AMERICAN BANKRUPTCY INSTITUTE

2019 Southeast Bankruptcy Workshop

PLENARY SESSION

Business Case Law Update

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Maynard Cooper & Gale; Birmingham, Ala.

Hon. Paul M. Black
U.S. Bankruptcy Court (W.D. Va.); Roanoke

Hon. Benjamin A. Kahn
U.S. Bankruptcy Court (M.D.N.C.); Greensboro

Prof. Bruce A. Markell
Northwestern University School of Law; Chicago

2019

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Hon. Paul M. Black, U.S. Bankruptcy Court, Western District of Virginia

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Removal
Where Should Notice Be Filed?

- ***Morgan v. Bruce***
  - Observed that "while the statute for removal directed one to file a removal petition with the District Court, the procedural rule enacted to effectuate § 1452(a) told litigants to file their removal petitions with the clerk of the Bankruptcy Court."
  - Rejected the argument that the automatic referral to the bankruptcy court was sufficient to allow for direct removal to that court, or that a bankruptcy court as a "unit" of the district court is able to accept a direct removal.
- ***In re VC Macon, LLC***
  - The debtor filed a Chapter 11, and a state court action was filed against a guarantor of an obligation evidenced by a note made by the debtor.
  - Debtor filed a notice of removal of the state court action with the bankruptcy court, under a theory the guarantor had asserted state law and contractual indemnity obligations.
  - In the removal notice, the debtor asserted that the matter was a core proceeding and arises out of, or related to, the main case
  - Bankruptcy court held a show cause hearing to determine whether it had subject matter jurisdiction, and limited the issue to whether the case was improperly removed to bankruptcy court.
  - Court followed *Morgan*, and found *Morgan* to be consistent with *Stern v. Marshall*.
  - Court found the removal directly to bankruptcy court improper and of no effect and remanded the case back to state court.

Third Party Releases
Implied Consent

In re Aegean Marine Petroleum Network Inc

- ***Background***
  - Creditors objected to a release provision that the debtor sought to impose on a non-consensual basis. The Plan included an exculpation provision meant to protect court-supervised fiduciaries and other parties from claims based on the restructuring.
- ***Holding***
  - The exculpation provision insulating "certain parties" from claims related "in any way" to the debtors, "with no exceptions for claims alleging fraud or willful misconduct" could not be confirmed.
- ***Reasoning***
  - "[T]hird-party releases are not a merit badge that somebody gets in return for making a positive contribution to a restructuring. They are not a participation trophy, and they are not a gold star for doing a good job." Releases are intended to immunize certain parties from claims where doing so is important to accomplish restructuring.

Third Party Releases

In re CJ Holding Co

- ***Background***
  - The debtor's non-debtor corporate parent sought to enforce a third-party release ("TPR") to enjoin an ex-employee of the debtor from pursuing sexual harassment, discrimination, and retaliation claims against the parent company. The ex-employee received notice of the bar date but never filed a proof of claim & did not object to confirmation of the Chapter 11 Plan.
  - The release provision in the plan expressly included the debtor's parent company as a "released party," and categorized the ex-employee as a "releasing party."
- ***Holding***
  - The court deemed the ex-employee to have consented to the non-debtor release provisions of the plan.
- ***Reasoning***
  - Although the ex-employee did not file a claim, he could have objected or otherwise participated in the case. Under Fifth Circuit precedent, a creditor who does not object to confirmation of a Chapter 11 Plan may not then appeal the confirmation order based on the doctrine of claim preclusion.
  - So, by failing to file a proof of claim, object to the plan, or attend the hearing on plan confirmation, the Debtor was deemed to have consented to the release provision.
- ***Notes***
  - Although the Fifth Circuit has been restrictive in allowing release provisions in Chapter 11 plans, the district court affirmed the bankruptcy court's decision to confirm the plan with this third-party release.

Third Party Releases

In re SunEdison, Inc.

