Airlines* cases, the courts held that section 503(b) is not the exclusive means for payment of creditors’ and/or indenture trustees’ fees and expenses and that such payments were authorized by section 1123(b)(6), subject to the section 1129(a)(4) reasonableness standard. Beginning with Judge Gerber in *Adelphia*, and followed by Judge Peck in *Lehman* and, most recently, by Judge Lane in *American Airlines*, the courts implicitly or explicitly found that there is no conflict or inconsistency between section 1129(a)(4) and section 503(b) because section 503(b) is a nonconsensual mechanism for payment of fees and expenses, whereas a plan provision is a consensual mechanism for payment of fees and expenses. See *In re Adelphia Commc’ns Corp.*, 441 B.R. 6, 12 (Bankr. S.D.N.Y. 2010); *In re Lehman Brothers Holdings Inc.*, 487 B.R. 181, 191–92 (Bankr. S.D.N.Y. 2013); *In re AMR Corp.*, 497 B.R. 690, 694–96 (Bankr. S.D.N.Y. 2013).

In *Adelphia*, 14 ad hoc committees and certain individual creditors sought approximately \$88 million in legal fees and expenses. The parties had ended their intercreditor disputes with a global settlement that included a plan provision allowing the applicants to receive payment of their reasonable fees incurred during the course of the cases.

In what appears to have been a case of first impression, Judge Gerber was asked to determine whether it was permissible to approve such payments pursuant to a plan provision and the reasonableness standard of section 1129(a)(4), as distinguished from the substantial contribution test of section 503(b). The UST objected on the ground that a plan

could not provide for payment of these parties absent a substantial contribution finding.

The court first analyzed whether the “substantial contribution” standard was the only basis for authorizing the payment of such fees. Reading the plain language of section 503(b), the court concluded that section 503(b) “does not provide, in words or substance, that it is the only way by which fees of this character may be absorbed by an estate.” Thus, the court was “free to look to other provisions of the Code that might also authorize a payment.” Accordingly, the court looked to sections 1123(b) and 1129(a)(4).

In particular, the court looked to section 1123(b)(6), which provides that a plan may include any provision “not inconsistent” with applicable provisions of the Bankruptcy Code. Because the court had concluded that section 503(b) was not the exclusive authority for the payment of non-estate-retained professionals’ fees and expenses, it reasoned that the payment of such fees and expenses pursuant to a plan was “not inconsistent” with section 503(b). The court ruled that a plan could include a provision to pay professionals for ad hoc committees and individual creditors without a showing of substantial contribution. The court did stress, however, that section 1129(a)(4) imposes a reasonableness requirement on the payment of any fees under a plan.

Although section 503(b) of the Bankruptcy Code provides for the payment of fees and expenses for an official creditors’ committee, since the 2005 amendments to the Bankruptcy Code, section 503(b) does not expressly permit individual committee members to seek reimbursement of professional fees for services rendered by an attorney or an accountant. In *Lehman*, the plan provided for the payment of approximately \$26 million in professional fees for individual committee members’ attorneys’ fees, subject only to the reasonableness standard of section 1129(a)(4). The UST objected on the basis that the plan provision attempted to circumvent the Bankruptcy Code’s restrictions on administrative expense treatment for professional compensation claims.

Noting the “lopsided affirmative vote by a vast majority of accepting creditors,” the *Lehman* court appeared reluctant to disrupt the heavily negotiated terms of a multibillion-dollar

plan for a fee dispute of this size. Ultimately, Judge Peck followed the reasoning in *Adelphia* and concluded that such payments under a plan were proper, provided that the payments were reasonable and not inconsistent with applicable provisions of the Bankruptcy Code. The court further found that the payments were indeed not inconsistent with section 503(b). Specifically, the court wrote that “[s]ection 503(b) is not a straitjacket, and the provisions of that section that directly govern the allowance of administrative claims do not control the plan process and are not inconsistent with [] the more liberal treatment provided in” a plan. Thus, the court concluded that the broad language of sections 1123(b)(6) and 1129(a)(4) allowed members of a creditors’ committee to bargain for their fees to be paid under a chapter 11 plan without meeting the requirements of section 503(b). The decision is currently on appeal before the U.S. District Court for the Southern District of New York. See *In re Lehman Brothers Holdings, Inc.*, No. 13-cv-02211-RJS (S.D.N.Y.).

