CHADBOURNE
& PARKE LLP

INTERNATIONAL
Restructuring NewsWire

February 2012

CHADBOURNE & PARKE LLP

The Year in Review: U.S. Business Bankruptcies in 2011

2011 did not begin with a bang for bankruptcy professionals. Commercial bankruptcy case filings were infrequent and so too were the release (or publication) of major bankruptcy court decisions. The second half of the year was a different story.

IN THIS ISSUE

1 The Business Bankruptcy World in 2011

2 Overview of Leading Bankruptcy Cases of 2011

4 Key 2011 Decisions on Chapter 11 Plan Confirmation Issues

9 Decisions in *Enron* and *Madoff* Cases Confirm Safe Harbor Protections

12 Is Chapter 9 Really an Option for Most Municipalities?

15 New Bankruptcy Rule 2019

16 Important 2011 Rulings on Foreign Proceedings

In June, the Supreme Court issued its ruling in *Stern v. Marshall,* one of the most significant Supreme Court bankruptcy rulings in recent history. In fact, we reported in October that scores of courts had already been required to address, although not necessarily resolve, the issues raised by the Supreme Court in *Stern.* Meanwhile, the pace of so-called "mega" bankruptcy case filings jumped. Of the top ten bankruptcy case filings of 2011, seven were filed in the second half of the year and, of those, each of the top five filings was made in the fall of 2011. Leading the charge (by size) was *MF Global Holdings* with over $40 billion in assets and *AMR/American Airlines* with over $25 billion in assets.

Meanwhile, by the end of the year, and largely unrelated to the increased number of 2011 mega-case filings, numerous court decisions had been issued by circuit courts and other courts that focused on fundamental bankruptcy issues that will likely affect future commercial bankruptcy practice. This issue of the *International Restructuring NewsWire* is dedicated to those decisions and issues.

This publication may constitute Attorney Advertising in some jurisdictions.

Overview of Leading U.S. Bankruptcy Cases of 2011

Category/ Bankruptcy Case	Why Case Matters?	Where You Can Find More Information
BANKRUPTCY COURT JURISDICTION		
Stern v. Marshall (Supreme Court)	**Ruling:** because jurisdiction of bankruptcy court is limited constitutionally, bankruptcy courts cannot decide certain matters that are state law-based even if relevant jurisdictional statute appears to grant the courts such powers	*NewsWire*, Oct. 2011 at p.1
	Result: creates additional possible jurisdictional issue to litigate in bankruptcy cases	
PLANS OF REORGANIZATION		
Dish Network Corp. v. DBSD N. America, Inc. — Gifting (Second Circuit)	**Ruling:** a senior class cannot violate the absolute priority rule by "gifting" value to junior creditors without the consent of any intermediate level creditors	*NewsWire*, May 2011 at p.8
	Result: to obtain the support of junior creditors with a "gift," the gift must be agreed to (and probably shared) with any intermediate creditors	
Washington Mutual, Inc. (Bankr. Del.)	**Ruling:** creditors who enter into confidentiality agreements with the debtors and/or other case parties in order to engage in plan settlement discussions may still be subject to insider trading claims after the confidentiality agreements expire if said creditors continue to hold inside information and trade with that knowledge *[NOTE: This opinion was partially vacated by the bankruptcy court on February 24, 2012; see note herein at page 7]*	*This Issue*, at p. 5
	Result: likely to discourage major claim traders from entering into confidentiality agreements and/or settlement discussions	
Tribune, Inc. (Bankr. Del.)	**Ruling:** each and every affiliated debtor must obtain affirmative creditor vote (or provide certain notices where no votes are cast) to confirm a plan for *that debtor,* even in mega jointly-administered cases where single debtor's value is insignificant	*This Issue*, at p. 7
	Result: additional focus on smaller debtors in mega-bankruptcy cases; new provisions in plans for non-voting classes	
Dish Network Corp. v. DBSD N. America, Inc. — Voting (Second Circuit)	**Ruling:** claim purchaser's vote can be disallowed where purchaser's motives to vote were related to interest in purchasing debtor, not in maximizing creditor recovery	*This Issue*, at p. 4
	Result: purchase of claims by strategic buyer less likely	
MUNICIPALITIES BANKRUPTCY FILINGS		
City of Harrisburg (Bankr. M.D. Pa.) and *Suffolk Regional Off-Track Betting Corp.* (Bankr. E.D.N.Y.)	**Rulings:** denied bankruptcy filings by municipalities where municipality was not authorized to file by applicable state law	*This Issue*, at p. 12
	Result: demonstrates the legal difficulties that municipalities face in attempting to file for bankruptcy	

Category/ Bankruptcy Case	Why Case Matters?	Where You Can Find More Information
AVOIDANCE ACTIONS		
Tousa (Southern Florida District Court)	**Ruling:** overturned controversial bankruptcy court ruling that appeared to expand lenders' potential fraudulent conveyance liability	*Client Alert, Feb. 15, 2011 & Client Alert, March 8, 2011*
	Result: although various case issues continue to wind through the appeal process, reversal demonstrated that legal view of fraudulent conveyance liability is consistent with lender (and market) understanding	
Enron Creditors Recovery Corp. v. Alfa, S.A.B. de C.B., ING et al. (Second Circuit) and *Picard v. Katz, et al. (In re Madoff)* (S.D.N.Y.)	**Rulings:** safe harbor for securities transactions set forth in section 546(e) of the Bankruptcy Code should be interpreted as written, with no additional requirements read into statute	*This Issue,* at p. 8
	Result: bankruptcy safe harbor for securities transactions is effective and will be enforced; derivative market players will be encouraged to continue to enter agreements protected by section 546(e)	
FOREIGN PROCEEDINGS/ CHAPTER 15		
Millennium Global Funds (Bankr. S.D.N.Y.)	**Rulings:** center of main interest ("COMI") measured on date on which foreign proceeding commended; fact and circumstances related to COMI will be carefully reviewed in each case	*This Issue,* at p. 16
	Result: the COMI of offshore hedge funds is not automatically suspect but will be reviewed in each and every case	
Toft (Bankr. S.D.N.Y.), *Sivec* (Bankr. E.D. Okla.) and *Qimonda* (Bankr. E.D. Va.)	**Rulings:** denied recognition of chapter 15 filings or related requested relief where inconsistent with "public policy" of the United States	*This Issue,* at p. 17
	Result: chapter 15 cases and related requests for bankruptcy court assistance may be denied on public policy grounds to protect U.S. privacy, legal process and intellectual property rights	
CREDITOR DISCLOSURE REQUIREMENTS		
New Rule 2019	**Rule Change:** clarifies that all groups involved in case must disclose economic interests when working in concert; purchase price need not be disclosed	*This Issue,* at p. 14
	Result: should provide additional clarity on whether parties are working together and source of economic motivations	

Key 2011 Decisions on Chapter 11 Plan Confirmation Issues

By Douglas E. Deutsch & Eric Daucher

Although 2011 saw major decisions concerning many facets of bankruptcy law, perhaps no area of bankruptcy law drew as many high-profile decisions as the standards for confirming a chapter 11 plan of reorganization. We draw your attention to three particularly important 2011 decisions that are likely to heavily influence the contours of many future chapter 11 plans.

Designating Votes Not Cast in Good Faith

On February 7, 2011, the United States Court of Appeals for the Second Circuit issued an opinion in *DBSD North America, Inc.* that has major implications for two aspects of chapter 11 plan confirmation: (a) the so-called "gifting" doctrine and (b) creditor vote designation. *See* 634 F. 3d 79. In the first part of its opinion, the Second Circuit concluded that the "gift" contained in the debtor's proposed chapter 11 plan violated the absolute priority rule and thereby rendered the plan unconfirmable. As we explained in our May 2011 issue of the *International Restructuring NewsWire*, the *DBSD* court narrowed the scope of the gifting doctrine by holding that it could not be used to circumvent absolute priority. However, the court left open the possibility that gifting can be used to overcome "unfair discrimination" challenges to confirmation.

This issue of the *NewsWire* focuses on the second major issue addressed by the *DBSD* opinion, claim designation. The Second Circuit affirmed the bankruptcy court's decision to designate (*i.e.*, disallow) votes cast by DISH Network Corp. because it found that the votes were cast to further an "ulterior strategic motive" unrelated to its interests as a creditor of DBSD. Sophisticated investors in distressed debt would be well-advised to pay close attention to this ruling.