- ***Background***
  - As part of its Chapter 11 plan, the SunEdison debtors sought approval of certain TPRs, and included creditors who failed to vote on the plan as releasing parties, on the grounds that such creditors could be deemed to have consented to the releases.
  - The plan defined "releasing parties" as "to the fullest extent permitted by law, all Holders of Claims entitled to vote for or against the Plan that do not vote to reject the Plan."
- ***Holding***
  - The plan may not grant TPRs of claims of non-voting creditors.
- ***Reasoning***
  - The debtors failed to show that the non-voting parties should be deemed to have consented to the releases.
  - Analyzing the issue of deemed consent as a contractual issue, the Court found that the notice in the disclosure statement and ballots stating that failing to vote would constitute implicit consent did not impose a duty to speak on creditors and therefore applied the general rule that, absent a duty to speak, silence does not constitute consent.

Third Party Releases
Jurisdiction/Constitutional Authority

In re CJ Holding Co.

- ***Background***
  - An ex-employee of the debtor attempted to sue the debtor's parent company. The parent company argued that the release provisions in the debtor's Chapter 11 Plan effectively enjoined the suit. In response, the ex-employer argued that the bankruptcy court did not have subject-matter jurisdiction, as his claims against the parent company were not "related to" the bankruptcy proceeding.
- ***Holding***
  - The record supported the bankruptcy court's finding that it had "related to" jurisdiction over the ex-employee's claims.
- ***Reasoning***
  - A bankruptcy court has "related to" jurisdiction where the result of the proceeding could have any effect on the bankruptcy estate. In this case, the ex-employee brought claims against the debtor's parent company for harassment and discriminatory conduct during his employment with the debtor.
  - The court recognized that any claims based on the debtor's conduct, even those brought against the parent company, could ultimately burden the debtor with the costs of litigation.

Third Party Releases Jurisdiction/Constitutional Authority

In re Fraser's Boiler Service, Inc.

- ***Background***
  - Fraser's, a company that used to manufacture industrial boilers but now exists to pay asbestos claims, filed bankruptcy to sell its insurance policies back to its original insurers. The bankruptcy court approved the sale free and clear of claims related to the policies and enjoined any such claims.
- ***Holding***
  - The bankruptcy court lacked authority to enjoin the third-party claims, as the Ninth Circuit has prohibited all third-party releases.
- ***Reasoning***
  - Ninth Circuit precedent held that TPRs granted pursuant to § 105(a) were inconsistent with § 524(e), which provides that "discharge of a debt of the debtor does not affect the liability of any other entity on . . . such debt."
  - The district court considered arguments that the Ninth Circuit's decision in *American Hardwoods* left open the possibility of exceptions to its general rule, but it noted that the Circuit's more recent decision in *In re Lowenschuss* effectively prohibited all TPRs.
  - Because the Bankruptcy Code was amended to include only a single exception in § 524(g), TPRs are prohibited unless they satisfy the requirements § 524(g).

Third Party Releases Jurisdiction/Constitutional Authority

In re Kirwan Offices S.A.R.L.

- ***Background***
  - Two of the three shareholders of the Chapter 11 debtor proposed a plan that included exculpation and injunction clauses enjoining any person from trying to sue the two shareholders on account of any events arising from the bankruptcy proceeding and reorganization. The bankruptcy court confirmed the plan and the third shareholder appealed, arguing that the bankruptcy court lacked subject matter jurisdiction and constitutional authority to consider whether the appellees breached the shareholder agreement governing the parties' legal relationship.
- ***Holding***
  - The bankruptcy court has both core and non-core jurisdiction over the exculpation provisions in the plan and holds the constitutional authority necessary to confirm the plan as proposed.
- ***Reasoning***
  - Release provisions in Chapter 11 Plans do not address the merits of released claims, but effectively cancel those claims to permit reorganization.
  - Moreover, when a bankruptcy court considers a release as part of a plan of reorganization, confirmation of which is a core proceeding & "integral to the integrity of the bankruptcy proceeding," the bankruptcy court has core jurisdiction over the matter.
  - As for constitutional authority, the district court acknowledged that a bankruptcy court cannot enter final orders on non-core matters, or ones that are not "integral to the restructuring of the debtor-creditor relationship." Nonetheless, it reasoned that the release of the appellant's claim was vital to the debtor's reorganization.
- ***Notes***
  - Before beginning its discussion, the Court identified the current split regarding a bankruptcy court's jurisdictional basis to consider involuntary TPRs & adopted the view that "[a] bankruptcy court acts pursuant to its core jurisdiction when it considers the involuntary release of claims against a third party, non-debtor in connection with the confirmation of a proposed plan of reorganization."

