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BUSINESS RESTRUCTURING REVIEW

SECOND CIRCUIT ISSUES KEY CRAMDOWN INTEREST RATE RULING

Bryan M. Kotliar

In *Momentive Performance Materials Inc. v. BOKF, NA (In re MPM Silicones, L.L.C.)*, 2017 BL 376794 (2d Cir. Oct. 27, 2017) ("*Momentive*"), the U.S. Court of Appeals for the Second Circuit, in a long-anticipated decision, affirmed a number of lower court rulings on hot-button bankruptcy issues, including allowance (or, in this case, denial) of a claim for a "make-whole" premium and contractual subordination of junior notes. However, the Second Circuit disagreed with the lower courts on the appropriate interest rate for replacement notes ("cramdown notes") issued to secured creditor classes that voted to reject a chapter 11 plan. In doing so, it joined the Sixth Circuit in requiring that cramdown notes bear a market rate of interest if an efficient market exists; if no such market exists, the notes may bear interest at the typically below-market formula rate.

CRAMDOWN UNDER SECTION 1129(b)(2) OF THE BANKRUPTCY CODE

To be confirmed by the bankruptcy court, a chapter 11 plan must satisfy the requirements of section 1129(a) of the Bankruptcy Code, including the mandate that the plan be accepted by each impaired class of claims or interests. Nevertheless, if an impaired class does not vote to accept the plan, the plan may still be confirmed if it satisfies the nonconsensual confirmation, or "cramdown," requirements set forth in section 1129(b).

Under section 1129(b), a plan may be confirmed over the objection of a rejecting class of claims or interests if the plan does not "discriminate unfairly" and is "fair and equitable." With respect to a dissenting class of secured claims, a plan is "fair and equitable" if, among other alternatives, the plan provides that:

> [T]he holders of such claims retain the liens securing such claims, whether the property subject to such liens is retained by the debtor or transferred to another entity, to the extent of the allowed amount of such claims; and . . . that each holder of a claim of such class receive on account of such claim *deferred cash payments totaling at least the allowed amount of such claim, of a value, as of the effective date of the*

IN THIS ISSUE

1 Second Circuit Issues Key Cramdown Interest Rate Ruling

5 Cross-Border Bankruptcy Update: COMI Migration and Illegitimate COMI Manipulation Distinguished

9 In Brief: First Circuit Rules That Section 1109(b) of the Bankruptcy Code Creates an Unconditional Right to Intervene in an Adversary Proceeding

11 Ninth Circuit: Federal Law Governs Substantive Consolidation, and Supreme Court's *Siegel* Ruling Does Not Bar Consolidation of Debtors and Nondebtors

15 To Have and to Hold: Third Circuit Rules That Physical Possession of Goods Is Required Under Section 503(b)(9) of the Bankruptcy Code

16 Newsworthy

19 Third Circuit Rules That WARN Act's "Unforeseeable Business Circumstances" Exception Requires That Layoffs Be Probable, Not Possible

24 In Brief: Bankruptcy Court Rules That It Has Constitutional Authority to Grant Nonconsensual Releases in Chapter 11 Plan

25 Chapter 11 Plan Not Providing for Payment of Make-Whole Premium Impaired Noteholders

27 The U.S. Federal Judiciary

plan, of at least the value of such holder's interest in the estate's interest in such property.

11 U.S.C. §§ 1129(b)(2)(A)(i)(I) and (II) (emphasis added).

Whether the plan satisfies the language of section 1129(b)(2)(A)(i)(II) of the Bankruptcy Code italicized above depends in part on the interest rate borne by the replacement notes issued under the plan to the dissenting secured creditor class. In *Till v. SCS Credit Corp.*, 541 U.S. 465 (2004), a plurality of the U.S. Supreme Court held that the interest rate on a cramdown loan under a similar provision of the Bankruptcy Code applicable to individual debtors in a chapter 13 case (section 1325(a)(5)(B)(ii)) should follow a simple "formula approach"—a risk-free rate (in that case, the prime rate) plus a premium for the risk of the debtor's nonpayment of the replacement loan (but excluding any profits, costs, or fees). The Court stated that the risk premium would typically range from 1 to 3 percent and factor in the circumstances of the debtor's estate, the nature of the collateral security and the terms of the cramdown note(s), and the duration and feasibility of the plan.

In selecting the formula approach, the *Till* plurality opinion rejected alternative theories of calculating the applicable cramdown interest rate, including:

(i) The rate the creditor could have obtained if it foreclosed on the loan, sold the collateral, and reinvested the proceeds in equivalent loans (the "coerced loan approach");

(ii) The contractual rate under the existing loan, which could be challenged with evidence that a higher or lower rate should apply (the "presumptive contract rate approach"); and

(iii) The cost to the creditor to obtain the cash equivalent of the collateral from another source (the "cost of funds approach").

The plurality opinion reasoned that each of these approaches is complicated, imposes significant evidentiary burdens, and overcompensates the creditor by including items like transaction costs and profits which are not relevant in the context of court-administered and court-supervised cramdown loans. Instead, the Supreme Court concluded that the formula approach more closely resembles a bankruptcy court's usual analysis in evaluating a chapter 13 debtor's financial condition and the feasibility of his or her plan.

It is important to note that in footnote 14, the Supreme Court expressly left open the possibility that the formula approach might not apply in a chapter 11 case. In its view, unlike in chapter 13, where there is no free market of willing cramdown lenders, many lenders are willing to provide debtor-in-possession financing in chapter 11 cases. Thus, the Court stated that "in chapter 11 it might make sense to ask what rate an efficient market would produce."

Taking this cue, a number of courts after *Till* have adopted the two-step analysis articulated by the Sixth Circuit in *In re American HomePatient, Inc.*, 420 F.3d 559 (6th Cir. 2005). Under that approach, "the market rate should be applied in Chapter 11 cases where there exists an efficient market. But where no efficient market exists for a Chapter 11 debtor, then the bankruptcy court should employ the formula approach endorsed by the *Till* plurality." *Id.* at 568; *see also Mercury Capital Corp. v. Milford Conn. Assocs., L.P.*, 354 B.R. 1 (D. Conn. 2006) (remanding to the bankruptcy court to determine whether an efficient market exists); *In re Prussia Assocs.*, 322 B.R. 572, 588–89 (Bankr. E.D. Pa. 2005) ("The Supreme Court's dicta implies that the Bankruptcy Court in such circumstances (i.e., efficient markets) should exercise discretion in evaluating an appropriate cramdown interest rate by considering the availability of market financing.").

However, a number of lower courts have employed in chapter 11 cases the formula approach adopted by the Supreme Court plurality in *Till*, including both lower courts in *Momentive*.

MOMENTIVE

Momentive Performance Materials Inc. and its subsidiaries (collectively, "MPM"), a leading producer of silicone and silicone derivatives, filed for bankruptcy in April 2014 in the Southern District of New York. At the time of its filing, MPM had approximately $1.35 billion of outstanding first- and 1.5-lien notes (bearing interest rates of 8.875 percent and 10 percent, respectively). MPM also had outstanding junior indebtedness, including more than $1.1 billion of second-lien notes.

MPM proposed a chapter 11 plan containing a "death trap" voting choice for the classes of the first-lien and 1.5-lien notes: either (a) accept the plan as a class and receive payment at par plus accrued interest, but excluding any make-whole or early prepayment premiums (as to which there was a pending dispute); or (b) reject the plan as a class and receive replacement notes bearing an interest rate to be determined by the

bankruptcy court, with a face amount that might include any make-whole or similar prepayment premium ultimately allowed by the bankruptcy court. The second-lien noteholders were to receive nearly 100 percent of the equity of reorganized MPM.

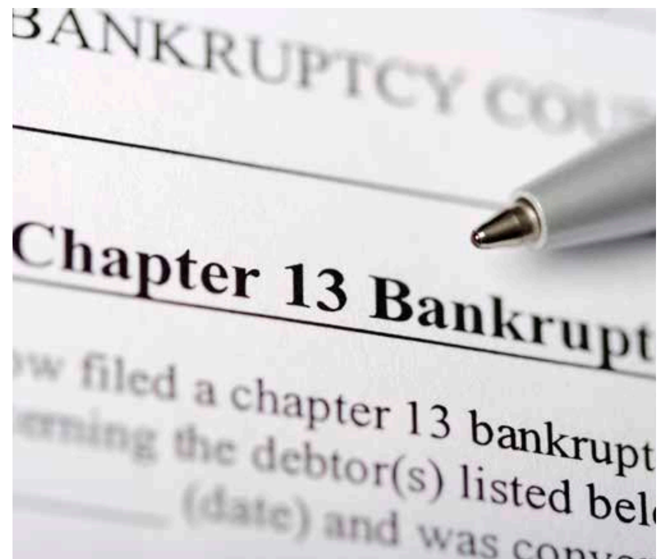
The first-lien and 1.5-lien note classes rejected the plan. During the confirmation proceedings, MPM argued that *Till*'s formula approach should determine the annual rate of interest to be borne by the replacement notes. For the first-lien notes, this rate consisted of the seven-year Treasury note rate (because the replacement notes would have a seven-year maturity) plus 1.50 percent, for a total of approximately 3.60 percent. For the 1.5-lien notes, this rate consisted of a 7.5-year Treasury note rate (based on the weighted average of seven- and 10-year Treasury notes) plus 2 percent, for a total of approximately 4.09 percent. MGM chose the Treasury note rate, rather than the prime rate (the risk-free rate in *Till*), because the prime rate generally applies to consumer borrowers, while Treasury rates more often apply to corporate borrowers.

The indenture trustees for the noteholders countered that the appropriate rate was a market rate based on what lenders would expect for new notes issued by comparable borrowers. MPM had already obtained commitments for backup financing facilities to cash out the first- and 1.5-lien notes, in the event that those classes had voted to accept the plan. Thus, the indenture trustees argued that the commitments received from potential third-party lenders—generally ranging from 5 to 6 percent and tied to LIBOR—should determine the interest rates for the replacement notes. Experts for the indenture trustees also testified that, at the rates suggested by MPM, the replacement notes would immediately trade below par after issuance because of their below-market characteristics.

THE LOWER COURTS APPLY THE *TILL* FORMULA APPROACH

Bankruptcy judge Robert Drain applied the formula approach and confirmed MGM's plan, albeit with slightly increased interest rates for the replacement notes. Judge Drain's increases amounted to 0.50 percent and 0.75 percent for the replacement first-lien and 1.5-lien notes, respectively, because the formula used by MPM was tied to Treasury rates (a truly riskless rate), whereas the base rate used in *Till* began with prime (an interbank lending rate that accordingly carries some risk).

In so ruling, the bankruptcy court found "no sufficiently contrary basis to distinguish the chapter 13 and chapter 11 plan contexts in light of the similarity of the language of the two



provisions [sections 1129(b)(2)(A)(i)(II) and 1325(a)(5)(B)(ii)] and the underlying present value concept that *Till* should be applied uniformly throughout the Code." The bankruptcy court also relied on prior precedent from the Second Circuit in *In re Valenti*, 105 F.3d 55 (2d Cir. 1997), a chapter 13 case cited favorably by *Till* that also applied the formula approach.

The bankruptcy court reasoned that, read together, *Till* and *Valenti* establish certain "first principles" which support application of the formula approach in chapter 11 despite *Till*'s dicta suggestion that the approach might not be appropriate in that context. The bankruptcy court echoed *Till*'s concerns regarding the drawbacks of market-based approaches, among other things. Referring to *Valenti*, the bankruptcy court reiterated that the purpose of the cramdown rate is "to put the creditor in the same economic position it would have been in had it received the value of its allowed claim immediately" and "*not* to put the creditor in the same position that it would have been in had it arranged a 'new' loan." *In re MPM Silicones, LLC*, 2014 BL 250360, at *32 (Bankr S.D.N.Y. Sept. 9, 2014) (quoting *Valenti*, 105 F.3d at 63–66).