Background

DBSD was founded in 2004 to develop and operate a mobile communications network that combined satellite and land-based broadcast technologies. To fund that development, DBSD issued senior secured notes. When it became clear that the network would be unable to launch on schedule, the company obtained a first lien revolving credit facility to meet its working capital needs. Nevertheless, as the maturity date on its senior secured notes neared, DBSD concluded that it would be unable to meet its obligations and filed for chapter 11 protection. Ultimately, DBSD proposed a plan of reorganization under which the holders of first lien debt would receive replacement debt payable in kind. The senior secured noteholders would receive 99.85% of new equity. Unsecured creditors would receive 0.15% of new equity.

Vote Designation Upheld

After the plan was proposed, DISH purchased the entirety of DBSD's first lien revolver debt *at par* (as well as a portion of the senior secured notes). DISH then voted to reject the plan. In response, DBSD filed a motion seeking to "designate" (*i.e.*, disallow) DISH's vote with respect to its first-lien debt, arguing, among other things, that DISH's vote was not intended merely to convey that payment to creditors must be increased, but rather that the vote was a strategic attempt to stymie the Debtors' reorganization and ultimately seize control of the company. The Debtors relied on Section 1126(e) of the Bankruptcy Rule which states, in relevant part, that a court may designate any entity whose acceptance or rejection of a plan "was not in good faith." Nowhere does the Bankruptcy Code define "good faith."

In objecting to the motion to designate its votes, DISH claimed that it was a "model bankruptcy citizen." It cited the fact that it had "not moved to terminate exclusivity . . . [or] propose[d] a competing plan" to support its assertion. However, in a textbook example of how not to win favor with a bankruptcy court, on the very day before the confirmation hearing, DISH filed a motion to terminate exclusivity and for authority to propose a competing plan. DISH also proposed a transaction with DBSD — the details of which were not made public — that (apparently) further evidenced its intent to take control of DBSD's assets. Based on those and other factors, the bankruptcy court concluded that "DISH made its investment . . . not as a traditional creditor seeking to maximize its return on the debt it holds, but as a strategic investor, 'to establish control over this strategic asset.'" Accordingly, the bankruptcy court concluded that DISH did not act in "good faith" and designated its vote.

On appeal, the Second Circuit established certain bright line rules for examining "good faith" under section 1126(e) of the Bankruptcy Code. First, the court concluded that merely purchasing claims in order to block a plan of reorganization does not amount to lack of good faith. The court also found that acting selfishly in purchasing and voting claims does not establish lack of good faith. Instead, lack of good faith may exist where creditors "venture beyond mere self-interested

Largest 2011 Bankruptcy Filings

Company	Bankruptcy Court	Filing Date	Industry	Approximate Assets
In re MF Global Holdings Ltd.	S.D.N.Y.	Oct. 31	Commodities/Derivatives Brokerage	$40.5 billion
In re AMR Corp.	S.D.N.Y.	Nov. 29	Air Carrier	$25 billion
In re Dynegy Holdings, LLC.	S.D.N.Y.	Nov. 7	Power Production	$9.9 billion
In re PMI Group, Inc.	D. Del.	Nov. 23	Mortgage Insurance	$4.2 billion
In re NewPage Corp.	D. Del.	Sept. 7	Paper Production	$3.5 billion
In re First State Bancorp.	D.N.M.	Apr. 27	Banking	$3.2 billion
In re Integra Bank Corp.	S.D. Ind.	July 30	Banking	$2.4 billion
In re General Maritime Corp.	S.D.N.Y.	Nov. 17	Oil Shipping	$1.8 billion
In re Borders Group, Inc.	S.D.N.Y.	Feb. 16	Book Retail	$1.4 billion
In re TerreStar Corp.	S.D.N.Y.	Feb. 16	Mobile Networking	$1.4 billion

promotion of their claims" and instead act to obtain some benefit to which they are not entitled. Specifically, creditor conduct is suspect where votes are cast to obtain more than the fair value of their claims or for some other impermissible ulterior motive. The court was careful to point out that not just any ulterior motive is sufficient to warrant vote designation. Instead, 1126(e)'s good faith requirement is intended to prohibit conduct whereby a creditor is willing to sacrifice value on its claim in order to realize some outside benefit.

Based on the foregoing, the Second Circuit reached the conclusion that DISH's vote was properly designated by the bankruptcy court. The court highlighted several facts that it believed relevant to the examination, including (i) DISH's admission that it voted to capture a strategic asset, (ii) overpayment of claims by DISH, (iii) DISH's attempt to propose its own plan or reorganization and (iv) internal communications within DISH that demonstrated an intent to take control of DBSD's bankruptcy process.

Takeaway Points

The Second Circuit noted that its ruling "should deter only attempts to 'obtain a blocking position' and thereby control the bankruptcy process. . . ." Given that bankruptcy investing often involves building a blocking position, the Second Circuit's "only" notation may be of little comfort to parties seeking an active role in a bankruptcy case. Although the court emphasized that its "opinion imposes no categorical prohibition on purchasing claims with acquisitive or other strategic intentions," activist investors should now carefully consider their options before investing in bankruptcy claims.

When Obtaining a Blocking Position Makes You an Insider

In the second major decision of 2011 to highlight the risks of intentionally acquiring substantial bankruptcy claims, the Bankruptcy Court for the District of Delaware in *In re Washington Mutual, Inc.*, 461 B.R. 200, granted the equity committee standing

to pursue claims for equitable disallowance against certain activist noteholders (the "Noteholders"). The claims for equitable disallowance were based upon, among other things, "colorable claims" that the Noteholders became non-statutory insiders by obtaining blocking positions in two classes of claims and then trading on material non-public information relating to plan negotiations.

Background

Shortly after Washington Mutual, Inc. (also known as "WaMu") filed for bankruptcy, multiparty disputes arose regarding ownership of certain assets previously held by WaMu's subsidiary, Washington Mutual Bank. In order to participate in plan negotiations (which principally involved a settlement concerning ownership of the disputed assets), the Noteholders signed certain confidentiality agreements that obligated them to either establish ethical walls or refrain from trading in WaMu's debt or other securities during relevant confidentiality periods. The confidentiality agreements also obligated the Debtors to publicly disclose all material, non-public information shared with the parties at the end of each confidentiality period. The disclosure, it was thought, would allow the parties to resume trading without fear of insider trading allegations.

As negotiations progressed, the Noteholders refrained from trading during confidentiality periods and the Debtors made various disclosures, including information relating to certain tax refund proceeds. The Debtors did not, however, disclose the status of negotiations (or even that negotiations were ongoing) or the stances taken by the various parties during the negotiations.

In March 2010, the Debtors submitted a plan calling for a global settlement of ownership disputes and other causes of action to the bankruptcy court for approval. In addition to the Debtors, the plan was supported by, among others, the Noteholders and the official creditors' committee. The official equity committee, holders of "trust preferred securities" and certain other creditors objected. On January 13, 2011, the bankruptcy court found that the global settlement proposed by the plan was fair and reasonable, but denied confirmation for other reasons. The plan was then amended to address the cited deficiencies and again submitted to the court for consideration. Support for and opposition to the amended plan again divided largely along the same lines.

Judge Walrath first concluded that the fact that settlement negotiations were occurring constituted material non-public information. Moreover, the court found that the Noteholders' knowledge of the positions taken by parties during the negotiations, *even where such positions did not result in a settlement,* was material.

Equity Committee's Arguments

In opposing the amended plan, the equity committee advanced two primary arguments. First, the equity committee contended that the plan was not proposed in good faith because the Noteholders "dominated" and "hijacked" the bankruptcy process by purchasing claims to obtain a blocking position. Judge Walrath rejected this argument, finding that the Noteholders actions enhanced recoveries to similarly situated creditors and did not unduly influence the Debtors' behavior. (In this respect the Noteholders' actions were markedly different than those of DISH in the *DBSD* case. In *WaMu*, the Noteholders sought greater recovery on their claims whereas in *DBSD,* DISH knowingly took a loss on its claims with the hope of achieving an outside strategic objective.)

Second, the equity committee argued that it should be granted standing to pursue the equitable disallowance of the Noteholders' claims based on allegations of insider trading. In general, a party is liable for insider trading if it (i) trades securities while in possession of material, non-public information and (ii) owes a fiduciary duty to either the issuer of the

securities or the party from which it received the material, non-public information. The equity committee argued that the Noteholders satisfied these criteria because the fact that negotiations were occurring (and the positions taken by parties during those negotiations) was material information that was never publicly disclosed. As a result, argued the equity committee, the Noteholders became non-statutory insiders of the Debtors.

