

Time to Think About Chapter 9?



by Andrew D. Gottfried and Patrick D. Fleming

While much press of late has been given to the federal budget and deficit, a close second in reporting goes to the fiscal problems of the nation's state and local governments. Some local governmental units have recently been the subject of bankruptcy proceedings (e.g., Vallejo, California), while others have been described as candidates for bankruptcy (e.g., Jefferson County, Alabama and Harrisburg, Pennsylvania).

The Bankruptcy Code (the Code), enacted in 1978, includes Chapter 9, titled "Adjustment of Debts of a Municipality." Chapter 9 has been infrequently utilized over the last 30 years. With the notable exception of the Orange County, California case in 1994, Chapter 9 has been primarily utilized by limited-purpose governmental units or small municipalities such as the San Jose Unified School District and Prichard, Alabama, the latter having sought Chapter 9 relief twice in the 1990s.

In view of the likely application of Chapter 9 in the near future to larger governmental units with greater debt, an understanding of the basic statutory features is important, including (i) a comparison of the Chapter 9 debt adjustment provisions to the more commonly used and understood Chapter 11 reorganization provisions, and (ii) consideration of the entities eligible for Chapter 9 relief.

Chapter 9 vs. Chapter 11

Although Chapter 9 and Chapter 11 cases are similar in many respects, there are numerous and significant differences, some of which arise out of concern for the Tenth Amendment guaranty of state sovereignty. As a result, Chapter 9 is "sufficiently narrow in scope to avoid intrusion by the federal courts on the sovereign power of the states."¹ A Chapter 9 debtor's creditors and the court are unable to affect the debtor's political or governmental powers unless the debtor consents, and the Chapter 9 debtor is free to continue managing its affairs without constraint or the need to seek approval by the court. Thus, a Chapter 9 debtor may dispose of its property or obtain credit without court approval, even if the transaction is not in the ordinary course. Notwithstanding the lack of creditor oversight or court control, Chapter 9 contains many of the Chapter 11 provisions that enable a debtor to restructure its liabilities, including the

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editors

Menachem O. Zelmanovitz
mzelmanovitz@morganlewis.com

Wendy S. Walker
wwalker@morganlewis.com

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1701 Market Street • Philadelphia, PA 19103-2921
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ability, in certain situations, to cram down a plan over the objection of dissenting creditors.

Understanding the similarities and differences between Chapter 9 and Chapter 11 requires a review of the structure of Chapter 9, which, in Code Section 901(a), incorporates specific provisions of Chapters 3, 5, and 11.

In Chapter 9, the bankruptcy court has no power to supervise borrowing by the municipality in instances in which none of the special bankruptcy powers are involved.

However, Section 901(a)'s limitations on the incorporated provisions, that are perhaps due to the unique limitations on the power of federal courts in municipal debt adjustments, underlie many of the important differences between Chapter 9 and Chapter 11.

Section 303: Involuntary Cases

Section 303, which allows creditors to commence an involuntary Chapter 7 or 11 case against a corporate or individual debtor, is not incorporated into Chapter 9. A Chapter 9 case may be voluntarily commenced only by appropriate action of a municipality.

Section 363: Disposition of Assets

Section 363 authorizes the bankruptcy court to regulate, in certain situations, a debtor's use, sale, or lease of property (including cash); however, Section 363 is *not* incorporated into Chapter 9. Moreover, Section 904 provides that "unless the debtor consents or the plan so provides, the court may not, by any stay, order, or decree, in the case or otherwise, interfere with ... the debtor's use or enjoyment

of any income-producing property." As a result, a Chapter 9 debtor is free to sell or otherwise dispose of its assets without notice to its creditors and without court approval.

Section 364: Obtaining Credit

Section 364 generally governs a debtor's ability to obtain credit and incur debt in a case under the Code. Subsections

(a) and (b), which relate to obtaining unsecured credit and incurring unsecured debt in the ordinary course of business as an administrative expense, are *not* incorporated into Chapter 9. To do so might be construed as giving the court authority to supervise the amount of debt the debtor could incur in the operation of its normal municipal affairs, contrary to the dictates of the Supreme Court in *United States v. Bekins*.² Therefore, in Chapter 9, the bankruptcy court has no power to supervise borrowing by the municipality in instances in which none of the special bankruptcy powers are involved.

If a Chapter 9 debtor chooses to use the extraordinary powers of the Code to borrow additional funds on a superpriority, unsecured basis or on a secured basis, subsections (c) and (d) of Section 364 are applicable for use by a Chapter 9 debtor. In other words, a Chapter 9 debtor is free to borrow funds, without court approval, to the same extent it could before commencing a Chapter 9 case, *and* is able to borrow funds with court approval on extraordinary bases where the financing would not have been available to it outside of a Chapter 9 case.

Section 365: Executory Contracts

Section 365, which provides a debtor with the ability to assume or reject executory contracts and unexpired leases, is incorporated in its entirety into Chapter 9. In Chapter 11, a debtor's ability to reject certain types of executory contracts is limited. Most notably, Section 1113 limits a Chapter 11 debtor's right to reject or modify a collective bargaining agreement. Section 1113 is *not* incorporated into Chapter 9. Accordingly, the decision to assume or reject a collective bargaining agreement in a Chapter 9 case is governed solely by Section 365 and the debtor's reasonable business judgment standard set forth in *NLRB v. Bildisco*.³ The three-part test enunciated by one court for a municipality's rejection of a collective bargaining agreement requires the debtor to establish only that (1) the collective bargaining agreement is burdensome; (2) the equities balance in favor of contract rejection; and (3) reasonable efforts to negotiate a voluntary modification have been made, and are not likely to produce a prompt and satisfactory solution.⁴ This simple three-part test is in sharp contrast to the more onerous standard of Section 1113 applicable to all Chapter 11 debtors.⁵

Section 507: Priorities

Section 507 provides for certain claims to have priority over other claims. Only Section 507(a)(2) is incorporated into Chapter 9, which grants priority to administrative expenses relating to the case. Thus, unlike Chapter 11, which identifies various types of priority claims, only administrative claimants are given priority in a Chapter 9 case.

