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BANKRUPTCY & RESTRUCTURING UPDATE

Squire, Sanders & Dempsey L.L.P.

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Welcome Note

– Stephen D. Lerner, Chair, Bankruptcy & Restructuring Practice, Cincinnati and New York

As chair of Squire, Sanders & Dempsey L.L.P.'s global bankruptcy and restructuring practice, I am pleased to introduce the Winter 2008/2009 *Bankruptcy & Restructuring Update.* I trust that you – our clients, colleagues and friends – will find the *Update* interesting and useful. The topics addressed in the articles and case summaries, together with the recent engagements noted, are representative of our bankruptcy and restructuring group's broad and deep experience across four continents. We take great pride in our ability to draw on the experience and talent of restructuring lawyers in the Americas, Europe and Asia – regularly working collaboratively with lawyers in other practice areas – to assist our clients. In this regard, we are pleased to include in this *Update* articles authored by both co-chairs of our International Insolvency Group, Thomas J. Salerno (Phoenix) and Andrew O. Visintin (London).

This *Update* comes at a time of serious turmoil in the financial markets. As these conditions adversely impact other areas of world economies, Squire Sanders' bankruptcy and restructuring group stands ready, as zealous advocates and trusted advisers, to assist our clients as they address the many challenges and opportunities in this extraordinary environment. Related directly to the rapid developments in the financial markets, I take this opportunity to remind you that Squire Sanders, together with its affiliate Squire Sanders Public Advocacy, LLC, has formed a multidisciplinary Financial Crisis Response Team to assist our clients. This team includes members of the following practice groups: financial services (United States, Europe and Asia), government relations and public advocacy, bankruptcy and restructuring (United States and Europe), real estate (United States, Europe and Asia), litigation, and tax and benefits. Further information about our Financial Crisis Response Team can be found here.

Again, on behalf of Squire Sanders' bankruptcy and restructuring group, I welcome you to this *Update* and look forward to our group's continued service to you.

ARTICLES

Delaware Bankruptcy Court Clarifies Priority of Claims for Violations of WARN Act

– *Tim J. Robinson, Columbus*

In an opinion issued October 10, 2008 in the Chapter 11 case of *In re Powermate Holding Corp.,* Judge Kevin Gross of the US Bankruptcy Court for the District of Delaware provided much-anticipated clarity to the question of whether claims brought by former employees of bankrupt companies on account of their employers' violations of the federal Worker Adjustment and Retraining Notification Act (the WARN Act) are entitled to priority in payment as administrative expenses of the employers' bankruptcy estates.

Among the less-noticed provisions added to BAPCPA is a provision that, from all outward appearances, intended to resolve any doubt that claims arising under the WARN Act are administrative claims.

Among the less-noticed provisions added to the Bankruptcy Code in the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) is Section 503(b)(1)(A)(ii), a provision that, from all outward appearances, intended to resolve any doubt that claims arising under the WARN Act are administrative claims. Beginning with the spate of airline bankruptcies in the spring of 2008 resulting in abrupt cessation of flights and large-scale reductions in force and continuing through the most recent two quarters with bankruptcy filings by, among others, Bill Heard Chevrolet, Archway and numerous other large companies, several putative class action lawsuits asserting WARN Act claims as administrative claims under Section 503(b)(1)(A)(ii) of the Bankruptcy Code have been filed.

I. The BAPCPA amendments to Section 503

Section 503(b)(1)(A)(ii) of the Bankruptcy Code now reads as follows:

> (b) After notice and a hearing, there shall be allowed administrative expenses, other than claims allowed under section 502 (f) of this title, including –
>
> (1) (A) the actual, necessary costs and expenses of preserving the estate including –
>
> * * * * *

(ii) wages and benefits awarded pursuant to a judicial proceeding or a proceeding of the National Labor Relations Board as back pay attributable to any period of time occurring after commencement of the case under this title, as a result of a violation of Federal or State law by the debtor, without regard to the time of the occurrence of unlawful conduct on which such award is based or to whether any services were rendered, if the court determines that payment of wages and benefits by reason of the operation of this clause will not substantially increase the probability of layoff or termination of current employees, or of nonpayment of domestic support obligations, during the case under this title.

II. Considerations

The WARN Act provides, generally, that an employer (as defined under the Act) must provide employees with 60 days' notice of a "plant closing" or "mass layoff." Failure to provide this notice may result in liability to affected employees of up to 60 days' back pay. To qualify as an employer, the business must employ a certain number of employees (generally 100 at the affected location) and must be a "business enterprise," which is not defined by the Act.

Debtors may be able to avoid or mitigate this liability by establishing either the "unforeseeable circumstances exception" or the "faltering business exception." However, the unforeseeable circumstances exception can be difficult to establish, as bankruptcy is rarely unforeseeable. The faltering business exception may be easier to establish where bankruptcy follows extensive efforts to obtain financing or business that would have prevented the plant shutdown, if there was a reasonable chance of obtaining either.

Prior to BAPCPA, case law generally held that, where a debtor undertook a pre-petition reduction in force and failed to provide 60 days' notice as required under the WARN Act, the WARN Act claim was a priority claim up to the amount set forth in current Section 507(a)(4),[1] with any remaining amount treated as a general unsecured claim. See, e.g., *In re Riker Indus., Inc.* 151 B.R. 823, 827 (Bankr. N.D. Ohio 1993); *Int'l Brotherhood of Teamsters, AFL-CIO v. Kitty Hawk Int'l, Inc. (In re Kitty Hawk, Inc.),* 255 B.R. 428 (Bankr. N.D. Tex. 2000). The addition of Section 503(b)(1)(A)(ii) placed the foregoing precedents in doubt and threatened to turn every WARN Act claim, regardless of the date of

[1] Pre-BAPCPA Section 507(a)(3).

the violation, into an administrative claim against the estate. The use of the term "back pay" in the new statutory language coincides with pre-BAPCPA opinions in this area holding that WARN Act claims constitute "back pay."

III. Implications

The risk that both debtors and creditors face if the BAPCPA amendments to Section 503(b)(1)(A)(ii) were construed as imparting administrative expense priority for WARN Act claims is that smaller estates could become administratively insolvent from the outset of the case. As the case law evolves, smaller bankruptcy estates that once would have benefited from an orderly liquidation under Chapter 11 may be filed as Chapter 7 cases, thus depriving the estate of several reorganizational avenues for maximizing creditor recoveries. Counsel to creditors would be advised to take the size of any potential WARN Act claim into account when recommending action to their clients, as unsecured creditor recoveries could be severely diminished, if not eliminated.

