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Client Alert

Financial Restructuring Practice Group

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Bankruptcy Court Surprises Observers and Transfers Venue of Patriot Coal Chapter 11 Cases to Missouri

In an important opinion released on November 27, 2012, Judge Shelley C. Chapman of the United States Bankruptcy Court for the Southern District of New York transferred the Patriot Coal Corporation (Patriot Coal) chapter 11 bankruptcy cases from the Southern District of New York to the Eastern District of Missouri. This decision comes as a surprise to many observers who had expected, based on prior failed attempts to change venue in Enron and other large cases filed in the Southern District of New York, that Judge Chapman would defer to the Debtor's choice of venue. Perhaps even more surprising, the court transferred venue to the Eastern District of Missouri, where Patriot Coal maintains its corporate headquarters, instead of to the Southern District of West Virginia, as requested in motion filed by the United Mine Workers of America (UMWA) in its motion.

The opinion is significant for several reasons. First, it relies extensively on the "interest of justice" element in the venue transfer statute and finds that the interest of justice compels transfer even though administrative efficiency and convenience favored the New York venue. More broadly, this opinion may signal a more receptive attitude towards transfers of venue away from the Southern District of New York, at least where venue is created on the eve of bankruptcy and requests to transfer garner some support from economic parties in interest.

Statutory Background

Venue in chapter 11 bankruptcy cases is controlled by 28 U.S.C. § 1408. That statute provides that a corporate debtor may file a chapter 11 petition in either (a) the district where it is incorporated; (b) the district where its principal assets are located; (c) the district where its corporate headquarters are located; or (d) any district where an affiliate, partner, or general partner has a pending bankruptcy case. There are no limits on how long the affiliate must have been in existence or the amount of assets that the affiliate must own. Critics of the statute charge that it permits corporations to forum shop in favor of the District of Delaware and the Southern District of New York, which are perceived as debtor-friendly jurisdictions. For reasons completely unrelated to bankruptcy, many businesses are incorporated under Delaware or New York state law, which allows them to file in those jurisdictions. Even those corporations not incorporated in Delaware or New York can artificially create venue in their preferred district with relative ease. While in contemplation of bankruptcy, a corporation may create an affiliate shell entity

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with no real capital, operations, or purpose under the laws of the state in which the parent wishes to file bankruptcy. Then, the affiliate shell entity files a bankruptcy petition in the district where it was incorporated. The parent company can then bootstrap itself to the affiliate shell company's bankruptcy and the venue statute will be satisfied in whatever district the shell company filed despite the fact that the parent company has no connection to that forum. Thus, given sufficient resources and time to plan, any corporation is capable of filing a chapter 11 petition in any district in the country. This is precisely what occurred in the Patriot Coal bankruptcy case.

The Patriot Coal Bankruptcy Case

On June 1, 2012, Patriot Coal created a new entity called PCX Enterprises, Inc. under the laws of the State of New York, and on June 14, 2012, Patriot Coal created another new entity called Patriot Beaver Dam Holdings, LLC, also formed under the laws of the State of New York. These entities do not have any employees and do not maintain offices in New York. Each of them has guaranteed Patriot Coal's obligations under its primary credit facility and its obligations as issuer of its senior bonds. Importantly, Patriot Coal stipulated that the sole purpose for creating these entities was to ensure that venue would be permissible in the Southern District of New York when Patriot Coal filed for bankruptcy.

On July 9, 2012 (38 days after creating PCX and 25 days after creating Patriot Beaver Dam Holdings), Patriot Coal filed a total of ninety-nine chapter 11 petitions in the Southern District of New York for itself and each of its various subsidiaries and affiliates. Among all of the entities comprising the jointly administered Patriot Coal bankruptcy case, the only two subsidiaries incorporated under New York law and domiciled in New York are PCX Enterprises, Inc. and Patriot Beaver Dam Holdings, LLC. Of the other ninety-seven Patriot Coal entities, fifty-four were incorporated in West Virginia, forty were incorporated in Missouri, and three were incorporated in Kentucky. Patriot Coal's headquarters is in St. Louis, Missouri and it conducts mining operations at twelve locations, nine of which are in West Virginia and three of which are in Kentucky.

The Motions to Transfer Venue

On July 19, 2012, just ten days after the petition date, the UWMA filed a motion to transfer the Patriot Coal bankruptcy cases to the Southern District of West Virginia. Thereafter, several insurance companies also filed a motion to transfer the cases to the Southern District of West Virginia, and both motions to transfer venue were later joined by several other parties.

The United States Trustee's office also filed its own motion to transfer venue under 28 U.S.C. § 1412 "to a district where venue is proper" and this motion was later joined by several parties. While admitting that the debtors were able to establish a "proper" venue in the Southern District of New York through the creation of the affiliate shell companies, the United States Trustee argued that the court should not permit such "unreasonable" forum shopping where the interest of justice favors venue elsewhere. The key points emphasized by the United States Trustee were that these affiliate shell companies were created shortly before the bankruptcy and with the express purpose of creating a venue that would not otherwise exist. The United States Trustee went so far as to allege that allowing the case to remain in the Southern District of New York would "raise serious questions about the efficacy of Congress's bankruptcy venue system as a whole" and that "[i]f it was unclear before, let it be clear now: The United States Trustee believes manufacturing venue with an eve of bankruptcy incorporation violates the interest of justice standard and compels transfer to another district where venue is proper."

