INSIDE THE MINDS

Chapter 11 Bankruptcy and Restructuring Strategies

Leading Lawyers on Navigating Recent Trends, Cases, and Strategies Affecting Chapter 11 Clients

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ASPATORE

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New Developments in Chapter 11 and Chapter 9 Filings

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Introduction

Everything is better in song, and the last year in the insolvency world brings to mind the prophetic words of The Grateful Dead and The Beatles:

"What a long, strange trip it's been."[1]

"I've got to admit it's getting better. A little better all the time (it couldn't get no worse)."[2]

The Long Trip

It is no surprise to bankruptcy practitioners that the number of US bankruptcy filings continued to decrease during 2014 and into 2015. This decrease is certainly not a new trend. As reflected in the chart below, the number of Chapter 11 filings decreased substantially each year since the end of the "Great Recession" in 2009:[3]

Year	Total Filings
2009	12,644
2010	10,625
2011	8,676
2012	7,788
2013	6,599
2014	5,188

Through the third quarter of 2015, there were 4,091 Chapter 11 filings. This represents a decrease of almost 60 percent from the number of Chapter 11 filings through the third quarter of 2009.[4]

[1] The Grateful Dead, "Truckin'," *American Beauty*," Warner Bros., 1970.
[2] The Beatles, "Getting Better," *Sgt. Pepper's Lonely Hearts Club Band*," Apple, 1967.
[3] See The National Bureau of Economic Research, "Business Cycle Dating Committee, National Bureau of Economic Research," available at http://www.nber.org/cycles/sept 2010.html (last visited on October 21, 2015) (noting the Business Cycle Dating Committee's determination that the recession that began in December 2007 ended in June 2009).
[4] See American Bankruptcy Institute Statistics from Epiq Systems, "September 2015 Bankruptcy Statistics – Commercial Filings," available at http://www.abi.org/newsroom/ bankruptcy-statistics (last visited on October 21, 2015).

It's Getting Better

There are some indications of recovery in the insolvency arena.[5] In December 2015, the Federal Reserve raised its benchmark interest rate. Higher interest rates are expected to exacerbate financial stresses, leading to more Chapter 11 filings. Moreover, certain industries, such as oil and gas, retail and health care, are already stressed and we have begun to see more companies in these sectors seek Chapter 11 protection.[6] Accordingly, we may soon see a rebound in the number of Chapter 11 filings.

363 Sales

Another trend, although in the opposite direction, is the continuing reliance on sales of substantially all of a debtor's assets under section 363[7] of the Bankruptcy Code as a primary component of bankruptcy cases. Since 2012, the percentage of large, public company bankruptcies utilizing a 363 sale of substantially all of the debtor's assets increased from 21 percent to 38 percent. [8] In fact, the use of 363 sales in 2014 was the second highest since 1994, eclipsed only by 2011, when 42 percent of large, public company bankruptcies utilized a 363 sale of substantially all of the debtor's assets.[9]

Sales under Section 363 can be a cost-effective way to generate recoveries for creditors. These sales are generally quick, and do not require the cumbersome, and expensive, procedure attendant with confirmation of a plan of reorganization or liquidation. Moreover, quick sales are sometimes

[5] The authors recognize that a recovery in the insolvency arena necessarily means that there is a loss in those sectors from which the corporate debtors emerge.
[6] For example, on October 5, 2015, clothing retailer American Apparel filed for Chapter 11 in the District of Delaware. On August 13, 2015, Hercules Offshore, an oil and gas driller, filed a pre-packaged bankruptcy in the District of Delaware, and confirmed its plan of reorganization on September 24, 2015. On May 19, 2015, El Paso Children's Hospital filed for Chapter 11 bankruptcy protection in the Western District of Texas.
[7] 11 U.S.C.A § 363.
[8] See UCLA-LoPucki Bankruptcy Research Database, "363 Sales of All or Substantially All Assets in Large, Public Company Bankruptcies as a Percentage of All Cases Disposed by Year of Case Disposition," available at http://lopucki.law.ucla.edu/tables_and_graphs/363_sale_percentage.pdf (last visited on October 21, 2015).
[9] See UCLA-LoPucki Bankruptcy Research Database, "363 Sales of All or Substantially All Assets in Large, Public Company Bankruptcies as a Percentage of All Cases Disposed by Year of Case Disposition," available at http://lopucki.law.ucla.edu/tables_and_graphs/363_sale_percentage.pdf (last visited on October 21, 2015).

necessary, especially when the assets to be sold are threatening to quickly decline in value (the so-called "melting ice-cube").[10] However, the expedited nature of a 363 sale raises a number of concerns. Are creditors' interests protected by a 363 sale? Is value lost through an expedited sale? Are 363 sales in effect *sub rosa* plans?[11]

Section 363 was a topic of focus for the Commission to Study the Reform of Chapter 11 (the "Commission") established by the American Bankruptcy Institute. In its Final Report and Recommendation (the "Report"), issued in April 2015, the Commission noted specific areas of concern with sales of substantially all of the debtor's assets (what the Commission called a "363x sale"). The pace at which 363x sales are accomplished was one area of concern raised by the Commission, since expedited 363x sales remove value quickly from the estate, without the full panoply of procedural safeguards. According to the Committee, these quick sales: (i) may not facilitate a robust auction; (ii) may not permit a debtor sufficient time to explore other restructuring alternatives; and (iii) may not allow parties in interest, including the debtor, to consider whether the debtor's market will rebound during the pendency of the bankruptcy case.[12] Because sales of substantially all of a debtor's assets dispose of all of the estate's valuable assets, these sales have the effect of setting creditor recoveries—and this is before creditors are fully informed of restructuring potentials and without the protection of the plan confirmation process.

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[10] See, e.g., *In re Lehman Brothers Holdings Inc.,* 445 B.R. 143, 180 (Bankr. S.D. N.Y. 2011), *aff'd in part, rev'd in part,* 473 B.R. 34 (S.D. N.Y. 2012), *opinion amended and superseded,* 478 B.R. 570 (S.D. N.Y. 2012), *aff'd,* 761 F.3d 303 (2d Cir. 2014)*, cert. denied,* 135 S. Ct. 2048, 191 L. Ed. 2d 956 (2015) *and aff'd,* 590 Fed. Appx. 92 (2d Cir. 2015) *and withdrawn from bound volume and withdrawn from bound volume and aff'd in part, rev'd in part,* 478 B.R. 570 (S.D. N.Y. 2012). ("A sale should be approved when the court is faced with the situation of a so-called 'melting ice cube,' a sale that would prevent 'further, unnecessary losses.'").

[11] Sales conducted under Section 363 of substantially all of a debtor's assets have been challenged as *sub rosa* plans for the reason that they dictate the provisions of a future plan of reorganization or liquidation without complying with the requirements for plan confirmation set forth in 11 U.S.C. § 1129. See, e.g.,*In re Chrysler LLC,* 576 F.3d 108, 116 (2d Cir. 2009)*, cert. granted, judgment vacated,* 558 U.S. 1087, 130 S. Ct. 1015, 175 L. Ed. 2d 614 (2009) *and judgment vacated, 592 F.3d 370 (2d Cir. 2010)* ("The reason *sub rosa* plans are prohibited is based on a fear that a debtor-in-possession will enter into transactions that will, in effect, short circuit the requirements of Chapter 11 for confirmation of a reorganization plan.") (citation omitted).

[12] Final Report and Recommendation, p. 87.

Recognizing the benefits afforded by 363x sales, as well as the potential for abuse, the Commission recommended that debtors should not be permitted to conduct an auction of, or receive final approval of a sale transaction involving, all or substantially all of the debtor's assets within sixty days of the petition date. The Commission's proposed deadline would not be able to be shortened unless (i) the debtor proves by clear and convincing evidence that there is a high likelihood that the value of the assets will decrease significantly during the sixty-day period and (ii) the court finds by a preponderance of the evidence that the sale is in the best interests of the estate, (a) satisfies some of the key plan confirmation requirements, and (b) shows that adequate notice has been given and that affected creditors and equity security holders have an opportunity to be heard. It remains to be seen where the Commission's 363 sale proposals go forward and whether they are given effect by amendments to the Bankruptcy Code or through local rules governing the bankruptcy courts. [13] However, the Commission's recommendations are sure to be cited by parties opposing expedited sales sought by debtors.

Venue

The Commission's recommendations regarding the 363 sale process are certainly interesting and thought-provoking. What is also interesting, albeit by its absence, is any recommendation by the Commission concerning changes to the bankruptcy venue statute, 28 U.S.C. § 1408.[14]

Section 1408 provides that a bankruptcy case may be filed in a jurisdiction where the debtor is domiciled or maintains its residence, principal place of business, or principal assets [15] A debtor can also file in a jurisdiction in which its affiliate files (as long as that affiliate is the first filing).[16] One result of the flexibility given to debtors in choosing venue is the concentration of business filings in the Southern District of New York and the District of Delaware, jurisdictions which may be far removed from the debtor's actual business, its employees, and creditors, therefore making it harder for these creditor constituencies to participate in the bankruptcy. According to the

[13] Specifically, the Commission recommended that the debtor would need to satisfy the plan confirmation requirements set forth in 11 U.S.C.A. § 1129(a)(1), (2), (3), (4), (9), (12). See Final Report and Recommendation, pp. 81, 201.
[14] 28 U.S.C.A. § 1408.
[15] 28 U.S.C.A § 1408(1). See Final Report and Recommendations, pp. 81, 201.
[16] 28 U.S.C.A. § 1408(2).

Governmental Accountability Office, between October 2009 and March 2015 a total of 765 major Chapter 11 cases (i.e., defined as those involving debtors with assets and liabilities of at least $50 million each), were filed. Out of this total, 61 percent were filed in either the Southern District of New York or the District of Delaware.[17] Nevertheless, the venue statute has its supporters as well, some of whom argue that the concentration of cases in New York and Delaware has led to the development of established, and hence predictable, case law, is convenient to most debtors' financial creditors, and is the result of debtors' selection of jurisdictions that will facilitate efficient bankruptcy proceedings.[18]

Given the arguments on both side of this issue, it is not surprising that the Commission could not reach a consensus regarding whether reform of the venue statute was necessary or appropriate.[19] However, it is clear that both practitioners and academics will continue to debate this issue in the years to come.

Key Cases

This year in the insolvency world was also unusual in that the Supreme Court issued two opinions addressing bankruptcy-specific issues. There were also opinions issued by the highly influential Third Circuit Court of Appeals and the Bankruptcy Court for the District of Delaware.