The bankruptcy court also characterized footnote 14 of the *Till* opinion as a "very slim reed" to support a market rate approach in chapter 11. According to the court, "[T]here is no meaningful difference between the chapter 11, corporate context and the chapter 13, consumer context to counter *Till*'s guidance that courts should apply the same approach wherever a present value stream of payments is required to be discounted under the Code." It also wrote that "the rights of secured lenders to consumers and secured lenders to corporations are not

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distinguished in *Till*, nor should they be." The court noted that other language in *Till* indicates a disagreement with market rates. For example, in footnote 15, the *Till* plurality rejected the coerced loan approach, which would put the creditor in the same position had it obtained a new loan of comparable duration and risk.

Finally, the bankruptcy court rejected the *American HomePatient* approach as the kind of unworkable, expensive, and burdensome standard that *Till* sought to avoid. The court cited to a number of cases in which the courts undertook an extensive inquiry into whether an efficient market existed, only to conclude that one did not exist, and applied the formula rate. *See In re 20 Bayard Views LLC*, 445 B.R. 83 (Bankr. E.D.N.Y. 2011); *In re Cantwell*, 336 B.R. 688 (Bankr. D.N.J. 2006). In addition, the court explained, unlike the Sixth Circuit, which followed a market or coerced loan approach even prior to *Till* (and *American HomePatient*), the pre-*Till* case law in the Second Circuit was *Valenti*, which supported a formula rate approach.

After the district court affirmed the ruling, the indenture trustees appealed to the Second Circuit.

THE SECOND CIRCUIT'S RULING

A three-judge panel of the Second Circuit reversed that portion of the lower court rulings regarding the appropriate interest rate for the replacement notes. Relying on footnote 14 of the *Till* plurality opinion, the court adopted the two-step *American HomePatient* approach. The Second Circuit invoked other U.S. Supreme Court precedent in other contexts, explaining that exposure to the market is the best determination of value. *See Bank of Am. Nat'l Trust & Sav. Ass'n v. 203 N. LaSalle St. P'ship*, 526 U.S. 434, 457 (1999); *U.S. v. 50 Acres of Land*, 469 U.S. 24 (1984).

The Second Circuit accordingly remanded the case below for additional findings on whether "an efficient market can be ascertained, and, if so, [to] apply it to the replacement notes."

OUTLOOK

Momentive is instructive for bankruptcy courts called upon to determine whether the interest rate on replacement debt instruments issued to secured creditors under a nonconsensual chapter 11 plan satisfies the "fair and equitable" test in section 1129(b)(2)(A). Still, the ruling leaves some important questions unanswered. For example, assuming a lending market exists in a given chapter 11 case, the Second Circuit provided very little guidance on what it means for such a market to be "efficient." However, it did cite to an example from a Fifth Circuit case—*In re Texas Grand Prairie Hotel Realty, L.L.C.*, 710 F.3d 324, 337 (5th Cir. 2013)—where the court explained that markets are efficient if they "offer a loan with a term, size, and collateral comparable to the forced loan contemplated under the cramdown plan."

In the *Momentive* bankruptcy court's proceedings, the indenture trustees offered evidence to establish the existence of an efficient market, including expert testimony regarding the accepted characteristics of an efficient market and an analysis of the current market conditions for exit financing available to MPM, including the proposed exit facilities. In addition, MPM's restructuring advisor testified that the proposed exit facilities resulted from a "competitive process" characterized by "good faith, hard bargaining by all interested parties," including three of the largest institutional providers of debtor-in-possession and exit financing.

The bankruptcy court expressed skepticism, however, as to whether the process that led to the quoted exit facilities' rates was produced by an efficient market. Because the bankruptcy court applied the formula approach before ascertaining whether such a market in fact existed, the Second Circuit remanded the case below, directing the courts to "engage the *American HomePatient* analysis in earnest." Thus, the dispute in *Momentive* over the cramdown interest rate on the replacement notes is far from over.

On November 3, 2017, the indenture trustees asked the Second Circuit to reconsider its ruling upholding the lower courts' disallowance of their make-whole claims. According to the indenture trustees, the decision squarely conflicts with the Third Circuit's ruling in *Del. Tr. Co. v. Energy Future Intermediate Holding Co. LLC (In re Energy Future Holdings Corp.)*, 842 F.3d 247 (3d Cir. 2016), in which, the indenture trustees claim, the court concluded that a chapter 11 refinancing triggered make-whole provisions under "substantively identical" conditions.

CROSS-BORDER BANKRUPTCY UPDATE: COMI MIGRATION AND ILLEGITIMATE COMI MANIPULATION DISTINGUISHED

Dan T. Moss
Mark G. Douglas

With the significant increase in cross-border bankruptcy and insolvency filings in the 43 nations or territories that have adopted the UNCITRAL Model Law on Cross-Border Insolvency (the "Model Law"), including the U.S., the incidence of "COMI migration"—the shifting of a debtor's "center of main interests" ("COMI") to a country with more favorable insolvency laws—has also increased. As demonstrated by a ruling handed down by the U.S. Bankruptcy Court for the Southern District of New York, COMI migration may be justified and legitimate under circumstances that do not represent bad-faith "COMI manipulation." In *In re Ocean Rig UDW Inc.*, 570 B.R. 687 (Bankr. S.D.N.Y. 2017), the court ruled that scheme of adjustment proceedings pending in the Cayman Islands (the "Caymans") should be recognized as "foreign main proceedings" under chapter 15 of the Bankruptcy Code, even though the debtors' COMI had been shifted to the Caymans less than a year before the proceedings were commenced, because the country in which the debtors' COMI had previously been located did not have a law permitting corporate restructurings.

PROCEDURES AND RECOGNITION UNDER CHAPTER 15

Eligibility of Foreign Debtor for Chapter 15 Relief

Under section 1515 of the Bankruptcy Code, the representative of a foreign debtor may file a petition in a U.S. bankruptcy court seeking "recognition" of a "foreign proceeding." Section 101(24) of the Bankruptcy Code defines "foreign representative" as "a person or body, including a person or body appointed on an interim basis, authorized in a foreign proceeding to administer the reorganization or the liquidation of the debtor's assets or affairs or to act as a representative of such foreign proceeding."

Section 109(a) of the Bankruptcy Code provides that, "[n]otwithstanding any other provision of this section, only a person that resides or has a domicile, a place of business, or property in the United States, or a municipality, may be a debtor under [the Bankruptcy Code]." In *Drawbridge Special Opportunities Fund LP v. Barnet (In re Barnet)*, 737 F.3d 238 (2d Cir. 2013), the Second Circuit ruled that section 109(a) applies in cases under chapter 15 of the Bankruptcy Code. "[P]roperty

in the United States" has been held to include an attorney retainer in a U.S. bank account, causes of action under U.S. law against parties in the U.S., and contract rights governed by U.S. law, including U.S. dollar-denominated debt issued under an indenture governed by New York law with a New York choice-of-forum clause. *See In re Cell C Proprietary Ltd.*, 571 B.R. 542 (Bankr. S.D.N.Y. 2017); *In re Berau Capital Resources Pte Ltd*, 540 B.R. 80 (Bankr. S.D.N.Y. 2015); *In re Octaviar Administration Pty Ltd.*, 511 B.R. 361 (Bankr. S.D.N.Y. 2014).

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

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

More than one bankruptcy or insolvency proceeding may be pending with respect to the same foreign debtor in different countries. Chapter 15 therefore contemplates recognition in the U.S. of both a "main" proceeding—a case pending in the country where the debtor's COMI is located (*see* 11 U.S.C. § 1502(4))—and "nonmain" proceedings, which may have been commenced in countries where the debtor merely has an "establishment" (*see* 11 U.S.C. § 1502(5)).

Foreign Main Proceedings—COMI

The Bankruptcy Code does not define "COMI." However, section 1516(c) provides that, "[i]n the absence of evidence to the contrary, the debtor's registered office, or habitual residence in the case of an individual, is presumed to be" the debtor's COMI.

Various factors have been deemed relevant by courts in determining a debtor's COMI, including the location of the debtor's headquarters, managers, employees, investors, primary assets, or creditors, as well as the jurisdiction whose law would apply to most of the debtor's disputes. *See In re SPhinX, Ltd.*, 351 B.R. 103 (Bankr. S.D.N.Y. 2006), *aff'd*, 371 B.R. 10 (S.D.N.Y. 2007). In addition, courts have considered any relevant activities, including liquidation activities and administrative functions. *See Morning Mist Holdings Ltd. v. Krys (In re Fairfield Sentry Ltd.)*, 714 F.3d 127 (2d Cir. 2013). Courts may also consider the situs of the debtor's "nerve center," including the location from which the debtor's "activities are directed and controlled, in determining a debtor's COMI." *Id.* at 138. "[R]egularity and ascertainability" by creditors are also important factors in the COMI analysis. *Id.*

In *Fairfield Sentry*, the Second Circuit ruled that the relevant time for assessing COMI is the chapter 15 petition date, rather than the date a foreign insolvency proceeding is commenced with respect to the debtor. The impact of the ruling is that, in cases where a foreign representative engages in significant pre-U.S. chapter 15 filing activities—such as operating or liquidating the debtor—in the jurisdiction where the foreign proceeding was commenced, COMI "can be found to have shifted from the foreign debtor's original principal place of business to the new locale." *In re Creative Finance Ltd. (In Liquidation)*, 2016 BL 8825, *31 (Bankr. S.D.N.Y. Jan. 13, 2016). Such a COMI "migration" can occur even if the activities take place in a "letterbox" jurisdiction where the debtor itself had few contacts and conducted no meaningful business. *Id.* (citing cases).

In *Fairfield Sentry*, the Second Circuit also noted concern about possible COMI "manipulation," ruling that a court "may look at the period between the commencement of the foreign proceeding and the filing of the Chapter 15 petition to ensure that a debtor has not manipulated its COMI in bad faith." *Fairfield Sentry*, 714 F.3d at 138.

Foreign Nonmain Proceedings—Establishment

An "establishment" is defined in section 1502(2) as "any place of operations where the debtor carries out a nontransitory economic activity." Unlike with the determination of COMI, there is no statutory presumption regarding the determination of whether a foreign debtor has an establishment in any particular location. *See In re British Am. Ins. Co.*, 425 B.R. 884 (Bankr. S.D. Fla. 2010). The debtor's foreign representative bears the burden of demonstrating that the debtor has an establishment in a particular jurisdiction. *Id.* at 915.

In *Ocean Rig*, the bankruptcy court considered whether it should recognize under chapter 15 provisional liquidation and scheme of arrangement proceedings filed on behalf of four affiliated debtors in the Caymans, even though the debtors' COMI had been purposely migrated from the Republic of the Marshall Islands ("RMI") 11 months before the proceedings were filed.

OCEAN RIG

Publicly traded Ocean Rig UDW Inc. ("UDW") is the ultimate parent of the Ocean Rig Group, which includes three holding companies—Drill Rigs Holdings Inc. ("DRH"), Drillships Financing Holding Inc. ("DFH"), and Drillships Ocean Ventures Inc. ("DOV")—that directly or indirectly own a fleet of deepwater oil drilling rigs leased worldwide to oil and gas exploration companies. Until April 2016, UDW and direct subsidiaries DRH, DFH, and DOV (collectively, the "debtors") were registered as nonresident corporations in the RMI. However, none of the debtors ever conducted operations, directed their affairs, maintained management offices, conducted meetings, or had directors residing in the RMI. UDW was also a tax resident of Cyprus and had previously maintained a "law 89 establishment" in Greece under a law allowing foreign companies to provide limited services for head offices or affiliates outside Greece.

Collectively, the Ocean Rig Group has approximately $4.5 billion in face amount of U.S. dollar-denominated notes issued under credit agreements governed by U.S. law, with U.S. financial institutions acting as indenture trustees or collateral agents.

The sharp decline in oil and gas prices in recent years took a major toll on the finances of the Ocean Rig Group. Faced with expected payment defaults, the debtors began exploring restructuring alternatives in 2016. However, the RMI, which at that time served presumptively as the debtors' COMI, did not have any laws or procedures permitting reorganization, as distinguished from liquidation, of companies.