In the briefing on the motions to transfer venue, Patriot Coal admitted that it desired to file its chapter 11 case in the Southern District of New York and had no purpose in creating the two affiliates other than to comply with 28 U.S.C. § 1408. Instead, Patriot Coal's argument focused on why the Southern District of New York, despite having no connection to assets or operations of the debtors, would be the most beneficial venue for creditors. According to Patriot Coal, because the parties who will be most active in the case (i.e. the debtors' lawyers, financial advisors, and the DIP lender) are located in New York, the Southern District of New York is a more cost-effective venue than the Southern District of West Virginia. By reducing travel time and expenses incurred by the estate, creditors would benefit through increased recoveries. The DIP lenders joined in the Debtors' opposition to the motion to transfer, noting that the bankruptcy court had already approved the debtors' post-petition DIP financing in the amount of $500 million which is a significant connection to New York. The objections to the motions did not include any evidence and did not allege that the filing was made in bad faith.

The UWMA countered that (1) the majority of Patriot Coal's mine workers (both active and retired) are located in West Virginia and that maintaining venue in New York would essentially prohibit them from actively and directly participating in the case, (2) Patriot Coal's assets are located mostly in West Virginia and no significant assets are located in New York, (3) ten of the fifty largest unsecured creditors are located in West Virginia while none of the largest fifty unsecured creditors is located in New York, (4) the majority of the ninety-nine debtors maintain offices in West Virginia and the two New York debtors have no employees and were created for the sole purpose of manufacturing a bankruptcy venue in the Southern District of New York, and (5) the case has not been pending in the Southern District of New York for a long period of time.

The Bankruptcy Court's Ruling

In a detailed and thoughtful opinion, the Court granted the United States Trustee's motion, granted the UMWA's motion in part, and transferred the cases to the Eastern District of Missouri, where Patriot Coal is headquartered. The Court began by tracing the history of venue under English law and noted the continued importance of the core considerations of fairness and convenience.

While there was no dispute that the Patriot Coal cases were filed in technical compliance with 28 U.S.C. § 1408, and that filing in the Southern District of New York did not constitute bad faith, the Court held that the "purposeful creation of the venue-predicate affiliates in New York on the eve of filing must be considered in the "interest of justice" analysis set forth in section 1412." The Court analogized the "artificial impairment" of claims in the bankruptcy plan confirmation context and the "substance-over-form" doctrine utilized in tax law. In those situations, technical compliance is not sufficient where the purpose of the statute is offended. The Court also relied on Judge Drain's opinion in *In re Winn-Dixie Stores, Inc*., Case No. 05-11063 (Bankr. S.D.N.Y. April 12, 2005), which held that "the interests of justice require transfer where . . . the facts were created to fit the statute [instead of] . . . applying the statute to fit the facts."

Ultimately, the Court concluded that allowing Patriot Coal's venue choice to stand "**would elevate form over substance in a way that would be an affront to the purpose of the bankruptcy venue statute and the integrity of the bankruptcy system**. Creating PCX and Patriot Beaver Dam shortly before bankruptcy solely for the purpose of establishing venue is not 'the thing which the statute intended.'" (emphasis added). Like Judge Drain in *In re Winn-Dixie*, the Court emphasized the distinction between creating facts to fit the statute and taking advantage of facts as they existed before a debtor begins bankruptcy planning. The Court stated:

> Permitting the Debtors' cases to remain in this District under these circumstances would all but render the venue statute meaningless. It would allow potential large corporate debtors to choose what they view as the optimal venue for their bankruptcy cases and, in preparation for filing chapter 11, incorporate an affiliate in that location for purposes of satisfying section 1408.

The Court further rejected the argument that convenience of the parties should trump the "interest of justice" set forth in the statute. According to Judge Chapman, elevating convenience and the efficient administration of the estate over the "interest of justice" would invariably lead to the Southern District of New York as the default venue in large cases. The Court rejected New York as a default venue based on convenience and its role as a financial center. However, the Court noted that the result may have been different if Patriot Coal's New York affiliates had been created at an earlier time.

Finally, in transferring venue to Missouri instead of West Virginia, the Court emphasized that "fairness, rather than geography" is the key factor. Transferring the cases to West Virginia would simply shift the home field advantage to the UMWA, "[b]ut it is not in the interest of justice merely to swap one party's perceived home field advantage for another. The Court categorically rejects such a parochial formulation of justice." On the other hand, the Eastern District of Missouri—which includes the Patriot Coal headquarters in St. Louis—best serves both the interest of justice and the convenience of the parties.

Legislative Reform

It is unclear if the Patriot Coal opinion is a tip of the hat to the pending venue reform efforts, but its result is consistent with the approach that has been proposed in the House of Representatives. On July 14, 2011, Lamar Smith, a Republican from Texas, and John Conyers, a Democrat from Michigan, co-sponsored a bill in the House of Representatives titled the Chapter 11 Bankruptcy Venue Reform Act of 2011 (H.R.2533). The shared interest of the co-sponsors in the bill arises from mega-cases in both Texas (e.g., Enron and Dynegy) and Michigan (e.g., General Motors and Chrysler) being filed in the Southern District of New York rather than the center of their business operations.

The proposed bill would limit corporations to filing chapter 11 cases in the district "in which the principal place of business in the United States, or principal assets in the United States, of such corporation have been located for 1 year immediately preceding such commencement, or for a longer portion of such 1-year period than the principal place of business in the United States, or principal assets in the United States, of such corporation were located in any other district." This eliminates the place of incorporation (often Delaware) as a venue choice. Additionally, the proposed bill would allow affiliates to file in district where a parent company has previously filed, but not vice versa, which would eliminate the bootstrapping method of creating venue (often in New York). The House Judiciary Committee has held hearings on the proposed bill, but it remains unclear if the bill will be considered by the entire House of Representatives.