Wellness Int'l Network. Ltd. v. Sharif[20]

- *The Background. Wellness* is that rare case that makes both district court judges and bankruptcy court judges, as well as the bankruptcy bar, happy. To understand the importance of the *Wellness* decision, one must go back to *Stern v. Marshall*[21], in which the Supreme Court held that bankruptcy courts do not have jurisdiction to enter final

[17] Government Accountability Office, "Corporate Bankruptcy: Stakeholders Have Mixed Views on Attorneys' Fee Guidelines and Venue Selection for Large Chapter 11 Cases," at page 42, available at http://www.gao.gov/asset/680/672696.pdf (last visited on Oct. 21, 2015).
[18] Final Report and Recommendation, pp. 311-313 (discussing arguments advanced by critics and supporters of the bankruptcy venue provisions).
[19] Final Report and Recommendation, p. 311.
[20] *Wellness Intern. Network, Ltd. v. Sharif*, 135 S. Ct. 1932, 191 L. Ed. 2d 911 (2015).
[21] *Stern v. Marshall*, 131 S. Ct. 2594, 180 L. Ed. 2d 475 (2011).

judgments on fraudulent conveyance claims against non-creditors even though fraudulent conveyance claims are expressly categorized by Congress as "core" claims.[22] *Stern* created a class of claims called "*Stern* claims" which are claims that are designated as core claims pursuant to 28 U.S.C. § 157,[23] but that are prohibited from final resolution by bankruptcy courts as a constitutional matter by *Stern*. Left open by *Stern* was whether Article III permits parties to consent to a bankruptcy court entering a final judgment on *Stern* claims. Subsequently, in *Executive Benefits Insurance Agency v. Arkison (In re Bellingham Insurance Agency, Inc.)*[24], the Supreme Court chose not to reach the consent issue but held that bankruptcy courts, when faced with *Stern* claims, should treat such claims as non-core bankruptcy claims. The bankruptcy court may issue proposed findings of fact and conclusions of law, which are then reviewable *de novo* by the district court. *Wellness* fills the gap by addressing the question of whether parties can consent to a bankruptcy court entering final judgment on *Stern* claims.

- *The Holding*. In a 5-4 decision authored by Justice Sotomayor, the Supreme Court held that litigants may waive their right to Article III adjudication for *Stern* claims. Therefore, bankruptcy courts may enter final judgment on *Stern* claims if the parties consent, even if the consent is not express.
- *The Rationale*. The question presented was whether allowing bankruptcy courts to decide *Stern* claims by consent of the parties would threaten the institutional integrity of the judicial branch. However, that question was decided by the Court "with an eye to the practical effect that the" practice "will have on the constitutionally assigned role of the federal judiciary."[25] Based upon this practicality analysis, the Court held that allowing bankruptcy courts to enter final judgments on *Stern* claims would not threaten the judicial branch's integrity because:

    - Bankruptcy judges are appointed and subject to removal by Article III judges.

[22] 28 U.S.C.A. § 157(b)(2)(H).
[23] 28 U.S.C.A. § 157.
[24] *Executive Benefits Ins. Agency v. Arkison*, 134 S. Ct. 2165, 189 L. Ed. 2d 83 (2014).
[25] *Wellness Intern. Network, Ltd. v. Sharif*, 135 S. Ct. 1932, 1944, 191 L. Ed. 2d 911 (2015).

  - Bankruptcy courts hear matters by reference from the district courts, and the district courts may withdraw the reference *sua sponte* or upon application of a party.
  - Bankruptcy courts are limited to "a narrow class of common law claims as an incident to the [bankruptcy courts'] primary, and unchallenged adjudicative function."[26] Therefore, there is limited intrusion into the jurisdiction of Article III courts.
  - Because the bankruptcy process takes place under the district courts' total control and jurisdiction, Congress was not attempting to emasculate Article III courts by allowing bankruptcy courts to enter final judgments on *Stern* claims.

- *The Takeaway*. In a simplistic way, the real winners in *Wellness* are the district court judges and bankruptcy court judges. Had the Supreme Court ruled that consent was insufficient to allow the bankruptcy court to enter final judgments on *Stern* claims, the district courts would have been virtually swamped with thousands of new complaints which otherwise would have been filed in the bankruptcy courts. It is highly doubtful that the district courts, which are already overwhelmed with their own caseloads, could handle an infusion of thousands of new cases.[27] Also happy with the holding are bankruptcy court judges who would have otherwise seen their jurisdiction further whittled away. Bankruptcy practitioners are also most likely thrilled since litigating in district court is far different from the streamlined litigation approach adopted by the local rules of many bankruptcy courts.[28] However, there are practical implications of the *Wellness* ruling:

[26] *Wellness Intern. Network, Ltd.*, 135 S. Ct. at 1945.

[27] For instance, between October 1, 2013, and September 30, 2014, more than 960,000 cases were filed in bankruptcy courts. This was more than double the total number filed in district and circuit courts. *Wellness Intern. Network, Ltd.*, 135 S. Ct. at 1939, n.2.

[28] For instance, in contrast to district courts which require a witness to be present for all testimony, many bankruptcy courts permit direct testimony via way of declaration, with the witness appearing in court solely for cross and redirect examination. *See, e.g.*, *In re Geller,* 170 B.R. 183, 186, 29 Fed. R. Serv. 3d 780 (Bankr. S.D. Fla. 1994). (*en banc*) (citing *In re Adair,* 965 F.2d 777, 779, 35 Fed. R. Evid. Serv. 966, 22 Fed. R. Serv. 3d 947 (9th Cir. 1992).) ("The Court finds that calling a witness to the stand, swearing the witness, having the witness swear or affirm the written declaration is his or her testimony and then turning over the witness for cross examination with right to redirect is the taking of the testimony in open court within the meaning of Fed. R. Civ. P. 43(a).").

  - Parties now may choose to have *Stern* claims, such as fraudulent conveyance and fraudulent transfer claims, finally decided in bankruptcy court.
  - Questions of adequacy of consent are going to proliferate, as unsuccessful parties before the bankruptcy court may challenge adverse rulings on jurisdictional grounds, arguing that they never knowingly and voluntarily consented to the bankruptcy court entering final judgment.
  - The careful practitioner seeking bankruptcy court jurisdiction should obtain, where possible, express statements consenting to the jurisdiction of the bankruptcy court. Contrarily, a party objecting to bankruptcy court jurisdiction should, as early as possible, clearly state the objection and repeat the objection where appropriate.

Baker Botts L.L.P. v. ASARCO, LLC[29]

- *The Background.* This case is of great importance to bankruptcy practitioners who represent debtors or official committees. These professionals are required to have their fees and costs approved by the bankruptcy court before they are paid. The issue before the Supreme Court was whether these professionals could get paid by the estate for the work done defending their own fee applications. In this case, the debtor's two law firms successfully prosecuted fraudulent transfer claims against the debtor's parent company, obtaining a judgment in excess of $7 billion. The debtor successfully reorganized, emerging from bankruptcy with $1.4 billion in cash, little debt, and resolution of environmental liabilities. The parent company, which reacquired ownership once all creditors were paid in full, objected to the fee applications. After extensive discovery and a six-day trial, the bankruptcy court awarded the law firms $120 million for their work in the bankruptcy case, a $4.1 million fee enhancement, and over $5 million for time spent litigating in defense of their fee applications. The district court affirmed the award, concluding that the law firms could recover fees for defending their own fee applications. The

[29] *Baker Botts L.L.P. v. ASARCO LLC*, 135 S. Ct. 2158, 192 L. Ed. 2d 208 (2015)..

Court of Appeals for the Fifth Circuit reversed, holding that the "American Rule," whereby each side must pay its own attorneys' fees absent explicit statutory authority to the contrary, precluded the law firms' recovery for fees incurred defending fees.

- *The Holding.* In a 6-3 ruling, the Supreme Court affirmed the appellate court's ruling. Justice Thomas, writing for the majority, emphasized that before the Court deviates from the American Rule, there must be "specific and explicit" statutory provisions for the allowance of attorneys' fees.[30] In this case, 11 U.S.C. § 330(a)(1)[31] governs payment of estate professionals. This section permits the court to award a professional "reasonable compensation for actual, necessary services rendered." Keying on the word "services," the Court held that the work for which fees and expenses are recoverable is limited to work done for the benefit of the estate (whether the debtor or an official committee).
- *The Rationale.* The Court's decision in *Baker Botts* is the product of narrow statutory construction. Section 327(a)[32] of the Bankruptcy Code permits the employment of professionals to serve the administrator of the estate, whether the debtor-in-possession or trustee, for the benefit of the estate. Section 330(a)(1)[33] in turn authorizes compensation for these professionals. The Court reasoned that Congress intended that compensable work performed by a professional would be performed on behalf of the estate. Because the fees incurred by a professional defending its own fee application were incurred by the professional on behalf of that same professional, the fees did not fall within the strict confines of Section 330(a)(1). By restricting its opinion to the narrow text of Section 330(a)(1), the Court was able to make short shrift of the argument advanced by the United States, as *amicus curiae*, that compensation for fee defense is a component of the reasonable compensation allowed under Section 330(a)(1). The Court also rejected the policy argument advanced by the United States that uncompensated fee litigation would lead to frivolous fee objections being filed as a way to force bankruptcy practitioners to reduce their fee requests. Instead, the

[30].*Baker Botts L.L.P.,* 135 S. Ct. at 2164.
[31] 11 U.S.C.A. § 330(a)(1).
[32] 11 U.S.C.A. § 327(a.)
[33] 11 U.S.C.A. § 330(a)(1).

Court noted that Rule 9011 of the Federal Rules of Bankruptcy Procedure,[34] bankruptcy's analogue to Rule 11 of the Federal Rules of Civil Procedure,[35] would dissuade frivolous objections.[36]

- *The Takeaways.* Bankruptcy professionals are right to be concerned with *Baker Botts* for a number of reasons.

  - The opinion gives a green light to parties to strategically object to fee applications since they now have little disincentive to object.
  - Professionals may be pressured to reduce their fee requests since they themselves will be responsible for the fees incurred in responding to fee applications.
  - As noted by Justice Breyer in the dissent, uncompensated fees spent defending fee applications will dilute the final fee award and may turn a reasonable compensation into an unreasonable one.[37]
  - Professionals have attempted to draft their way around *Baker Botts* by including indemnification provisions in their engagement agreements. However, these efforts have been opposed by the United States Trustee's Office. On January 29, 2016, the first ruling on such issues sustained the objections of the US Trustee to retention provisions for recovery of fee defense costs and expenses.[38] It thus seems increasingly unlikely that clever drafting can avoid the Court's clear conclusion that Section 330(a)(1) does not provide the required "specific and explicit" exception to the American Rule.