Therefore, the debtors decided to migrate their COMI to the Caymans, which does have a corporate reorganization law—the Cayman Islands Companies Law (the "CICL"). Accordingly, in April and October 2016, UDW and the other debtors registered as Cayman corporations. Among other things, each debtor thereafter: (i) maintained its head offices and books and records in the Caymans; (ii) conducted board meetings in the Caymans; (iii) had some, but not all, officers and directors residing in the Caymans; (iv) appointed registered agents for payment and notices in the Caymans; (v) provided notification of the change to investment service providers, the U.S. Securities and Exchange Commission, and various media outlets; (vi) issued a press release noting the relocation of its principal place of business to the Caymans; (vii) opened a bank account in the Caymans; and (viii) conducted restructuring discussions and negotiations from the Caymans.

Beginning on March 27, 2017, the debtors commenced provisional liquidation proceedings and scheme of arrangement proceedings under the CICL (the "Cayman Proceedings") for

The ruling reaffirms the principle that COMI migration for a legitimate purpose, such as to restructure a company, preserve going-concern value and jobs, and maximize asset values, does not offend the purposes underlying chapter 15 and the Model Law.

the purpose of implementing a debt restructuring involving a debt-for-equity swap. The Grand Court of the Cayman Islands (the "Cayman Court") appointed Simon Appell and Eleanor Fisher as joint provisional liquidators (the "liquidators") for the debtors. Creditors voted to support the schemes of arrangement in August 2017, and the Cayman Court sanctioned the schemes on September 14, 2017.

On March 27, 2017, the liquidators filed a petition in the U.S. Bankruptcy Court for the Southern District of New York, seeking recognition of the Cayman Proceedings under chapter 15 as either foreign main or nonmain proceedings, as well as the enforcement of any schemes of arrangement for the debtors sanctioned by the Cayman Court. Certain parties objected to recognition, focusing principally on the shift in COMI from the RMI to the Caymans.

THE BANKRUPTCY COURT'S RULING

The bankruptcy court granted the petition for recognition of the Cayman Proceedings as foreign main proceedings.

Initially, bankruptcy judge Martin Glenn found that the debtors were eligible for relief under chapter 15 because they satisfied section 109(a)'s requirement of property in the U.S. by means of: (i) $1 million in legal fee retainers deposited into U.S. bank accounts; and (ii) $4.5 billion in face amount of U.S. dollar-denominated debt issued under debt instruments governed by New York law (which also satisfied the venue requirements under U.S. law).

Judge Glenn ruled that schemes of arrangement, such as the Cayman Proceedings and similar restructuring proceedings sanctioned under the laws of the U.K., Hong Kong, and Singapore, satisfy section 101(23)'s definition of "foreign proceeding," as required for recognition under section 1517(a) of the Bankruptcy Code.

Judge Glenn also found that the debtors' COMI was the Caymans despite their previous contacts with the RMI, Cyprus, and Greece. According to the judge, on the basis of all the actions taken by the debtors in the year preceding commencement of the Cayman Proceedings (described previously), the shift of COMI to the Caymans was "real" and "done for proper purposes to facilitate a value-maximizing restructuring of [the debtors'] financial debt," rather than being "manipulated prior to the filing in bad faith." There was no evidence, the judge explained, pointing to any "'insider exploitation, untoward manipulation, [and] overt thwarting of third party expectations' that would support denying recognition" (quoting *In re Fairfield Sentry Ltd.*, 440 B.R. 60, 65–66 (Bankr. S.D.N.Y. 2010)).

Judge Glenn issued an order enforcing the debtors' Cayman schemes of arrangement on September 20, 2017.

OUTLOOK

Ocean Rig is instructive as to the steps a debtor should take to ensure that its COMI has been legitimately shifted to a new jurisdiction for purposes of recognition of a bankruptcy proceeding in that jurisdiction as a foreign main proceeding under chapter 15 of the U.S. Bankruptcy Code and versions of the Model Law enacted elsewhere. The ruling reaffirms the principle that COMI migration for a legitimate purpose, such as to restructure a company, preserve going-concern value and jobs, and maximize asset values, does not offend the purposes underlying chapter 15 and the Model Law. By contrast, bad-faith COMI manipulation violates those purposes. *See, e.g.*, *Creative Finance*, 2016 BL 8825, at *3–4 (denying recognition of a British Virgin Islands ("BVI") liquidation commenced as part of a scheme to avoid paying a U.K. judgment and finding that the debtors' foreign representative failed to demonstrate that the debtors' COMI was in the BVI—either at the time of the filing of the liquidation or because of the liquidator's post-filing activities—or even that the debtors had an establishment in the BVI).

IN BRIEF: FIRST CIRCUIT RULES THAT SECTION 1109(b) OF THE BANKRUPTCY CODE CREATES AN UNCONDITIONAL RIGHT TO INTERVENE IN AN ADVERSARY PROCEEDING

In *Assured Guaranty Corp. v. Fin. Oversight & Mgmt. Bd. for Puerto Rico*, 872 F.3d 57 (1st Cir. 2017), the U.S. Court of Appeals for the First Circuit ruled that section 1109(b) of the Bankruptcy Code gave an unsecured creditors' committee an "unconditional right to intervene," within the meaning of Fed. R. Civ. P. 24(a)(1), in an adversary proceeding commenced during the course of a bankruptcy case. The court reversed a district court order denying a motion to intervene filed by the official committee of unsecured creditors appointed in the quasi-bankruptcy cases filed on behalf of certain Puerto Rico instrumentalities under the Puerto Rico Oversight, Management, and Economic Stability Act, 48 U.S.C. §§ 2161–2177 ("PROMESA"). The First Circuit's decision deepens a circuit split on whether an official committee's unconditional right to intervene applies to adversary proceedings.

THE RIGHT TO BE HEARD IN CHAPTER 11 AND INTERVENTION

Section 1109(b) of the Bankruptcy Code provides that "[a] party in interest, including the debtor, the trustee, a creditors' committee, an equity security holders' committee, a creditor, an equity security holder, or any indenture trustee, may raise and may appear and be heard on any issue in a case under this chapter."

This provision expressly provides any party in interest with an unconditional right to participate in a chapter 11 "case." "Case" refers to "litigation commenced by the filing with the bankruptcy court of a petition under the appropriate chapter of Title 11." *Term Loan Holder Comm. v. Ozer Grp., L.L.C. (In re Caldor Corp.)*, 303 F.3d 161, 167 (2d Cir. 2002) (internal quotation marks and citations omitted). By contrast, an "adversary proceeding" in bankruptcy is discrete litigation commenced during a bankruptcy case to, among other things: recover money or property (e.g., avoid fraudulent or preferential transfers); determine the validity, priority, or extent of a lien or other interest in property; revoke an order confirming a chapter 11 plan; or obtain injunctive relief. *See* Fed. R. Bankr. P. 7001.

"Intervention" is a procedure that permits a nonparty to join ongoing litigation, either as a matter of right or at the discretion of the court, without the permission of the original litigants, generally because a judgment in the case may impact the rights of the nonparty intervenor. The ability to intervene in federal litigation is generally governed by Fed. R. Civ. P. 24, which is made applicable in its entirety to adversary proceedings commenced in a bankruptcy case by Fed. R. Bankr. P. 7024.

Fed. R. Civ. P. 24(a) provides that the court "must permit anyone to intervene who . . . is given an unconditional right to intervene by a federal statute." Rule 24 also provides for intervention as a matter of right if necessary to protect a nonparty's interest in property that is the subject of the litigation, as well as for permissive intervention under certain circumstances.

Because section 1109(b) says nothing about "proceedings," some courts, noting the general distinction between cases and proceedings, have concluded that the provision applies only to bankruptcy cases and does not create an unqualified right to intervene in adversary proceedings. *See Fuel Oil Supply & Terminaling v. Gulf Oil Corp.*, 762 F.2d 1283 (5th Cir. 1985). Two other circuits have, in dicta, suggested that they agree with the *Fuel Oil* approach. *See Richman v. First Woman's Bank (In re Richman)*, 104 F.3d 654, 658 (4th Cir. 1997); *Vermejo Park Corp. v. Kaiser Coal Corp. (In re Kaiser Steel Corp.)*, 998 F.2d 783, 790 (10th Cir. 1993).

> The First Circuit's decision deepens a circuit split on whether an official committee's unconditional right to intervene applies to adversary proceedings.

However, both the Second and Third Circuits have rejected the reasoning in *Fuel Oil*, ruling instead that section 1109(b) provides a statutory right to intervene in adversary proceedings for purposes of Fed. R. Civ. P. 24(a)(1). *See Caldor Corp.*, 303 F.3d at 176; *Phar-Mor, Inc. v. Coopers & Lybrand*, 22 F.3d 1228, 1240 (3d Cir. 1994). In *Caldor*, the Second Circuit explained that "the plain text of § 1109(b) does not distinguish between issues that occur in . . . different types of proceedings within a Chapter 11 case," concluding that the provision applies to adversary proceedings as well as bankruptcy cases. 303 F.3d at 169.

PROMESA

PROMESA was enacted in June 2016 to help Puerto Rico manage its financial crisis after the U.S. Supreme Court struck down as 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 be restructured. PROMESA provides for the establishment of a Financial Oversight and Management Board entrusted with determining the adequacy of budgets and fiscal plans for Puerto Rico and certain of its instrumentalities. 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 under Title III of the statute.

PROMESA expressly makes applicable in a Title III debt restructuring case many provisions of the Bankruptcy Code, including section 1109, as well as the entirety of the Federal Rules of Civil Procedure.

On May 3, 2017, the Financial Oversight and Management Board for Puerto Rico filed voluntary petitions for relief under Title III of PROMESA in the District of Puerto Rico on behalf of certain Puerto Rico instrumentalities. The same day, insurers of Puerto Rico bonds commenced an adversary proceeding, alleging that the commonwealth's proposed fiscal plan violated various provisions of PROMESA and the U.S. Constitution and seeking declaratory and injunctive relief to prevent the implementation of that plan.

The official committee of unsecured creditors (the "committee") appointed in the Title III cases in June 2017 moved to intervene in the adversary proceeding, arguing that Fed. R. Civ. P. 24(a)(1) and section 1109(b) gave the committee "an unconditional right to intervene." The insurer plaintiffs opposed the motion to intervene.

District judge Laura Taylor Swain (sitting by designation) denied the motion to intervene. She said she was bound to do so by a footnote in *Kowal v. Malkemus (In re Thompson)*, 965 F.2d 1136, 1142 n.8 (1st Cir. 1992), where the First Circuit (which exercises appellate jurisdiction over the District of Puerto Rico) stated that section 1109(b) "does not afford a right to intervene under Rule 24(a)(1)."

A three-judge panel of the First Circuit reversed on appeal. According to the panel, although apparently on point, the footnote that Judge Swain relied upon in *Thompson* was nonbinding dicta because *Thompson* involved an appeal in a chapter 7 case, and thus section 1109(b) was "inapplicable on its face." The panel also distinguished other decisions in which the courts have cited *Fuel Oil* with approval. *Richman*, like *Thompson*, the First Circuit panel noted, was a chapter 7 case, "so § 1109(b) was facially incapable of providing the requisite statutory right of intervention." In *Kaiser*, the panel explained, the Tenth Circuit held that the putative appellants were not

parties in interest and therefore were not entitled to the rights conferred by section 1109(b).

Therefore, the First Circuit panel examined whether section 1109(b) confers an unconditional right to intervene in an adversary proceeding. After considering the conflicting decisions on the issue, the panel found the Second and Third Circuits' position more persuasive. The panel explained that the text of section 1109(b) applies generally to "cases," a term which encompasses all litigation commenced by the filing of a chapter 11 petition. It agreed with a leading commentator that, "[b]ecause every issue in a case may be raised and adjudicated only in the context of a proceeding of some kind, it is apparent that the reference . . . to 'any issue in a case' subsumes issues in a proceeding" (citing COLLIER ON BANKRUPTCY ¶ 1109.04[1][a][ii]).

