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Second Circuit Holds District Court Must Mandatorily Abstain from Deciding Parmalat State Court Action Related to U.S. Ancillary Bankruptcy Proceeding

Under 28 U.S.C. § 1334(c)(2), a district court must abstain from hearing state law claims that are related to a bankruptcy case when those claims can be timely adjudicated in state court. In Parmalat Capital Finance Ltd. v. Bank of America Corp., No. 09-4302-cv (L), 2012 WL 539957 (2d Cir. Feb. 21, 2012), the United States Court of Appeals for the Second Circuit ruled that certain state court actions brought by Parmalat affiliates or their representatives against their former auditor Grant Thornton should be remanded to the Illinois court based on the Second Circuit's application of a four-factor test governing mandatory abstention it adopted in a prior appeal in the same case.

The Facts

Plaintiff-appellant Dr. Bondi ("Bondi") represents Parmalat Finanziaria, S.p.A. in Italian bankruptcy proceedings commenced in 2003 as its extraordinary commissioner under Italian law. Plaintiff-appellant Parmalat Capital Finance Limited ("PCFL") is a Grand Caymans-based corporate subsidiary of Parmalat. PCFL is in liquidation in the Cayman Islands.

In 2004, Bondi and PCFL commenced separate ancillary U.S. bankruptcy proceedings under former 11 U.S.C. § 304 (the predecessor to Chapter 15 of the Bankruptcy Code) in the U.S. Bankruptcy Court for the Southern District of New York in order to enjoin litigation against PCFL and Parmalat in the United States. Prior to the commencement of the section 304 proceedings, purchasers of Parmalat's debt and equity securities had filed securities fraud class action lawsuits in the United States against Parmalat and various banks and auditing firms that had allegedly participated in the fraud, including the Appellees Grant Thornton International, Inc., Grant Thornton International Ltd. and Grant Thornton LLP ("Grant Thornton"), who had been auditors for Parmalat and PCFL. The Bankruptcy Court enjoined the actions as against the debtors and the class action plaintiffs subsequently dropped Parmalat from the class action lawsuits.

In 2004 and 2005, Bondi and PCFL separately filed suits in Illinois state court against Grant Thornton, alleging claims arising under Illinois state law including

professional malpractice, fraud, negligent misrepresentation, and unlawful civil conspiracy.¹ Grant Thornton removed these cases in separate proceedings to the United States District Court for the Northern District of Illinois on the basis of 28 U.S.C. §§ 1334(b) and 1452, arguing that removal of each case was proper because the case was “related to” Parmalat and PCFL’s respective section 304 proceedings pending in the Southern District of New York. Appellants moved to remand the cases to Illinois state court, arguing that the district court was required to abstain from hearing the cases pursuant to the mandatory abstention provided under 28 U.S.C. § 1334(c)(2). The Appellants’ motions were denied, the cases were transferred to and consolidated in the Southern District of New York, and their claims were dismissed. Bondi and PCFL appealed to the Second Circuit.

In a 2011 decision, the Second Circuit vacated the district court’s decision not to abstain under section 1334(c)(2), and articulated a four-factor test to determine whether a case can be “timely adjudicated” by state courts for purposes of section 1334(c)(2), including: “(1) the backlog of the state court’s calendar relative to the federal court’s calendar; (2) the complexity of the issues presented and the respective expertise of each forum; (3) the status of the title 11 bankruptcy proceeding to which the state law claims are related; and (4) whether the state court proceeding would prolong the administration or liquidation of the estate.” Parmalat Capital Finance Ltd. v. Bank of America Corp., 639 F.3d 572, 580 (2d Cir. 2011) (citing In re Georgou, 157 B.R. 847, 851 (N.D. Ill. 1993)). The Second Circuit remanded the cases for the district court to determine whether the cases could be “timely adjudicated” in Illinois state court as analyzed under the four-factor test. On remand, the district court again concluded that mandatory abstention did not apply. The Appellants renewed their appeals to the Second Circuit seeking mandatory abstention.

The Decision

The Second Circuit analyzed each of the four factors *de novo*, and concluded that the cases can be “timely adjudicated” by Illinois state court for purposes of mandatory abstention under section 1334(c)(2).

