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Lehman Brothers' ADR Procedures for Resolving Its Derivative Contracts in Bankruptcy

By Andrew J. Olejnik

Lehman Brothers' bankruptcy case was the largest and most complex Chapter 11 case in history. Among other complexities, when Lehman filed for bankruptcy on Sept. 15, 2008, it was a party to approximately 1.2 million derivative transactions with approximately 6,500 counterparties. Lehman had entered into derivative transactions through a number of wholly owned subsidiaries, both in a trading capacity and as an end-user. No Chapter 11 debtor had had as many or as complex a collection of derivative contracts. Disputes relating to the contracts threatened to become a quagmire of extensive and costly litigation. However, Judge James Peck, overseeing the Lehman bankruptcy, approved alternative procedures, proposed by Lehman's bankruptcy counsel (Weil, Gotshal & Manges), to resolve these disputes. This approach to these issues undoubtedly contributed to Lehman's ability to resolve its bankruptcy case with a consensual plan in less than three-and-a-half years.

Assessing the Situation

Lehman's bankruptcy filing constituted an event of default under most (if not all) of its derivative contracts. As a result, the vast majority of its counterparties terminated their transactions with Lehman (by election or automatic termination), accelerated amounts owed, and exercised rights of setoff against collateral in their possession. Although Sections 362 and 365(e)(1) of the Bankruptcy Code generally prohibit the termination of contracts as a result of a bankruptcy filing, certain financial contracts are exempted by the "safe-harbor" provisions of the Bankruptcy Code. Some counterparties, however, did not exercise their termination rights.

In many instances, terminating counterparties owed Lehman money, and non-terminating counterparties would have owed Lehman money under the contracts. These "in-the-money" derivative contracts constituted significant assets of Lehman's bankruptcy estate. However, disputes arose regarding amounts owed under the terminated contracts, and, in those cases in which counterparties did not elect to

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Issue-Specific Withdrawal Of the Reference

By Menachem O. Zelmanovitz and Rachel Jaffe Mauceri

Traditionally, defendants in actions brought by debtors or trustees have struggled to level the playing field and extricate themselves from the bankruptcy court, a forum often perceived as the plaintiff's "home court." At one time, litigants hoped to utilize motions to withdraw the reference from the bankruptcy court pursuant to 28 U.S.C. § 157(d), to enhance their prospects of a favorable resolution from a presumably friendlier judicial forum. However, more often than not, movants were disappointed by the district courts' natural reluctance to relieve the bankruptcy courts of their intended role and increase their own considerable workloads.

The Supreme Court's recent ruling in *Stern v. Marshall* has revitalized this litigation tactic and encouraged a veritable torrent of such motions. In *In re Bernard L. Madoff Investment Securities LLC* (*Madoff*) alone, a liquidation proceeding under the Securities Investor Protection Act currently pending before the Bankruptcy Court for the Southern District of New York, literally hundreds of such motions have been filed in the fraudulent transfer actions commenced by the trustee. District Judge Jed S. Rakoff has issued several orders withdrawing the reference, not with respect to the adversary proceedings in their entirety, and not even with

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terminate the derivative contract, the value of the contract was trapped unless Lehman could assume and assign it, the counterparty defaulted, or the contract expired on its own terms. Additionally, in some instances, counterparties refused, based upon alleged defaults, to make ongoing payments due to Lehman under the derivative contracts.

As of March 31, 2011, however, according to Lehman's Chapter 11 Plan Disclosure Statement, Lehman had reconciled the universe of all trades between itself and a particular counterparty under 99% of its derivative contracts, had valued 99% of the contracts, and had finally settled 58.5% of them. Through Dec. 31, 2010, Lehman had collected more than $12.2 billion from counterparties to derivative contracts and expected to collect another $5.2 billion, though actual recoveries could vary materially. Lehman achieved these results through a variety of efforts to protect its large portfolio of derivative contract assets.

Assumption and Assignment

Lehman's first effort to monetize its open "in-the-money" contracts was to market and sell those contracts to third parties. Approximately two months after Lehman filed for bankruptcy, it asked the bankruptcy court to approve procedures to reduce costs associated with assuming and assigning its "in-the-money" derivative contracts, and settling claims arising from terminated derivative contracts. Over the next several months, the bankruptcy court entered several orders establishing expeditious procedures providing Lehman with flexibility to agree on amounts owed, expediting the consensual resolution of derivative contract disputes, and authorizing Lehman to enter into transactions to hedge the loss of value embedded in its open, "in-the-money" derivative contracts.