Counsel to creditors would be advised to take the size of any potential WARN Act claim into account when recommending action to their clients, as unsecured creditor recoveries could be severely diminished, if not eliminated.

The first reported decision on the issue of the priority of former employees' claims under the WARN Act came in June 2008 in *In re First Magnus Financial Corp.,* 2008 WL 2491636 (Bankr. D. Ariz. 2008). The Bankruptcy Court for the District of Arizona concluded that Congress did not intend to permit an employee terminated pre-petition to be entitled to both a Section 507(a)(4) priority claim for unpaid pre-petition wages as well as an administrative claim for any WARN Act damages claims and held that Section 503(b)(1)(A) as amended does not allow pre-petition WARN Act claims to be given administrative priority.

In *First Magnus,* the employees bringing the WARN Act claims were terminated just prior to a voluntary Chapter 11 petition. They claimed that they were owed 60 days of pay running from the date of termination and that the portion of the claim that ran beyond the date of petition should be given administrative priority status under Section 503(b)(1)(A)(ii). Without the benefit of precedent or clear legislative intent, the *First Magnus* court looked to canons of statutory interpretation and policy arguments for guidance.

Noting that the legislative history of Section 503(b)(1)(A)(ii) is sparse and therefore not reliable, the court considered the fundamentals of statutory construction. The court focused on the use of the word "and" connecting subsections 503(b)(1)(A)(i) and (A)(ii), concluding that in order to qualify under this section, both parts of the subsections (i) and (ii) must be met for the claimant to be entitled to an administrative expense. By requiring both (i) and (ii) to be met, it becomes clear that wages sought must have been for services rendered after the commencement of the case. Since the claimants were terminated pre-petition, they were found to fail to qualify for administrative expense priority.

The *First Magnus* court bolstered its opinion by determining that a prerequisite under the statute was not met: Section 503(b)(1)(A)(ii) requires that any WARN Act claim be awarded by the National Labor Relations Board or a judicial proceeding. Finding that the bankruptcy court lacks jurisdiction to make such an award, the court concluded that the claimants could not meet the requirement: "[It] is statutorily clear that the type of award contemplated by §503 must originate from a federal court of *general* jurisdiction" – as opposed to the limited jurisdiction of the bankruptcy court.

By focusing on the construction of the statute, the court determined that the BAPCPA amendment does not affect the treatment and prioritization of pre-petition WARN Act claims. The Court's ruling is consistent with prior case law but, in light of the BAPCPA amendments, may not be consistent with legislative intent. A notice of appeal of the *First Magnus* decision was filed on June 30, 2008 and remains pending. Many practitioners are skeptical that the reasoning applied by the *First Magnus* court will withstand appellate scrutiny.

IV. The Delaware bankruptcy court weighs in

In the *Powermate Holding Corp.* cases,[2] Judge Gross was faced with adjudicating a putative class action on behalf of approximately 260 workers whose employment was terminated on the date that the Powermate debtors filed for bankruptcy protection, but mere hours prior to the filing of the Chapter 11 petitions. The debtor companies moved to dismiss the former employees' claims seeking administrative expense status for their damages under the WARN Act on account of the debtors' failure to provide *any* advance notice of termination. Utilizing a "plain meaning" analysis, the *Powermate* court first focused on the statutory language of Section 503(b)(1)(A)(ii) as amended by

[2] Powermate Holding Corp. affiliates Powermate Corporation and Powermate International, Inc. also filed Chapter 11 petitions on March 17, 2008, and the three cases are being jointly administered under case no. 08-10498.

BAPCPA and concluded that Congress could have intended WARN Act violation claims to be accorded priority as administrative expenses of a bankruptcy proceeding. Next, however, the court ruled that the use of the terms "attributable" and "occurrence" in the statute describes two potentially different periods of time. According to Judge Gross, the "only relevant consideration is . . . the time to which the back pay is attributable which is when [the employees'] claims *vest* or *accrue,* and how that time relates to the petition date." Next, the court analyzed the legislative history of, and case law interpreting, the precise vesting of employee claims under the WARN Act, concluding that "because the back pay provided to employees is meant as compensation for lack of notice [of a plant closure/mass layoff], 'the purpose of WARN is to provide a statutory form of severance pay.'"

In what will likely be an oft-cited footnote of the *Powermate* decision, the bankruptcy court focused on the timing of the vesting of the employees' WARN Act claims vis-à-vis the timing of the filing of the Chapter 11 petitions by the employer debtors. Noting that the legislative history of the BAPCPA amendment gave no indication of Congress' intent to effect a "sea change" in the priority to be accorded WARN Act claims, Judge Gross focused squarely on the hypothetical situation of a corporation filing for bankruptcy after its employees had completed their work and left for the day and then discharged them before returning to work the subsequent day. According to the court, the "vesting rights" approach to the question of the resulting priority to be provided to employees' claims would require the conclusion that their WARN Act claims vested upon termination of employment, which would be post-bankruptcy filing under the foregoing hypothetical and thus entitled to priority in payment as administrative expenses of the bankruptcy estate.

Applying the foregoing analysis to the facts before it, the *Powermate* court ruled that, notwithstanding that mere hours separated the companies' termination of the employees and the filing of the bankruptcy petitions, the employees' rights due to the discharge in violation of the WARN Act nonetheless vested prior to the commencement of bankruptcy proceedings and therefore could not be accorded a priority as an administrative expense of the estate. Conversely, in a situation where employees are discharged subsequent to the filing of a bankruptcy petition, the entirety of the employees' WARN Act claims would be entitled to priority in payment, as the vesting of rights under the WARN Act would also occur subsequent to the commencement of bankruptcy proceedings.

V. Conclusion

Employers contemplating a bankruptcy filing that will entail immediate large-scale reductions in force that could trigger liability under the WARN Act are advised to proceed cautiously with respect to coordinating the provision of notice to affected employees with the timing of the filing of a bankruptcy petition. The Delaware bankruptcy courts have long been a preferred venue for the Chapter 11 proceedings of large corporate debtors, and the *Powermate* ruling provides much-needed guidance for distressed company executives and their advisers to provide employees with notice of a WARN Act triggering event on a business day prior to the last business day before commencing a bankruptcy proceeding.

