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BANKRUPTCY PRACTICE

Expert Analysis

Bankruptcy Law in 2010: The Year in Review

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Although the number of large corporate chapter 11 filings fell dramatically in 2010, there certainly was no shortfall of influential rulings that changed the bankruptcy landscape. Among the most significant developments that emerged over the past year are the retrenchment of secured creditors' rights, the diverging treatment of environmental clean-up obligations, further guidance on issues arising in chapter 15 cases, and a widely held concern about pervasive municipal distress.

Third Circuit Rulings

The U.S. Court of Appeals for the Third Circuit had the greatest impact on bankruptcy practice in 2010 and thus deserves special mention. The appellate court's decisions in *In re Philadelphia Newspapers, LLC*[1] and *In re Visteon Corp.*[2] were among the most notable of the year, not only because these rulings will be controlling law in mega-cases filed in the District of Delaware, but also because the court upended conventions that evolved in bankruptcy practice over the years.

Early in 2010 the Third Circuit's decision in *Philadelphia Newspapers* was seen by many practitioners as a significant setback for secured creditors' rights. Specifically, the U.S. Court of Appeals for the Third Circuit upheld bidding procedures pursuant to which the debtors proposed to prohibit their secured lenders from credit bidding their claims in the auction for substantially all of the debtors' assets under their chapter 11 plan, which otherwise proposed to provide those creditors with the "indubitable equivalent" of the value of their claims. While the credit bidding impairment presaged by *Philadelphia Newspapers* has not been tested widely in recently proposed plans, some commentators have viewed this ruling as effectively restoring to debtors certain lien-stripping strategies that the Bankruptcy Code was meant to outlaw upon its enactment in 1978.

In another significant opinion issued in *In re Visteon Corp.*, the Third Circuit turned its attention to the treatment of retiree benefits under the Bankruptcy Code. At issue in *Visteon* was whether a debtor could terminate retiree benefits that are otherwise terminable at will by utilizing its general right to reject contracts under §365 instead of §1114, which imposes a more onerous burden to effect such termination.

In a rare instance in which prepetition contractual rights were narrowed, the Third Circuit held that Bankruptcy Code §1114 trumped the debtor's right to terminate those retiree benefits during bankruptcy even though the debtor had the clear right under the applicable plan document and the Employee Retirement Income Security Act of 1974 to unilaterally terminate those benefits outside of bankruptcy. This ruling surprised many because it went against a majority of lower courts that permitted debtors to avoid compliance with §1114 and terminate such agreements under §365 if the debtor has a right to unilaterally terminate retiree benefits outside of bankruptcy.[3]

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All ground broken in 2010 by the Third Circuit, however, was not new, and the appellate court reaffirmed old standards as well. For example, in a case involving the approval of break-up fees in sale transactions pursuant to §363 of the Bankruptcy Code, the Third Circuit in *In re Reliant Energy*[4] affirmed its prevailing standard established in 1999 in *In re O'Brien*.[5] Unlike other jurisdictions, which typically evaluate break-up fees under the more lenient "business judgment" standard or "best interest of the estate" test, the Third Circuit reaffirmed its requirement that the proponent of the break-up fee satisfy the standard for allowance of an administrative expense and demonstrate that the fee is actually necessary to preserve the value of the estate.

Asset Sales

During the past year, asset sales conducted pursuant to §363(b) of the Bankruptcy Code remained a prominent and commonly employed tool in chapter 11 cases. The lack of widely available financing options impaired certain companies' ability to effectuate a classic reorganization, forcing many companies to sell substantially all of their assets to satisfy creditors' claims.

This trend provided bankruptcy courts with opportunities to elucidate the scope of bidding procedures that govern such sales. In order to ensure that it obtains the highest purchase for its assets, debtors often work closely with their secured creditors in crafting bidding procedures and conducting auctions. This past year there were a few instances in which courts ruled that the parties had gone too far when drafting bidding procedures.

In *In re Thompson Publishing Holding Co. Inc.*, the U.S. Bankruptcy Court for the District of Delaware rejected bidding procedures that vested the first lien lender with consent rights over the declaration of the winning bidder. While this right is customary in the typical case, the *Thompson Publishing* court held it was improper there because the lender was also acting as the "stalking horse" or lead bidder in the auction and thus was likely to chill bidding by third parties.