The Court's Opinion with Respect to Insider Trading Allegations
After reviewing the record, the bankruptcy court found "colorable" claims that the Noteholders had engaged in insider trading and that, accordingly, the equity committee should be granted standing to pursue claims for disallowance. In reaching that conclusion, Judge Walrath made a number of findings that distressed debt investors and others should consider.

Judge Walrath first concluded that the fact that settlement negotiations were occurring constituted material non-public information. Moreover, the court found that the Noteholders' knowledge of the positions taken by parties during the negotiations, *even where such positions did not result in a settlement*, was material. Thus, the first element of an insider trading claim could be satisfied. In reaching its conclusions, the court specifically rejected arguments by the Noteholders that requiring disclosure of every position taken during settlement negotiations would be impractical. The court also specifically found that the Noteholders were not entitled to rely on the Debtors' contractual obligation to disclose all material non-public information.

The court then turned to the second element of a possible trading claim, whether the Noteholders owed a fiduciary duty to some relevant party. On this point, the court concluded that, by intentionally acquiring a blocking position in certain creditor classes, the Noteholders became temporary or non-statutory insiders who owed duties to, and were required to act for the benefit of, those classes in which they held blocking positions. Based on the foregoing, the court reasoned that the Noteholders may have traded on material information that was unavailable to other members of these classes and, thus, be liable under the theory of "classical" insider trading.

Takeaway Points
As we discussed at Chadbourne & Parke's October 20, 2011 presentation, "New Perils in Chapter 11 — Distressed Investing after *Washington Mutual*," any party engaging in non-public settlement talks should be aware that post-confidentiality disclosure may now require releasing virtually all information that was conveyed during negotiations. The alternative is to require all parties to settlement negotiations to implement permanent ethical walls or, as suggested by Judge Walrath, to indefinitely refrain from trading. The latter options, of course, are difficult or unworkable for many active distressed debt investors. Accordingly, one solution – which we understand is already being implemented by some active investors – may be to require confidentiality agreements to include provisions that allow any party to negotiations to disclose, at the conclusion of the confidentiality period, any and all information that it reasonably believes might be regarded as material.

Current Status
On February 17, 2012, Judge Walrath preliminarily approved a further-revised plan of reorganization. This plan appears to have the support of all major stakeholders. In addition to the settlements envisioned in previous iterations of the plan, the revised plan contains a settlement of the causes of action that the equity committee had been granted standing to pursue. Importantly, that settlement is conditioned on the court vacating key portions of its earlier opinion, including those provisions related to the alleged insider trading activities of the Noteholders. Surprising many, the court indicated a willingness to strike those provisions from its prior opinion and, in fact, partially vacated its ruling on February 24, 2012. Accordingly, the key question for active claims traders and other case parties in the future will likely be what affect Judge Walrath's (partially) vacated opinion will have on case participation where insider trading claims could later be asserted.

Creditors' Votes Must be Obtained for Each and Every Debtor (Unless You Plan Ahead)

In *Tribune, Inc.*, another important decision out of the Bankruptcy Court for the District of Delaware, the court ruled that jointly administered plans of reorganization cannot be crammed down under section 1129(b) of the Bankruptcy Code without being accepted by at least one impaired class at *each* debtor under the jointly-administered plans. *See* No. 08-13141, 2011 WL 5142420 (Oct. 31, 2011). This is an important decision in "mega-cases" where there are often numerous (tens or even hundreds) of subsidiaries being jointly administered in bankruptcy. The decision is all the more important because, surprisingly, very few cases have previously addressed the issue.

Background
In *Tribune*, two competing jointly-administered plans of reorganization for the more than 100 debtors were submitted for

confirmation. The first plan (the "DCL Plan") was supported by the debtors, the debtors' secured lenders and the creditors' committee. The second plan (the "Noteholder Plan") was supported by certain parties holding senior unsecured debt at the parent debtor. Both plans divided creditor classes by, among other things, which Tribune entity owed the debt.

When the votes on both of the plans were tallied, the Noteholder plan had won creditor support from three creditor classes – two at the parent debtor and one class at a non-operating subsidiary. The DCL Plan, in contrast, obtained support from an impaired class at every debtor for which any votes were cast.

Arguments on the Scope of Section 1129(a)(10)

The creditors' committee, represented by Chadbourne, argued that the Noteholder Plan was unconfirmable even under cramdown because section 1129(a)(10) of the Bankruptcy Code forbids plan confirmation where any creditor class is impaired unless at least one class of claims that is impaired under that individual debtor's plan has accepted the plan. The committee contended that, because joint administration — unlike substantive consolidation — has no substantive impact on creditors' rights, and because corporate separateness is intended to be strictly honored absent substantive consolidation, allowing creditors of one debtor to cram down a plan on the creditors of another debtor is impermissible. Section 1129(a)(10), should, it was argued, be treated as a debtor-by-debtor requirement.

The proponents of the Noteholder Plan responded that 1129(a)(10) simply refers to "the plan" and should therefore be tested on a "per-plan basis." Further, the Noteholder Plan proponents contended that if the Noteholder Plan was unconfirmable under section 1129(a)(10), so too was the DCL Plan as it had not obtained an accepting impaired class at the debtors for which no creditors voted at all. In response, the DCL Plan proponents argued that there was precedent for treating classes as accepting in large, jointly-administered cases for debtors where no votes are cast.

After considering the arguments, Judge Carey determined that there was "nothing ambiguous" about section 1129(a)(10) and found that it must be satisfied on a debtor-by-debtor basis. He also ruled that, although there is precedent for treating silent or non-voting classes as accepting a plan in megacases where the debtor at issue is a relatively small entity, such treatment is only appropriate where creditors are warned in plain, bold text in the disclosure statement that failure to vote may result in their class being treated as accepting. Accordingly, the court denied confirmation of both plans on this basis (among others).

Takeaway Points

After the ruling in *Tribune*, proponents of jointly administered plans will have to be certain that they appeal to a broad base of creditors at each and every debtor. This remains true even where one debtor's creditors are far more numerous and economically significant (for example, the parent debtor's creditors) than the creditors of other affiliated debtors. Additionally, even where a plan has broad-based appeal, drafting parties should include language in their disclosure statements making clear that the Court may confirm the plan as to debtors whose creditors fail to vote. ◎

Decisions in *Enron* and *Madoff* Cases Confirm Safe Harbor Protections

By Robert J. Gayda

Active participants in the derivatives market rely on the Bankruptcy Code safe harbor set forth in section 546(e) in pricing their securities. That provision restricts a debtor's power to recover payments made in connection with certain securities transactions that might otherwise be avoidable under the Bankruptcy Code. Two high profile cases decided in 2011 addressed challenges to the application of section 546(e). The more widely reported decision (at least outside the bankruptcy arena) was in connection with the Madoff insolvency case. *See Picard v. Katz, et al.*, 2011 WL 4448638 (S.D.N.Y. Sept. 27, 2011) ("*Madoff*"). In that opinion, District Judge Rakoff was asked to determine the applicability of section 546(e) to lawsuits filed against several of the Madoff fraud "winners" (that is, Madoff investors who had been paid more money than they had invested). He found that section 546(e) was to be interpreted broadly, thus protecting the transfers at issue. In reaching this holding, the court followed the logic first set forth in another headline grabbing case decided three months earlier, *Enron Creditors Recovery Corp. v. Alfa, S.A.B. de C.V., ING VP Balanced Portfolio, Inc., and ING VP Bond Portfolio, Inc.*, 651 F.3d 329 (2d Cir. June 28, 2011) ("*Enron*"). This article will review section 546(e) generally, as well as the *Enron* and *Madoff* decisions and examine what those decisions mean to creditors.

Preferences, Fraudulent Transfers and the Section 546(e) Safe Harbor

The Bankruptcy Code vests in the debtor the power to avoid certain transfers made prior to the bankruptcy filing. These include both (i) preferential transfers, or transfers made within ninety days of the petition date which "prefer" one creditor over other similarly situated creditors, and (ii) fraudulent transfers, which are transfers made by the debtor with either the intent to hinder, delay, or defraud creditors or are transfers made for less than reasonably equivalent value at a time when the debtor is in a fragile financial condition. (A more detailed introductory overview of preferential and fraudulent transfers has been included in this issue of *NewsWire*. *See* sidebar on this page).