A Request for ADR Procedures

Then, in July 2009, Lehman asked the Bankruptcy Court to approve a set of alternative dispute resolution (ADR) procedures with respect to its "in-the-money" derivative contracts. Lehman sought procedures that would: 1) allow it to capture the value of its "in-the-money" derivative contracts; and 2) streamline the process and promote judicial efficiency. Lehman estimated that there were approximately 250 counterparties with respect to these contracts, and that many of them would have common issues such as the appropriateness of setoff, termination, valuation, computation of termination payments, and notice. The counterparties ranged from big financial institutions to smaller educational and healthcare entities.

Without the ADR procedures, Lehman likely would have been forced to commence and prosecute hundreds of adversary proceedings or contested matters. Such a process would have been expensive and time-consuming, would have delayed the administration of Lehman's bankruptcy case, and would have risked the loss of value embedded in the contracts. In their most basic form, however, these disputes were simply collection actions against parties that owed Lehman money.

Legal Bases for ADR Procedures

The legal bases for Lehman's requested relief were Section 105(a) of the Bankruptcy Code and the Southern District of New York Bankruptcy Court's Standing Order with respect to ADR.

Section 105(a) of the Bankruptcy Code grants bankruptcy courts the "equitable power to 'issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title.'"

The Standing Order permits bankruptcy courts to assign any adversary proceeding, contested matter, or other dispute to mediation "upon its own

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Court Reverses 'Ponzi-Like' Fraudulent Transfer Ruling

By Michael L. Cook

The United States Court of Appeals for the Fifth Circuit, on March 20, 2012, reversed a district court's fraudulent transfer judgment based on a financially troubled entity's gift to a charity. *The American Cancer Society v. Cook*, 2012 WL 919 674 (5th Cir. 3/20/12) (Jones, Ch. J.). The transferor was the subject of a Securities and Exchange Commission (SEC) receivership, not a bankruptcy case, and the plaintiff was its court-appointed receiver. Because the Fifth Circuit found no evidence in the record of "a traditional Ponzi scheme," it held that "the district court erred in applying the presumption of [actual] fraudulent intent." *Id*. at *3. As the court stated, "[n]ot all securities frauds are Ponzi schemes." *Id*. at *1.

Relevance

The defendant charity in *Cook* had a difficult defense. Courts (bankruptcy and non-bankruptcy) have regularly held that so-called "Ponzi scheme" debtors presumptively make transfers to their investors with actual fraudulent intent to hinder, delay or defraud other creditors. *Warfield v. Byron*, 436 F.3d 551, 558-59 (5th Cir. 2006) (held, receiver satisfied burden of showing fraudulent intent with evidence that transferor had created Ponzi scheme, and was thus, "as a matter of law, insolvent from its inception"), citing *Cunningham v. Brown*, 265 U.S. 1 (1924).

Bankruptcy Code § 548(c) and § 8(a) of the Uniform Fraudulent Transfer Act, applicable in 43 states, insulate a transferee from liability, however, if it can prove that it took "for a reasonably equivalent value and in good faith." This defense applies in bankruptcy cases and in state law fraudulent transfer cases like *Cook*. According to the court in *Warfield*, when "analyzing the exchange of value for any transfer," it had to look at "the degree to which the transferor's net worth is preserved." *Id*. at 560. Because the defendant in the *Warfield* Ponzi scheme could not argue that its "broker services … were reasonably equivalent value for transfers it had received," it could hardly argue that "the … Ponzi scheme benefited from his efforts to extend the fraud by securing new investments." *Id*. *In re Fin. Federated Title & Trust, Inc*., 309 F.3d 1325, 1332-1333 (11th Cir. 2002) (defendant's services deepened debtor's insolvency and may have been part of fraudulent transfer, but services did constitute value; upon remand, court must determine whether those services represented reasonably equivalent value for the payments defendant received.); *AFI Holding, Inc. v. MacKenzie* (*In re AFI Holding, Inc*., 525 F.3d 700 (9th Cir. 2008) (defendant investor in Ponzi scheme not barred as matter of law from establishing good-faith receipt of his initial investment in exchange for extinguishment of claim of restitution); *Securities & Exchange Commission v. Res. Dev. Int'l LLC*, 487 F.3d 295, 302 (5th Cir. 2007) (held, good-faith defense failed because defendants could not show they exchanged reasonably equivalent value for transfer from "debtor.").

A defendant, in any event, is entitled to show the value of its good-faith services despite the existence of the debtor's Ponzi scheme and its actual fraudulent intent. *In re Bayou Group LLC*, 439 B.R. 284, 3214-15 (S.D.N.Y. 2010) (reversing, the bankruptcy court held, "a transferee is entitled to offer evidence and to argue to the finder of fact that no diligent investigation would have disclosed the transferor's insolvency or fraudulent purpose. If the transferee can meet its burden of demonstrating that a diligent investigation would not have led to discovery of the fraud, it may prevail on this prong of the good faith affirmative defense."). Had the plaintiff receiver in *Cook* been able to rely on the Ponzi scheme presumption, the defendant charity would have been liable because, regardless of its good faith, it could not prove reasonably equivalent value, having admittedly received a gift.

