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The Connecticut Bankruptcy Beat

Legal Developments in Restructuring and Creditors' Rights

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Welcome to the inaugural edition of Pullman & Comley's Connecticut Bankruptcy Beat. This newsletter will be circulated on a bi-monthly basis and will cover current bankruptcy law developments of interest in Connecticut, the Second Circuit and nationally. We hope you find it of interest and welcome your comments and ideas for future topics.

"It is said that the world is in a state of bankruptcy, that the world owes the world more than the world can pay."
-Ralph Waldo Emerson

In This March 2012 Issue:

The Potential Impact of the Bankruptcy Venue Reform Act of 2011 (HR 2533)

The Status Quo

Under current law, corporate debtors can typically position themselves to file chapter 11 in a favored venue, which most often ends up being Delaware or New York. Under the current version of 28 U.S.C. § 1408(1), a debtor may file in any district in which its domicile, residence, principal place of business or principal assets are located. For a corporation, "domicile" means its state of incorporation.

This wide latitude over where corporate debtors may file chapter 11 exists for two reasons. First, they can file in their state of incorporation as their "domicile," even though they have no other connection to that state. Second, under an "affiliated venue rule," 28 U.S.C. § 1408(2), they can file where one of their subsidiaries, or a parent holding company, files as long as the subsidiary or parent is "domiciled" in the state where the bankruptcy is filed. While bankruptcy courts may overrule the choice in venue on grounds of manifest unfairness, this power is seldom invoked and filing such motions is usually futile.

The statistics suggest that New York and Delaware are, in fact, the favored venues. Since 2005, 70 percent of Chapter 11 cases involving assets of more than $100 million dollars have been filed in only two courts: the District of Delaware and the Southern District of New York ("SDNY"). While some of these cases rightfully belong within these districts, many bankrupt entities have no legitimate connection to the SDNY or Delaware aside from a convenient certificate of incorporation.

The two forums are popular with bankrupt entities because they are perceived by some as getting quick and debtor-friendly results and for having a large assortment of banks, distressed lending institutions, bankruptcy attorneys and other restructuring professionals. Unfortunately, the debtor's corporate domicile and chosen bankruptcy venue may be a far removed from its actual headquarters. In such instances, small stakeholders, such as local suppliers, former employees and local governments, face the logistical hurdles of attempting to participate in an ongoing proceeding in a far-away court.

The Proposed Changes

The Chapter 11 Bankruptcy Venue Reform Act of 2011 (HR 2533) seeks to change bankruptcy venue rules by imposing limitations on where corporations may file for bankruptcy protection. HR 2533 would require Chapter 11 bankruptcy cases to be filed in the judicial district where the debtors have their principal place of business or principal assets and would eradicate the subsidiary "affiliated venue rule" altogether. As a result, according to Rep. John Conyers, Jr., one of the bill's sponsors, "employees [and other interested parties] will now have a greater ability to protect their interests and to make their concerns known to the bankruptcy court without having to be forced to do so in distant venues."

Opposition to HR 2533 is prefaced by the argument that the majority of bankruptcy courts are ill-equipped to handle large cases and that only the judges of District of Delaware and the SDNY have sufficient experience and expertise to handle the complexities of the most important bankruptcies in the country. Supporters of the bill counter that such logic is nothing more than a self-fulfilling prophecy and note that all bankruptcy judges are equally qualified to preside over the most challenging cases. While complex cases may require specialized procedures, the underlying principles and doctrine of the bankruptcy code remain the same regardless of the asset size of the debtor.

The Potential Impact on Connecticut

The UCLA-LoPucki Bankruptcy Research Database ("BRD") lists all Chapter 11 bankruptcies involving assets of more than $100 million dollars. Since 1979, Connecticut-headquartered companies with such assets have filed for bankruptcy a total of 16 times. Only one of these companies filed for Chapter 11 in the District of Connecticut, Service America Corp., in 1992. Ten of the remaining companies filed in the SDNY and five filed in the District of Delaware. While there is no similar database available for bankruptcies with assets under $100 million, anecdotally, plenty of mid-size Connecticut-based companies continue to utilize the flexible bankruptcy venue laws to file out of state. If the proposed legislation becomes law, it follows that most Connecticut-based companies would be required to file within the District of Connecticut.