Employers contemplating a bankruptcy filing that will entail immediate large-scale reductions in force that could trigger liability under the WARN Act are advised to proceed cautiously with respect to coordinating the provision of notice to affected employees with the timing of the filing of a bankruptcy petition.

The Cross-Border Insolvency Regulations 2006: Some Practical Considerations and a Case for Reform Already?

– *Grant M. Jones, London; Christopher Reed, London; and David Marks, 3-4 South Square*[3]

Setting the Cross-Border Regs context

The Cross-Border Regs implementing the UNCITRAL Model Law on Cross-Border Insolvency consist of an introduction (stating the Model Law shall have the force of law modifying "British insolvency law"); Schedule 1, the modified Model Law itself; Schedules 2-4 inclusive, procedural matters; and Schedule 5, a Model Law explanatory note. The EC Regulation on Insolvency Proceedings 2000 (the EC Reg) implementing EC Regulation No 1346/2000 (the EU regime) has much in common with the Cross-Border Regs. Why? Because the EC Reg and the Model Law themselves have much in common. Neither claim to be harmonizing, but are merely facilitative measures. Both share similar concepts – notably, the now well-known "center of main interests" (COMI), although regarding COMI there is an irritating but illuminating terminological distinction. The EU regime refers to "main proceedings," the COMI jurisdiction, and "secondary proceedings," the non-COMI jurisdiction; whereas the Model Law refers to the "foreign main proceeding," the COMI jurisdiction, and the "foreign non-

[3] The authors thank Geoff Bouchier of MCR, the Eos Airlines administrator, for his assistance.

main proceeding," the non-COMI jurisdiction. The Model Law does not have the EU regime third status, that of "territorial proceedings," and this points to the major ideological difference, noted below, which in the authors' view can create procedural complexities.

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The Model Law and EU regime ideological difference

The EU regime presupposes a series of cooperating interlocking, but inherently separate Member State insolvency procedures, focused on the main proceedings, being supported by the secondary proceedings. EU regime "territorial proceedings" exist where secondary proceedings occur before or without main proceedings. Conversely, the Model Law creates a role for the "foreign main proceeding" practitioner in non-COMI jurisdictions. This role is undertaken by "a foreign representative" or the "foreign main proceeding" practitioner having direct local non-COMI court access to apply for remedies available to a local non-COMI insolvency practitioner. Unlike the EU regime, the Model Law does not presuppose a separate local non-COMI insolvency procedure. Consequently, there is no Model Law "territorial proceedings" equivalent requirement. The EU regime is therefore more coordinated whereas the Model Law is simply assistive.

The UK context

The United Kingdom is a (perhaps too) highly regulated insolvency jurisdiction that has chosen the "licensed insolvency practitioner" (IP) route of allowing a highly regulated professional to conduct the insolvent's affairs. The *quid pro quo* of high regulation, especially in the form of the very detailed Insolvency Regulations 1986 (IR), is less court involvement. Therefore, the Cross-Border Regs immediately create an uneven playing field. A "foreign representative" can apply for IP remedies without immediate concomitant IP IR duties or other regulatory and hence costly obligations. This is unfair and it immediately negates the post-Insolvency Act 1986's government regulatory thrust. Alternatively, UK legislation and practice is awash with references to IPs and such references have not been altered to include Cross-Border Regs "foreign representative." An example is the Redundancy Payments Directorate (RPD), which handles employee guaranteed claims. RPD practice is to deal only with IPs. Without local IP involvement employees may suffer. While "foreign representatives" can apply for UK IP remedies, even applying adds to costs and delays.

By way of background, the RPD is an executive division of the Department for Business, Enterprise & Regulatory Reform (BERR), which makes payments to redundant employees of insolvent companies in respect of unpaid wages, holiday pay, notice pay, redundancy pay and pension contributions, subject to certain statutory limits, from the government fund. The RPD will ordinarily make payments to employees of insolvent companies only if the company is subject to a formal insolvency process in the United Kingdom. A complication therefore arises when a US-based corporation with a branch office in the United Kingdom enters Chapter 11 proceedings in the United States. In such a scenario, payments to employees from the government fund are likely to be delayed or even disallowed as the RPD may adjudge that the company does not meet its criteria for an insolvent company. The commencement of concurrent proceedings in the United Kingdom overcomes this potential problem.

Joint capacity appointments as both foreign representative and local UK IP

The obvious solution is for the foreign representative to be a UK insolvency practitioner appointed under ancillary (or concurrent) proceedings (i.e., also locally clothed) and the Insolvency Act. For "ancillary proceedings" (either "secondary proceedings" or "foreign non-main proceedings") to exist there must be a non-COMI "establishment." This "establishment" existence already (regardless of the Cross-Border Regs or indeed the EC Reg) gives rise to possible Insolvency Act Part V winding up of an unregistered, or foreign, company or Administration Order equivalent. If UK IPs take advantage of this law there is no uneven playing field; a local UK IP does not need to go to the court and can meet in the usual manner with appropriate UK bodies (such as the RPD) and creditors who will feel familiar with the process.

An increasingly typical scenario

Take the recent case of Eos Airlines, Inc. in its Chapter 11 and administration phase. Eos, whose COMI is in the state of New York, had a branch in England registered under the Companies Act 1985 or, as the Cross-Border Regulations put it, in Great Britain[4]. Most of Eos' creditors are in the United States and number in the thousands. There are, however, a few creditors who or which have addresses in Great Britain. Article 14 is an attempt to lessen the burden of notification, which is invariably made on a postal basis and which is otherwise borne by an English office holder with regard to the principal events that unfold in English insolvency proceedings such as administration. Reliance

[4] The term "Great Britain" is employed because that is the expression used in the Model Law, more particularly Article 14.

on postal notification represents an understandable desire on the part of the legislation to ensure that all creditors are notified in the proper manner of the key events in the process.

Eos was placed into Chapter 11 proceedings under the US Bankruptcy Code, also known as debtor-in-possession proceedings. The opening of the US proceedings under Chapter 11 is done by the mere filing of what is called a voluntary petition. There is no formal court order and therefore no formal appointee, save for the very limited role, if any, of the US bankruptcy trustee. There is no one in a position analogous to that of an English administrator over whom the court can exercise its control. The object of the exercise is to ensure rehabilitation of the company in question.