Ponzi Scheme Defined

The receiver's entire fraudulent transfer case, based on the transferor's actual intent in *Cook*, turned on the existence of a Ponzi scheme. According to the Fifth Circuit, however, a "Ponzi scheme is a 'fraudulent investment scheme in which money contributed by later investors generates artificially high dividends or returns for the original investors, whose example attracts even larger investments.'" 2012 WL 919674, at * 2, citing *Janvey v. Alguire*, 647 F.3d 585, 597 (5th Cir. 2011) (quoting Black's Law Dictionary, 1198 (8th ed. 2004)). Accord, *Perkins v. Haines*, 661 F.3d 623, 625n.1 (11th Cir. 2011) ("The essence of a Ponzi scheme is to use newly invested money to pay off old investors and convince them that they are earning profits rather than losing their shirts."). The receiver here had only her affidavit and meaningless documents attached as exhibits, but "[n]othing in these documents demonstrates that investor funds were used to issue 'returns' to other investors — a *sine qua non* of any Ponzi scheme." *Id*., at *3. Moreover, the receiver "failed to identify in those exhibits any instance in which a single payment was made to an investor," enabling the court of appeals to find that the lower court had "erred in placing determinative weight on the [receiver's] declaration that [the transferor] operated as a Ponzi scheme." *Id*.

The debtor and its related entities, referred to as "Giant" by the court, had raised substantial funds from investors through unregistered securities offerings, promising "considerable returns within twelve months." *Id*. at *1. In fact, according to the complaint filed by the SEC, "a considerable portion of investor funds was transferred" and diverted for personal use by Giant's insiders, causing the SEC to charge Giant with "multiple violations of federal securities laws," *Id*.

The allegations of the complaint, however, did not support the existence of a Ponzi scheme. "Giant may well have operated as a fraudulent or at least badly mismanaged drilling investment program, but there was no proof that its perpetuation, unlike

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Fraudulent Transfer

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that of a traditional Ponzi scheme, was based on the manufacturing of 'returns' to investors from other investor's contributions." *Id*. at *3.

Nor could the plaintiff receiver support her fraudulent transfer claim with circumstantial evidence showing actual fraudulent intent, an essential element of her claim under the UFTA. Although the receiver asserted that "the purpose of the … donations was to lure new investors into Giant's fraudulent scheme, and that the donations were not an authorized use of the investors' money," she could only support these assertions with her "conclusory" affidavit that was "factually bare." *Id*. The receiver could provide "no explanation" for her conclusions, "nor any supporting facts … ." *Id*. And the SEC's complaint was hardly "evidence of the charges contained in it." *Id*., quoting *Scholes v. Lehmann*, 56 F.3d 750, 762 (7th Cir. 1995). Because of the absence of hard factual evidence, the Fifth Circuit found that the district court had "clearly erred in finding that the donations … were fraudulent transfers," making it unnecessary for the court to consider any defenses that the charity had as to reasonably equivalent value and good faith. *Id*. at n.1.

Other Flaws in the Receiver's Case

1. Defendants' counsel in *Cook* waged an effective defense against a court-appointed receiver. They attacked the very premise of the receiver's claim, enabling the appellate court to confirm the precise definition of a Ponzi scheme.
2. The *Cook* decision further confirmed the need for hard facts in fraudulent transfer litigation, regardless of whether a creditor or a fiduciary prosecutes the claim. Despite the receiver's good-faith belief in Giant's misconduct, she had no facts to prove a Ponzi scheme. As Dickens put it 158 years ago, "[f]acts alone are wanted in life." C. Dickens, Hard Times, ch 1 (1854).
3. The plaintiff receiver also inexplicably failed to allege constructive fraud under the Uniform Fraudulent Transfer Act (UFTA). Had she done so, she could have merely alleged insolvency and the debtor's failure to receive "reasonably equivalent value." UFTA § 5(a) (transfer voidable by present creditors when debtor makes transfer "without receiving a reasonably equivalent value in exchange for the transfer" and "the debtor was insolvent at that time or the debtor became insolvent as a result of the transfer … ."). Accord, Texas UFTA § 24.006(b); Bankruptcy Code § 548(a)(i)(B)(ii).
4. The Fifth Circuit summarily rejected the receiver's other claims. Her reliance on a receivership order enabling her to recover assets was thus "meritless." 2012 WL919674, at *4. She failed to "establish an independent legal basis to justify their recovery." *Id*. Similarly, the court rejected the receiver's attempt to have it "impose a constructive trust on" the transferred cash. *Id*. Aside from a lack of equity for such a remedy against a charitable entity, the receiver offered "no evidence that Giant's contributions furthered any fraudulent scheme or were … made with

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motion, or upon a motion by any party in interest or the U.S. Trustee." The current Standing Order, M-390, was entered on Dec. 1, 2009, and amended, restated, and combined two prior Standing Orders, M-143 (entered in 1995) and M-211 (entered in 1999), which had separately addressed mediation, early neutral evaluation, and med/arb. *See also* S.D.N.Y. Local Bankr. R. 9019-1 (stating alternative dispute resolution shall be governed by standing order).