In re LCI Holding Co.[39]

- *The Background. In re LCI Holding Co.* will have a significant impact upon both purchasers of assets under Section 363, as well as plan proponents, since *LCI* makes it easier to resolve objections to sales and plan confirmation. In *LCI,* the debtors were leading operators of

[34] Fed. R. Bankr. P. 9011.
[35] Fed. R. Civ. P. 11.
[36].*Baker Botts L.L.P.,* 135 S. Ct. at 2168, n. 4.
[37].*Baker Botts L.L.P.,* 135 S. Ct. at 2170.
[38] *In re Boomerang Tube, LLC,* Case No. 15-11247 (MFW), United States Bankruptcy Court for the District of Delaware, at Dkt. No. 860.
[39] See *In re ICL Holding Co., Inc.,* 802 F.3d 547 (3d Cir. 2015).

long-term acute care hospitals who sought to sell substantially all of their assets to their secured creditors via way of a credit bid. Because the secured creditors were undersecured, no cash was to be paid—instead, the secured creditors would purchase substantially all of the debtors' assets via a credit bid. However, as part of the sale, the secured creditors deposited $1.8 million in escrow to cover the professional fees for the debtors and the unsecured creditors committee, as well as the debtor's wind-down costs. Additionally, to resolve the committee's objections to the sale, the secured creditors agreed to deposit into trust $3.5 million for payment to the unsecured creditors. The US government, which asserted an administrative claim estimated at $24 million, objected to the sale, arguing that it violated the Bankruptcy Code's priority scheme because the secured lender group agreed to pay some administrative claims (the professionals for the debtors and the committee) but not others of equal priority (the government). Further, the government objected to the approval of the settlement agreement with the committee since under the settlement junior creditors (the unsecured creditors) were to be paid before senior creditors (the government). The government's objections were overruled by the bankruptcy court and the district court affirmed the bankruptcy court's ruling.

- *The Holding.* The Third Circuit affirmed the ruling of the district court and approved the sale and the settlement. Finding that the government's appeal was not constitutionally, statutorily, or equitably moot, the Court held that neither the escrowed funds nor the settlement funds were property of the estate and that the payments to the professionals and unsecured parties did not violate the Bankruptcy Code's priority scheme.
- *The Rationale.*

    - The Court first addressed the $3.5 million paid to the unsecured creditors in settlement of the committee's objections. The Court rejected the government's argument that the $3.5 million was in essence an increased bid for the debtors' assets and therefore should be considered to be proceeds from the sale of the debtors' assets and part of the estate. The Court held that the $3.5 million did not constitute proceeds from the secured creditors' liens, at no time belonged to the debtors' estate, and would not become part

of the estate if the settlement was not approved. Instead, the $3.5 million were funds belonging to the secured creditors, and those creditors were entitled to use their own funds as they saw fit, including paying the funds to the unsecured creditors.

- The funds escrowed for the professionals and the debtors' wind-down expenses presented a more complex question because the funds were identified as part of the purchase price in the asset purchase agreement. Nonetheless, the Court looked at the "economic reality" of the sale and held that the purchase price was limited to the $320 million credit bid. Furthermore, the Court found that the escrowed funds were not analogous to a carve-out, where a secured creditor permits the use of a portion of its collateral (which is estate property) to pay administrative costs. Instead, the escrowed funds were funds belonging to the secured creditors and were not part of the debtors' estate.
- Because the Code's creditor-payment hierarchy only comes into issue when distributing estate property, neither the $3.5 million in settlement payments, nor the $1.8 million in escrow were contrary to the Code.

- *The Takeaways.* The import of the Third Circuit's decision in *LCI Holding* must be examined from two separate standpoints. First, from the standpoint of either a buyer of assets under Section 363[40] or a plan proponent; and second, from the standpoint of a creditor.

  - From the standpoint of a buyer of assets under Section 363 or a plan proponent, *LCI Holding* provides a powerful tool with which to overcome or avoid objections. In many cases, there are creditors with significant claims entitled to priority payment. By utilizing escrows to pay certain priority creditors over other creditors with the same priority, purchasers can resolve (i.e., buy off) objections to the sale. Plan proponents can likewise use an infusion of new funds (i.e., non-estate property) to resolve plan objections. As long as the payments are coming from the outside of the estate, they are not subject to the Bankruptcy Code's priority scheme.

[40] 11 U.S.C.A. § 363.

- From the standpoint of creditors holding administrative or priority claims, *LCI Holding* is a wake-up call that these claims may not be paid before other claims, including junior claims, are paid.
- *LCI Holding* also highlights the importance of drafting agreements and motions that are clear and unambiguous. Although the Third Circuit was able to divine the parties' intent and to thereby enforce the "economic reality" of the transaction, parties certainly do not want to leave themselves at risk of an adverse ruling based upon an ambiguous document. Counsel to parties who are seeking to follow the *LCI Holding* roadmap must ensure the documents clearly establish the payments are not coming from the estate but are instead coming from the purchaser or plan proponent. This will allow their clients to be paid in advance of either similarly situated, or even senior, creditors.

In re Northshore Mainland Services, Inc.[41]

- *The Background.* Recent years have brought about a dramatic increase in the number of cross-border insolvency proceedings.[42] The Bankruptcy Court's decision in *Northshore* provides guidance on when US courts should abstain from hearing US proceedings in favor of insolvency proceedings pending in foreign jurisdictions. The pertinent facts of *Northshore* are straightforward.

  - Fifteen debtors filed for bankruptcy protection in the United States. All of the debtors were Bahamian companies, except for the lead debtor Northshore Mainland Services, Inc. (Northshore), which was a corporation that was incorporated in Delaware.
  - The debtors were involved in the development and construction of a $3.5 billion, 3.3 million square-foot resort

[41] *In re Northshore Mainland Services, Inc.,* 537 B.R. 192 (Bankr. D. Del. 2015).

[42] For instance, the number of Chapter 15 filings in the Southern District of New York, a hotbed of cross-border filings, increased approximately 90 percent from 2014 to 2015. See American Bankruptcy Institute, "SDNY Chapter 15 Caseload Up 90 Percent to Date over 2014," available at http://www.abi.org/newsroom/chart-of-the-day/sdny-chapter-15-caseload-up-90-percent-to-date-over-2014 (last visited on October 21, 2015).

located in The Bahamas. The resort project is one of the largest of its kind in the Western Hemisphere and has enormous economic implications for the Bahamas. The debtors projected that revenues from the project would exceed 12 percent of the GDP of The Bahamas and would employ 1 percent of its population.

- Immediately after the cases were filed in the US, the fourteen Bahamian debtors filed an application in the Bahamas seeking recognition of the Chapter 11 cases and a stay of all legal proceedings in the Bahamas involving the Bahamian debtors pending the completion of the Chapter 11 cases. The Bahamian court declined to recognize the Delaware proceedings or to enforce the automatic stay in the Bahamas.
- Shortly thereafter, the Bahamian government sought orders from the Bahamian court for the winding up of all the Bahamian debtors' businesses and the appointment of provisional liquidators. On September 4, 2015, the Bahamian court appointed joint provisional liquidators for seven of the Bahamian debtors.

- *The Holding.* Two creditors in the US proceeding filed motions to dismiss the US cases under Sections 305(a) and 1112(b)[43] of the Bankruptcy Code. The Bankruptcy Court dismissed the bankruptcy cases of all fourteen Bahamian debtor entities. The Court refused to dismiss the case filed by Northshore, the lone US debtor entity.
- *The Rationale.* The Court's decision was guided by three main considerations.

  - First, the Bankruptcy Court focused on the necessity to complete the resort project as soon as possible. The Bankruptcy Court held that while allowing the Chapter 11 cases to proceed would not advance the project given the Bahamian court's non-recognition order, the provisional liquidators could expedite the completion of the project

[43] 11 U.S.C.A. §§ 305(a), 1112(b).

since they were appointed with limited powers to promote a scheme/plan of compromise.[44] The Bankruptcy Court therefore rejected the argument that the only relief available under Bahamian insolvency law was liquidation.[45]

- Second, the Bankruptcy Court agreed with the Bahamian court and found that many stakeholders would expect the insolvency proceeding to take place in the Bahamas, the location of the project.[46] There was no rationale for the "main" proceeding to occur in the United States.[47] The Court held that the parties' expectations of where disputes will be resolved should be respected and not disturbed without a compelling reason.[48]
- Third, the Bankruptcy Court was concerned with the principle of comity. Here, provisional liquidators had been appointed by the Bahamian courts and were given the mandate to preserve the assets in the Bahamas and promote a compromise between all the parties-in-interest in the hope of completing the project. Although insolvency laws were different in the Bahamas as compared to the US, the Court found that the Bahamian law did not contravene US public policy, and that comity therefore dictated that the Bahamas be permitted to adjudicate the insolvency of the Bahamian debtor entities.[49]

- *The Takeaways*. Chapter 11 has provided an attractive opportunity for companies located in other countries to seek to reorganize their businesses. The threshold necessary to demonstrate that there are sufficient connections for the United States bankruptcy courts to exercise their jurisdiction is very low. In the *Northshore* case, a $10,000 deposit account was found to meet that standard. However, there are limits to the power of US bankruptcy courts. The uncontroverted and compelling interests of the Bahamian

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[44] *In re Northshore Mainland Services, Inc.,* 537 B.R. 192 (Bankr. D. Del. 2015).
[45] *In re Northshore Mainland Services, Inc.,* 537 B.R. at 205 n. 8.
[46] *In re Northshore Mainland Services, Inc.,* 537 B.R. at 206.
[47] *In re Northshore Mainland Services, Inc.,* 537 B.R. at 206.
[48] *In re Northshore Mainland Services, Inc.,* 537 B.R. at 206.
[49] *In re Northshore Mainland Services, Inc.,* 537 B.R. at 207-208.

government, the citizens of the Bahamas, and the debtors' Bahamian creditors led the Bahamian court to deny the authority of the US Bankruptcy Court and instead insist on local control of the reorganization of an enterprise vital to the Bahamian economy. The US court respected, and gave comity to, this ruling. It remains to be seen whether this case represents the unique "exception to the rule" or whether it is the beginning of a trend for foreign jurisdictions to assert greater authority over their local debtors.

Energy Trends in 2015: The Oil and Gas Market

Since the third quarter of 2014 in the United States, the appetite for lending to small and midsized exploration and production companies (E&P companies) has decreased substantially for several reasons. The most significant reason is the drop in oil prices to the WTI Spot close at Cushing, Oklahoma in the $35 per barrel range at the end of 2015.

Exploration and production (E&P) loans in the United States are made available via a borrowing base, the value of which is driven by reserve reports prepared by reserve engineering companies. These reserve reports are generally only prepared semi-annually and incorporate the current prices for oil and gas as of the report date. Most reserve reports are prepared as of December 31 and June 30 of each year. However, the reports take several months to prepare and are not due to the lenders until early March and early September of each year respectively, although the value of the reserves is based on December 31 and June 30 numbers. Hence, E&P companies with borrowing base credit facilities began feeling the effect of this price slide beginning in March 2015, based on the price of oil and gas as of the previous December 31.

