AMERICAN BANKRUPTCY INSTITUTE

2018 Bankruptcy Battleground West

"Shark Tank"

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Bankruptcy Battleground West

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SHARK TANK!

Structured Dismissals Following

Consummated Sales Under 11 U.S.C. § 363(f)

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I. The Pitch

Following an approved and consummated sale of substantially all of the assets of a Chapter 11 estate, there are, at present, a limited number of options available to the debtor to distribute the sale proceeds to creditors. A debtor may proceed with a plan of liquidation, convert to a Chapter 7 to allow a trustee to administer the distribution of funds on hand, or proceed with a "structured dismissal" conditioned upon an agreement among relevant constituencies regarding the manner in which sale proceeds are allocated. Each of these options raises legal and practical issues which could be addressed by revising Sections 363 and 1112 and codifying the terms and conditions upon which, subject to Bankruptcy Court approval, a case may be dismissed post-sale and funds distributed to creditors in a streamlined fashion.

Proposed Bankruptcy Code Amendments

Add 11 U.S.C. § 363(q):

"(q)(1) Following consummation of a sale of all or substantially all of the assets of a debtor's estate that has been authorized under subsection (b) or (c) and (f) of this section, the court, in its discretion and following notice to all creditors and parties in interest and a hearing, may authorize the trustee to distribute all cash proceeds from any sale to creditors, provided:

A. All cash shall be distributed to creditors according to their relative order of priority as set forth in section 726 of this title;

B. After payment of all claims senior to the claims of general unsecured creditors, the total amount of cash proceeds that would be available to pay holders of allowed unsecured claims against the debtor either (i) does not exceed $5,000,000, or (ii) would result in a distribution to holders of allowed unsecured claims of not more than 5% of the amount of such allowed claims; and

C. Any variance from the payment priorities of section 726 of this title proposed as a condition to the distribution of cash proceeds from any sale requires the consent of all creditors who would be adversely affected by such variance.

(2) Any request to distribute cash proceeds of a sale may be joined with a request for approval of such sale under subsection (f) of this section."

Add 11 U.S.C. § 1112(b)(4)(Q):

"(Q) distribution of the cash proceeds from any sale under section 363(b) or (c) and (f) of this title has occurred in accordance with the provisions of section 363(q) of this title, and there would be no benefit to the continued administration of the debtor's estate."

II. Background

Often, particularly in so-called "middle market" cases filed with the specific intent to consummate a sale under 11 U.S.C. § 363(f), once the sale has been consummated, the debtor is left with a decision: how best to distribute the cash received in a cost-effective and timely manner? As noted, generally there are three paths a debtor may take: (1) propose and confirm a plan of liquidation; (2) convert to chapter 7 and allow a trustee to oversee the distribution to creditors; or (3) do a "structured dismissal" of the bankruptcy case, conditioned upon distributions being made to creditors. However, each of these paths involves its own complications.

A chapter 11 plan process is time-consuming and complex. While a liquidating plan does not involve the same issues regarding, for example, plan feasibility as a true plan of reorganization, the disclosure statement process, solicitation of votes and plan confirmation procedures remain the same. These steps involve extensive legal work which may consume the bulk of the cash proceeds received by the debtor from the consummated sale, particularly after payment of allowed secured and priority claims. In addition, if the only remaining creditors are the holders of general unsecured claims who, as a class, vote "no" on the plan, there may be no legally permissible way to proceed with plan confirmation. As a result, even after the expenditure of estate resources to seek confirmation of a liquidating plan, the debtor may still face the need to convert to a liquidation under chapter 7.

A liquidation of the estate under chapter 7 has its own drawbacks. A trustee and her professionals will incur their own expenses in addition to any remaining unpaid chapter 11 administrative expenses, all of which take priority over the payment of general unsecured claims. *See* 11 U.S.C. § 726. Perhaps the most significant downside to a chapter 7 liquidation is the potential for a long period between conversion of the case and the trustee's final report and distribution to creditors. That process can often take even longer than the plan confirmation process to complete.

A "structured dismissal" has the advantage of an expedited distribution to creditors, but as noted by the Supreme Court in *Czyzewski v. Jevic Holding Corp.*, 137 S.Ct. 973 (2017) ("*Jevic*"), "[n]othing … in the [Bankruptcy] Code authorizes a court ordering a dismissal to make general end-of-case distributions of estate assets to creditors of the kind that normally take place in a Chapter 7 liquidation or Chapter 11 plan…" *Id.* at 984. Indeed, as noted by the Supreme Court in *Jevic*, "[n]either the word 'structured,' nor the word 'conditions,' nor anything else about distributing estate value to creditors pursuant to a dismissal appears in any relevant part of the [Bankruptcy] Code." *Id.*

Parties have attempted to rely upon 11 U.S.C. § 349(b), which addresses the effects of dismissal of a case, as authority for distributions made outside of a chapter 7 liquidation or chapter 11 plan. That section essentially provides for the restoration of the *status quo ante* upon dismissal of a case, "[u]nless the court, for cause, orders otherwise." In *Jevic*, the Supreme Court found that it was inappropriate to use section 349(b) as a justification for a structured dismissal, and that "… the word 'cause' is too weak a reed upon which to rest so weighty a power." *Id.* at 985.

Further complicating the analysis in *Jevic*, the proposed dismissal included distributions in violation of the provisions of section 726 of the Bankruptcy Code. Specifically, the proposed distribution of funds did not include anything for holders of priority wage claims, and instead allocated funds to the holders of general (lower priority) unsecured claims. This priority-skipping aspect of the structured dismissal was the principal basis for the Supreme Court's holding. As stated in the *Jevic* opinion, "[W]e would expect to see some affirmative indication of intent if Congress actually meant to make structured dismissals a backdoor means to achieve the exact kind of nonconsensual priority-violating final distributions that the Code prohibits in Chapter 7 liquidations and Chapter 11 plans." *Id.* at 984. The Supreme Court analogized the situation to "proposed transactions that lower courts have refused to allow on the ground that they circumvent the Code's procedural safeguards. *See*, *e.g., In re Braniff Airways, Inc.,* 700 F.2d 935, 940 (5th Cir. 1983) (prohibiting an attempt to "short circuit the requirements of Chapter

11 for confirmation of a reorganization plan by establishing the terms of the plan *sub rosa* in connection with a sale of assets"); *In re Lionel Corp.,* 722 F.2d 1063, 1069 (2d Cir. 1983) (reversing a Bankruptcy Court's approval of an asset sale after holding that § 363 does not "gran[t] the bankruptcy judge *carte blanche* " or "swallo[w] up Chapter 11's safeguards"); *In re Biolitec, Inc.,* 528 B.R. 261, 269 (Bankr. N.J. 2014) (rejecting a structured dismissal because it "seeks to alter parties' rights without their consent and lacks many of the Code's most important safeguards"). *Cf. Institutional Creditors of Cont'l Air Lines, Inc. v. Cont'l Air Lines, Inc. (In re Cont'l Air Lines, Inc.)*, 780 F.2d 1223, 1228 (5th Cir. 1986) (no *per se* rule against transactions under 11 U.S.C. § 363 that could impact terms of reorganization: "…when an objector to a proposed transaction under § 363(b) claims that it is being denied certain protection because approval is sought pursuant to § 363(b) instead of as part of a reorganization plan, the objector must specify exactly what protection is being denied. If the court concludes that there has in actuality been such a denial, it may then consider fashioning appropriate protective measures modeled on those which would attend a reorganization plan.")

