Hot Topics in Bankruptcy

Hon. Martin R. Barash, Moderator
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Hot Topics in Bankruptcy
ABI Bankruptcy Battleground West
Friday, March 11, 2016

- For-Profit Education
  Presented by: Amir Agam, Senior Managing Director, FTI Consulting
- In re ICL Holding Company, Inc. – "Gifting" Around the Bankruptcy Code
  Presented by: Hon Martin R. Barash
- Entertainment Bankruptcies
  Presented by: Jennifer L. Nassiri, Partner, Venable L.L.P.
- Recent Developments in Chapter 9
  Presented by: Paul Glassman, Shareholder, Stradling, Attorneys at Law
- *Moderated by: Victor A. Sahn, Partner, Sulmeyer Kupetz*

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Hot Topics in Bankruptcy
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Presented by: Amir Agam, Senior Managing Director, FTI Consulting

For-Profit Education: Sector Overview & Trends
Key Takeaways

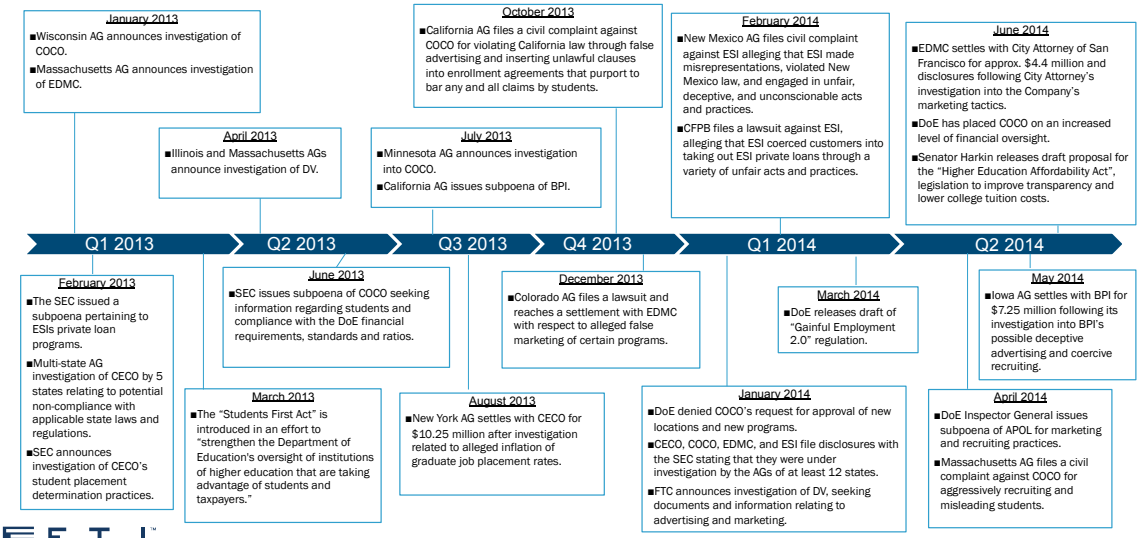
- The federal government is a key player in this industry
  - Approves mergers or sales of entities
  - Approves new programs and locations
  - Provides and can interrupt federal student loan funding (also is the owner of loans and takes losses on forgiveness)
  - Regulatory / investigative powers
  - Multiple federal agencies, as well as state attorney generals, are currently focused on this industry
  - It may be difficult to assess the scope of potential regulatory issues without insider knowledge
- The industry has received negative publicity due to its reliance on taxpayer supported student loans and the perception of poor student outcomes. Regulators and politicians have increasingly been taking aggressive actions.
- Pressures facing the industry have resulted in decreasing enrollment, revenue, and valuations.
- National student debt is approximately $1.2 trillion and total number of student loan defaults is approximately 7 million. For-profit college students represent approximately $372 billion of debt and 3.5 million of all student loan defaults.
- The industry has a number of unique characteristics which affect restructurings
  - Inability to utilize bankruptcy protection and maintain operations as a going concern
  - Cannot sell operations post-filing and revive student loan eligibility
  - Cannot sell operations without regulatory approval
- Liquidations in this industry also contain unique challenges related to the needs of the student population, managing the employee population, retaining information and safeguarding PII, and cooperating with regulators and accreditors.

For-Profit Education: Sector Overview & Trends
Key Regulatory Issues

- 90 / 10 Rule
- Composite Score
- Gainful Employment Rule
- Ownership Changes (result in termination of federal student loans, entity must re-apply)
  - Adopt a default prevention plan approved by the DoE and implemented successfully for at least 2 years.
  - Provide two years of audited financial statements, pursuant GAAP standards.
  - May also lead to Letter of Credit requirements.

For-Profit Education: Sector Overview & Trends
Regulatory Environment

- The industry has received negative publicity due to its reliance on taxpayer supported student loans and the perception of poor student outcomes. Regulators and politicians have increasingly been taking aggressive actions.
- For-profit institutions are subject to regulations from three distinct groups: accreditation agencies, state regulators (including state attorney generals, "AGs"), and the Department of Education ("DoE"). Government agencies such as the Consumer Financial Protection Bureau (the "CFPB"), the U.S. Securities and Exchange Commission (the "SEC"), and Federal Trade Commission (the "FTC") have also been involved in investigating the sector.
- The timeline below outlines significant regulatory and investigative events since 2013.