Nevertheless, the decline in prices and decreases in borrowing bases is mitigated to some extent by borrowers having active hedging programs that limit their downside in a declining oil price market. Commodity hedging programs assist both borrowers and lenders in a declining price market and in their simplest form, serve as a price floor for the volume (notional amount) of future oil and gas to be produced. Consequently, lenders will generally require non-investment grade (or non-near investment grade) E&P companies to maintain a certain level of commodity hedges under the covenant provisions of

their credit agreements. A typical hedging covenant would require the borrower to hedge no less than 50 percent of their future oil and gas production and generally no more than 80 percent of such production.

The E&P lenders have taken a similar approach to the decline in oil and gas prices to that of the 2008-09 decline, which is to work with the E&P companies as much as possible, tinker with the credit agreements around the edges, and only take action on those E&P companies that are in critical condition. That said, prior to the price decline, the average E&P company was only approximately 60 percent drawn on their credit facility. However, assuming oil and gas prices remain flat for the next six months, as currently projected by the futures market, this 40 percent cushion will continue to erode for leveraged companies with required active drilling programs between the April 2016 and the October 2016 borrowing base redeterminations.

The initial drop in borrowing base availability has already caused a number of E&P companies to be required to repay a portion of their credit facility. Many of the companies were not in a position to make these payments as a result of their drilling commitments and ongoing cash needs. This first group became watch list credits, workout counsel was engaged for a number of these credits, and special asset groups have begun to monitor all oil and gas credits generally.

The price decline and related decrease in borrowing base availability has also led to a number of high profile E&P company Chapter 11 proceedings throughout the United States and over three dozen E&P company bankruptcies were filed in 2015. Energy sector Chapter 11 filings represented more than 26 percent of all the Chapter 11 reorganizations filed in 2015, and 2016 does not promise to improve. We have also begun to see credit facility amendments that are purely workout in nature: waiving a covenant violation; adding specific borrower undertakings to pay for lender's cost of restructuring advisors; lenders waiving a "going concern" paragraph in borrower's audit letter; etc.

Discussions with capital market investment advisors in the E&P space regarding the current state of the market have yielded consistent reports. Public offerings for virtually all E&P companies have been shelved at this time. Therefore, the public capital markets are generally not available and

are not expected to open up in 2016 if prices remain where they are today. This lack of public capital market availability will place additional pressures on companies that anticipated using those markets in the capital structure for continued E&P development and commitments. As a result of these changes, more expensive specialty lending groups have already begun lending into the E&P space. These specialty lending groups were previously limited to very distressed companies due to the general availability of fairly inexpensive money. Additionally, private debt and equity has also seen an increase in the E&P investment space during 2015.

M&A activity is expected to increase in 2016, with private investor groups looking for distressed assets and large financially stable oil and gas companies looking to acquire valuable assets at distressed market prices. More M&A activity was expected to be completed in 2015; however, the delta between the ask and bid prices between sellers and buyers was generally seen as too great in many proposed transactions. The second dip in oil and gas prices in 2015 led many investors to take a wait and see approach to what happens in 2016 before jumping into the market. Because borrowing bases are likely to continue to tighten if the market remains unchanged and hedges continue to roll-off each month, investors believe they will be able to acquire assets at bargain prices if they wait into 2016 to make their investments.

Oilfield services companies have already begun to feel the squeeze of the drop in oil prices. Rigs are being mothballed in basins around the country. Oilfield service companies have been asked to drop their prices immediately by between 10-40 percent, whether or not they have a contract in place. These changes are being driven both by industry players as well as professional advisory companies that have been engaged to right-size the E&P companies.

Oilfield service companies are generally governed by ABL credit facilities that make credit available based on their hard assets and the value of their contracts. This revenue squeeze is likely to create opportunities for specialty lenders as well as in the M&A space. However, there are over-leveraged and inefficiently run companies that cannot operate in a $35 to $40 per barrel environment, and we have already seen bankruptcies from WBH Energy LP (a Texas drilling company) and GASFRAC Energy Service Inc. (a Canadian waterless fracking company). The longer low oil and gas prices continue, the more these companies will feel the economic pressure, resulting in increased chapter proceedings and in some cases, mergers.

Bankruptcy Issues Applicable to Oil and Gas Leases

The variety of state laws governing the conveyance of interests in minerals leads to complexity in how US bankruptcy courts will determine the rights of the landowner in the event an E&P company files for bankruptcy.

Section 365(a)[50] of the US Bankruptcy Code provides that a bankruptcy trustee (or debtor in possession) may assume or reject any executory contract or unexpired lease. In states where oil and gas leases are considered to be fee simple interests, the leases do not constitute "unexpired leases" under the Bankruptcy Code, and therefore, Section 365[51] does not govern their assumption or rejection. The unpaid royalty owner holds a claim against the debtor to be settled in the bankruptcy case. Furthermore, Section 541[52] of the Bankruptcy Code precludes any forfeiture of the lessee's interest in minerals based solely upon the insolvency or financial condition of the lessee.

However, in states where oil and gas leases constitute leasehold interests rather than fee interests, Section 365 governs their disposition. In those states, the debtor must cure any defaults to assume the lease, and must provide "adequate assurance" of future performance. In such states, the debtor must pay all past due royalties in full, and provide assurance it will comply with the terms of the lease in the future. Section 365 allows assumption notwithstanding any lease term that would otherwise permit the landowner to terminate the lease based upon the insolvency or financial condition of the lessee.

Joint Operating Agreements

Companies wanting to develop oil and gas interests tend to involve other investors to share the risk. In US jurisdictions, the Joint Operating Agreement (JOA) describes what the investing party is to do and what the party owning the oil and gas lease is to do. A JOA provides the contractual basis for the cooperative exploration, development, and production of oil and gas properties among multiple leasehold co-tenants. The E&P company often assigns undivided fractional shares of those oil and gas leases to third parties. The result is that any given oil and gas property is

[50] 11 U.S.C.A. § 365(a).
[51] 11 U.S.C.A. § 365.
[52] 11 U.S.C.A. § 541.

typically concurrently owned by numerous co-tenants. The parties may hold leases that cover various undivided interests in a single tract of land, or they may own leasehold interests in nearby tracts of land and wish to pool their interests together to drill a well.

Under a JOA, the leasehold co-tenants appoint one party as "operator," who then has full control of conducting and directing all operations in the contract area, under the confines of the JOA. The remaining co-tenants are then considered "non-operators," who only retain indirect control of the operations in the contract area, such as voting on subsequent operations, electing whether to consent to subsequent operations, and certain inspection rights.

Bankruptcy Risks Applicable to Joint Operating Agreements

In light of current oil and gas market distress, we can expect the terms of JOAs will be tested in US bankruptcies. The JOA gives rise to a credit risk for all of the working interest owners which are parties to the agreements, both operators and non-operators. Operators frequently make advances on behalf of non-operators for both capital expenditures and lease operating expenses. The typical process under the JOA is for the operator to make cash calls for drilling expenses and the costs of production. Payment terms for these cash calls range from thirty days in advance or payable in arrears and the non-operators are obliged to pay the cash calls at that time without question. Any objections to the charges are to be made through an audit process specified in the JOA.

Upon the bankruptcy of the non-operator, claims for both capital expenditure amounts and for unpaid lease operating expenses generally will be unsecured claims against the non-operator debtor. Operators, on the other hand, often market hydrocarbons for the non-operators. Prior to the operator paying over the proceeds of the sale of such hydrocarbons, the non-operator will be taking a credit risk on the operator. In that circumstance, the bankruptcy of the operator will result in the non-operators being left with claims for hydrocarbons that have been produced and sold prior to the bankruptcy.

JOAs are always held to be executory contracts and can thus be assumed or rejected under Section 365[53] of the Bankruptcy Code. If the debtor rejects

[53] 11 U.S.C.A. § 365.

the JOA, generally the non-breaching counterparty will have an unsecured claim for damages against the debtor party. One consequence of rejection of the JOA is that the non-breaching counterparty should be able to enforce its rights under the JOA against the breaching debtor party, except that any money damages will be treated as any other unsecured claim against the debtor, and will likely be compromised.

In contrast, if the debtor assumes the JOA, it will be required to "cure" all payment defaults within a reasonable time after assumption. Furthermore, a party assuming a JOA will be required to provide adequate assurance of future performance under the agreement if there has been a default. The debtor must assume the entire JOA; it may not pick and choose which terms to assume. Anti-alienation provisions which limit or prohibit the assignment of a JOA are unenforceable in bankruptcy. Therefore, a debtor for the most part has the power to assign a contract or lease without the consent of contract counterparties, which would be required in the absence of bankruptcy.

It should be noted that the Bankruptcy Code does not impose a strict, fixed period within which the debtor must decide to assume or reject the JOA. During the period while the debtor is deciding whether to assume or reject a JOA, generally the non-debtor party must continue to perform its obligations. During that "gap period," the non-debtor party will bear the risk and uncertainty which results from not knowing whether the contract will be rejected, assumed, or assumed and assigned. Particularly with "core contracts" that are central to a producer's business, the uncertainty surrounding whether such an agreement will be assumed or rejected and whether the counterparty will have sufficient capital to meet its ongoing obligations thereunder can layer on enormous additional risks for capital intensive projects. The Bankruptcy Code permits the counterparty to reduce this uncertainty by seeking to shorten the time period for a debtor to assume or reject the JOA.

Environmental Risk/Decommissioning Liabilities

In the United States, the federal Comprehensive Environmental Response, Compensation and Liability Act (CERCLA),[54] imposes joint and several

[54] Comprehensive Environmental Response, Compensation and Liability Act, Pub. L. No. 96-510, 94 Stat. 2767.

liability for the release of a hazardous substance on the owner or operator of a facility and on any person who arranges for the disposal of a hazardous substance offsite. Petroleum, including crude oil and any fraction thereof, and natural gas are excluded from the definition of "hazardous substance."

However, state laws impose a separate layer of regulations dealing with releases of hazardous substances, as well as the "plugging and abandonment" of oil and gas wells. Each oil- and gas-producing state has its own industry regulator. Because the laws of each state can vary greatly, it is critical to have locally licensed oil and gas and environmental counsel available to address the environmental ramifications of drilling operations in states where an E&P company operates.

The federal bankruptcy laws generally require trustees to comply with state laws in administering their estates. Consequently, US courts have held that the bankruptcy trustee has an obligation to plug the unproductive wells, if the obligation arose during the bankruptcy proceedings, and that such obligation has an administrative priority status.

The Wrap-Up: Energy Trends

Providers of oil field services continue to face liquidity crises over the next six months as E&P companies struggle to operate within the constraints of $35 per barrel oil. Many service companies had borrowed heavily to upgrade equipment, and now find themselves on an unstable financial footing. Most oil field service companies have already implemented one or more rounds of lay-offs to minimize or eliminate operational losses. However, even with these lay-offs, many service companies continue to lose money.

