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BUSINESS RESTRUCTURING REVIEW

U.S. SUPREME COURT SCUTTLES PUERTO RICO'S 2014 MUNICIPAL DEBT RESTRUCTURING LAW

Ben Rosenblum and Mark G. Douglas

On June 13, 2016, the U.S. Supreme Court upheld lower court rulings declaring unconstitutional a 2014 Puerto Rico law, portions of which mirrored chapter 9 of the Bankruptcy Code, that would have allowed the commonwealth's public instrumentalities to restructure a significant portion of Puerto Rico's bond debt (widely reported to be as much as $72 billion). In *Commonwealth v. Franklin Cal. Tax-Free Tr.*, 2016 BL 187308 (U.S. June 13, 2016), the Court ruled by a 5-2 margin (with one justice abstaining) that the Puerto Rico Public Corporations Debt Enforcement and Recovery Act (the "Recovery Act") is preempted by a provision of chapter 9 invalidating any "State" law purporting to implement a nonconsensual "method of composition" of a municipality's debts, even though Puerto Rico's municipalities are not eligible to file for relief under chapter 9. Following the ruling and facing the prospect of a July 1, 2016, default by Puerto Rico on a $2 billion bond payment, Congress passed the Puerto Rico Oversight, Management, and Economic Stability Act.

MUNICIPAL BANKRUPTCY LAW

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

The Supreme Court later validated a revised municipal bankruptcy statute in *United States v. Bekins*, 304 U.S. 27 (1938), concluding that revisions to the law designed to reduce the opportunity for excessive federal control over state

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sovereignty struck a constitutionally permissible balance. The present-day legislative scheme for municipal debt reorganizations was implemented in the aftermath of New York City's financial crisis and bailout by the New York State government in 1975, but chapter 9 has rarely been used.

Historically, relatively few cities or counties have filed for chapter 9 protection—with notable exceptions, including the City of Detroit and Orange County, California. The vast majority of chapter 9 filings have involved municipal "instrumentalities," such as irrigation districts, public-utility districts, waste-removal districts, and health-care or hospital districts.

In fact, according to the Administrative Office of the U.S. Courts, fewer than 700 municipal bankruptcy petitions have been filed in the 79 years since Congress established a federal mechanism for the resolution of municipal debts in 1937. Fewer than 300 chapter 9 cases have been filed since the current version of the Bankruptcy Code was enacted in 1978—although the volume of chapter 9 cases has increased somewhat in recent years. By contrast, there were 7,241 business chapter 11 cases filed in 2015 alone.

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

Various provisions of chapter 9 establish strict limitations to preserve the delicate constitutional balance between state sovereignty and federal bankruptcy power. For example, section 903 of the Bankruptcy Code expressly reserves to the states the power "to control, by legislation or otherwise," municipalities that file for chapter 9 protection, *with the caveat—and the significant limitation*—that any state law (or judgment entered thereunder) "prescribing a method of composition of indebtedness" among a municipality's creditors is not binding on dissenters. As discussed in more detail below, section 903—sometimes referred to as the "preemption" provision—is generally understood to preempt state municipal bankruptcy laws.

MUNICIPAL BANKRUPTCY LAW AND PUERTO RICO

Puerto Rico has been a territory of the U.S. since 1898. Like the states, it cannot file for bankruptcy protection. Among other reasons, the Contracts Clause of the U.S. Constitution (Art. I, § 10, cl. 1) prohibits any "state"—which has been held to include Puerto Rico (*see Auto Workers v. Fortuño*, 633 F.3d 37 (1st Cir. 2011)—from "impairing the obligation of contracts."

However, at least from 1938 until the Bankruptcy Code was enacted in 1978, Puerto Rico's *municipalities*, like state municipalities, could obtain federal municipal bankruptcy relief. *See Franklin Cal. Tax-Free Tr. v. Puerto Rico*, 805 F.3d 322, 329 (1st Cir. 2015), *aff'd*, 2016 BL 187308 (U.S. June 13, 2016). Section 84 of the Bankruptcy Act of 1898, as amended, provided that "[a]ny State's political subdivision or public agency or instrumentality" could file for relief under chapter IX—the predecessor to chapter 9—under certain specified circumstances. *See* 11 U.S.C. § 403(e)(6) (repealed 1978). The Bankruptcy Act of 1898 originally defined "State" to include "the Territories, the Indian Territory, Alaska, and the District of Columbia." 30 Stat. 545. The statutory definition was later amended to include "the Territories and possessions to which this Act is or may hereafter be applicable," *see* 11 U.S.C. § 1 (29) (repealed 1978), which included Puerto Rico. *See* 48 U.S.C. § 734.

The Bankruptcy Code omitted any definition of the term "State" when it was enacted in 1978. Congress remedied that oversight in 1984, when it amended the Bankruptcy Code to address jurisdictional infirmities in the statutory framework highlighted by the Supreme Court's ruling in *Northern Pipeline Construction Co. v. Marathon Pipe Line Co.*, 458 U.S. 50 (1982). The re-introduced definition, however, provides that " 'State' includes the District of Columbia and Puerto Rico, *except for the purpose of defining who may be a debtor under chapter 9 of this title.*" 11 U.S.C. § 101(52) (originally designated 11 U.S.C. § 101(44) (emphasis added)). As a result of this exception, Puerto Rico municipalities became expressly (though indirectly) barred from filing for relief under chapter 9. The legislative history of the 1984 amendments does not indicate why Puerto Rico was excluded from the definition of "State" for the purpose of chapter 9 eligibility.

PREEMPTION

The Bankruptcy Clause of the U.S. Constitution grants authority to Congress to establish a uniform federal law of bankruptcy. U.S. CONST. art. I, § 8, cl. 4. The Supremacy Clause of the Constitution mandates that federal laws, such as those concerning bankruptcy, "shall be the supreme Law of the Land; . . . [the] Laws of any State to the Contrary notwithstanding." U.S. CONST. art. VI, cl. 2. Thus, under the doctrine of preemption, "state laws that interfere with or are contrary to federal law are preempted and are without effect pursuant to the Supremacy Clause." *In re Loranger Mfg. Corp.*, 324 B.R. 575, 582 (Bankr. W.D. Pa. 2005); *accord Hillsborough County v. Automated Medical Labs, Inc.*, 471 U.S. 707, 712 (1985). "For preemption purposes, the laws of Puerto Rico are the functional equivalent of state laws." *Antilles Cement Corp. v. Fortuño*, 670 F.3d 310, 323 (1st Cir. 2012).

Through the years, three types of federal-law preemption over state law have been developed by the courts: (i) express preemption; (ii) field preemption; and (iii) conflict preemption. *In re Nickels Midway Pier, LLC*, 332 B.R. 262, 273 (Bankr. D.N.J. 2005). Express preemption applies "when there is an explicit statutory command that state law be displaced." *Id.* Field preemption applies when federal law "is sufficiently comprehensive to warrant an inference that Congress 'left no room' for state regulation." *In re Miles*, 294 B.R. 756, 759 (B.A.P. 9th Cir. 2003); *Hillsborough County*, 471 U.S. at 713. Conflict preemption applies when state law conflicts with federal law such that: "(1) it is impossible to comply with both state law and federal law; or (2) the state law stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress." *Nickels Midway Pier*, 332 B.R. at 273.

Congress enacted a provision expressly preempting state municipal bankruptcy laws in 1946 in response to the U.S. Supreme Court ruling in *Faitoute Iron & Steel Co. v. Asbury Park*, 316 U.S. 502 (1942), which rejected the contention that field preemption prohibited such laws. *See* Act of July 1, 1946, 60 Stat. 415. That express preemption provision is now codified in section 903(1) of the Bankruptcy Code.

PUERTO RICO'S RECOVERY ACT

On June 28, 2014, Puerto Rico's governor, Alejandro García Padilla, without access to chapter 9 of the Bankruptcy Code, signed legislation—the Recovery Act—creating a judicial debt-relief process for three Puerto Rico instrumentalities with approximately $20 billion in bond debt. Portions of the Recovery Act mirrored provisions of chapter 9 of the Bankruptcy Code.

Under the Recovery Act, an eligible public corporation could have pursued two courses of action: (i) a "consensual debt relief transaction" akin to a prepackaged or prenegotiated chapter 11 case; and/or (ii) the filing of a petition for relief with the court.

Under the first option, the court could approve debt relief if: (a) creditors holding at least 50 percent of the amount of debt within a class of substantially similar obligations participated in a vote or a consent solicitation for a proposed amendment, modification, waiver, or debt exchange; and (b) at least 75 percent of participating voters approved the proposed relief. Upon approval by a class of creditors, the applicable debt relief would have been binding on all creditors within the applicable class.

Under the second option, the court could approve a debt adjustment plan if at least one class of impaired debt voted to accept the plan. A class was deemed to approve a plan if: (i) creditors in the class holding at least two-thirds of the amount of the debt involved voted on the plan; and (ii) of the class members who actually voted, the holders of more than one-half of the debt in the class approved the plan.

Impaired creditors had to receive at least as much under a debt adjustment plan as they would have received if all creditors had been allowed to enforce their claims on the petition filing date. Also, each impaired creditor had to receive its pro rata share of 50 percent of the debtor's positive free cash flow, if any, after payment of certain specified expenses, during the 10 fiscal years following the first anniversary of the plan's effective date, until creditors were paid in full.

CONSTITUTIONAL CHALLENGES

The Recovery Act's obvious similarities to chapter 9 and chapter 11 of the Bankruptcy Code, as well as the fact that the legislation was not enacted in accordance with the U.S. Constitution, immediately provoked attacks on its constitutionality. Bond funds affiliated with Franklin Resources Inc., Oppenheimer Rochester Funds, and BlueMountain Capital Management, LLC, which collectively hold approximately $2 billion in bonds issued by the Puerto Rico Electric Power Authority, filed a lawsuit on June 30, 2014, in the U.S. District Court for the District of Puerto Rico, alleging, among other things, that the Recovery Act is

unconstitutional because the legislation is preempted by chapter 9. The district court subsequently consolidated the cases.

THE DISTRICT COURT'S RULING

The court ruled that "by enacting section 903(1) [of the Bankruptcy Code], Congress *expressly* preempted state laws that prescribe a method of composition of municipal indebtedness that binds nonconsenting creditors."

According to the district court: (i) Puerto Rico is a "State" within the meaning of section 903, which "says nothing of who may be a Chapter 9 debtor"; (ii) the Recovery Act, because it establishes procedures for indebted public corporations to adjust or discharge their obligations to creditors, "prescribes a method of composition of indebtedness, which is exactly what section 903(1) prohibits"; (iii) the Recovery Act applies to the debts of Puerto Rico "instrumentalities," which are "municipalities" for purposes of section 903(1); and (iv) because the Recovery Act does not require unanimous creditor consent, the compositions prescribed in the Recovery Act may bind nonconsenting creditors, contrary to section 903(1).

The court wrote that Congress's decision not to permit Puerto Rico municipalities to be chapter 9 debtors "reflects its considered judgment to retain control over any restructuring of municipal debt in Puerto Rico." It rejected the argument that section 903 does not apply to Puerto Rico because Puerto Rico municipalities are not eligible to be debtors under chapter 9. According to the court, "Nothing in the text, context, or legislative history of section 903 remotely supports the Commonwealth defendants' inferential leap that Congress intended the prohibition in section 903(1) to apply only to states whose municipalities are eligible to file for Chapter 9 bankruptcy."

THE FIRST CIRCUIT'S RULING

The U.S. Court of Appeals for the First Circuit affirmed the ruling in *Franklin Cal. Tax-Free Tr. v. Puerto Rico*, 805 F.3d 322 (1st Cir. 2015).

The First Circuit framed the issue before it as "whether the preemption provision of § 903(1) still applies in the face of the 1984 amendment." It concluded that the addition of the definition of "State" in 1984 did not, "by its text or its history, change the applicability of § 903(1) to Puerto Rico." According to the court, if Congress had wanted to alter the applicability of section 903(1) to Puerto Rico, it "easily could have written § 101(52) to exclude Puerto Rico laws from the prohibition of § 903(1), just as it had excluded Puerto Rico from the definition of debtor under § 109(c)."