More importantly, however, the US proceedings do not involve the appointment of a "foreign representative" unless an application is made for that purpose pursuant to the meaning of that term afforded to it in the Model Law. It is only the duly appointed foreign representative who can either seek direct access to a court in Great Britain, or who can commence a proceeding under British insolvency law if the conditions are otherwise met within the meaning of Articles 9 and 11 of the Model Law. Critically, it is only the foreign representative who can apply to the court in this country for recognition of the foreign main proceeding in which he or she has been appointed: see generally Article 15 and the procedure set out in the Cross-Border Regs.

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Those advising Eos, perhaps not surprisingly, suggested that what are called concurrent proceedings should be opened under the Model Law. The purpose was to ensure that there would be due cooperation and some degree of synchronized control operating between the US proceedings, albeit notionally under the control of Eos' board, and the English proceedings. The latter took the form of an out-of-court appointment of English administrators sought on the day of the opening of the proceedings in the United States.

Recognition

The voluntary petition filed in support of the Chapter 11 order in the United States is normally preceded by an appropriate board resolution or series of board resolutions. In the case of Eos, although no express reference was made in such board resolutions to non-US concurrent

proceedings, it was resolved that a single board member could properly seek relief on behalf of Eos with regard to the seeking of protection not only under Chapter 11 but also "in connection" with those proceedings.

Moreover and more importantly in the formal notice of commencement of the Chapter 11 proceedings (which is similar in form and layout to the type of narrative one would find in a witness statement or in a lengthy application under the Insolvency Act) not only was there a specific reference to the English administration, but also mention was made of the purpose of those proceedings. This purpose was stated as being "in support of" the Chapter 11 proceedings. This was to reflect the fact that Eos had its COMI in the United States. The notice went on to say that the English administrators would "deal with UK-based assets" in support of the Chapter 11 plan.

On the face of Article 28 of the Model Law, recognition of a foreign main proceeding is required formally to confirm the position as set out in the last sentence of the preceding paragraph. Article 28 is in fact headed "Commencement of a proceeding under British insolvency law after recognition of a foreign main proceeding." It confirms that after such recognition the English office holder is concerned only with UK-based assets.

The definitions in Article 2 of the Model Law are very important. The term "British insolvency law" is employed to cover the Insolvency Act for the purposes of addressing the position in England and Wales, and the equivalent Scottish provisions for the purposes of recognition in Scotland. This double-barreled definition entails the use of the expression "British insolvency office holder." The term "foreign main proceeding" describes the foreign proceeding taking place in the state where the debtor has its COMI. Finally, and crucially for the purposes of recognition applications and other related applications, a "foreign representative" is defined as meaning: ". . . a person or body . . . authorised in a foreign proceeding to administer the reorganisation or the liquidation of a debtor's assets or affairs or to act as a representative of the foreign main proceeding." Normally, as in the case of the EC Reg, such a person would be "the liquidator," in effect the foreign office holder.

In the case of Eos, the board not only expressly confirmed that the US voluntary petition contemplated and authorized the English administration but it also authorized the individual appointees in their

personal capacity to act as foreign representatives. In so doing, the board was acting in accordance with the specific board regulation referred to above, which clothed an individual board member with authority to pass any appropriate consequential resolutions in the wake of the US Chapter 11 proceedings.

It is suggested that if the English administrators in their role had sought to act as foreign representatives in order to seek recognition of the US proceedings, this may well have entailed some risk of a conflict of interest. That conflict would have reflected a clash between their duties as officers of the court in England on the one hand and on the other their role as authorized foreign representatives with regard to the foreign main proceedings.

If the English administrators in their role had sought to act as foreign representatives in order to seek recognition of the US proceedings, this may well have entailed some risk of a conflict of interest.

The concurrent proceedings

The order for recognition that was duly obtained on behalf of Eos therefore ensured that in accordance with Article 28 of the Model Law administration of the assets in the English administration was expressly limited to assets "located in Great Britain."

The fact remained that a number of practical and procedural steps needed to be taken and addressed by the English administrators in relation to the English administration, which might in practical terms have entailed their trespassing into the US Chapter 11 proceedings.

The English administrators duly prepared proposals designed to mirror the unfolding of the US proposals that contemplated an auction and ultimate disposal plan. Not the least of the problems facing the English administrators was the express requirement to "send" such proposals to creditors[5]. Such judicial learning as there has been in this country suggests that "sending" necessarily involves postal notifications[6]. Public advertisement was therefore not regarded as at all permissible. Similar requirements applied to the circulation of any proposals and the notification of progress and final progress reports. Further, it was not thought appropriate to invite the English court to entertain any form of court-to-court dialogue.

[5] See generally paragraph 51(1) of Schedule B1 of the Insolvency Act.
[6] See e.g. *Re Sporting Options Plc* [2005] BPIR 435.

Article 26 of the Model Law obliges a British insolvency office holder, "to the extent consistent with his other duties under the law of Great Britain" and in the exercise of his or her functions and subject to the supervision of the court, to cooperate to the maximum extent possible with non-UK courts and representatives. That requirement clearly left the British insolvency office holders facing a problem over notification of the United States and foreign creditors.

Reliance could be placed on Article 14. While Article 14 requires "foreign creditors" to be notified "individually," the court can, on the application of the British insolvency office holder, order some other form of notification if it considers the latter "more appropriate." There could be no doubt that insertion of an appropriate newspaper advertisement in the United States as well as due notification of the proposals on the website that had been employed throughout the course of the US proceedings, was clearly "more appropriate" than a postal bill reflecting thousands of letters posted to creditors located in the United States and beyond. It is worth noting that the use of the US website had been formally endorsed in those proceedings.

A case for reform?

It is contended that as currently drafted the Model Law and the Cross-Border Regs, which brought the Model Law into force, make what can be called a "local" appointment of an English insolvency practitioner problematic since, as the above case study shows, every procedural or practical requirement borne by that office holder with regard to the English process, in this case an administration, has to be fulfilled unless specifically dispensed with. Article 14 provides limited relief but other practical problems arise – e.g., with regard to employees and the processing of their claims by the RPD in respect of monies owed to them under their contracts of employment (as discussed above).