E&P companies have mitigated against the decline in oil prices and decreases in borrowing bases in the short term by active hedging programs that limit their downside in a declining oil price market. However, the public capital markets are generally not available to E&P companies at this time, and it remains to be seen whether their capital needs can be met by means of specialty lending groups, private debt, and M&A transactions. Additionally, each month sees hedges in the $100 per barrel range roll-off either to be replaced with current market price hedges in the $35-$40 per barrel range or not being replaced, allowing the value of such production to

float with the market. Further, the futures market presently projects oil to sell for approximately $60 per barrel by 2020 and gas to sell for approximately $3.85 per MCF[55] at that time. If this slow rise in value occurs over the next five years, many more E&P companies and oil field service companies will require reorganization, both through chapter proceedings and otherwise.

Municipal Updates

This year we review the important takeaways from the Detroit, Illinois, Chicago, Nevada, Stockton, San Bernardino, and Jefferson County bankruptcies, looking at what comes next for municipal restructuring and Chapter 9.

Detroit Revisited: Post-Bankruptcy Issuance and Chapter 9 Feasibility Test

Post-bankruptcy, Detroit provides two important takeaways. The first is case law providing a framework for what constitutes a workable or "feasible" plan of adjustment ("Plan" or "Plan of Adjustment") that recognizes the significant risk of implementation and post-bankruptcy performance. The second is Detroit's statutorily lien protected post-bankruptcy bond issuance.

Detroit: Overview

Detroit's Chapter 9 case, the largest municipal bankruptcy in US history, ended on December 11, 2014. That is when Detroit's Plan became effective, and the City closed a $275 million exit financing with Barclays and issued $280 million in bonds to creditors. After making initial payments due under the Plan, the City disbursed payments to bond insurers and other creditors as part of the settlement of over $12 billion in debt.

Detroit's Plan shed $7 billion of long-term debt, the bulk of it from retiree health care benefits. Assuming everything goes right, including reducing expenses and increasing revenue, the City hitting its budget target and raising revenues in multiple areas over the next ten years, the Plan projects that Detroit will be able to invest a projected $1.7 billion in new and/or improved services for Detroit residents.

[55] One MCF is equivalent to a thousand cubic feet of natural gas.

Finding Feasibility

The Court's independent expert, Martha E.M. Kopacz (Kopacz), Senior Managing Director of Phoenix Management Services, LLC, filed a lengthy expert report and two supplements in the bankruptcy case (the "Kopacz Report").[56] Kopacz also testified at the confirmation hearing, where she opined on a test for feasibility, provided a deep factual analysis of the feasibility of Detroit's plan, and identified specific questions that required answering to determine whether the Plan met the Code's requirements.

By way of background, Kopacz was asked, among other things, to investigate and reach a conclusion on whether the City's Plan was feasible as required by 11 U.S.C. § 943(b)(7)[57], and whether the assumptions underlying the City's cash flow projections and forecasts regarding its revenues, expenses, and plan payments were reasonable. Section 943(b)(7) of the Bankruptcy Code requires that before a Plan may be confirmed the Court must determine that the Plan is feasible.

The Kopacz Standard

The Bankruptcy Code does not define "feasible" nor is there a meaningful body of Chapter 9 jurisprudence on the issue. The Kopacz Report defined a threshold standard for feasibility (the "Standard") asking:

> Is it likely that the City of Detroit after the confirmation of the Plan of Adjustment will be able to sustainably provide basic municipal services to the citizens of Detroit and to meet the obligations contemplated in the Plan without the significant probability of default?[58]

The Court adopted the Kopacz Standard in its Confirmation Order, providing the first clear and unequivocal ruling on Chapter 9 feasibility. The questions and issues addressed by the Kopacz Report provide the

[56] Squire Patton Boggs partners Stephen Lerner and Scott Kane represented Kopacz and her team.

[57] 11 U.S.C.A. § 943(b)(7).

[58] "Expert Report of Martha E.M. Kopacz Regarding the Feasibility of the City of Detroit Plan of Adjustment", *In re: CITY OF DETROIT, MICHIGAN, Debtor.,* 2014 WL 4408048 (Bankr. E.D. Mich. 2014).

foundation for establishing feasibility, and Detroit's feasibility lesson creates a very useful test for any municipality seeking to create and implement a truly workable Plan, whether in or out-of-court.

The Kopacz Report breaks down the assessment of feasibility into two component parts. The Standard looks to answer both quantitative and qualitative questions that are generic enough to apply in future municipal restructurings. These are questions cities should be asking themselves and their creditors and stakeholders should be following closely. They include:

Quantitative Questions

- Are the projections in the Plan of Adjustment mathematically correct and materially reasonable?
- Are the assumptions that the City has used to develop its projections individually and when taken as a group reasonable?
- Is there an adequate contingency included in the projections?[59]

Qualitative Questions

- Does the City have the human resources, or can it likely recruit the human resources, required to meet its obligations under the Plan of Adjustment?
- Does the City have the appropriate systems and procedures in place to monitor its financial performance and to provide early warning signs of variances in performance that might cause the City to fall short of the projections and be unable to meet its obligations under the Plan of Adjustment?
- Are there appropriate structures to ensure the City's compliance with the Plan of Adjustment and with reasonable government standards of operation?
- Will the City be able to reasonably deliver a minimum level of municipal services?
- Is the city's trajectory sustainable?

[59] *In re: CITY OF DETROIT, MICHIGAN, Debtor*., 2014 WL 4408048 (Bankr. E.D. Mich. 2014).

Considering the challenge of pension obligations, Kopacz' questions were:

- Do we consider the timeframe over which financial commitments are made in the Plan of Adjustment?
- That is, do we look at the restructured pension obligations of the retirees and current employees and attempt to determine whether the Plan of Adjustment is feasible during their entire lifetimes?

Finding Feasibility for Detroit

Kopacz ultimately found Detroit's Plan feasible, stating that Detroit differs from a company emerging from Chapter 11 in that the City does not have to be service delivery solvent to emerge from bankruptcy. Instead, it will be on a trajectory toward service delivery solvency. For Detroit, emerging from essential services failure to adequate and reasonable service delivery will be a success.

In Kopacz' last supplemental report, prepared after settlements were reached with most objecting parties, she found Detroit's current projections to be within the range of reasonableness, making the Plan feasible, stating:

> I want to emphasize, however, that there is little space remaining on the continuum of reasonableness. The recent settlements and corresponding amendments to the Plan of Adjustment have served the laudable goals of efficiently resolving disputes and garnering additional support for the Plan of Adjustment. Conversely, they have imposed additional financial obligations on the City.
>
> I have already expressed concerns regarding the level of contingency provided for in the Plan of Adjustment. The financial obligations associated with the recent settlements only intensify this concern.
>
> While the Detroit Plan is feasible for purposes of confirmation, it is going to require strict and careful implementation. There is little, if any, room for error if the Plan is to succeed post-bankruptcy. Getting out of bankruptcy was just the first step for Detroit—the real test

> is whether the process delivered true value and the City has the discipline to perform under the Plan.[60]

Detroit Post-Bankruptcy Bond Issuance

Post-bankruptcy, in the spring of 2015, Detroit issued $245 million in enhanced bonds under new legislation that provide a statutory lien on income tax revenue and an intercept feature that routes income tax revenue first to the bond trustee. Detroit used the proceeds from the bond issuance to repay the Barclays funded bankruptcy exit financing. In one of the first bespoke statutory liens for a post-bankruptcy issuer, the offering statement noted:

> Thus, the opinion of bond counsel to the city is not (and cannot be) a guaranty that the pledged income tax revenues would be treated as subject to a statutory trust or lien.[61]

Having a statutory lien is better than not having one. At least for the new issuance, bondholders can assert that they have a true lien (i.e., one that should be recognized by a bankruptcy court) instead of something more ephemeral and akin to "full faith and credit." Statutory liens are a developing part of municipal finance law as bondholders now understand that a "lien" that attaches to assets is required to be a protected creditor in a bankruptcy case.

Takeaways from Detroit

The Kopacz Report provides any city looking to restructure with the essential questions that must be addressed to determine the feasibility of any plan. This is the first time that the elements of municipal feasibility have been defined and the first time a court has adopted a clear and unequivocal test for municipal feasibility. The Kopacz Standard and its underlying questions provide a clear starting point for what a Chapter 9 plan needs to

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[60] "Second Supplemental Report of Martha E.M. Kopacz Regarding the Feasability of the City of Detroit Plan of Adjustment", *In re City of Detroit, Michigan,* Case No. 13-53846, (Bankr. E.D. MI. 2014) https://www.michigan.gov/documents/treasury/FRC_Court_Advisor_Report_-_Kopacz_-_Supplemental_-_10-21-14_474089_7.pdf. at p. 6.

[61] Official Offering Statement, Michigan Finance Authority, $245,000,000 Local Government Loan Program Revenue Bonds, Series 2014F (City of Detroit Financial Recovery Income Tax Revenue and Refunding Local Project Bonds) at p. 22.

accomplish. What now exists is a paradigm that can make the plan process more efficient and more transparent for cities, their creditors, and stakeholders. Answering the questions posed by the Kopacz Standard will organize the more detailed and often complicated factual analysis that is necessary to determine feasibility.

Illinois: Chicago Pensions and Higher Taxes and the Possibility of Chapter 9

Illinois' municipal distress is severe and we have witnessed the political maneuvers to address Chicago's ongoing fiscal dilemma. In 2013, Chicago Mayor Rahm Emmanuel stoked bankruptcy fears citing the city's ballooning pension obligations that could exceed $1.6 billion in 2016. Pew Charitable Trusts has reported that among the nation's five largest cities, Chicago has put aside the smallest portion of its looming pension obligations.

After winning an unexpected run-off election for mayor and losing in court on proposed pension reform that is presently the subject of an appeal, Mayor Emmanuel pushed through one of the biggest property tax increases in Chicago's history to help pay its annual pension costs. The tax increases real estate levies by $543 million over the next four years. The tax will be increased by additional jumps through 2018 and funds will go to police and firefighter pensions. While the property tax is a beginning step toward dealing with out of control pension costs, expected revenues fall short of what the actuaries are likely to recommend for annual contributions. The mayor is hoping that the legislature will pass a law that would reduce the city's 2015 contributions. The bill remains stalled in the legislature because of the budget impasse.

In January 2016, Chicago returned to the municipal bond market to cover mounting pension obligations, even after its record property-tax increase. The City is seeking to sell $500 million of general obligation bonds to refinance existing obligations and cover debt service. The cost of issuance reflects Chicago's dire financial condition. The federally tax exempt securities sold at a top yield of 4.27 percent, which is 1.3 percentage points higher than in cities in better financial condition who can issue at the benchmark rate.[62]

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[62] See, http://ww2.cfo.com/credit/2016/01/chicago-issues-debt-cover-pension-shortfall/.