Instead, the First Circuit reasoned, lawmakers reserved the authority to determine what debt relief, if any, is appropriate for Puerto Rico and its instrumentalities:

> In denying Puerto Rico the power to choose federal Chapter 9 relief, Congress has retained for itself the authority to decide which solution best navigates the gauntlet in Puerto Rico's case. The 1984 amendment ensures Congress's ability to do so by preventing Puerto Rico from strategically employing federal Chapter 9 relief under § 109(c), and from strategically enacting its own version under § 903(1), to avoid such options as Congress may choose. . . . We must respect Congress's decision to retain this authority.

The Supreme Court granted Puerto Rico's petition for a writ of certiorari on December 4, 2015.

THE SUPREME COURT'S RULING

The Supreme Court affirmed. Writing for the 5-2 majority (with Justice Samuel Alito abstaining), Justice Clarence Thomas explained that the cases required the Court to parse three provisions of the Bankruptcy Code: the gateway provision (section 109(c)), the preemption provision (section 903(1)), and section 101(52) (defining "State"). The majority ruled that "Puerto Rico is still a 'State' for purposes of the pre-emption provision . . . and this provision pre-empts the Recovery Act."

The 1984 amendment that added section 101(52), Justice Thomas wrote, "precludes Puerto Rico from authorizing its municipalities to seek relief under Chapter 9, but it does not remove Puerto Rico from the reach of Chapter 9's pre-emption provision." This conclusion he based on the plain text of the Bankruptcy Code, "which begins and ends our analysis."

According to the majority, the exception in section 101(52) "excludes Puerto Rico *only* for purposes of the gateway provision." Puerto Rico, Justice Thomas wrote, "is no less a 'State' for purposes of the pre-emption provision than it was before Congress amended the definition." He explained that, had Congress, which does not " 'hide elephants in mouseholes,' "

intended to alter the 70-year prohibition of state and territory municipal bankruptcy schemes in 1984, "we would expect the text of the amended definition to say so" (citation omitted).

Justice Thomas was critical of the argument—made by both Puerto Rico and the dissent—that Puerto Rico is not a "State" for the purpose of chapter 9. According to the majority, even if Puerto Rico is not a "State" for the purpose of the gateway provision, this does not mean that Puerto Rico is not a "State" for purposes of the other provisions in chapter 9, such as the preemption provision. Although a municipality that cannot obtain state authorization to file a chapter 9 petition is excluded from chapter 9 entirely, Justice Thomas wrote, "the same cannot be said about the *State* in which that municipality is located." Finally, Justice Thomas responded to the argument that the government and people of Puerto Rico should not have to wait for congressional action to avert the consequences of the fiscal crisis. "[O]ur constitutional structure," he wrote, "does not permit this Court 'to rewrite the statute that Congress has enacted' " (citation omitted).

DISSENTING OPINION

Justice Sonia Sotomayor filed a dissenting opinion in which Justice Ruth Bader Ginsburg joined. The dissent expressed, among other things, the view that the gateway provision (section 109(c)) "by its terms presupposes that Chapter 9 applies only to States who have the power to authorize their municipalities to invoke its protection." Because Puerto Rico does not have that power, the dissent maintained, the preemption provision should not apply to preempt the Recovery Act:

> By amending the definition of State to exclude Puerto Rico, the District of Columbia, and their municipalities from §109(c)'s gateway, Congress excluded Puerto Rico from Chapter 9 for all purposes—it shut the gate and barred it tight. And because Chapter 9's process and rules by their terms can only affect municipalities and States eligible to pass through the gateway in §109(c), that must mean that none of Chapter 9's provisions—including §903's pre-emption provision—apply to Puerto Rico and its municipalities.

Finally, the dissent faulted the majority for ignoring the "real-world consequences" of preemption for Puerto Rico and its people, who the dissent described as facing a looming humanitarian crisis.

OUTLOOK

The majority opinion in *Commonwealth v. Franklin* is true to Justice Thomas's "structuralist" approach to statutory interpretation. In the absence of ambiguity, the analysis begins and ends with the statutory language. Thus, Puerto Rico is a state for the purpose of preemption, yet precluded from authorizing its municipalities to seek debt relief under chapter 9. The upshot is that access of Puerto Rico instrumentalities to chapter 9 of the Bankruptcy Code was not entrusted to Puerto Rico.

Facing a July 1, 2016, deadline for Puerto Rico to make a $2 billion debt payment, U.S. lawmakers forged bipartisan support for the "Puerto Rico Oversight, Management, and Economic Stability Act" ("PROMESA"), Pub. L. No. 114-187 (2016) (H.R. 5278 and S. 2328). PROMESA was approved by the House of Representatives on June 9, 2016, and by the Senate on June 29. President Obama signed the bill into law on June 30, 2016. PROMESA creates an oversight board appointed by the president with the power to restructure Puerto Rico's debts. The law also includes an automatic stay upon enactment of all creditor collection efforts against Puerto Rico or its instrumentalities, a mandate to continue funding pensions, and a lower minimum wage for young workers. PROMESA also contains a preemption provision that contains similarities to section 903 of the Bankruptcy Code. A more detailed discussion of PROMESA is available elsewhere in this edition of the *Business Restructuring Review*.

Subsequent to the lower court rulings striking down the Recovery Act, Puerto Rico signed into law the Puerto Rico Emergency Moratorium and Financial Rehabilitation Act. That legislation too is the subject of challenge by certain creditors under, among other things, the reasoning of the Supreme Court's *Franklin* decision and the provisions of PROMESA.

A BRIEF GUIDE TO AUTOMATIC STAY WAIVERS, BANKRUPTCY REMOTENESS, AND BAD BOY GUARANTEES

Mark A. Cody and Mark G. Douglas

Key Points

- A borrower's pre-bankruptcy waiver of the automatic stay is more likely to be enforced if contained in a forbearance agreement or an agreement approved by the court in a previous bankruptcy case.
- A bankruptcy remote organizational structure that includes a blocking director may be invalidated by a court if it permits a director to disregard fiduciary duties.
- A bad boy or springing guarantee under which the guarantor's liability is triggered by the borrower's bankruptcy filing is generally enforceable.

Astute lenders are always looking for ways to minimize exposure, protect remedies, and maximize recoveries in connection with a loan, especially with respect to borrowers that have the potential to become financially distressed. Some of these efforts have been directed toward minimizing the likelihood of a borrower's bankruptcy filing by making the borrower "bankruptcy remote," such as by implementing a "blocking director" organizational structure. Others involve attempts to structure a loan transaction to ensure as nearly as possible that, despite a bankruptcy filing by or against the borrower, the lender can exercise its remedies without unreasonable delay—by means of, for example, a pre-bankruptcy waiver of the automatic stay or an agreement not to contest a motion for stay relief—or can look to an alternate source for repayment under a "bad boy" or "springing" guarantee.

Depending on the jurisdiction involved and the particular circumstances, including the terms of the relevant documents, these mechanisms may or may not be enforceable. Here, we briefly offer some guidance on what may or may not pass muster under the relevant case law in connection with waivers of the automatic stay, bankruptcy remote structures, and bad boy guarantees.

WAIVERS OF THE AUTOMATIC STAY

The enforceability of prepetition waivers of the right to seek bankruptcy protection or specific bankruptcy benefits (such as the automatic stay) has been the subject of substantial litigation. Under case law dating back to at least the 1930s, the general rule as a matter of public policy has been that a waiver of the right to file for bankruptcy is unenforceable. *See In re Weitzen*, 3 F. Supp. 698 (S.D.N.Y. 1933); *accord Continental Ins. Co. v. Thorpe Insulation Co. (In re Thorpe Insulation Co.)*, 671 F.3d 1011 (9th Cir. 2012); *Wank v. Gordon (In re Wank)*, 505 B.R. 878 (B.A.P. 9th Cir. 2014); *Nw. Bank & Trust Co. v. Edwards (In re Edwards)*, 439 B.R. 870 (Bankr. C.D. Ill. 2010); *Double v. Cole (In re Cole)*, 428 B.R. 747 (Bankr. N.D. Ohio 2009); *see also In re Madison*, 184 B.R. 686 (Bankr. E.D. Pa. 1995) (agreement not to file bankruptcy for certain time period is not binding). If the law were otherwise, "astute creditors would require their debtors to waive." *Bank of China v. Huang (In re Huang)*, 275 F.3d 1173, 1177 (9th Cir. 2002).

Pre-bankruptcy waivers of the automatic stay, however, are sometimes enforceable. *See, e.g.*, *In re Bryan Road, LLC*, 382 B.R. 844, 849 (Bankr. S.D. Fla. 2008) (setting forth factors for court to consider in deciding whether to enforce stay relief agreement, including: (i) sophistication of waiving party; (ii) consideration for waiver, including creditor's risk and length of time covered by waiver; (iii) whether other parties are affected; and (iv) feasibility of debtor's plan) (citing *In re Desai*, 282 B.R. 527, 532 (Bankr. S.D. Ga. 2002)); *In re Frye*, 320 B.R. 786 (Bankr. D. Vt. 2005) (although prepetition waiver not per se enforceable, waiver would be enforced unless debtor could show sufficient equity in property, sufficient likelihood of effective reorganization, or sufficient prejudice to other creditors); *In re Excelsior Henderson Motorcycle Mfg. Co.*, 273 B.R. 920 (Bankr. S.D. Fla. 2002) (enforcing a prepetition agreement); *In re Atrium High Point L.P.*, 189 B.R. 599 (Bankr. M.D.N.C. 1995) (prepetition waivers by debtor of automatic stay protection are enforceable in appropriate cases where enforcement does not violate public policy concerns, but are not binding on third-party creditors); *In re Darrel Creek Associates, L.P.*, 187 B.R. 908, 910 (Bankr. D.S.C. 1995) (prepetition waivers are enforceable in appropriate circumstances, and such agreements function as a factor in determining whether relief from stay may be granted); *In re Powers*, 170 B.R. 480 (Bankr. D. Mass. 1994) (same); *In re Cheeks*, 167 B.R. 817 (Bankr. D.S.C. 1994) (prepetition agreements are enforceable on policy grounds of encouraging out-of-court restructurings and settlements, but waivers are not self-executing and are not binding on third parties); *In re Club Tower L.P.*, 138 B.R. 307 (Bankr. N.D. Ga. 1991) (prepetition agreement granting creditor relief from stay was binding on parties where bankruptcy was filed in bad faith); *In re Citadel Properties, Inc.*, 86 B.R. 275 (Bankr. M.D. Fla. 1988) (same).

NEWSWORTHY

Gregory M. Gordon (Dallas), ***Scott J. Greenberg (New York)***, ***Thomas A. Howley (Houston)***, ***Aldo L. LaFiandra (Atlanta and New York)***, ***Brad B. Erens (Chicago)***, ***Bruce Bennett (Los Angeles and New York)***, ***Carl E. Black (Cleveland)***, ***Corinne Ball (New York)***, ***David G. Heiman (Cleveland)***, ***Heather Lennox (New York and Cleveland)***, ***James O. Johnston (Los Angeles)***, ***Pedro A. Jimenez (Miami and New York)***, and ***Richard L. Wynne (Los Angeles)*** were recommended in *Best Lawyers* for 2016 in the field of Bankruptcy and Creditor Debtor Rights/Insolvency and Reorganization Law.

Bruce Bennett (Los Angeles and New York), ***Corinne Ball (New York)***, ***James O. Johnston (Los Angeles)***, and ***Sidney P. Levinson (Los Angeles)*** were recommended in *Best Lawyers* for 2016 in the field of Bankruptcy—Litigation.