That is not to say that there is no basis for a court to order distributions to creditors while a case is pending outside of a chapter 7 liquidation or chapter 11 plan. As one court noted, "… the [Bankruptcy] Code does not bar an interim distribution, and when it benefits the estate to do so, the Court is authorized to approve any interim distribution using its authority pursuant to [11 U.S.C.] § 105(a)." *In re Bird*, 565 B.R. 382, 400 (Bankr. S.D. Tex. 2017); *see also In re Chateaugay Corp.*, 80B.R. 279 (S.D. N.Y. 1987). Section 105(a) of the Bankruptcy Code authorizes a court to "issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title." 11 U.S.C. § 105(a).

Section 105(a) has served as the basis for the so-called "doctrine of necessity," which has been applied to "justify the pre-plan payment of prepetition claims of creditors who threaten to withhold goods or services believed critical to the debtor's continued viability and reorganization." *Capital Factors, Inc. v. Kmart Corp.*, 291 B.R. 818, 822 (N.D. Ill. 2003), *aff'd* 359 F.3d 866 (7th Cir. 2004). However, the Seventh Circuit, in considering a request to pay "critical vendors" in the Kmart case held that section 105(a), "… does not create discretion to set aside the Code's rules about priority and distribution; the power conferred by § 105(a) is one to implement rather than override. See *Norwest Bank Worthington v. Ahlers,* 485 U.S. 197, 206, 108 S.Ct. 963, 99 L.Ed.2d 169 (1988); *In re Fesco Plastics Corp.,* 996 F.2d 152, 154 (7th Cir.1993). *Cf. United States v. Noland,* 517 U.S. 535, 542, 116 S.Ct. 1524, 134 L.Ed.2d 748 (1996)." There remains a split of authority regarding a bankruptcy court's ability to rely upon section 105 to permit pre-plan payment of prepetition unsecured claims. *See, e.g.*, *In re Just for Feet, Inc.*, 242 B.R. 821 (D. Del. 1999) (payments permitted); *In re CoServ, L.L.C.*, 273 B.R. 487 (Bankr. N.D. Tex. 2002) (same); *In re Wehrenberg, Inc.*, 260 B.R. 468 (Bankr. E.D. Mo. 2001) (same); *In re Tusa-Expo Holdings, Inc.*, 273 B.R. 487 (Bankr. N.D. Tex. 2008)(same); *In re Jeans.com, Inc.*, 502 B.R. 250 (Bankr. D. P.R. 2013); *but see, e.g., Official Comm. Of Equity Sec. Holders v. Mabey*, 832 F.2d 299 (4th Cir. 1987) (payment not permitted); *B & W Enters., Inc. v. Goodman Oil Co. (In re B & W Enters., Inc.)*, 713 F.2d 534 (9th Cir. 1983) (same); *Chiasson v. J. Louis Matherne & Assocs. (In re Oxford Mgmt. Inc.)*, 4 F.3d 1329 (5th Cir. 1993) (same).

There is also reason to question the use of section 105(a) to create substantive rights that are not otherwise specifically provided for under the Bankruptcy Code. As the court in *In re G-I Holdings, Inc.*, 327 B.R. 730, 740 (Bankr. D. N.J. 2005) held:

"… [T]his generalized equitable power [under section 105(a)] is not without restriction. Section 105(a) of the Code does not 'elevate a bankruptcy court to 'super court' status; a bankruptcy court's equitable powers are available to serve any constituency involved in any particular case, but may be exercised only within the confines of the Code.' *Florida Bay Banks, Inc. v. Florida Dep't of Banking & Fin. (In re Florida Bay Banks, Inc.),* 156 B.R. 673, 677 (Bankr.N.D.Fla.1993) (citing *Norwest Bank Worthington v. Ahlers,* 485 U.S. 197, 206, 108 S.Ct. 963, 99 L.Ed.2d 169 (1988)). That is, pursuant to § 105(a), a bankruptcy court 'must locate its equitable authority in the Bankruptcy Code.' *Pacific Shores Dev., LLC v. At Home Corp. (In re At Home Corp.),* 392 F.3d 1064, 1070 (9th Cir.2004) (citation omitted). *See also In re The Colad Group, Inc.,* 324 B.R. 208, 213 (Bankr.W.D.N.Y.2005) (" 'By its very terms, section 105(a) limits the bankruptcy court's equitable powers, which must and can only be exercised within the confines of the Bankruptcy Code, and cannot be used in a manner inconsistent with the commands of the Bankruptcy Code' ") (citation omitted). Moreover, a bankruptcy court's utilization of its equitable powers under § 105(a) of the Code is discretionary and must be " 'carefully honed in light of the facts of the case, applicable precedent and appropriate policy.' " *In re Charles & Lillian Brown's Hotel, Inc.,* 93 B.R. 49, 55 (Bankr.S.D.N.Y.1988) (citing *Lesser v. A–Z Assocs. (In re Lion Capital Group),* 44 B.R. 690, 701 (Bankr.S.D.N.Y.1984))."

Thus, absent some authority for pre-plan payments to creditors otherwise set forth in the Bankruptcy Code, the use of section 105(a) to create a substantive basis for relief is subject to serious question.

Pre-plan payment of unsecured claims in the chapter 11 context also contradicts the provisions of Federal Rule of Bankruptcy Procedure 3021, which provides, in relevant part, "after a plan is confirmed, distribution shall be made to creditors whose claims have been allowed…" Fed. R. Bankr. Pro. 3021. Although the rule does not expressly *prohibit* pre-plan payments, the Fourth Circuit has held that any such payments would run afoul of the restrictions imposed by Rule 3021. *See Official Comm. Of Equity Sec. Holders v. Mabey*, 832 F.2d 299, 302 (4th Cir. 1987) ("The clear language of these statutes, as well as the Bankruptcy Rules applicable thereto, does not authorize the payment in part or in full, or the advance of monies to or for the benefit of unsecured claimants prior to the approval of the plan of reorganization.")

Given the efforts that have been made to cobble together legal support for pre-plan/pre-liquidation payments to unsecured creditors, codification of the concept of structured dismissals by way of proposed amendments to the Bankruptcy Code would appear necessary and appropriate.