Of particularly far greater import is the way in which Eos was compelled to seek out-of-court appointments of its English administrators, who then had to be reinvented as foreign representatives for the purposes of the recognition application. In the authors' view there is a particularly strong argument for reviewing the possibility of an out-of-court appointment of itself being the proper vehicle by which the English appointees can be treated or regarded as foreign representatives subject to suitable procedural safeguards. More importantly perhaps, an out-of-court appointment in a case such as this could of itself have been the vehicle for recognition, again subject to suitable safeguards as the

ability of an interested party or parties making an application to set the subsequent effect of the recognition aside.

A New Era in Bankruptcy – The New Czech Republic Insolvency Act

– *Thomas J. Salerno, Phoenix*

Introduction

The Act makes wide sweeping reforms to the Czech Republic's insolvency law in order to help preserve and rehabilitate financially distressed business enterprises.

The Czech Republic's Insolvency Act and its Resolution of March 30, 2006 went into effect on January 1, 2008. This new law is a long awaited and exciting major overhaul to the Czech Republic's insolvency laws. It is an extraordinary step forward and a significant improvement over the prior insolvency laws. The new Act is now one of the most modern in Europe, and may well become a standard for other legal reforms in the future.

The Act makes wide sweeping reforms to the Czech Republic's insolvency law in order to help preserve and rehabilitate financially distressed business enterprises. In the United States, this is referred to as having a law that promotes a "rescue culture." The Act attempts to balance the competing (and often contradictory) interests of creditors and debtors, debtors and trustees, and different groups of creditors – a difficult and delicate balancing act.

Implementation challenges

The Act represents a major departure from prior insolvency laws and practice, particularly with respect to the reorganization of financially distressed businesses. The concept of reorganization under the Act, with a "debtor with disposal rights," is materially different from prior insolvency laws in the Czech Republic. The Act creates new dynamics between creditors, debtors and trustees, and also puts new and varied responsibilities on the courts charged with overseeing and enforcing the Act. The old skill sets under the prior law need to be modified, and new skill sets need to be acquired if the Act is to live up to its potential.

If the Act is to be used effectively, all of the system's parties must recognize its legitimacy. While each has its own agenda, rights and desired outcomes, the system requires that each work with each other

in a way that promotes consensus as much as possible within the legal framework. If this does not occur, the Act will devolve into a contentious precursor to protracted and expensive liquidations – frankly, the current state of affairs under the Czech Republic's insolvency laws. This is not to suggest that all parties will always get along or work cooperatively – that does not happen under any law.

The hallmark of implementation of the Act will be education of the numerous parties that will implement it. As such, educating the participants in this process is key to the effectiveness of the new Act. The most modern and progressive law is only as good as the people entrusted with its implementation. Let's focus on three very important groups – judges, trustees and creditors.

Judicial education

Judicial education is critical to the effectiveness of the new Act.

The Czech Republic's judges will need to learn a new skill set to implement the new Act. This was also true when the United States made major modifications to its bankruptcy laws in 1978. Under the Act, judges must have an understanding of basic economic principles and, perhaps more importantly, business concepts, in order to effectively enforce and implement the Act. Judges will need to understand balance sheets and income statements, and become facilitators to allow the parties to reach a consensus on a restructuring if at all possible. In order for the system to work, in the United States, and to a lesser extent Germany, reorganization is much more a judicially supervised negotiation than a litigation process.

Judicial education is critical to the effectiveness of the new Act. Judicial education of judges has already begun in the Czech Republic. In December 2006 the Ministry of Justice and American Chamber of Commerce sponsored a judicial training program in Prague, which was voluntary for all judges. The training program dealt with a hypothetical case study of a distressed business, and worked through the case study with the judges to explore how the issues facing the company (and its creditors) would be dealt with under the Act. The Czech Republic lecturers (co-drafters of the Act) were assisted by several foreign bankruptcy judges and reorganization experts. This approach is highly recommended. It deals with the very practical issues that come up in the reorganization of a business, which go beyond merely legal issues and encompass some economic issues as well.

The Ministry of Justice, in cooperation with private organizations, can and should take a proactive role in the education of the Czech Republic's judges to prepare them for the new skill sets they will need under the Act. Given the major new concepts and issues, the educational process will be ongoing – early programs (which, as stated above, are already ongoing) will need to be followed up by continuing programs both before and after the Act becomes effective. Having programs continue after the Act becomes effective has the benefit of allowing the judges to be more vocal in the problems and issues they are seeing in the actual cases.

Trained professionals from countries that have encountered these practical and legal issues should be actively involved in these training programs. There are judges, financial advisers and lawyers from other countries who are available to assist in these programs, working closely with the Czech Republic's judges and professionals to ensure that the training programs remain relevant to the Czech Republic's anticipated and actual experience. There are numerous non-profit organizations that can also be helpful and instrumental in this process. Having trainers who have been involved in such programs before and being very familiar with the Act is helpful.

Finally, judicial education must be mandatory if at all possible, or at least strongly encouraged (with the government paying expenses for judges to attend). In the United States, bankruptcy judges are strongly encouraged to attend a certain amount of ongoing educational programs (many of which are sponsored by the Federal Judicial Center, a government organization), and all new bankruptcy judges are strongly encouraged to attend a new judge training class that is many days in length. Judges' travel and lodging expenses for attending these conferences are paid by the government. Other, more experienced judges, law professors and experienced lawyers are brought in to assist in this process. In addition, many US bankruptcy judges are active participants on educational panels with members of the legal bar, so their education is an ongoing process.

Trustee education

Trustees will need to understand their roles in supervising the debtors with disposal rights.

Trustees, as an integral part of the Act, also will need training in their new supervisory roles under the Act. In particular, trustees will need to understand their roles in supervising the debtors with disposal rights. The Act does not clearly

delineate the division of responsibility between trustees and debtors with disposal rights, so some training or coordination is needed to avoid duplication of effort and conflicting actions.There are numerous organizations internationally to assist in the training of trustees, as well as trustee organizations within the Czech Republic. Trustees and the professionals that represent them in other countries can assist in the training of trustees regarding their obligations and duties under the Act.