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Source: Company filings; Republic Report.
Note: APOL: Apollo Education Group; BPI: Bridgepoint Education; CPLA: Capella Education; CECO: Career Education; COCO: Corinthian Colleges; DV: DeVry Education Group; EDMC: Education Management Corporation; LOPE: Grand Canyon Education; ESI: ITT Educational Services; LINC: Lincoln Educational Services; STRA: Strayer Education; UTI: Universal Technical Institute.

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For-Profit Education: Sector Overview & Trends
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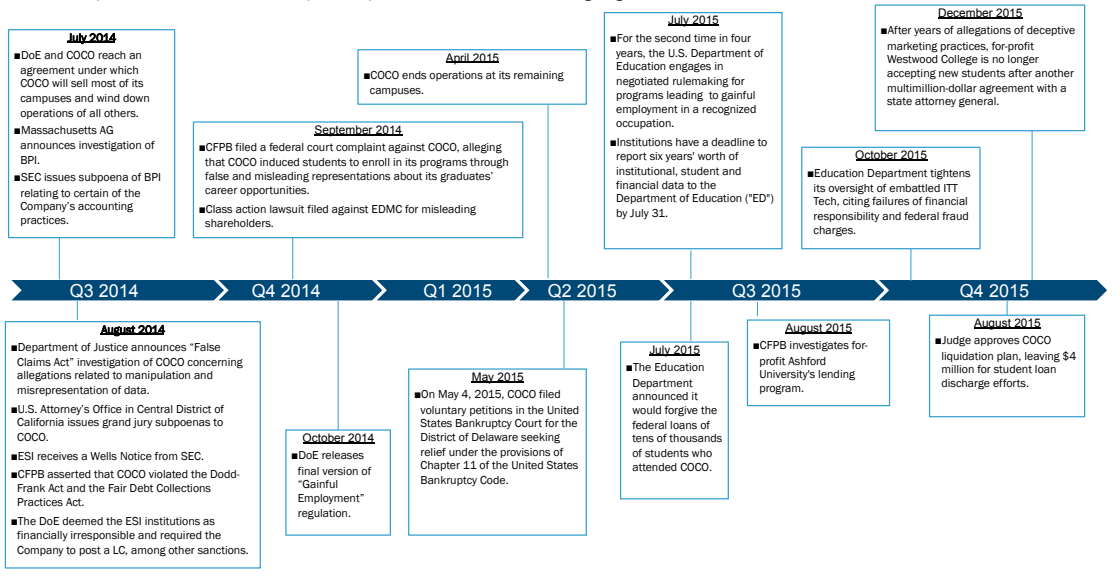

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For-Profit Education: Sector Overview & Trends
Gainful Employment 2.0

- To address a growing concern over burdensome student debt, on October 30, 2014, the DoE released the final version of Gainful Employment 2.0 legislation ("GE 2.0"), amending the unofficial draft of GE 2.0, released on March 15, 2014.
  - The regulation became effective on July 1, 2015.

Overview

- Pursuant to the final GE 2.0 regulation, the DoE will assess school programs solely on debt-to-earning rate ("DTE"). Programs would have to pass DTE test to remain fully eligible for Title IV funding.
  - Pursuant to the DTE test, graduates' annual loan payments cannot exceed 12% of their annual earnings or 30% of their discretionary earnings.
  - The DoE made a key change to the proposed GE 2.0 by removing program cohort default rate ("pCDR"), or the percentage of defaults on federal student loans, as an accountability metric.

Impact

- Available data indicates that the majority of programs will pass GE 2.0 threshold, but about 1,400 will not.
  - The DoE estimates that approximately 840,000 students are enrolled in programs that will not pass, 99% of which are for-profit programs.
  - The elimination of the default measure is expected to spare 500 programs.

Reaction

- For-profit institution lobbyists and student advocacy groups are unsatisfied with the final regulation.
  - Student and consumer advocacy groups argue that the final GE 2.0 regulation does not address dropouts, as institutions with high dropout rates could still pass the rule.

Gainful Employment 2.0 Final Regulation Eligibility Requirements
Debt-to-Earnings Rate
Students
Completers Only (Excludes Dropouts)
Categories & Thresholds
Pass
Annual Debt/Earnings ≤8%, OR Annual Debt/Discretionary Earnings ≤ 20%
Zone
Annual Debt/Earnings 8% ≤ 12%, OR Annual Debt/Discretionary Earnings 20% ≤ 30%
Fail
Annual Debt/Earnings >12%, AND Annual Debt/Discretionary Earnings >30%
Threshold During Transition Period
If the program DTE "fails" or is "in the zone" for any year during the transition period, the DTE rate for that year will be calculated using the most current debt and earnings of graduates, to the extent the current DTE rate is lower. Transition Period: ≤ 1 Year Program = 5 Years 1 - 2 Year Program = 6 Years > 2 Year Program = 7 Years
Ineligibility
A program becomes ineligible for Title IV funding for 3 years if: 1 - It "fails" in any 2 out of 3 consecutive years, OR 2- Remains in "the zone" or "fails" for four consecutive years
Disclosures
Institutions will be required to make public disclosures regarding the performance and the outcomes of programs.