Proposed Chapter 9 Access: Importance of State Supervision and Oversight

For Chicago or any US city to file for Chapter 9 bankruptcy, the city must be authorized by state law to file a bankruptcy case. Without such specific authorization, the bankruptcy process simply is not available and there is no bankruptcy process for a state. Current Illinois law does not permit Chicago or other Illinois municipalities to file for bankruptcy. That could change if a bill filed in the Illinois legislature in 2015 becomes law.[63]

On January 26, 2015, Illinois Representative Ron Sandack filed a House Bill with the Illinois House of Representatives that, if enacted, would allow Chicago and other Illinois municipalities to file for bankruptcy immediately without any additional action by the legislature or other state agencies. Rep. Sandack was quoted by *The Chicago Tribune* as saying "House Bill 298 would allow desolate and debt-ridden municipalities in Illinois to seek bankruptcy protections through the federal bankruptcy law. As more and more municipalities are looking for relief and ways to deal with rising pension liabilities and other costs, this is a tool that can help them stabilize and reorganize financial affairs in ways that benefit taxpayers."[64]

House Bill 298 was referred to the Rules Committee for review and after a brief trip to the Judiciary Civil Committee the bill was returned to the Rules Committee where it has languished. The bill is intended to give Chicago, and other Illinois municipalities, additional flexibility in devising ways to tackle fiscal distress, including the spiraling costs of pensions. Made necessary by the judicial rejection of pension reform on both a state constitutional and local level, Illinois municipalities may need to turn to bankruptcy to have any process to restructure crippling obligations and continue to provide an acceptable level of services to its residents.

Allowing access to Chapter 9 is a pragmatic solution, particularly in a state where financial difficulties at the state level all but preclude financial assistance to distressed municipalities. Should Illinois go further and

[63] "Illinois Penalized as It Ends Hiatus From Muni Bond Market", Bloomberg Business, January 14, 2016

[64] "Representative Ron Sandack Files Bill to Allow Illinois Municipalities to Seek Bankruptcy Protection", Chicago Tribune, December 7, 2015, http://www.chicagotribune.com/suburbs/bolingbrook-plainfield/community/chi-ugc-article-representative-ron-sandack-files-bill-to-allo-2015-01-27-story.html.

provide for oversight and supervision prior to an actual bankruptcy filing, it has the opportunity to be one of a few states to implement a pre-packaged business approach to municipal bankruptcy. While testimony was presented to the legislature regarding oversight and supervision pre-bankruptcy filing, the legislation has not been amended or updated to provide for any kind of oversight or supervision prior to a municipality filing.

Utilizing lessons learned (sometimes painfully) in Stockton, Detroit, and San Bernardino, Illinois could advance the Chapter 9 process simply by providing oversight and supervision to the municipality before permitting a filing. In the absence of financial support, providing assistance designed to make the bankruptcy process as efficient and cost-effective as possible and to ensure meaningful compliance with the Bankruptcy Code's eligibility requirements should be an additional consideration that goes hand-in-hand with allowing access to Chapter 9.

What remains to be seen as the Illinois legislature moves its Chapter 9 proposal through the legislative process is how this will affect capital market access and pricing for Illinois municipalities. On some level, providing access to Chapter 9 in the absence of state supervision and support will likely be viewed by bondholders as the least attractive option. The absence of supervision and oversight leaves creditors at risk of the free fall that San Bernardino's bankruptcy illustrates. With no state intervention in the process, San Bernardino asserted a fiscal emergency, skipped the pre-filing neutral evaluation process, and landed in a Chapter 9 bankruptcy on August 1, 2012 with no preparation and no idea about how it was going to exit. Despite its efforts San Bernardino has not been able to obtain court approval of its disclosure statement after two attempts. Judge Jury has scheduled a hearing on San Bernardino's second amended disclosure statement in March 2016.[65]

Capital market creditors, for the most part, have demonstrated a greater willingness to negotiate as they have moved through Vallejo, Stockton, and Detroit. State oversight of the pre-filing process has the potential to produce better results for everyone involved, particularly when a state can offer financial support, professional services and advice. While the market's

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[65] *See generally, In re City of San Bernardino, California,* Case No. 12-28006 (Bankr. C.D.CA.).

reaction to emergency managers has been decidedly mixed, the expertise and organization an emergency manager can bring to a restructuring often outweighs the chaos of an unsupervised municipal restructuring.

Nevada's Approach: Better Oversight, Supervision, and Financial Support...and No Chapter 9

Indeed, while Nevada municipalities do not have access to Chapter 9, the state recently expanded its local government oversight and supervision, having recently passed Assembly Bill 54.[66] In addition to providing monitoring, Assembly Bill 54 has the potential to provide financial assistance in addition to escalating the state's ongoing involvement. One of the effects of Assembly Bill 54 has been to send a clear message to the capital markets of Nevada's willingness to actively address municipal distress.

Assembly Bill 54 provides for a "Fiscal Watch" and a tiered approach that allows the state to intervene earlier and upon the request of a troubled municipality. During Fiscal Watch, a local government can request assistance from the state regarding functions such as budget preparation, contract review, and debt management. The next tier is "Severe Financial Emergency Status." Once a local government is in Severe Financial Emergency, the state has the power to renegotiate, in good faith, existing collective bargaining agreements. This allows the local government to modify its labor cost structure before the existing agreements expire. After a Severe Financial Emergency is declared negotiations with creditors regarding any debt liquidation plan must be conducted in good faith. This provision encourages all parties to explore solutions to avoid protracted legal conflicts. During a Severe Financial Emergency, the state also has the ability to increase property taxes levied by the local government if revenue enhancement and expense mitigation are insufficient.

With the passage of Assembly Bill 54, the legislature elected not to pass a state Senate bill that would have allowed Nevada municipalities access to Chapter 9. Under the failed bill, a bankruptcy filing would have been available only after exhaustion of the Assembly Bill 54 process and the approval of the governor.

[66] *See, Chapter 161, Revises provisions relating to local governments existing in a severe financial emergency. (BDR 31-308)* Effective May 25, 2015.

Rather than providing access to bankruptcy, Nevada improved statutory oversight, supervision, and financial support for a financially troubled municipality. While it is too early to evaluate the statute, Nevada and its municipalities now have better tools to timely address municipal distress.

Puerto Rico and a "Super Chapter 9"

The debate about who gets to access Chapter 9 is far from over, as capital market creditors have harshly criticized the United State Treasury's proposal and many other proposals for a "Super Chapter 9" bankruptcy bill for Puerto Rico as dangerous for the broader municipal market. From the capital market perspective there is no legal basis for a bankruptcy process that could undermine the legal rights and remedies that were in place at the time the creditors agreed to provide capital. There is also a concern that if Puerto Rico has access to Chapter 9 for all of its municipal securities, it is a slippery slope for states like Illinois that are in significant financial trouble.

In December 2015, the Supreme Court granted cert to consider Puerto Rico's appeal of a lower court ruling that the commonwealth's local restructuring law is not allowable under federal bankruptcy law.[67] The Puerto Rico Public Debt Enforcement and Recovery Act (the "Act"), enacted in 2014 to allow the territory's utilities to restructure, was found to be illegal in July 2015 after a three-judge panel on the US Court of Appeals for the First Circuit in Boston held the law violated a section of federal bankruptcy law that prohibits states from passing laws that would allow their public entities to restructure without the approval of those entities' creditors. The decision upheld a prior ruling from the US District Court of Puerto Rico. At issue is Puerto Rico's assertion that just because public utilities cannot restructure their debts under federal law does not mean restructuring cannot take place under commonwealth law. This argument is flatly inconsistent with 11 U.S.C. Section 903(1)[68] of the Bankruptcy Code which expressly prohibits state laws from providing for the adjustment of municipal debts over the objection of non-consenting creditors. All three of the reviewing appeal court judges found federal law preempts the Act with Judge Juan Torruella noting in his concurring opinion that the appeals court

[67] *Puerto Rico v. Franklin California Tax-Free Trust,* 136 S. Ct. 582 (2015). and *Acosta-Febo v. Franklin California Tax-Free Trust*, 136 S. Ct. 582 (2015).
[68] 11 U.S.C.A. § 903(1).

"sends Puerto Ricans to Congress" to reverse the 1984 amendments to the bankruptcy code that prevent Puerto Rico's public authorities from seeking the protections of a Chapter 9 bankruptcy filing.[69]

As Puerto Rico and Illinois, among other municipalities, wrestle with the challenge of either making payments and avoiding default or paying for essential services, the conversation regarding access to Chapter 9 is going to continue as a lively debate for the foreseeable future.

Pension Obligations: Reform or Restructure and the Coming Conflict Between the Contracts Clause and the Police Power

This year, as briefly discussed above, the Illinois Supreme Court unanimously rejected legislative pension reform for state pension plans as unconstitutional, ruling that the 2013 legislation violated pension protections written into the state's Constitution. Illinois' Constitution provides that benefits promised as part of a pension system for public workers cannot be diminished or impaired.

With a pension shortfall estimated at $111 billion, Illinois has struggled to address its staggering $2 billion budget deficit for the coming fiscal year. Noting the state's financial circumstances, the Illinois Supreme Court held that dire fiscal challenges were not enough to modify pension benefits protected by the state's Constitution, stating:

> The financial challenges facing state and local governments in Illinois are well known and significant. In ruling as we have today, we do not mean to minimize the gravity of the state's problems or the magnitude of the difficulty facing our elected representatives. It is our obligation, however, just as it is theirs, to ensure that the law is followed. That is true at all times. It is especially important in times of crisis when, as this case demonstrates, even clear principles and long-standing precedent are threatened. Crisis is not an excuse to abandon the rule of law. It is a summons to defend it.[70]

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[69] *Franklin California Tax-Free Trust v. Puerto Rico*, 805 F.3d 322, 354 (1st Cir. 2015)..
[70] *In re Pension Reform Litigation,* 2015 IL 118585, 392 Ill. Dec. 1, 32 N.E.3d 1 (Ill. 2015). para. 87 at p. 35.

Or, maybe it is time to apply federal law.

Can this opinion be squared with the state's police powers to modify contractual obligations when it is necessary to protect the general public welfare? Not easily if you look at federal case law—but more easily if you limit the analysis to Illinois case law. According to the Illinois Supreme Court, the legislative history surrounding the 1970 Constitution shows that the drafters failed to specifically provide that the pension protections were to remain subject to the authority of the State to step in when public safety and welfare so required. The Court concluded that without an express reservation of police power authority, the State could not adjust constitutionally protected pension benefits through legislation.[71]

The Illinois Attorney General argued that this analysis is backwards. The applicable doctrine requires that if exercise of police power is to be limited, it must be done so in clear, unambiguous, and explicit language. The legislative history is silent on this matter, and under federal case law exercise of a state's police power cannot be so easily set aside. In fact, the US Supreme Court has consistently ruled that states cannot abdicate their inalienable governmental power to provide essential services.[72] This means that, at least on a federal level, a state's constitutional contract clause and the Contract Clause of the US Constitution do not prevent or preclude the state's exercise of police power.

