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Bankruptcy Court Holds that Venue of Houghton Mifflin Case is Improper, But Delays Transfer

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The authors analyze a decision in which a bankruptcy court found itself bound by the applicable venue statutes but nevertheless held that because the statutes did not dictate when it had to transfer the case, it would order the transfer at a time that would minimize the prejudicial effect to creditors.

Judge Robert E. Gerber of the United States Bankruptcy Court for the Southern District of New York recently granted the U.S. Trustee's motion to transfer the Chapter 11 cases of Houghton Mifflin Harcourt Publishing Company ("Houghton") and its affiliates to a different venue, notwithstanding the fact that the debtor's pre-packaged plan had been confirmed with unanimous support from its creditors, the cases were projected to conclude within 30 days of filing, and the debtors' primary creditor constituencies supported venue in New York. While the court found itself bound by the applicable venue statutes, the court nevertheless held that because the statutes did not dictate *when* the court must transfer the case, it would order the transfer at a time that would minimize the prejudicial effect to creditors – the first to occur of the effective date of the prepackaged plan or three weeks from the date of entry of the confirmation order.[1]

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TRANSFER OF VENUE OF BANKRUPTCY CASES

Venue for bankruptcy cases is governed by Section 1408 of the Judicial Code, which provides five bases for venue. They are the district where:

(1) the debtor has a domicile,

(2) the debtor has a residence,

(3) the debtor has a principal place of business,

(4) the debtor has principal assets, or

(5) there is a pending bankruptcy case concerning the debtor's affiliate, general partner, or partnership.[2]

Pursuant to Section 1412 of the Judicial Code, "a district court *may* transfer a case or proceeding under title 11 . . . in the interest of justice or for the convenience of the parties."[3] This statute expressly addresses the transfer of cases under the Bankruptcy Code, but not situations in which venue is unsupportable under Section 1408.

Section 1406(a) of the Judicial Code, on the other hand, does not expressly address cases under the Bankruptcy Code, but does address cases in which venue is unsupportable. It provides that "[t]he district court of a district in which is filed a case lying venue in the wrong division or district *shall* dismiss, or if it be in the interest justice, transfer such case to any district or division in which it could have been brought."[4] Courts are split as to whether Section 1406 applies to cases under the Bankruptcy Code; however, the majority view is that it does and, therefore, a bankruptcy court lacks authority to retain a case that fails to satisfy the venue requirements of Section 1408.[5]

BACKGROUND

Houghton, one of the nation's largest publishing companies, encountered significant financial difficulties largely due to its highly leveraged capital structure and reduced demand for grade school textbooks. To address these problems, Houghton negotiated a prepackaged plan of reorganization with its creditors that would convert billions of dollars of secured debt into equity and leave unsecured creditors unimpaired. Houghton also entered into a plan support agreement with its secured creditors that, among other things, required Houghton to file its cases in the Southern District of New York.

On May 21, 2012, Houghton and 24 of its affiliates commenced their cases. Although the debtors' cases were estimated to be completed within 30 days, the U.S. Trustee moved on May 30 to transfer venue from New York asserting that none of the statutory requirements of Section 1408 had been satisfied and therefore, the court was required to transfer venue under Section 1406, even if transfer would be more expensive and less convenient for the debtors' creditors.

The debtors countered that venue was proper based upon the "residence" of Houghton and the "principal assets" of Houghton's ultimate parent, Houghton Mifflin Holding Company ("Holdco"). Specifically, Houghton leased an office in New York that employs 60 full-time employees and had 15 sales representatives that work from home. Holdco leased office space in New York where it did not conduct business but instead subleased the space to a nonaffiliated entity. The debtors argued that the lease and sublease were the only assets of Holdco's estate. All the other affiliates of Houghton anchored venue based on Houghton's and Holdco's cases. The debtors also argued that transferring venue would be greatly prejudicial to creditor interests by increasing costs and slowing administration of their cases. Indeed, the agent of the debtors' lenders, as well as substantially all of the senior creditors party to the plan support agreement and the professionals for the various interested parties were located in New York.

The U.S. Trustee requested that its venue motion be heard before confirmation of the debtors' prepackaged plan, however, the court refused and confirmed the plan with unanimous consent of the debtors' creditors on June 21, 2012.

BANKRUPTCY COURT'S DECISION

A day after the debtors' plan was confirmed, the court entered its decision transferring venue of the debtors' cases. The court was quick to note that it found the U.S. Trustee's motion "perplexing" and that it would have hoped the U.S. Trustee would exercise more "prosecutorial discretion" and "good sense," especially when interested parties supported venue in New York and transfer would materially prejudice creditors. However, the court followed the majority of courts that held that Section 1406 of the Judicial Code applies to bankruptcy cases and mandates transfer where none of the five bases for venue have been satisfied. The court based this conclusion on, among other things, its reading of the plain text of Section 1406, a comparison of Section 1406 with its predecessor statute, which authorized courts to either transfer or retain a case that had been commenced in an improper venue, and observance of precedent in the Southern District of New York, which Judge Gerber is fond to follow as a matter of judicial consistency.[6]

Turning to the specifics of the debtors' cases, the court held that none of the debtors satisfied the statutory predicates of Section 1408. The court found that the principal place of business for each of the debtors was a place other than New York. Further, most of the debtors were Delaware corporations and none were organized in New York.