Supreme Court Grants Writ of Certiorari to Resolve Credit-Bidding Circuit Split

Cramdowns and Credit Bids

When a debtor proposes a plan of reorganization under Chapter 11, adversely affected secured creditors may vote against the plan or object to its confirmation. However, § 1129(b)(1) of the Bankruptcy Code provides that a plan may nevertheless be “crammed down” over a dissenting creditor class so long as the plan is “fair and equitable” with respect to the dissenting class. § 1129(b)(2)(A) of the Bankruptcy Code describes three different mechanisms by which a crammed down plan of reorganization may be deemed "fair and equitable":

(i) lender retention of liens securing the obligations and receipt of the present value of its secured claim,

(ii) sale of collateral free and clear of liens but subject to credit bidding, or

(iii) the realization by the creditor of the "indubitable equivalent" of its secured claim.

When a plan of reorganization proposes a sale of assets, secured creditors are able to compete against cash-bidders by the credit-bidding clause of subsection (ii), because it gives them the ability to “credit-bid” for the assets with the entire amount they are owed. The right to credit bid is an important privilege to secured creditors under the Bankruptcy Code and is particularly valuable to undersecured creditors seeking control over their collateral. To illustrate how this works, if a debtor’s real estate is currently worth $200,000 with a bank mortgage of $400,000, the debtor would find it extremely difficult to sell the property over the objection of the mortgagee because the mortgagee has the ability to credit bid the full amount of its $400,000 claim without having to raise any additional funding. The secured creditor is thus afforded more leverage in the bankruptcy because it would be quite unlikely that any cash bidder would match the $400,000 price tag to acquire the property.

Two opposing court of appeals decisions have set up the showdown in the Supreme Court over whether the right to credit-bid under a sale plan is absolute. In *In re Philadelphia Newspapers LLC*, 599 F. 3d 298 (3d Cir. 2010), the Third Circuit held that a debtor may confirm a plan proposing the sale of encumbered assets without offering secured creditors the opportunity to credit bid, so long as the lenders received the "indubitable equivalent" of their secured claims. In that case, it was suggested that the “indubitable equivalent” could be the proceeds from a fair market sale of the creditor’s collateral. In looking at the plain text of the statute, the Third Circuit concluded that Congress intended for the three subsections to function as “alternative paths” for meeting the fair and equitable test of § 1129(b)(2)(A).

In re River Road Hotel Partners, LLC, et al., 651 F.3d 642 (7th Cir. June 28, 2011), the Seventh Circuit held that encumbered assets could not be sold free and clear of liens without permitting secured lenders the right to credit bid for the assets. Through its own textual analysis, the Seventh Circuit determined that a plan proposing a sale free and clear of liens must fall under the specific requirements of § 1129(b)(2)(A)(ii) (i.e., providing the right to credit-bid) and may not rely on the general requirement of subsection (iii) ("indubitable equivalent").

To the High Court

On December 12, 2011, the United States Supreme Court granted a petition for certiorari in the River Road Hotel Partners case. The case will be closely watched as it pits what was thought to be an inviolate right to credit-bid against an expanded opportunity to "cram-down" secured creditors by a sale of their collateral. Debtors vs. creditors, what else is new?