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Source: The U.S. Department of Education

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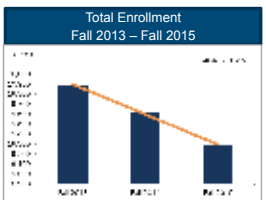
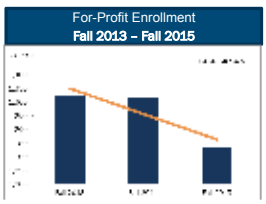
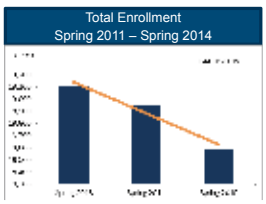
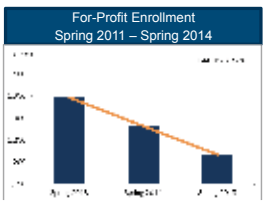
For-Profit Education: Sector Overview & Trends
Performance Trends

- According to the DoE, post-secondary education enrollment has decreased by 1.7%, while for-profit school student enrollment decreased by 14% since 2013.
- Various issues can explain the decline, including:
  - Increasingly competitive online market.
    - While for-profit schools have the highest portion of their students online, over the last several years, traditional schools have expanded into online education.
      - Pursuant to Babson Survey Research Group, 62.4% of all post-secondary institutions offered fully-online degree programs in 2012, up from 34.5% in 2002.
    - Massive Open Online Courses (MOOCs) (e.g. Udacity, Coursera, edX, Udemy) will continue to attempt to disintermediate established players.
  - Negative publicity due to headlines regarding public distressed situations and aggressive regulatory actions.
- In an effort to increase enrollment, for-profit schools implemented several initiatives, including:
  - Instituting new pricing structures and more scholarships to lower net tuition.
    - In doing so, institutions encroach upon the 90/10 Title IV funding cushion and reduce operating margins.
  - Focusing on efforts to increase retention (i.e., rates at which students remain enrolled) by:
    - Assessing whether students are ready for school via orientation programs;
    - Limiting use of third-party lead aggregators; and
    - Increasing number of full time faculty teaching students.









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Source: The U.S. Department of Education; Babson Survey Research Group; National Student Clearinghouse; research analyst reports.

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For-Profit Education: Sector Overview & Trends
Enrollment Trends of Select Companies

- The majority of public for-profit education companies' revenues have decreased due to declining enrollment and heightened regulations.

Company	Calendar Year Revenue ($ in millions) 2012	2013	2014	Trend	Company	Calendar Year Revenue ($ in millions) 2012	2013	2014	Trend
Apollo Education Group	$ 4,152	$ 3,474	$ 2,882		Education Management	$ 2,606	$ 2,408	NA	
% Change		*-16.3%*	*-17.1%*		*% Change*		*-7.6%*	*NA*	
Bridgepoint Education	$ 943	$ 751	$ 639		ITT Educational Services	$ 1,287	$ 1,072	$ 962	
% Change		*-20.4%*	*-15.0%*		*% Change*		*-16.7%*	*-10.3%*	
Career Education Corp	$ 1,491	$ 840	$ 741		Lincoln Educational Services	$ 397	$ 345	$ 326	
% Change		*-43.7%*	*-11.7%*		*% Change*		*-13.1%*	*-5.6%*	
Corinthian Colleges	$ 1,606	$ 1,508	NA		Grand Canyon Education	$ 511	$ 598	$ 691	
% Change		*-6.1%*	*NA*		*% Change*		*17.0%*	*15.5%*	
Capella Education	$ 422	$ 416	$ 422		Strayer Education	$ 562	$ 504	$ 446	
% Change		*-1.5%*	*1.5%*		*% Change*		*-10.4%*	*-11.4%*	
DeVry Education Group	$ 2,027	$ 1,926	$ 1,928		Universal Technical Institute	$ 406	$ 379	$ 377	
% Change		*-5.0%*	*0.1%*		*% Change*		*-6.6%*	*-0.5%*	

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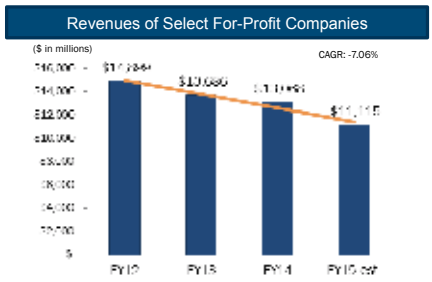
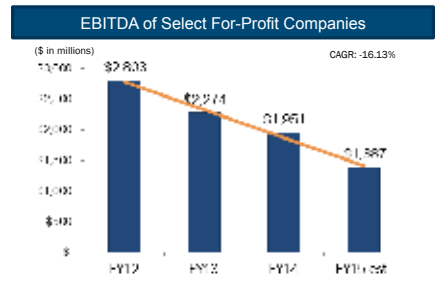
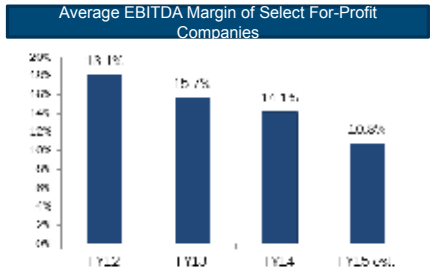
Source: Bank of America – 3Q15 education wrap

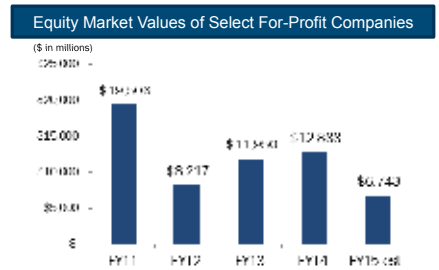
For-Profit Education: Sector Overview & Trends
Revenue, EBITDA, and Market Valuation Trends

- Deteriorating operating performance resulting from declining enrollment trends across the for-profit education sector has negatively impacted valuations.