In *In re American Safety Razor, LLC,* the debtor's proposed bidding procedures defined a "qualified bidder" as one that was reasonably likely according to the debtor to submit a bona fide offer and be able to consummate a transaction and provided the debtor with sole discretion to demand a deposit from any bidder but not necessarily all bidders.[6] The bankruptcy court did not approve the proposed procedures, holding that the "qualified bidder" definition vested the debtor with too much discretion and could be susceptible to abuse if the debtor sought to unfairly disqualify bidders from the process. The *American Safety Razor* court also found the deposit provision to be unreasonable because it afforded the debtor the ability to create an unequal playing field among bidders by demanding deposits from some bidders and not others.

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Setoff

The bankruptcy case of Lehman Brothers Holdings Inc. has been a veritable fount of important decisions related to financial contracts and banking institutions. In particular, the right of setoff was the focus of two opinions in adversary cases filed in *Lehman Brothers*. In the first case, Swedbank AB sought to set off obligations owed by one of the Lehman debtors under a swap agreement against proceeds such debtor deposited with Swedbank postpetition.[7] Generally, setoffs are permissible in bankruptcy if the claims subject to setoff arose prepetition and are "mutual," which means the claims are owed to and from the same entity and in the same capacity.

Swedbank argued that, because the debtor's obligation arose under a "safe harbored" swap agreement that was otherwise not subject to the Bankruptcy Code's automatic stay, the mutuality obligations of Bankruptcy Code §553(a) did not apply. The *Lehman Brothers* court disagreed with Swedbank and, consistent with legislative history, held that the Bankruptcy Code's applicable safe harbor provisions do not nullify the mutuality requirement of §553(a).

In the second case, one of Lehman's many banks set off without bankruptcy court approval $500 million in a cash collateral account that had been established prepetition to protect the bank against overdrafts on Lehman's accounts in order to set such funds off against other debts owed by Lehman.[8] After setting off the funds, the bank sought a declaratory judgment that the setoff was exempt from, and did not violate, the automatic stay.

The bankruptcy court held that the bank's seizure of the funds violated the automatic stay because the collateral account was a special purpose account, which is a kind of account set up to provide a bank security for a specific, well-defined overdraft risk and not subject to setoff under New York law. The court further ordered the bank to return the $500 million of account proceeds plus accrued interest.

Environmental Claims

Many were left disappointed in October when the U.S. Supreme Court denied certiorari in *United States v. Apex Oil Co*.[9] In 1985, the high court in *Ohio v. Kovacs* upheld a debtor's right to discharge an injunctive obligation to clean up a contaminated site on the ground that the injunctive order had been converted to a cost recovery action and, therefore, was cognizable as a "claim" under the Bankruptcy Code.[10] Since *Kovacs*, environmental law has played an increasing role in large industrial bankruptcy cases, and yet courts remain split on this issue.

In *Apex*, the U.S. Court of Appeals for the Seventh Circuit held that an environmental cleanup injunction issued pursuant to the Resource Conservation and Recovery Act of 1976 is not a "debt" or "liability on a claim" subject to discharge under the Bankruptcy Code. Thus, the successor to the chapter 11 debtor responsible for the environmental damages at issue remained liable for the clean-up costs associated with the injunction. Although many practitioners were hoping that the Supreme Court would use *Apex* to resolve competing environmental and bankruptcy policy interests, courts may continue to diverge on this important issue.

Chapter 15

Chapter 15 of the Bankruptcy Code, which permits foreign debtors to protect and administer their assets located in the United States, marked its fifth year on the books in 2010. *In re Metcalfe & Mansfield Alternative Investments* and *In re Condor Insurance Limited* were among the two most notable chapter 15 opinions this past year.

In *Metcalfe & Mansfield*, the court was charged with determining whether a chapter 15 debtor that had obtained extraordinary injunctive and other relief in its Canadian bankruptcy proceeding was entitled to enforce that relief in the United States, even though the relief likely could not have been granted under applicable U.S. law.[11] The court held that principles of comity in chapter 15 cases support the enforcement of Canadian orders in the United States regardless of whether the same relief is available under U.S. federal or state law when the Canadian proceeding had been litigated fairly according to procedures similar to those available to litigants in the United States.