III. The Pros

A. The structured dismissal of bankruptcy cases will allow for more rapid distributions to unsecured creditors following the consummation of a sale under section 363 than would otherwise be the case if creditors had to wait for confirmation of a plan or a final distribution by a chapter 7 trustee. Similarly, the estate would be able to avoid the fees and costs associated either with a plan process or administration by a chapter 7 trustee.

B. By codifying the concept of structured dismissals into the Bankruptcy Code, parties will not need to rely upon the general equitable powers of Bankruptcy Courts to effectuate pre-plan distributions in chapter 11 cases.

C. By limiting the applicability of the structured dismissal provisions to those cases where sale proceeds fall below a certain threshold, there would be no general right to a structured dismissal in every case, and such a result would be available only in those cases where it is economically rational to save the fees and delay associated with the chapter 11 plan process or a liquidation under chapter 7.

D. As long as distribution priorities are recognized and maintained, no class of unsecured creditor would be prejudiced by the proposed dismissal.

E. Any variance from the payment priorities of the Bankruptcy Code would require the consent of the affected class. This could prompt negotiations among the various classes of creditors either in connection with or immediately following the closing of a section 363 sale regarding the disposition of sale proceeds without the need for extensive litigation or the tactics employed in *Jevic*.

IV. The Cons

A. The timing of a structured dismissal, particularly in connection with the closing of a section 363 sale, would not allow for a thorough review of claims asserted by creditors. Even assuming the debtor obtained a claims bar date prior to the date of the sale, it would be difficult, if not impossible, to assess the validity of each claim or the entitlement of any creditor to participate in a proposed distribution. This is particularly true where, as is often the case, sale motions are filed very early in a chapter 11 case and are set for hearing on an expedited basis.

B. As a practical matter, the proposed structured dismissal would effectively do away with the analysis and pursuit of avoidance causes of action. Given that the case would be dismissed upon the closing of a sale, there would be no way in which a debtor or trustee could pursue an avoidance claim. Unsecured creditors, particularly those who could be exposed to potential preference litigation, would not likely mind this result. However, to the extent avoidance causes of action are intended to equalize distributions among similarly situated creditors, those creditors who are not litigation targets would be harmed.

C. The dismissal in connection with consummation of a section 363 sale would create another basis upon which an interested party could object to the sale itself. This could have the adverse impact of actually slowing down the sale process as objections are addressed.

D. There is no philosophical reason to limit structured dismissals to those cases where sale proceeds are limited, or where projected distributions to unsecured creditors are minimal. Unsecured creditors' interest in obtaining rapid distributions in amounts as great as possible at the lowest cost possible is consistent regardless of the size of the case.

Bankruptcy Battleground West

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SHARK TANK!

A Constitutional Amendment Should Be Required to Modify the Existing Bankruptcy Venue "Hooks"

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I. The Pitch

Your Honor, the current bankruptcy venue statute (28 U.S.C. § 1408), with its several venue "hooks" offered to potential debtors, should be protected by requiring a Constitutional amendment to make any changes to it. The venue law (or its similar predecessors) has generally worked for decades, espousing important public policy principles including allowing debtors access to courts equipped to efficiently and effectively reorganize their financial affairs, and should be protected from mercurial forces that may try to unnecessarily tinker with its language for political reasons.

II. Background

Under the current venue rules, a debtor is permitted to file for bankruptcy in the district in which it has: (1) its domicile (which, for a corporation is generally its state of incorporation); (2) its residence: (3) its principal place of business in the United States; (4) its principal assets; or (5) an affiliate that has already filed for bankruptcy.

Specifically, the bankruptcy venue statute provides:

> Venue of cases under title 11
>
> Except as provided in section 1410 [venue of cases ancillary to foreign proceedings] of this title, a case under title 11 may be commenced in the district court for the district -
>
> (1) in which the domicile, residence, principal place of business in the United States, or principal assets in the United States, of the person or entity that is the subject of such case have been located for the one hundred and eighty days immediately preceding such commencement, or for a longer portion of such one-hundred-and-eighty-day period than the domicile, residence, or principal place of business, in the United States, or principal assets in the United States, of such person were located in any other district; or
>
> (2) in which there is pending a case under title 11 concerning such person's affiliate, general partner, or partnership.

There has been dispute over the years as to what "hooks" should be provided for potential debtors to use to be able to file in a certain venue. In particular, some politicians, jurists, academics and commentators have criticized the state of incorporation (domicile) and affiliate venue provisions. Attempts have been made unsuccessfully in the past to remove or substantially modify these provisions, and Senators Elizabeth Warren and John Cornyn recently introduced a bill in the Senate dealing with these provisions. Critics often refer to such provisions as "loopholes" leading to forum shopping and purportedly preventing employees, small business vendors, and retirees from having a voice in the bankruptcy proceedings in a far-removed venue.

III. The Arguments Supporting the Pitch

A. **Optimal Specialized Venues for Restructuring.** Debtors should be allowed to choose a venue that provides them the best opportunity to reorganize or otherwise maximize estate value – the fundamental goals of the Bankruptcy Code. In many debtors' views, that optimal venue may be Delaware or the Southern District of New York, which bankruptcy court systems have developed special expertise and infrastructure over many years to be able to efficiently and expeditiously deal with numerous, complicated bankruptcy cases. Accordingly, a Constitutional amendment is needed to ensure that debtors are accorded great deference in their careful selection of venue for the benefit of these companies, bankruptcy estates, and creditors), as permitted under section 1408, and not be subject to mercurial political whim. *See generally In re Enron Corp.* 274 B.R. 327, 342 (S.D.N.Y. 2002) ("A debtor's choice of forum is entitled to great weight if venue is proper." (citations omitted)).

B. **Policy Considerations.** Removing the state of incorporation (domicile) and affiliate options would be an enormous mistake for important policy reasons.

- Such change would overturn a long history of established bankruptcy practice. With certain exceptional periods (like during part of the 1970s), a corporation has traditionally been permitted to file for bankruptcy in its state of incorporation. That corporations should be permitted to file for bankruptcy in their state of incorporation is closely linked to and consistent with the longstanding belief that corporations should generally be regulated by the states, not by Congress. Corporations are creations of the states: They are created by the states, and the states regulate their internal affairs. While corporations are also subject to federal laws, of course (including antitrust and securities laws, environmental laws, and bankruptcy laws), the starting point is state law. The well-established rule that corporations can file for bankruptcy in their state of incorporation has to be seen in this context.

- The affiliate provision has for decades facilitated the efficient administration of bankruptcy cases involving multiple entities. This venue provision is designed to allow interconnected entities to proceed in the same bankruptcy court to avoid inconsistent rulings and to improve the prospects for providing full relief for the related entities.

Based on such history and background, there is no reason to eliminate these venue hooks now. Where the circumstances warrant deviation, the bankruptcy courts can grant and have granted motions to transfer venue.