The safe harbor set forth in section 546(e) of the Bankruptcy Code acts as a defense to certain preference and fraudulent transfer attacks when the transfer in question relates to a securities transaction. Section 546(e) provides:

> [T]he [debtor or a] trustee may not avoid a transfer that is a . . . settlement payment . . . made by or to (or for the benefit of) a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency, or that is a transfer made by or to (or for the benefit of) a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency, in connection with a securities contract, . . . commodity contract, . . . or forward contract, that is made before the commencement of the case, except [with respect to transfers made with an actual intent to hinder, delay, or defraud]. . . .

According to the Second Circuit's *Enron* decision, Congress enacted section 546(e)'s safe harbor in 1982 in an attempt to minimize any displacement that may be caused in the commodities and securities markets by a bankruptcy of a major player in those industries. It was thought that requiring a major securities firm to repay amounts received in settled securities transactions could leave the securities firm with insufficient capital or liquidity to meet its securities trading obligations, placing other market participants and the securities markets in general at risk.

Introduction to Preferences and Fraudulent Transfers

In his *Madoff* decision, Judge Rakoff recently provided a review of the types of avoidance actions that exist in bankruptcy cases. *See Madoff*, 2011 WL 4448638 at *1. His review, which is summarized herein, may be helpful to some readers.

Preference and fraudulent transfer actions both address whether prior payments made by a debtor may be, in effect, rescinded — or, in the language of bankruptcy law, "avoided" — and the payments returned to the bankrupt's estate. Once returned, the recovery can be distributed to all of a debtor's creditors in accordance with bankruptcy law claim priorities. Each type of action is discussed in turn.

"Preferences" occur when, prior to the bankruptcy filing, the bankrupt makes a transfer to some of its creditors in preference to others. For example, if a debtor owed two creditors $5,000 each but only had $5,000 in assets, paying one creditor in full and not paying the other could constitute a preferential transfer. This preference may be avoided if it was made within ninety days of a bankruptcy filing without regard to the transferor's intent. No "wrongdoing" is required by any party in connection with an alleged preference. The idea behind the concept is that, while an ongoing business may decide which creditors to pay first, an insolvent business cannot be allowed to deplete its remaining assets in favor of one creditor over another. If a preferential transfer is recovered, the proceeds would be shared equally among creditors. Using the example set forth above and assuming the debtor has only two creditors, the $5,000 recovery would be distributed so that each of the two creditors (including the recipient of the original "preference") would receive $2,500.

"Fraudulent transfers" include two types of transfers: actual fraudulent transfers and constructively fraudulent transfers. Actual fraudulent transfers require a showing of actual fraudulent intent; that is that the debtor made the transfer with the actual intent to hinder, delay, or defraud other creditors. If a debtor who has a large judgment filed against him intentionally seeks to hinder recovery on the judgment by transferring all of his assets to a friend, the transfer would constitute an actual fraudulent transfer. In contrast, constructively fraudulent transfers do not require proof of actual fraudulent intent, but rather a showing that the debtor did not receive reasonably equivalent value for the transfers and was in a fragile financial condition at the time of the transfer (poor financial condition may be measured in several different ways). Such a transfer could include an insolvent debtor selling its assets in a "fire sale" for less than market value on the eve of bankruptcy in an attempt to raise cash. ◎

Enron

The *Enron* decision was the result of years of litigation surrounding the redemption of $1.1 billion in unsecured commercial paper in the final months before Enron's collapse. Between October 25, 2001 and November 6, 2001, Enron drew down its $3 billion revolving lines of credit and used the proceeds, in part, to retire more than $1.1 billion of unmatured commercial paper. Enron redeemed the commercial paper at its accrued par value, calculated as the price originally paid plus accrued interest. The amount paid was thus considerably higher than the paper's market value. In November 2003, two years after Enron filed for bankruptcy, the reorganized entity sued numerous parties, including the defendants Alfa, S.A.B. de C.V., ING VP Balanced Portfolio, Inc. and ING VP Bond Portfolio, Inc., alleging that the payments they received as holders of the commercial paper were recoverable as preferential and constructively fraudulent transfers.

While many defendants settled these issues with Enron over the course of the litigation, Alfa and ING continued to vigorously defend against the claims, arguing that the redemption payments were "settlement payments" protected under section 546(e). They were unsuccessful at the bankruptcy court level, where the court issued two separate opinions rejecting Alfa and ING's arguments.

The bankruptcy court undertook a detailed examination of the term "settlement payment," beginning with the definition of the term. The bankruptcy court explained that section 741(8) of the Bankruptcy Code defines "settlement payment" as "a preliminary settlement payment, a partial settlement payment, an interim settlement payment, a settlement payment on account, a final settlement payment, or any other similar payment commonly used in the securities trade."

The bankruptcy court first ruled that the phrase "commonly used in the securities trade" in Bankruptcy Code section 741(8) modified all of the terms in the section's definition and thereby limited the settlement payments entitled to protection to those that are common in the industry. The court additionally held that settlement payments included only payments to buy or sell securities, and did not include payments to retire debt. Accordingly, because Alfa and ING had failed to establish that the payments in question were made to acquire title to the securities rather than to retire debt, section 546(e) did not apply. Alfa and ING appealed this ruling.

Upon review, the district court came to a different conclusion and reversed the bankruptcy court. The district court held that (i) section 741(8)'s definition of "settlement payment" was not limited to payments that are "commonly used" and therefore, found that the circumstances of a particular payment do not dictate whether that payment fits within the definition, (ii) a "settlement payment is any transfer that concludes or consummates a securities transaction" and (iii) Enron's redemption constituted a securities transaction regardless of whether Enron acquired title to the commercial paper, because the redemption involved the delivery and receipt of funds and securities. Enron appealed this ruling to the Second Circuit.

At the circuit court level, Enron made arguments similar to those cited by the bankruptcy court in its decision. The Second Circuit rejected each of Enron's arguments, starting by finding that the phrase "commonly used in the securities trade" does not modify all of the preceding terms of the definition of "settlement payment." Reviewing the grammatical structure of the statute, the court stated that "[t]he phrase is not a limitation on the definition of settlement payment, but rather...is a catchall phrase intended to underscore the breadth of the section 546(e) exemption." Moreover, the court found that Enron's proposed reading would make application of the safe harbor in every case dependent on a factual determination regarding the commonness of a given transaction. This would result in commercial uncertainty and unpredictability, a result clearly at odds with the safe harbor's purpose.

Next, the court rejected Enron's argument that the redemption payments were not settlement payments because they involved the retirement of debt rather than the acquisition of title to the commercial paper. The court stated that there was no basis in the Bankruptcy Code or the relevant case law to interpret section 741(8) as excluding the redemption of debt securities. Moreover, because Enron's redemption payments completed a transaction in securities, the court held that they were payments within the meaning of section 741(8).

Finally, Enron argued that the redemption of debt did not constitute a protected settlement payment because it did not involve a financial intermediary that took a beneficial interest in the securities during the course of the transaction. As such, stated Enron, the redemption did not implicate the systemic risks that motivated Congress's enactment of the safe harbor. The court ruled that Enron was correct that the Depository Trust Company acted as a conduit and recordkeeper rather than a clearing agency that takes title to the securities during the course of the transaction. Nevertheless, the court did not find that the absence of an intermediary that takes title to the transacted securities during the course of the transaction is a proper basis on which to deny safe harbor protection. In so holding, the court found that undoing Enron's redemption pay-

ments, which involved over a billion dollars and approximately two hundred noteholders, could have a substantial negative impact on the financial markets, and therefore fell within the intent of the statute.

Madoff

Again, in the *Madoff* case, the court was asked to consider section 546(e) protected payments to investors who had actually been paid more than they invested with Madoff. The defendants included members of the Katz and Wilpon families, their partners and their closely held investment companies. The Katz and Wilpon families own, whether directly or indirectly, vast real estate holdings as well as the New York Mets baseball franchise. They had collectively invested substantial amounts in Bernard L. Madoff Investment Securities over the years and, unlike many others, were fortunate enough to withdraw those funds (a large portion of which were "profits" earned in the Madoff scheme) prior to the discovery of Madoff's fraud. The decision at issue arose out of a complaint filed against the defendants by Irving H. Picard, as trustee of the Bernard L. Madoff and Bernard L. Madoff Investment Securities estates.