Section 547: Preferences

Section 547, relating to the avoidance of preferential transfers, is incorporated into Chapter 9. However, Section 926(b)

grants special protection to bondholders and noteholders, and provides that a transfer of property of the debtor for the benefit of any holder of a bond or note, on account of such bond or note, may not be avoided under Section 547.

Section 552: Postpetition Effect of Security Interest

Section 552(a) generally provides that property that a debtor acquires after filing for bankruptcy is not subject to liens created prior to bankruptcy. Although Section 552(a) is incorporated into Chapter 9, Section 928 provides separate rules for “special revenues,” as defined in Section 902.⁶ Section 928(a) provides that a lien on special revenues acquired by the debtor after commencement of a Chapter 9 case cannot be avoided. Thus, a prepetition lien granted to holders of special revenue bonds, for example, will attach to postpetition revenue, but is “subject to the necessary operating expenses of such project or system.” Moreover, while the Section 362 automatic stay applies upon the commencement of a Chapter 9 case, the application of pledged special revenues is not stayed. Nevertheless, there is no specific requirement that the debtor pay any pledged special revenues to the secured parties during the pendency of the case.

Section 1104: Appointment of a Trustee

Section 1104 provides for appointment by the court of a trustee or an examiner to oversee management of a Chapter 11 debtor or to investigate the debtor. There is no provision for appointment of a trustee or examiner in a Chapter 9 case, except for the sole purpose of exercising avoidance powers under Section 544, 545, 547, 548, 549(a), or 550, should the debtor refuse to do so.

Section 1121: Exclusivity

Section 941 provides that the debtor shall file a plan for the adjustment of its debt with the filing of the petition or at such later time as the court fixes. The debtor in a Chapter 9 case always has the exclusive right to propose a Chapter 9 plan. In contrast, under Section 1121, which is not incorporated into Chapter 9, a Chapter 11 debtor’s exclusivity can expire, thereupon permitting creditors to file a plan.

Section 1123: Contents of a Plan

Section 1123, relating to the contents of a Chapter 11 plan, is largely incorporated into Chapter 9. Excluded from Section 1123(a), which lists mandatory plan provisions, are provisions relevant only to a corporate debtor. Section 1123(b), which sets forth provisions that *may* be included in a Chapter 11 plan, is incorporated in its entirety into Chapter 9.

Section 1126: Acceptance of the Plan

Section 1126 regulates acceptance of a plan of reorganization under Chapter 11. With the exception of subsection (d), which applies to acceptances by a class of equity securities, Section 1126 is incorporated in its entirety into Chapter 9. Thus, as in a Chapter 11 case, unanimity is not required. A class of claims accepts a Chapter 9 plan by a vote of at least two-thirds in amount and a majority in number of those voting to accept or reject the plan.

Section 1129: Confirmation of the Plan

Section 943 governs confirmation of a Chapter 9 plan and incorporates parts of Section 1129. Section 943 provides that the court “shall confirm a plan if” the requirements set out in Section 943 are met, while Section 1129 provides that the court “shall confirm a plan only if” the requirements set out in Section 1129 are

met. It is unclear whether this distinction is intended to grant the court greater discretion in a Chapter 9 case.

Sections 1129(a)(2), (3), (6), (8), and (10) and Sections 1129(b)(1), (2)(A), and (2)(B) are incorporated into Chapter 9. The *omitted* subsections of Section 1129(a) provide that prior to confirmation of a Chapter 11 plan, the court must have approved the administrative costs and expenses of the debtor in connection with the proceeding; the proponent of the plan must have disclosed the identities of directors, officers, or voting trustees of the reorganized debtor; the debtor must have received the consent of each impaired class of claims, which receives an amount less than it would receive upon liquidation of the debtor; each priority claim must be paid in full; and the plan must provide for continuation after its effective date of all retiree benefits.

In addition, a Chapter 9 debtor may invoke the “cramdown power” of Section

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1129(b) to overcome a class of claims that voted to reject a plan. A cramdown under Chapter 9 varies somewhat from Chapter 11. The “fair and equitable” requirement applicable in Chapter 11 to the cramdown of unsecured claims is modified, since most municipalities do not have a “going concern” or “reorganization” value, nor is there a class of equity interest holders. Under case law,⁷ a Chapter 9 plan is “fair and equitable” if the amount to be received by a class of creditors is all that it can reasonably expect under the circumstances.⁸ This modified “fair and equitable” standard in Chapter 9 provides a municipality with wide discretion in restructuring its debt.

As a result of the court's limited power to oversee or control a municipal debtor, a Chapter 9 case can only end in one of two ways: the court can confirm a debtor's plan or it can dismiss the case.⁹ If the court is dissatisfied with the debtor's conduct in the case, the only remedy is dismissal.