In prior bankruptcy cases in the Southern District of New York (and elsewhere), ADR procedures have been used, for example, with respect to over 900 adversary proceedings commenced against preference defendants (*In re Ames Department Stores, Inc., et al*., Case No. 01-42217 (REG) (Bankr. S.D.N.Y. June 25, 2007) [Docket No. 3195]); personal injury, tort, product liability, and other claims (*In re Motors Liquidation Company et al*., Case No. 09-50026 (REG) (Bankr. S.D.N.Y. Feb. 23, 2010) [Docket No. 5037]); and adversary proceedings regarding trading disputes (*In re Enron Corp., et al*., Case No. 01-16034 (ALG) (Bankr. S.D.N.Y. March 4, 2003) [Docket No. 9533] and (Bankr. S.D.N.Y. March 20, 2003) [Docket No. 9862]).

Objections to the ADR Procedures

In response to Lehman's request for ADR procedures, several parties objected, stating that, despite these sources of authority, the bankruptcy court lacked power to order ADR. In that regard, parties argued that, among other things: 1) the ADR procedures should apply only to adversary proceedings; 2) their contracts do not provide for mediation; 3) mediation is inconsistent with a centralized decision-making process that bankruptcy usually entails; 4) Lehman's claims may be non-core proceedings that must be heard by an Article III judge; and 5) the court lacked personal jurisdiction over counterparties outside the United States.

Other objections centered on parties' substantive rights, the applicability of sanctions, the scope of the procedures, mediation logistics, and special needs for indenture trustees.

ADR Procedures Approved

In response, Lehman modified some of the procedures. As to those objections that remained, the Bankruptcy Court overruled them and on Sept. 17, 2009, entered an order approving the ADR procedures. The procedures establish a method by which Lehman can commence an ADR matter prior to filing litigation and which includes a notice and response phase. If the dispute cannot

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Asbestos Claims

Insurance Liabilities May Be Transferred to Trusts

By Jeff Mordock

Asbestos defendants that file for reorganization under the U.S. Bankruptcy Code and seek to establish a personal injury trust for the payment of claims may transfer their liability insurance recovery rights to the trust even if the insurance policies include provisions barring the transfer of such rights, the U.S. Court of Appeals for the Third Circuit has ruled. *In Re: Federal-Mogul Global Inc.*, Nos. 09–2230, 09–2231 (May 1, 2012).

Background

Federal-Mogul, a Southfield, MI, automobile parts supplier incorporated in Delaware, filed for bankruptcy in the District of Delaware on Oct. 1, 2001, because of numerous asbestos-related claims filed against it. At the time of the corporation's bankruptcy filing, 500,000 personal injury claims were pending and it had already spent roughly $350 million to defend and indemnify those claims.

Per U.S. bankruptcy law, all claims against Federal-Mogul were halted so it could establish a reorganization plan and a trust to pay the victims.

Federal-Mogul's proposed reorganization plan assigned various assets to the victims' trust, including its recovery rights under its liability insurance. The plan also included provisions that granted insurers the right to assert against the trust any defense to coverage already available under the policies.

In 2007, a Delaware bankruptcy court approved Federal-Mogul's proposed reorganization plan. Five insurers, which insured Federal-Mogul for personal injury claims, objected to the plan. The insurers charged that the transfer of Federal-Mogul's recovery rights violated the anti-assignment provisions, which barred the transfer of recovery rights.

In 2008, the bankruptcy court held that statutes found in U.S. bankruptcy law trumps the insurance policies' anti-assignment provisions. The District of Delaware affirmed the decision in 2009. The insurers appealed the previous decisions to the Third Circuit, which upheld the previous court opinions.

The Third Circuit Ruling

The appellate court held that the plain language of a U.S. bankruptcy law statute pre-empts any anti-assignment provision found within the individual insurance policies. Specifically, the court held that Title 11, Section 1123(a)(5)(b) of the U.S. Code permits the transfer of estate property to the trust "notwithstanding any otherwise applicable nonbankruptcy law."