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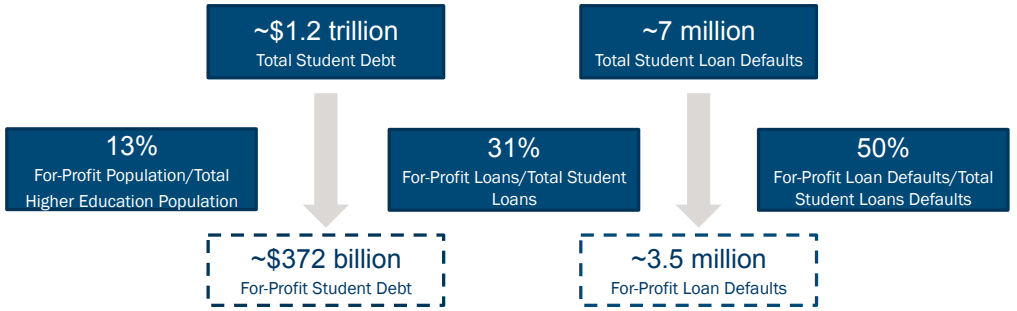
Source: S&P's Capital IQ
Comparable set includes: American Public Education, Apollo Education Group, Bridgepoint Education, Capella Education, Career Education, DeVry Education Group, Grand Canyon Education, ITT Educational Services, Lincoln Educational Services, National American University Holdings, Strayer Education, Universal Technical Institute.

For-Profit Education: Sector Overview & Trends
Student Debt Overview



- Students at for-profit colleges represent approximately 13% of the total higher education population, yet disproportionately represent 31% of all student loans and 50% of all student loan defaults. Given that national student debt is approximately $1.2 trillion and total number of student loan defaults is approximately 7 million, for-profit colleges students represent approximately $372 billion of debt and 3.5 million of all student loan defaults.
- The higher student loan defaults for for-profit colleges has a number of contributing factors.

Source: The U.S. Department of Education; 2012 U.S. Senate Health, Education, Labor, and Pensions Committee Report; The Economist.

For-Profit Education: Sector Overview & Trends
Unique Restructuring Issues

- Inability to Utilize Bankruptcy Protection and Maintain Operations as a Going Concern
  - Bankruptcy results in an immediate loss of eligibility of Title IV funds (immediate loss of revenue)
  - Historically, the DoE has not allowed formerly bankrupt institutions to regain eligibility for Title IV or to be transferred to other entities as going concerns
  - Bankruptcy may have implications for corporate officers
  - Severe implications for students, creditors, landlords, employees, and other stakeholders
- Going Concern Solutions May Require Extended Out of Court Restructuring
  - Negotiate capital infusion
  - Sale of institution / campus(es): This will require approval from regulatory authorities which can be time consuming and uncertain
  - Acquiring Company must also assume certain Title IV liabilities known and unknown. Perceived successor liability issues impact potential acquirers, regulators, and students
  - Acquisition requires existing OPEID or posting a LC which reduces the universe of potential investors.
- Other Potential Results
  - Teaching out campuses
  - "White Knight" takes over campus and teaches out

For-Profit Education: Sector Overview & Trends
Liquidation Issues

- If required to wind-down, a number of issues related to for profit educational institutions require special consideration

- Support for Students
  - Managing communication
  - Preserving ability to obtain transcripts / records / financial information
  - Information about transferring credits
  - Potential for student loan relief

- Employee Issues
  - Safety and security

- Information
  - Safeguarding of PII
  - Retention of key records

- Communication with regulatory agencies and accreditors

- Liquidation of equipment and teaching materials

- Potential for hazardous materials

HOT TOPICS IN BANKRUPTCY
ABI BANKRUPTCY BATTLE GROUND WEST
FRIDAY, MARCH 11, 2016

In re ICL Holding Company, Inc. – "Gifting" Around the Bankruptcy Code
Presented by: Hon. Martin R. Barash

Equity in Bankruptcy Distributions

- "Vertical Equity" – the absolute priority rule.
  - Junior creditors do not receive distributions until more senior creditors are paid or allocated value in full, or consent.
- "Horizontal Equity"
  - Creditors of the same priority (e.g., administrative, general unsecured) receive proportionally equal shares of estate property.

The Practice of "Gifting"

- A higher-priority lender (generally secured) pays a lower-priority creditor directly.
- Relatively common in Section 363 sales.
- Circuit court level decisions rare.

ICL Holding Company, Inc. et al.

- U.S Court of Appeals for the Third Circuit
  - Argued January 14, 2015
  - Opinion filed September 14, 2015
- Citations
  - 802 F.3d 547
  - 2015 U.S. App. LEXIS 16306
  - Bankr. L. Rep. (CCH) P82, 867
  - 61 Bankr. Ct. Dec. 155

ICL Holding Company, Inc. et al.

- Issues:
  - Whether payment by an asset purchaser of certain administrative claims through an escrow account while leaving other claims of the same priority unpaid violates the Bankruptcy Code.
  - Whether payment of unsecured creditors by the asset purchaser pursuant to a settlement agreement with the Unsecured Creditors Committee while leaving higher priority claims unpaid violates the Bankruptcy Code.

Factual and Procedural Background

- Debtor agrees to sell all assets to secured creditor group for credit bid.
- No cash is transferred from the purchaser to the debtor.
- Purchaser agrees to put its own money in escrow account to pay for administrative professional fees and wind-down costs.
- Debtor files chapter 11 petition, seeks permission to consummate the sale to the purchaser.

Objections to the Asset Sale

- U.S. Government objects to sale on the grounds that the transaction will result in a $24 million administrative tax claim which will go unpaid while administrative professionals are paid, thus violating horizontal equity rules.
- Committee objects that sale is a "veiled foreclosure" which will leave the estate so insolvent that even administrative claims will go unpaid.