On the basis of this reasoning, the First Circuit panel ruled that "§ 1109(b) provides the [committee] with an 'unconditional right to intervene' in the adversary proceeding."

NINTH CIRCUIT: FEDERAL LAW GOVERNS SUBSTANTIVE CONSOLIDATION, AND SUPREME COURT'S *SIEGEL* RULING DOES NOT BAR CONSOLIDATION OF DEBTORS AND NONDEBTORS

Aaron M. Gober-Sims
Mark G. Douglas

In *Clark's Crystal Springs Ranch, LLC v. Gugino (In re Clark)*, 692 Fed. Appx. 946, 2017 BL 240043 (9th Cir. July 12, 2017), the U.S. Court of Appeals for the Ninth Circuit ruled that: (i) the remedy of "substantive consolidation" is governed by federal bankruptcy law, not state law; and (ii) because the Bankruptcy Code does not expressly forbid the substantive consolidation of debtors and nondebtors, the U.S. Supreme Court's decision in *Law v. Siegel*, 134 S. Ct. 1188 (2014), does not bar bankruptcy courts from ordering the remedy.

SUBSTANTIVE CONSOLIDATION

"Substantive consolidation" is an equitable remedy pursuant to which a bankruptcy court may order that the assets and liabilities of separate entities be treated as if they belonged to a single, combined entity.

The Bankruptcy Code does not expressly authorize substantive consolidation, but it recognizes that a chapter 11 plan may provide for the consolidation of a "debtor with one or more persons" as a means of implementation. *See* 11 U.S.C. § 1123(a)(5)(C). In addition, Fed. R. Bankr. P. 1015(b) provides that a bankruptcy court may direct that cases involving affiliated debtors be jointly administered ("procedural consolidation"), but the rule is silent regarding substantive consolidation.

A majority of courts have concluded that bankruptcy courts have the power to substantively consolidate debtor entities under section 105(a) of the Bankruptcy Code, which provides that a court "may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions" of the Bankruptcy Code. However, because forcing the creditors of one entity to share equally with the creditors of a less solvent entity is not appropriate in many circumstances, courts generally hold that substantive consolidation is an extraordinary remedy which should be used sparingly. *See Buridi v. KMC Real Estate Investors, LLC (In re KMC Real Estate Investors, LLC)*, 531 B.R. 758 (S.D. Ind. 2015).

Different standards have been employed by courts to determine the propriety of substantive consolidation. Common to all of these tests is a fact-intensive examination and an analysis of consolidation's impact on creditors. For example, in *Eastgroup Properties v. Southern Motel Assoc., Ltd.*, 935 F.2d 245 (11th Cir. 1991), the Eleventh Circuit adopted a modified version of the standard articulated by the District of Columbia Circuit in *Drabkin v. Midland Ross Corp. (In re Auto-Train Corp., Inc.)*, 810 F.2d 270, 276 (D.C. Cir. 1987). According to this standard: (i) the proponent of consolidation must demonstrate that there is substantial identity between the entities to be consolidated and that consolidation is necessary to avoid some harm or to realize some benefit; and (ii) a creditor may object on the grounds that it relied on the entities' separate credit and will be prejudiced by consolidation, in which case the court can order consolidation only if it determines that the benefits of consolidation "heavily" outweigh the harm.

The Second Circuit established a somewhat different two-part disjunctive standard for gauging the propriety of substantive consolidation in *Union Savings Bank v. Augie/Restivo Baking Co., Ltd. (In re Augie/Restivo Baking Co., Ltd.)*, 860 F.2d 515, 518 (2d Cir. 1988). There, the court concluded that the factual elements considered by the courts are "merely variants on two critical factors: (i) whether creditors dealt with the entities as a single economic unit and did not rely on their separate identity in extending credit, . . . or (ii) whether the affairs of the debtors are so entangled that consolidation will benefit all creditors."

Factors that may be relevant in satisfying the first requirement include the following:

(1) Fraud or other complete domination of the corporation that harms a third party;

(2) The absence of corporate formalities;

(3) Inadequate capitalization of the corporation;

(4) Whether funds are put in and taken out of the corporation for personal rather than corporate purposes;

(5) Overlap in ownership and management of affiliated corporations;

(6) Whether affiliated corporations have dealt with one another at arm's length;

(7) The payment or guarantee of debts of the dominated corporation by other affiliated corporations;

(8) The commingling of affiliated corporations' funds; and

(9) The inability to separate affiliated corporations' assets and liabilities.

Id. at 518–19. The *Augie/Restivo* test was adopted by the Ninth Circuit in *Bonham v. Compton (In re Bonham)*, 229 F.3d 750 (9th Cir. 2000). Many other circuit and lower courts have adopted tests similar to the *Augie/Restivo* and *Eastgroup* standards. In *In re Owens Corning*, 419 F.3d 195 (3d Cir. 2005), the Third Circuit opted for an "open ended, equitable inquiry" rather than a factor-based analysis, as employed by many courts, in reversing lower court rulings approving "deemed" consolidation of 18 debtors and three nondebtor subsidiaries under a plan.

SUBSTANTIVE CONSOLIDATION OF DEBTORS AND NONDEBTORS

Although the majority of courts have held that the substantive consolidation of debtor entities is permitted in certain cases, they disagree as to whether the substantive consolidation of debtors and nondebtors should be permitted. Some courts have concluded that such substantive consolidation is appropriate on the basis of: (i) section 105's broad grant of authority; (ii) a bankruptcy court's ability to assert personal and subject matter jurisdiction over nondebtors; and/or (iii) a bankruptcy court's mandate to ensure the equitable treatment of all creditors. *See, e.g.*, *Lassman v. Cameron Constr. LLC (In re Cameron Constr. & Roofing Co.*), 565 B.R. 1, 10 (Bankr. D. Mass. 2016); *In re S&G Fin. Servs.*, 451 B.R. 573, 579–82 (Bankr. S.D. Fla. 2011); *Simon v. ASIMCO Techs., Inc. (In re Am. Camshaft Specialties, Inc.)*, 410 B.R. 765, 786 (Bankr. E.D. Mich. 2009); *Walls v. Centurion Asset Mgmt., Inc. (In re Bolze)*, 2009 BL 157145, *4 (Bankr. E.D. Tenn. July 23, 2009); *Dominion Fin. Corp. v. Morfesis (In re Morfesis)*, 270 B.R. 28, 31 (Bankr. D.N.J. 2001).

Other courts have held that the substantive consolidation of debtors and nondebtors is inappropriate because: (i) bankruptcy courts lack jurisdiction over nondebtors; and/or (ii) substantive consolidation of debtors and nondebtors circumvents the procedures concerning involuntary bankruptcies set forth in section 303 of the Bankruptcy Code. *See, e.g.*, *Official Comm. of Unsecured Creditors v. Archdiocese of Saint Paul & Minneapolis*, 562 B.R. 755, 762 (D. Minn. 2016); *In re Pearlman*, 462 B.R. 849, 854 (Bankr. M.D. Fla. 2012); *Helena Chem. Co. v. Circle Land & Cattle Corp. (In re Circle Land & Cattle Corp.)*, 213 B.R. 870, 877 (Bankr. D. Kan. 1997); *In re Hamilton*, 186 B.R. 991, 993 (Bankr. D. Colo. 1995).

The Ninth Circuit addressed the propriety of substantively consolidating an individual debtor and nondebtor entities in *Clark*.

CLARK

In 2008, Jay P. Clark (the "Debtor") created a trust (the "Trust") for the benefit of his children. The Debtor was both the grantor and the trustee of the Trust. Shortly afterward, the Debtor created an Idaho limited liability company (the "LLC" and, together with the Trust, the "Defendants") to own a ranching operation. The LLC was a single-member, member-managed limited liability company, and its sole member and manager was the Trust. Even though the Debtor was the de facto "manager" of the ranch, he was neither the member nor the manager of the LLC. In March 2012, the Debtor filed a voluntary chapter 12 petition in the District of Idaho, stating in the petition that he was doing business as the LLC. In May 2013, the bankruptcy court granted a creditor's motion to convert the Debtor's case to a chapter 7 liquidation.

In June 2013, the chapter 7 trustee filed an adversary complaint against the Defendants, alleging various claims in an effort to bring certain assets of the LLC into the Debtor's bankruptcy estate. In this complaint, the chapter 7 trustee sought, among other things: (i) a finding that, because the LLC and the Trust were alter egos of the Debtor under Idaho law, the assets of the LLC and the Trust should be treated as assets of the Debtor's bankruptcy estate; and (ii) substantive consolidation of the assets and liabilities of the Debtor, the LLC, and the Trust.

Noting that the alter ego claim was a remedy rather than a cause of action and that it was "tantamount to a request for substantive consolidation," the bankruptcy court analyzed the chapter 7 trustee's arguments concerning the alter ego claim in the context of the chapter 7 trustee's request for substantive consolidation. The court applied the *Augie/Restivo* factors and determined that: (i) because the Debtor commingled his personal, financial, and operational affairs with the affairs of the Trust and the LLC, creditors generally dealt with the

Debtor and the LLC as a single economic unit; and (ii) the affairs of the Debtor, the LLC, and the Trust were so entangled that unraveling them would require significant time, effort, and expense. On the basis of those findings, the bankruptcy court concluded that substantive consolidation benefited creditors and outweighed any potential harm.

The Defendants appealed the bankruptcy court's order to the Ninth Circuit Bankruptcy Appellate Panel, arguing, among other things, that: (i) bankruptcy courts lack the power to substantively consolidate debtors and nondebtors under the U.S. Supreme Court's ruling in *Siegel*; (ii) the bankruptcy court erred by not considering the Defendants' separate property rights under Idaho law, as mandated by the Supreme Court's decision in *Butner v. United States*, 440 U.S. 48 (1979); and (iii) the bankruptcy court erred in granting substantive consolidation.

In *Siegel*, the Supreme Court reversed a bankruptcy court's order under section 105(a) that expressly contravened another provision of the Bankruptcy Code (section 522, which specifies exempt property). The Supreme Court explained that although section 105(a) allows a bankruptcy court to issue orders "necessary or appropriate" to carry out the provisions of the Bankruptcy Code, it is "hornbook law" that section 105(a) does not allow a bankruptcy court to "override explicit mandates of other sections of the Bankruptcy Code." *Siegel*, 134 S. Ct. at 1192.

In *Butner*, the Supreme Court held that "Congress has generally left the determination of property rights in the assets of a bankrupt's estate to state law." *Butner*, 440 U.S. at 54.

The bankruptcy appellate panel affirmed the bankruptcy court's ruling. First, the court held that, because the Bankruptcy Code does not expressly forbid the substantive consolidation of nondebtor entities, the Defendants' reliance on *Siegel* was inapposite. Next, the court rejected the argument that the bankruptcy court should have considered property rights under Idaho law. The court reasoned that, because substantive consolidation (1) is designed to remedy injury caused by entities which disregard separateness, and (2) does not exist outside bankruptcy, "the law of substantive consolidation is federal bankruptcy law and is not dependent upon state law concepts."

Finally, the court held that the record supported the bankruptcy court's decision to substantively consolidate the Defendants. It wrote that "the commingling of assets and the operation of the Trust and the LLC without any formality demonstrate[d] a close interrelationship between Debtor and the Trust and the LLC," and concluded that the Debtor failed to show the separateness of himself, the LLC, and the Trust after the chapter 7 trustee satisfied his initial burden. The Defendants appealed to the Ninth Circuit.

THE NINTH CIRCUIT'S RULING

A three-judge panel of the Ninth Circuit affirmed in an unpublished ruling. The panel agreed with the lower courts that *Siegel* was not implicated because the Bankruptcy Code does not expressly forbid substantive consolidation. According to the Ninth Circuit panel, "Bankruptcy courts retain equitable power to grant substantive consolidation notwithstanding Congress's amendment of the Code without codifying that power." The Ninth Circuit also rejected the Defendants' argument that the bankruptcy court was required to consider Idaho property law, simply stating that "[t]he law of substantive consolidation is governed by federal bankruptcy law, not state law."