"The critical words here are 'notwithstanding any otherwise applicable nonbankruptcy law,'" Judge Anthony J. Scirica wrote in the court's opinion. "The Supreme Court has held that a 'notwithstanding' clause 'clearly signals the drafter's intention that the provisions of the 'notwithstanding' section override conflicting provisions,' noting numerous instances when the courts of appeals have interpreted similar 'notwithstanding' language ... to supersede all other laws, stating that '[a] clearer statement is difficult to imagine.'"

Insurers' Objections

The insurers noted that the structure of Section 1123(a) includes a subsection listing 10 transactions that constitute "adequate means for the plan's implementation," including the transfer of the estate's property. Furthermore, the insurers argued that any transaction listed in the "means" is not subject to the "notwithstanding" clause.

Once again, the court disagreed with the insurers' claims.

"It is hardly natural to read the 'notwithstanding' clause in Section 1123(a) as applying only to some, but not all of Subsection(a), an approach that contravenes any normal method of statutory interpretation," Scirica said. "It could hardly be read otherwise; no other express presumption provision is necessary."

The insurers argued that the phrase "otherwise applicable nonbankruptcy law" found in Section 1123's language does not encompass private contracts. Furthermore, the insurers contend that other sections of the Bankruptcy Code contain language that explicitly pre-empts private contracts as well as government enactments. For example, 11 U.S.C. Section 363(l) states, "notwithstanding any provision in a contract, a lease or applicable law." However, the court denied the insurers' claims, holding that many of the transactions listed under Section 1123(a)(5) implicate contractual rights.

"The plain language of Section 1123(a) evinces clear congressional intent for a pre-emptive scope that includes the transactions listed under Section 1123(a)(5) as 'adequate means' for the plan's information, including the transfer of property authorized by (a)(5)(B)," Scirica's opinion said. "The plain language also reaches private contracts enforced by state common law, and overcomes the presumption against pre-emption."

Further Claims

The insurers also claimed that the anti-assignment provisions serve an important purpose because they protect them from covering a risk different from the originally contracted to provide. Specifically, the insurers claimed that by transferring Federal-Mogul's rights to recover to the trust, their exposure increased, because the trust allows claims that would be barred in the tort system.

However, the court disagreed with their assertions.

"We doubt whether transfer in this instance materially alters insurers' risk," Scirica continued. "The bankruptcy here shifted debtor's asbestos-related liabilities — based on events which had already occurred and for which the insurers were already potentially responsible — to the post-confirmation trust."

Pre-emption Is Not Unlimited

While the court did rule that Section 1123(a) does trump private contracts, it also held that such pre-emption is not unlimited.

"Any reorganization plan must still comply with all aspects of the Bankruptcy Code and be approved by the bankruptcy court," Scirica wrote. "In particular, it must satisfy 11 U.S.C. Section 1129(a)(3), which provides that a court shall confirm a reorganization plan only if it 'has been proposed in good faith and not by any means forbidden by law.'"

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be resolved during this first phase, the next phase is a mediation conducted by one of four individuals appointed to serve as mediators under the procedures. The mediation phase entails a briefing process and in-person meeting, after which the mediation may end upon the request of a party and concurrence by the mediator.

Participation in the process is mandatory, though parties are not required to settle nor do they waive any substantive rights, procedural rights, or defenses by participating. The entire process is confidential — nothing is provided to the court except for a monthly report indicating the number of notices served, settlements reached after mediation, mediations pending, mediations terminated without settlement, and the dollar amount of settlements reached with counterparties after service of the notices.

Tier 2 Procedures Proposed

Approximately one year after entry of the order establishing the ADR procedures, Lehman asked the bankruptcy court to approve "Tier 2" ADR procedures for contracts in which Lehman's claim was $1 million or less. (The Bankruptcy Court recently approved Lehman's request and Lehman filed a motion to increase this amount to $5 million.) The Tier 2 procedures are intended to streamline the ADR procedures to increase speed and effectiveness and to minimize costs. Although Lehman retains the flexibility to decide whether to use the initially approved procedures or the Tier 2 ones, Lehman estimated that the Tier 2 procedures would impact disputes with at least 100 counterparties (though not any deals involving indenture trustees). No parties objected to the motion, and the Bankruptcy Court granted the motion on Sept. 27, 2010. The changes in procedures included, among other things, shortened response times, limitations on the lengths of mediation briefs, and a different group of four mediators to oversee the Tier 2 mediations.

SPV Procedures Proposed

Shortly thereafter, on Nov. 24, 2010, Lehman asked the bankruptcy court again to modify the ADR procedures as they relate to Special Purpose Vehicle (SPV) counterparties. Lehman proposed specific SPV procedures because of the difficulty it had in bringing SPV counterparties to the negotiating table. The procedures require mandatory participation by SPV counterparties, which are parties to pending adversary proceedings or will be named as defendants in future actions. Thus, the procedures apply only after the commencement of litigation against the SPV counterparty. In large measure, the procedures are consistent with the prior approved procedures, but are designed to accommodate the unique aspects that face SPVs, in particular with respect to identifying and involving a representative who has settlement authority on behalf of the SPV.