The trustee's complaint sought to recover over a billion dollars based on theories of actual fraud, constructive fraud and preferential transfer. In response to the complaint, the defendants filed a motion to dismiss the trustee's claims, asserting, among other things, that the transactions were protected by the section 546(e) safe harbor. The court ultimately agreed with the defendants and dismissed all claims against the defendants predicated on principles of preference or constructive fraud, leaving only those claims based on allegations of actual fraud.

In its ruling, the court relied on the plain language of the statute. As section 546(e) applies to any "settlement payment . . . made by or to (or for the benefit of) a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency," the court first examined whether Madoff Securities was a registered stockbrokerage firm. It found that Madoff Securities plainly satisfied this requirement. The court then examined whether the payments made to the defendants were "settlement payments." The court had little trouble concluding that the payments made to the defendants, customers of a stockbrokerage firm, were in fact "settlement payments." In so deciding, the court rejected the trustee's argument that payments to customers should not be protected by section 546(e), as the avoidance of such payments would not threaten the financial markets.

The court had little trouble concluding that the payments made to the defendants, customers of a stockbrokerage firm, were in fact "settlement payments." In so deciding, the court rejected the trustee's argument that payments to customers should not be protected by section 546(e), as the avoidance of such payments would not threaten the financial markets.

The court also reached the same conclusion on an alternative basis, finding that any payment made by Madoff Securities to its customers that somehow did not qualify as a "settlement payment" qualified as a "transfer" made "in connection with a securities contract." Thus, by its literal language, the court found that the Bankruptcy Code precluded the trustee from bringing any action to recover from any of Madoff's customers any of the monies paid by Madoff Securities to those customers except in the case of actual fraud.

Practical Considerations

Both of the *Enron* and *Madoff* decisions will have significant precedential value, as they focused on the practical application of the statute and found that the safe harbor provision in section 546(e) and the related definitions should be read broadly. The *Enron* decision also explicitly rejected a significant limitation on the safe harbor, refusing to read an extra "common-

ness of the transaction" requirement into the statute. Based on the two rulings, when faced with a preference or fraudulent conveyance action, a creditor should always consider whether section 546(e) is applicable. This issue may be particularly important in the many bankruptcy cases involving significant financial participants, such as the MF Global cases. As an absolute bar to actions to recover certain transfers, section 546(e) may provide a powerful shield. ◎

Is Chapter 9 Really an Option for Most Municipalities?

By Francisco Vazquez and Marc Roitman

News reports in 2011 suggested that municipal bankruptcy filings were frequent and substantial. Each of Central Falls, Rhode Island, Harrisburg, Pennsylvania, and Jefferson County, Alabama filed for bankruptcy protection in the second half of 2011. Even a state-owned local monopoly on (legal) gambling was not safe from financial turmoil in 2011: Suffolk County's Off-Track Betting Corporation filed for bankruptcy on March 18. Indeed, 2011 seemed to be the year of chapter 9, which governs municipal bankruptcy filings. Despite the frequent headlines, however, these cases ultimately demonstrated how difficult it is for a municipality to restructure through bankruptcy. Of the above-noted cases, the filings by Harrisburg and the Suffolk County Off-Tracking Betting Corporation were ultimately dismissed. *See In re City of Harrisburg, Pa*, No. 11-06938, 2011 WL 6026287 (Bankr. M.D. Pa. Dec. 5, 2011); *In re Suffolk Regional Off-Track Betting Corp.*, No. 11-42250, 2011 WL 6010673 (Bankr. E.D.N.Y. Dec. 2, 2011). This article will review these two dismissed bankruptcy cases to demonstrate why a substantial increase in municipal bankruptcy filings in 2012 and beyond is not likely.

State vs. Federal Law

In general, federal law supersedes conflicting state law. There is an exception, however, with respect to a state's power over its municipalities. The Tenth Amendment provides that "[e]ach state retains its sovereignty, freedom, and independence, and every power, jurisdiction, and right, which is not by this Confederation expressly delegated to the United States. . . ." This reservation ensures that Congress cannot interfere with a state's power over its municipalities, including a state's rights related to a municipal bankruptcy filing.

Section 109 of the Bankruptcy Code sets forth the requirements for a municipality to file for bankruptcy. Among other requirements, the municipality must be "insolvent" (not measured by a balance sheet test but measured by the municipality's ability to pay debts), must desire to effect a plan to adjust such debts, and must have attempted to negotiate a restructuring prior to the municipality's bankruptcy filing. Additionally, and most importantly, the municipality *must be authorized by state law* to be a debtor under chapter 9 of the Bankruptcy Code. This final provision seems to be the most difficult for financially strapped municipalities to satisfy.

Harrisburg

Harrisburg, the capital of the Commonwealth of Pennsylvania, faced a debt crisis beginning in late 2010 as a result of the city's guarantee of certain revenue bonds related to the municipal utility company. Pursuant to state law, Pennsylvania appointed a coordinator who prepared a financial recovery plan for Harrisburg. The Harrisburg City Council rejected the coordinator's plan and decided to begin preparations for a possible filing under chapter 9. Meanwhile, the Commonwealth enacted Act 26, a law which provided that financially distressed cities of a particular class (which included Harrisburg) were specifically not permitted to file a petition for relief under chapter 9.

Despite what appeared to be a clear prohibition on a bankruptcy filing, on October 11, 2011, the Harrisburg City Council voted to authorize Harrisburg to file for chapter 9 with the Bankruptcy Court for the Middle District of Pennsylvania. Once the bankruptcy case was filed, a group of objectors — including the Commonwealth of Pennsylvania, the mayor of Harrisburg, and the county in which Harrisburg is located — sought to dismiss the case, asserting that the City of Harrisburg could not be a debtor under chapter 9 because it did not have authorization to file for bankruptcy protection and was specifically prohibited from doing so by Act 26. The Harrisburg City Council argued that it had been permitted to file prior to the passage of Act 26 and that the new law was unconstitutional.

The bankruptcy court found that the City of Harrisburg had the requisite authorization to file a chapter 9 petition prior to the passage of Act 26 but that its authorization had been revoked by Act 26. In ruling that Act 26 was valid, the court deferred to Pennsylvania's sovereignty and concluded that the prohibition on filing did not violate either the U.S. Constitution or the Constitution of the Commonwealth of Pennsylvania.

Suffolk OTB

Suffolk OTB, a public benefit corporation under New York law, was one of five separately governed regional off-track betting corporations in New York that offered wagering on thoroughbred and harness horse races. Under the legislative scheme governing off-track betting, Suffolk OTB was required to distribute certain percentages of its revenue to state and local governments and to New York's horse racing industry. As Suffolk OTB's revenue declined, the required payments left Suffolk OTB facing insolvency. As a result, Suffolk OTB determined to file chapter 9, hoping to reduce costs, improve operational efficiencies, expand its business, and obtain new debt financing.

Suffolk OTB ultimately received what it believed to be specific authorization to file when the Suffolk County Legislature issued, and the Suffolk County Executive approved, a resolution authorizing Suffolk OTB to file a petition under chapter 9. One objector, Churchill Downs, asserted that the County's resolution exceeded the Suffolk County Legislature's authority and, therefore, Suffolk OTB was not authorized to file under chapter 9.

The bankruptcy court agreed with Churchill Downs and concluded that Suffolk OTB was not eligible to be a debtor under chapter 9. In reaching its conclusion, the court analyzed New York State law and determined that (i) although state law authorized Suffolk County to file a chapter 9 petition, state law did not permit the county to authorize a filing by a separate entity, such as Suffolk OTB, and (ii) New York State law contained a "comprehensive and detailed regulatory scheme" in the area of off-track betting which preempted any local law on the subject, including the County's resolution. Moreover, the court emphasized that the County resolution made one of the state's public-benefit corporations subject to the Bankruptcy Code, which directly usurped the state's sovereign power, thereby raising a significant Tenth Amendment concern. Accordingly, Suffolk OTB's chapter 9 petition was dismissed.

