

BANKRUPTCY PRACTICE

Expert Analysis

Bankruptcy Law in 2011: The Year in Review

Early 2011 was a quiet period in the corporate bankruptcy world as many distressed companies turned to fairly robust capital markets to refinance their debt or effectuated out-of-court workouts with their lenders. The second half of the year saw stagnant growth and unemployment statistics as well as anxiety over the European financial system take a toll on the U.S. economy, causing credit markets to close up to highly leveraged companies. This trend led to the filing of some spectacular bankruptcy cases as MF Global and American Airlines entered chapter 11.

On the legal front, it was an exciting, but also unsettling year. Not only did the U.S. Supreme Court decide arguably the most important opinion concerning bankruptcy court jurisdiction in decades (*Stern v. Marshall*) but a major rule change went into effect, and courts issued groundbreaking decisions on such bankruptcy issues as the standards for plan confirmation, the potential for insider trading claims to arise from stakeholder negotiations, the relationship between intellectual property law and international insolvency law, and eligibility for municipal bankruptcy.

Jurisdiction

The late Anna Nicole Smith was the nominal appellant in one of the most significant bankruptcy opinions in recent years. In an opinion by Chief Justice John Roberts, the Supreme Court ruled 5-4 that a bankruptcy court lacked constitutional authority to issue a final ruling on state law counterclaims by a debtor against a claimant. More specifically, the Court found that a statutory provision¹ that had previously authorized bankruptcy courts to enter final judgments on such counterclaims ran afoul of Article III of the Constitution, which requires common law claims to be adjudicated by Article III judges.

While the Supreme Court referred to *Stern* as a “narrow” decision that would not “meaningfully change” the division of labor between bankruptcy

By
**John J.
Rapisardi**



courts and district courts,² bankruptcy practitioners worried that the scope of the ruling was unclear and would require increased, costly litigation to clarify. Indeed, dozens of opinions since *Stern* have struggled to limn a bright line on the jurisdictional authority of bankruptcy courts. One question that has arisen frequently post-*Stern* is whether parties could consent to bankruptcy court adjudication of state law claims that the court otherwise would not have the authority to adjudicate. While the majority of courts thus far have held that consent is sufficient to permit bankruptcy courts to adjudicate such disputes,³ at least one judge foresaw the possibility that “consent, no matter how uncoerced and unequivocal, will never again be sufficient” to allow bankruptcy courts to decide matters lying outside their core jurisdiction.⁴

While ‘*Stern*’ has raised significant questions regarding numerous issues, it has not yet had the drastic impact that many bankruptcy practitioners had feared.

Stern also led some to question whether bankruptcy courts still have the authority to enter final judgments in fraudulent transfer cases. While some language in *Stern* itself implied that such claims must be decided by Article III judges,⁵ which rationale has been adopted by some courts,⁶ other courts have disagreed.⁷ The U.S. Court of Appeals for the Ninth Circuit is scheduled to issue a decision in early 2012 regarding this issue.

On another *Stern*-related issue, the Delaware bankruptcy court ruled that it had the authority to approve a settlement involving state law claims that, under *Stern*, it would likely not have the power to adjudicate.⁸ Justice Antonin Scalia’s

conurrence in *Stern* suggested that non-Article III adjudication would be allowed whenever such adjudication is based on “a firmly established historical practice,”⁹ an exception the court found to apply to bankruptcy court approval of settlement agreements.

While *Stern* has raised significant questions regarding numerous issues, it has not yet had the drastic impact that many bankruptcy practitioners had feared. The next year or two will be instrumental in determining whether Justice Scalia’s “historical practice” exception gains acceptance and whether Justice Roberts’ prediction that *Stern* will not “meaningfully change”¹⁰ the division of labor between bankruptcy courts and district courts holds true.

Plan Confirmation Issues

Several important decisions addressed the standards a plan of reorganization must meet in order to be confirmed. The U.S. Court of Appeals for the Second Circuit dealt a blow to the “gifting doctrine” in *In re DBSD North America Inc.*,¹¹ which involved a proposed plan that did not give unsecured creditors the full value of their claims but under which the second lien creditors voluntarily agreed to give value to the pre-petition equity holder. Although other courts had previously upheld plans in which senior creditors voluntarily offered a portion of their recovery to junior stakeholders, the Second Circuit held that the proposed plan violated the absolute priority rule. While *DBSD* limits the bounds of creative plan structuring, it will no doubt give rise to novel strategies for alternative exit structures and means of distributing value to key stakeholders.