In *American Airlines*, the debtors’ plan also provided for the payment of the professional fees of individual creditors’ committee members pursuant to the section 1129(a)(4) reasonableness standard. As in *Adelphia* and *Lehman*, the UST objected on the ground that professional fees not explicitly authorized by section 503(b) could not be paid. Judge Lane found the rulings in *Adelphia* and *Lehman* persuasive and reached the same conclusion: that fees are permissible when proposed and approved in a consensual plan. The judge specifically noted that section 503(b): (i) provides a creditor with an affirmative right to a claim whether or not a debtor agrees to such payment, provided that the creditor meets the standards set forth therein; and (ii) does not contain prohibitive or restrictive language and thus permits fees paid pursuant to a reasonableness standard under sections 1123(b)(6) and 1129(a)(4) if such provision is proposed and approved through a consensual plan.

Notably, there are no published opinions in the District of Delaware (or any other jurisdiction outside the Southern District of New York) that address the section 1129(a)(4) versus section 503(b) issue. However, there are several instances of plans in Delaware incorporating a fee provision pursuant to the section 1129(a)(4) reasonableness standard that have been confirmed without objection from the

Delaware UST. See, e.g., *In re Tribune Co.*, No. 08-13141 (KJC) (Bankr. D. Del.), ECF No. 11747, 12074; *In re Amicus Wind Down Corp. (Friendly’s Ice Cream)*, No. 11-13167 (KG) (Bankr. D. Del.), ECF No. 948, 1123; *In re Rotech Healthcare Inc.*, No. 13-10741 (PJW) (Bankr. D. Del.), ECF No. 512, 1007.

### **IS THE ADELPHIA FEE DECISION AND ITS PROGENY AS “RADICAL” AS THE UST FEARED?**

Courts that have addressed the issue have found a way to reconcile sections 1129(a)(4) and 503(b) under the appropriate circumstances. Significant leeway is granted to plan proponents under section 1123(b)(6) to include in plans any appropriate provision not inconsistent with the applicable provisions of the Bankruptcy Code, and courts are granted authority and discretion to approve payments in connection with a plan, subject to the reasonableness standard of section 1129(a)(4).

The UST Executive Office authored an article immediately following the *Adelphia* decision which suggested that the decision would set troubling precedent. See John Sheahan, *You Support My Plan, I’ll Pay Your Attorneys: Adelphia’s Troubling Precedent*, AM. BANKR. INST. J. 24 (May 2012), available at [http://www.justice.gov/ust/eo/public\\_\\_affairs/articles/docs/2012/abi\\_\\_201205.pdf](http://www.justice.gov/ust/eo/public__affairs/articles/docs/2012/abi__201205.pdf) (all websites herein last visited on Mar. 19, 2014). In that article and in its now numerous objections filed in bankruptcy cases pending in the Southern District of New York, the UST argued that *Adelphia* would lead to a parade of horrors, including: (i) use of section 1129(a)(4) as a vehicle for fraud or abuse and illegitimate settlements entered into in exchange for the withdrawal of a plan objection or a competing plan, even asserting that a promise to pay attorneys’ fees could induce a committee member to violate its fiduciary duty to its constituency or an attorney to violate a duty to a client or to cover up wrongdoing; (ii) the attempts of creative attorneys to bypass section 330 as the exclusive vehicle for paying professionals retained by the estate; (iii) the fact that payment of administrative expenses would be subject to two entirely different standards, depending on whether the plan proponent (typically the debtor) was aligned with the applicant; and (iv) possible attempts of plan proponents to evade other specific limitations of section 503, including the section 503(b)(7) cap on damage claims under previously assumed leases or the section 503(b)(4) exclusion



of payment of attorneys who represent individual committee members. In the three years since the *Adelphia* decision, however, it does not appear that the UST's dire prognostications have come to pass.

### CONCLUSION

Although reliance on section 1129(a)(4) for payment of fees may not arise in the typical case, it is important for creditors and interested parties to know that the substantial contribution provision of section 503(b) is not the only avenue for approval of their fees. Such parties should consider whether it would be appropriate to seek a plan provision for the payment of their fees under the reasonableness standard of section 1129(a)(4). If a party secures a provision for payment

of fees in a plan which is ultimately confirmed (particularly in cases where there is overwhelming creditor support for the plan), that party may be relieved of the burden of proving substantial contribution. In cases where the substantial contribution test might not otherwise be met, the section 1129(a)(4) alternative can make the difference between obtaining and forgoing payment of fees from the estate.

