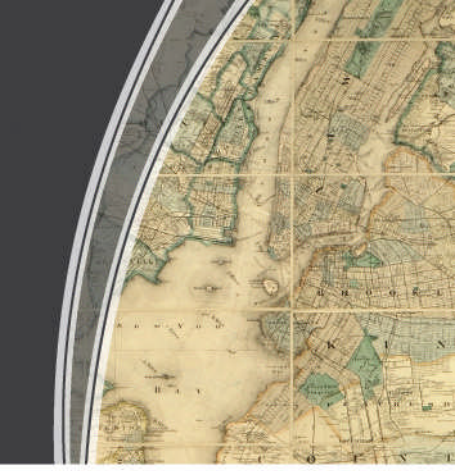

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# LENDING & RESTRUCTURING ALERT JULY 2012

**"The Cheese Stands Alone": United States Trustee Forces Transfer of Houghton Mifflin Harcourt Cases Despite Objection of All Other Parties**

Congratulations! You just successfully negotiated a prepackaged chapter 11 plan of reorganization for a multi-billion dollar enterprise which leaves general unsecured creditors unimpaired and has been unanimously approved by the debtors' creditors. It's smooth sailing from here, right? Just file your cases in a convenient district, breeze through confirmation and emerge from bankruptcy 30 days later. "Not so fast," says the United States Trustee ("UST"). "You don't belong in this court." Those are the facts in In re Houghton Mifflin Harcourt Publishing Company, et al.[1], where Judge Gerber reluctantly granted the UST's motion to transfer venue out of the Southern District of New York over the objection of all other parties. Happily, however, he did not permit the granting of the UST's motion to delay the confirmation proceedings. Instead, he first confirmed the plan of reorganization, and then transferred venue, so his practical ruling did not delay the restructuring.

**Background**

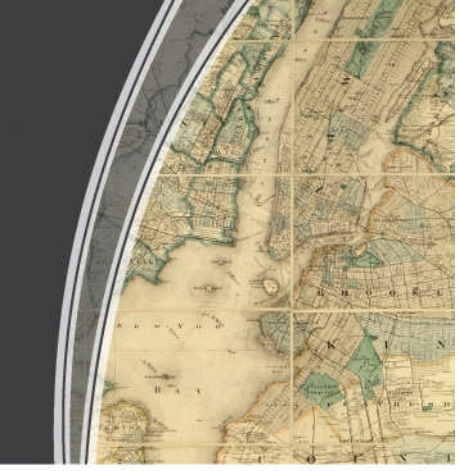
Houghton Mifflin Harcourt Publishing Company ("Publishing"), Houghton Mifflin Holding Company ("HoldCo") and their related entities (collectively, the "Debtors") publish textbooks used in elementary and secondary schools throughout the United States. The Debtors encountered financial difficulties due to their excessive debt and a marked decline in demand for their products. To resolve these difficulties, the Debtors, with their banks and bondholders, successfully negotiated a consensual reorganization in bankruptcy.

The prepackaged plan provided for the conversion of approximately $3 billion dollars of secured debt into equity, and left the claims of general unsecured creditors unimpaired. The Debtors obtained unanimous consent from their banks and bondholders for the plan, and commenced their chapter 11 cases in the Southern District of New York. Although there was no dispute that the Debtors' principal places of business and places of incorporation were located outside the state, the Debtors asserted that debtors Publishing and HoldCo were eligible to file in New York, and therefore all of them could do so.

**A Short Primer on Venue**

The bankruptcy venue statute[2] sets forth four bases to file a case: domicile, residence, principal place of business or principal assets.[3] Once proper venue is established for one debtor, its affiliates and partnerships may file related cases in the same district.[4] Another federal statute[5] provides that when a case is filed in an improper venue, the court must either dismiss the case, or if the best interests of justice would be served, transfer the case to a proper district. Most courts, including courts in the Southern District of New York, hold that this statute applies in bankruptcy cases. A third statute[6] provides that a court

[1] 2012 WL 2368547 (Bankr. S.D.N.Y. June 22, 2012).
[2] 28 U.S.C. § 1408.
[3] 28 U.S.C. § 1408(1).
[4] 28 U.S.C. § 1408(2).
[5] 28 U.S.C. § 1406.
[6] 28 U.S.C. § 1412. Transfer under § 1412 is permissive, while transfer under § 1406 is mandatory.