Settlement of the Committee Objection

- Prior to the sale hearing, the Committee reaches a settlement with the purchaser.
  - The purchaser will pay $3.5 million directly to unsecured creditors.
  - The Committee will drop objection to sale.
  - The U.S. Government still gets nothing on its administrative tax claim.
- U.S. Government objects to the settlement as violating vertical equity principles.

Bankruptcy Court Approval

- The Bankruptcy Court approves the proposed payments because:
  - Payment of certain administrative fees, but not others of same priority, by purchaser does not violate the Bankruptcy Code because the funds are not estate property.
  - Payment of unsecured creditors by purchaser pursuant to settlement, when higher priority creditors receive nothing, does not violate Bankruptcy Code because the funds are not estate property.
- The U.S. Government appeals.

Third Circuit Considerations

- Is the appeal moot?
- Were the payments from the purchaser to the administrative professionals (per the Asset Purchase Agreement) and the unsecured creditors (per the purchaser's settlement with the Committee) property of the bankruptcy estate?

Mootness Arguments Rejected

- Constitutional mootness
  - Third Circuit holds this does not apply because the possibility of relief for the U.S. Government, however remote, exists.
- Statutory mootness
  - Third Circuit holds that Section 363(m) did not bar appellate review of *all* aspects of court-approved sales.
- Equitable mootness
  - Third Circuit holds that outside of the plan context, equitable mootness does not cutoff court's authority to consider appeal.

Settlement Funds Not Estate Property

- $3.5 million to unsecured creditors not "an increased bid," as U.S. Government contends, because the funds were neither paid into estate, nor paid at the direction of the debtor.
- Committee's reference to settlement funds as "proceeds derived from the sale" in its 9019 motion irrelevant, as settlement funds were clearly not estate property.

Escrowed Funds Not Estate Property

- Bankruptcy Code Section 541(a)(6): Proceeds from sale of estate property are deemed estate property.
- Escrowed funds referred to as "consideration" in Asset Purchase Agreement.
- Asset Purchase Agreement includes the sale of all of the debtor's cash.
- There are no "proceeds" from the sale because any residual cash goes to the purchaser.
- Because the estate had no interest in any proceeds from the sale, the cash in escrow funds cannot be deemed estate property.

Outcome

- Neither the escrowed funds for the administrative professionals nor the settlement funds paid to the unsecured creditors came from the estate.
- The Bankruptcy Code therefore does not apply to those funds and they may be distributed in a way which, had they been estate property, would violate the principals of vertical equity and horizontal equity established by the Bankruptcy Code.

Discussion – Potential Limitations

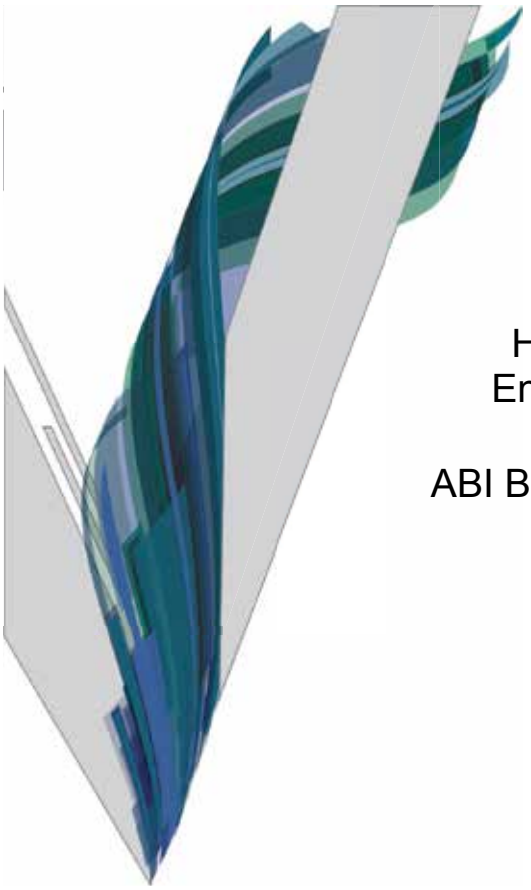
- Potential limitations on the holding
  - Secured creditor purchased all cash of debtor.
  - Credit bid ensured that no funds entered the debtor's estate.
  - Decision likely not applicable outside of Section 363 sales.

Discussion – Other "Gifting" Cases

- First Circuit: *In re SPM Manufacturing Corporation*, 984 F.2d 1305 (1st Cir. 1993)
  - Gifting allowed where secured creditor had obtained relief from stay over all property and transferred funds were not property of the estate.
- Second Circuit: *In re DBSD North America, Inc.*, 634 F.3d 73 (2d Cir. 2011)
  - Gifting not allowed through a chapter 11 plan.
- Third Circuit: *In re Armstrong World Industries, Inc.*, 432 F.3d 507 (3d Cir. 2005)
  - Gifting not allowed through a chapter 11 plan. Distinguished from *ICL Holding*, which did not involve plan or estate property.

Discussion – "Gifting" in the Future

- Observations for the future
  - Whether Committees and/or individual creditors file objections in the hopes of extracting payment on claims from non-estate funds.
  - Is the decision of the Court in *ICL Holding* an inappropriate work-around of the priorities established in the Bankruptcy Code?
  - Whether the Third Circuit's rationale will extend beyond the sale context.
  - Whether Bankruptcy Courts should approve sales under Section 363 of the Code where such a sale, if imbedded in a Plan under Section 1123(a)(5)(D), would not be confirmed because of its violation of the absolute priority rule.