C. **Legitimate Forum Shopping.** Strategic venue selection (what some critics label as "forum shopping") is generally a legitimate, statutorily-sanctioned practice (i.e., section 1408 expressly gives several alternatives from which the debtor can choose). There are numerous legitimate reasons for a debtor to select one venue over another. For example, (1) substantive precedent in a particular jurisdiction is beneficial in a case, i.e. differences between Second Circuit and Third Circuit on test for rejection of a collective bargaining agreement; (2) a particular venue may enhance the chances of a soft landing in chapter 11 through the expeditious consideration and approval of first day relief or other emergency relief; (3) it may minimize uncertainty, risk, and administrative costs by, for instance, having clearer precedent for legal issues that might arise during the case; (4) it may allow for the expeditious consideration of key matters through its docket management and infrastructure; and (5) it may reduce the overall costs of the case through efficient case administration and more judicial experience, expertise, predictability, and accessibility, as well as potentially a reduction in travel and other costs (e.g., debtors' key executives and key creditors like the debtors' lenders may be relatively close to the court). In short, strategic venue selection is often an important piece of the process to a successful chapter 11 case.

D. **Venue Transfer Safeguard.** If and to the extent warranted, bankruptcy judges (who are competent, neutral parties) can address venue concerns through, for example, transferring the bankruptcy case to another venue under 28 U.S.C. § 1412 "in the interest of justice" or "for the convenience of the parties."

- *See, e.g., In re Patriot Coal Corp.*, 482 B.R. 718 (Bankr. S.D. N.Y. 2012): While the debtors did not act in bad faith in filing the chapter 11 cases of two New York incorporated companies in the Southern District of New York and then using those filings as the basis for filing the cases of nearly 100 other affiliated debtors incorporated elsewhere in that venue, "this Court cannot allow the Debtors' venue choice to stand, as to do so would elevate form over substance in 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 [the two debtors incorporated in New York] [a month before the bankruptcy filing] solely for the purpose of establishing venue is not 'the thing which the statute intended.'" The bankruptcy court transferred the cases to the Eastern District Missouri, because debtors' corporate headquarters and executive offices were located in Missouri and many of debtors' key corporate functions were based there, all of debtors' books and records, including those established postpetition, were located in Missouri, and several members of debtors' executive management team resided in Missouri or Illinois.

- Section 1412 and applicable case law make that statute an effective and sufficient tool against any manipulative forum shopping. When considering the "convenience of the parties" element, courts generally use a flexible balancing test, weighing (i) the proximity of creditors to the court, (ii) the proximity of the debtor to the court, (iii) the proximity of the witnesses necessary to the administration of the estate, (iv) the location of the debtor's assets, (v) the economic administration of the estate, and (vi) the necessity for ancillary administration if liquidation should result. Potentially more powerful is the "in the interest of justice" element which has been described as a "broad and flexible standard" that involves "a consideration of whether transferring venue would promote the efficient administration of the bankruptcy estate, judicial economy, timeliness and fairness."

E. **Lack of Prejudice.** Any alleged potential prejudice to creditors who are located far away from the selected venue is not a real issue. Importantly, in larger bankruptcies, there will likely be a creditors' committee, and possibly other special committees depending on the circumstances (like an equity holders committee, a tort litigation committee, or retirees committee), to watch out for the interests of the creditor body. Moreover, in most cases, out-of-state creditors can obtain access to bankruptcy court documents electronically (including, often, through a special website set up by the debtor's noticing agent) and participate in hearings telephonically. Indeed, it is likely that the bankruptcy court overseeing the case will be more flexible in terms of dealing with out-of-state creditors and providing them with reasonable notice and opportunity to participate in the proceedings. The bankruptcy judge is independent and disinterested and will not rubberstamp the debtor's requests simply because the debtor chose that particular venue.

IV. The Most Prevalent (Albeit Extremely Weak) Arguments Against the Pitch

A. **Purposeless Basis for Venue.** The state of incorporation hook is too tenuous. Many corporations do not do business or own assets in the state in which they are incorporated, and thus, the state of incorporation as a basis for venue is really just a pretext for forum shopping. This hook improperly allows debtors to sort out their financial problems far removed from local creditors and other parties like employees, small vendors, local government, and retirees – which parties have a substantial interest in the outcome of the bankruptcy case.

B. **Widespread Forum Shopping.** Forum shopping is a real problem. Debtors should not be permitted to obtain improper advantage over creditors and other parties. The advantages can result simply from the court being in a location distant from significant constituencies in the case (like local vendors and workers), to an implicit suggestion or message to such constituencies that the chosen court may not vigilantly protect their legitimate interests or be sensitive to the interests of the local harms being suffered (thus, any participation by such constituencies will be chilled). Further, there is a concomitant erosion of public confidence in the bankruptcy system as more affected parties believe that the bankruptcy system can be manipulated by debtors. The bankruptcy reorganization process should remain within the communities that have the most significant interest in the outcome. This can only be accomplished by allowing a corporate debtor to file only in districts where its principal place of business or principal assets has been located for a significant period prior to the commencement of the case.

C. **Inadequate Transfer Mechanism.** Seeking to have a case transferred to another venue is a costly and difficult legal hurdle to overcome, and thus, an inadequate safeguard mechanism. Often, it is the small vendor, the former/current employee, or the retiree who may desire a change in venue (to, for example, where the debtor's primary operations are located), but these parties, individually, cannot afford the litigation. Additionally, because in some courts' view there is a significant presumption in favor of the forum chosen by the debtor, it is very difficult to carry the burden of persuading the court to change venue.

D. **Over-Centralization.** It is important that innovative case-management techniques and legal interpretations be formulated by bankruptcy judges around the nation, as opposed to having the law and rules be developed primarily by so-called magnet venues. As more judicial decisions are rendered by just a few courts like the Delaware and New York federal benches, those courts arguably take on a greater significance than is appropriate in a national, uniform bankruptcy system as contemplated by the U.S. Constitution. Further, there is an ample supply of competent and willing bankruptcy judges across the U.S.

Bankruptcy Battleground West

March 6, 2018

SHARK TANK!

Set Free the Lessee: Debtors Rights to Sell Free and Clear After *Spanish Peaks*

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[1] The author would like to thank Stephen Astringer, Esq., an associate in Polsinelli's Bankruptcy & Financial Restructuring practice for his assistance in this presentation.

I. The Pitch

Under section 365(h) of the Bankruptcy Code, nondebtor lessees are granted certain rights when their unexpired leases of real property are rejected by a trustee or debtor in possession. Specifically, pursuant to section 365(h)(1)(A)(ii), the lessee is entitled to retain its rights under the lease for the remainder of the leasehold term, subject to applicable nonbankruptcy law. This provision seemingly conflicts with the ability of a trustee or debtor in possession to "sell property . . . free and clear of any interest in such property" if certain conditions are met under section 363(f). Or does it?