Eligibility to Be a Debtor Under Chapter 9

Code Section 109(c) sets forth five eligibility requirements for a debtor under Chapter 9. The putative debtor is eligible if such entity (1) is a municipality; (2) is specifically authorized by state law in its capacity as a municipality or by name, or by an appropriate empowered governmental officer or organization under state law, to be a debtor under Chapter 9; (3) is insolvent; (4) desires to effect a plan to adjust its debts; and (5) (a) has obtained the agreement of creditors holding at least a majority in amount of the claims of each class that the debtor intends to impair under a plan, (b) has negotiated in good faith with creditors, (c) is unable to negotiate because such negotiation is impracticable, or (d) reasonably believes that a creditor may attempt to obtain a preference.¹⁰

The Debtor Must Be a Municipality

At first blush, the notion of what is a “municipality” may seem self-evident. The Code concept is more arcane. Section 101 of the Code defines “municipality” as a “political subdivision or public agency or instrumentality of a State.”¹¹ While the term “State” includes the District of Columbia and Puerto Rico, it excludes both of those entities for the purpose of defining who may be a debtor under Chapter 9.¹² Since a “State” is not a municipality, it cannot be a debtor in Chapter 9, nor can a political subdivision, public agency, or instrumentality of the United States; the District of Columbia; Puerto Rico; or a U.S. territory. Similarly, neither Native American tribes nor gaming entities created by them fall within the definition of “municipality,” and thus are not eligible for Chapter 9 relief.

In determining whether the debtor was a municipality and eligible to be a Chapter 9 debtor, the court in *In re Las Vegas Monorail* considered the following three factors: “(1) ‘whether the entity has any of the powers typically associated with sovereignty, such as eminent domain, the taxing power, or sovereign immunity’; (2) whether the entity has a public purpose and the ‘level of control exercised by the state (or its agreed agents) on the entity's activities’; and (3) ‘the State's own designation and treatment of the entity.’”¹³

The Debtor Must Be Insolvent

Although Chapter 11 debtors frequently are insolvent at the commencement of their cases, there is no Code requirement of insolvency for seeking Chapter 11 relief. A municipality must be insolvent as a condition for its seeking Chapter 9 relief.

Section 101 of the Code defines “insolvent” with reference to a municipality as a “financial condition such that the

municipality is (i) generally not paying its debts as they become due unless such debts are the subject of a bona fide dispute; or (ii) unable to pay its debts as they become due.”¹⁴ This definition differs from the conventional balance sheet test, under which a nonmunicipality entity is insolvent when “the sum of such entity's debts is greater than all of such entity's property, at a fair valuation.”¹⁵

Although it may have the ability to levy taxes, commentators and courts have recognized that “[a] municipality need not exercise its taxing or assessment authority to the fullest extent before a court may conclude that it is unable to meet its debts as they mature.”¹⁶ As one court stated: “[T]he mere contingency that the [municipality] could improve its financial situation by increasing its rates does not alter the fact that at the present time the [municipality] cannot meet its debts as they mature.”¹⁷

Conclusion

Chapter 9 is a powerful yet largely unutilized tool in municipal finance. While there are political and practical constraints on a municipality's resort to Chapter 9, the present pressure on local finances, in particular massive unfunded pension liabilities, may lead to the inevitable resort to Chapter 9 by larger municipal entities. Should this occur, the largely untested Chapter 9 will emerge as a prominent feature of the political and financial landscape.

endnotes

- 1 *In re Richmond Unified Sch. Dist.*, 133 B.R. 221, 224 (Bankr. N.D. Cal. 1991).
- 2 See *United States v. Bekins*, 304 U.S. 27 (1938); 1977 House Report at 393–95.
- 3 See *In re City of Vallejo*, 403 B.R. 72 (Bankr. E.D. Cal. 2009) (citing *NLRB v. Bildisco*, 465 U.S. 513 (1984)).
- 4 *City of Vallejo*, 403 B.R. at 78 (quoting *Bildisco*, 465 U.S. at 526).
- 5 Pursuant to Section 1113, a Chapter 11 debtor must meet the following requirements in order to modify or reject a collective bargaining agreement: “[T]he debtor in possession or trustee must have made a proposal to the union for changes to the collective bargaining agreement based on the most complete and reliable information available at the time of the proposal; the proposed modifications must be necessary to permit reorganization of the debtor; the proposed modifications must assure that all affected parties are treated fairly and equitably; the debtor in possession or trustee must have provided the union with such relevant information as is necessary to evaluate the proposal, must have met with the collective bargaining representative at reasonable times subsequent to making the proposal and must have negotiated in good faith with the union concerning the proposal; the union must have refused to accept the proposal without good cause; and the balance of the equities must clearly favor rejection of the agreement.” *Collier on Bankruptcy* ¶ 1113.01 (Alan N. Resnick & Henry J. Sommer eds., 15th ed. rev.) (citing 11 U.S.C. § 1113).
- 6 Section 902(a) defines special revenues as: “(A) receipts derived from the ownership, operation, or disposition of projects or systems of the debtor that are primarily used or intended to be used primarily to provide transportation, utility, or other services, including the proceeds of borrowings to finance the projects or systems; (B) special excise taxes imposed on particular activities or transactions; (C) incremental tax receipts from the benefited area in the case of tax-increment financing; (D) other revenues or receipts derived from particular functions of the debtor, whether or not the debtor has other functions; or (E) taxes specifically levied to finance one or more projects or systems, excluding receipts from general property, sales, or income taxes (other than tax-increment financing) levied to finance the general purposes of the debtor.”
- 7 See, e.g., *Lorber v. Vista Irrigation Dist.*, 127 F.2d 628, 639 (9th Cir. 1942) (citing *West Coast Life Ins. Co. v. Merced Irrigation Dist.*, 114 F.2d 654 (9th Cir. 1940), cert. denied, 311 U.S. 718 (1941)).
- 8 With respect to secured claims, the “cramdown” requirements are similar to those in a Chapter 11 case.
- 9 See, e.g., *In re New York Off-Track Betting Corp.*, Ch. 9 Case No. 09-17121 (MG) (Bankr. S.D.N.Y. Jan. 25, 2011) [Docket No. 302] (Memorandum Opinion and Order Granting the Debtor’s Motion to Dismiss Chapter 9 Case and Denying District Council 37, Local 2012’s Motion to Appoint a Trustee Pursuant to Section 926 of the Bankruptcy Code).
- 10 11 U.S.C. § 109(c).
- 11 *Id.* § 101(40).
- 12 *Id.* § 101(52).
- 13 *Collier on Bankruptcy* ¶ 900.02 (quoting Case No. BK-S-10-10464-BAM, “Order Regarding AMBAC’s Motion to Dismiss” (Bankr. D. Nev. Apr. 26, 2010)).
- 14 11 U.S.C. § 101(32)(c).
- 15 *Id.* § 101(32)(a).
- 16 *Collier on Bankruptcy* ¶ 900.02 (citing *In re Sullivan County Reg’l Refuse Disposal Dist.*, 165 B.R. 60, 75–76 (Bankr. D.N.H. 1994) (failure to levy a special assessment does not preclude a claim of insolvency)); *In re Ellicott Sch. Bldg. Auth.*, 150 B.R. 261, 265 (Bankr. D. Colo. 1992); *In re Villages at Castlerock Metro. Dist. No. 4*, 145 B.R. 76, 84 (Bankr. D. Colo. 1990); *In re Pleasant View Util. Dist.*, 7 C.B.C.2d 788, 796, 24 B.R. 632, 639 n.6 (Bankr. M.D. Tenn. 1982), *aff’d*, 27 B.R. 552 (M.D. Tenn. 1982).
- 17 *Id.* (quoting *In re Pleasant View Util. Dist.*, 7 C.B.C.2d at 796, 24 B.R. at 639 n.6).