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Hot Topics in Bankruptcy: Entertainment Bankruptcies

ABI Bankruptcy Battleground West

Friday, March 11, 2016

Jennifer L. Nassiri
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Current Issues in Cinema and Film: Guild Liens

- What is a Guild Lien?
  - Secures payment of residuals , requires reporting, and may include payments to health plans related to the guild for the benefit of guild or union members
  - Perfected by recording the Security Agreement with the United States Copyright Office and a UCC-1 in the jurisdiction related to the covered production
  - Security Agreement grants broad interests in collateral related to the production
- Guild Liens in Action
  - In re Relativity Fashion, LLC, et al., 15-11989-mew (Bankr. S.D.N.Y.)
  - Guilds assert priority over creditor seeking adequate protection
  - Guilds involved in the DIP financing and sale processes
- Practice Tip
  - Guild liens are often recorded early in production – be aware of priority
  - Check for recorded agreements in the applicable jurisdictions and the United States Copyright Office

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Current Issues in Art Galleries: Consignment & Inspection

- Consigned Artwork
  - In re Salander-O'Reilly Galleries, LLC, No. 14 CV 3544 (VB), 2014 WL 7389901 (S.D.N.Y. Nov. 25, 2014)
  - Bank obtained prepetition lien on "all personal . . . property of every kind an nature" owned by art gallery
  - Prepetition art owner consigned Madonna and Child, by Botticelli, to the gallery
  - District court, on appeal, reverse bankruptcy court determination that consigned artwork was collateral
- Inspection
  - Art and Architecture Books of the 21st Century, 2:13-bk-14135-RK, Doc. 1685 (Bankr. C.D. Cal. Jan. 27, 2016)
  - Creditors' committee sought an order compelling an art gallery-debtor to allow inspection of artwork to aid the committee in formulating a competing plan
  - The bankruptcy court ordered the debtor to allow the committee to inspect any artwork (i) owned by the debtor (consigned artwork was specifically excluded) and (ii) intended to fund the debtor's plan
- Practice Tip
  - Ensure that security agreements unambiguously describe collateral
  - Prepare for a thorough review of artwork owned by the debtor – either by a trustee or creditors' committee

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Current Issues in Intellectual Property: Trademark

- Limited § 365(n) for Trademark Licensees
  - In re Tempnology, LLC, 541 B.R. 1 (Bankr. D.N.H. 2015)
  - Prepetition co-marketing and distribution agreement contained exclusive distribution and trademark rights
  - Debtor rejected agreement and sought an order confirming that § 365(n) protections did not apply to the exclusive distribution rights or trademark
  - Bankruptcy court found that exclusive distribution rights are not "intellectual property" under § 365(n) and the Bankruptcy Code's definition of "intellectual property" in § 101(35A) excludes trademarks
  - The court rejected In re Crumbs Bake Shop, Inc., 522 B.R. 766 (Bankr. D.N.J. 2014) (expressing the minority view that bankruptcy courts may use their equitable power to decide, on a case-by-case basis, whether trademark licensees retain rights under § 365(n))
- Trademark Licensor's "Veto Powers"
  - In re Trump Entertainment Resorts, Inc., 526 B.R. 116 (Bankr. D. Del. 2015)
  - Trademark licensor sought relief from stay to terminate license agreement in state court
  - Bankruptcy court granted relief from stay after determining that trademark license could not be assumed and assigned under the "hypothetical test" because trademark licenses are non-assignable without consent
  - In jurisdictions applying the hypothetical test, a contract can only be assumed if it is assignable under nonbankruptcy law
- Practice Tip
  - Debtor-licensees must be aware of the likely treatment of their trademark license rights before filing a bankruptcy petition

VENABLE

Current Issues in Music: Sale of Digital Assets

- Streaming Services and Sale Issues
  - In re Rdio, Inc., 15-31430 (Bankr. N.D. Cal.)
  - Background
    - Rdio, Inc., a digital music streaming service, filed a chapter 11 petition on November 16, 2015
    - The debtor entered into an agreement to sell substantially all of its assets to Pandora Media, Inc., a competitor in the digital music space
  - Problem: Integrating Competing Technologies
    - Rdio's music library includes 35 million songs which are licensed differently than music held by Pandora
    - Rdio and Pandora platforms also offer different levels of consumer customization
  - Solution: Master Services Agreement
    - Pandora agreed to engage the services of Rdio employees under a Master Services Agreement comprised of discreet statements of work to aid in the technological integration
    - Master Services Agreement was approved by the bankruptcy court in connection with the sale
- Practice Tip
  - Integration of technology must be considered at the early stages of a proposed § 363 sale

VENABLE

Current Issues in Entertainment: Bankruptcy and the Disruptive Effects of Digital Services

- Digital Services as a Cause of Bankruptcy Filings
  - Failure to provide add a digital services component to an analog DVD distribution business model overarching reason for the bankruptcy filing in In re Filmed Entm't, Inc., 15-12244 (SCC) (Bankr. D.N.J.) (aka Colombia House)
  - In In re SFX Entertainment, Inc., 16-10238-MFW (Bankr. D. Del.), the debtor cited the acquisition of underperforming digital platforms and digital integration problems as causes of the bankruptcy filing
- The Uniform Fiduciary Access to Digital Assets Act
  - Uniform Law Commission approved the UFADAA which generally provides that fiduciaries, including trustees, will have access to digital assets to the same extent the trustee would have access to a tangible asset
  - UFADAA was introduced as legislation in 13 states as of February 1, 2016
- Impact of Privacy Policies on Asset Sales
  - Privacy policies contained on websites may trigger the appointment of a consumer privacy ombudsman to review a proposed sale of digital assets under 11 U.S.C. § 332
  - Ombudsman appointments can delay the sale process and, in certain larger cases such as In re RS Legacy Corporation fka RadioShack Corporation, et al., 15-10197 (BLS) (Bankr. D. Del.), can attract the attention of other agencies such as the Federal Trade Commission