One could describe the Illinois Supreme Court's ruling as a "Through the Looking Glass" view of Illinois law. The Court gave short shrift to federal case law and well-established US Supreme Court authority that establishes that no contract right, even a constitutionally protected right, is absolute. And, if a state needs to assert its police power to impair contracts to deliver essential services, at least under federal case law, a state has the option of presenting the evidence necessary to establish the appropriate use of police power.

What does this mean for Illinois' pension obligations? Nothing good. Two opinions later, when one considers the lower court and the Supreme Court,

[71] *See generally, In re Pension Reform Litigation, 2015 IL 118585, 392 Ill. Dec. 1, 32 N.E.3d 1 (Ill. 2015)*

[72] See 2015 WL 1378612 at 40-45.

Illinois' police powers are pretty much nullified with regard to pension reform. When the Illinois Attorney General elected not to seek review by the US Supreme Court, Illinois' options regarding pension reform are now limited to the governor's immediate call for a constitutional amendment to clarify the distinction between guarantees of benefits already earned and changes to future benefits. Referendums and initiatives involve difficult and protracted processes, as seen in California with its "Reed Initiatives" seeking to reform pension structures for non-retired workers.[73] A constitutional amendment may not be in California's or Illinois' immediate future, but it cannot hurt to start and continue the dialogue. Illinois now joins Oregon and Arizona as recent examples of high courts rejecting pension reform.[74]

Other states have upheld cutting benefits. Two states that come to mind are Colorado and Florida.[75] Whatever approach a state takes with regard to pension reform, state law will govern and state law can often be an impediment to restructuring escalating unfunded pensions and related retirement costs. When high courts reject reform, it is probably time to consider access to Chapter 9 to allow federal bankruptcy courts to apply the Bankruptcy Code and decide pension reform in the context of a plan of adjustment. That solution will have its own set of costs, not the least of which will be increased costs to access the capital markets.

Chapter 9: A Roadmap to a Complete Municipal Restructuring

While Stockton confirmed its plan in 2014, the Court did not issue its formal confirmation opinion until the spring of 2015. Noteworthy are the Court's comments on how pensions can be impaired in a Chapter 9 bankruptcy—at least in California, calling into question when and under what circumstances pensions should be restructured along with a municipal debtor's other obligations. The Court's opinion also highlights the need for a complete restructuring instead of a piecemeal approach.

Starting with the California Public Employees' Retirement System's (CalPERS) lack of standing the Court stated:

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[73] https://www.oag.ca.gov/system/files/initiatives/pdfs/15-0076%20%28Pension%20Reform%20V2%29_0.pdf and https://oag.ca.gov/system/files/initiatives/pdfs/15-0077%20(Pension%20Reform%20V3)_0.pdf.

[74] http://www.pensionlitigation.org/.

[75] http://www.pensionlitigation.org/.

> [I]t is doubtful that CalPERS even has standing to defend the City pensions from modification. CalPERS has bullied its way about in this case with an iron fist, insisting that it and the municipal pensions it services are inviolable. The bully may have an iron fist, but it also turns out to have a glass jaw.[76]

Colorful language to be sure, but critical for every municipality in California, and here is why. Next time we see a California Chapter 9 bankruptcy filing, pensions will be up for negotiation, just like every other creditor. No longer will cities be able to avoid dealing with pensions in California out of a fear of facing off with CalPERS and its massive bank account. The Stockton Court found that CalPERS, as a pension fund administrator, likely does not have standing to object to or intervene in a Chapter 9 bankruptcy case. This means that pensions are now on the restructuring table; and it also means that the conversation between a municipality and its creditors, employees, and retirees just got a whole lot more interesting.[77]

As a result of the Court's opinion, those cities facing no other option but bankruptcy are in a position to fully negotiate their obligations with all of their creditors and consider whether and what changes need to be made to their pension obligations. Cities now know that CalPERS cannot easily run interference and, as a result, cities can negotiate pension obligations directly with employees and retirees without objections from CalPERS. The bully with the glass jaw lost its seat at the table, to the extent it ever had one.

The Court also shot down CalPERS assertions regarding its "termination lien," finding that the Bankruptcy Code authorizes the avoidance of statutory liens that are not perfected or enforced at the time of the commencement of the case. Therefore, if a city needs to restructure its pension obligations and does so post-filing, CalPERS' termination lien becomes a "springing lien," which cannot be enforced. The key point for municipalities is that the lien can only be avoided if the termination of the CalPERS' agreements occurs *after* a bankruptcy filing.

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[76] *In re City of Stockton, California,* 526 B.R. 35,2 (Bankr. E.D. Cal. 2015)*, aff'd in part, dismissed in part,* 542 B.R. 261 (B.A.P. 9th Cir. 2015).

[77] The issue is ground zero in San Bernardino's bankruptcy case as the City current proposed to assume 100% of its pension obligations and return approximately 1% to bondholders.

Of course, no one wants to impair pensions or any other creditor in a municipal restructuring, and we all appreciate that Chapter 9 is not a panacea. It is a process to deal with the challenges of municipal restructuring. Nonetheless, where resources are scarce and there is no way through other than a restructuring in bankruptcy court, the Stockton opinion provides a handy roadmap of how to put pensions on the bargaining table, thus creating the opportunity for a more complete restructuring, assuming a city has the political will to tackle pensions and examine all of its significant liabilities, including pensions, and develop a plan that is truly feasible. This is good news for all creditors because essential parties to a restructuring conversation are now playing with a full deck. Before, pensions were off the table because of the fear of taking on CalPERS on top of all the other challenges being addressed.

It also means that employees and retirees can and should have a seat at California's pre-bankruptcy negotiating table under AB 506, which provides for neutral evaluation before a bankruptcy filing. As a result, a city considering bankruptcy now has a decent shot of negotiating with all of its critical creditors during the AB 506 process and maybe even a better shot at reaching consensual deals. Also, AB 506 is now more valuable, thanks to the Court's holding early on that creditors, along with the city, have an obligation to negotiate in good faith before filing.

Jefferson County: Chapter 9, Constitutional Taxing Authority, and Equitable Mootness

Surprising almost everyone involved in Jefferson County's bankruptcy, the Eleventh Circuit agreed to hear Jefferson County's (JeffCo) interlocutory appeal of US District Court Judge Sharon Blackburn's ruling refusing to dismiss one of three appeals filed by JeffCo's sewer system ratepayers.

In September 2014, Judge Blackburn ruled that while JeffCo's Chapter 9 plan of adjustment had been confirmed and new sewer warrants issued to retire the outstanding debt, that the constitutionality of the plan provisions that ceded JeffCo's future authority to set sewer rates to the bankruptcy court could be reviewed and reconsidered post-confirmation. Setting off a legal firestorm, Judge Blackburn found the District Court could review a plan provision that gives the presiding bankruptcy court the authority to enforce sewer rate increases to pay off the $1.8 billion in sewer warrants issued under the confirmed plan for the next forty years. Notably, under Alabama law, only county commissioners can set sewer rates.

Judge Blackburn held, "Although this court agrees that some part or parts of the Confirmation Order may be impossible to reverse, the County's ceding of its future authority to set sewer rates to the bankruptcy court as a term of the New Sewer Warrants is not one of those parts."[78] Judge Blackburn's opinion created a market uproar because it called into question whether a plan that has been substantially consummated, meaning fully performed, could be attacked post performance jeopardizing the participating parties' interests. At issue is the concept of equitable mootness that has long protected parties from appeals of substantially consummated plans.

2015 was a year for arguments over equitable mootness, as noted above with regard to Detroit and Stockton and in several other appellate decisions. JeffCo's case is unique because it touches on constitutional issues bringing to a head whether and how far a confirmed bankruptcy plan can go in terms of changing or ignoring state law. In JeffCo's case, at issue is whether the right to determine sewer rates lies squarely with the purview of state law calling the confirmed plan's vesting of rate-setting authority with the bankruptcy court into question. Throughout 2015, the Eleventh Circuit has had Judge Blackburn's rather lengthy decision under review with little progress being made on the interlocutory appeal.[79]

The preliminary question is whether the alleged unconstitutional plan provision can be reviewed on appeal, leading to the pivotal question: is the appeal moot? For longer than anyone can remember, a bankruptcy plan, once confirmed and substantially consummated, is protected by the doctrine of equitable mootness. Absent the issuance of a stay pending appeal, appeals of confirmed plans are usually dismissed as moot if the plan has been substantially consummated. The mootness doctrine is important because it gives confirmed and consummated bankruptcy plans a finality designed to reinforce confidence that a confirmed plan will not be altered after the fact. The embedded policy is the parties' need to be able to rely on a confirmed plan.

JeffCo's bankruptcy case is complex. It is complex because the state sovereignty and bankruptcy policies at stake are of critical importance. Can parties to a Chapter 9 plan rely on a confirmed and substantially

[78] *Bennett v. Jefferson County,* Ala., 518 B.R. 613 (N.D. Ala. 2014).
[79] *See, Jefferson County, Alabama v. Andrew Bennett, et al.,* Case No. 14-90024, (11th Cir. 2014).

consummated plan? Can a plan with an alleged state constitutional violation that arguably invades a state ratemaking authority for forty years be denied appellate review because of equitable mootness? Where are the lines going to be drawn between the competing state sovereignty rate-setting interests and bankruptcy's interests in confirmed and consummated plans being protected from appeal by the doctrine of equitable mootness?

For states providing access to Chapter 9, and for municipalities contemplating a Chapter 9, the question in JeffCo of whether ratemaking authority can be assigned to a bankruptcy court is an important and precedent-setting question. There is scant authority on just how far the bankruptcy code can override state law in a Chapter 9 case. Rate setting is a particularly sensitive and complex area, as this power often is left to the states for state utilities, thereby making this a state sovereignty issue. Under applicable Alabama law, only county commissioners can set sewer rates. But, the JeffCo bankruptcy court found as part of the confirmation process that JeffCo's plan complied with existing state law. The analysis becomes even more complex when the fact that JeffCo consented to the transfer of rate-setting authority to the bankruptcy court for forty years is considered.

Investors who purchased the $1.8 billion in sewer warrants would very much like to see the Eleventh Circuit dismiss the appeal of the confirmation order as moot, thereby eliminating appellate review of a rate-setting provision that may be unconstitutional. The briefs are plentiful, arguing appellate review should be denied because of mootness. Arguing a need for post-confirmation certainty and predictability, investors want to know that they are going to receive the benefit of their bargain and that their payment stream is going to be under the control of the presiding bankruptcy court as promised.