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may transfer an improperly venued case "in the interest of justice or for the convenience of the parties."

**The United States Trustee Moves to Transfer Venue**

Shortly after the petition date, the UST moved to transfer the cases arguing that venue in the Southern District of New York was improper, and that the cases must be transferred under the mandatory venue transfer statute. The Debtors and all creditors who weighed in on the matter supported keeping the cases in the Southern District of New York.

The Debtors alleged that HoldCo was properly venued in the Southern District of New York because HoldCo's principal asset, a commercial lease, was located in the district. The Court rejected this assertion, finding that HoldCo's "money-losing" lease did not exceed the value, or the importance, of HoldCo's stock in an out-of-state subsidiary, which in turn owned 14 direct and indirect out-of-state subsidiaries having assets of more than a billion dollars. While not expressly valuing the Debtors, the Court found that the cash flow generated by those subsidiaries was substantially more valuable than the lease. Accordingly, the Court concluded that the "principal assets" basis for venue had not been satisfied.

The Debtors also alleged that venue was proper because New York was Publishing's "residence" under the bankruptcy venue statute. The Court dismissed this argument, finding that using residence as an alternative venue for corporations "would create an exception that would dilute the other two bases [principal place of business and principal assets] effectively beyond recognition."[7] The Court concluded that residence is a basis for venue under the bankruptcy venue statute only for natural persons, not businesses. Thus, the Court found that there was no proper basis for venue for any of the Debtors, and therefore the cases had to be transferred.

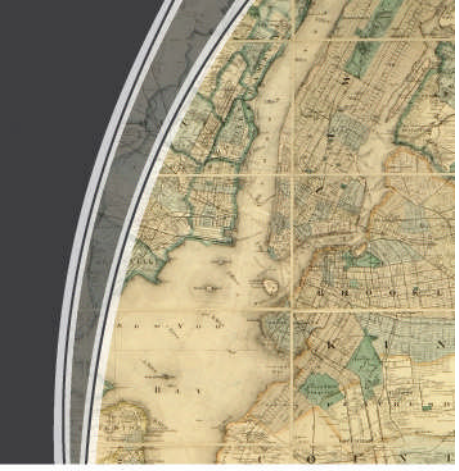
The Debtors and their creditors argued that the convenience of the parties and the interests of justice would overwhelmingly be served by keeping the cases in New York. The Court agreed, stating that the objectors "would win in a heartbeat" if the UST's motion were made under the permissive venue transfer statute where the Court could consider equitable factors. But because the UST moved for transfer under the mandatory venue transfer statute, the Court ruled that its hands were tied. Instead, the Court explained, "the answer, to the extent there is an answer, is for the UST to exercise prosecutorial discretion in deciding when to make motions like this one, keeping in mind the interests of the creditors who would be affected by the motion's outcome."[8]

**Judge Gerber Fashions an Equitable Solution**

While recognizing that it was obligated to transfer the cases, the Court also found that delaying confirmation of the Debtors' plan would materially prejudice the interests of creditors. Accordingly, Judge Gerber invoked his general equitable powers to apply the mandatory venue transfer statute so as to "mitigate the resulting damage to the creditor community." The Court pointed out that the mandatory venue transfer statute is silent as to when a transfer must occur. Thus, because it is widely accepted that venue is not a limit on the bankruptcy court's jurisdiction, the Court confirmed the Debtors' prepackaged plan, and ordered that the cases be transferred afterwards to a consensual venue.

**Observations**

[7] 2012 WL 2368547, *8.
[8] 2012 WL 2368547, *10.



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As Houghton Mifflin illustrates, Debtors and their counsel should be aware that even a lone dissenting party can raise venue and transfer arguments. As Judge Gerber warned, the venue transfer rules "can subject the entire creditor community to the actions of a gadfly or an entity with a private or political agenda, even if creditor convenience, avoiding unnecessary expense, and the interests of justice cry out for keeping the case where it is."[9] Careful attention must be paid to the selection of proper venue, and debtors must be prepared to substantiate their venue decisions under the bankruptcy venue statute. In light of the UST's motion, debtors and creditors negotiating prepackaged plans will need to give careful consideration to the validity of their preferred venue.

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[9] 2012 WL 2368547, *8.