Thomas M. Wearsch (Cleveland), ***Richard L. Wynne (Los Angeles)***, ***Bennett L. Spiegel (Los Angeles)***, ***Charles M. Oellermann (Columbus)***, ***Sidney P. Levinson (Los Angeles)***, ***Heather Lennox (New York and Cleveland)***, ***James O. Johnston (Los Angeles)***, ***Thomas A. Howley (Houston)***, ***David G. Heiman (Cleveland)***, ***Gregory M. Gordon (Dallas)***, ***Brad B. Erens (Chicago)***, ***Carl E. Black (Cleveland)***, ***Jeffrey B. Ellman (Atlanta)***, ***Amy Edgy (Washington)***, ***Bruce Bennett (Los Angeles and New York)***, and ***Corinne Ball (New York)*** were recommended in the field of Bankruptcy/Restructuring in *Chambers USA* 2016.

Bruce Bennett (Los Angeles and New York) and ***Corinne Ball (New York)*** were named "Leading Lawyers" in the field of "Restructuring (including bankruptcy): corporate" in *The Legal 500 United States* 2016.

Heather Lennox (New York and Cleveland) was included in *Expert Guides: Women in Business Law* 2016 as one of the world's leading Insolvency & Restructuring practitioners.

Bruce Bennett (Los Angeles and New York) was named a "Leading Lawyer" in the field of "Restructuring (including bankruptcy): municipal" in *The Legal 500 United States* 2016.

Amy Edgy (Washington), ***Erin N. Brady (Los Angeles)***, ***Bruce Bennett (Los Angeles and New York)***, ***Corinne Ball (New York)***, ***Michael J. Cohen (New York)***, ***David G. Heiman (Cleveland)***, ***Kevyn D. Orr (Washington)***, ***Heather Lennox (New York and Cleveland)***, ***Scott J. Greenberg (New York)***, ***James O. Johnston (Los Angeles)***, ***Jeffrey B. Ellman (Atlanta)***, ***Joshua D. Morse (San Francisco)***, and ***Mark A. Cody (Chicago)*** were recommended in the field of "Corporate Bankruptcy" and/or "Municipal Bankruptcy" in *The Legal 500 United States* 2016.

Kevyn D. Orr (Washington) was the commencement speaker at Georgia State University College of Law on May 13, 2016.

On June 10, 2016, ***Erin N. Brady (Los Angeles)*** participated in a panel asking "Are You Ready for the New Bankruptcy Forms?" at the Association of Insolvency & Restructuring Advisors' 32nd Annual Bankruptcy & Restructuring Conference in Coronado, California.

Laurent Assaya (Paris) participated in a panel discussion on May 24, 2016, concerning "Trading of claims and interests pre- and post-insolvency: a new restructuring regime" at the 22nd Annual IBA Global Insolvency and Restructuring Conference in Milan.

Ben Rosenblum (New York) was a speaker in a June 7, 2016, webcast entitled "Into the Storm: How Safe is the Bankruptcy 546(e) Safe Harbor?"

On July 6, 2016, ***Kevyn D. Orr (Washington)*** spoke at the National Lieutenant Governors Association Annual Meeting in Grand Rapids, Michigan.

Gregory M. Gordon (Dallas) participated in a panel discussion on May 20, 2016, regarding "Anatomy of a Case (RadioShack)" at the District of Delaware Bench & Bar Conference in Wilmington, Delaware.

On June 10, 2016, ***Thomas A. Howley (Houston)*** participated in a panel discussing "Oil and Gas Bankruptcies" at the Association of Insolvency & Restructuring Advisors' 32nd Annual Bankruptcy & Restructuring Conference in Coronado, California.

On June 10, 2016, ***Kevyn D. Orr (Washington)*** participated in a panel discussing "Municipal Credit and Restructurings" at the Morgan Stanley Municipal Issuer & Investor Conference in Washington.

On June 15, 2016, ***Kevyn D. Orr (Washington)*** participated in a panel discussing "What's Next—The Future of Chicago" at a conference in Chicago sponsored by *Crain's Chicago Business*.

Gregory M. Gordon (Dallas) was named to the Top 100 list of Restructuring & Turnaround Professionals by the *Global M&A Network*.

An article written by ***Corinne Ball (New York)*** entitled "Kaisa Effects Restructuring of U.S. Bonds Offshore" was published in the June 23, 2016, edition of the *New York Law Journal*.

On May 17, 2016, *Global M&A Network* honored the winners of the Turnaround Atlas Awards. The "Turnaround of the Year" award went to NII Holdings for its chapter 11 plan of reorganization and sale of Nextel Mexican to AT&T. The "Insolvency of the Year" award went to RadioShack for its chapter 11 restructuring, the sale of its stores to General Wireless and Sprint, and the liquidation of its remaining assets. ***Jones Day*** represented NII Holdings and RadioShack in connection with the transactions.

Jones Day won the "Insolvency & Restructuring Deal of the Year" award for the Atlas Iron restructure at the Australasian Law Awards ceremony in Sydney.

On June 8, 2016, ***Kevyn D. Orr (Washington)*** received the Abraham Krasnoff Courage and Commitment Award at the ERASE Racism Annual Benefit for his visionary leadership in saving the historic City of Detroit.

Courts have typically enforced prepetition stay waivers as part of forbearance agreements, as distinguished from original loan documentation, or agreements that have been approved by courts in previous bankruptcy cases. *See Bryan Road*, 382 B.R. at 848; *In re BGM Pasadena, LLC*, 2016 BL 134299, *3 (Bankr. C.D. Cal. Apr. 27, 2016) ("While it is true that courts have generally treated waivers of the automatic stay as unenforceable when they are contained in prepetition agreements between a lender and a borrower (because the interests of third parties, such as unsecured creditors, for whose benefit the automatic stay exists were not considered at the time the agreement was made), the same cannot be said of waivers that are approved after notice and an opportunity for hearing in the context of an earlier bankruptcy case"); *In re DB Capital Holdings, LLC*, 454 B.R. 804, 816 (Bankr. D. Colo. 2011) (prepetition stay waivers may be enforced if part of confirmed plan or stipulation resolving earlier motion for relief, but otherwise "appear to conflict with the policies and purposes of the Bankruptcy Code, and should not be enforced."); *Atrium High Point*, 189 B.R. at 607 (waiver in plan of reorganization confirmed in previous chapter 11 case).

Many courts which have enforced prepetition waivers of the stay have reasoned that enforcement furthers the legitimate public policy of encouraging out-of-court restructurings and settlements. *See*, *e.g.*, *Cheeks*, 167 B.R. at 818 ("Perhaps the most compelling reason for enforcement of the [waiver] is to further the public policy in favor of encouraging out-of-court restructuring and settlement. . . . Bankruptcy courts may be an appropriate forum for resolving many of society's problems, but some disputes are best decided through other means.") (citation omitted); *Powers*, 170 B.R. at 483; *Club Tower, L.P.*, 138 B.R. at 311.

Although the enforceability of prepetition stay waivers under appropriate circumstances is the majority view, some courts have rejected this approach, principally due to the resulting prejudice to creditors other than the beneficiary of the waiver. *See*, *e.g.*, *Ostano Commerzanstalt v. Telewide Systems, Inc.*, 790 F.2d 206, 207 (2d Cir. 1986) ("Since the purpose of the stay is to protect creditors as well as the debtor, the debtor may not waive the automatic stay"); *Matter of Pease*, 195 B.R. 431, 434 (Bankr. D. Neb. 1996) ("the pre-bankruptcy debtor simply does not have the capacity to waive rights bestowed by the Bankruptcy Code upon a debtor in possession, particularly where those rights are as fundamental as the automatic stay."); *In re Jenkins Court Assoc. L.P.*, 181 B.R. 33 (Bankr. E.D. Pa. 1995) (refusing to enforce prepetition waiver agreement without further development of facts); *Farm Credit of Cent. Florida, ACA v. Polk*, 160 B.R. 870 (M.D. Fla. 1993) (same); *In re Sky Group Int'l, Inc.*, 108 B.R. 86 (Bankr. W.D. Pa. 1989) (prepetition waiver was not self-executing or per se enforceable).

Courts have been critical of prepetition stay waivers in cases involving single asset debtors, reasoning that such a waiver too closely approximates a prohibited waiver of the right to file for bankruptcy. *See DB Capital*, 454 B.R. at 814; *Jenkins*, 181 B.R. at 37; *accord In re Triple A & R Capital Inv., Inc.*, 519 B.R. 581, 584 (Bankr. D.P.R. 2014) (agreeing with *DB Capital*, but ruling that waiver in prepetition forbearance agreement was enforceable because, after filing for chapter 11, debtor entered into court-approved cash collateral stipulation in which it ratified prepetition loan documents, including forbearance agreement).

BANKRUPTCY REMOTENESS AND BLOCKING DIRECTORS

As a general rule, corporate formalities and applicable state law must be satisfied in commencing a bankruptcy case. *See In re NNN 123 N. Wacker, LLC*, 510 B.R. 854 (Bankr. N.D. Ill. 2014) (citing *Price v. Gurney*, 324 U.S. 100 (1945); *In re Gen-Air Plumbing & Remodeling, Inc.*, 208 B.R. 426 (Bankr. N.D. Ill. 1997)); *In re Comscape Telecommunications, Inc.*, 423 B.R. 816 (Bankr. S.D. Ohio 2010). As a result, while contractual provisions that prohibit a bankruptcy filing may be unenforceable as a matter of public policy, other measures designed to preclude a debtor from filing for bankruptcy may be available.

Lenders, investors, and other parties seeking to prevent or limit the possibility of a bankruptcy filing have attempted to sidestep the public policy invalidating contractual waivers of a debtor's right to file for bankruptcy protection by eroding or eliminating the debtor's authority to file for bankruptcy under its governing organizational documents. *See*, *e.g.*, *DB Capital Holdings, LLC v. Aspen HH Ventures, LLC (In re DB Capital Holdings, LLC)*, 2010 WL 4925811 (B.A.P. 10th Cir. Dec. 6, 2010); *NNN 123 N. Wacker*, 510 B.R. at 862; *In re Houston Regional Sports Network, LP*, 505 B.R. 468 (Bankr. S.D. Tex. 2014); *In re Quad-C Funding LLC*, 496 B.R. 135 (Bankr. S.D.N.Y. 2013); *Green Bridge Capital S.A. v. Ira Shapiro (In re FKF Madison Park Group Owner, LLC)*, 2011 BL 24531 (Bankr. D. Del. Jan. 31, 2011); *In re Global Ship Sys. LLC*, 391 B.R. 193 (Bankr. S.D. Ga. 2007); *In re Kingston Square Associates*, 214 B.R. 713 (Bankr. S.D.N.Y. 1997). These types of provisions have not always been enforced, particularly where the

organizational documents include an outright prohibition of any bankruptcy filing. *See In re Bay Club Partners-472, LLC*, 2014 BL 125871 (Bankr. D. Or. May 6, 2014) (refusing to enforce restrictive covenant in debtor limited liability company's operating agreement, rather than loan agreement; prohibiting bankruptcy filing; and stating that covenant "is no less the maneuver of an 'astute creditor' to preclude [Bay Club Partners-472] from availing itself of the protections of the Bankruptcy Code prepetition, and it is unenforceable as such, as a matter of public policy").

Many of these efforts have been directed toward "bankruptcy remote" special purpose entities ("SPEs"). An SPE is an entity created in connection with a financing or securitization transaction structured to ring fence the SPE's assets from creditors other than secured creditors or investors (e.g., trust certificate holders) that provide financing or capital to the SPE.

Such an entity is generally designed to be bankruptcy remote to minimize exposure to a voluntary bankruptcy filing by limiting the circumstances under which the SPE's board or managing members can put the entity into bankruptcy. A common way of achieving this goal is to appoint an "independent" or "blocking" director to the SPE's governing body.

The organizational documents of an SPE typically will provide that a bankruptcy filing and certain other significant actions must be approved unanimously by the board of directors or other governing body. A director nominated by the lender then has the power to prevent a bankruptcy filing by withholding consent. The documents will further provide that actions requiring unanimity may not be taken if that director's seat is vacant and that the documents may not be amended without the consent of all directors.

Exposure to involuntary bankruptcy can be limited by specifically restricting the secured and unsecured debt that an SPE can incur, thereby limiting the pool of qualified petitioning creditors for an involuntary bankruptcy petition. Finally, SPEs are typically structured to reduce the risk that the corporate structures of an SPE and related entities are disregarded (e.g., through veil piercing or substantive consolidation) by requiring the SPE to observe corporate formalities.