Although lower courts have ruled in differing manners over the years, only one circuit court had weighed in until the Ninth Circuit did in *Pinnacle Restaurants at Big Sky, LLC v. CH SP Acquisitions, LLC (In re Spanish Peaks Holdings, II, LLC)*, 872 F.3d 892 (9th Cir. 2017) ("**Spanish Peaks**"). The Court in *Spanish Peaks* held that "section 363 governs the sale of estate property, while section 365 governs the formal rejection of a lease. Where there is a sale, but no rejection (or a rejection, but no sale), there is no conflict."[2] It could not have been more clearly stated. This interpretation promotes the Bankruptcy Code's purpose of allowing debtors to rehabilitate and reorganize, does not seriously jeopardize the rights of lessees, and provides clarity for all parties. Not to mention, it also properly states the correct outcome in this situation. Therefore, all Bankruptcy Courts should follow the learned decision by the Ninth Circuit and adopt this interpretation of the interplay between sections 363(f) and 365(h).

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[2] *Id.* at 899.

II. Background

Statutory Background

Pursuant to section 363(f), trustees are authorized to sell a debtor's assets free and clear of any liens, claims, and encumbrances, including third party interests, subject to certain exceptions. Specifically, section 363(f) allows a trustee or debtor in possession to sell property free and clear if:

> (1) applicable nonbankruptcy law permits such a sale of such property free and clear of such interest;
> (2) such entity consents;
> (3) such interest is a lien and the price at which such property is to be sold is greater than the aggregate value of all liens on such property;
> (4) such an interest is in bona fide dispute; or
> (5) such entity could be compelled, in a legal or equitable proceeding, to accept money is satisfaction of such interest.[3]

Additionally, section 363(e) provides that "[o]n request of an entity that has an interest in property used, sold, or lease . . . the court . . . shall prohibit or condition such use, sale, or lease as is necessary to provide adequate protection of such interest."[4]

Section 365 of the Bankruptcy Code addresses executory contracts and unexpired leases. In relevant part, it provides that:

> (A) If the trustee rejects an expired lease of real property under which the debtor is the lessor and
>
> (i) if the rejection by the trustee amounts to such a breach as would entitle the lessee to treat such lease as terminated by virtue of its terms, applicable nonbankruptcy law, or any agreement made by the lessee, then the lessee under such lease may treat such lease as terminated by the rejection; or
>
> (ii) if the term of such lease has commenced, the lessee may retain its rights under such lease (including rights such as those relating to the amount and timing of payment of rent and other amounts payable by the

[3] 11 U.S.C. 363(f).
[4] 11 U.S.C. 363(e).

lessee and any right of use, possession, quiet enjoyment, subletting, assignment, or hypothecation) that are in or appurtenant to the real property for the balance of the term of such lease and for any renewal or extension of such rights to the extent that such rights are enforceable under applicable nonbankruptcy law.

(B) If the lessee retains its rights under subparagraph (A)(ii), the lessee may offset against the rent reserved under such lease for the balance of the term after the date of the rejection of such lease and for the term of any renewal or extension of such lease, the value of any damage caused by the nonperformance after the date of such rejection, of any obligation of the debtor under such lease, but the lessee shall not have any other right against the estate or the debtor on account of any damage occurring after such date caused by such nonperformance.

(C) The rejection of a lease of real property in a shopping center with respect to which the lessee elects to retain its rights under subparagraph (A)(ii) does not affect the enforceability under applicable nonbankruptcy law of any provision in the lease pertaining to radius, location, use, exclusivity, or tenant mix or balance.[5]

As succinctly put by the Ninth Circuit, "[t]he crux of this dense statutory language is that the rejection of an unexpired lease leaves a lessee in possession with two options: treat the lease as terminated (and make a claim against the estate for any breach via a rejection damages), or retain any rights—including a right of continued possession—to the extent those rights are enforceable outside of bankruptcy."[6]

Prior Decisions

Before *Spanish Peaks*, two separate approaches emerged: the *majority view*, which determined that section 365(h) governed, thus disallowing the trustees right to sell free and clear;[7] and the *minority view*, which determined that trustees should be able to extinguish

[5] 11 U.S.C. §365.

[6] *Spanish Peaks*, 872 F.3d at 898.

[7] *See, e.g.*, *In re Haskell L.P.*, 321 B.R. 1, 8-9 (Bankr. D. Mass 2005); *In re Zota Petroleums, LLC*, 482 B.R. 154 (Bankr. E.D. Va. 2012); *In re Revel AC, Inc.*, 532 B.R. 216 (Bankr. D.N.J. 2015); *In re Churchill Props.*, 197 B.R. 283, 286 (Bankr. N.D. Ill. 1996); *In re Taylor*, 198 B.R. 142 (Bankr. D.S.C. 1996); *In re LHD Realty Corp.*, 20 B.R. 717 (Bankr. S.D. Ind. 1982); *Indepdence Village, Inc.*, 5 B.R. 715, 732 (Bankr. E.D. Mich. 1985).

leases through a free and clear sale.[8] Those courts who embraced the majority contended that the minority's view would render section 365(h) "meaningless" if subjugated to section 363(f).[9]

However, until now, the seminal decision at this intersection was the Seventh Circuit's in *Qualitech*. There, a lessee did not seek adequate protection or object prior to the free and clear sale.[10] The Court found that despite the seeming disagreement between the two sections, there was no real conflict, and they did not limit one another.[11] According to the Court, section 363's right to sell free and clear of any interest did not exempt leases and because section 365(h) applied only to rejected leases, while section 363(f) applied only to sales. Additionally, the Court found that lessees whom were worried could seek adequate protection from the bankruptcy court under section 363(e).

Commenters, including several from the American Bankruptcy Institute ("**ABI**") strongly disagreed with the Seventh Circuit, arguing, among other things: "[r]arely does a bankruptcy case have the potential to profoundly impact the nonbankruptcy world" in part because it "completely eviscerates a lessee's § 365 rights" and "creates an incentive for debtors to try to accomplish a steal rejection of leases in an attempt to extinguish unwanted leaseholds";[12] that "great concern in the real estate investment community" with possible "ripple effect[s] in many

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[8] *See, e.g.*, *Precision Industries, Inc. v. Qualitech Steel SBQ, LLC (In re Qualitech Steep Corp & Qualitech Steel Holdings Corp.)*, 327 F.3d 537 (7th Cir. 2003) ("***Qualitech***"); *Dishi & Sons v. Bay Condos, LLC*, 510 B.R. 696 (Bankr. S.D.N.Y. 2014) ("***Dishi***"); *In re MMH Automotive Group, LLC*, 385 B.R. 347, 361 (Bankr. S.D. Fla. 2008); *In re Hill*, 307 B.R. 821, 826 (Bankr. W.D. Pa. 2004); *Cheslock-Bakker & Assocs. V. Kremer (In re Downtown Athletic Club of New York City, Inc.*, 2000 WL 744126 (S.D.N.Y. June 9, 2000).

[9] *See, e.g.*, *Churchill*, 197 B.R. at 286-88.