Third Party Releases Jurisdiction/Constitutional Authority

In re SunEdison, Inc.

- ***Background***
  - The TPRs included past and future claims against an expansive list of third parties and also extended to a list of unidentified current and former affiliates, employees and advisors of the identified released third parties.
- ***Holding***
  - The Court held it has limited jurisdiction to grant broad TPRs. Specifically, it does not have jurisdiction over third-party claims that would not give rise to contribution or indemnification against the debtor's estate.
- ***Reasoning***
  - The Court considered whether it had jurisdiction over the proposed release of creditors' unasserted claims against third parties and whether exercise of such jurisdiction would be proper. The Court noted that even if a bankruptcy court has jurisdiction over releases of third-parties' unasserted claims, exercise of such jurisdiction is proper only in rare and unique circumstances.
  - The Court concluded that it did not have jurisdiction over third-party claims that would not give rise to contribution or indemnification claims against the debtor's estate because such claims do not have a "conceivable effect" on the estate for purposes of a bankruptcy court's "related to" jurisdiction.

Third Party Releases Jurisdiction/Constitutional Authority

In re Millennium Lab Holdings II, LLC

- ***Background***
  - Chapter 11 Plan included a non-consensual TPR that released common law fraud and RICO claims against the debtor's former equity holders.
  - The creditors argued that the bankruptcy court did not have authority to grant the releases pursuant to the Supreme Court's 2011 ruling in *Stern v. Marshall* and that granting the release in this case would be tantamount to adjudicating a state law claim.
- ***Holding***
  - *Stern* analysis is inapplicable to a plan confirmation because the "operative proceeding" in this case was the confirmation of a plan, and not the underlying lawsuit.
- ***Reasoning***
  - Both the bankruptcy court and district court reasoned that approving the release was not an adjudication of the creditor's state-law claim on the merits. The releases had only a collateral impact on the RICO lawsuit, because they provided the shareholders with a defense in that lawsuit.
  - A bankruptcy order that merely "impacts a litigant's state law claim" does not violate *Stern*. Additionally, because "confirmation of plans is an enumerated core proceeding," the bankruptcy court has "statutory authority to enter a final judgment."
- ***Notes***
  - The bankruptcy court read *Stern* as largely consistent with the Supreme Court's decision in *Northern Pipeline Construction Co. v. Marathon Pipe Line Co.*. The bankruptcy court also cited a number of other Delaware bankruptcy court opinions that interpreted *Stern* narrowly.

Small Business Reorganization

- ***Charles Grassley (R-IA) introduced the Small Business Reorganization Act of 2019 ("SBRA") on April 9, 2019 & currently has bi-partisan support in the Senate***
- ***The summary of the bill provided by the Senate Judiciary staff describes some of the current difficulties for small businesses including high costs, monitoring deficits, and procedural roadblocks***
- ***The SBRA will add a new subchapter V to Chapter 11 to address these issues, leading to more successful restructurings, reducing liquidations, and increasing recoveries to creditors***
- ***One of the intended goals of the bill is to increase a debtor's ability to negotiate a successful reorganization and retain control of the business.***
- ***In furtherance of that goal, the SBRA makes the following modifications and additions to Chapter 11:***

Small Business Reorganization Ctd.

- ***The Debtor***
  - Means a "small business debtor" under the new subchapter, defined as a person in commercial or business activity that has aggregate or noncontingent liquidated secured and unsecured debts as of the filing date of not more than $2,725,625
  - Notably, a debtor must affirmatively elect "that subchapter V of chapter 11 shall apply."
- ***The Trustee***
  - If the United States Trustee has appointed a standing trustee, that individual shall serve as a trustee in a subchapter V case. If there is no standing trustee, the United States Trustee shall appoint a disinterested person
  - The trustee in a subchapter V case will perform the duties of a trustee outlined in paragraph (2), (5), (6), (7), and (9) of section 704(a)
  - The trustee in a subchapter V case will performs the duties of a trustee outlined in paragraphs (3), (4), and (7) of section 1106(a)
  - 11 U.S.C. 1183(b)(2)-(7) & 1183(c)(1)-(2) outline additional duties of subchapter V trustees

Small Business Reorganization Ctd.