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Current Issues in Entertainment: Summary

- Drafting Considerations
  - Be aware of potential Guild liens when engaged in financing related to movies – check local jurisdictions for UCC-1 filings and the United States Copyright Office
  - Draft security agreements carefully and ensure that artwork covered under the agreement is appropriate collateral
- Pre-Bankruptcy Planning
  - Review trademark licensing agreements and determine potential ability to assume and assign under applicable law
  - Prepare for close scrutiny of any artwork assets that form the basis of a plan
- Asset Sales in Bankruptcy
  - Establish mechanisms to address integration between digital platforms when selling digital assets
  - Ensure trademark licenses can be assumed and assigned in a sale under § 363(a) or pursuant to a chapter 11 plan
- Other Issues
  - Review website privacy policies to determine whether a consumer privacy ombudsman may affect a sale
  - Consider unique issues presented by digital asset sales including impact of upcoming legislation like UFADAA

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RECENT DEVELOPMENTS IN CHAPTER 9

Los Angeles, CA March 11, 2016

AMERICAN BANKRUPTCY INSTITUTE

Chapter 9 – Introduction

General Overview

- The essential law of municipal bankruptcies is found in chapter 9 of the Bankruptcy Code.
- The first municipal bankruptcy legislation was enacted in 1934 during the Great Depression, and has been amended several times (most significantly in 1978 with the enactment of the modern Bankruptcy Code).
- The evolution of chapter 9 has resulted in the filing of larger and more complex cases.

Chapter 9 – Introduction

General Overview

Municipal Debtor	Year	Reason for Filing
Orange County, Cal.	1994	Investment losses
City of Dessert Hot Springs, Cal.	2001	Judgment
Valley Health System	2007	Voter rejection of a referendum that would have led to a sale of the hospital
City of Vallejo, Cal.	2008	Financial distress, due to depletion of the general fund and large labor costs
Jefferson County, Ala.	2011	Extreme debt load, followed by state court decision striking a significant portion of general fund tax revenues
Town of Mammoth Lakes, Cal.	2012	Judgment
City of Stockton, Cal.	2012	Financial distress in part due to increasing pension costs and falling tax revenues
City of San Bernardino, Cal.	2012	Liquidity issues caused by, among other things, high labor and pension costs
City of Detroit, Mich.	2013	Severe financial distress, exacerbated by years of declining tax revenue and high pension costs

Chapter 9 – Introduction

General Overview

- The Tenth Amendment of the U.S. Constitution protects state sovereignty and places certain restrictions upon the powers of a bankruptcy court in chapter 9 cases.
- The reservation of state power is incorporated into the Bankruptcy Code in:
  - Section 903, which provides that chapter 9 may not "limit or impair the power of a State to control… a municipality… in the exercise of the political or governmental powers of such municipality." 11 U.S.C. § 903.
  - Section 904, which restricts the bankruptcy court from interfering with the political or governmental powers of the debtor or any property or revenues of the debtor – unless the debtor consents. *See* 11 U.S.C. § 904.

Chapter 9 – Introduction

General Overview

- Because of these differences from chapter 11, a chapter 9 debtor does not need to obtain bankruptcy court permission to take various actions such as: (i) selling assets and engaging in transactions outside the ordinary course; (ii) making certain borrowings (on an unsecured basis); and (iii) retaining and paying its professionals.
- Other distinctions include that chapter 9 creditors cannot file an involuntary, obtain appointment of an independent trustee, propose a competing plan in chapter 9 or force a municipal debtor to liquidate (although a chapter 9 case can be dismissed).
- Also unlike a chapter 7 or chapter 11 debtor, a chapter 9 debtor has the initial hurdle of establishing eligibility to be a debtor in a chapter 9 case – which is often a hotly contested matter.

Chapter 9 – Introduction

Confirmation Issues

- Although many of the same requirements for chapter 11 confirmation apply in chapter 9, such as the requirements that a plan be proposed in good faith, be feasible and be in the best interests of creditors, these tests are applied differently in chapter 9. *See* Section 943.
- For example, since there is no liquidation in chapter 9, the "best interests" test differs from the chapter 11 context, where the comparison is to recovery from a hypothetical chapter 7 liquidation.
- "Best interests" in chapter 9 requires that the plan must be better than other alternatives available to creditors – such as what creditors could reasonably expect to recover from an insolvent municipality had the bankruptcy case not been filed (or should it be dismissed).

Chapter 9 – Confirmation Issues

Recent Case Studies

Franklin High Yield Tax-Free Income Fund, et al. v. City of Stockton, California (In re City of Stockton, California), 542 B.R. 261 (B.A.P. 9th Cir. 2015)

- In the *Stockton* decision, the 9th Circuit BAP affirmed the Bankruptcy Court's confirmation of the City's chapter 9 plan of adjustment over the objection of two Franklin funds that had appealed the decision.
- In *Stockton*, all impaired classes had voted to accept the City's plan of adjustment – and all capital markets creditors, other than Franklin, had entered into settlements with the City, whereby each was separately classified.
- In contrast, Franklin's approximately $30 million unsecured deficiency claim had been classified with other general unsecured creditors, including over $500 million of impaired retiree healthcare claims.
- The general unsecured class was proposed to allow all unsecured creditors to participate in an approximate 1% distribution.