1. Backlog of the state court’s calendar relative to the federal court’s calendar

With regard to the first factor, the “backlog of the state court’s calendar relative to the federal court’s calendar,” the Second Circuit agreed with the district court that on balance this factor weighed against abstention but emphasized that this factor is not dispositive. The

¹ Bondi filed a similar suit in New Jersey state court against Citigroup, and PCFL filed another lawsuit in North Carolina state court against Bank of America. Bondi’s suit against Citigroup remained in New Jersey state court while PCFL’s North Carolina suit was removed to the Southern District of New York. With respect to PCFL’s North Carolina suit, the district court granted summary judgment to Bank of America, which was affirmed by the Second Circuit. Parmalat Capital Fin. Ltd. v. Bank of Am. Corp., 412 F. App’x 325 (2d Cir. 2011) (summary order). Also, after the Italian bankruptcy court approved the plan of reorganization (the “Concordato”), plaintiffs in the securities fraud class action litigation and Grant Thornton were allowed file claims against Parmalat. The securities class actions were eventually settled.

Court noted that the district court was familiar with the case having overseen discovery and accordingly an Illinois court that was new to the case may be somewhat slower in ruling on the pending summary judgment motion. However, the Court concluded that a mere delay of a few months, where there was no evidence of general backlog in the Illinois courts, was insufficient alone to not abstain.

2. Complexity of the issues presented and the respective expertise of each forum

The Court concluded that the second factor, “the complexity of the issues presented and the respective expertise of each forum,” favors abstention. In particular, the Court focused on the assertion of an *in pari delicto* defense, the nature and scope of which remained unsettled under Illinois law. The Second Circuit was not moved by arguments that the district court was better equipped to adjudicate these cases due to its familiarity with the underlying facts, instead emphasizing the focus is the complexity of the specific legal issues presented.

3. Status of the title 11 bankruptcy proceeding to which the state law claims are related

The “status of the title 11 bankruptcy proceeding to which the state law claims are related” also was found to favor abstention. Where the pending U.S. bankruptcy case was an ancillary proceeding rather than a full chapter 11 case, the Second Circuit found no evidence showing the adjudication of the cases would have an effect on the section 304 ancillary proceedings. Accordingly, the federal interest in “related-to” jurisdiction was not implicated in a remand of the cases.

4. Whether the state court proceeding would prolong the administration or liquidation of the estate

The Second Circuit similar concluded that the fourth factor, “whether the state court proceeding would prolong the administration or liquidation of the estate,” weighed in favor of abstention given that Parmalat’s ability to pay creditors under its approved Concordat in its Italian bankruptcy proceedings did not depend on the resolution of the U.S. litigations. The Second Circuit clarified that this factor considers the effect on the bankruptcy estate (here, the subject of the Italian and Cayman proceedings), not merely the pending U.S. ancillary bankruptcy proceedings. The Court also rejected the Appellees’ argument that remand of the cases to the state court would harm creditors by increasing the cost of litigation, noting that the inquiry focuses not on whether abstention increases the ultimate payout to the creditors, but on whether it unduly prolongs the administration of the estate.

Based on the four-factor test, the Second Circuit determined that mandatory abstention under section 1334(c)(2) was warranted in these cases. While recognizing that some additional time will be expended by remanding these cases, the Second Circuit concluded that such a delay does not outweigh the substantial factors that call for abstention, namely the complexity of the state law issues, the deference owed to state courts with

respect to state law matters, and the minimal effect of the state cases on the federal bankruptcy action and on the administration of the underlying estates. The Second Circuit did comment that the cases are “unusual cases” in that Grant Thornton had asserted third party contribution claims against Parmalat in securities fraud class actions also pending in the District Court for the Southern District of New York, and that Parmalat and its representatives could have asserted claims against Grant Thornton in that pending litigation. However, the ability to bring such claims in federal court shouldn’t weigh upon the abstention analysis where the debtor in fact chose to avail itself of the state court and the defendants had waived this argument against abstention by failing to raise it earlier.

Implications

The *Parmalat* decision is noteworthy in that it provides a roadmap of how to approach weighing the various factors previously espoused by the Second Circuit to consider whether abstention is mandatory in favor of state court litigation. According to the decision, the four-factor test is meant to guide courts in reaching the balance between, on the one hand, creating a federal forum for purely state law cases which, due to delay, might impinge upon the federal interest in the administration of a bankruptcy estate, and, on the other, ensuring that purely state law cases remain in state courts when they would not significantly affect that federal interest. In answering the mixed question of fact and law, the four factors ultimately are interrelated and may carry different weight depending on, among other things, the time and resources available to the relevant courts at times, the key issues in adjudging the state law questions, the nature and status of the underlying bankruptcy proceedings, the level of impact the state court proceeding will have to the administration or liquidation of the estates. Of note, the facts that the related U.S. bankruptcy cases were mere ancillary proceedings and the foreign proceedings were both in end stages and likely materially unaffected by the U.S. litigations were significant to the Second Circuit and may prove to be a basis for distinguishing other cases that are removed to federal court as related to pending bankruptcy cases.

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