On March 3, 2011, after Lehman modified its proposed order to account for parties' objections and after overruling other parties' objections to the procedures, the bankruptcy court entered an order approving the SPV-specific ADR procedures.

Results

According to Lehman's most recent monthly report filed with the Bankruptcy Court on May 14, 2012, Lehman had achieved settlements in 202 ADR matters involving 224 counterparties — all of which were achieved prior to the commencement of any litigation with respect to the contracts in dispute. Upon the closing of the most recent settlements, Lehman will have received an aggregate total of over $1.1 billion for its bankruptcy estate. Of the 77 ADR matters that reached the mediation stage and have been concluded, 73 have been settled in mediation and only four have terminated without settlement. Thirteen additional mediations have been scheduled over the next several months, and Lehman's Chapter 11 Plan Confirmation Order provides that the ADR procedures continue to apply and are binding on all parties.

The ADR procedures in the Lehman case serve as an example of how mediation can successfully limit litigation, even after the parties have failed to negotiate an agreement between themselves. Parties often enter a mediation asserting litigation positions which can be millions or tens of millions of dollars apart. Moreover, in these disputes, Lehman is essentially operating as a bill collector, and the mediation is a single-issue dispute — how much money is owed. Such single issue disputes can be difficult to mediate (as opposed to adjudicate whether in arbitration or court proceedings). Nonetheless, the mediations being conducted in Lehman's case have been working — particularly following tweaks that Lehman and the court made for smaller disputes and SPV disputes.

One downside to the process is that because the process is confidential, the derivatives marketplace may not benefit from the public identification and resolution of common issues that arise from ambiguities in the relevant ISDA and Bankruptcy Code provisions. In addition, Lehman's experience with these ADR procedures highlights the challenges of pursuing ADR procedures with SPVs and indenture trustees whose settlement authority may be far from clear.

Nonetheless, the ADR procedures appear to be well structured and effective in achieving settlements for Lehman. The results have significantly decreased the stakes of litigation that may eventually be brought to adjudicate issues arising in unsettled disputes. In future complex Chapter 11 cases, bankruptcy courts likely will be receptive to similar procedures to benefit the estate.

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Withdrawal

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respect to individual claims, but with respect to discrete issues underlying those claims (including the effect of *Stern v. Marshall* on the bankruptcy court's ability to hear and adjudicate avoidance claims).

This article considers the genesis, tendency and scope of the district courts' withdrawals of the reference in some of the more complex proceedings pending today.

What Is Withdrawal of the Reference?

Section 157(a) of the Judicial Code (28 U.S.C. § 101 *et seq.*) provides the federal district courts with a

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mechanism for "referring" to bankruptcy courts in their respective districts "any or all cases under title 11 and any or all proceedings arising under title 11 or arising in or related to a case under title 11." Generally, each district court issues a standing order automatically referring such matters to the bankruptcy court in its district.

However, not all matters are appropriately referred to bankruptcy courts. Limitations on the bankruptcy courts' power to hear and decide controversies were codified as part of the Bankruptcy Amendments and Federal Judgeship Act of 1984 in response to the Supreme Court's decision in *Northern Pipeline Construction Co. v. Marathon Pipe Line Co.*, 485 U.S. 50 (1982). In *Marathon*, the Supreme Court (in a plurality decision) held that the attempt under the Bankruptcy Reform Act of 1978 to vest bankruptcy judges with broad jurisdictional powers was unconstitutional, as bankruptcy judges do not have the life tenure or protection against salary diminution guaranteed to Article III judges. Thus, the non-Article III bankruptcy courts could only be vested with the ability to adjudicate matters "involving public rights," *i.e.*, matters involving the government or a governmental scheme, and not state-created private rights, such as state law claims of breach of contract or warranty. *Marathon Pipeline*, 458 U.S. at 71. In response to *Marathon*, Section 157(b)(2) sets forth a non-exclusive list of "core" matters over which bankruptcy courts have historically exercised jurisdiction to issue orders and judgments. Section 157(c), in turn, provides that for non-core "related-to" matters, a bankruptcy judge may hear and render proposed findings of fact and conclusions of law to the district court for *de novo* review, but may not finally determine or issue orders or judgments without the consent of the parties.