The Suffolk OTB decision is especially enlightening when viewed through the prism of the chapter 9 bankruptcy case of New York City's Off-Track Betting Corporation, *In re New York City Off-Track Betting Corp.*, 427 B.R. 256 (Bankr. S.D.N.Y. 2010), in which the bankruptcy court held that NYC OTB was eligible to be a debtor under chapter 9. The bankruptcy court in *Suffolk OTB* distinguished the *NYC OTB* case by highlighting that NYC OTB obtained authority to file for bankruptcy from the Governor of New York in an executive order. The NYC OTB court determined that the executive order satisfied the eligibility requirements because the Governor has broad executive

SUPREME COURT WATCH

Supreme Court to Weigh in on Plan Credit Bidding

About two years ago, decisions were issued by different circuit court of appeals that addressed the fundamental issue of whether a plan proponent can deny a secured creditor the right to credit bid on collateral of the secured creditor when the sale is made pursuant to a plan of reorganization. Both circuit courts, including the Third Circuit in the much heralded *Philadelphia Newspapers LLC* decision, found that a debtor could deny a secured creditor that opportunity. *See In re Philadelphia Newspapers,* 599 F.3d 298 (3rd Cir. 2010); *In re Pacific Lumber Co.,* 584 F.3d 229 (5th Cir. 2009). This result was a surprise to many given that secured creditors were specifically authorized to credit bid in stand-alone sales authorized pursuant to section 363 of the Bankruptcy Code.

In 2011, yet another circuit weighed in on this very important issue for secured creditors. *See River Road Hotel Partners,* 651 F.3d 642 (7th Cir. 2011). On this occasion, however, the outcome was different: the Seventh Circuit court of appeals found that the secured creditors had the right to credit bid even if the sale was part of a plan of reorganization. This decision was subsequently appealed to the Supreme Court. Surprisingly, given the few matters that the Supreme Court is able to hear and decide each year, the Supreme Court agreed that it would hear the appeal. The case is now scheduled for hearing before the Supreme Court in April of 2012. Stay tuned for updates later this year. ◎

powers and is permitted to take actions even without express statutory authority. In contrast, a county's powers are limited by New York law to those expressly granted to it by the state. Interestingly, unlike the Commonwealth of Pennsylvania's reaction to the Harrisburg filing, there is no evidence that the State of New York opposed Suffolk OTB's chapter 9 petition.

Take-Away Points

As the economic crisis worsened in recent years, some experts anticipated an unprecedented number of defaults by municipalities on their debt, resulting in an avalanche of chapter 9 filings. Although some municipalities have filed for chapter 9, the substantial increase in forecasted filings has not yet occurred. Indeed, the number of chapter 9 bankruptcy filings in 2011 appears to be consistent with the trend over the past thirty years, with less than twenty municipal bankruptcy cases filed each year. It may be that municipalities are not defaulting on their debt to the same extent anticipated. However, the outcome of several attempts by municipalities to file for chapter 9 in 2011 suggests that states — whether by old standards or new ones — may be preventing municipalities from filing for chapter 9 protection. ◎

New Bankruptcy Rule 2019

By Douglas E. Deutsch and Jessica Marrero

In a September 7, 2010 article, the *Wall Street Journal* reported an uptick in bankruptcy claim activity by traders and the desire of the traders to not comply with certain bankruptcy disclosure requirements that applied to "committees." The *Journal* highlighted one case where Bankruptcy Judge Brendan Shannon of the Delaware District Court held the following exchange with a lawyer for certain bondholders: "'Are you a Committee?' The lawyer began to answer, 'Well, actually Your Honor, we are a group of - -'. Interrupting, Judge Shannon said sarcastically: 'A gaggle, a murder, a pod, a herd.'" The *Journal* then explained that Judge Shannon ultimately ordered the bondholders to file trading disclosures with the court but kept the disclosures under seal.

The amendments to Bankruptcy Rule 2019 — the Rule governing claim trading disclosures — generally clarified who was required to make disclosures on claim ownership interests and also expanded the types of interests that were required to be disclosed. Following much debate among the parties who weighed in on the rule-making process, the amended Rule 2019 took a middle-ground approach to disclosing details on the purchase price, requiring only limited information.

Such squabbles, a frequent event in bankruptcy courts during the last several years, helped encourage the enactment of amendments to the Federal Rules of Bankruptcy Procedure. The amendments to Bankruptcy Rule 2019 — the Rule governing claim trading disclosures — generally clarified who was required to make disclosures on claim ownership interests and also expanded the types of interests that were required to be disclosed. Following much debate among the parties who weighed in on the rule-making process, the amended Rule 2019 took a middle-ground approach to disclosing details on the purchase price, requiring only limited information. The changes to Rule 2019 should be of interest to all involved in the sale or purchase of bankruptcy claims.

The Need to Amend Bankruptcy Rule 2019

The old version of Bankruptcy Rule 2019 required every entity or committee representing more than one creditor to provide, in relevant part, the names of each creditor, the nature and amount of the claims, and the acquisition date for each claim. Litigation regarding the pre-amendment version of Rule 2019 was rare until about five years ago. At that time, *ad hoc* groups of distressed debt buyers became more active in bankruptcy cases. Certain case parties, undoubtedly motivated at least in part by a desire to curb the influence of the new group of debt buyers, sought to strictly enforce the Rule and require these distressed debt traders to disclose the prices paid for their interests. The traders objected, arguing that such data was proprietary trading information. Given that such an exception to old Rule 2019 compliance did not exist, objectors sought another route highlighted in the *Wall Street Journal* quoted above: they challenged whether Rule 2019 applied at all to "*ad hoc*" groups. The results were mixed: some courts agreed that the *ad hoc* groups were not committees under Rule 2019 and other courts found they were committees that were required to fully comply with Rule 2019.

In an attempt to clarify the scope of Rule 2019, the advisory committee responsible for drafting new bankruptcy rules considered various amendments in 2009. Parties advocating for greater transparency in claims trading encountered a great deal of push back from the above-noted distressed debt buyers who sought to protect trading information. Traders claimed that such disclosure would adversely affect the distressed debt market. In addition, they argued that such disclosure would discourage investors from serving on *ad hoc* groups or committees, thus harming the reorganization process as a whole. Ultimately, amended Rule 2019 struck a compromise between the two positions. While the Rule has been clarified to include *ad hoc* committees and other groups of creditors, the amended Rule does not require the disclosure of the price paid or the exact date of any claim acquisition (the latter data point would allow parties to determine the price paid).

Complying with the Amended Version of Bankruptcy Rule 2019

New Rule 2019 applies to every group or committee that consists of or represents, and every entity that represents multiple creditors or equity security holders that are (a) acting in concert to advance their common interests, and (b) are not composed entirely of affiliates or insiders of one another. Accordingly, unlike the prior rule, the new version of Rule 2019 now unambiguously applies to *ad hoc* groups or committees (including bondholder committees). In fact, the new Rule 2019 even requires official committees appointed pursuant to Sections 1102 or 1114 of the Bankruptcy Code to disclose certain information, although this disclosure is more limited than the disclosure required of *ad hoc* committees and other creditor groups. Only a few entities are expressly exempt from automatic compliance with the new version of Rule 2019 solely because of their status: indenture trustees, agents under credit agreements, class action representatives and governmental units that are not defined as "persons" (such as the Pension Benefit Guaranty Corporation).

Determining what must be disclosed now hinges on the new Bankruptcy Rule 2019 concept of "disclosable economic interest." The term is broadly defined as "any claim, interest, pledge, lien, option, participation, derivative instrument, or any other right or derivative right granting the holder an economic interest that is affected by the value, acquisition or disposition of a claim or interest." This modification makes clear that creditors must now disclose all interests they hold, including short positions and credit default swaps even though such interests were not customarily disclosed under the old version of Rule 2019.

In application, official committees must now disclose the name and address of each member of the committee as well as the nature and amount of all disclosable economic interests held in relation to the debtor as of the date the committee was formed. Meanwhile, an *ad hoc* committee's verified statement must also contain (in addition to the above-noted creditor information required for official committee members), "pertinent facts and circumstances" concerning the formation of the group, including the name of each entity at whose instance the group was formed or for whom the group has agreed to act.

It is important to note that, like its predecessor, the current version of Bankruptcy Rule 2019, requires parties to file an update should any disclosed information materially change. If a court finds that a party has not amended its disclosure or has otherwise not complied with any provision of amended Rule 2019, it may refuse to permit that party from being heard or from intervening in the case. Additionally, a court may sanction a group or committee by refusing to recognize any right that such a group or committee would normally be entitled to, such as the right to a vote to accept or reject a plan. A court also has additional enforcement and penalty options should it find other sanctions to be warranted. ◎

Important 2011 Rulings on Foreign Proceedings

By Francisco Vazquez and Eric Daucher

Chapter 15 of the Bankruptcy Code was enacted in 2005 to create a procedure to recognize an insolvency or debt adjustment proceeding in another country and to, in essence, domesticate that proceeding in the United States. Once a foreign proceeding is "recognized," a step which cannot be achieved without a foreign representative satisfying various requirements, the foreign representative may obtain certain protections from a United States bankruptcy court, including the imposition of the automatic stay to protect the foreign debtor's property in the United States.