The court rejected the debtors' argument that Houghton's office in New York constituted a "residence" under Section 1408. Based on textual analysis and relevant precedent, the court held that a "residence" under Section 1408 applies only to individuals, and not to business entities.[7] Thus, while Houghton's office is sufficient to be considered doing business in New York, Houghton could not have a residence there by law, and it was admittedly not Houghton's principal place of business or domicile.

The court also rejected the debtors' contention that Holdco's lease and sublease of office space in New York constituted its principal assets under Section 1408. As an initial matter, counsel to the debtors admitted during oral arguments that the leases were not Holdco's only assets. Second, the lease-sublease arrangement was a net cash drain on the debtors' estates and the lease itself was not undermarket, and thus the court found that the assets were of no material value.

Third, the court noted that Holdco is the ultimate parent of 15 direct and indirect subsidiaries, including Houghton, which reported assets exceeding $2.4 billion and was the overwhelming source of the consolidated debtors' $238 million EBITDA.

Although no evidence was submitted regarding the value of the subsidiaries stock, or their tax attributes, such as net operating losses, that may be attributable to Holdco, the court found that it strained credulity that "HoldCo's money-losing lease and sublease assets are worth more than 15 subsidiaries, generating close to a quarter billion dollars in EBITDA." Notably, the court held that it can consider both the quantitative value of assets and the qualitative value – the importance of the assets – when making its venue determination.[8] In this case, the court considered the 15 subsidiaries to be much more important than a pair of leases.

Thus, the court held that venue must be transferred, but with two caveats. First, despite Section 1406's mandate, the court noted that the statute does not say when such transfer must occur. Therefore, the court elected to implement the decision under a timetable that "minimizes . . . harm to the creditors and other stakeholders that this motion engendered." At the court's direction, the case would not be transferred until the first to occur of the effective date of the debtors' prepackaged plan or three weeks from the date of entry of the confirmation order, if the plan has not gone effective by then, thereby avoiding any unnecessary and costly delays administering the case.

Second, although the court granted transfer of venue, it left open the question as to where the case should be transferred. Several states were possible candidates, and the court directed the parties to consult and agree on a new venue or settle an order. Ultimately, the debtors' cases were transferred to the District of Massachusetts on July 9, 2012.

CONCLUSION

The *Houghton Mifflin* decision is another example of courts grappling with a statutory mandate in the face of countervailing concerns. Where the requirements of Section 1408 of the Judicial Code are not satisfied, many courts find themselves bound to transfer venue upon motion of a party in interest, even when the transfer will prejudice the debtor and its creditors. Thus, *Houghton Mifflin* may provide creditors with a potential leverage point – a threat to move bankruptcy venue strategically. Yet, this does not necessarily sound the death knell for forum shopping by debtors. As Judge Gerber acknowledges, venue, even if improper, is not jurisdictional.

Accordingly, debtors can commence cases in improper venues and, absent objection (which, unlike jurisdiction, can be waived if not timely asserted), courts can hear them. Alternatively, in the event of a venue dispute, courts can follow the Southern District's approach and exercise their temporal discretion under Section 1406 to reach a more reasonable outcome consistent with the goals of Chapter 11.

Judge Gerber's decision to transfer venue comes at a time when the Southern District of New York and the District of Delaware have faced pressure for their dominance over the bankruptcy process. Congress is (again) considering legislation to limit debtors' ability to file for bankruptcy in venues in which they have more limited contacts. In late 2011, the House Judiciary Committee eliminated a corporation's domicile – its place of incorporation – as a possible venue and no longer permitted parent companies to bootstrap affiliates' pending cases. While Congress has expressed a desire for more bankruptcy cases to be filed where a debtor operates so local creditors and employees are better able to participate in the bankruptcy process, they have considered other bills that have gone nowhere.

NOTES

[1] *In re Houghton Mifflin Harcourt Publ'g Co.*, 2012 Bankr. LEXIS 2868 (Bankr. S.D.N.Y. June 22, 2012).

[2] 28 U.S.C. § 1408.

[3] *Id.* § 1412 (emphasis added).

[4] *Id.* § 1406 (emphasis added).

[5] *See, e.g.*, *Thompson v. Greenwood*, 507 F.3d 416, 422 (6th Cir. 2007) (holding that a court must dismiss or transfer a case when venue is improper under Section 1408 and an interested party timely objects); *accord In re*

Washington, Perito & Dubuc, 154 B.R. 853, 858 (Bankr. S.D.N.Y. 1993); *In re Suzanne de Lyon, Inc.*, 125 B.R. 863, 866 (Bankr. S.D.N.Y. 1991). *But see In re Lazaro*, 128 B.R., 168, 174 (Bankr. W.D. Tex. 1991) (holding that Section 1412 trumps Section 1406 in bankruptcy cases and therefore permits retention of cases filed in an improper venue); *accord In re Capital Hotel Grp., Inc.*, 206 B.R. 190, 193 (Bankr. E.D. Mo. 1997).

[6] *See Houghton Mifflin*, 2012 Bankr. LEXIS 2868, at *29-30 & n. 35-38.

[7] *See id.* at *34 (citing *Suzanne de Lyon*, 125 B.R. at 866).

[8] *Houghton Mifflin*, 2012 Bankr. LEXIS 2868, at *38-39.