[10] 327 F.3d at 547.

[11] *Id.*

[12] Michael St. Patrick Baxter, *Section 363 Sales Free and Clear of Interests: Why the Seventh Circuit Erred in Precision Industries v. Qualitech Steel*, 59 BUS. LAW. 475, 475-77 (2004).

areas";[13] and that section 365(h) should be amended to effectively overrule *Qualitech.*[14] Though more than a decade passed, *Qualitech* continued to generate scholarship and debate, mainly because this issue did not arise as often before the market crash in 2007.[15]

The most recent case of note addressing this problem was *Dishi*, which expanded upon *Qualitech*.[16] In *Dishi*, the lessee's lease was rejected and it sought to retain possession. A free and clear sale was proposed and rejected by the bankruptcy court for two reasons: (1) section 365(h) trumped section 363(f) because the specific overrides the general; and (2) because the lessee sought adequate protection, it could retain possession. The District Court affirmed the Bankruptcy Court on the latter, finding that the lessee could retain possession of the real property after a sale under section 363(f). The court did not agree regarding the first argument, finding it "proves too much," but it did determine that adequate property under a section 363 sale could take the form of continued possession.[17]

<u>*Spanish Peaks*</u>

Then came *Spanish Peaks*. In *Spanish Peaks*, the debtor owned a resort in Montana. Through a series of assignments, one lessee held a restaurant lease at $1,000 in annual rent for 99 years. A second lessee held a parcel of commercial real estate at the resort for $1,285 per

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[13] Robert M. Zinman, *Precision in Statutory Drafting: The* Qualitech *Quagmire and Sad History of § 363(h) of the Bankruptcy Code*, 38 J. MARSHALL L. REV. 97 (2004).

[14] James H. Millar, Fixing the *Qualitech Problem by Revising § 365(h)*, 31-JUL AM. BANKR. INST. J. 36 (2012).

[15] *See, e.g.*, Bruce Grohsgal, *Colder Than a Landlord's Heart? Reconciling a Debtor's Authority to Sell Property Free and Clear of a Lease Under Bankruptcy Code Section 363(f) with the Tenant's Right to Remain in Possession on a Lease Rejection Under Bankruptcy Code Section 365(h)*, 100 MARQ. L. REV. 295 (2016); Anthony Asebedo, *The Sale of Real Property Free and Clear of a Lease: Making Sense of Sections 363(f) and 365(h) of the Bankruptcy Code*, 24 AM. BANKR. INST. L. REV. 279 (2016).

[16] 510 B.R. at 698-99.

[17] *Id.*

year for 60 years. The debtor and its affiliated entities filed a chapter 7 petition.[18] Though the resort was secured by a $122 million mortgage, the trustee and the debtor's largest creditor agreed to a plan of liquidation with an auction and sale "free and clear of all liens, claims, encumbrances and interests," except certain specified interests. The trustee filed a motion seeking an order authorizing and approving the sale. The two lessees were not listed under the specified interests. The lessees objected to the sale, arguing a sale could not be free and clear of their leasehold interests. The bankruptcy court did not rule on the objection, but authorized the sale. After the sale completed, for a price of $26.1 million, the lessees again argued that they were able to retain their leases. The buyer's "principal testified that its bid was contingent on the property being free and clear of the leases." The Bankruptcy Court approved the sale free and clear of any interests and the District Court affirmed.

The lessees appealed to the Ninth Circuit, arguing their leases survived the sale. After reviewing sections 363(f) and 365(h), the Circuit Court noted that these "statutes frequently operate in isolation. . . . But when both provisions come into play—that is, when the trustee proposes to sell property free and clear of encumbrances, and one of the encumbrances is an unexpired lease—federal courts have addressed the resulting dilemma in different ways."[19] The Court adopted *Qualitech*'s reasoning, determining that sections 363(f) and 365(h) could be read in a way as to not conflict.[20] This is because "section 363 governs the sale of estate property, while section 365 governs the formal rejection of a lease. Where there is a sale, but

[18] It is worth noting that the original case was filed in Delaware, a jurisdiction where there is a surprising absence of precedent on this issue. The case was transferred to the Bankruptcy Court for the District of Montana.

[19] *Id.* at 897.

[20] *Id.* at 899.

no rejection (or a rejection, but no sale), there is no conflict."[21] In the instant case, the lessees' leases were not rejected, therefore, section 365 did not apply.

The Circuit Court next expanded upon the reasoning of *Dishi* and *Qualitech* by noting two distinct points: (1) adequate protection under section 363(e) is mandatory and an option for lessees; and (2) section 363(f) is limited, allowing free and clear sales only in certain circumstances.[22] With regard to the first point, the Court focused on *Dishi*, which attempted to bridge the gap between the majority and minority approach. While noting that the lessees in *Spanish Peaks* did not seek adequate protection, the Court seemingly endorsed *Dishi*'s view "that adequate protection could take the form of continued possession."[23] With regard to the second point, the Court noted that, for example, section 361(f) authorizes free and clear sales where "applicable nonbankruptcy law permits sales of such property free and clear of such interest." In the case of the lessees, Montana foreclosure law would have led to the same result, the termination of the leases. The Court concluded its analysis by recognizing that generally, bankruptcy is designed to the debtor's benefit and that section 365 could not be enhanced to increase lessee's protections outside of bankruptcy.

III. The Pros

A. Free and clear sales should be – Free and clear. A debtor-lessor should be able to avail itself of all applicable provisions of the Bankruptcy, in particularly, being able to sell substantially all of its assets free and clear of liens, claims, and encumbrances, including any rights of lessees that are tantamount to an encumbrance. Free and clear sales have a long

[21] *Id.* at 899.
[22] *Id.* at 900.
[23] Because the lessees did not seek adequate protection, the Ninth Circuit could not rule on what form adequate protection should or could take.

tradition in American bankruptcy law, and are often a necessity.[24] Real properties sold in bankruptcy encumbered by leases are less attractive and will not generate the same value of as encumbered properties. Allowing such properties to be sold free and clear is a better option and consistent with the purpose of the Bankruptcy Code.

B. *Spanish Peaks* is consistent with the purpose of the Bankruptcy Code—to allow debtors to rehabilitate and reorganize. One of the main purposes of the Bankruptcy Code, and specifically of chapter 11, is to allow debtors to rehabilitate and reorganize.[25] As recognized in *Qualitech,* and adopted in *Spanish Peaks*, "[t]he interpretation [of sections 363(f) and 365(h)'s relationship] is . . . consistent with the process of marshalling the estate's assets for the twin purposes of maximizing creditor recovery and rehabilitating the debtor, which are central to the Bankruptcy Code."[26] *Spanish Peaks* interpretation of the interplay of sections 363(f) and 365(h) is not be to purposefully disadvantage lessees, it "is to grant a 'fresh start' to the 'honest but unfortunate debtor.'"[27] Debtors who obtain more flexibility under *Spanish Peaks* have a better opportunity to emerge from chapter 11 reorganized for the benefit of its estate and creditors.