Recent court rulings have led to significant questions regarding the efficacy of the SPE model as an effective means of achieving bankruptcy remoteness. For example, in *In re Gen. Growth Props., Inc.*, 409 B.R. 43 (Bankr. S.D.N.Y. 2009), the court denied a motion by secured lenders to dismiss voluntary chapter 11 filings by several SPE subsidiaries of real estate investment trust General Growth Properties, Inc. ("GGP"). The lenders argued, among other things, that the loan agreements with the SPEs provided that an SPE could not file for bankruptcy without the approval of an independent director nominated by the lenders. The lenders also argued that, because the SPEs had no business need to file for bankruptcy and because GGP exercised its right to replace the independent directors less than 30 days before the bankruptcy filings, the SPE's chapter 11 filings had not been undertaken in good faith.

The bankruptcy court ruled that it was not bad faith to replace the SPEs' independent directors with new independent directors days before the bankruptcy filings because the new directors had expertise in real estate, commercial mortgage-backed securities, and bankruptcy matters. The court determined that, even though the SPEs had strong cash flows, bankruptcy remote structures, and no debt defaults, the chapter 11 filings had not been made in bad faith. The court found that it could consider the interests of the entire group of affiliated debtors as well as each individual debtor in assessing the legitimacy of the chapter 11 filings.

Among the potential flaws in the bankruptcy remote SPE structure brought to light by *General Growth* was the requirement under applicable Delaware law for independent directors to consider not only the interests of creditors, as mandated in the charter or other organizational documents, but also the interests of shareholders. Thus, an independent director or manager who simply votes to block a bankruptcy filing at the behest of a secured creditor without considering the impact on shareholders could be deemed to have violated its fiduciary duties of care and loyalty. *See In re Lake Mich. Beach Pottawattamie Resort LLC*, 547 B.R. 899 (Bankr. N.D. Ill. 2016) ("blocking" member provision in membership agreement of special purpose limited liability company was unenforceable because it did not require member to comply with fiduciary obligations under applicable nonbankruptcy law); *see also In re Intervention Energy Holdings, LLC*, 2016 BL 181680, *5 (Bankr. D. Del. June 3, 2016) ("A provision in a limited liability company governance document obtained by contract, the sole purpose and effect of which is to place into the hands of a single, minority equity holder [by means of a "golden share"] the ultimate authority to eviscerate the right of that entity to seek federal bankruptcy

relief, and the nature and substance of whose primary relationship with the debtor is that of creditor—not equity holder—and which owes no duty to anyone but itself in connection with an LLC's decision to seek federal bankruptcy relief, is tantamount to an absolute waiver of that right, and, even if arguably permitted by state law, is void as contrary to federal public policy.").

BAD BOY GUARANTEES

Rapid expansion of the market for commercial mortgage-backed securities (CMBS) has led to an increasing use of "nonrecourse" financing, whereby the lender may look only to its collateral, as distinguished from other assets of the borrower, in seeking repayment of a loan. As a way to enhance recoveries on nonrecourse loans, lenders have in the past relied on "bad boy," "springing," or "nonrecourse carveout" guarantees that give a lender some degree of recourse to the borrower should the borrower commit fraud or other "bad acts," such as converting rents, withholding other payments earmarked for the lender, making intentional misrepresentations, or encumbering the collateral without permission.

Nonrecourse lenders intent upon minimizing opposition to the enforcement of their remedies against the collateral and/or making borrowers more bankruptcy remote have expanded the scope of bad boy guarantees. In doing so, through the guarantees, the lenders impose personal liability on any person controlling the borrower upon the occurrence of events that were not traditionally deemed "bad acts," such as a bankruptcy filing by (or against) the borrower, the borrower's opposition to foreclosure, or the borrower's failure to maintain its status as an SPE.

Courts have generally enforced bad boy guarantees triggered by bankruptcy filings or other equivalent events, such as an assignment for the benefit of creditors or generally not paying debts as they mature. *See*, *e.g.*, *G3-Purves St., LLC v. Thomson Purves, LLC*, 101 A.D.3d 37, 41 (N.Y. App. Div. 2012) ("contrary to the guarantors' contention, the carve-out language in the loan agreement was unambiguous and provided for personal liability for a violation of certain enumerated exceptions, including defined 'springing recourse events' "); *Wells Fargo Bank, N.A. v. Daniels*, 2011-Ohio-6555 (Ohio Ct. App. 2011) ("the plain language of the guaranty agreements and the related agreements provided that Daniels and Baird would become liable for the entire indebtedness upon the occurrence of certain events, including the borrower filing a petition for bankruptcy," and that "[t]he agreements did not require the guarantors' consent to, authorization of, or even knowledge about the filing of the bankruptcy petition in order to trigger their liability"); *First National Bank v. Brookhaven Realty Assoc.*, 637 N.Y.S. 2d 418, 421 (N.Y. App. Div. 1996) ("[t]he appellants are bound by the terms of the contract[,] and enforcement of the bankruptcy default clause is neither inequitable, oppressive, [nor] unconscionable"), *appeal dismissed*, 88 N.Y.2d 963 (1996); *see also CT Inv. Mgmt. Co. v. Carbonell*, 2012 BL 8472 (S.D.N.Y. Jan. 11, 2012) (extending comity to Mexican court order staying actions against guarantors based on Mexican debtor's voluntary bankruptcy filing).

For example, in *Bank of America, N.A., et al., v. Lightstone Holdings, LLC, et al.*, 2011 BL 396859 (N.Y. Sup. Ct. July 14, 2011), the court granted summary judgment against David Lichtenstein and Lightstone Holdings, LLC, finding them liable under bad boy guarantees given in connection with a structured commercial real estate loan secured by the Extended Stay hotel properties. The bad boy acts included a voluntary bankruptcy filing by the borrowers, which triggered recourse liability to the borrowers as well as the guarantors' personal liability for up to $100 million. The court rejected the guarantors' arguments that the guarantee violated public policy or was an unenforceable penalty, thereby reaffirming its prior decision in *UBS Commercial Mortg. Trust 2007-FLI v. Garrison Special Opportunities Fund L.P.*, 2010 BL 295421 (N.Y. Sup. Ct. Mar. 8, 2011).

Other courts have also concluded that bad boy guarantee liability triggered by a bankruptcy filing is not unenforceable as a matter of public policy. *See*, *e.g.*, *BayNorth Realty Fund VI, L.P. v. Shoaf*, 2010 BL 290453 (Mass. Super. Ct. Oct. 19, 2010) (noting that public policy dictated upholding such guarantees in order to preserve commercial value of loan guarantees and not negatively impact credit availability); *see also In re Extended Stay Inc.*, 418 B.R. 49, 59 (Bankr. S.D.N.Y. 2009) (noting that "public policy arguments relating to the guaranty claims [were] of minimal relevance" where principal liable under bad boy guarantee due to bankruptcy filing by borrower actually authorized the filing), *aff'd*, *Five Mile Capital II SPE LLC v. Cerberus Capital Mgmt. (In re Extended Stay Inc.)*, 435 B.R. 139 (S.D.N.Y. 2010).

THE THIRD CIRCUIT WEIGHS IN AGAIN ON THE MEANING OF "UNREASONABLY SMALL CAPITAL" IN CONSTRUCTIVELY FRAUDULENT TRANSFER AVOIDANCE LITIGATION

Jane Rue Wittstein and Mark G. Douglas

In the November/December 2014 edition of the *Business Restructuring Review*, we discussed a decision handed down by the U.S. District Court for the District of Delaware addressing the meaning of "unreasonably small capital" in the context of constructively fraudulent transfer avoidance litigation. In *Whyte ex rel. SemGroup Litig. Trust v. Ritchie SG Holdings, LLC (In re SemCrude, L.P.)*, 526 B.R. 556 (D. Del. 2014), the district court upheld a bankruptcy court's reaffirmation of two guiding principles in this context: (i) a debtor can have unreasonably small capital even if it is solvent; and (ii) a "reasonable foreseeability" standard should be applied in assessing whether capitalization is adequate. A three-judge panel of the Third Circuit Court of Appeals affirmed the decision in *In re SemCrude, L.P.*, 2016 BL 135006 (3d Cir. Apr. 29, 2016).

AVOIDANCE OF FRAUDULENT TRANSFERS IN BANKRUPTCY

Section 548(a)(1) of the Bankruptcy Code authorizes a trustee or chapter 11 debtor-in-possession ("DIP") to avoid any transfer of an interest of the debtor in property or any obligation incurred by the debtor within the two years preceding a bankruptcy filing if: (i) the transfer was made, or the obligation was incurred, "with actual intent to hinder, delay, or defraud" any creditor; or (ii) the transaction was "constructively fraudulent" because the debtor received "less than a reasonably equivalent value in exchange for such transfer or obligation" and was, among other things, insolvent, left with "unreasonably small capital," or unable to pay its debts as such debts matured, when or immediately after the transfer was made or the obligation was incurred.

For one of these categories of constructive fraud, section 548(a)(1)(B)(ii)(II) provides that a transfer or obligation, if made or incurred by the debtor without an exchange of reasonably equivalent value, may be avoided if, among other things, the debtor "was engaged in business or a transaction, or was about to engage in business or a transaction, for which any property remaining with the debtor was an unreasonably small capital."

Transfers or obligations may also be avoided under analogous state laws by operation of section 544(b) of the Bankruptcy Code, which empowers a DIP or trustee to "avoid any transfer of an interest of the debtor in property or any obligation incurred by the debtor that is voidable under applicable law by a creditor holding an unsecured claim" against the debtor. Examples of such laws are the versions of the Uniform Voidable Transactions Act (the "UVTA"), until 2014 known as the Uniform Fraudulent Transfer Act (the "UFTA"), and the Uniform Fraudulent Conveyance Act (the "UFCA") that have been adopted by most states.

The UFTA (which currently is in force in 35 states, the District of Columbia, and the U.S. Virgin Islands) and the UVTA, which has been adopted by nine states, include the phrase "the remaining assets of the debtor were unreasonably small in relation to the business or transaction" in place of the corresponding language regarding "unreasonably small capital" in section 548(a)(1)(B)(ii)(II). *See* UFTA § 4(a)(2)(i); UVTA § 4(a)(2)(i). The older UFCA, which remains in effect only in New York and Maryland, tracks the "unreasonably small capital" language in section 548(a)(1)(B)(ii)(II). *See* N.Y. Debt. & Cred. L. § 274.

The Bankruptcy Code and the UFCA do not define "unreasonably small capital," nor do the UFTA and the UVTA define "unreasonably small" assets. This has been left largely to the courts.

The leading case on this issue is *Moody v. Security Pacific Business Credit, Inc.*, 971 F.2d 1056 (3d Cir. 1992). In *Moody*, the Third Circuit expressed the concept as follows:

> [A]n "unreasonably small capital" would refer to the inability to generate sufficient profits to sustain operations. Because an inability to generate enough cash flow to sustain operations must precede an inability to pay obligations as they become due, unreasonably small capital would seem to encompass financial difficulties short of equitable insolvency.

Id. at 1070 (footnote omitted). The Third Circuit further explained that, because a debtor's cash flow projections tend to be optimistic, the reasonableness of projections "must be tested by an objective standard anchored in the company's actual performance." According to the court, relevant data include

cash flow, net sales, gross profit margins, and net profits or losses, but "reliance on historical data alone is not enough." *Id.* at 1073. The Third Circuit wrote that "parties must also account for difficulties that are likely to arise, including interest rate fluctuations and general economic downturns, and otherwise incorporate some margin for error." *Id.*

As explained by the court in *Autobacs Strauss, Inc. v. Autobacs Seven Co. (In re Autobacs Strauss, Inc.)*, 473 B.R. 525, 552 (Bankr. D. Del. 2012), in accordance with *Moody*, "Reasonable foreseeability is the standard." Because the term is "fuzzy, and in danger of being interpreted under the influence of hindsight bias," courts should resist the temptation to "suppose that because a firm failed it must have been inadequately capitalized." *Boyer v. Crown Stock Distributions, Inc.*, 587 F.3d 787, 794 (7th Cir. 2009) (citing *Moody*).