Another confirmation issue related to the Bankruptcy Code’s requirement that at least one impaired class accept a plan as a condition to confirmation.¹² *In re Tribune Co.*¹³ clarified what this requirement means in jointly administered cases where a single plan encompasses multiple debtors. The debtors argued that, because they were all covered by a single plan, only a single impaired class of creditors of any debtor (as opposed to each debtor) should be required to vote in favor of the plan. The *Tribune* court disagreed; hewing closely to the Bankruptcy Code language governing plans, it held that a joint plan requires the consent of at least one impaired creditor class “per debtor,” not “per plan.” This ruling promises to

JOHN J. RAPISARDI is a partner and the co-head of the financial restructuring department of Cadwalader, Wickersham & Taft and an adjunct professor at Pace University School of Law. MICHAEL J. COHEN, MATTHEW J. OLIVER, and CASEY SERVAIS, associates of the firm, assisted in the preparation of this article.

make it more difficult for large corporate debtor groups to confirm joint plans over the objections of holdout creditors.

River Road Hotel Partners,¹⁴ an opinion out of the U.S. Court of Appeals for the Seventh Circuit, is probably the most significant plan-related decision that will have continuing impact in the coming year. In *River Road*, the Seventh Circuit created a circuit split with the Fifth and Third circuits by denying confirmation of a plan under which the debtors proposed to sell encumbered assets free and clear of liens without allowing their secured lenders to credit bid for these assets. The right to credit bid, the court emphasized, provides an important protection to secured creditors whose collateral might otherwise be sold at depressed prices at a bankruptcy auction. This decision was appealed to the U.S. Supreme Court and recently accepted for review.

Insider Trading

A major Delaware bankruptcy court decision gave the concept of insider trading new relevance in the context of bankruptcy negotiations. In *In re Washington Mutual Inc.*,¹⁵ the bankruptcy court conferred standing on the debtors' equity holders to seek equitable disallowance of senior claims owned by certain investment funds based on the equity holders' allegations that these funds had traded the debtor's securities while in possession of material nonpublic information (MNPI) obtained during plan negotiations with the debtors.

Notably, the *Washington Mutual* court took an expansive view of MNPI, finding that not only specific information obtained during the negotiations, but also the very fact that such negotiations were taking place, constituted MNPI. The investment funds and equity holders ultimately settled their dispute, so the uncertainty created by the bankruptcy court's opinion will linger into the foreseeable future.

As a result of *Washington Mutual*, creditor groups will now need to be more cautious about the types of confidential information they receive and more careful about trading decisions at any time after receiving such information. In order to foster settlement discussions, debtors will need to make robust and timely disclosures of MNPI, despite hesitancy many distressed companies may have over such disclosures, especially in the prepetition period.

Cross-Border Cases

An important case decided under chapter 15 explored the intersection of international insolvency law and intellectual property law. In *In re Qimonda AG*,¹⁶ a German debtor holding valuable patents sought to apply German law to its U.S. licenses, provoking objections from affected licensees who argued that U.S. law should apply instead. While §365(n) of the U.S. Bankruptcy Code excepts intellectual property licenses from the general rule that a debtor may reject executory contracts in bankruptcy, under German law, a bankruptcy filing automatically renders such licenses unenforceable unless the debtor elects to perform them.

The *Qimonda* court applied U.S. law, concluding that the risk posed to investments the creditors had made in reliance on the licenses outweighed the limited loss of value to the bankruptcy estate, and that allowing the debtor to abandon the licenses would be "manifestly contrary" to U.S. public policy as embodied in the Bankruptcy Code. The decision was good news for U.S. licensees of foreign-owned intellectual property, and also a rare chapter 15 ruling favoring U.S. law over foreign law.

Another chapter 15 case, *In re Vitro, S.A.B.*, involved a complex interplay between U.S. and Mexican courts. The Mexican debtor's proposed plan modified the rights of some U.S. noteholders, who in turn sought a declaratory judgment in New York state court to the effect that their rights could not be impaired. The New York court deferred to the Mexican and U.S. bankruptcy courts handling the case, however, holding that it was up to the Mexican court to rule on the plan's validity under Mexican law, and the U.S. bankruptcy court's responsibility to decide whether the Mexican plan would bind U.S. creditors.