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[24] Free and clear sales date back to at least the Bankruptcy Act of 1841, *see* Bankruptcy Act of 1841, ch. 9, 5 Stat. 440 (1841), repealed by Act of March 3, 1843, ch. 82, 5 Stat. 614 (1843). According to Professor Grohsgal, "[t]he Bankruptcy Act of 1841 was enacted in the midst of the economic depression that followed the Panic of 1837, the deepest U.S. downturn prior to the Great Depression." Grohsgal, *supra*, note 6, at 326 n.175. Such is the harsh reality of the world post-economic downturn in which *Spanish Peaks* was decided. *See also*, *Ex Parte Christy*, 44 U.S. 292 (1845).

[25] *N.L.R.B v. Bildisco & Bildisco*, 465 U.S. 513, 527 (1984) ("the policy of Chapter 11 is to permit successful rehabilitation of debtors"). *See, also*, Douglas G. Baird, *Bankruptcy's Uncontested Axioms*, 108 YALE L.J. 573, 580 (1998).

[26] *Qualitech*, 327 F.3d at 548. *Spanish Peaks* also recognized that "[t]o some extent, protecting leases reduces the value of the estate-property presumably fetches a lower price if it is subject to a lease-and is therefore contrary to the goal of 'maximizing creditor recovery,' *Qualitech*, 327 F.3d at 548, another core purpose of the Code." *Spanish Peaks*, 872 F.3d at 900-01.

[27] *Marrama v. Citizens Bank of Mass.*, 549 U.S. 365, 367 (2007) (quoting *Grogan v. Green*, 498 U.S. 279, 286-87 (1991)).

C. Statutes should be read in a way so that they do not conflict (and actually make sense). Both the Seventh and Ninth Circuits have determined that a plain reading of section 363(f) has no limitation and can be read to not conflict. Indeed, the Supreme Court has instructed that federal courts "are not at liberty to pick and choose among congressional enactments, and when two statutes are capable of co-existence, it is the duty of the courts, absent a clearly expressed congressional intention to the contrary, to regard each as effective."[28] *Spanish Peaks* recognizes that these sections do not have to conflict because they address the realities of two separate and discrete situations in the bankruptcy: sales and the rejection of leases.[29] Courts following *Spanish Peaks* have a simple decision tree: determine if an unexpired lease of real property was rejected, if so, apply section 365(h), if not, apply section 363(f) allowing for a free and clear sale, but permit lessee to seek adequate protection under section 363(e).[30]

D. Lessees' interests remained protected. A lessee whose lease was rejected pursuant to section 365(h) is not left bereft of options. Lessees are able to seek adequate protection, section 363(e), and "the bankruptcy court is obligated to ensure that their interests are adequately protected.[31] As noted by the Ninth Circuit, the language in section 363(e) is mandatory, meaning "[a] bankruptcy court *must* provide adequate protection for an interest that will be terminated by a sale if the holder of the interest requests it."[32] Adequate protection could even take the form of continued possession.[33] Under section 361(3), the

[28] *Morton v. Mancari*, 417 U.S. 535, 551 (1974).
[29] 872 F.3d at 899. *See also Dishi*, 510 B.R. at 704-07.
[30] *Dishi*, 510 B.R. at 699 (noting that "nothing in § 365(h) mandates a contrary result").
[31] *Qualitech*, 327 F.3d at 548.
[32] *Spanish Peaks*, 872 F.3d at 899.
[33] *Dishi*, 510 B.R. at 711-12.

bankruptcy courts are given wide latitude to determine what type of adequate protection should be provided to a lessee and "the broad definition of adequate protection makes it a powerful check on potential abuses of free-and-clear sales."[34] Further, free and clear sales are only available when nonbankruptcy law "permits sale of such property free and clear of such interest."[35] Therefore, lessees are also protected by any applicable state law, such as the foreclosure law in Montana in the case of *Spanish Peaks* (though it was not in favor of the lessee there).[36]

E. Certainty. A debtor lessor needs certainty in the outcome of its bankruptcy proceeding. Alleviating the alleged discrepancy between section 363(f) and 365(h) will provide such certainty when a debtor lessors sells its interest to a third party without the burden of the underlying lease.

IV. The Cons

A. Specificity. Section 365(h) is more specific than section 363(f). Allowing section 363(f) to control would be paramount to granting relief under section 105(a) of the Bankruptcy Code. The Latin phrase "generalia specialibus non derogant" translates to "things general do not derogate from specific things."[37] This canon of statutory interpretation is widely recognized and respected; here, section 365(h) specifically addresses leases, while section 363(f) is silent. Therefore, section 365(h) should prevail, allowing lessees to remain in possession.

B. ENOUGH IS ENOUGH! The Bankruptcy Code is already friendly enough to struggling companies, and adverse to the little guy, (e.g., the lessee) enough is enough already.

[34] *Spanish Peaks*, 872 F.3d at 900.
[35] 11 U.S.C. § 363(e).
[36] *See e.g.*, *Dishi*, 510 B.R. at 704-07.
[37] BLACKS LAW DICTIONARY (1oth ed. 2014).

Free and clear sales after *Spanish Peaks* would restrict section 365(h)'s purpose of protecting lessees' leasehold interests when their lessor files for bankruptcy. These section 363 sales already happen on an extremely expedited basis in most cases. Alleviating the protections of 365(h) will require lessees to be even more diligent than usual in responding to a bankruptcy filing. *No mas!*

Bankruptcy Battleground West

March 6, 2018

SHARK TANK!

Avoiding Avoidance Risk – Protecting Settlement Payments From Preference Liability

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I. THE PITCH

Promoting settlement of litigation is good public policy, and is no different when a defendant is in financial distress. But too often litigants settle with defendants, only to see their former adversaries file for bankruptcy and seek to avoid as preferences settlement payments. Even worse, sometimes settling creditors can be stuck with recovering in bankruptcy only the amount of their settled claim, as opposed to the full amount of the litigation claim.

While some of these concerns can be alleviated through careful drafting, the right answer is to avoid the concerns and attendant uncertainty and expense altogether. The Bankruptcy Code's preference section and related claim allowance provision should be amended to reward settlements, or at least avoid forfeitures of legitimate claims solely because of savvy debtors filing for bankruptcy to preserve preference claims.

Proposed Bankruptcy Code Amendments

Add 11 U.S.C. § 547(c)(10):

"made in connection with any settlement or compromise, entered into prior to the commencement of the case under this title, of a liquidated claim against the debtor, to the extent of the amount that is equal to the difference between such liquidated claim and the amount of the transfer."