Sharks in the Safe Harbor The “End Run” Around Section 546(e)

by Menachem O. Zelmanovitz and Rachel Jaffe Mauceri

Introduction

The growth of the distressed debt trading industry has led to the introduction of litigation as a business model: hedge funds or other investment funds trading in the secondary loan and similar markets (usually at prices substantially below par) regularly sue issuers and other parties on a variety

of legal theories in an effort to increase the recovery on their investments. In the case of a leveraged buyout (LBO) that results in or is followed by insolvency and/or bankruptcy, such litigation often includes efforts to recover payments from former stockholders whose shares were redeemed or acquired in the LBO transaction.

To protect the investing public and the securities industry from such claims, Congress enacted Bankruptcy Code Section 546(e), the so-called “safe harbor” that insulates certain transactions from avoidance as constructive fraudulent transfers. Recent bankruptcy cases, however, are testing the limits of this “safe

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harbor.” This article considers whether, notwithstanding Section 546(e), the failure of the debtor or other estate representative to timely assert fraudulent conveyance claims under state law empowers individual creditors to assert and prevail on such claims.

Who May Assert a Claim on Behalf of a Debtor’s Estate?

Upon the commencement of a bankruptcy case, standing to assert fraudulent conveyance and other transfer avoidance claims is deemed to reside with the bankruptcy estate for the benefit of all creditors, whether such claims arise under the Bankruptcy Code or under applicable nonbankruptcy law.¹ 11 U.S.C. § 544(b). The right to assert these claims is reserved to the trustee, debtor-in-possession, or other party acting on behalf of the estate for the duration of the statutory period set forth in Section 546(a), which is usually two years. Individual creditors are prohibited

claim within the two-year period, the claim is deemed to revert back to the underlying creditors.³

Section 546(e)

Section 546(e) protects, among other payments, “settlement payments” made by, to, or for the benefit of a financial institution from avoidance as constructive fraudulent transfers. “Constructive” fraudulent transfers are those that, regardless of the intent of the parties, are made for less than a reasonably equivalent value and that, among other things, cause the transferor to become insolvent or leave the transferor with unreasonably small operating capital. 11 U.S.C. § 548(a)(1)(B). To be clear, Section 546(e) does not insulate from avoidance transfers made with actual intent to hinder, delay, or defraud any of a debtor’s creditors.

“Settlement payments” are defined in the Bankruptcy Code to include, among others, “a settlement payment

Thus, the Section 546(e) safe harbor shelters former shareholders from constructive fraudulent transfer claims asserted under the Bankruptcy Code based on the redemption or sale of their stock. On its face, however, Section 546(e) applies only to claims of the estate under the Bankruptcy Code. As yet unresolved is the question of whether shareholders are also fully protected from other claims, particularly state statutory claims, that seek to recover the same stock redemption payments where such claims have arguably reverted back to and are asserted by individual creditors.

Preemption

Based on the Supremacy Clause of the Constitution, a leading argument for an expansive safe harbor would preempt a trustee or other estate representative from doing an “end run” around Section 546(e) by bringing a state law claim that seeks similar relief. In *Official Committee of Unsecured Creditors v. Fleet Retail Financial Group (In re Hechinger Investment Co. of Delaware) (Hechinger)*,⁵ the debtors filed for bankruptcy following an LBO. The Committee sued the debtors’ selling shareholders, among others, asserting a fraudulent transfer claim under Section 548(a)(1)(B) of the Bankruptcy Code and a state law unjust enrichment claim. The district court held that Section 546(e) precluded not only the fraudulent transfer claim, but also state law fraudulent conveyance claims asserted under Section 544(b) of the Bankruptcy Code and, by extension, the unjust enrichment claim that was based on the same facts and sought the same relief. The court reasoned that to permit the unjust enrichment claim would frustrate the purpose of Section 546(e).⁶

Circuits applying the so-called “transaction” test to claim preclusion issues consider ... whether “the new complaint grows out of the same transaction or series of connected transactions.”