Creditor education

Finally, creditors must be educated regarding the new realities of the Act, and how the dynamic has shifted from prior law. For example, under the Act the possibility exists for "cramdown" – that is, approval of a plan even if a creditor votes against it or otherwise opposes it. In addition, the role of creditors under the Act has changed, and the Act requires more active participation than prior law in order to protect rights. There are professional groups both within and outside of the Czech Republic that can assist in this process, as well as international agencies (such as the International Section of the American Bankruptcy Institute, INSOL, and the International Bar Association, as well as the American Chamber of Commerce). Lawyers who become well versed in the new Act (as they must) will also assist their clients (and potential clients) in understanding their rights and obligations under the Act.

If the Czech Republic's judges, administrators and professionals are properly trained in the administration of the Act, the Czech Republic will take a massive leap forward in having a legal regime wherein financially distressed businesses can be rehabilitated. The benefits to society as a whole in having a viable and balanced "rescue culture" reorganization law are many including:

- Rehabilitated businesses retain at least some of their work force, so there is less unemployment or disruption to workers' lives and incomes;
- Rehabilitated businesses continue as productive tax bases;
- Over the long run, rehabilitated businesses produce a greater return to creditors as compared to liquidation (and certainly liquidations under the existing law); and
- Outside sources of capital feel more secure in investing in countries where there is a viable restructuring law, so financial distress does not always lead to liquidation (as a matter of law or practice).

If the European Union becomes a "hedge fund friendly" environment as is possible, there will be available capital to recapitalize viable businesses that are overleveraged through the Act. In the end, society as a whole benefits.

CASE SUMMARIES

Ninth Circuit Bankruptcy Appellate Panel Holds That Assets Sold to Senior Creditor Are Not Transferred Free and Clear of Junior Lien

– *Andrew M. Simon, Cincinnati*

The Ninth Circuit Bankruptcy Appellate Panel (BAP) recently issued a surprising decision that may significantly change how bankruptcy assets are sold outside a plan of reorganization, although the extent to which other courts follow the decision remains to be seen. The BAP, writing in *Clear Channel Outdoor, Inc. v. Knupfer (In re PW, LLC),* held that Section 363(f) of the Bankruptcy Code would not permit estate property to be sold to a senior lender through a credit bid free and clear of the lien of a nonconsenting junior lienholder. This decision may result in more senior lenders seeking state law foreclosures or sales through Chapter 11 plans instead of Section 363 asset sales to obtain control of their collateral. Additionally, the decision could similarly impact *all* Section 363 sales, and not merely sales to credit bid purchasers.

Bankruptcy asset sales in common practice

Senior secured creditors frequently try to acquire the underlying collateral by submitting a bid equal to the outstanding credit in a sale under Section 363. Assuming no higher bids are received, the court will allow the sale and "strip" any junior liens from the property. In so doing, the court relies on Section 363(f), which allows the debtor to "sell property under subsection (b) or (c) of this section free and clear of any interest in such property. . . ." If a junior lienholder fails to obtain a stay of the sale at this point, any appeal would be mooted by Section 363(m) and the property transfer could not later be unwound.

What the *Clear Channel* panel decided

In *Clear Channel,* a hedge fund held a US$40 million first lien on real estate located in California. Another creditor held a US$2.5 million second priority lien. The senior lienholder agreed to act as the "stalking horse" in a Section 363 sale, submitting a bid for the full amount of its debt plus administrative expenses. The bankruptcy court received no higher bids and it authorized the transfer, stripping the junior lien pursuant to Section 363(f)(5).

The junior creditor unsuccessfully sought a stay of the sale, and then appealed on grounds that Section 363(f)(5) did not authorize the stripping of its lien. The BAP reversed the bankruptcy court's decision, finding that none of the statutory grounds upon which a sale free and clear of liens may be authorized applied in this case. Section 363(f)(3), which allows a sale free and clear if "the price at which such property is to be sold is greater than the aggregate value of all liens on such property; . . ." did not apply because the property was sold for the face amount of the senior lien, which is obviously less than the face amount of all liens. The court rejected the notion that this language refers to the *economic* value of liens, which in a bankruptcy proceeding is often presumed to be lower than the face amount of such liens.

The BAP also determined that Section 363(f)(5) did not apply because it requires that "a legal or equitable proceeding" exist in which a creditor can be forced to accept money in satisfaction of its lien before the lien can be stripped. The BAP rejected the lower court's determination that a Section 1129(a) cramdown is such a proceeding, but did not address whether nonbankruptcy foreclosure proceedings might qualify. The BAP remanded the case to the bankruptcy court to provide the parties the opportunity to identify a nonbankruptcy legal proceeding that might qualify as a basis to strip the lien under Section 363(f)(5), but the parties settled the matter before identifying one to the court.

Importantly, the BAP also held that the junior creditor's appeal was not rendered moot by Section 363(m), reasoning that this provision applies to asset *sales* under Sections 363(b) and (c), but not to *liens stripped* under Section 363(f). So, the senior creditor took valid title, but *subject to* the junior creditor's lien.

What this decision implies

These readings of Sections 363(f) and (m) contradict common practice, and it remains to be seen how widely they will be adopted. There are different views on the precedential effect of BAP decisions, but other courts may be persuaded by the BAP's analysis. Until more courts weigh in on the issues, lienholders seeking to credit bid for control of their collateral should proceed with caution and may wish to consider a foreclosure process or plan sales as an alternative strategy. Moreover, because the panel's opinion does not seem analytically limited to credit bid purchases under Section 363(k), *all* 363 buyers need to be mindful of the *Clear Channel* decision.

Sellers of Goods (Re)Claim Victory in Sixth Circuit

– *Rebecca S. Revich, Phoenix*

In July the Court of Appeals for the Sixth Circuit gave vendors cause for celebration when it issued its decision in *Phar-Mor, Inc. v. McKesson Corp.,* 534 F.3d 502 (6th Cir. 2008). In *Phar-Mor,* the Sixth Circuit held that a vendor's administrative expense priority on its reclamation claim would not be extinguished when the goods subject to reclamation were sold and the proceeds were used to satisfy Phar-Mor's indebtedness to its secured lenders. Importantly, while *Phar-Mor* was decided under a superseded version of Section 546(c) of the Bankruptcy Code, we believe that a critical aspect of the decision may have vitality under current law.