One does not have to look hard to find the many Chapter 11 cases that have had to accept and cede to state ratemaking authority when it comes to utilities. As a general proposition, the provision is surprising because bankruptcy courts usually work hard to limit post-confirmation jurisdiction.

So what can we expect? We can expect to see the Eleventh Circuit decide whether Judge Blackburn got it right in terms of her ruling that she could consider the constitutional issue. But the larger questions are murkier. Can

the Bankruptcy Code really override state ratemaking authority? Or, did JeffCo's transfer of ratemaking authority to the bankruptcy court go too far in terms of a state's sovereign right to set rates?

What happens in the Eleventh Circuit could depend on how the Court peels this particular onion. The questions are interrelated because if the plan is equitably moot, the constitutional state rate-setting question will be given short shrift and not considered.

However, if the Court determines that Judge Blackburn can consider and review the constitutional question then the matter returns to Judge Blackburn, and each side has compelling arguments in their favor. Arguably, a constitutionally defective confirmed plan that violates state sovereignty should be unenforceable as a matter of law since the Bankruptcy Code requires that plans comply with state law. As a result, review of alleged unconstitutional plan provisions should not be foreclosed simply because part of the plan has been consummated. After all, there is a forty-year run off period. The impact of a decision not to permit review will adversely impact states and the municipalities they permit to access Chapter 9. A decision that denies review could likely lead to states reconsidering whether access to Chapter 9 is a good idea.

The rulings in JeffCo will become our future landmarks in terms of where Chapter 9 is headed and how useful it may ultimately be. If sovereign immunity is violated and appellate review prevented by the mootness doctrine, states will need to consider whether they want access to Chapter 9 for their municipalities at all. How this ends is anyone's guess. The only certainty is that the legal process likely will not end with the Eleventh Circuit.

Equitable Mootness in Franklin's Appeal of Stockton's Confirmation Order

No municipal update would be complete without noting the battle between Stockton and one of its most unhappy creditors, Franklin. Franklin appealed confirmation, asserting that the plan failed to treat Franklin's claim fairly and equitably, among other arguments. A primary tenet of the Bankruptcy Code is that any plan must treat similarly situated creditors fairly and must not discriminate either in treatment or in classification. Franklin asserted that Stockton's plan did both.

Stockton moved to dismiss Franklin's appeal to the Bankruptcy Appellate Panel for the Ninth Circuit (BAP), asserting it was equitably moot.[80] In December 2015, the BAP dismissed Franklin's appeal as equitably moot and affirmed the confirmation order's treatment of Franklin's general unsecured claim under the plan. The Bankruptcy Appellate Panel was persuaded by the reasoning in *Darrah v. City of Detroit, Michigan*[81] finding that equitable mootness has a role to play in all bankruptcy cases, including Chapter 9. The Detroit Court specifically noted that the constitutional and political concerns that troubled Judge Blackburn in JeffCo, discussed above, were not present because Stockton's voters approved the sale tax increase necessary to fund Stockton's plan in advance of confirmation and those who voted for approval of the tax increase did so in reliance on the City's efforts to confirm the plan to safeguard delivery of future municipal services.[82] Applying the four-part test to determine equitable mootness in the Ninth Circuit, the BAP found that Franklin attempted to obtain a stay of the confirmation order and it was denied and the plan was substantially consummated.[83]

Taking Franklin at its word that it was seeking greater payment on its unsecured claim, the BAP found that a greater payment was theoretically possible and that the claim was not equitably moot.[84] After a lengthy analysis, the BAP ruled that (1) the bankruptcy court did not err in finding that the plan was filed in good faith; (2) the City's classification scheme met the requirements of the bankruptcy code; and (3) the plan met the best interest of creditors' test. In short, the bankruptcy court's findings of fact and rulings of law were affirmed creating initial precedent for Chapter 9 cases on these legal issues.

The Wrap Up: Municipal Trends

Predictions in the municipal space are not worth the paper they are written on. Legal precedent is being developed in the pending cases such as San

[80] *In re City of Stockton, California,* 542 B.R. 261 (B.A.P. 9th Cir. 2015).
[81] *In re City of Detroit, Michigan*, 2015 WL 5697779 (E.D. Mich. S.D. Sept. 29, 2015).
[82] *In re City of Stockton, California,* 542 B.R. 261 (B.A.P. 9th Cir. 2015).
[83] *In re City of Stockton, California,* 542 B.R. 261 (B.A.P. 9th Cir. 2015). The four factor test requires (1) seeking a stay; (2) substantial consummation of the plan; (3) whether relief sought would bear unduly on innocent third parties; and (4) whether the bankruptcy court could fashion equitable relief without completely undoing the plan. *In re Thorpe Insulation Co.,* 677 F.3d 869,881 (9th Cir. 2012).
[84] *In re City of Stockton, California,* 542 B.R. 261 (B.A.P. 9th Cir. 2015).

Bernardino, JeffCo and Puerto Rico as this chapter goes to press. Municipal cases are complicated and bring with them the challenges of being unable to increase revenues, existing and competing constitutional obligations to deliver an acceptable level of services, and pay creditors, employees and retirees, including funding pensions. Local, state and federal law is in conflict in terms of when and how the police power can be exercised to the detriment of creditors, employees, and retirees so necessary services can be delivered to residents. When can pension be impaired in order to deliver essential services? This conflict is ripe for further consideration.

For those representing parties in Chapter 9 cases, it is important to consider the benefits of negotiated resolutions and mediated settlements whenever possible. Because of political, financial and legal impediments, bankruptcy may not be avoided in all cases. When representing creditors that are not employees or retirees, it is important to carefully consider the risk of objecting to the debtor's proposed claim treatment in light of whether and what improvement in terms of distributable value can actually be achieved. A bankruptcy court will always weigh the municipal debtor's ability to continue to deliver services against the treatment of its creditors with a focus on employees and retirees. Creditors can and should expect that the Chapter 9 process is worlds away from the Chapter 11 process.

Conclusion

Indications are that the insolvency world, and insolvency practitioners, will be getting busier in the coming years. Many of the new cases will continue to involve quick sales under Section 363[85] and professionals should keep up to date on the courts' treatments of Section 363 sales, especially at the outset of the cases. Especially in recognition of the concerns raised by the Commission, courts may be inclined to push back on requests for expedited sales.

Energy prices in 2016 are not expected to recover in any material way, and high value hedges will continue to roll-off each month. Consequently, borrowing base availability under credit facilities for E&P companies is expected to decline in April and October of 2016, further reducing cash-strapped operators' ability to meet ongoing obligations. Further, financially sound E&P companies have already announced significant decreases in

[85] 11 U.S.C.A. § 363.

capital expenditure budgets for 2016. As a result of all these pressures, we expect that E&P company bankruptcies and restructurings will accelerate in 2016. Additionally, oil field service companies will continue to fight for the decreasing work volume (at already reduced rates) resulting from capital expenditure cuts at the operator level, which will drive more bankruptcies and restructurings in their market segment.

M&A activity in the E&P space is expected to increase in 2016. Buyer and seller price expectations are likely to converge in the wake of the April 2016 borrowing base redeterminations as E&P companies recognize that they need to sell assets at realistic prices to meet ongoing cash demands. This forced realism will provide financially sound O&G companies the opportunity to acquire future development properties, and investors their long-awaited opportunity to acquire oil and gas assets at what they deem to be reasonable prices. E&P company bankruptcies will also provide investors the chance to acquire oil and gas assets through the Section 363[86] sale process. All in all, oil and gas asset sales in 2016 should be very significant with some parties expressing concern that too much property for sale could drive asset prices below even market expectations. The O&G market was full of surprises in 2015, and 2016 is sure to bring twists and turns of its own.

As for the municipal space, pensions will continue to put pressure on even well run municipalities. Much uncertainty remains regarding enforceability of statutory and other liens, standing for pension fund administrators and how pension liability should be estimated in a Chapter 9 filing. Bondholders and their insurers can be expected to continue their efforts to reverse the unprecedented determinations in Detroit, Stockton and likely San Bernardino to allow pension holders to receive better treatment than bondholders. In short, the law for municipal bankruptcy is far from settled providing good reasons for parties to attempt to resolve these matters outside of bankruptcy whenever possible.

Key Takeaways

- Sales under Section 363 can be a cost-effective way to generate recoveries for creditors. These sales are generally quick, and do not require the cumbersome, and expensive, procedure attendant with

[86] 11 U.S.C.A. § 363.

confirmation of a plan of reorganization or liquidation. However, the expedited nature of a 363 sale raises a number of concerns. Are creditors' interests protected by a 363 sale? Is value lost through an expedited sale?

- Be aware that if you are seeking bankruptcy court jurisdiction you should obtain, where possible, express statements from your adversary consenting to the jurisdiction of the bankruptcy court. Contrarily, a party objecting to bankruptcy court jurisdiction should, as early as possible, state the objection and repeat the objection where appropriate.
- Keep in mind that counsel to parties who are seeking to follow the *LCI Holding* roadmap must ensure that the documents clearly establish that the payments are not coming from the estate but are instead coming from the purchaser or plan proponent. This will allow their clients to be paid in advance of either similarly situated, or even senior, creditors.
- Advise clients that Chapter 11 provides an attractive opportunity for companies located in other countries to seek to reorganize their businesses. The threshold necessary to demonstrate that there are sufficient connections for US bankruptcy courts to exercise their jurisdiction is very low.
- Note that the Kopacz Report provides any city looking to restructure with the essential questions that must be addressed to determine the feasibility of any plan. This is the first time that the elements of municipal feasibility have been defined and the first time a court has adopted a clear and unequivocal test for municipal feasibility.
- Inform clients that whatever approach a state takes with regard to pension reform, state law will govern, and in many states can be expected to have an impact on options available to address municipal distress caused by escalating pensions and related retirement costs.
- Chapter 9 precedent now exists to help municipalities that have access to Chapter 9 to negotiate and propose complete restructurings that allow them to deliver essential services and address all of their liabilities, including bondholders, general creditors, employees, retirees and pensions. Detroit provides a road map for feasibility and Stockton provides a road map, at least for California municipalities, on pension restructuring, and in more

general terms, good faith filing, claim classification and the best interest of creditors' test.

- Equitable mootness remains an open question for JeffCo along with how far can a bankruptcy plan go in terms of invading state law. The constitutional and state sovereignty issues in JeffCo are complex and their resolution by the Eleventh Circuit important in terms of developing Chapter 9 precedent.

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As municipalities have become fiscally distressed, Ms. Denniston's practice has expanded to include working with clients to implement transactional solutions focusing on the use of economic development, private to public structures and other financing structures as part of

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