In an earlier decision—*Alexander v. Compton (In re Bonham)*, 229 F.3d 750 (9th Cir. 2000)—the Ninth Circuit ruled that debtors and nondebtors can be substantively consolidated. Consistent with *Bonham*, the Ninth Circuit panel in *Clark* held that the following factors supported the bankruptcy court's substantive consolidation order: the Debtor's control over the LLC and the Trust; the Debtor's personal liability for the LLC's liabilities; the lack of records tracking the LLC's distributions to the Debtor; and the LLC's payments for the Debtor's personal expenses.

OUTLOOK

Among the circuit courts of appeal, only the Ninth Circuit has explicitly held that a bankruptcy court has the power to substantively consolidate debtor and nondebtor entities. Other

circuits have addressed the issue only tangentially. *See Spradlin v. Beads & Steeds Inns, LLC (In re Howland)*, 674 Fed. Appx. 482 (6th Cir. 2017) (affirming lower court orders denying a trustee's motion to file an amended complaint in a turnover proceeding predicated on substantively consolidating debtors with nondebtors because the complaint did not adequately state a claim for substantive consolidation); *Wells Fargo Bank of Tex. N.A. v. Sommers (In re Amco Ins.)*, 444 F.3d 690 (5th Cir. 2006) (holding that the bankruptcy court erred in ordering substantive consolidation of the debtor and nondebtor *nunc pro tunc*, but declining to address whether the court had the power to grant substantive consolidation); *Soviero v. Franklin Nat'l Bank of Long Island*, 328 F.2d 446 (2d Cir. 1964) (affirming a turnover order disregarding the corporate separateness of the debtor and 13 nondebtor affiliates that were instrumentalities of the debtor in a case under the former Bankruptcy Act of 1898).

Unfortunately, *Clark* is unlikely to provide much in the way of useful guidance on this issue. The decision contains little analysis and relies heavily on the lower courts' reasoning as well as the Ninth Circuit's earlier ruling in *Bonham*.

For example, the Ninth Circuit did not satisfactorily explain why the substantive consolidation of debtors and nondebtors does not violate section 303 of the Bankruptcy Code by effectively bringing a nondebtor into bankruptcy without complying with section 303's involuntary bankruptcy petition requirements—thus arguably running afoul of *Siegel*. In this regard, the Ninth Circuit simply stated that the fact that there are "other ways to bring non debtors into a bankruptcy case also does not render substantive consolidation in conflict with express provisions of the Code."

It remains to be seen whether *Clark* will appreciably impact the reluctance of most courts to substantively consolidate debtors with nondebtors.

TO HAVE AND TO HOLD: THIRD CIRCUIT RULES THAT PHYSICAL POSSESSION OF GOODS IS REQUIRED UNDER SECTION 503(b)(9) OF THE BANKRUPTCY CODE

Danielle Barav-Johnson

Since its enactment as part of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, section 503(b)(9) of the Bankruptcy Code has provided an important safety net for creditors selling goods to financially struggling companies that file for bankruptcy. The provision gives vendors an administrative expense priority claim for the value of goods "received by the debtor" during the 20-day period before the bankruptcy petition date. The U.S. Court of Appeals for the Third Circuit recently considered section 503(b)(9) and its relationship with another important vendor protection—reclamation rights under section 546 of the Bankruptcy Code and related nonbankruptcy law—in *In re World Imports, Ltd.*, 862 F.3d 338 (3d Cir. 2017). The Third Circuit reversed lower court rulings that the phrase "received by the debtor" in section 503(b)(9) includes constructive possession of goods at the time title is transferred, in addition to physical possession of the goods.

SECTION 503(b)(9) CLAIMS AND RECLAMATION RIGHTS

Section 503(b)(9) provides that a creditor shall have an administrative expense claim for "the value of any goods received by the debtor within 20 days before the date of commencement of a [bankruptcy] case . . . in which the goods have been sold to the debtor in the ordinary course of such debtor's business." Administrative expense priority is a benefit to creditors and a burden to debtors. Unless the creditor agrees otherwise, the debtor cannot confirm a chapter 11 plan without paying administrative claims in full. *See* 11 U.S.C. § 1129(a)(9)(A). By contrast, vendor claims that do not meet the requirements of section 503(b)(9) typically are treated as general unsecured claims, entitling the holders to no more than their pro rata share of the estate's unencumbered assets.

Section 503(b)(9) works in tandem with a seller's "reclamation" rights under applicable nonbankruptcy law. Section 546(c) of the Bankruptcy Code provides that, with certain exceptions, the avoidance powers of a trustee or chapter 11 debtor-in-possession are subject to the right of a vendor who sold goods to a debtor in the ordinary course of the vendor's business to "reclaim" those goods from the debtor, including by stopping shipment of or retrieving the goods, "if the debtor has received

such goods while insolvent" and within 45 days before filing for bankruptcy, provided that the vendor timely gives notice of the reclamation. Section 546(c)(2) explicitly provides that a seller failing to timely give such notice may nonetheless "assert the rights contained in section 503(b)(9)." Thus, the applicability of both provisions hinges in part on when a debtor receives the applicable goods.

In *World Imports*, the Third Circuit examined the meaning of "received" under section 503(b)(9) as a matter of first impression in the circuit courts of appeal.

WORLD IMPORTS

World Imports, Ltd. (the "debtor") purchased furniture and other goods from two international vendors. The vendors shipped the goods to the debtor by common carrier more

NEWSWORTHY

Gregory M. Gordon (Dallas), ***Dan B. Prieto (Dallas)***, ***Jeffrey B. Ellman (Atlanta)***, ***Brad B. Erens (Chicago)***, and ***Amanda S. Rush (Dallas)*** are representing Georgia-Pacific affiliate Bestwall LLC in connection with a chapter 11 case filed by Bestwall on November 2, 2017, in the U.S. Bankruptcy Court for the Western District of North Carolina. Bestwall, which formerly manufactured asbestos-containing joint compound used to seal drywall, filed its chapter 11 petition in an effort to equitably and permanently resolve its current and future asbestos liabilities.

Bruce Bennett (Los Angeles and New York) was included in the "Top 100 Lawyers in California" for 2017 by the *Daily Journal*. One of California's leading legal newspapers, the *Daily Journal* introduced the "Top 100 Lawyers" list in 1997 as a compilation of California attorneys doing the most cutting-edge legal work in California and around the nation; it has since grown into a closely watched annual report of the state's most influential attorneys.

Scott J. Greenberg (New York), ***Carl E. Black (Cleveland)***, ***Michael J. Cohen (New York)***, ***Daniel J. Merrett (Atlanta)***, and ***Stacey L. Corr-Irvine (New York)*** are representing M&G Chemicals S.A., one of the world's largest producers of polyethylene terephthalate ("PET") resin for packaging applications, in connection with chapter 11 cases filed by M&G and certain affiliates on October 30, 2017, in the U.S. Bankruptcy Court for the District of Delaware. With 14 locations in six countries around the world, M&G supplies PET to major plastic packaging companies worldwide, and its product is used extensively in the beverage, food, and personal-care industries. Significant construction delays and cost overruns with respect to its Corpus Christi plant were primary causes of the company's recent liquidity challenges. M&G filed for chapter 11 to obtain debtor-in-possession financing that will facilitate an organized and orderly sale of the Corpus Christi plant and other assets.

Ben Larkin (London) and ***Sion Richards (London)*** were recommended as "leading individuals" in the field of Restructuring/Insolvency in the 2018 edition of *Chambers UK: A Client's Guide to the UK Legal Profession*.

Scott J. Greenberg (New York) and ***Mark A. Cody (Chicago)*** represented General Wireless Operations Inc., the parent company of RadioShack, in connection with the confirmation on October 25, 2017, of a chapter 11 plan by the U.S. Bankruptcy Court for the District of Delaware. Under the plan, Standard General LP will exchange $5 million in secured debt for the equity of the reorganized company, which will be moving away from its physical-store model to focus on the company's dealer network and online operations. RadioShack has shuttered all but 30 of its 1,500 retail locations but is still operating its online division. While in chapter 11, it received court approval for a $15 million credit-bid sale of the company's intellectual property.

An article written by ***Charles M. Oellermann (Columbus)*** and ***Mark G. Douglas (New York)*** entitled "Yet Another Ruling Deepens the Divide on Whether the Bankruptcy Code's Avoidance Provisions Apply Extraterritorially" was reprinted in the October 2017 issue of the *INSOL International News Update*.

Ben Larkin (London) was recognized as a "Leading Lawyer" in the field of "Finance – Corporate restructuring and insolvency" in the 2017 edition of *The Legal 500 United Kingdom*.

An article written by ***Charles M. Oellermann (Columbus)*** and ***Mark G. Douglas (New York)*** entitled "Additional Rulings Deepen the Divide on Whether the Bankruptcy Code's Avoidance Provisions Apply Extraterritorially" was featured in the November 14, 2017, *Harvard Law School Bankruptcy Roundtable*.

than 20 days before it filed for chapter 11 protection on July 3, 2013, in the Eastern District of Pennsylvania. Certain of the goods were shipped directly ("drop-shipped") to the debtor's customers, while others were shipped directly to the debtor. In each case, the goods were shipped "free on board" ("FOB") at the port of origin, meaning that title to the goods and the risk of loss passed to the debtor at the port. All of the goods were received by either the debtor or its customers within the 20-day period prior to the debtor's bankruptcy filing.

The vendors asserted administrative expense claims under section 503(b)(9), arguing that the goods were "received" when they were delivered to the debtor or its customers. The debtor countered that it "received" the goods for purposes of section 503(b)(9) when title to the goods transferred to the debtor upon shipment FOB—prior to the 20-day window.

Because the term "received" is not defined in the Bankruptcy Code, the debtor and the vendors insisted that the definition must be drawn from nonbankruptcy law, but they disagreed on the appropriate source of law. The vendors argued that the definitional "gap" should be filled by state law—specifically, the Uniform Commercial Code (the "UCC"). The debtor maintained that the definition should be drawn from the law governing the sale transaction, which in this case was the Convention on Contracts for the International Sale of Goods (the "CISG") and the international commercial terms ("incoterms") incorporated therein.

The bankruptcy court held that, as an international treaty, the CISG preempts application of the UCC and provides the meaning of undefined terms for transactions which fall under its purview. Although the CISG and the incoterms do not directly define the term "received," the court explained, the incoterms provide that goods shipped FOB are delivered by the seller when placed on board a common carrier for shipment. As a result, the bankruptcy court found that all goods were constructively received by the debtor when they were shipped FOB more than 20 days prior to the bankruptcy petition, except for the drop-shipped goods, which were never received by the debtor. Therefore, the court ruled that the vendors were not entitled to a section 503(b)(9) claim for the value of the goods.

The district court affirmed on appeal, and the vendors appealed to the Third Circuit.

THE THIRD CIRCUIT'S RULING

A three-judge panel of the Third Circuit reversed. The panel held, among other things, that the UCC is the proper source of law to fill in the gaps of undefined terms in section 503(b)(9), regardless of whether the CISG otherwise governed the transaction.

The Third Circuit noted the presumption that an undefined statutory term incorporates the ordinary meaning of the term which was in use when the statute was enacted, if there was one. After consulting several dictionaries, the panel concluded that the legal and dictionary definitions of "received" all require physical, as distinguished from constructive, possession. Moreover, the Third Circuit explained, Article 2 of the UCC, which defines "receipt" of goods as "taking physical possession of them" (*see* UCC § 2-103(1)(c)), governed the sale of goods in 49 states when section 503(b)(9) was enacted, and the legislative history indicates that Congress relied on the UCC definition for the term "received."

Because section 546(c) of the Bankruptcy Code (governing reclamation) was designed to function in conjunction with section 503(b)(9), the Third Circuit panel examined the meaning of "received" under section 546(c), reasoning that a consistent definition of the term must apply to each provision. The Third Circuit had previously ruled in *Montello Oil Corp. Cities Service Co. v. Marin Motor Oil, Inc. (In re Marin Motor Oil, Inc.)*, 740 F.2d 220 (3d. Cir. 1984), that Congress intended to incorporate the UCC's reclamation provision (UCC § 2-702) into the Bankruptcy Code when it enacted section 546(c) in 1978 and, therefore, that the provision incorporates the UCC definition of "receipt." Adopting that reasoning, the Third Circuit panel in *World Imports* concluded that section 503(b)(9) must incorporate the same UCC definition.