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## 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 28 countries that comprise the European Union, as well as the collective viability of eurozone economies. Here we provide a snapshot of some recent developments regarding insolvency, restructuring, and related issues in the EU.

**France—French insolvency proceedings will be significantly overhauled in the near term, as reforms are currently being implemented under the Enabling Law of January 2, 2014.**

The reforms are designed to strengthen the efficacy of preventive measures and procedures in order to avoid the need for formal public insolvency proceedings. Various new provisions are being contemplated, including the nonenforceability of contractual clauses providing for acceleration of an obligation in the event that *mandat ad hoc* or *conciliation* proceedings are commenced with respect to a debtor. It is also anticipated that it will now be possible to implement, in a conciliation agreement, a business plan providing for the sale of a company.

Furthermore, it is anticipated that the rules governing an accelerated financial safeguard procedure (*procédure de sauvegarde financière accélérée*) will be amended to make the procedure more accessible. Fast-track safeguard procedures would be segmented into two different procedures: one limited to financial creditors, and a second, separate procedure for financial creditors and trade suppliers.

Finally, the reforms are intended to balance the interests of different stakeholders involved in insolvency procedures. The reforms would be less “debtor-friendly” and would introduce a mechanism enabling creditors to be more involved in the process. For example, creditors would have the ability to propose their own restructuring plans. A presiding court would also have the power to order a sale of the controlling shareholders’ shares or to appoint a legal representative to vote on a debt-for-equity swap, instead of the shareholders. The possibility of a “cram-down” of equity interests in French

reorganization proceedings akin to procedures governing the confirmation of nonconsensual chapter 11 plans in the U.S. will have serious ramifications for the way future out-of-court restructurings are conducted.

**The U.K.—On February 24, 2014, the English Court of Appeal ruled in *Pillar Denton Limited and Ors v Jervis & Ors* [2014] EWCA Civ 180 that an administrator or liquidator must pay the rent arising with respect to property leased by the company for any period during which the administrator or liquidator retains possession of the premises for the benefit of the administration or liquidation.**

Previous judgments (namely *Goldacre (Offices) Ltd v Nortel Networks UK Ltd* [2009] EWHC 3389 (Ch); [2011] Ch 455 and *Leisure (Norwich) II Ltd v Luminar Lava Ignite Ltd* [2012] EWHC 951 (Ch); [2013] 3 WLR 1132) relating to rent payable by a company in administration and whether an insolvent company’s liability to pay rent will rank as an expense of the administration have been hotly disputed by landlords. In *Goldacre*, the High Court held that rent payable in advance and falling due before the commencement of administration could not be payable as an administration expense, even though the administrator might retain the property for the purposes of the administration for the whole or part of the period to which the advance payment related. The judgment in *Goldacre* has caused insolvency practitioners and their advisors to make commercial decisions on the timing of appointments so as to prevent rent from becoming payable as an administration expense.

In *Pillar Denton*, the court of appeal (overruling *Goldacre*) held that an administrator must make payments at the rate of the rent for the duration of any period during which he retained possession of the premises for the benefit of the administration and that the rent would be treated as accruing from day to day. Accordingly, rent payable in advance (like rent payable in arrears) will be payable as an expense of the administration or winding up for the duration of the period of “beneficial retention.” The duration of that period will be a question of fact and is not determined merely by reference to whether a rent day occurs before, during, or after such period.

**Spain—On January 24, 2014, the Council of Ministers approved Royal Decree-Law 1/2014, which introduces certain changes in administrative regulations regarding the state’s liability in the event of the termination of an administrative toll-road concession.** Two specific regulations were amended in order to clarify the role of the state if it is obligated to compensate concession companies upon the termination of a concession: (i) Law 8/1972 of May 10, 1972, which governs the construction, maintenance, and operation of toll roads under the concession regime; and (ii) Legislative Royal Decree 3/2011 of November 14, 2011, in which the Rewritten Text to the Public Sector Agreements Act was approved.