When Phar-Mor filed for Chapter 11, McKesson and other vendors sought to reclaim goods they sold to Phar-Mor under Ohio law and Section 546(c). The vendors were denied reclamation but granted administrative expense claims (an alternative remedy under former Section 546(c)). Phar-Mor also owed its secured lenders US$103 million. The bankruptcy court authorized Phar-Mor to borrow from debtor-in-possession (DIP) lenders to repay the pre-petition lenders in exchange for release of their liens. Phar-Mor eventually liquidated its assets and paid off the loan to the DIP lenders. The issue before the Sixth Circuit was whether McKesson could retain its administrative claim when the goods subject to reclamation had been sold and the proceeds used to pay off the DIP lenders' superior claims.

Ruling in favor of McKesson, the court reasoned that any goods that were properly subject to reclamation remained the vendor's property and never became the debtor's property, so the secured creditor's claim could not attach to the properly reclaimed goods. In other words, the debtor was essentially holding the reclaimed goods "in trust" for the reclaiming vendor. The Sixth Circuit also maintained that it would be inequitable to deny a "defrauded" seller its reclamation rights by reclassifying its administrative claim as a general unsecured claim because "it would be unjust to permit general creditors to benefit at the expense of one whose assets come into a bankrupt's possession under conditions which warrant rescission."

Although *Phar-Mor* clearly declares the reclaiming seller of goods the victor in the battle with the debtor's secured lender (in the Sixth Circuit) for cases filed before the October 2005 Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA), the effect of the decision remains less certain in the post-BAPCPA era, especially outside of the Sixth Circuit. Post-BAPCPA, Section 546(c)(1) of the Bankruptcy Code explicitly states that a vendor's reclamation rights are "subject to the prior rights of a holder of a security interest in such goods or the proceeds thereof." Whether a secured creditor's rights are, in fact, "prior" will be determined under non-bankruptcy law. For post-BAPCPA cases within the Sixth Circuit, the reclaiming vendor will likely be able to retain its reclamation claim since the *Phar-Mor* decision made it clear that a reclaiming vendor's rights are "prior" to that of a secured creditor with an after-acquired property clause. However, for post-BAPCPA cases outside of the Sixth Circuit, the answer to whether a reclaiming vendor will be able to retain its reclamation claim under Section 546(c) is less clear. The answer will hinge on whether relevant non-bankruptcy law regards a reclaiming vendor's rights as "prior" to a security interest holder's rights in the goods subject to reclamation.

Sixth Circuit Rebuffs Debtor's Insurer in Quest for Administrative Expense

– *Elliot M. Smith, Cincinnati*

In August the Sixth Circuit Court of Appeals denied administrative expense priority status to a claim filed by Zurich American Insurance Co. for the deductible portion of workers compensation claims – claims payable in the future (if established) for injuries that occurred during the bankruptcy of the

insured debtor. The court rendered this decision in *Zurich American Ins. Co. v. Lexington Coal Co., LLC (In re HNRC Dissolution Co., et al.),* 536 F.3d 683 (6th Cir. 2008).

Zurich had provided workers comp coverage to the Chapter 11 debtors before and during the bankruptcy cases. Under the policies, Zurich was required to pay all claims and then bill the debtors for the deductible portion. As security for the deductible payments, Zurich received cash collateral, letters of credit and security bonds. Unfortunately for Zurich, however, the issuer of the security bonds was placed into a receivership and the value of Zurich's security was rendered worthless, or nearly so. Zurich timely filed an administrative claim request for US$44.7 million based on an actuarial report of its total expected exposure to injuries that occurred during the bankruptcy.

The bankruptcy court denied Zurich's claim and the US District Court for the Eastern District of Kentucky affirmed the ruling. Adopting the district court's opinion, the Sixth Circuit reasoned that Zurich's claim failed under the plain language of Section 503(b)(1) of the Bankruptcy Code because the expenses were not actual expenses that were necessary to preserve the debtors' estates. In the court's view, Zurich had no "actual" expense because its exposure had not been realized during the bankruptcy case, and even if Zurich paid the claims in the future, its payment would not preserve the estate, because the estate would no longer exist.

The court also explained that Zurich could not satisfy the "benefit to the estate" test – the two-part test used to determine whether expenses should receive Section 503 priority status. Under this test, the claim must have (1) arisen from a transaction with the bankruptcy estate, and (2) directly and substantially benefited the estate. The court explained that even assuming that Zurich's claim arose from a transaction with the debtors, there can be no direct and substantial benefit to the estate where the debtors' liability for the deductibles would not become fixed until an unknown future time, if ever. The court did not find persuasive Zurich's concerns that a denial of administrative expense status would harm the ability of debtors to obtain insurance coverage, noting that Zurich's troubles stemmed largely from the fact that its collateral proved to be insufficient.

While other courts may not follow the Sixth Circuit's view, this opinion certainly represents a cautionary note for insurers that might otherwise look to receive administrative expense status for post-

confirmation deductibles. As a result, this ruling highlights the importance of obtaining sufficient and reliable security for the insured's obligations. More broadly, the Sixth Circuit's reasoning might preclude a claim for administrative expense priority to *any* provider of goods or services to a Chapter 11 debtor when the debtor incurs a contingent or unliquidated obligation to the provider during the bankruptcy case – for example, a claim for indemnification or reimbursement – that remains contingent or unquantifiable at the time of plan confirmation.

Second Circuit Agrees: Derivative Claims Belong to the Estate

– *Kristin E. Richner, Columbus*

On September 24, 2008 the Second Circuit concluded that the bankruptcy court overseeing the bankruptcy proceeding of Adelphia Communications was permitted to transfer the derivative claims of the Equity Committee to a litigation trust, without the consent of the Equity Committee. See *In re Adelphia Communications, Inc., 2008 U.S. App. LEXIS 20224 (2d Cir. 2008).*

In August 2005 the Equity Committee moved for standing to assert certain claims on behalf of Adelphia against Adelphia's bank lenders and investment banks that Adelphia itself would not assert. The bankruptcy court granted derivative standing to the Equity Committee to pursue those claims, concluding that pursuit of the claims was in the best interests of the estate because the claims were sufficiently "colorable."

In January 2007 the bankruptcy court entered an order confirming Adelphia's Chapter 11 plan, which provided that various causes of action, including those for which the court had granted derivative standing to the Equity Committee, would be turned over to a litigation trust to prosecute on behalf of the estate. The Equity Committee objected to the transfer of the derivative claims without its consent primarily on the grounds that, as a result of its derivative standing, it acquired ownership and control over the asserted claims. Agreeing with the lower courts, the Second Circuit held that derivative standing does not vest the derivative plaintiff with ownership over the claims; to find otherwise would permit a derivative plaintiff a veto over both the court and the debtor-in-possession, a concept which is not supported by precedent.