Since 2005, over 450 chapter 15 cases have been filed in the United States. Most of these filings have resulted in recognition of a foreign proceeding. Some requests for recognition have, however, been denied. Many of the reported decisions that resulted in the denial of recognition have focused on whether the foreign proceeding was pending in the country where the debtor's "center of main interests" (also known as "COMI") was located. For example, in *In re Bear Stearns High-Grade Structured Credit Strategies Master Fund, Ltd.*, 373 B.R. 122 (Bankr. S.D.N.Y.), *aff'd*, 389 B.R. 325 (S.D.N.Y. 2008), one of the most highly publicized chapter 15 rulings, the court denied recognition to the liquidation of two Bear Stern's hedge funds on the basis that the foreign proceeding was not pending in the debtors' COMI.

Interestingly, in 2011, almost the exact issues raised in the *Bear Stearns* opinion were revisited by the same court. However, the results appear to contradict the *Bear Stearns* ruling. A review of the new decision begins our 2011 highlights of chapter 15 bankruptcy decisions. We next turn our attention to a recent group of cases in which bankruptcy courts were required to decide whether to deny recognition or take other steps to limit bankruptcy court relief where approval of the request could be considered "manifestly contrary to the public policy of the United States." *See* 11 U.S.C. § 1506.

Offshore Funds' Liquidation Granted Recognition

The Bankruptcy Court for the Southern District of New York recently recognized the Bermuda liquidations of two offshore funds — Millennium Global Emerging Credit Master Fund Ltd. and Millennium Global Emerging Fund Ltd. — as foreign main proceedings under chapter 15 of the Bankruptcy Code. *See In re Millennium Global Emerging Credit Master Fund Ltd.*, 458 B.R. 63 (Bankr. S.D.N.Y. 2011). At first glance, the facts are similar to those in the above-noted *Bear Stearns* case in that the Millennium Funds are funds that went into liquidation in an offshore jurisdiction. The Millennium Funds were incorporated and had their registered offices in Bermuda and were managed by an entity located in Guernsey. That manager, in turn, appointed Millennium Global Investments Ltd., a London-based organization, as investment manager for the Funds. Nearly three years after the Millennium Funds were placed into liquidation, the Bermuda liquidators requested recognition of the liquidations under chapter 15 of the Bankruptcy Code. Contending that the Millennium Funds' COMI was the United Kingdom rather than Bermuda, BCP Securities, LLC, objected to recognition of the Bermuda liquidations as foreign main proceedings.

In support of its objection, BCP noted that the management activities of Millennium took place in London and many creditors were located in the United Kingdom. Moreover, according to BCP, the Millennium Funds did not conduct any business at its Bermuda office. In response, the Millennium Funds' liquidators argued that a debtor's COMI should be determined as of the time that the chapter 15 petition was filed. Thus, according to the liquidators, the court should not consider the location and actions of Millennium London but should instead focus its analysis on the Bermuda liquidators who were overseeing the Funds as of the chapter 15 petition date.

The court began its analysis by noting that COMI has been equated with "principal place of business." The court noted that a liquidating debtor does not continue to operate and therefore cannot be said to have a principal place of business at the time of the filing of the chapter 15 petition. Thus, the date of the chapter 15 filing is not the appropriate date for determining a debtor's COMI. Moreover, the court observed that using the date of the filing of the chapter 15 petition would allow foreign representatives to forum shop by transferring COMI immediately before seeking recognition. Ultimately, the court held that a debtor's COMI should be determined as of the date on which the foreign proceeding for which recognition is being sought was commenced.

Having determined the time frame on which a court should focus its analysis, the court considered the various factors (*e.g.*, location of debtor's headquarters, management, primary assets, majority of creditors) used by other courts to determine COMI. The court noted that (i) the majority of the Funds' directors were located in Bermuda, (ii) those directors could in theory replace the Funds' other agents, (iii) the Funds' bank was

located in Bermuda, (iv) the Funds' custodian was located in Bermuda and (v) the Funds' auditors were located in Bermuda. Moreover, the Millennium Funds' offering memoranda and related documents described the Funds as Bermuda incorporated entities located in Bermuda and directed investors to transfer funds to a Bermuda-based account. Based on the foregoing facts, the court concluded that Bermuda was the only COMI "reasonably ascertainable by third parties." Therefore, the court was satisfied that the liquidation of the Millennium Funds should be recognized as a foreign main proceeding.

The Millennium court's decision to grant recognition appears to have been at least partially policy-driven. As the court recognized, "denial of any recognition to the Liquidators here would appear to deny them access to our judicial system and possibly prevent them from pursuing legitimate claims against third parties. This would disadvantage U.S. creditors who claim in the Bermuda proceedings." In distinguishing the exclusionary principle suggested by the court in *Bear Stearns*, the Millennium court again observed that the Millennium Funds had more than mere "letter box" operations in Bermuda and thus had a legitimate basis for claiming COMI there. Thus, the court took the pragmatic approach of granting recognition where the alternative would have left U.S. creditors without a centralized forum for recovering on their claims.

Limiting Chapter 15 Relief on Public Policy Grounds

Section 1506 of the Bankruptcy Code provides that "[n]othing in this chapter prevents the court from refusing to take an action governed by this chapter if the action would be manifestly contrary to the public policy of the United States." Courts have noted that this public policy exception must be narrowly construed and is limited to the most fundamental policies of the United States. In 2011, several courts elaborated on what would be "manifestly contrary" to United States public policy.

Section 1506 of the Bankruptcy Code provides that "[n]othing in this chapter prevents the court from refusing to take an action governed by this chapter if the action would be manifestly contrary to the public policy of the United States." . . . In 2011, several courts elaborated on what would be "manifestly contrary" to United States public policy.

Privacy Rights

Chapter 15 permits a foreign representative to seek discovery concerning a debtor's assets, affairs, rights, obligations, or liabilities. In general, discovery of a debtor's personal financial information should be balanced against privacy interests. Thus, a bankruptcy court may deny a discovery request under chapter 15 — even though it would have been allowed under the law governing the foreign proceeding — on the grounds that the discovery request violated what might be considered fundamental privacy protections in the United States. The case of *In re Toft*, 453 B.R. 186 (Bankr. S.D.N.Y. 2011), involved a discovery request that raised such concerns.

In June 2010, an involuntary administration proceeding was commenced in Germany against Dr. Jurgen Toft. When Dr. Toft failed to cooperate with the administration by, among other things, refusing to turn over certain documents, the German court entered a "mail interception order." The order authorized the German administrator to intercept Dr. Toft's physical and electronic mail. However, because certain of Dr. Toft's emails were transmitted through, and stored on servers located in the United States, the German administrator was unable to obtain copies notwithstanding the German court's order. Ultimately, the German administrator filed a chapter 15 case seeking recognition of the administration and enforcement of the mail interception order in the United States.

Although the bankruptcy court acknowledged that mail interception orders are common practice under German law, it refused to enforce the order in the United States because doing so would violate fundamental United States public policies. In particular, the court noted that the privacy of electronic

communications is subject to comprehensive legislation in the United States, including through the Wiretap Act, the Privacy Act and the Stored Communications Act. Under U.S. law, any individual intentionally intercepting electronic communications, such as the emails that would be subject to the mail interception order, may be subject to criminal and civil penalties. Such interceptions may only be authorized during the course of a criminal investigation and upon a "heightened showing of necessity." Finding that recognition would, in this instance, be manifestly contrary to United States public policy by resulting in a violation of privacy rights, the bankruptcy court denied the request for chapter 15 recognition of the German proceeding.

Due Process Rights

One of the fundamental features of U.S. law is that parties affected by a legal proceeding are entitled to due process and notice. A recent decision illustrates that a bankruptcy court may deny recognition to a foreign proceeding if creditors are deprived of any right to receive notice of or an opportunity to be heard. In *In re Sivec SRL*, No. 11-80799, 2011 WL 3651250 (Bankr. E.D. Okl. Aug. 18, 2011), the Italian liquidator of Sivec, an Italian company, sought recognition of Sivec's Italian liquidation under chapter 15. It was undisputed that the liquidation satisfied the elements of a "foreign proceeding" and that Sivec's COMI was in Italy. However, Zeeco, Inc., a creditor, opposed recognition on the grounds that recognition would violate U.S. public policy.