The amendments were motivated by recent Spanish Supreme Court rulings construing the role of the state in expropriation procedures in the aftermath of the controversial toll-road concessions for Madrid (*Radiales*), whereby the state was declared liable (upon default of the concession companies) for the payment of expropriation liabilities. The amendments were also enacted in the context of Spain’s proposed rescue project for failed toll roads. The new changes were effective as of January 26, 2014. It is anticipated that the amendments will be retroactive. A more detailed discussion of the amendments can be found at <http://www.jonesday.com/spanish-toll-motorways-concessions-new-regulations-regarding-the-states-liability-in-the-event-of-liquidation-01-29-2014/>.

**Spain—On March 8, 2014, significant changes to the Spanish Insolvency Act (the “Act”) became effective that implement urgent reforms to the rules and procedures governing the refinancing and restructuring of corporate debts.** The primary objective of Spanish Royal Decree-Law 4/2014, dated March 7 (“RDL 4/2014”), is to improve the legal framework for refinancing agreements and to remove the legal obstacles that have previously impeded the successful execution of restructuring and refinancing transactions.

Among the most significant amendments to the Act implemented by RDL 4/2014 are the following:

- **Enforcement of security.** Extending the stay on enforcement actions in pre-insolvency proceedings to assets required for the trading of the debtor’s business. However,

the moratorium on enforcement by secured creditors upon commencement of insolvency proceedings no longer applies where the relevant collateral comprises shares in an SPV holding company (provided that this will not affect the ability of the debtor to trade);

- **Insolvency claw-back.** A new safe-harbor regime for refinancing agreements removing the risk of claw-back in certain circumstances;
- **New money priority.** Priority as administration expense for new monies injected as part of a refinancing;
- **Insider rules for “compulsory subordination.”** New rules governing the priority of related-party claims so that debt held by holders of equity obtained following a debt-for-equity swap is no longer at risk of being subordinated as an “insider” transaction;
- **Personal liability for shareholders.** Personal liability for equity holders who unreasonably reject a debt-for-equity swap as part of a refinancing agreement where the debtor is later declared insolvent and is forced into liquidation;
- **Voting.** Modified thresholds and procedures for creditors, as well as court approval of refinancing agreements, that will make it easier for a debtor to propose and obtain approval for a refinancing agreement; and
- **Takeover act exemptions.** Certain exemptions from the rules regarding takeover bids where a controlling stake in a company is acquired by means of a debt-for-equity swap.

A more detailed discussion of RDL 4/2014 is available at <http://thewritestuff.jonesday.com/rv/ff0015f1d33f32336c46ec8e5b4e98e3674acf89/p=3430586>.

Other recent European developments can be tracked in Jones Day’s *EuroResource*, available at <http://www.jonesday.com/euroresource--deals-and-debt-02-28-2014/>.

## SOVEREIGN DEBT UPDATE

On February 18, 2014, the Republic of Argentina filed a petition with the U.S. Supreme Court (*available at* <http://blogs.reuters.com/alison-frankel/files/2014/02/argentina-paripassucertpetition.pdf>) seeking review of a pair of lower-court rulings that, among other things, construed *pari passu*, or equal footing, clauses of a bond indenture to prohibit Argentina from making payments to bondholders who participated in 2005 and 2010 debt restructurings before it pays \$1.3 billion to distressed debt investors who refused to exchange their defaulted bonds.

In *NML Capital, Ltd. v. Republic of Argentina*, 699 F.3d 246 (2d Cir. 2012), the U.S. Court of Appeals for the Second Circuit upheld a lower court's orders barring Argentina from paying holders of restructured debt without also paying holdout bondholders in full. On October 7, 2013, the Supreme Court denied Argentina's petition for the court to review the nonfinal ruling.

In *NML Capital, Ltd. v. Republic of Argentina*, 727 F.3d 230 (2d Cir. 2013), the Second Circuit upheld a lower court's order directing Argentina to pay holdout bondholders \$1.3 billion. On November 1, 2013, a three-judge panel of the Second Circuit refused to lift a stay of execution of its ruling, pending possible en banc or Supreme Court review.