As a result of 'Washington Mutual,' creditor groups will now need to be more cautious about the types of confidential information they receive and more careful about trading decisions at any time after receiving such information.

Municipal Bankruptcies

Although 2011 failed to produce the municipal bankruptcy boom that some had predicted, the year did witness some intriguing beginnings, endings, and false starts in the world of Chapter 9. The city of Vallejo, Calif., which filed for bankruptcy in 2008, finally emerged this year through confirmation of a plan that reduced its lease obligations and labor costs. The City of Harrisburg, the state capital of Pennsylvania, attempted to file for Chapter 9, only to have a bankruptcy judge dismiss its case in light of a newly passed state law that deprived the city of the necessary state law authorization for its filing.

Despite Harrisburg's setbacks, a number of other municipalities did succeed in entering bankruptcy this year, including Central Falls, R.I., and Jefferson County, Ala., whose municipal bankruptcy case is the largest in history as measured by the amount of outstanding debt. Like Harrisburg, Jefferson County is facing opposition to its filing from a party who has argued that the county is not authorized to file under Alabama law.

Revised Rule 2019

Along with *Stern*, the year's other most-talked-about development was the amendment to

Bankruptcy Rule 2019, effective as of Dec. 1, 2011, that would modify the disclosure requirements imposed on creditor groups. Unlike the prior version of the rule, the new rule unambiguously requires disclosure from ad hoc groups that are not formally organized as statutory committees so long as these groups represent or consist of multiple creditors acting in concert.

Although earlier drafts of the Rule 2019 amendment gave rise to worries that enhanced disclosure requirements might discourage claims trading—particularly by hedge funds—the version of the rule ultimately adopted does not generally require disclosure of the price paid for claims or the exact date on which claims were purchased, which are the main types of information from which a hedge fund's proprietary trading strategy could be inferred. For this reason, the new rule will likely have a less significant impact on trading activity than originally feared. In some respects, however, the rule expands the types of economic information that must be reported and requires disclosure of all economic rights and interests, including derivative instruments, that could affect the legal and strategic positions that a stakeholder takes in a case.

Looking Ahead

The U.S. Supreme Court's forthcoming review of the Seventh Circuit's *River Road* decision sets up what may be the most significant bankruptcy law event of the coming year because the high court will have the opportunity to resolve the existing circuit split on the critical issue of credit bidding. In general, 2012 promises to be another busy year for bankruptcy practitioners as the world economy continues to face headwinds and U.S. courts continue to cope with the aftermath of *Stern*.

-●.....
- 28 U.S.C. §157(b)(2)(C).
 - Stern v. Marshall*, 131 S. Ct. 2594, 2620 (2011).
 - See, e.g., *In re GB Herndon and Assoc. Inc.*, No. 10-00945 (Bankr. D.D.C. Oct. 4, 2011).
 - In re BearingPoint Inc.*, 453 B.R. 486, 497 (Bankr. S.D.N.Y. 2011).
 - Stern*, 132 S. Ct. at 2614.
 - See, e.g., *In re Edra D. Blixseth*, No. 10-00088 (Bankr. D. Mont. Aug. 1, 2011).
 - In re Refco Inc.*, No. 05-60006 (Bankr. S.D.N.Y. Nov. 30, 2011).
 - In re Washington Mutual Inc.*, No. 08-12229 (Bankr. D. Del. Sept. 13, 2011).
 - Stern*, 132 S. Ct. at 2621 (Scalia, J., concurring).
 - Id.* at 2620.
 - In re DBSD North America Inc.*, 634 F.3d 79 (2d Cir. 2011).
 - See 11 U.S.C. §1129(a)(10).
 - In re Tribune Co.*, No. 08-13141 (Bankr. D. Del. Oct. 31, 2011).
 - In re River Road Hotel Partners LLC*, 651 F.3d 642 (7th Cir. 2011).
 - Washington Mutual*, No. 08-12229, slip op. at 139.
 - In re Qimonda AG*, No. 09-14766-SSM (Bankr. E.D. Va. Oct. 28, 2011).