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In *Condor Insurance*, the foreign debtor was an insurer incorporated under Nevis law and the subject of a wind-up petition filed in Nevis. The liquidators filed a case under chapter 15 in Mississippi for the purpose of recovering fraudulent transfers under Nevis law. The U.S.-based fraudulent transfer defendant moved to dismiss the chapter 15 case, contending that avoidance actions may only be pursued in cases under chapters 7 or 11 and not chapter 15. The U.S. Court of Appeals for the Fifth Circuit rejected this argument and held that a foreign representative may commence avoidance actions in a chapter 15 case that are based on foreign law.

Municipal Distress

Municipal bond defaults are exceedingly rare as is the deployment of chapter 9—the special chapter of the Bankruptcy Code dedicated to municipal debtors. The recent economic downturn adversely affected a number of municipalities nationwide, in large part due to their inability to pay liabilities attributable to bond debt and pension benefits in the face of shrinking tax revenues.

The city of Vallejo, Calif., was an early example of this problem, having filed in 2008 to modify its collective bargaining agreements. This past year the U.S. District Court for the Eastern District of California upheld Vallejo's motion to reject these agreements under the general contract-rejection mechanism under §365 of the Bankruptcy Code as opposed to the more stringent standard under §1113 for the modification or rejection of collective bargaining agreements, holding that Congress did not specifically incorporate §1113 into chapter 9.[12]

Looking ahead to 2011, many cities and towns across America may have to consider the option of filing under chapter 9, especially since their usual benefactors—states—are in equal or worse financial straits. For instance, the city of Harrisburg, Pa., recently retained attorneys to advise on a potential bankruptcy filing because the city is having trouble repaying over $300 million in bond debt incurred to build an incinerator. Also, the city of Hamtramck, Mich., which is embroiled in a tax dispute with the city of Detroit, recently sought authority to file for chapter 9 from Michigan's governor, who denied the request.

Conclusion

While bankruptcy filings were down in 2010 compared to the peak of the financial crisis in 2008 and 2009, it is difficult to predict what 2011 has in store for bankruptcy practitioners. One thing people agree on is that there is still uncertainty surrounding tax and monetary policy, the Dodd-Frank legislation, the high yield bond markets (especially for weaker issuers), and looming debt maturities. In any given case, several variables will determine whether solutions will be credit markets-focused or restructuring-focused. While banks began late in the year to step up lending to corporate borrowers, there are likely to remain pockets of distress, mainly from companies that remain hopelessly overleveraged or are unable to generate revenue growth following extensive cost-cutting.

1. *In re Philadelphia Newspapers, LLC*, 599 F.3d 298 (3d Cir. 2010).
2. *In re Visteon Corp.*, 612 F.3d 210 (3d Cir. 2010).
3. See, e.g., *In re Delphi Corp.*, No. 05-44481, 2009 WL 637315 (Bankr. S.D.N.Y. March 10, 2009); *LTV Steel Co. v. United Mine Workers* (*In re Chateaugay Corp.*), 945 F.2d 1205 (2d Cir. 1991).
4. *In re Reliant Energy Channelview LP*, 594 F.3d 200 (3d Cir. 2010).
5. *Calpine Corp. v. O'Brien Envtl. Energy Inc.* (*In re O'Brien Envtl. Energy Inc.*), 181 F.3d 527 (3d. Cir. 1999).
6. *In re Am. Safety Razor Co., LLC*, No. 10-12351 (MFW) (Bankr. D. Del.).
7. *In re Lehman Brothers Holdings Inc.*, 433 B.R. 101 (Bankr. S.D.N.Y. 2010).
8. *Bank of America NA v. Lehman Brothers Holdings Inc.* (*In re Lehman Brothers Holdings Inc.*), No. 08-01753, 2010 WL 4628139 (Bankr. S.D.N.Y. Nov. 16, 2010).
9. *United States. v. Apex Oil Co.*, 579 F.3d 734 (7th Cir. 2009), cert. denied, 131 S. Ct. 67 (2010).
10. *Ohio v. Kovacs*, 469 U.S. 274 (1985).
11. *In re Metcalfe & Mansfield Alternative Investments*, 421 B.R. 685 (Bankr. S.D.N.Y. 2010).
12. *In re City of Vallejo*, 432 B.R. 262, (E.D. Cal. 2010).