Prior to liquidation, Sivec and Zeeco had entered into a contract pursuant to which Sivec agreed to manufacture certain industrial equipment for Zeeco. In 2008, Sivec went into liquidation in Italy. Zeeco was not provided with any notice of the liquidation. Moreover, the Italian liquidation did not give rise to a stay of litigation against Sivec. In 2010, Zeeco requested a judgment from a U.S. court declaring that it was entitled to retain a deposit it had received from Sivec. In response, the Italian liquidator argued that the deposit should be returned to Sivec. Ultimately, the Italian liquidator requested recognition of the Italian liquidation to obtain a stay enjoining, among other things, Zeeco's litigation.

Zeeco argued that Sivec's failure to provide it with notice or the opportunity to be heard in the liquidation violated fundamental U.S. policy and warranted denial of recognition. The bankruptcy court disagreed and refused to deny recognition to the Italian liquidation. The bankruptcy court, however, was troubled by the Italian liquidator's inability to provide any "explanation or assurance of how Zeeco's rights [would] be protected should a turnover of the disputed funds be ordered." According to the court, there were no procedures in Italy that would ensure resolution of Zeeco's dispute with Sivec or payment on account of its claim. Thus, pursuant to section 1506 of the Bankruptcy Code, the bankruptcy court modified the stay to allow the litigation to continue in the United States such that Zeeco would be able to obtain a recovery against Sivec.

Licensee's Rights

Under the Bankruptcy Code, a licensee's right to use intellectual property cannot be unilaterally terminated by rejection in a licensor's bankruptcy. Section 365(n) of the Bankruptcy Code generally provides that upon rejection, the licensee may (i) treat the contract as terminated, or (ii) retain its right to such intellectual property for the duration of the contract and any period of extension. Section 365(n) is not expressly incorporated into chapter 15, but a court has the power to apply this provision in a chapter 15 case in appropriate instances. *See In re Qimonda AG*, No. 09-14766, 2011 WL 5149831 (Bankr. E.D. Va. Oct. 28, 2011).

Qimonda, AG is a German manufacturer of semi-conductor memory devices that was the subject of German insolvency proceedings recognized under chapter 15 of the Bankruptcy Code. In connection with recognition, the bankruptcy court issued an order making section 365 applicable to the chapter 15 case. Subsequently, the German liquidator sought and obtained an order providing that section 365 would apply only if the liquidator rejected an executory contract under section 365. This would permit the liquidator to terminate the license under German law and leave the licensee without the right to retain the intellectual property.

Certain U.S. patent licensees appealed the bankruptcy court's order. They argued that failure to apply section 365(n) would be manifestly contrary to U.S. public policy. The district court remanded the matter to the bankruptcy court to determine whether the failure of German law to afford licensees the protections they have under section 365(n) is manifestly contrary to U.S. public policy.

In its review, the bankruptcy court reframed the inquiry as "whether the policy that § 365(n) seeks to promote is *fundamental*." Reviewing the legislative history, the court noted that Congress enacted section 365(n) to address the concern that allowing licenses to be terminated in bankruptcy would encourage assignments instead of licenses, which would, in turn, reduce the financial return to the inventor licensor resulting from multiple licenses. The court noted that despite Congress' determination that a licensee's right to continue

using intellectual property notwithstanding a licensor's bankruptcy is "of great public importance," Congress did not make section 365(n) applicable to all chapter 15 cases.

The court concluded that allowing licenses to be cancelled would create great uncertainty in the intellectual property markets and "undermine a fundamental U.S. public policy promoting technological innovation." Therefore, to protect the patents and as permitted by the applicable statute and section 1506 of the Bankruptcy Code, the court mandated that section 365(n) apply with respect to Qimonda's U.S. patents.

Take-Away Points

The last grouping of 2011 cases discussed demonstrates that a bankruptcy court will not simply "rubber stamp" a chapter 15 petition or the related relief that may be requested as part of such a proceeding. Where fundamental policies are at issue, creditors may have a basis to challenge the relief sought by a foreign representative. Ultimately, recognition of a foreign proceeding and/or the relief requested is dependent on the facts and circumstances of the particular case. ◎

IN OTHER NEWS

Speeches and Events

Howard Seife will Chair a panel entitled "Government Regulations and Their Impact on Preventing or Increasing the Chance of Insolvency" at the INSOL International Annual Regional Conference in Miami (May 21, 2012).

Howard Seife was a speaker at an HB Litigation Conference entitled "Solvent Schemes—Latest Developments in the UK and U.S. and the impact on Policyholders & Insurers". Mr. Seife spoke on Rhode Island's breakthrough solvency scheme (January 2012).

Francisco Vazquez was a speaker at the St. John's University 2011 CLE Program in New York City entitled "Bankruptcy Fundamentals" (November 5, 2011).

Publications

Douglas Deutsch and ***Eric Daucher*** co-authored a chapter on Dodd-Frank's liquidation scheme for the book *"Best of ABI 2011, The Year in Business Bankruptcy"* (2011).

Francisco Vazquez authored a chapter of the book *"Chapter 9 Strategies: Leading Lawyers on Navigating the Chapter 9 Filing Process, Counseling Municipalities, and Analyzing Recent Trends and Cases"* (2011).

Howard Seife and ***Francisco Vazquez*** co-authored *"When Insurers Can Object to Asbestos Trusts,"* Law360 (November 30, 2011).

For additional information, please contact

Howard Seife
+1 (212) 408-5361
hseife@chadbourne.com

N. Theodore Zink
+1 (212) 408-5356
tzink@chadbourne.com

Seven Rivera
+1 (212) 408-5529
srivera@chadbourne.com

David M. LeMay
+1 (212) 408-5112
dlemay@chadbourne.com

Douglas E. Deutsch
+1 (212) 408-5169
ddeutsch@chadbourne.com

Andrew Rosenblatt
+1 (212) 408-5559
arosenblatt@chadbourne.com

International Restructuring NewsWire is published by Chadbourne & Parke LLP for general information purposes only. It does not constitute the legal advice of Chadbourne & Parke LLP and it is not a substitute for fact-specific legal counsel. For complimentary copies or changes of address, please contact Helen Lamb at hlamb@chadbourne.com.

Chadbourne & Parke LLP

New York
30 Rockefeller Plaza
New York, NY 10112
+1 (212) 408-5100

Washington, DC
1200 New Hampshire Avenue, NW
Washington, DC 20036
+1 (202) 974-5600

Los Angeles
350 South Grand Avenue, 32nd Floor
Los Angeles, CA 90071
+1 (213) 892-1000

Mexico City
Chadbourne & Parke SC
Paseo de Tamarindos, No. 400-B Piso 22
Col. Bosques de las Lomas
05120 México, D.F., México
+ 52 (55) 3000-0600

São Paulo
Av. Pres. Juscelino Kubitschek, 1726
16° andar
São Paulo, SP 04543-000, Brazil
+55 (11) 3372-0000

London
Chadbourne & Parke (London) LLP
Regis House, 45 King William Street
London EC4R 9AN, UK
+44 (0)20 7337-8000

Moscow
Riverside Towers
52/5 Kosmodamianskaya Nab.
Moscow 115054 Russian Federation
+7 (495) 974-2424
Direct line from outside C.I.S.:
(212) 408-1190

Warsaw
Chadbourne & Parke
Radzikowski, Szubielska i Wspólnicy sp.k.
ul. Emilii Plater 53
00-113 Warsaw, Poland
+48 (22) 520-5000

Kyiv
25B Sahaydachnoho Street
Kyiv 04070, Ukraine
+380 (44) 461-7575

Almaty
Dostyk Business Center
43 Dostyk Avenue, 4th floor
Almaty 050010, Republic of Kazakhstan
+7 (727) 258-5088

Istanbul
Chadbourne & Parke
Büyükdere Cad. No: 191
Apa Giz Plaza, Kat 17
34330 Levent, Istanbul, Turkey
+90 (212) 386-1300

Dubai
Chadbourne & Parke LLC
City Tower I, Sheikh Zayed Road
P.O. Box 23927, Dubai, United Arab Emirates
+971 (4) 331-6123

Beijing
Beijing Representative Office
Room 902, Tower A, Beijing Fortune Centre
7 Dongsanhuan Zhonglu, Chaoyang District
Beijing 100020, China
+86 (10) 6530-8846

© 2011 Chadbourne & Parke LLP
All rights reserved.

www.chadbourne.com

12-042 INTLR Newswire February 2012