Many other courts have also endorsed *Moody*'s articulation of the meaning of "unreasonably small capital." *See*, *e.g.*, *Global Outreach, S.A. v. YA Global Invs., LP (In re Global Outreach, S.A.)*, 2014 BL 275891, *15 (Bankr. D.N.J. Oct. 2, 2014); *Gilbert v. Goble (In re N. Am. Clearing, Inc.)*, 2014 BL 271090, *8 (Bankr. M.D. Fla. Sept. 29, 2014); *Tronox Inc. v. Kerr-McGee Corp. (In re Tronox Inc.)*, 503 B.R. 239, 320 (Bankr. S.D.N.Y. 2013).

A leading bankruptcy treatise supplements *Moody*'s formulation of the definition of "unreasonably small capital" with the following commentary:

> Adequate capitalization is also a variable concept according to which specific industry of business is involved. The nature of the enterprise, normal turnover of inventory rate, method of payment by customers, etc[.], from the standpoint of what is normal and customary for other similar businesses in the industry, are all relevant factors in determining whether the amount of capital was unreasonably small at the time of, or immediately after, the transfer.

COLLIER ON BANKRUPTCY ¶ 548.05[3][b] (16th ed. 2016).

SEMCRUDE

SemGroup, L.P. ("SemGroup"), at one time the fifth-largest privately held U.S. company, was a "midstream" energy company that provided transportation, storage, and distribution of oil and gas products to oil producers and refiners. SemGroup's general partner was SemGroup G.P., L.L.C. ("SGP"). Approximately 25 percent of SemGroup's limited partnership interests were held by Ritchie SG Holdings, L.L.C., and two affiliates (collectively, "Ritchie").

More than 100 lenders formed a syndicate (the "bank group") that provided SemGroup with a line of credit from 2005 through July 2008.

SemGroup also traded options on oil-based commodities, using a trading strategy that was inconsistent with both its risk management policy and the agreement governing its line of credit (the "credit agreement"). In addition, SemGroup made advances on an unsecured basis to fund trading losses incurred by Westback Purchasing Company, L.L.C. ("Westback"), a company owned by SemGroup's CEO and his wife, without any loan documentation calling for payment of principal or interest.

In August 2007 and February 2008, SemGroup and SGP paid Ritchie more than $55 million in distributions with respect to Ritchie's limited partnership interests. Because oil prices between July 2007 and February 2008 were volatile, SemGroup was obligated to post large margin deposits on the options it sold, which forced the company to increase its borrowing under the credit agreement from $800 million to more than $1.7 billion.

In July 2008, the bank group declared SemGroup in default of the credit agreement. SemGroup filed for chapter 11 protection on July 22, 2008, in the District of Delaware.

SemGroup's confirmed chapter 11 plan became effective in November 2009. The plan provided for, among other things, the creation of a litigation trust to prosecute avoidance claims belonging to the bankruptcy estate. In 2010, the litigation trustee sued Ritchie, seeking to avoid the $55 million in distributions as constructively fraudulent transfers under section 548(a) of the Bankruptcy Code and Oklahoma's version of the UFTA. The trustee alleged in the complaint, among other things, that SemGroup was left with unreasonably small capital after both distributions.

Bankruptcy judge Brendan L. Shannon granted summary judgment in favor of Ritchie on the "unreasonably small capital" issue. He concluded that, because all available sources of

capital, including bank lines, should be considered when determining whether a company is adequately capitalized, there was no serious dispute that SemGroup had adequate capital and liquidity to operate after the distributions to Ritchie. Judge Shannon also found that there was no evidence that SemGroup had engaged in fraud or that the bank group had declared SemGroup in default due to the company's options trading or the Westback payments.

The litigation trustee appealed to the district court.

THE DISTRICT COURT'S RULING

The district court affirmed on appeal. After examining the standard articulated in *Moody*, Judge Sue L. Robinson emphasized that " 'there must be a causal relationship between the [fraudulent transfer] and the likelihood that the Debtor's business will fail . . . [and that a] debtor's later failure, alone, is not dispositive on the issue' " (quoting *In re Kane & Kane*, 2013 BL 79573 (Bankr. S.D. Fla. Mar. 25, 2013)). According to the district court, "unreasonably small capital" refers to problems that " 'are short of insolvency in any sense but are likely to lead to insolvency at some time in the future' " (quoting *In re Tronox*, 503 B.R. 239, 320 (Bankr. S.D.N.Y. 2013)).

Judge Robinson found no error in the bankruptcy court's conclusion that SemGroup's substantial line of credit should be considered in assessing whether the company was adequately capitalized. She rejected the litigation trustee's argument that the complaint raised a material disputed fact concerning whether it was reasonably foreseeable that SemGroup would be unable to sustain its operations due to its "massive breach" of the credit agreement:

> It is not clear from the record whether or not the Bank Group was aware of the business activities identified by appellant as being inconsistent with SemGroup's obligations under the Credit Agreement. . . . As recognized by the bankruptcy court, however, it makes no difference. If the Bank Group was aware of such, appellant's position collapses on itself, for there is no forecast to make—SemGroup's access to credit had not been withdrawn at the time of either of the distributions despite the "massive" breach of the Credit Agreement. If the Bank Group was not aware of such activities, one has to engage in multiple levels of forecasting in order to embrace appellant's position. . . . [A]ppellant would have the court, in effect, forecast (1) the lenders' reaction to discovering the conduct, and then (2) the consequences of that reaction, i.e., that the only option chosen by all of the lenders would have been to foreclose access to all credit, which (3) had the reasonably foreseeable consequence of bankruptcy.

Judge Robinson agreed with the bankruptcy court that "what appellant proposes is a 'speculative exercise' not rooted in the case law." Once more, the litigation trustee appealed.

THE THIRD CIRCUIT'S RULING

A three-judge panel of the Third Circuit affirmed in a nonprecedential ruling for substantially the same reasons articulated by the lower courts. Writing for the panel, circuit judge Thomas I. Vanaskie wrote that "[a]bsent the bias of hindsight, it simply cannot be said that SemGroup was likely to be denied access to a credit facility that had been in place while it was engaging in the allegedly improper trading strategy." Under the circumstances, the judge explained, it cannot be said that it was reasonably foreseeable that SemGroup's capitalization was unreasonably small because the company would forfeit the ability to draw on its credit facility.

The Third Circuit panel also briefly considered Ritchie's argument that the rulings below should be affirmed because the indenture trustee failed to show a causal link between the equity distributions and the adequacy of SemGroup's capitalization—i.e., that the distributions were the cause of undercapitalization. Judge Vanaskie acknowledged that "[t]here may be some force to this argument." However, he concluded that the court need not resolve the question "because it cannot be shown that it was reasonably foreseeable at the time of the equity distributions that SemGroup would lack adequate access to capital."

OUTLOOK

Even though the Third Circuit's ruling is not precedential, *SemCrude* provides important guidance in avoidance litigation involving constructively fraudulent transfers. Determining whether a debtor has unreasonably small capital as a consequence of a transfer or obligation that is later challenged as being constructively fraudulent is a fact-intensive inquiry.

Guided by *Moody*, the Third Circuit as well as the lower courts in *SemCrude* reinforced the widely held recognition in the courts that: (i) "unreasonably small capital" is something less than insolvency but is likely to lead to insolvency at some time in the future; and (ii) it is not enough for a company to have small capital—there must also be a "reasonable foreseeability" that a corporation does not have sufficient capital to sustain its business.

The Second Circuit recently handed down a ruling reaffirming these basic concepts in *Adelphia Recovery Tr. v. FPL Grp., Inc. (In re Adelphia Commc'ns Corp.)*, 2016 BL 190083 (2d Cir. June 15, 2016). In *Adelphia*, the Second Circuit affirmed lower court rulings that the assets of defunct cable services provider Adelphia Communications Corp. ("Adelphia") were not "unreasonably small" within the meaning of Pennsylvania's version of the UFTA when Adelphia repurchased its stock in 1999.

The Second Circuit rejected Adelphia's argument that the lower courts "improperly conflated" their analysis of Adelphia's solvency with their analysis of the adequacy of the company's capital. Concluding that the "unreasonably small" test focuses on reasonable foreseeability and that the test is met if the debtor shows it had such minimal assets that insolvency was "inevitable in the foreseeable future," the Second Circuit determined that Adelphia's legal argument was without merit.

In particular, the court concluded that, although insolvency and unreasonably small capital are analytically distinct, the concepts overlap and "adequacy of capital is typically a major component of any solvency analysis." According to the Second Circuit, the lower courts analyzed Adelphia's solvency separately from the adequacy of its capital and properly relied on some of the same key facts to support their findings on both of these issues.

IN HEAD-TO-HEAD CONTEST BETWEEN SEPARATE DEBTORS IN BANKRUPTCY, RIGHT TO REJECT EXECUTORY CONTRACT PREVAILS

Joseph A. Florczak

A recent dispute in the U.S. Bankruptcy Court for the Eastern District of Missouri addressed a somewhat novel question of bankruptcy law: What is the proper standard of review when a debtor in a chapter 11 case wants to reject a contract with a counterparty that is also a chapter 11 debtor in a different bankruptcy court and that wishes to assume the same contract? According to the court in *In re Noranda Aluminum, Inc.*, 549 B.R. 725 (Bankr. E.D. Mo. 2016), the "business judgment" standard applies to determine whether rejection should be authorized, rather than a "balancing of the equities" test.

A SALES CONTRACT BURDENSOME TO ONE DEBTOR AND ESSENTIAL TO ANOTHER

The treatment of a long-term sales contract for bauxite used in the initial phases of aluminum manufacturing was the central issue in this duel of competing bankruptcy cases. Noranda Bauxite Ltd. ("NBL") is a debtor affiliate of Noranda Aluminum, Inc. ("Noranda") in their jointly administered chapter 11 cases in the Eastern District of Missouri.

NBL is a Jamaican company whose principal business is the operation of a bauxite mine in Discovery Bay, Jamaica. Bauxite is the principal raw material used in the refining and manufacture of aluminum primary-metals products. NBL's operations provided substantially all the bauxite used in Noranda's upstream primary-metals business, as well as bauxite for sales to third-party metal producers. Among NBL's principal third-party customers was Sherwin Alumina Company, LLC ("Sherwin").

Sherwin's principal business is the operation of a facility to refine bauxite in Gregory, Texas (the "Gregory Facility"). The Gregory Facility is intentionally located on the Gulf of Mexico to facilitate easy access to bauxite mined in Jamaica. The facility was also designed and engineered for the particular features of Jamaican bauxite, which requires more energy and specific processes than bauxite mined in other locations.

In December 2012, NBL and Sherwin entered into a long-term sale-purchase agreement by which Sherwin would purchase bauxite from NBL through 2018 (the "Bauxite Contract"). Under the terms of the Bauxite Contract, Sherwin would purchase bauxite from NBL at a price indexed to Mineração Rio do Norte

("MRN"), a floating reference point that is pegged to the market price for bauxite set by the largest Brazilian bauxite producer. Reflecting the additional effort required to refine Jamaican bauxite as compared to other sources, NBL agreed to a sales price of 73 percent of MRN.

Sherwin viewed the Bauxite Contract as essential to its business viability. The Bauxite Contract provided 65 percent of the total bauxite used in Sherwin's operations. Moreover, Sherwin viewed obtaining bauxite from different sources as wholly impractical, given the location of its operations on the Gulf Coast and because the Gregory Facility is specially engineered to refine Jamaican bauxite. Sherwin estimated that obtaining bauxite from an alternative source might be 50 percent more expensive, not including an estimated $10 million to retool the Gregory Facility to process non-Jamaican bauxite. In brief, without the Bauxite Contract, Sherwin judged that it would likely have to cease operations, which would likely result in the loss of more than 1,000 jobs on the Texas Gulf Coast.