Amend 11 U.S.C. § 502(h)

"A claim arising from the recovery of property under section 522, 550 or 553 of this title shall be determined, and shall be allowed under subsection (a), (b), or (c) of this section, or disallowed under subsection (d) or (e) of this section, the same as if such claim had arisen before the date of the filing of the petition; *provided, however, notwithstanding the foregoing, if such claim arises from the avoidance of a transfer made pursuant to a settlement or compromise entered into prior to* *the commencement of the case under this title, the allowed amount of such claim shall not be limited by or to amount recovered or the settlement or compromise.*

II. BACKGROUND

Bankruptcy Code section 547 is the preference statute. According to section 547(b), a trustee may avoid any transfer of an interest of the debtor in property that is (1) to or for the benefit of a creditor; (2) for or on account of an antecedent debt owed by the debtor before such transfer was made; (3) made while the debtor was insolvent; (4) made on or within 90 days before the date of the filing of the petition (or within a year for insiders); and (5) that enables such creditor to receive more than such creditor would receive in a chapter 7 had the transfer not been made. 11 U.S.C. § 547(b).

The purpose of the preference statute is to promote equality of distribution instead of preferring favored creditors, *see In re Taylor*, 599 F.3d 880 (9th Cir. 2010), prevent a race to the courthouse, *see In re JWJ Contracting Co., Inc.*, 371 F.3d 1079 (9th Cir. 2004), and/or deter unusual or coercive collection tactics. *See In re NETtel Corp. Inc.*, 364 B.R. 433 (Bankr. D.D.C. 2006). There are nine enumerated defenses, *see* 11 U.S.C. § 547(c), several of which are designed to encourage parties to continue to transact with debtors even when they are in financial difficulties. *See In re PMC Marketing Corp.*, 518 B.R. 150 (1st Cir. BAP 2014).

A classic preferential transfer is a payment in settlement of litigation for historical acts and omissions. *See In re Red Way Cartage Co., Inc.*, 84 B.R. 459, 462 (Bankr. E.D. Mich. 1988) ("There is no more classic example of a "true preference" than the preference involved herein."). Indeed, there are numerous instances where a plaintiff has settled with a defendant for a lesser amount than it asserts, released its asserted claim and dismissed with prejudice its action, and received a settlement payment, only to see the defendant file for bankruptcy within ninety days of the payment. In these circumstances, the settling creditor is at risk for preference liability for payments received. *See, e.g., In re Henninger*, 336 B.R. 733 (Bankr. N.D. Tex. 2005); *In re Phoenix Restaurant Group, Inc.*, 316 B.R. 671 (Bankr. M.D. Tenn. 2004).

The settling creditor's loss in this fact pattern may be even worse – if the payment under the settlement is avoided, the plain language of Bankruptcy Code section 502(h) provides that the creditor receives a claim equal to the amount of the transfer, not the original claim that was released in the settlement. Section 502(h) states: "A claim arising from the recovery of property under section 522, 550 or 553 of this title shall be determined, and shall be allowed under subsection (a), (b), or (c) of this section, or disallowed under subsection (d) or (e) of this section, the same as if such claim had arisen before the date of the filing of the petition." While section 502(h) grants a claim equal to the amount recovered by the estate, section 502(h) does not mean the settlement itself is avoided, suggesting that the creditor may be stuck with being able to only assert a proof of claim for the settled claim amount, not the claim amount that it had originally pursued.

Because of the risk that a plaintiff settling its claim against a financially troubled defendant may have to disgorge settlement payments if the defendant files during the preference period, creditors are wise to have counsel negotiate settlement agreements to try to minimize preference risk, especially when the settlement calls for payments over time. Beyond trying to obtain collateral, letters of credit or guarantees, settlement drafting issues include delaying release of the litigation claim until 91 days after receipt of last payment and stipulating to facts that arguably support a contemporaneous exchange of new value. But given the current language of the Bankruptcy Code, more likely than not, a discounted settlement payment is preferential and subject to avoidance if the debtor files within 90 days after a payment.

Moreover, the debtor and creditor cannot provide in their settlement that the debtor waives and releases any preference claims. Preference claims are creditor remedies, generally arising only in a bankruptcy case, and courts typically hold that a debtor cannot waive prepetition estate claims and defenses. *See Bank of China v. Huang (In re Huang)*, 275 F.3d 1173, 1176-77 (9th Cir. 2002) (settlement of litigation by settlement agreement which was approved by court and provided that judgment debt was non-dischargeable in bankruptcy amounted to an unenforceable prepetition waiver of the right to a discharge).

III. THE PROS

A. **Settlements of litigation have long been favored**. Just as settlements are favored in bankruptcy, *see In re Dewey & LeBoef LLP*, 478 B.R. 627, 640 (Bankr. S.D.N.Y. 2012), settlements when litigation otherwise might force a person or company into bankruptcy should be promoted. Amending the Bankruptcy Code to provide some protection for settling creditors undoubtedly promotes settlements, as creditors have reason to accept a bigger discount if in doing so the creditor better insulates from preference litigation received settlement payments.

B. **No adverse impact on the preference policies**. A primary purpose of the preference statute is to prevent a near-bankrupt debtor from favoring one creditor over another. That purpose is not undermined because there is value to the debtor through settlement – the savings in avoiding continuing litigation costs and procuring any discount off of the litigation claim.

C. **Narrow Application**. The new exception is narrowly tailored to apply only to liquidated claims that are compromised or settled, not unliquidated claims, and provides a defense only for the savings the debtor obtains through settling. For example, if the liquidated claim is $1 million and the settlement payment is $500,000 (or less) that is paid within the preference period, there is no preference liability. But if the settlement payment is $750,000, then there is $250,000 of preference liability.

D. **Avoidance of improper windfalls**. The amendment to section 502(h) should be viewed as providing clarification and avoiding a fundamentally unfair result. In the hypothetical above, in the event that the creditor has to return a preference payment, the creditor should be able to assert a $1 million claim, not the settlement amount, even if the settlement itself is not subject to avoidance. To limit the creditor to only the settlement amount would effectively deprive the creditor of any benefit of the bargain in settling.

IV. THE CONS

A. **Elevates litigation claimants**. There is a reason why settlement payments have been coined "classic" preferences. They concern a creditor using litigation - the most extreme form of collection tactics - to receive payments ahead of other creditors. Preferences may seem unfair to the creditors who have to disgorge payments, but the preference statute is itself the embodiment of fundamental fairness – it ensures equality of treatment among creditors. Creating a new exception for litigation settlement payments, when the statute is already riddled with exceptions, is bad policy.

B. **Uncertain whether litigation costs are avoided**. The proposed exception would not necessarily encourage better or faster settlements, and may generate even more litigation, as parties spar over whether a claim was liquidated and what precisely is the value saved through settlement.

C. **No need to clarify the Code**. Section 502(h) does not need amendment and there is no windfall to a creditor if it properly drafts the settlement agreement to preserve, and not release, the full amount of its asserted claim. It is simply one of many issues to be negotiated.

The Bankruptcy Code should not need amendment any time a party or its counsel is not careful in drafting contracts.