Finally, Section 157(d) prescribes where the district courts may — or must — "withdraw the reference" and hear the case or proceeding directly. First, the district court may withdraw any case or proceeding "for cause shown." Such a withdrawal is "permissive." Cause is not defined, but courts weigh "whether the claim or proceeding is core or non-core, whether it is legal or equitable, and considerations of efficiency, prevention of forum shopping, and uniformity in the administration of bankruptcy law." *Orion Pictures Corp. v. Showtime Networks Inc.* (*In re Orion Pictures Corp.*), 4 F.3d 1095, 1101 (2d Cir. 1993). Withdrawal is mandatory, however, "if the court determines that resolution of the proceeding requires consideration of both title 11 and other laws of the United States regulating organizations or activities affecting interstate commerce." 28 U.S.C. § 157(d). In short, if the court is going to be asked to determine substantial and material issues arising under federal non-bankruptcy statutes, the reference must be withdrawn.

What Can Be Withdrawn?

Section 157(d) provides for withdrawal "*in whole or in part*" of any case or proceeding. The scope of "*in part*" is unclear. The 1984 Act has scant meaningful legislative history; there is no separate report accompanying the bill, and the individual remarks shed little light. The Emergency Interim Rule in place following *Marathon* and prior to the effectiveness of the 1984 amendments provides no greater clarity, having given the district court discretion to retain withdrawn matters, or to refer them back to the bankruptcy court in part, or in whole, with instructions for proceeding.

Courts historically have interpreted the statute in a number of different ways. They regularly permit the withdrawal of particular counts or claims. *See, e.g., Mirant Corp. v. The Southern Company*, 337 B.R. 107 (N.D. Texas 2006) (withdrawing the reference with respect to non-core claims); *In re The Babcock & Wilcox Co.*, 2000 U.S. Dist. LEXIS 5626 (E.D. La. April 17, 2000) (partially withdrawing the reference with respect to asbestos personal injury claims). In other cases, the district court withdrew the reference only for trial, leaving all discovery and motion practice to the bankruptcy court. *See, e.g., Rice v. Luke Communications, LLC*, 2011 U.S. Dist. LEXIS 14222 (E.D. Ark. Feb. 3, 2011) (delegating pre-trial coordination to bankruptcy court). Less frequently, courts may withdraw particular issues within a controversy. *See, e.g., Barona Group of the Capitan Grande Band of Mission Indians v. American Management & Amusement, Inc.*, 840 F.2d 1394 (9th Cir. 1987) (reference withdrawn to determine validity of management agreement in breach of contract action); *see also Securities Investor Protection Corp. v. Bernard L. Madoff Investment Securities LLC*, Adv. Pro. No 08-01789, 12 MC 0115 (S.D.N.Y. April 13, 2012); *Picard v. Avellino*, 2012 U.S. Dist. LEXIS 35260 (S.D.N.Y. March 1, 2012); *Picard v. Flinn Invs, LLC*, 463 B.R. 280 (S.D.N.Y. 2011) (discussed below).

Appealing the Withdrawal of The Reference

Orders withdrawing the reference are interlocutory, and several circuit courts have held that they are unreviewable under 28 U.S.C. § 1291 until after a final order has been entered. *See, e.g., Lieb v. Thomson* (*In re Lieb*), 915 F.2d 180, 184 (5th Cir. 1990) (citing decisions in the Second, Third, Seventh, Ninth, Tenth and Eleventh Circuits), reh'g denied, 1990 U.S. App. LEXIS 21898 (5th Cir., Dec. 13, 1990). However, the Supreme Court has held that 28 U.S.C. § 1292(b) enables circuit courts to hear appeals of interlocutory bankruptcy orders where the district judge states in writing that the matter "involves a controlling question of law as to which there is substantial ground for difference of opinion and that an immediate appeal … may materially advance the ultimate termination of the litigation." *See Connecticut National Bank v. Germain*, 503 U.S. 249 (1992); *see also* 1-3 Collier on Bankruptcy at ¶ 3.04 (Matthew Bender & Co. 2012). Moreover, at least two circuit courts have granted mandamus review where the district court, acting *sua sponte*, failed to show cause for withdrawing the reference. *See Canter v. Canter* (*In re Canter*), 299 F.3d

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1150, 1154-55 (9th Cir. 2002); *In re Pruitt*, 910 F.2d 1160, 1165 (3d Cir. 1990). Both *Canter* and *Pruitt* acknowledge that withdrawal orders are interlocutory and generally unappealable absent extraordinary circumstances. Clearly, immediate review of orders determining withdrawal of the reference motions is the exception rather than the rule.

The Impact of *Stern v. Marshall*

Historically, courts treated withdrawal of the reference as not mandatory for any "core" matter pursuant to 28 U.S.C. § 157(b). The Supreme Court's ruling in *Stern v. Marshall*, 564 U.S. ___, 131 S. Ct. 2594 (2011) compelled a reexamination of that treatment.