Argentina has now petitioned for review of both Second Circuit rulings. The petition marks the latest and, most likely, the last chance for Argentina to avoid paying holdout bondholders. In its petition for certiorari, Argentina argues, among other things, that: (i) because the defaulted bond indenture is governed by New York law and because a New York court has never decided the issue, the Supreme Court should refer to New York State's highest court the question of whether a foreign sovereign is in breach of a *pari passu* clause when it makes periodic interest payments on performing debt without also paying on its defaulted debt; and (ii) the Second Circuit's rulings upend the "carefully-crafted regime" of foreign sovereign immunity, upsetting the compromise that the U.S. Congress and the U.S. Executive Branch struck between the interests of foreign sovereigns and their creditors in the Foreign Sovereign Immunities Act.

If the Supreme Court agrees to review the rulings, Argentina will have two cases before the Court involving its sovereign debt restructuring. On January 10, 2014, the Supreme Court agreed to resolve a court-of-appeals split over the scope of discovery orders aimed at enforcing judgments against foreign states. In *Argentina v. NML Capital, Ltd.*, No. 12-842, 2014 BL 7274 (Jan. 10, 2014), the Court granted a petition for a writ of certiorari to hear an appeal stemming from a decision by the Second Circuit upholding a lower court's order forcing two banks to disclose information concerning assets that Argentina owns outside the U.S. See *EM Ltd. v. Republic of Argentina*, 695 F.3d 201 (2d Cir. 2012). This ruling, however, put the Second Circuit at odds with three of its sister circuits.

## FROM THE TOP IN BRIEF

In its first bankruptcy decision of 2014 (October Term, 2013), the U.S. Supreme Court held on March 4, 2014, in *Law v. Siegel*, No. 12-5196 (Mar. 4, 2014) (available at [http://www.supremecourt.gov/opinions/13pdf/12-5196\\_8mjp.pdf](http://www.supremecourt.gov/opinions/13pdf/12-5196_8mjp.pdf)), that a bankruptcy court cannot impose a surcharge on exempt property due to a chapter 7 debtor's misconduct, acknowledging that the Supreme Court's decision may create "inequitable results" for trustees and creditors.

In reversing a ruling by the Ninth Circuit Court of Appeals, *Law v. Siegel (In re Law)*, 2011 BL 148411 (9th Cir. June 6, 2011), cert. granted, 133 S. Ct. 2824 (2013), the Supreme Court concluded that the bankruptcy court overstepped the bounds of its statutory authority (under section 105(a) of the Bankruptcy Code) and inherent authority when it imposed a \$75,000 surcharge on the debtor, who engaged in litigation misconduct by falsely claiming, in an effort to defraud creditors, that his California homestead was encumbered by a lien securing a \$168,000 purchase money loan provided by a personal friend. Litigation concerning the fabricated lien and the debtor's "egregious misconduct" caused the bankruptcy estate to incur \$450,000 in legal fees and related expenses.

Writing for a unanimous Court, Justice Antonin Scalia reasoned that "[a] bankruptcy court may not exercise its authority to 'carry out' the provisions of the Code, or its 'inherent power . . . to sanction abusive litigation practices,' by taking action prohibited elsewhere in the Code."

According to Justice Scalia, the bankruptcy court's surcharge contravened section 522 of the Bankruptcy Code, which gave the debtor the right to use California's "homestead exemption" to exempt \$75,000 of equity in his home from the bankruptcy estate.

Justice Scalia acknowledged that the Supreme Court's ruling may cause bankruptcy trustees and creditors to shoulder greater costs in fighting allegedly fraudulent claims. However, he wrote, "it is not for courts to alter the balance struck by the statute." Moreover, he explained, ample authority remains to address debtor misconduct, including denial of discharge under section 727(a); sanctions for bad-faith litigation conduct under Rule 9011 of the Federal Rules of Bankruptcy Procedure, section 105(a), or a bankruptcy court's inherent powers; enforcement of monetary sanctions through the procedures set forth in section 727(b) for collecting money judgments; and possible prosecution for bankruptcy crimes under 18 U.S.C. § 152.

On March 25, 2014, the Supreme Court ruled in *U.S. v. Quality Stores, Inc.*, No. 12-1408, 2014 BL 80719 (Mar. 25, 2014), available at [http://www.supremecourt.gov/opinions/13pdf/12-1408\\_6468.pdf](http://www.supremecourt.gov/opinions/13pdf/12-1408_6468.pdf), that severance payments made to employees who were involuntarily terminated prior to and during an agricultural retailer's chapter 11 case pursuant to plans which did not tie payments to the receipt of state unemployment insurance are taxable under the Federal Insurance Contributions Act ("FICA").