In contrast, NBL viewed the Bauxite Contract as economically burdensome. NBL's cost per ton to mine, process, and transport the bauxite from its Jamaican mines exceeded the sale price. In other words, NBL lost money on every ton of bauxite that it shipped under the terms of the Bauxite Contract with Sherwin. In addition, the terms of NBL's chapter 11 debtor-in-possession ("DIP") financing agreement required NBL to reject the Bauxite Contract. Although NBL did not view the rejection of the Bauxite Contract as a central component of its restructuring, the company determined that rejection of the contract might allow NBL to enter into a new agreement with Sherwin or another third-party buyer at more favorable rates.

Sherwin filed for chapter 11 protection in January 2016 in the Southern District of Texas. In the first days of its bankruptcy case, given the importance of the Bauxite Contract to its operations, Sherwin moved to assume the Bauxite Contract pursuant to section 365 of the Bankruptcy Code. Less than a month later, in February 2016, NBL filed its own chapter 11 case. Contending that the Bauxite Contract was economically unfavorable, NBL sought court authority to reject the Bauxite Contract. Accordingly, the conflicting motions set up a duel between the two chapter 11 cases.

ASSUMPTION AND REJECTION UNDER SECTION 365 OF THE BANKRUPTCY CODE

Under section 365 of the Bankruptcy Code, a bankruptcy trustee or DIP may, among other things, "assume" or "reject" executory contracts or unexpired leases (agreements with respect to which material obligations remain for each contract party). Generally speaking, the assumption of an executory contract or unexpired lease restores the terms and enforceability of the agreement, provided that any defaults under the agreement are cured, among certain other conditions. In contrast, the rejection of an executory contract operates as a deemed breach of the contract effective immediately before the filing of the bankruptcy petition, with the nonbreaching counterparties receiving prepetition damages claims on account of such rejection in the bankruptcy case.

The underlying policy consideration of this framework is to allow a trustee or DIP to maximize the value of the bankruptcy estate by assuming contracts that are beneficial to the bankruptcy estate and rejecting contracts that pose an economic burden to the estate.

The Business Judgment Standard

In nearly every circumstance, a bankruptcy court will evaluate a decision by a trustee or DIP to assume or reject a contract according to the "business judgment" standard. Under this deferential standard, the court will not substitute its own judgment so long as the decision reflects a rational business purpose and lacks any indicia of fraud, insider dealing, or other forms of abuse.

In the Eighth Circuit, which encompasses the district where Noranda's chapter 11 case is pending, the business judgment standard has two prongs: the assumption or rejection must (i) be in the exercise of sound business judgment, showing benefit to the estate; and (ii) not involve bad faith or gross abuse of business discretion. *See In re Crystalin, L.L.C.*, 293 B.R. 455 (B.A.P. 8th Cir. 2003).

Balancing of the Equities Test

In its objection to NBL's motion to reject the Bauxite Contract, Sherwin argued that a "balancing of the equities" test should be applied in cases where one chapter 11 debtor seeks to assume a contract which another chapter 11 debtor seeks to reject, citing the 1980s-era decisions in *In re Midwest Polychem, Ltd.*, 61 B.R. 559 (Bankr. N.D. Ill. 1986); *In re H.M. Bowness, Inc.*, 89 B.R. 238, 242 (Bankr. M.D. Fla. 1988); and *In re Sun City Investments, Inc.*, 89 B.R. 245, 249 (Bankr. M.D. Fla. 1988). Under this test, Sherwin argued, the court should balance the relative benefits and/or harms to each of the bankruptcy estates that would be caused by assumption or rejection of the contract at issue. Using such a framework, Sherwin maintained, a court could

properly deny rejection of a contract if rejection would "mortally wound" the business of one chapter 11 debtor and produce only a marginal benefit for the other chapter 11 debtor.

THE BANKRUPTCY COURT'S RULING—THE BUSINESS JUDGMENT TEST PREVAILS

The *Noranda Aluminum* bankruptcy court declined to adopt the balancing of the equities test, noting that the cases applying it were neither current nor binding precedent. Moreover, the court observed that the *Midwest Polychem* court did not choose between the business judgment standard and the balancing of the equities test, as that court's determination was the same under either standard. The *Noranda Aluminum* court also noted that a careful reading of *H.M. Bowness* and *Sun City* indicates that those courts actually applied the business judgment standard.

The *Noranda Aluminum* court also rejected Sherwin's arguments in the alternative, asserting that application of the business judgment standard in this "extreme case" would require consideration of the potential impact on the contract counterparty in certain exceptional circumstances. The court acknowledged that a higher standard may apply when a debtor's authority to reject a contract would conflict with "policies designed to protect the national interest underlying federal regulatory schemes." However, it found that no such interests were implicated in NBL's proposed rejection of the Bauxite Contract. According to the court, the Bankruptcy Code creates special protections for certain types of executory contracts or unexpired leases, including intellectual property license agreements (section 365(n)), collective bargaining agreements (section 1113), aircraft leases (section 1110), and railroad line leases (sections 1165 and 1169), none of which the Bauxite Contract implicated.

OUTLOOK

Despite the court's professed sympathy for Sherwin's plight, its analysis in *Noranda Aluminum* adheres closely to the long-established principles and policy rationale of the business judgment rule. The court flatly rejected the argument that a court must consider the impact of the rejection of a contract on the contract counterparty, at least under the circumstances presented. The ruling suggests that, in competing bankruptcy cases, a trustee or DIP's right to reject an executory contract or unexpired lease as an exercise of business judgment trumps the desire of a different trustee or DIP to assume the same contract.

LEGISLATIVE UPDATE

On June 30, 2016, President Obama gave his imprimatur to the Puerto Rico Oversight, Management, and Economic Stability Act, Pub. L. No. 114-187 (2016) ("PROMESA") (H.R. 5278 and S. 2328). The bipartisan legislation was approved by both Houses of Congress in a flurry of legislative dealmaking that preceded a July 1, 2016, deadline for Puerto Rico to make $2 billion in bond payments. Despite the passage of PROMESA, Puerto Rico defaulted on its constitutionally guaranteed debt for the first time on July 1.

The enactment of PROMESA followed a June 13, 2016, ruling by the U.S. Supreme Court that upheld lower court rulings declaring unconstitutional a 2014 law, portions of which mirrored chapter 9 of the Bankruptcy Code, which law would have allowed the commonwealth's public instrumentalities to restructure a significant portion of Puerto Rico's bond debt (widely reported to be as much as $72 billion). *See Commonwealth v. Franklin Cal. Tax-Free Tr.*, 2016 BL 187308 (U.S. June 13, 2016) (discussed elsewhere in this edition of the *Business Restructuring Review*).

Among other things, PROMESA provides for the establishment of an Oversight Board entrusted with determining the adequacy of budgets and fiscal plans for the instrumentalities of Puerto Rico and other covered territories. It also provides a mechanism for the implementation of voluntary out-of-court restructuring agreements between an instrumentality and its bondholders as well as bond debt adjustment plans (consensual and nonconsensual) in a case commenced in federal district court.

Set forth below is a brief summary of PROMESA's most important provisions.

Effective Date	June 30, 2016
Covered Territories	Puerto Rico, Guam, American Samoa, the Commonwealth of the Northern Mariana Islands, and the United States Virgin Islands.
Oversight Board	An oversight board consisting of seven members appointed by the president for a three-year term (subject to renewal).
Powers of the Oversight Board	The Oversight Board has the power to, among other things: • Require the governor of a covered territory, including Puerto Rico ("PR," for ease of reference), to submit budgets and monthly reports regarding the commonwealth's instrumentalities; • Approve fiscal plans that provide a method to achieve fiscal responsibility and access to capital markets; • Ensure that the assets of an instrumentality are not loaned to, transferred to, or otherwise used for the benefit of PR or its instrumentalities unless permitted by the Constitution or agreed to in a certified voluntary restructuring agreement or an approved adjustment plan; • Approve annual budgets, failing which the board shall have the power to make appropriate reductions in nondebt expenditures to ensure that actual quarterly revenues and expenditures are in compliance, institute automatic hiring freezes, and prohibit PR from entering into any contract or engaging in any financial or other transactions without board approval; • Disclose information regarding the identity of creditors and their claims; • Certify a voluntary restructuring agreement between an instrumentality and bondholders holding a majority in principal amount of its bonds, provided the Oversight Committee determines that the agreement provides for a sustainable level of debt for the instrumentality and is in conformance with a certified fiscal plan; • Commence a voluntary case under PROMESA on behalf of an eligible instrumentality by filing a petition with the district court; • Certify voluntary restructuring agreements between PR and its bondholders; • Certify a plan of adjustment between PR and creditors as being consistent with the applicable certified fiscal plan; • Exercise the exclusive right to propose or modify debt adjustment plans; • Ensure the prompt and efficient payment and administration of taxes through adoption of electronic reporting, payment, and auditing technologies; • Approve or deny any proposal by PR or an instrumentality to issue debt or guarantee, exchange, modify, repurchase, redeem, or enter into similar transactions with respect to its debt; • Analyze materially underfunded pension liabilities of PR or its instrumentalities; and • Approve (with the votes of at least five members) an instrumentality as an eligible debtor for purposes of a debt adjustment plan.
Termination of the Board	The Oversight Board shall terminate upon certification that PR has adequate access to short- and long-term markets at reasonable rates, that PR has developed an approved budget for at least four years, and that expenditures did not exceed revenues during that period.
No U.S. Government Guarantee	The full faith and credit of the U.S. is not pledged for the payment of any bond, note, or other obligation issued by PR or its instrumentalities after the enactment of PROMESA.
Preemption	PROMESA preempts any PR law purporting to implement a binding composition of indebtedness or moratorium without the consent of creditors.
Jurisdiction	The federal district courts shall have exclusive jurisdiction over all cases brought under PROMESA.

Bankruptcy Code Provisions Applicable in PROMESA Cases	Sections 101 (with certain exceptions), 102, 104, 105, 106, 107, 108, 112, 333, 344, 347(b), 349, 350(b), 351, 361, 362, 364(c), 364(d), 364(e), 364(f), 365, 366, 501, 502, 503, 504, 506, 507(a)(2), 509, 510, 524(a)(1), 524(a)(2), 544, 545, 546, 547, 548, 549(a), 549(c), 549(d), 550, 551, 552, 553, 555, 556, 557, 559, 560, 561, 562, 902 (with certain exceptions), 922, 923, 924, 925, 926, 927, 928, 942, 944, 945, 946, 1102, 1103, 1109, 1111(b), 1122, 1123(a)(1), 1123(a)(2), 1123(a)(3), 1123(a)(4), 1123(a)(5), 1123(b), 1123(d), 1124, 1125, 1126(a), 1126(b), 1126(c), 1126(e), 1126(f), 1126(g), 1127(d), 1128, 1129(a)(2), 1129(a)(3), 1129(a)(6), 1129(a)(8), 1129(a)(10), 1129(b)(1), 1129(b)(2)(A), 1129(b)(2)(B), 1142(b), 1143, 1144, 1145, and 1146(a) apply in a PROMESA case, and section 930 shall also apply (governing dismissal of a case), except during the first 120 days after the petition date.
Confirmation of Plan of Adjustment	To be confirmable, a plan of adjustment must: • Be feasible and in the best interests of creditors, upon consideration of whether available remedies under nonbankruptcy law and the PR Constitution would result in greater recovery for creditors than the recoveries provided under the plan; • Be consistent with the approved fiscal plan; and • Satisfy the requirements of section 1129(a) of the Bankruptcy Code, unless only a single class of impaired claims has not accepted the plan, which must be fair and equitable and must not discriminate unfairly with respect to the impaired class.
Automatic Stay	PROMESA provides that, effective upon enactment, and subject to a police and regulatory powers exception for governmental units, there shall be an automatic stay of all creditor collection efforts against PR and its instrumentalities until the later of February 15, 2017, or six months after the establishment of the Oversight Board. Certain extensions of the duration of the stay are permitted. Relief from the stay may be granted by the court for "cause." The stay terminates automatically 45 days after a request for stay relief is made unless the court orders otherwise. Parties providing goods and services to PR or its instrumentalities must continue to perform under their contracts during the pendency of the stay, provided that PR or the instrumentality is not in default other than as a consequence of its insolvency or financial condition. If the Oversight Board determines it is feasible, PR shall continue to make interest payments on debt during the pendency of the stay.
Liability of Transferees	Transferees of PR or instrumentality property in violation of any applicable law for the benefit of creditors or security agreement shall be liable for the value of the property transferred.
Solicitation of Plan	Solicitation of votes on a proposed plan of adjustment must be accompanied by any approved fiscal plan and any other information required under applicable securities laws.
Voting on Plan and Binding Effect	A plan of adjustment is accepted by bondholders if the holders of at least two-thirds of the principal amount of bonds in each "pool" of bonds (secured, unsecured, guaranteed, and nonguaranteed bonds generally being separately classified) vote to accept the plan. Modification of the rights of bondholders under a plan of adjustment shall be binding on all holders of a series of bonds, whether or not they consent, if: (i) eligible voting bondholders in each pool vote to accept the plan by the requisite majority; and (ii) the Oversight Board certifies that (a) the voting requirements have been satisfied, (b) the proposed modification provides for, among other things, a sustainable level of debt, and (c) any dissenting secured bondholder will retain the liens securing its bonds or will receive on account of its bond claim, through deferred cash payments, substitute collateral or otherwise value equivalent to the lesser of the face amount of its claim or the value of its collateral.