Chapter 9 – Confirmation Issues: Equitable Mootness

Recent Case Studies

In re City of Stockton, California (cont.)

- The City moved to dismiss Franklin's appeal of the confirmation order as "equitably moot" because the plan of adjustment had been substantially consummated.
- Franklin argued in response that equitable mootness was a chapter 11 concept that did not apply in the chapter 9 context, relying upon a recent decision in the *Jefferson County* case.
- In *Jefferson County*, *Bennett, et al. v. Jefferson County, Alabama*, 518 B.R. 613 (N.D. Ala. 2014), the District Court held that equitable mootness did not apply in chapter 9 cases, and that critical elements of the plan were subject to review and reversal because the appeal had raised serious state constitutional issues.
- In contrast, the District Court in *In re City of Detroit, Michigan*, 2015 U.S. Dist. LEXIS 131177 (E.D. Mich. Sept. 29, 2015) distinguished *Jefferson County* and found equitable mootness to apply in chapter 9, determining that the interests of finality and reliance required the application of the equitable mootness doctrine.

Chapter 9 – Confirmation Issues: Equitable Mootness

Recent Case Studies

In re City of Stockton, California (cont.)

- Distinguishing *Jefferson County* and relying, in part, on *Detroit*, the BAP found that equitable mootness applies in a chapter 9 case.
- Franklin argued that notwithstanding substantial consummation of the plan, it was seeking "only money" in the form of a greater recovery on its claim – and that such relief was available without completely upending the plan.
- The BAP concluded that the City's plan had been substantially consummated, reversing the plan would "have a potentially devastating impact on creditor constituencies" not appearing in the appeal and that, therefore, Franklin's appeal was generally equitably moot.
- Nevertheless, the BAP also noted that if Franklin truly sought only a greater payment on its unsecured claim, an effective remedy would be "theoretically possible". So, ultimately, the BAP considered the merits of Franklin's arguments.

Chapter 9 – Confirmation Issues: Good Faith

Recent Case Studies

In re City of Stockton, California (cont.)

- The BAP first considered Franklin's argument that the City's plan had not been proposed in good faith because its unsecured deficiency claim was placed in the general unsecured claims class, while pension benefit claims were not being altered.
- The BAP reiterated the Bankruptcy Court's finding that even pension creditors had been indirectly impaired under the plan by virtue of the reduction of employee compensation, employee positions and the reduction of pension benefits for new employees.
- The BAP also disagreed with Franklin's position that its deficiency claim should be separately classified like other capital markets creditors, noting that despite pre-petition negotiations and post-petition mediation, Franklin had been the only capital markets constituency that had refused to settle with the City.
- Franklin's argument that the City had improperly gerrymandered the general unsecured class to minimize Franklin's vote was also dismissed by the BAP which, as noted below, affirmed the Bankruptcy Court's determination that classification was proper.

Chapter 9 – Confirmation Issues: Classification

Recent Case Studies

In re City of Stockton, California (cont.)

- Franklin next argued, in respect of classification, that the inclusion of its unsecured deficiency claim in the general unsecured class was improper under Bankruptcy Code Section 1122(a), and that, like the other capital markets creditors, its claims should have been separately classified.
- The BAP affirmed the Bankruptcy Court's decision that separate classification of the other capital markets creditors was appropriate given that such creditors had their own legal rights, status and collateral – and had ultimately settled with the City.
- In addition, Franklin had argued that the retiree healthcare claims had been improperly separately classified from pension claims – even though such claims were substantially the same. The BAP found that the City's decision to separately classify such claims had legitimate business and economic substantiation.
- In addition, since all unsecured claims in the general unsecured claims class were to be treated the same as Franklin's unsecured claims, the BAP affirmed the Bankruptcy Court's approval of the separate classification of such claims – including Franklin's deficiency claims.

Chapter 9 – Confirmation Issues: Best Interests

Recent Case Studies

In re City of Stockton, California (cont.)

- Franklin also argued that the Bankruptcy Court had improperly applied the "best interests" test on a collective basis, rather than individually and in relation to Franklin's deficiency claim.
- In rejecting Franklin's position, the BAP held that, by its terms, the chapter 9 "best interests" test required a collective outlook – rather than an individual view as in a chapter 11 case.
- The BAP further found that the "best interest" test in chapter 9 required that a proposed plan "provide a better alternative for creditors than what they already have" – looking to whether the plan would provide a better alternative for creditors as a whole than dismissal of the case.

Chapter 9 – Confirmation Issues: Best Interests

Recent Case Studies

In re City of Stockton, California (cont.)

- The bankruptcy court in *Detroit*, in the context of its confirmation opinion, had similarly described the best interests test as a collective, rather than an individual, test. *See In re City of Detroit, Michigan*, 524 B.R. 147, 213 (Bankr. E.D. Mich. 2014).
- The BAP affirmed the Bankruptcy Court's finding that the City's plan had been the "best that could be done" under the circumstances in terms of restructuring and adjustment of the debts of the City.
- Finding no clear error in the Bankruptcy Court's determination that creditors' collective treatment was fair under the plan, and separately noting the fairness of Franklin's individual treatment, the BAP affirmed the Bankruptcy Court's finding that the plan had met the "best interests" test for confirmation.