from asserting such claims during this period. The estate representative’s exclusive standing applies not only to avoidance actions, but also to other state law claims, such as successor liability and tortious interference claims, that are based on the same set of transactions that give rise to avoidance claims.² However, where the estate representative fails to bring a

on account, a final settlement payment, or any other similar payment commonly used in the securities trade.” *Id.* § 741(8). Several circuits have held that the term “settlement payment” in Section 546(e) is to be broadly interpreted so as to cover payments by a company, utilizing an intermediary financial institution, to redeem its shareholders’ stock in an LBO.⁴

Similarly, in *Official Committee of Unsecured Creditors v. Clark (In re National Forge Co.)*,⁷ the Bankruptcy Court found that even though Section 546(e) did not apply to claims for actual fraud under Section 548(a)(1)(A) of the Bankruptcy Code, it nevertheless precluded a claim for actual fraud under Pennsylvania's version of the Uniform Fraudulent Transfer Act, a state statute that contains language substantially similar to Section 548(a)(1)(A), but that has a longer statute of limitations than the federal statute. The court reasoned that, in order to preserve Section 548(a)(1)(A)'s narrow scope, Congress intended to preempt any claims brought under a state fraudulent transfer law with a longer statute of limitations than the federal statute.⁸

Hechinger and *National Forge*, however, dealt with an estate representative's alternate claim to one barred by Section 546(e). Those cases did not involve an individual creditor's claim under state law. That distinction appears to have been made in *PHP Liquidating, LLC v. Charles H. Robbins (PHP Liquidating)*.⁹ There, pursuant to a plan of liquidation, the debtor's avoidance claims were assigned to a trust (the Trust) for the benefit of creditors, who were also given the option of assigning their individual claims to the Trust. The court held that although Section 546(e) barred claims, including state law claims, by the Trust as a successor to the debtor,¹⁰ it did not bar the Trust from bringing a state law claim on behalf of individual creditors.

Nonetheless, the court dismissed the action, holding that (i) the Trust did not have an actionable claim under applicable state law because no section of the Delaware General Corporation

Law (DGCL) provided a remedy against shareholders for the corporation's asserted violation of the DGCL, and (ii) in any event, the asserted claims were general claims that had accrued to all creditors, such that the individual creditors did not own the claims and could not assign them to the Trust. Accordingly, the court found that, even assuming there was an underlying cause of action, the Trust did not have standing to pursue the claims under applicable nonbankruptcy law and the plan of liquidation.

Interestingly, *PHP Liquidating* does not discuss the *Hechinger* decision, also decided by the district court, which predated *PHP Liquidating* by a year. In any event, the underlying rationale of *Hechinger*, i.e., preemption, appears to be inconsistent with the *PHP Liquidating* decision.

Standing

Independent of the preemption argument, instances where the estate representative asserts certain avoidance claims within the statutory two-year period, but does not bring alternative claims effectively seeking the same relief (i.e., the unwinding of the same transaction), raise a further issue regarding the scope of the safe harbor. For example, should the trustee's timely assertion of a fraudulent conveyance claim based on actual fraud under Section 548(a)(1)(A) preclude creditors, following expiration of the two-year period, from asserting under state law constructive fraudulent conveyance claims to avoid the same transfers? Theoretically, were the creditor permitted to proceed notwithstanding the estate representative's assertion of an avoidance claim seeking the same

relief, a defendant could be held liable to different plaintiffs in different courts for the same transaction.

Current case law does not provide a clear answer. Circuits applying the so-called "transaction" test to claim preclusion issues consider, among other factors, whether "the new complaint grows out of the same transaction or series of connected transactions."¹¹ A subsequent claim may be barred by res judicata if the new claim is merely an alternate theory of liability seeking to attack the same transaction or set of transactions as a prior litigated claim.¹² On this theory, one might also argue that an estate representative's assertion of certain avoidance liability theories within the two-year statutory period precludes individual creditors from asserting any other claim seeking the same result.

A similar argument recently proved unsuccessful in *Baron Financial Corp. v. Natanzon*.¹³ There, pursuant to an agreement between a bankruptcy trustee and certain individual creditors, the creditors pursued nonstate claims in district court against certain individuals and LLCs arising from asserted breaches of a settlement agreement related to the bankruptcy of the debtor. The defendants asserted that the creditors' claims were essentially avoidance actions that belonged to the bankruptcy estate. Although the claims did have "some similarity in object and purpose" to estate claims, the district court agreed with the prior finding of the Bankruptcy Court, holding that the claims did not belong to the bankruptcy estate, and that the individual creditors had standing to pursue the claims.¹⁴ Accordingly, it remains uncertain whether lack of standing is a viable argument.

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The Tribune Bankruptcy

The bankruptcy cases of the Tribune Company and its affiliates, *In re Tribune Company, et al.* (Bankr. D. Del. 08-13141 (KJC)) (*Tribune*), illustrate the complexity of these issues. In *Tribune*, the creditors' committee on behalf of the debtor's estate filed an adversary proceeding complaint asserting numerous claims (the Committee Litigation), including an actual fraudulent transfer claim under Section 548(a)(1)(A) against the debtor's former shareholders seeking to recover payments received by the shareholders for their stock in the debtor's prepetition LBO. Presumably, no constructive fraudulent transfer claim was asserted against the shareholders because such claim was barred by Section 546(e).¹⁵

Once the two-year period in which to assert a constructive fraudulent transfer claim under Section 548(a)(1)(B) or Section 544(b) expired, certain

of Tribune's unsecured noteholders (collectively, the Noteholders) sought authority to file complaints asserting constructive fraudulent transfer claims under the applicable state statutes, arguing that such claims had reverted to them as creditors upon expiration of the Section 546(a) two-year statute of limitations. A number of former shareholders objected to the Noteholders' motion asserting both preemption and the lack of standing due to the Committee Litigation, which sought avoidance of the same transfers, albeit as an actual rather than constructive fraudulent conveyance.