Notably, the Third Circuit held that the definitional gap in section 503(b)(9) is not to be filled by reference to applicable law on a case-by-case basis. The court determined instead that Congress incorporated the UCC definition of "receipt" into section 503(b)(9) upon its enactment as a static definition. In other words, the Third Circuit panel explained, the meaning of "received" is not drawn from applicable law governing the relevant transaction, but rather is consistent regardless of the terms of the underlying transaction.

The Third Circuit rejected the debtor's argument that the goods were constructively "received" more than 20 days prior to the bankruptcy filing when they were delivered FOB to a common carrier, at which point both title and the risk of loss passed to the debtor. The court ruled that neither transfer of title nor the risk of loss amounts to constructive receipt of goods. Furthermore, the court noted, although physical receipt of goods by an agent of the buyer constitutes constructive receipt for purposes of section 503(b)(9), Third Circuit case law has consistently held that common carriers do not qualify as agents under section 503(b)(9) or the UCC.

The court ruled that, because the debtor physically received the goods which were not drop-shipped within 20 days of filing for bankruptcy, the vendors were entitled to an administrative expense claim for the value of those goods delivered to the debtor.

RAMIFICATIONS OF *WORLD IMPORTS*: *IN RE SRC LIQUIDATION, LLC*

World Imports is significant as the first circuit court decision to address whether physical possession is required for goods to be "received" under section 503(b)(9). However, the Third Circuit was not the first court to consider the issue. Several other courts have similarly held that a section 503(b)(9) claim requires physical possession of goods by the debtor or its agent within the 20-day prepetition window. *See, e.g.*, *In re Wezbra Dairy, LLC*, 493 B.R. 768 (Bankr. N.D. Ind. 2013) (holding that goods are "received" under section 503(b)(9) when they come into the debtor's physical possession, rather than when title to the goods transfers to the debtor); *In re Circuit City Stores, Inc.*, 432 B.R. 225 (Bankr. E.D. Va. 2010) (same). It remains to be seen whether other courts not bound by the Third Circuit precedent will also adopt this approach.

Although the Third Circuit did not address the issue, *World Imports* is likely to impact administrative expense claims for goods that have been drop-shipped. Like several other courts that have considered the matter (*see, e.g.*, *Ningbo Chenglu Paper Prod. Mfg. Co. v. Momenta, Inc.*, 2012 WL 3765171 (D.N.H. Aug. 29, 2012); *In re ADI Liquidation, Inc.*, 2017 WL 2712287 (Bankr. D. Del. June 22, 2017); *In re Momenta, Inc.*, 455 B.R. 353, 361 (Bankr. D.N.H. 2011)), the bankruptcy court in *World Imports* held that drop-shipped goods were not "received" by the debtor for purposes of section 503(b)(9). *See In re World Imports, Ltd.*, 511 B.R. 738, 740 n.2 (Bankr. E.D. Pa. 2014), *aff'd*, 549 B.R. 820 (E.D. Pa. 2016), *rev'd*, 862 F.3d 338 (3d Cir. 2017). Neither the district court nor the Third Circuit directly reviewed

this ruling (because it was not appealed), focusing instead on the goods that were not drop-shipped.

Nevertheless, the bankruptcy court in *In re SRC Liquidation, LLC*, 573 B.R. 537 (Bankr. D. Del. 2017), relied on *World Imports* in ruling that goods drop-shipped directly to a debtor's customers were not "received" by the debtor for purposes of section 503(b)(9). In that case, a vendor drop-shipped goods to the debtor's customers using the debtor's United Parcel Service ("UPS") account. The court held that transfer of title to the debtor at the time of shipment did not constitute receipt of goods under section 503(b)(9). Further, the court determined, because UPS is a common carrier, it could not serve as the debtor's agent for the purpose of receipt.

OUTLOOK

World Imports clarifies that "received" under section 503(b)(9) means physical possession of goods rather than the passage of title.

In addition, on the basis of *World Imports*, *SRC Liquidation*, and similar rulings, vendors who drop-ship goods directly to customers of a buyer may not rely on section 503(b)(9) to improve their position in the event the buyer files for bankruptcy. To mitigate potential losses, such vendors may be forced to look to their reclamation rights instead. Alternatively, a vendor could require a buyer to take constructive possession prior to delivery of drop-shipped goods by, for example, arranging for receipt of the goods by an agent of the buyer or a bailee when the goods are delivered to a storage facility or processed by a customs agent. *See, e.g.*, *Momenta*, 455 B.R. at 360–61 (noting that attorning goods to a debtor, e.g., at a storage facility or through receipt by a customs agent, would result in constructive possession for purposes of section 503(b)(9)).

THIRD CIRCUIT RULES THAT WARN ACT'S "UNFORESEEABLE BUSINESS CIRCUMSTANCES" EXCEPTION REQUIRES THAT LAYOFFS BE PROBABLE, NOT POSSIBLE

Charles M. Oellermann
Mark G. Douglas

In *Varela v. AE Liquidation, Inc. (In re AE Liquidation, Inc.)*, 866 F.3d 515 (3d Cir. 2017), the U.S. Court of Appeals for the Third Circuit became the sixth circuit court of appeals to rule that a "probability standard" applies in determining whether an employer is relieved from giving 60 days' advance notice to employees of a mass layoff under the Worker Adjustment and Retraining Notification Act of 1988 (the "WARN Act"). The court upheld lower court rulings that a chapter 11 debtor-employer could rely on the WARN Act's "unforeseeable business circumstances" exception because a proposed sale of the company as a going concern under section 363(b) of the Bankruptcy Code collapsed due to the failure of a Russian bank to honor its commitment to provide the buyer with acquisition financing.

THE WARN ACT

Enacted in 1988, the WARN Act protects workers, their families, and communities by requiring most employers with 100 or more employees to provide notification of plant closings and mass layoffs 60 calendar days prior to the event. *See* 29 U.S.C. § 2102(a).

U.S. Department of Labor regulations prescribe when an employer must give WARN Act notice, whom the employer must notify, how the employer must give notice, and what information the notice must contain. *See* 20 C.F.R. §§ 639 *et seq*.

According to 29 U.S.C. § 2104(a), an employer failing to give WARN Act notice shall be liable to each aggrieved employee who suffers an employment loss as a result of a plant closing or mass layoff for, among other things, back pay for each day during the period of the violation.

However, if an employer can prove that it shut down operations because either it was a "faltering company" or the shutdown was due to business circumstances "that were not reasonably foreseeable," it need not comply with the WARN Act's 60-day notice provisions. *See* 29 U.S.C. §§ 2102(b)(1) and (b)(2)(A); 20 C.F.R. § 639.9. Twenty-nine U.S.C. § 2102(b)(1) and (2)(A) provide as follows:

(1) An employer may order the shutdown of a single site of employment before the conclusion of the 60-day period if as of the time that notice would have been required the employer was actively seeking capital or business which, if obtained, would have enabled the employer to avoid or postpone the shutdown and the employer reasonably and in good faith believed that giving the notice required would have precluded the employer from obtaining the needed capital or business.

(2)(A) An employer may order a plant closing or mass layoff before the conclusion of the 60-day period if the closing or mass layoff is caused by business circumstances that were not reasonably foreseeable as of the time that notice would have been required.

In addition, 29 U.S.C. § 2102(b)(2)(B) provides that "[n]o notice under [the WARN Act] shall be required if the plant closing or mass layoff is due to any form of natural disaster, such as a flood, earthquake, or the drought currently ravaging the farmlands of the United States."

Finally, a court-fashioned "liquidating fiduciary" exception provides that a liquidating fiduciary in a bankruptcy case (e.g., a trustee or other estate representative) does not fit the definition of "employer" for purposes of the WARN Act. *See Official Comm. of Unsecured Creditors of United Healthcare Sys., Inc. v. United Healthcare Sys., Inc. (In re United Healthcare Sys., Inc.)*, 200 F.3d 170 (3d Cir. 1999) (a healthcare debtor that filed for chapter 11 as a business liquidating its affairs rather than a business operating as a going concern was not an "employer" under the WARN Act, even though it retained its 1,200 employees for 16 days after the petition date); *Conn v. Dewey & LeBoeuf LLP (In re Dewey & LeBoeuf LLP)*, 487 B.R. 169 (Bankr. S.D.N.Y. 2013).

The unforeseeable business circumstances exception is an affirmative defense. The employer must demonstrate that: (i) the business circumstances causing the layoff were not reasonably foreseeable; and (ii) those circumstances caused the layoff. *See Calloway v. Canaco Pharm. Labs., Ltd.*, 800 F.3d 244 (6th Cir. 2015); 20 C.F.R. § 639.9(b).

Under the implementing regulations, closings and layoffs are not foreseeable when "caused by some sudden, dramatic, and unexpected action or condition outside the employer's control." 20 C.F.R. § 639.9(b)(1). The regulations also provide that, in assessing the foreseeability of business circumstances, the focus should be "on an employer's business judgment" and that an employer is required only to "exercise such commercially reasonable business judgment as would a similarly situated employer in predicting the demands of its particular market." 20 C.F.R. § 639.9(b)(2).

Five circuit courts of appeal have ruled that, in order to be "reasonably foreseeable" as this phrase is used in the WARN Act, an event must be probable rather than merely possible. *See United Steel Workers of Am. Local 2660 v. U.S. Steel Corp.*, 683 F.3d 882, 887 (8th Cir 2012) (an employer's knowledge that an economic downturn would hurt demand for its product did not preclude the unforeseeable business circumstances exception because "[n]othing in the record suggests that the extent of the economic downturn and its effects on the steel industry were probable any time before [the time notice was given]"); *Gross v. Hale-Halsell Co.*, 554 F.3d 870, 876 (10th Cir. 2009) ("[W]e do not rely on the mere possibility that layoffs will occur, but rather look for their probability."); *Roquet v. Arthur Andersen LLP*, 398 F.3d 585, 589 (7th Cir. 2005) (ruling that although it was "[c]ertainly possib[le]" that the accounting firm rather than its individual officers would be indicted, that possibility never rose to the level of "probable," and thus the unforeseeable business circumstances exception applied); *Watson v. Mich. Indus. Holdings, Inc.*, 311 F.3d 760, 765 (6th Cir. 2002) (adopting the probability standard and noting that "WARN was not intended to force financially fragile, yet economically viable, employers to provide WARN notice . . . when there is a *possibility* that the business may fail at some undetermined time in the future"); *Halkias v. General Dynamics Corp.*, 137 F.3d 333, 336 (5th Cir. 1998) (noting that anything less than probability would be "impracticable" and reasoning that, if the mere possibility of layoffs were enough to trigger the WARN Act, contractors "would be put to the needless task of notifying employees of possible contract cancellation and concomitant lay-offs" every time cost overruns caused the cancellation of contracts, even though layoffs were not likely).

Even if the exceptions in 29 U.S.C. § 2102(b)(1) and (b)(2)(A) apply, an employer is not completely relieved of its obligation to notify employees. The employer can give less than 60 days' WARN Act notice, provided that the notice contains certain "basic" information (*see* 20 C.F.R. § 639.7) and the reasons the employer could not provide the full 60 days' notice. *See* 29 U.S.C. § 2102(b)(3).

If an employer is selling all or part of its business, the WARN Act provides that the seller is responsible for providing employees with notice of any mass layoff "up to and including the effective date of the sale," after which that responsibility shifts to the buyer. 29 U.S.C. § 2101(b)(1). If the sale is on a going-concern basis, it is presumed that the sale "involves the hiring of the seller's employees unless something indicates otherwise," whether or not the sale agreement expressly provides for retention of the seller's employees. *Wilson v. Airtherm Prods., Inc.*, 436 F.3d 906, 912 (8th Cir. 2006).