The Second Circuit utilized the "best interests of the estate" standard and determined that "[t]he bankruptcy court not only had the authority to confer derivative standing upon the Equity Committee, it also had the authority to – and did – effectively withdraw that standing when it concluded that the Equity Committee's role was no longer in the best interests of the estate. . . ." The Second Circuit also found that the bankruptcy court conducted a reasonable cost-benefit analysis of the Equity Committee's continued management of the claims. Because the bankruptcy court had already concluded that the equity holders were "out of the money" unless the litigation trust recovered more than an unlikely US$6.5 billion, the Second Circuit determined that there was no abuse of discretion in moving the claims to the litigation trust. Additionally, the court noted that the plan expressly required the litigation trust to maximize the value of the transferred claims, and its trustees would be liable for intentionally injuring or recklessly disregarding the best interests of trust beneficiaries (including equity holders).

With this decision, the Second Circuit confirmed that a derivative plaintiff serves and is subject to the approval of the bankruptcy court; it does not acquire ownership over the derivative claims nor does it usurp the role of the court or debtor in managing the estate's legal claims. The *Adelphia* decision offers an interesting twist on derivative actions, although the underlying principles on which it rests are not particularly controversial. The court's analysis of whether the bankruptcy court abused its discretion in approving the transfer of the claims under the plan gives some guidance to derivative plaintiffs faced with the prospect of losing control of claims of a bankruptcy estate, as well as some comfort that the interest of their constituencies in the continued pursuit of those claims should be a factor in that decision.

Recent Notable Representations

The firm represented **Enron's Official Creditors Committee** in the most complex Chapter 11 cases in US history (SD N.Y.). While engaged on a wide-ranging variety of matters, Squire Sanders' principal focus was on the investigation and analysis of Enron's most complicated structured finance and off-balance-sheet transactions. As a result of the firm's efforts, across a multitude of practice areas, creditor recoveries were enhanced by several billion dollars.

The firm represents one of the leading bond insurers in the pending Chapter 9 case of Bay Area city **Vallejo, California** (ED Calif.). Squire Sanders' client insured one of the city's large bond issuances. The city's case is one of the largest Chapter 9 bankruptcy proceedings ever filed.

The firm represented a **large public home builder** in Ohio in several phases of a multiyear restructuring process. The process was brought to a successful conclusion earlier this year when the company and its principal secured lenders closed on a going-private transaction. This is one of the only, if not *the* only, public homebuilders to be successfully restructured outside of a bankruptcy or a liquidation.

The firm represents a number of the 15 largest commercial banks and other financial institutions and other parties in interest in both the Chapter 11 cases of **Lehman Brothers Holdings, Inc.** (and its affiliates) and the Securities Investor Protection Corporation (SIPC) liquidation case of **Lehman Brothers, Inc.** (SD N.Y.). Our clients hold diverse claims and/or are parties to substantial agreements with the Lehman entities. For example, we are representing Itochu Corporation on matters concerning treatment of financial instruments (SD N.Y.).

Squire, Sanders & Dempsey Peña Prieto Gamundi represents **Tricom SA** and its subsidiaries **Tricom USA** and **TCN Dominicana SA** as special counsel in the Dominican Republic in connection with their prepackaged Chapter 11 cases (SD N.Y.). Tricom SA is the second-largest telecommunications provider based in the Dominican Republic and, to date, has been the only Dominican Republic-based company ever listed on the New York Stock Exchange. Squire Sanders currently counsels Tricom on a number of matters related to operations in the Dominican Republic including licensing and regulatory issues, general Dominican corporate, tax and litigation matters, and the estimation of certain claims.

The firm represents one of the 10 largest commercial banks in the United States with respect to a substantial investment in bonds issued by **Sigma Finance,** currently in insolvency proceedings in the United Kingdom.

The firm represented the agent to the senior secured lenders in the Chapter 11 case of Carlton Cove, Inc., a continuing retirement care community located in Huntsville, Alabama (ND Ala.). We advised our client in all aspects of the case including complex intercreditor issues, DIP financing, tax exempt

financing issues and a process to sell the business in a Section 363 sale. The sale of Carlton Cove's assets was concluded earlier this year.

The firm represents a large institutional purchaser of real estate loans in the Chapter 11 case of **Ownit Mortgage Solutions** (CD Calif.). We advised our client concerning a substantial claim in the bankruptcy case and in connection with significant litigation with the Creditors Committee regarding whether funds held in escrow by Ownit were subject to a trust in favor of our client, rather than estate property. Both the bankruptcy court and, on appeal, the district court found in favor of our client.

The firm represented **The Austin Company,** now known as **TAC Company (TAC),** as debtor in its Chapter 11 filing (ND Ohio). Squire Sanders assisted TAC in successfully packaging and selling its operating assets including ongoing projects. The new owners have maintained the venerated Austin name and its headquarters in Cleveland and, significantly, preserved employee jobs and projects throughout the United States. The sale proceeds funded a confirmed plan of liquidation resulting in the TAC Liquidating Trust, also represented by Squire Sanders.

The firm also represented General Electric Credit Equities, Inc., the secured lender for an apartment complex, in the Chapter 11 case of **Brice Road Developments, LLC** (SD Ohio); Itochu Corporation, on matters concerning treatment of contract issues, in the Chapter 11 case of **Pope & Talbot** (Del.); The Furukawa Electric Co., Ltd., on matters concerning treatment of contract and claim issues, in the Chapter 11 case of **Delphi Corporation** (SD N.Y.); TRW Automotive, in litigation concerning substantial avoidance claims, in the Chapter 11 case of **Tower Automotive** (SD N.Y.); Electrolux, a major customer of the debtor, on matters concerning contract treatment, asset disposition and avoidance actions, in the Chapter 11 case of **Victor Plastics, Inc.** (Minn.); and the senior secured lender to regional electronics retailer **Harvey Electronics Inc.** in its Chapter 11 case (SD N.Y.). The firm also represented significant claimholders, counterparties and other stakeholders in the Chapter 11 cases of **Advanced Marketing Services** (Del.), **Refco** (SD N.Y.) and **Adelphia** (SD N.Y.).

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