In overruling the objections and permitting the Noteholders to commence the state law actions, the Bankruptcy Court declined to address the substantive objections to the motion, expressly preserving those issues for determination by the courts in which the actions will be brought. Similar objections have been raised in the context of

plan confirmation in *Tribune*, as the two competing plans of reorganization each contemplate the assignment of individual claims to a trust, to be litigated for the benefit of the assigning creditors. To date, the Bankruptcy Court has not addressed the substance of these issues.

Conclusion

The right of individual creditors to pursue state law claims in the absence of estate litigation raises thorny issues. If left to the state courts to decide, as the Bankruptcy Court's order in *Tribune* appears to do, a lack of uniformity among the courts may further confuse matters. It will be interesting to observe whether these issues proceed to judgment, and, if so, how they are ultimately determined.

endnotes

- 1 The trustee or estate representative succeeds only to “general” claims, with no “particularized injury” arising from them. See, e.g., *St. Paul Fire and Marine Ins. Co. v. PepsiCO, Inc.*, 884 F.2d 688, 701 (2d Cir. 1989); *Bd. of Trs. of Teamsters Local 863 Pension Fund v. Foodtown, Inc.*, 296 F.3d 164, 170 (3d Cir. 2002) (“If the claim is specific to the creditor, it is a ‘personal’ one and is a legal or equitable interest only of the creditor. A claim ... is personal to the creditor if other creditors generally have no interest in that claim.”) (internal citations omitted).
- 2 See, e.g., *Gulf Ins. Co. v. Ruppert Landscaping Co. (In re Nat'l Am. Ins. Co.)*, 187 F.3d 439, 441 (4th Cir. 1999) (where asserted causes of action were “so similar in object and purpose to claims that the trustee could bring in bankruptcy court” asserting parties did not have standing to pursue the claims); *Poth v. Russey (In re Poth)*, 99 Fed. Appx. 446 (4th Cir. 2004); *Hoyt v. Aerus Holdings, LLC*, 2011 Bankr. LEXIS 765, at *8–9 (Bankr. D. Ariz. Mar. 10, 2011) (“[W]hen th[e] same factual nexus gives rise to both a cause of action assertable by the trustee and a cause of action assertable by a creditor,

both causes of action must vest exclusively in the trustee until they are abandoned.”). But see *In re Glo-Tex Int'l, Inc.*, 2010 Bankr. LEXIS 4330 (Bankr. D.S.C. Nov. 30, 2010) (permitting individual creditors to bring fraud, misrepresentation, and other claims that were personal to creditors against the debtor after the estate's claims asserted by the trustee against the debtor had been settled).

- 3 See, e.g., *Barber v. Westbay (In re Integrated Agri, Inc.)*, 313 B.R. 419 (Bankr. C.D. Ill. 2004); *Klingman v. Levinson*, 158 B.R. 109 (N.D. Ill. 1993).
- 4 See, e.g., *Quality Stores, Inc. v. Alford (In re QSI Holdings, Inc.)*, 571 F.3d 545 (6th Cir. 2009); *Lowenschuss v. Resorts Int'l, Inc. (In re Resorts Int'l, Inc.)*, 181 F.3d 505 (3d Cir. 1999); *Kaiser Steel Res., Inc. v. Pearl Brewing Co. (In re Kaiser Steel Corp.)*, 952 F.2d 1230 (10th Cir. 1991); *Wyle v. Howard, Weil, Labouisse, Friedrichs, Inc. (In re Hamilton Taft & Co.)*, 176 B.R. 895 (Bankr. N.D. Cal. 1995); *Mishkin v. Ensminger (In re Adler, Coleman Clearing Corp.)*, 218 B.R. 689, 703–04 (Bankr. S.D.N.Y. 1998) (noting broad application in Third, Ninth, and Tenth Circuits). But see *Buckley v. Goldman, Sachs & Co.*, 2005 U.S. Dist. LEXIS 9626 (D. Mass. May 20, 2005); *Weiboldt Stores,*

Inc. v. Schottenstein, 131 B.R. 655 (N.D. Ill. 1991). There is a split among circuits as to whether Section 546(e) applies to all securities-related transactions, or only with respect to publicly traded securities. See, e.g., *Brandt v. B.A. Capital Co. LP (In re Plassein Int'l Corp.)*, 590 F.3d 252 (3d Cir. 2010), cert. denied, 130 S. Ct. 2389 (2010); *Official Comm. of Unsecured Creditors of CIC v. Frost (In re Contemporary Indus. Corp.)*, 564 F.3d 981 (8th Cir. 2009); *Official Comm. v. Acres of Diamonds, L.P. (In re The IT Group, Inc.)*, 359 B.R. 97 (Bankr. D. Del. 2006) (each applying Section 546(e) to private securities transactions); *Geltzer v. Mooney (In re McMamin's Grill)*, Case No. 08-23660 (RDD), Adv. Pro. No. 09-8266 (RDD) (Bankr. S.D.N.Y. Apr. 21, 2011); *Official Comm. v. Lattman (In re Norstan Apparel Shops, Inc.)*, 367 B.R. 68 (Bankr. E.D.N.Y. 2007) (finding that Section 546(e) does not apply when transfers do not involve public securities markets).

- 5 274 B.R. 71 (D. Del. 2002).