Prior to filing for bankruptcy and continuing afterward pursuant to a court-approved bonus plan, Quality Stores, Inc. ("Quality") paid more than \$10 million in severance pay, for which it made the required contributions under FICA. Quality later sought a refund of the tax payments, claiming that the severance pay should be exempt from FICA taxes.

After the Internal Revenue Service ("IRS") failed to respond to the refund request, Quality asked the bankruptcy court to rule on the issue. The IRS argued that the severance pay met the definition of "wages" for FICA purposes. Quality countered that the payments were made after employment ended and therefore should not be considered wages for work.

The bankruptcy court, a district court, and the Sixth Circuit Court of Appeals all ruled in Quality's favor. See *Quality Stores, Inc. v. United States (In re Quality Stores, Inc.)*, 383 B.R. 67 (Bankr. W.D. Mich. 2008), *aff'd*, 424 B.R. 237 (W.D. Mich. 2010), *aff'd*, 693 F.3d 605 (6th Cir. 2012). Other circuits, however, have concluded that at least some severance payments do constitute wages subject to FICA tax. See *CSX Corp. v. United States*, 518 F.3d 1328 (D.C. Cir. 2008); *University of Pittsburgh v. United States*, 507 F.3d 165 (3d Cir. 2007); *North Dakota State Univ. v. United States*, 255 F.3d 599 (8th Cir. 2001).

The Supreme Court reversed the Sixth Circuit's ruling in *Quality Stores*. Writing for a unanimous court (with Justice Kagan taking no part in the consideration or decision), Justice Kennedy explained that: (i) "[a]s a matter of plain meaning," severance payments fit the definition of "wages" under FICA because "[t]hey are a form of remuneration made only to employees in consideration for employment"; and (ii) the provisions of the Internal Revenue Code (see 15 U.S.C. §§ 3401(a) and 3402(o)) governing income-tax withholding do not limit the meaning of "wages" for FICA purposes.

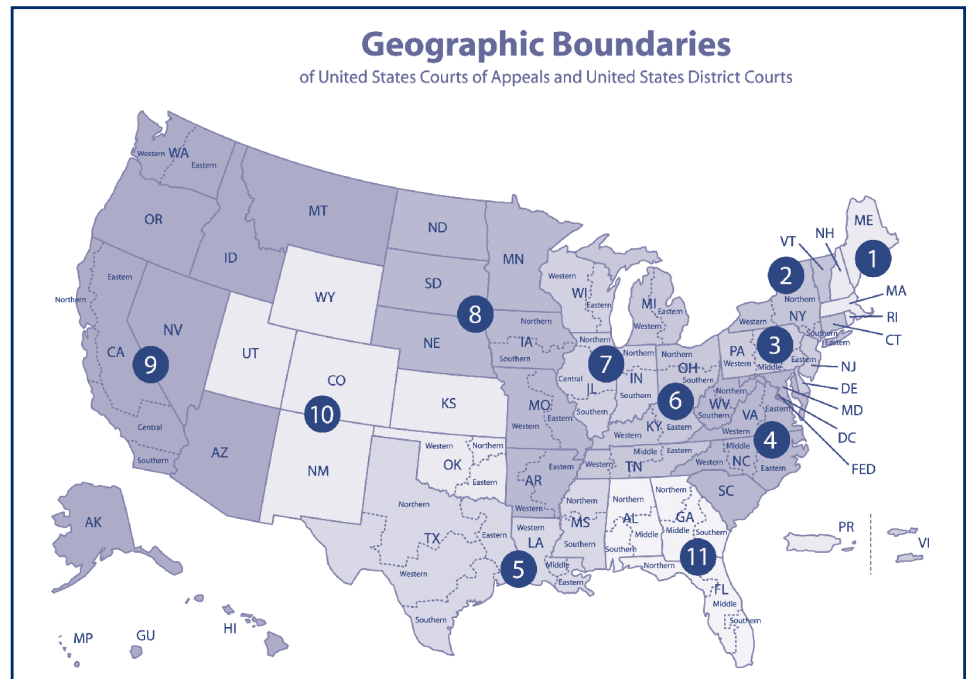
The ruling may have a significant impact on the future implementation of severance-pay plans for companies undergoing restructuring in or outside bankruptcy.

## 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.



## BUSINESS RESTRUCTURING REVIEW

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