In *Stern*, the Supreme Court held that the conferral of authority on the bankruptcy court under 28 U.S.C. § 157(b) to determine the debtor's state law counterclaim was unconstitutional. Following its holdings in *Marathon* and *Granfinanciera S.A. v. Nordberg*, 492 U.S. 33 (1989) (where the Court held that a fraudulent conveyance action against a non-creditor did not fall within the "public rights" exception), the Court held the counterclaim to be a private claim, not subject to the "public rights" exception. Plaintiff's proof of claim, which asserted a defamation claim, did not alter that result since it was wholly unrelated to the debtor's counterclaim. Absent consent of the parties, bankruptcy courts lack the constitutional authority to enter final judgment on such state law counterclaims.

Fallout from *Stern v. Marshall*: Increased Withdrawal of Discrete Issues?

Much has been written about the uncertainty raised by *Stern v. Marshall* and the administrative inefficiencies it will cause. Bankruptcy and district courts are already treading carefully in *Stern's* wake. *See, e.g., Kirschner v. Agoglia*, 11 Civ. 8250 (S.D.N.Y. Opinion and Order dated May 9, 2012) (although the bankruptcy court lacked constitutional authority to issue a final order on a motion to dismiss core fraudulent conveyance claims, it could issue a report and recommendation subject to the district court's *de novo* review); *Schwartz v. Deutsche Bank National Trust Co.* (*In re Schwartz*), 2011 U.S. Dist LEXIS 144470, *2 (D. Mass. Dec. 15, 2011) (the district court withdrew the reference "to ensure that the adversary proceeding conforms with the constitutional requirements elucidated in *Stern v. Marshall*"); *Federal Insurance Co. v. DBSI, Inc.* (*In re DBSI, Inc.*), 2011 Bankr. LEXIS 2727, (Bankr. D. Del. July 22, 2011) (the bankruptcy court declined to rule on a motion for summary judgment, instead inviting the parties to file written submissions on whether *Stern v. Marshall* permitted it to do so). Many district courts have issued amended standing orders of reference providing for bankruptcy judges to submit proposed findings of fact and conclusions of law to the district on "core" matters where there may be a Constitutional question as to the bankruptcy judge's authority to enter a final order or judgment. *See, e.g.*, *In re Standing Order of Reference Re: Title 11*, 12 Misc. 32 (S.D.N.Y. Feb. 1, 2012) (C.J. Preska).

Litigants have capitalized on the courts' collective hesitation by filing motions to withdraw the reference in droves. Nevertheless, while *Stern* may have directly led to the recent deluge of such motions, the results may be narrowly limited in scope. Courts have increasingly limited the withdrawal to a specific issue or issues, such as the bankruptcy court's jurisdiction and ability to issue proposed findings and conclusions in "core" matters.

The district court presiding over hundreds of withdrawal of the reference motions by fraudulent transfer defendants in the *Madoff* proceedings has taken precisely that approach. Judge Rakoff has issued several orders withdrawing the reference to the bankruptcy court to determine how *Stern* impacts the bankruptcy court's ability to render decisions and/or to propose findings of fact and conclusions of law, as well as to address issues requiring significant interpretation of securities and other federal law. *See, e.g., Securities Investor Protection Corp. v. Bernard L. Madoff Investment Securities LLC*, Adv. Pro. No 08-01789, 12 MC 0115 (S.D.N.Y. April 13, 2012); *Picard v. Avellino*, 2012 U.S. Dist. LEXIS 35260 (S.D.N.Y. March 1, 2012); *Picard v. Flinn Invs, LLC*, 463 B.R. 280 (S.D.N.Y. 2011).

However, not all post-*Stern* efforts to withdraw the reference have been successful. Judge Denise Cote of the Southern District of New York denied without prejudice two motions to withdraw the reference to the bankruptcy court in fraudulent transfer litigation arising out of the *Lyondell* bankruptcy. While acknowledging that the bankruptcy court did not have authority to issue a ruling on the pending fraudulent transfer claims, Judge Cote noted that at the present time, efficiency dictated that the cases remain before the bankruptcy court, which had presided over pretrial proceedings, including discovery and motion practice. *See* Opinion and Order, 11 Civ. 8251, 11 Civ. 8445 (S.D.N.Y. March 29, 2012).

Conclusion

While it may be efficient to address threshold issues at the outset, the propriety of issue-based withdrawals of the reference is unclear, given the lack of clarity as to what withdrawal "in part" means. The general unavailability of interlocutory appeals will hamper any effort to test the district court's ability to exercise withdrawal on an issue-by-issue basis. It will be interesting to see whether the trend of issue-based withdrawals continues, and whether motions to withdraw the reference become a staple of defendants' tactics in bankruptcy litigation.

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