- 6 See also *In re Contemporary Indus. Corp.*, 564 F.3d at 988 (disallowing state law unjust enrichment and illegal and/or excessive shareholder distribution claims and noting



Lessons for Proponents of “Gift Plans” and Purchasers of Claims After *DBSD*

by Wendy Walker

The recent decision by the Second Circuit Court of Appeals in *In re DBSD North America, Inc.*¹ contains important rulings for all parties in interest in Chapter 11 cases: (i) “gift plans,” under which a junior class receives plan consideration (e.g., equity or cash), while a senior class of interests or claims is not satisfied in full, violate the absolute priority rule, and (ii) purchasers of claims motivated by factors other than a monetary recovery could be at risk of having their votes under a reorganization plan disregarded.

Background

DBSD North America, Inc. (the Debtor) is a satellite telecommunications

provider that commenced a voluntary Chapter 11 case on May 15, 2009 in the U.S. Bankruptcy Court for the Southern District of New York.²

the reorganized entity worth 51% to 73% of the original claims, general unsecured creditors would also receive stock worth 4% to 46% of claims, and

The Second Circuit decision contains important rulings for parties in interest in Chapter 11 cases.

Under its proposed reorganization plan, existing first lien debt of approximately \$40 million would be restructured, existing second lien creditors holding debt of approximately \$740 million were to receive stock in

the existing shareholder was to receive the remaining stock and warrants.³

Sprint Nextel Corp. (Sprint), a creditor holding an unliquidated, disputed claim temporarily allowed for voting purposes, objected to the plan, asserting that it was not “fair and equitable” under Bankruptcy Code §1129(b)(1) as a result of the proposed distribution to existing equity.⁴ Separately, after the disclosure statement was approved, DISH Network Corp. (DISH) purchased 100% of the first lien lender claims and a portion of the second lien lender claims and voted them against the plan. DISH also objected to the plan, asserting that it was not feasible. On the Debtor’s motion, the Bankruptcy Court designated DISH’s votes, disregarding the entire first lien class of claims’ vote as having been cast in bad faith, and overruled its and Sprint’s confirmation objections.⁵

that “[a]llowing recovery on these claims would render the [Section] 546(e) exception meaningless, and would wholly frustrate the purpose behind that section”).

⁷ 344 B.R. 340 (Bankr. W.D. Pa. 2006).

⁸ *Id.* at 370 (“We presume that, if Congress had intended to exempt from [Section] 546(e)’s protection allegations of actual fraud under state law fraudulent transfer theories, it could have easily done so.”). See also *In re Hamilton Taft & Co.*, 176 B.R. at 901–02 (holding that, notwithstanding the carve-out for claims under Section 546(a)(1)(A), Bankruptcy Code Section 546(e) “does bar actions brought under section 544 (using state fraudulent conveyance statutes) to recover transfers made more than one year [the statutory period then applicable under the Bankruptcy Code] prepetition with actual intent to hinder, delay, or defraud creditors”), *aff’d*, 196 B.R. 532 (N.D. Cal. 1995), *aff’d*, 114 F.3d 991 (9th Cir. 1997).

⁹ 291 B.R. 603 (D. Del. 2003).

¹⁰ *Id.* at 607 (“In sum, even where the debtor redeemed securities in violation of Section 160 of

the DGCL, a trustee or debtor-in-possession may not use its Section 544(b) avoidance powers if the transaction was completed through a stockbroker.”).

¹¹ *Bezanson v. Atlantic Battery Co. (In re Surrette Storage Battery Co.)*, 109 B.R. 544 (Bankr. D.N.H. 1989) (finding that res judicata required granting summary judgment to defendants in trustee’s action asserting fraudulent transfer and other claims where prior trustee had already pursued a Bulk Sales Act complaint arising from the same transaction).

¹² See *id.*; see also *Corestates Bank, N.A. v. Huls Am., Inc.*, 176 F.3d 187 (3d Cir. 1999) (finding that a creditor’s failure to fully raise a subordination agreement in the context of its unfair discrimination objection to the proposed plan precluded the creditor from later raising the claim against the subordinated creditor that was allegedly favored under the debtor’s plan).

¹³ 509 F. Supp. 2d 501 (D. Md. 2007).

¹⁴ See *id.* at 521.

¹⁵ See *In re Resorts Int’l, Inc.*, *supra*, at 516.

Lessons for Proponents of “Gift Plans” and Purchasers of Claims After DBSD

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The Bankruptcy Court confirmed the plan, the district court affirmed, and both Sprint and DISH appealed.⁶

The Second Circuit Decision

Do Gift Plans Still Work?

Known as the “absolute priority rule,” Bankruptcy Code § 1129(b)(1)(ii) provides that, in order to confirm a

the plan expressly so provided, and (3) the interests and claims of senior classes were not being satisfied in full. The court based its decision on a literal interpretation of the Bankruptcy Code, but also found support in legislative history and judicial precedent leading up to the codification of the absolute

When Are Votes on Purchased Claims Subject to Designation?

Bankruptcy Code § 1126(e) provides that the court, after notice and a hearing and on request of a party in interest, “may designate any entity whose acceptance or rejection of a plan was not in good faith.” The vote of a designated entity is not considered in determining whether a plan has been approved by a class of claims or interests.¹² DISH’s vote was designated and, as a result, was not considered in the tabulation of votes necessary for confirmation of the Debtor’s plan.¹³

The Second Circuit held that the plan violated the absolute priority rule.

reorganization plan with an impaired dissenting class, the plan must be “fair and equitable” with respect to each such class.⁷ A plan is not fair and equitable to a class of general unsecured claims unless:

(i) the plan provides that each holder of a claim of such class receive or retain on account of such claim property of a value, as of the effective date of the plan, equal to the allowed amount of such claim; or

(ii) the holder of any claim or interest that is junior to the claims of such class will not receive or retain under the plan on account of such junior claim or interest any property.⁸