THE THIRD CIRCUIT RULES THAT TENDER OFFER PRIOR TO CONFIRMATION OF CHAPTER 11 PLAN IS NOT PROHIBITED BY THE BANKRUPTCY CODE

Charles M. Oellermann and Mark G. Douglas

In the March/April 2015 issue of the *Business Restructuring Review*, we discussed a ruling by the U.S. District Court for the District of Delaware addressing the propriety of an unusual pre-confirmation tender offer in the chapter 11 cases of Energy Future Holding Corporation and its affiliates (collectively, "Energy Future"). In that ruling, *Del. Trust Co. v. Energy Future Intermediate Holdings, LLC (In re Energy Future Holding Corp.)*, 527 B.R. 157 (D. Del. 2015), the district court affirmed a bankruptcy court order approving a settlement between Energy Future and certain secured noteholders. The vehicle for the settlement was a postpetition tender offer of old notes for new notes to be issued under a debtor-in-possession ("DIP") financing facility. The district court ruled that a tender offer may be used to implement a classwide debt exchange in bankruptcy outside a plan of reorganization. It also held that the Bankruptcy Code's confirmation requirements do not apply to a pre-confirmation settlement and that the settlement at issue did not constitute a *sub rosa* chapter 11 plan.

The U.S. Court of Appeals for the Third Circuit recently affirmed the district court's decision. In *In re Energy Future Holding Corp.*, 2016 BL 142290 (3d Cir. May 4, 2016), a three-judge panel of the Third Circuit ruled in a nonprecedential opinion (per the court's designation) that a pre-confirmation tender offer "is not precluded by the Bankruptcy Code and [that] the Bankruptcy Court acted within its discretion to approve the offer as a means to settle certain claims against the estate." The court also ruled that the settlement was neither "inconsistent with the equal treatment rule" nor a *sub rosa* plan.

TENDER OFFERS AND SECURITIES LAW EXEMPTIONS IN BANKRUPTCY

Debt-for-equity swaps and debt exchanges are common features of out-of-court as well as chapter 11 restructurings. For publicly traded securities, out-of-court restructurings in the form of "exchange offers" or "tender offers" are, absent an exemption, subject to the rules governing an issuance of new securities under the Securities Act of 1933 (the "SA") as well as the SA tender offer rules. By contrast, it is generally understood that the SA rules do not apply if an exchange or tender offer takes place as part of a restructuring under chapter 11 of the Bankruptcy Code, which provides in section 1145 that certain federal and state securities laws do not apply to the offer or sale of securities under a chapter 11 plan.

ENERGY FUTURE

Known as TXU Corp. until 2007, when it was acquired in what was then the largest leveraged buyout ever, Texas-based Energy Future filed for chapter 11 protection on April 29, 2014, in the District of Delaware to implement a restructuring that would split the company between groups of creditors and eliminate more than $26 billion in debt. Energy Future is organized into two principal businesses, one of which is Energy Future Intermediate Holdings, LLC ("EFIH"). EFIH owns 80 percent of Oncor Electric Delivery Co. LLC, the largest regulated utility in Texas.

EFIH's capital structure includes $4 billion of first-lien notes, $2.2 billion of second-lien notes, and $1.7 billion of unsecured notes. The first-lien notes consist of two separate tranches: $3.5 billion of 10 percent notes due 2020 (the "10% Notes") and $500 million of 6-7/8 percent notes due 2017 (the "6-7/8% Notes"). Both issuances of first-lien notes include identical "make-whole" provisions that protect the noteholders from early redemption. However, the amounts of the make-whole premiums payable in respect of the 10% Notes and the 6-7/8% Notes differ to account for the different interest rates and maturity dates governing the instruments.

On the bankruptcy petition date, Energy Future filed a restructuring support and lockup agreement that documented a broad settlement reached among Energy Future and various creditors. This "global settlement" included a settlement between Energy Future and some of the first-lien noteholders (the "first-lien settlement") that was to be implemented by means of a postpetition "tender offer." The tender offer proposed a "roll-up"—an exchange of existing first-lien notes for new notes bearing a lower interest rate to be issued under a $5.4 billion DIP financing facility.

In exchange for new notes valued at 105 percent of outstanding principal and 101 percent of accrued interest, participating noteholders would agree to release their make-whole premium claims (the allowance of which in bankruptcy was disputed by Energy Future). However, although the settlement offered all first-lien noteholders principal and accrued interest premiums as an inducement to settle their claims for a make-whole premium, the amounts the two classes of noteholders would

receive compared to "the maximum potential value" of their make-whole claims (the "MPV") were unequal, due to the varying principal amounts and maturities. Specifically, for holders of the 6-7/8% Notes (the "6-7/8% Noteholders"), 5 percent of their principal represented 64 percent of the MPV, whereas for the holders of the 10% Notes (the "10% Noteholders"), 5 percent of principal amounted to only 27 percent of the MPV.

Ninety-seven percent of the 6-7/8% Noteholders and 34 percent of the 10% Noteholders accepted the tender offer. While settling noteholders released the disputed make-whole claims, non-settling noteholders retained the right to litigate the validity of their make-whole premium claims.

On the basis of these results, the bankruptcy court approved the first-lien settlement under Fed. R. Bankr. Proc. 9019 ("Rule 9019"). However, Energy Future subsequently abandoned the other elements of the global settlement.

The indenture trustee for the 10% Notes appealed the order approving the first-lien settlement, contending that: (i) Energy Future's use of a tender offer as the vehicle for the settlement was improper; (ii) approval of a settlement which offered disparate make-whole claim recoveries to similarly situated creditors violated section 1123(a)(4) of the Bankruptcy Code; and (iii) the first-lien settlement constituted an improper *sub rosa* chapter 11 plan.

THE DISTRICT COURT'S RULING

On appeal, the indenture trustee argued, among other things, that a tender offer is improper in a chapter 11 case because the Securities and Exchange Commission (the "SEC") plays only a limited role in chapter 11 bankruptcies, and it was improper for Energy Future "to invoke an SEC-governed procedure in lieu of seeking judicial approval to initiate the [first-lien settlement] offer." The district court rejected this argument. According to the court, pre-confirmation settlements are allowed under section 363(b) of the Bankruptcy Code and Rule 9019 as a way "to minimize litigation and expedite the administration of the bankruptcy estate." Moreover, it wrote, the Bankruptcy Code "does not impose any restrictions on a debtor's ability to propose pre-confirmation settlements."

A tender offer, the district court explained, is nothing more than "a vessel to comply with certain disclosure rules when offering securities publicly for sale or exchange," and the SEC's limited role in chapter 11 cases does not suggest that it is improper for a debtor to comply with securities laws. Section 1145 of the Bankruptcy Code, the court noted, delineates specific situations where certain federal and state securities laws do not apply to, among other things, the offer or sale of securities under a chapter 11 plan. Because section 1145 does not encompass pre-confirmation settlement offers, the court wrote, Energy Future may have "deemed it necessary to comply with the appropriate securities laws." According to the court, regardless of whether this assessment was correct, "the Court cannot accept the argument that the SEC's limited role in chapter 11 litigation somehow categorically forbids a debtor from complying with securities laws."

"Plans of reorganization," the district court concluded, "are not the exclusive mechanism to exchange debt or pay off existing creditors in chapter 11." Noting that the first-lien settlement was simply a roll-up of the first-lien notes with new DIP financing, the court ruled that the use of a tender offer to accomplish this exchange was not improper under bankruptcy law.

The district court also rejected the indenture trustee's contention that the first-lien settlement should not have been approved because it violated section 1123(a)(4) of the Bankruptcy Code—the "equal treatment" rule. Section 1123(a)(4) provides that a plan must "provide the same treatment for each claim . . . of a particular class, unless the holder of a particular claim . . . agrees to a less favorable treatment." By its express terms, the district court reasoned, section 1123(a)(4) applies only to plan confirmations. Although other courts have applied to pre-confirmation settlements certain chapter 11 plan confirmation requirements—such as the "absolute priority" rule (*see*, *e.g.*, *Motorola, Inc. v. Official Comm. of Unsecured Creditors (In re Iridium Operating LLC)*, 478 F.3d 452 (2d Cir. 2007); *United States v. AWECO, Inc. (In re AWECO, Inc.)*, 725 F.2d 293 (5th Cir. 1984))—the district court in *Energy Future* noted that courts in the Third Circuit (which includes the District of Delaware) have not adopted, and in some cases have expressly rejected, this approach.

Furthermore, the court explained, even if section 1123(a)(4) did apply in this context, the first-lien settlement did not violate the provision. As noted, section 1123(a)(4) permits creditors to agree to less favorable treatment of their claims. To the extent that the first-lien settlement treated the make-whole claims of the 10% Noteholders and the 6-7/8% Noteholders differently, the district court wrote, "those parties voluntarily accepted that treatment."

In addition, the district court concluded that the indenture trustee's interpretation of the phrase "equal treatment" was flawed. According to the district court, although the phrase is not "precisely" defined in the Bankruptcy Code or its legislative history, courts have interpreted "equal treatment" to mean that "all

claimants in a class must have the *same opportunity* for recovery" (citation omitted and emphasis added). Here, the court wrote, although the first-lien settlement treated the make-whole claims of the 10% Noteholders and the 6-7/8% Noteholders differently, "each noteholder had the opportunity to decline the settlement offer and litigate the full value of the claim."

Finally, the district court ruled that the first-lien settlement did not constitute an improper *sub rosa* chapter 11 plan. A *sub rosa* plan, the court explained, is a broad settlement that amounts to a de facto plan of reorganization but is not subject to the plan confirmation requirements and other creditor protections set forth in the Bankruptcy Code. Energy Future, however, withdrew its request for approval of the global settlement. Thus, the district court found that the indenture trustee failed to demonstrate how the first-lien settlement by itself "disposes of all claims against the estate or restricts creditors' rights to vote."

The district court accordingly affirmed the bankruptcy court's order approving the first-lien settlement. The indenture trustee appealed the ruling to the Third Circuit.

THE THIRD CIRCUIT'S RULING

A three-judge panel of the Third Circuit affirmed the rulings below for substantially the same reasons articulated by the district court.

Writing for the panel, circuit judge Patty Schwartz explained that, although the parties referred to the arrangement in question as a "tender offer," it was nothing more than a vehicle for conveying a settlement offer. She further noted that the indenture trustee failed to identify any section of the Bankruptcy Code that forbids settlements using a tender offer process, which has been used to settle claims in other bankruptcy cases, including *In re AMR Corp.*, 485 B.R. 279 (Bankr. S.D.N.Y. 2013); *In re Eastman Kodak Co.*, 479 B.R. 280 (Bankr. S.D.N.Y. 2012); and *In re Standard Oil & Expl. of Del., Inc.*, 136 B.R. 141 (Bankr. W.D. Mich. 1992).

