ROCHESTER BUSINESS JOURNAL
RBJ
VOLUME 32, NUMBER 16 WWW.RBJDAILY.COM JULY 22, 2016

Two recent decisions change bankruptcy landscape

VIEWPOINT
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This year, two recent decisions of the U.S. Supreme Court have affected core bankruptcy law principles and shaped the rights of debtors and creditors in bankruptcy. Additionally, the Supreme Court is scheduled to hear an appeal on another key bankruptcy topic that will certainly affect debtors and creditors alike. This article reviews the important bankruptcy issues implicated by these Supreme Court decisions and analyzes the effect of each decision.

■ Chapter 9 bankruptcy relief and Puerto Rico

Chapter 9 bankruptcy relief is available solely to municipalities. The Bankruptcy Code defines "municipality" as a "political subdivision or public agency or instrumentality of a State." For most states, this includes all cities and towns, villages, counties, taxing districts, municipal utilities, school districts, bridge and highway authorities, and gas authorities.

Chapter 9 generally adopts many provisions from other chapters of the Bankruptcy Code, including application of the automatic stay preventing most collection actions against the municipality, the ability to reject burdensome executory contracts, cramdown of dissenting classes of creditors, priority treatment for those providing bankruptcy financing to the municipality, and discharge of debts.

While the municipality enjoys the benefits of Chapter 9 bankruptcy, the filing provides a major distraction to elected officials and government personnel who must deal with the administration of the bankruptcy case. A Chapter 9 bankruptcy filing also damages the municipality's financial ratings, making future financing expensive and difficult to obtain.

Unlike other chapters of the Bankruptcy Code, the requirements to be a debtor under Chapter 9 are stringent. First, the municipality must be authorized by state law to file for bankruptcy relief. Second, the municipality must be insolvent as defined by the Bankruptcy Code. Third, the municipality must demonstrate a desire to effect a plan to adjust its debts. Finally, the municipality must either obtain the consent of a majority of its creditors or satisfy certain other technical requirements regarding negotiations with creditors.

Embroiled in a deep financial crisis in 2014, the Commonwealth of Puerto Rico enacted its own municipal bankruptcy law, the Puerto Rico Public Corporation Debt Enforcement and Recovery Act. The objective of the act was to permit Puerto Rico's public utility corporations to restructure their climbing debt, which had reached roughly $20 billion.

A group of investment funds and utility bondholders sought to challenge the act in federal court. After the District Court prevented the act's enforcement, and the U.S. Court of Appeals for the First Circuit affirmed, the issue went before the Supreme Court. The Supreme Court held that the act was in violation of Section 903(1) of the Bankruptcy Code, which prohibits states from enacting their own municipal bankruptcy laws.

In *Puerto Rico v. Franklin California Tax-Free Trust*, the Supreme Court held that the definition of "state" under the Bankruptcy Code expressly excludes Puerto Rico and the District of Columbia for purposes of determining who may be a debtor under Chapter 9. However, Chapter 9 does prevent Puerto Rico from enacting state bankruptcy laws that enable insolvent municipalities to restructure their debts over the objections of creditors. Further, the Supreme Court held that the Bankruptcy Code prohibits Puerto Rico from authorizing its municipalities to file for Chapter 9 bankruptcy relief. As such, the act is preempted by the Bankruptcy Code because it is a state-created bankruptcy scheme.

The *Puerto Rico* decision demonstrates the giant hurdles a municipality faces when trying to get in the Chapter 9 bankruptcy door. By contrast, the city of Detroit was able to convince the bankruptcy court that it was eligible for Chapter 9 bankruptcy relief. When Detroit sought to file for bankruptcy relief, however, its eligibility was hotly contested by its creditors.

■ Exceptions to a bankruptcy discharge and "actual fraud"

The "grand prize" for debtors in bankruptcy is generally a discharge of their debts. The Bankruptcy Code, however, provides that certain debts are non-dischargeable. One such exception to discharge is for debts obtained by "false pretenses, a false representation, or actual fraud." A split among U.S. Circuit Courts erupted regarding whether a finding that a debt was obtained by "actual fraud" requires a false representation or whether its scope covers traditional forms of fraud that are typically achieved without a false representation, such as a fraudulent transfer of property made with the intent to hinder creditors.

A claim for common law fraudulent transfer does not require a third party to show that a false statement was made by the transferor. Rather, a fraudulent transfer claim could arise by a transfer of property made to an insider or relative of the transferor where the transferor intends to hide or shelter the property from the transferor's creditors.

In *Husky International Electronics Inc. v. Ritz*, a supplier of electronic device components brought an adversary proceeding against a debtor under Chapter 7 of the Bankruptcy Code to, among other things, exclude from discharge a corporate debt incurred when the debtor had control over the company that purchased the components from the creditor. The Supreme Court held that the term "actual fraud," for purposes of the non-dischargeability provisions of the Bankruptcy Code, does not require a false representation.

The court conducted a historical analysis of bankruptcy law to determine that the term "fraud" has been typically used in the bankruptcy context to include transfers made with actual intent to evade creditors, such as the transfers in the above case. The court further held that anything that constitutes fraud and is executed with a wrongful intent is "actual fraud." The court restricted, however, the boundaries of its decision by distinguishing actions made with "actual fraud" from those made with "implied fraud," i.e., without the imputation of bad faith or immorality.

The *Husky* decision provides creditors with additional tools to combat a debtor's discharge of a debt where one of the forms of traditional fraud is present. As objections to discharge are typically subject to deadlines imposed by the Federal Rules of Bankruptcy Procedure or court order, practitioners should be wary of such deadlines.

■ Structured dismissals in Chapter 11 cases

When a debtor sells off all or substantially all of its assets in a Chapter 11 case pursuant to Section 363(b) of the Bankruptcy Code, the debtor will typically seek confirmation of a liquidating plan to wind down any remaining business affairs of the debtor.

However, this can be a costly process and can result in reduced creditor recoveries. Even in situations where the Chapter 11 case is converted to a Chapter 7 case, the time and expense in liquidating the remaining assets of the debtor can frustrate the recoveries of creditors.

As a result, debtors have increasingly avoided liquidating plans in favor of structured dismissals. A "structured dismissal" is an agreement among the stakeholders regarding the procedures for winding down and liquidating the unencumbered assets of the debtor outside of bankruptcy.

While a structured dismissal is not expressly sanctioned by the Bankruptcy Code, a bankruptcy case may be dismissed if such dismissal is in the best interest of creditors. Recently, debtors have been using structured dismissals to avoid the Bankruptcy Code's order of priorities for distributions among creditors.

In *Official Committee of Unsecured Creditors v. CIT Group/Business Credit Inc. (In re Jevic Holding Corp.)*, the U.S. Court of Appeals for the Third Circuit addressed the issue of whether a structured dismissal that deviates from the Bankruptcy Code priority scheme can nonetheless be approved by a bankruptcy court.

The Third Circuit ultimately held that a bankruptcy court can approve a structured dismissal so long as there is no evidence that it was manufactured to evade the procedural safeguards of the Bankruptcy Code. Following this decision, there is a clear split of authority on this issue. The Second Circuit ruled similarly to the Third Circuit, but the Fifth Circuit barred such dismissals holding that they must be subject to a "fair and reasonable" standard.

Recently, the Supreme Court granted certiorari to decide an appeal of the *Jevic Holding* decision. The Supreme Court's decision is likely to be issued in the fourth quarter of 2016 or first quarter of 2017. If the Supreme Court affirms *Jevic Holding*, debtors will be provided with an additional wind-down option following a Section 363 sale.

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