The Second Circuit held that the Debtor’s plan violated the absolute priority rule because (1) the existing shareholder was to receive shares and warrants to purchase equity in the reorganized entity “on account of” or “in exchange for” its existing junior interest, (2) the property to be received by the existing shareholder was received “under the plan” because

priority rule in the current Bankruptcy Code.⁹ The court distinguished other decisions, including *In re SPM Manufacturing Corp.*,¹⁰ in which a gift plan was approved in the context of a Chapter 7 case where the absolute priority rule is not relevant because Section 1129 does not apply.¹¹

Are gift plans dead? Certainly, in situations where all classes of creditors vote in favor of a plan or where all creditors other than those receiving the gift are being paid in full, gift plans are alive and well as the absolute priority rule is not implicated in either situation. Further, the Second Circuit expressly stated that the court was basing its decision only on the facts before it, i.e., where the so-called “gift” to old equity was provided for under the Debtor’s plan and not where, for example, a senior creditor agreed *outside of a plan* to cede a portion of its recovery to a junior creditor or interest holder. A plan that includes a “gift” to a junior class, structured similarly to the Debtor’s plan, however, should not be confirmable in the Second Circuit from this point forward.

The Second Circuit found that designation was warranted because (1) DISH was an “indirect competitor” of the Debtor and an investor in a direct competitor, and (2) DISH admittedly purchased an entire class of claims “with the intention not to maximize its return on the debt” but in furtherance of a “strategic transaction.” The court suggested that DISH should not have used its status as a creditor and its votes under the plan in this manner and, rather, should have either proposed an alternative plan or bid for the Debtor’s assets. Instead, the court characterized DISH’s actions as manipulating its claim and vote under the plan as “levers to bend the bankruptcy process toward its own strategic objective of acquiring DBSD’s spectrum rights, not toward protecting its claim.”¹⁴

The Second Circuit stressed that “our opinion imposes no categorical prohibition on purchasing claims with acquisitive or other strategic intentions” and that, quoting from DISH’s own internal documents, “our

ruling today should deter only attempts to 'obtain a blocking position' and thereby 'control the bankruptcy process for [a] potentially strategic asset.'"¹⁵

Despite the court's statements, there remains a lack of clarity as to precisely which situations or motivations underlying the purchase of claims in bankruptcy will result in designation of votes and the concomitant frustration of the creditor's strategy. Clearly, a direct business competitor of a debtor who purchases claims in an attempt to stymie the debtor's efforts to reorganize or to force a transaction is substantially at risk of having its votes designated.

Would a private equity fund purchasing claims in furtherance of a "loan to own" strategy and with a view toward combining the target debtor company with another portfolio company of the fund run afoul of the Second Circuit's ruling? That is possible, depending upon the facts and circumstances of the case and the court's view of the "ulterior motives" of the purchaser.

Conclusion

Plan proponents, creditors, and strategic purchasers of claims in Chapter 11 cases should be aware of these significant rulings by the Second

Circuit in the *DBSD* case. Specifically, gift plans structured in a manner similar to *DBSD*'s plan are potentially unconfirmable in the absence of creditor consent. Further, purchasers of claims seeking a strategic or competitive advantage, as opposed to a return on investment, should carefully scrutinize their transactions in light of the Second Circuit's ruling and the risk of designation.

endnotes

¹ 634 F.3d 79 (2d Cir. 2011).

² *Id.* at 85–86.

³ *Id.* at 86.

⁴ *Id.* at 86–87.

⁵ *Id.* at 87–88.

⁶ *Id.* at 88. Also an issue on appeal was Sprint's standing to appeal at all. The Debtor argued that

Sprint should not have standing because it was an "out of the money" creditor that stood to receive nothing should the plan not be confirmed. At least one judge agreed with the Debtor, stating that Sprint's unliquidated, contingent, and disputed claim was insufficient to confer standing to appeal. The majority held that Sprint did have standing to appeal because Sprint held a claim that was temporarily allowed for voting purposes and, as a creditor, its rights were affected by the confirmation order. *Id.* at 88–93 and 108–12.

⁷ 11 U.S.C. § 1129(b)(1)(ii).

⁸ *Id.* § 1129(b)(1).

⁹ *DBSD*, 634 F.3d at 100–01.

¹⁰ 984 F.2d 1305 (1st Cir. 1993).

¹¹ *DBSD*, 634 F.3d at 98.

¹² 11 U.S.C. § 1126(c) and (d).

¹³ *DBSD*, 634 F.3d at 88.

¹⁴ *Id.* at 101–06.

¹⁵ *Id.* at 105.

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1 *In re Adelpia Recovery Trust*, 634 F.3d 678 (2d Cir. 2011). Where the debtor did not notify the banks or the court of its potential fraudulent conveyance action against the banks based upon its payment of the banks' loans to a partnership in connection with the acquisition of the partnership by the debtor's principals, while pursuing the free and clear sale of the partnership's assets to the banks, the debtor was judicially estopped from asserting such claims.

2 *In re Lett*, 632 F.3d 1216 (11th Cir. 2011). An impaired creditor in a dissenting class need not formally object to confirmation of a plan on the ground that it failed to satisfy absolute priority in order to appeal a "cramdown" as having violated that rule.

3 *In re TOUSA, Inc.*, 444 B.R. 613 (S.D. Fla. 2011). Reversing the Bankruptcy Court, the district court held that where, by reason of their guarantees, debtor-subidiaries had a vital stake in the prepetition settlement of antecedent debt owed to joint venture lenders that would have been triggered by an anticipated adverse judgment in litigation or by the debtor-parent's bankruptcy filing, the debtor-subidiaries received reasonably equivalent value in exchange for the liens they granted to the new lenders that financed the settlement payment. The settlement economically benefited debtor-subidiaries by eliminating the threat to their viability as a going concern and their continued access to financing.

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