Although the debtors in those cases sought approval from the court prior to launching their tender offers, Judge Schwartz wrote, "we see no reason to hold that the order of events dictates whether a settlement achieved by a tender offer is fair and equitable." Instead, the bankruptcy court "retains the discretion to determine whether the circumstances and timing surrounding an offer undermine its fairness." Here, Judge Schwartz concluded, the bankruptcy court appropriately exercised that discretion in approving the settlement.

The Third Circuit panel rejected the indenture trustee's argument that the tender offer process is incompatible with various provisions of chapter 11, including section 1125 (requiring court approval of a disclosure statement for solicitation of a plan), section 1126(c) (providing for class voting on and acceptance of plans), section 1128 (plan confirmation hearing), and chapter 11's "class-based" procedures for negotiating the terms of a plan. According to Judge Schwartz, "None of the sections apply to court-approved settlements entered before the plan confirmation process has begun . . . [and consequently], there is nothing to show [that] the use of such a process contravenes the Bankruptcy Code."

The Third Circuit panel also rejected the indenture trustee's contention that the settlement violated the "equal treatment" rule set forth in section 1123(a)(4) because various first-lien noteholders received different percentages of the potential full value of the make-whole premiums. Citing *In re Jevic Holding Corp.*, 787 F.3d 173 (3d Cir. 2015), Judge Schwartz explained that core bankruptcy principles applicable in the plan confirmation context, such as the absolute priority rule (section 1129(b)(2)) and the equal treatment rule, "are not categorically applied in the settlement context." Instead, she wrote, although a "settlement's fidelity to the requirements of the Bankruptcy Code will generally be the most important factor in determining whether a settlement is fair and equitable," a settlement may deviate from such rules if the bankruptcy court "ensur[es] the evenhanded and predictable treatment of creditors" and has "specific and credible grounds to justify the deviation" (citing *Jevic*, 787 F.3d at 178, 184).

According to the Third Circuit panel, the bankruptcy court properly concluded that there was in fact equal treatment because each first-lien noteholder was offered: (i) the same percentage of both principal and accrued interest; and (ii) the opportunity to retain its rights to seek a make-whole premium. This choice to participate or not, Judge Schwartz wrote, "is all that the Bankruptcy Code requires" (citing *In re W.R. Grace & Co.*, 729 F.3d 332, 344 (3d Cir. 2013) ("[C]ourts have interpreted the same treatment requirement to mean that all claimants in a class must have the same opportunity for recovery.")). She explained that "mere differences in potential final outcomes resulting from choices made by individual creditors do not violate the equal treatment protections of § 1123(a)(4)."

Finally, the Third Circuit panel ruled that, in the absence of evidence that uninvolved creditors' recoveries were impacted by the settlement or that any requirement of chapter 11 was

subverted by it, the settlement did not constitute a *sub rosa* chapter 11 plan.

OUTLOOK

Energy Future is a highly unusual case. In addition to being nonprecedential, the Third Circuit's ruling should not be read as an endorsement of the tender offer as a preferred vehicle for effectuating a debt restructuring in chapter 11. In fact, one of the principal advantages of chapter 11 over out-of-court restructurings for public companies is not having to comply with the registration requirements of laws that govern the offer or sale of securities outside bankruptcy. Compliance with such nonbankruptcy laws is generally unnecessary in the chapter 11 plan process in light of the Bankruptcy Code's disclosure requirements in connection with the solicitation of votes on a plan and the chapter 11 plan confirmation standards.

Energy Future filed for chapter 11 protection to implement a prenegotiated restructuring that contemplated a series of exchange offers, cash tender offers, and related transactions. Instead of attempting to implement the exchanges as part of a chapter 11 plan, Energy Future elected to seek court approval of the restructuring under Rule 9019 as part of a global settlement. Because the offers would not be subject to chapter 11's disclosure statement and plan confirmation requirements, Energy Future decided to comply with securities laws in making the offers, presumably to ward off objections directed toward the propriety of the process.

Why it chose this strategy is unclear. Perhaps it calculated that the transactions comprising the global settlement were more likely to be approved under the standards governing a Rule 9019 motion—in the Third Circuit, a settlement must be "fair and equitable" and "above the lowest point in the range of reasonableness" (*see In re Capmark Financial Group, Inc.*, 438 B.R. 471, 475 (Bankr. D. Del. 2010))—than under the more exacting chapter 11 plan confirmation requirements.

The Third Circuit's rejection of the approach employed by the Fifth Circuit (and, to a lesser extent, the Second Circuit) in applying plan confirmation requirements to pre-confirmation settlements is notable. To the extent that a proposed settlement does not comply with such requirements, it puts the burden squarely on objecting parties to demonstrate that the settlement is not fair and equitable.

FROM THE TOP IN BRIEF

The U.S. Supreme Court has handed down two rulings thus far in 2016 (October 2015 Term) involving issues of bankruptcy law. In the first, *Husky Int'l Elecs., Inc. v. Ritz*, 194 L. Ed. 2d 655, 2016 BL 154812 (2016), the Court addressed the scope of section 523(a)(2)(A) of the Bankruptcy Code, which bars the discharge of any debt of an individual debtor for money, property, services, or credit to the extent obtained by "false pretenses, a false representation, or actual fraud, other than a statement respecting the debtor's or an insider's financial condition."

In a 7-1 decision, the Court ruled that the term "actual fraud" in section 523(a)(2)(A) encompasses a fraudulent transfer even if the transfer does not involve a false representation by the debtor transferor. Writing for the majority, Justice Sonia Sotomayor explained that "actual fraud" does not require a false representation; rather, "anything that counts as 'fraud' and is done with wrongful intent is 'actual fraud.' " Indeed, she wrote, "actual fraud" has "long encompassed . . . a transfer scheme designed to hinder the collection of debt."

Justice Clarence Thomas dissented. In his dissenting opinion, Justice Thomas wrote that the majority departed "from the plain language of §523(a)(2)(A), as interpreted by our precedents," and that a close reading of the statute indicates that Congress did not intend to include fraudulent transfers in section 523(a)(2)(A).

In so ruling, the Court reversed a decision by the U.S. Court of Appeals for the Fifth Circuit and resolved a circuit split on the issue. The Fifth Circuit ruled that the "actual fraud" exception to a bankruptcy discharge under section 523(a)(2)(A) requires the debtor to make some kind of false representation to the creditor. *See Husky Int'l Elecs., Inc. v. Ritz (In re Ritz)*, 787 F.3d 312 (5th Cir. 2015). That ruling conflicted with a Seventh Circuit decision that actual fraud under 523(a)(2)(A) "is not limited to misrepresentations and misleading omissions." *See McClellan v. Cantrell*, 217 F.3d 890 (7th Cir. 2000).

Jones Day successfully argued *Husky* before the Supreme Court on behalf of the prevailing party—Husky International Electronics.

In its second bankruptcy ruling of 2016, *Commonwealth v. Franklin Cal. Tax-Free Tr.*, 2016 BL 187308 (U.S. June 13, 2016), the Court upheld a decision by the U.S. Court of Appeals for the First Circuit that legislation enacted by Puerto Rico in 2014 to provide debt relief to its public instrumentalities is unconstitutional. A detailed discussion of the ruling can be found elsewhere in this edition of the *Business Restructuring Review*.

On June 28, 2016, the Court granted a petition for a writ of certiorari in *Czyzewski et al. v. Jevic Holding Corp.*, No. 15-649 (June 28, 2016), in which it will review a ruling by the U.S. Court of Appeals for the Third Circuit upholding the "structured dismissal" of a chapter 11 case. *See Official Committee of Unsecured Creditors v. CIT Group/Business Credit Inc. (In re Jevic Holding Corp.)*, 2015 BL 160363 (3d Cir. May 21, 2015.

INTERNATIONAL LEGISLATIVE UPDATE

AUSTRALIAN INSOLVENCY LAW REFORM PROCESS CONTINUES

On December 7, 2015, the Australian government released its "National Innovation and Science Agenda" (the "Agenda"). In the Agenda, the government outlined its intention to make three significant reforms to Australia's insolvency laws, adopting the recommendations of the Productivity Commission in its report, "Business Set-up, Transfer and Closure," which was released on the same day as the Agenda. The proposed reforms include the following:

- Reducing the default bankruptcy period (the customary length of time before the debtor receives a discharge) for individuals from three years to one year;
- Introducing a "safe harbour" providing corporate directors with immunity from personal liability for insolvent trading under section 588G of the Corporations Act 2001 (the "Act") during the implementation of a restructuring plan; and
- Preventing the enforcement of "ipso facto" contractual clauses during a restructuring attempt.

Insolvency reforms of the kind proposed in the Agenda have long been welcomed in the industry. Indeed, there has been a widespread perception that directors have increasingly appointed voluntary administrators for companies at the first sign of financial trouble to take advantage of the defense to insolvent trading in sections 588H(5) and 588H(6) of the Act. Voluntary administration has in turn triggered the destruction of companies' enterprise value, as core creditors and suppliers have terminated their contracts in reliance on ipso facto clauses that apply when companies experience an "insolvency event." All too often, those companies have ultimately been liquidated to the detriment of employees and other unsecured creditors.

In advancing the reforms, the Australian government released a proposals paper entitled "Improving Bankruptcy and Insolvency Laws" (the "Proposals Paper") on April 29, 2016, for public consultation. Public submissions on the Proposals Paper closed on May 27. The new government is expected to advance the insolvency reforms by preparing draft legislation and actively engaging with stakeholders in what would appear to be the most significant adjustment to Australia's insolvency landscape in the last decade.

DECREE TO PROMOTE EFFICIENCY OF ITALIAN INSOLVENCY PROCEEDINGS

A recent decree issued by the Italian Council of Ministers would—if enacted in its current form by the Italian Parliament—establish provisions governing nonpossessory pledges of certain assets, permit extrajudicial appropriation of real estate assets used to secure financing, and raise efficiency levels for insolvency proceedings. During the last two years, the Italian government has focused on reforming the Italian lending market, with the aim of boosting access to financing for Italian businesses and improving bankruptcy and enforcement proceedings in Italy. As part of this reform process, the Italian Council of Ministers enacted Decree No. 59 of 3 May 2016 (the "Decree"). The Decree introduces measures designed to, among other things: (i) create a new form of security—a "nonpossessory pledge," or floating charge; (ii) establish the "*patto marciano*" agreement, which permits extrajudicial foreclosure on real property collateral; and (iii) expedite and improve the efficiency of enforcement and insolvency proceedings.

UNITED KINGDOM LEGISLATION SOON EFFECTIVE TO EXPEDITE RECOVERY FROM INSOLVENT DEBTOR'S LIABILITY INSURERS

On August 1, 2016, six years after it received Royal Assent, the U.K. Third Parties (Rights against Insurers) Act 2010 (the "2010 Act") will finally come into force. It is expected to provide a more effective mechanism for third-party claimants to seek recovery directly from an insolvent debtor's liability insurers. The 2010 Act will supersede the U.K. Third Parties (Rights against Insurers) Act 1930 (the "1930 Act"), which provides for a statutory assignment to a third-party claimant of an insolvent debtor's rights to claim against its liability insurer. This allows the third party to "step into the shoes" of the insured debtor and sue the debtor's insurers directly, rather than having its judgment left unsatisfied through the judgment debtor's insolvency. The 1930 Act, however, has proved cumbersome in operation because, before being able to pursue action directly against insurers, the claimant first has to pursue the defunct (insured) defendant to a successful outcome (establishing liability by agreement, award, or judgment). Two separate sets of proceedings have therefore been needed. With the coming into force on August 1, 2016, of the 2010 Act, however, while the statutory assignment device is retained, it will no longer be necessary to institute two separate sets of proceedings in order to benefit from it. Instead, the claimant can simply sue the defendant's insurers directly, while at the same time seeking a declaration of the insured defendant's liability in that single set of proceedings.

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