Recent Developments in Connecticut Bankruptcy Law

New England National, LLC v. Town of East Lyme (In re New England National, LLC), 2011 WL 5041500 (Bankr. D. Conn. Hon. Judge Weil Oct. 24, 2011). New England National, LLC (the "Debtor") filed a Motion to Compel the Town of East Lyme (the "Town") to produce materials related to a prior mediation in connection with a different lawsuit. While the Town produced the final settlement agreement resulting from the mediation, it refused to turn over recorded discussions, position statements, and other materials from the mediation on account of the mediation privilege under Conn. Gen. Stat. § 52-235d. After conducing an *in camera* review of the disputed mediation materials, the Bankruptcy Court concluded that the Debtor did not demonstrate "substantial need" for the materials, *i.e.*, that the interest of preserving the confidentiality of the communications outweighed the Debtor's contention that the materials were essential to its claims and defenses and that the Debtor would furthermore not suffer undue hardship absent disclosure.

In re Gasztold, 2011 WL 5075440 (Bankr. D. Conn. Hon. Judge Dabrowksi Oct. 25, 2011). A married couple filed a joint petition under Chapter 7 listing their jointly-owned residence with a value of $125,900. Each debtor claimed a homestead exemption of $62,950, the value of his or her one-half ownership interest in the property. One month later, the debtors were divorced. Subject to the divorce decree, husband would obtain financing to pay for wife's $62,950 and the wife would quitclaim her interest in the property to the husband. The Chapter 7 Trustee argued that because the $62,950 that the wife would obtain pursuant to the divorce was not exempt by Connecticut statutes, that sum became property of the estate under § 541(a)(5)(B) (making property acquired by debtor under the divorce decree within 180 days after bankruptcy filing property of the estate). The Bankruptcy Court first noted that the sum was not a new asset acquired by the wife, but rather proceeds from her exempt interest which had already been included in the property of the estate and subsequently withdrawn therefrom. While Connecticut's exemption statutes initially determine whether a debtor's interest in property – as of the petition date - is exempt, Section 522(c) of the Code protects that property from postpetiton creditors. Therefore, the Court sided with the majority rule that a postpetition transformation of exempt property into a form of property which would not be exempt under state law does not return the property to the estate.

In re Kochman, 2011 WL 5325792 (Bankr. D. Conn. Nov. 3, 2011) (Shiff, J.). Husband and wife (the "Debtors") filed a joint petition under Chapter 7. The Debtors were also joint owners of Kochman Holdings Group LLC, a single asset real estate holding company which held their primary residence. In their bankruptcy petition, the Debtors sought to exempt the real estate property through the homestead exemption of Conn. Gen. Stat. § 52-352b(t). The Court held that the term "natural person" in § 52-352b(t) mandated that the property must be held by a human being and not an artificial or juristic entity such as an LLC.

Freeman v. Wright (In re Wright), 2011 WL 6202883 (Bankr. D. Conn. Dec. 8, 2011) (Shiff, J.). Defendant sought to reopen an adversary proceeding and vacate a $12 million default judgment entered against him. After rejecting Defendant's factual contention that certain Skype messages constituted "newly discovered evidence" under Rule 60(b)(2), the Court also rejected Defendant's attempt to use Rule 60(b)(6) to alleviate negligence on the part of his former counsel.

Rigoni v. Mucci (In re Mucci), 458 B.R. 802 (Bankr. D. Conn. 2011) (Weil, J.). Judgment creditors brought an adversary proceeding against Chapter 7 debtor, seeking determination that the judgment debt was excepted from discharge under § 523(a)(6). In the prior suit, the District Court concluded that Mucci had violated the Lanham Act by "actively and knowingly" causing trademark infringement. More significantly, the District Court took the rare step of awarding attorney's fees under the Lanham Act because the defendant's trademark infringement was deemed "malicious, fraudulent, deliberate, and willful" under 15 U.S.C. § 1117(a). On motion for summary judgment, the Bankruptcy Court held in favor of the judgment creditors under § 523(a)(6) because the prior judgment damages were based on "willful and malicious" injury and that Mucci had a full and fail opportunity to litigate this issue. Therefore, the Chapter 7 Debtor was collaterally estopped from relitigating those issues.

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