The Third Circuit addressed the unforeseeable business circumstances exception in *AE Liquidation*.

AE LIQUIDATION

Eclipse Aviation Corp. ("EAC") manufactured specialty aircraft. Beginning in 2007, EAC customer European Technology and Investment Research Center ("ETIRC") acquired a significant percentage of EAC's preferred stock and provided EAC with financial support in the form of loans.

In late 2007, EAC and ETIRC entered into an agreement whereby ETIRC was to purchase aircraft kits from EAC to be assembled by a factory in Russia. Financing for the arrangement was to be provided by Vnesheconombank ("VEB"), a state-owned Russian bank. In June 2008, the Russian factory deal was delayed and EAC began to run out of cash, prompting ETIRC, whose chairman was appointed EAC's chief executive officer, to lend EAC an additional $25 million.

Continued delays in the closing of the factory deal caused a liquidity crisis. EAC's board considered a bankruptcy filing to sell the company's assets or liquidate the company.

EAC filed for chapter 11 protection on November 25, 2008, in the District of Delaware with the intention of selling substantially all of its assets as a going concern at auction, with ETIRC acting as the stalking-horse bidder. The proposed purchase agreement provided that VEB would finance the acquisition with a $205 million loan to ETIRC. The agreement further provided that EAC was to continue operating its business and retain its employees prior to the closing, but the agreement did not expressly obligate ETIRC to take on the employees as part of the transaction. In addition, in boilerplate language, the agreement expressly provided that ETIRC: (i) was not obligated to pay any claims or liabilities of EAC's employees, including salaries and severance pay; and (ii) was "under no obligation to employ or continue to employ any individual for any period."

The bankruptcy court approved the sale transaction with ETIRC (as the only qualified bidder) in January 2009.

The closing of the sale transaction was delayed multiple times during the next two months. VEB needed, among other things, to be recapitalized, which could be approved only by then-Russian Prime Minister Vladimir Putin. During that two-month period, Russian officials repeatedly assured EAC, ETIRC, and an ad hoc committee of EAC's noteholders that the recapitalization would occur.

EAC became administratively insolvent on February 6, 2009, and the company's board was informed on February 17 that, without additional funding, EAC would run out of cash on February 27. EAC's board informed the company's employees on February 18, 2009, that the sale was taking longer than expected and that, although the board believed that the closing was "well within reach," all employees were being furloughed indefinitely to make the company's cash last as long as possible.

Additional assurances that the VEB recapitalization was imminent were also illusory. Accordingly, the noteholders' committee and EAC's board adopted a resolution directing management to file a motion to convert the chapter 11 case to a chapter 7 liquidation on February 24 if the Russian government did not commit to closing the transaction on VEB's behalf prior to that date.

The conversion motion was filed on February 24. That same day, EAC informed its employees by email that, despite its best efforts, "closing of the sale transaction has stalled and our company is out of time and money." The notice further stated that, because of the "dire circumstances in today's global marketplace" and the lack of any additional funding, EAC's bankruptcy case was being converted to a liquidation, meaning that the prior furlough had been converted into a layoff, effective February 19. Finally, the notice provided that employees would receive information regarding their benefits packages by mail later that week.

EAC's employees filed a class action adversary proceeding in the bankruptcy court, alleging that the company's failure to give them 60 days' notice prior to the layoff violated the

With its ruling in *AE Liquidation*, the Third Circuit joins the Fifth, Sixth, Seventh, Eighth, and Tenth Circuits in adopting the heightened probability standard in determining whether an employer should be relieved under the unforeseeable business circumstances exception from complying with the 60-day notice period prescribed in the WARN Act. This is doubtless a welcome development for employers, both financially distressed and otherwise, because it brings greater certainty to an important issue.

WARN Act. The bankruptcy court granted EAC's motion for summary judgment, ruling that the unforeseeable business circumstances exception barred WARN Act liability.

The district court affirmed on appeal, and the employees appealed to the Third Circuit.

THE THIRD CIRCUIT'S RULING

A three-judge panel of the Third Circuit affirmed the rulings below.

Writing for the panel, circuit judge Cheryl Ann Krause rejected each of the arguments made by the employees—namely: (i) EAC was ineligible for the exception because it never provided employees with proper notice under the WARN Act; (ii) EAC could not demonstrate that the purported unforeseeable business circumstance (its failure to close the sale to ETIRC) caused the mass layoff; and (iii) the exception did not apply because the failure to close was not "unforeseeable," but instead could have been anticipated on many different occasions during the 60-day period prior to the layoff.

Explaining that 20 C.F.R. §§ 639.7(a)(4) and 639.8 provide that notice to employees must be "based on the best information available to the employer at the time the notice is served" and delivered in a manner "designed to ensure receipt," the panel concluded that EAC's notice was not deficient.

The Third Circuit panel also found that failure to close the sale to ETIRC caused the layoff. According to Judge Krause, notwithstanding the boilerplate language in the sale agreement, the evidence supported "the presumption that [EAC's] employees would have retained their jobs had the sale been finalized, and the District Court did not err in concluding as a matter of law that the failure to obtain financing for the sale was the cause of the layoff." Such boilerplate language, she wrote, addressed a buyer's "typical litigation concerns over successor liability and third-party beneficiary claims" rather than undermining the intent that the sale transaction proceed on a going-concern basis, including the retention of EAC employees.

Finally, turning to whether the collapse of the sale was reasonably foreseeable, the Third Circuit panel acknowledged that it had never addressed the "probability standard" directly. However, Judge Krause noted, the adoption of that standard found support in the court's sole previous precedential ruling on the unforeseeable business circumstances exception. In *Hotel Employees & Restaurant Employees Int'l Union Local v. Elsinore Shore Assocs.*, 173 F.3d 175 (3d Cir. 1999), she explained, the court held that a casino's closure by the state casino control commission was not reasonably foreseeable and that, because of the exception, the casino was not required to give its employees 60 days' WARN Act notice. According to Judge Krause, although the court did not explicitly address whether the closure was probable or merely possible, the facts indicated that the court was "applying a higher standard more akin to a probability test." Moreover, in dicta, the Third Circuit in *Elsinore* endorsed the logic of that standard, observing that the WARN Act was not intended to "require an economically viable employer to provide notice of a possible—but unlikely—closing." *Id.* at 185 n.7.

"[R]equiring such premature notice," Judge Krause wrote in *AE Liquidation*, "could have the perverse effects of causing creditors to refuse to provide the struggling company with further credit or prompting employees to unnecessarily leave their jobs—potentially forfeiting valuable future assets such as unvested benefits." Such unintended consequences would

also “increase the chance that an employer will be forced to close and lay off its employees, harming precisely those persons WARN attempts to protect” (quoting *id.*).

The Third Circuit panel joined its sister circuits in holding that “the WARN Act is triggered when a mass layoff becomes probable—that is, when the objective facts reflect that the layoff was more likely than not.” According to Judge Krause, this approach strikes an appropriate balance in ensuring that employees receive the protections of the WARN Act without imposing an “impracticable” burden on employers:

> Companies in financial distress will frequently be forced to make difficult choices on how best to proceed, and those decisions will almost always involve the possibility of layoffs if they do not pan out exactly as planned. If reasonable foreseeability meant something less than a probability, nearly every company in bankruptcy, or even considering bankruptcy, would be well advised to send a WARN notice, in view of the potential for liquidation of any insolvent entity. . . . [S]uch premature [and costly] warning has the potential to accelerate a company’s demise and necessitate layoffs that otherwise may have been avoided.

Applying the foreseeability analysis to the facts, the Third Circuit panel concluded that EAC met its burden of demonstrating that ETIRC’s failure to obtain the financing necessary to close the sale was not probable prior to EAC’s decision to lay off its employees. Among other things, the panel found that, although a close call in some cases, EAC’s reliance on assurances regarding VEB’s continued commitment to funding the sale transaction was “commercially reasonable.”

OUTLOOK

With its ruling in *AE Liquidation*, the Third Circuit joins the Fifth, Sixth, Seventh, Eighth, and Tenth Circuits in adopting the heightened probability standard in determining whether an employer should be relieved under the unforeseeable business circumstances exception from complying with the 60-day notice period prescribed in the WARN Act. This is doubtless a welcome development for employers, both financially distressed and otherwise, because it brings greater certainty to an important issue.

AE Liquidation is also notable because the Third Circuit ruled that, when a corporation is sold as a going concern, there is a presumption that the buyer will be hiring the seller’s employees as part of the sale, “regardless of whether the seller has expressly contracted for the retention of its employees.” The Third Circuit thereby aligned itself with the Eighth and Ninth Circuits, which adopted a similar approach in *Wilson* and *Int’l All. of Theatrical & Stage Employees & Moving Picture Mach. Operators, AFL-CIO v. Compact Video Servs., Inc.*, 50 F.3d 1464 (9th Cir. 1995), respectively.

Finally, the ruling demonstrates the interaction between the WARN Act and the Bankruptcy Code. Had EAC filed for chapter 11 protection for the purpose of liquidating the company, rather than for the purpose of selling it as a going concern under section 363(b) of the Bankruptcy Code or pursuant to a chapter 11 plan, no WARN Act notice would have been required under the “liquidating fiduciary” exception. Because EAC’s proposed sale as a going concern under section 363(b) collapsed, the unforeseen business circumstances exception was still available to the company.

IN BRIEF: BANKRUPTCY COURT RULES THAT IT HAS CONSTITUTIONAL AUTHORITY TO GRANT NONCONSENSUAL RELEASES IN CHAPTER 11 PLAN

In *In re Millennium Lab Holdings II, LLC*, 2017 BL 354864 (Bankr. D. Del. Oct. 3, 2017), the U.S. Bankruptcy Court for the District of Delaware ruled that it had the constitutional authority to grant nonconsensual third-party releases in an order confirming the chapter 11 plan of laboratory testing company Millennium Lab Holdings II, LLC ("Millennium"). In so ruling, the court rejected an argument made by a group of creditors that a provision in Millennium's plan releasing racketeering claims against the debtor's former shareholders was prohibited by the U.S. Supreme Court's 2011 ruling *Stern v. Marshall*, 564 U.S. 462 (2011), which limited claims that can be finally adjudicated by a bankruptcy judge. Bankruptcy judge Laurie Selber Silverstein wrote that the objecting creditors' position was unsupported and would "dramatically change the division of labor between the bankruptcy and district courts."

In December 2015, the bankruptcy court confirmed Millennium's chapter 11 plan. The plan released claims against various nondebtor entities, including Millennium's former shareholders, who contributed $325 million to the estate, in part to fund a $250 million settlement with federal regulators on False Claims Act claims that had to be paid within weeks to avoid forfeiture of Millennium's Medicare billing privileges.

A group of creditors led by Voya Investment Management ("Voya"), which asserted racketeering claims against the shareholders on the basis of allegations of disclosure failures and conflicts related to a $1.8 billion pre-bankruptcy dividend recapitalization, objected to confirmation. Voya contended, among other things, that the court did not have subject matter jurisdiction to grant nonconsensual third-party releases and that the plan releases did not satisfy the Third Circuit's decision in *Gillman v. Continental Airlines (In re Continental Airlines)*, 203 F.3d. 203, 214 (3d Cir. 2000), which requires specific factual findings that proposed releases are fair and necessary to a reorganization.

The court overruled the objections, and Voya appealed the confirmation order. It argued on appeal, among other things, that the bankruptcy court lacked authority to grant the releases under *Stern* because barring the racketeering claims was tantamount to adjudicating them, which is outside a bankruptcy court's constitutional jurisdiction. The district court remanded the constitutionality issue to the bankruptcy court.

On remand, Judge Silverstein rejected Voya's "expansive reading of *Stern*, which not only applies *Stern* outside of the narrow context in which it was made, but far beyond the holding of any court." In *Stern*, the Supreme Court ruled that a bankruptcy court cannot enter a final judgment on a state law counterclaim of the bankruptcy estate which is not resolved in the process of ruling on a creditor's proof of claim.

According to Judge Silverstein:

> *Stern* did not hold, as Voya suggests, that regardless of which articulated (or unarticulated) core proceeding is before the court, the bankruptcy judge cannot, consistent with the Constitution, enter a final order in that proceeding if that order affects a party's entitlement to have a debtor's or trustee's state law claim heard by an Article III court.

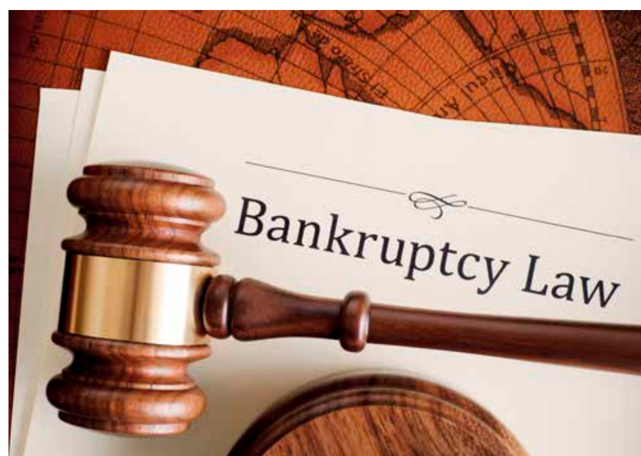
She also noted that Voya's *Stern*-based argument was misplaced because, among other reasons, the racketeering claims were federal and, although the releases undeniably "impacted" the racketeering claims, they did not actually adjudicate them, but were part of a settlement that would give the shareholders an affirmative defense in any racketeering litigation.

Judge Silverstein emphasized that Voya's interpretation of *Stern* would "dramatically change the division of labor between the bankruptcy and district courts." She explained that, without

consent, which could be withheld as leverage, district courts would be compelled to enter final orders approving a wide range of relief traditionally granted by bankruptcy courts, including orders approving free-and-clear asset sales under section 363, substantive consolidation, and the recharacterization or subordination of claims.

Finally, Judge Silverstein ruled that Voya forfeited any challenge on *Stern* grounds by failing to make it during the plan confirmation process.

Voya appealed the decision on October 16, 2017.



CHAPTER 11 PLAN NOT PROVIDING FOR PAYMENT OF MAKE-WHOLE PREMIUM IMPAIRED NOTEHOLDERS

Brad B. Erens
Timothy Hoffmann
Thomas A. Howley

In *In re Ultra Petroleum Corp.*, 2017 BL 335015 (Bankr. S.D. Tex. Sept. 21, 2017), the U.S. Bankruptcy Court for the Southern District of Texas ruled that certain private-placement noteholders were entitled to receive a "make-whole" premium in excess of $200 million under a chapter 11 plan that rendered the noteholders' claims unimpaired.

The ruling is significant because the court determined that: (i) a "model form" make-whole provision triggered by a bankruptcy filing created an enforceable liquidated damages claim, an issue with respect to which there have been conflicting decisions (*compare Del. Tr. Co. v. Energy Future Intermediate Holding Co. LLC (In re Energy Future Holdings Corp.)*, 842 F.3d 247 (3d Cir. 2016) (reversing lower court rulings disallowing the claims of noteholders for make-whole premiums allegedly due under public indentures) *with Momentive Performance Materials Inc. v. BOKF, NA (In re MPM Silicones, L.L.C.)*, 2017 BL 376794 (2d Cir. Oct. 27, 2017) (upholding the bankruptcy court's denial of the noteholders' make-whole claim)); and (ii) the chapter 11 debtors must pay the make-whole amount in full to render the noteholders' claims "unimpaired."

Ultra Petroleum Corp. ("UPC") issued approximately $1.5 billion in unsecured notes from 2008 to 2010. The note agreement, which was governed by New York law, provided that UPC had the right to prepay the notes at 100 percent of principal plus

a make-whole amount. Events of default under the agreement included a bankruptcy filing by UPC.

UPC filed for chapter 11 protection in April 2016. Improving business conditions during the course of the case allowed UPC to seek confirmation of a chapter 11 plan that provided for the payment in cash of all unsecured claims in full. The plan designated the noteholders' claims as "unimpaired" but did not provide for the payment of the make-whole amount or postpetition interest at the default rate. UPC contested the noteholders' right to receive the make-whole amount, post-petition default-rate interest, and certain other related fees and expenses.

The bankruptcy court first decided that the make-whole amount was an enforceable liquidated damages provision—rather than an unenforceable penalty—under New York law. The court rejected UPC's arguments that the make-whole amount was "conspicuously disproportionate to foreseeable losses at the time the parties entered" into the note agreement because it would result in a double recovery.

The court also held that UPC's chapter 11 plan impaired the noteholders' claims because the plan failed to provide for the payment of the make-whole amount and postpetition default-rate interest. The court rejected UPC's position that, because the make-whole amount represented "unmatured interest" and was not allowable under section 502(b)(2) of the Bankruptcy Code, the plan left the noteholders' rights under the Bankruptcy Code unaltered, and the noteholders' claims were therefore unimpaired under section 1124(1) of the Bankruptcy Code. Section 1124 provides in substance that, unless a creditor consents, its claim is impaired under a plan unless: (1) the plan "leaves unaltered the legal, equitable, and contractual rights to which such claim . . . entitles [the creditor]"; or (2) reinstates the maturity of the claim after curing any monetary defaults and compensating the creditor for any reliance damages.

In support of its position, UPC relied on the Third Circuit's ruling in *In re PPI Enterprises (U.S.) Inc.*, 324 F.3d 197 (3d Cir. 2003). In *PPI*, the court ruled that a plan proposing to pay a landlord's lease rejection claim in an amount equal to the cap on future rent claims set forth in section 502(b)(6) left the landlord's claim unimpaired.

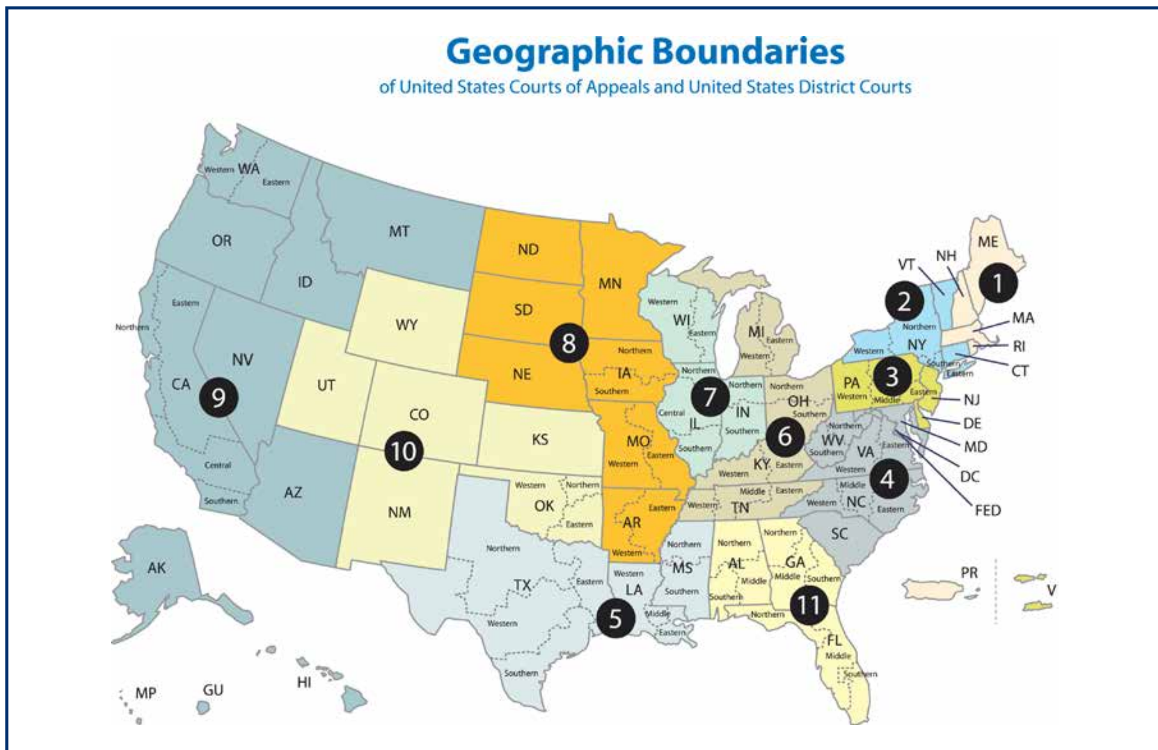
The *Ultra Petroleum* court rejected this reasoning. According to the court, because, pursuant to section 1141(d) of the Bankruptcy Code, UPC's chapter 11 plan, rather than section 502(b)(2), would result in the discharge of UPC's liability on the unpaid make-whole claim, the plan would impair the noteholders' claims unless the plan provided for the payment of the make-whole claim in full.

The court noted in dicta that UPC might have attempted to render the noteholders unimpaired without paying the make-whole amount by reinstating the notes and curing any defaults, as permitted by section 1124(2), but elected not to do so.

UPC appealed the court's order on October 5, 2017. On October 6, the bankruptcy court entered an agreed order directing that, pending resolution on appeal, UPC must pay the make-whole claims and postpetition interest no later than October 13, 2017, from a UPC reserve fund.

On October 26, 2017, the bankruptcy court certified a direct appeal of its order to the U.S. Court of Appeals for the Fifth Circuit, which may or may not agree to hear the appeal. In certifying the appeal, the court noted that Fifth Circuit law is "unambiguous" in holding that even a "slight deterioration" in the rights of a claimant leaves the claimant impaired. However, the court emphasized, the Fifth Circuit has not addressed the issue of "whether impairment should be measured against the non-bankruptcy state law claim or against the claim allowed under § 502." Because that issue of law is fundamental to the reorganized UPC's appeal, the court concluded, it constitutes a matter on which there is no controlling precedent within the Fifth Circuit or from the U.S. Supreme Court, thus warranting direct certification.

THE U.S. FEDERAL JUDICIARY



U.S. federal courts have frequently been referred to as the "guardians of the Constitution." Under Article III of the Constitution, federal judges are appointed for life by the U.S. president with the approval of the Senate. They can be removed from office only through impeachment and conviction by Congress. The first bill considered by the U.S. Senate—the Judiciary Act of 1789—divided the U.S. into what eventually became 12 judicial "circuits." In addition, the court system is divided geographically into 94 "districts" throughout the U.S. Within each district is a single court of appeals, regional district courts, bankruptcy appellate panels (in some districts), and bankruptcy courts.

As stipulated by Article III of the Constitution, the chief justice and the eight associate justices of the Supreme Court hear and decide cases involving important questions regarding the interpretation and fair application of the Constitution and federal law. A U.S. court of appeals sits in each of the 12 regional circuits. These circuit courts hear appeals of decisions of the district courts located within their respective circuits and appeals of decisions of federal regulatory agencies. Located in the District of Columbia, the Court of Appeals for the Federal Circuit has nationwide jurisdiction and hears specialized cases such as patent and international trade cases. The 94 district courts, located within the 12 regional circuits, hear nearly all cases involving federal civil and criminal laws. Decisions of the district courts are most commonly appealed to the district's court of appeals.

Bankruptcy courts are units of the federal district courts. Unlike that of other federal judges, the power of bankruptcy judges is derived principally from Article I of the Constitution, although bankruptcy judges serve as judicial officers of the district courts established under Article III. Bankruptcy judges are appointed for a term of 14 years (subject to extension or reappointment) by the federal circuit courts after considering the recommendations of the Judicial Conference of the United States. Appeals from bankruptcy court rulings are most commonly lodged either with the district court of which the bankruptcy court is a unit or with bankruptcy appellate panels, which presently exist in five circuits. Under certain circumstances, appeals from bankruptcy rulings may be made directly to the court of appeals.

Two special courts—the U.S. Court of International Trade and the U.S. Court of Federal Claims—have nationwide jurisdiction over special types of cases. Other special federal courts include the U.S. Court of Appeals for Veterans Claims and the U.S. Court of Appeals for the Armed Forces.

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Executive Editor: Charles M. Oellermann
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