- ***Rights and Powers of a Debtor in Possession.***
  - Proposed Section 1184 would provide the debtor in possession with all the rights and powers of a trustee, including operating the business of the debtor, other than the right to compensation under section 330 of the Bankruptcy Code and the duties specified in paragraphs (2), (3), and (4) of section 1106(a) of the bankruptcy code
- ***Removal of a Debtor in Possession.***
  - Subsection (a) of section 1185 would allow a party in interest to seek removal of the debtor in possession for cause either before or after the date of commencement of the case, or for failure to perform the obligations of the debtor under a plan confirmed under subchapter V.
  - Subsection (b) would allow a party in interest to seek reinstatement of the debtor in possession

Small Business Reorganization Ctd.

- ***Property of the Estate.***
  - Subsection (a) of proposed section 1186 provides that in addition to property set forth under section 541, property of the estate also includes the property of the debtor acquires, and earnings for services performed by the debtor, after the commencement of the case but before the case is closed, dismissed, or converted to a case under chapter 7, 12, or 13.
  - Subsection (b) provides that the debtor shall remain in possession of all property of the confirmed plan or an order confirming a plan.
- ***Reporting Requirements.***
  - Subsection (a) of proposed section 1186 provides that in addition to property set forth under section 541 of the Bankruptcy Code, property of the estate also includes property the debtor acquires, and earnings for services performed by the debtor, after the commencement of the case but before the case is closed, dismissed, or converted to a case under chapter 7, 12, or 13.
  - Subsection (b) provides that the debtor shall remain in possession of all property of the estate unless the debtor is removed under section 1185 of subchapter V or as provided in a confirmed plan or an order confirming a plan.

Small Business Reorganization Ctd.

- ***Reporting Requirements***
  - Section 1187 subsection (a) would require that the debtor file the most recent balance sheet, statement of operations, cash-flow statement, and Federal income tax return or a statement made under the penalty of perjury that no balance sheet, statement of operations, or cash-flow statement has been prepared and no Federal tax return has been filed.
  - Subsection (b) would required the debtor to:
    - (i) comply with the financial reporting requirements of section 308 of the Bankruptcy Code,
    - (ii) attend meetings scheduled by the court of the United States Trustee, including initial debtor interviews, scheduling conferences, and meetings of creditors convened under section 341 of the Bankruptcy Code,
    - (iii) timely file all schedules and statements of financial affairs, file all post petition financial and other reports required by the Federal Rules of Bankruptcy Procedure or by local rule of the district court,
    - (iv) maintain insurance customary and appropriate to the industry,
    - (v) timely file tax returns and other required government filings and timely pay all taxes entitled to administrative expense priority except those being contested by appropriate proceedings being diligently prosecuted, and
    - (vi) allow the United States Trustee to inspect the debtor's business premises, books, and records.
  - Subsection (c) of proposed Section 1187 would provide that if the court orders that the disclosure statement requirement under section 1125 of the Bankruptcy Code applies, then section 1125(f) shall also apply, allowing the debtor to sue the plan as the disclosure statement, submit a plan based on a standard form, and have disclosure statement conditionally approved subject to final approval at a combined disclosure statement/plan confirmation hearing.

Small Business Reorganization Ctd.

- ***Status Conference***
  - Section 1188 subsection (a) would provide that the court should hold a status conference not later than 60 days after the order for relief is granted in the case.
  - Subsection (b) would allow the court to extend the 60 day deadline based on circumstances for which the debtor should not justly be held accountable
  - Subsection (c) requires the debtor to file a report detailing the debtor's efforts to attain a consensual plan of reorganization not later than 14 days prior to the status conference.
- ***Filing of the Plan***
  - Section 1189 subsection (a) provides that only a debtor may file a plan
  - Subsection (b) provides that the debtor shall file the plan not later than 90 days after the order for relief is entered in the case
  - The court may extend the 90 day deadline based on circumstances for which the debtor should not justly be held accountable

Small Business Reorganization Ctd.

- ***Contents of the Plan***
  - Section 1190 subsection (1) would require that a plan include a brief history of the business operations of the debtor, a liquidation analysis, and projections with respect to the ability of the debtor to make payments under the proposed plan.
  - Subsection (2) would require that the plan provide that all future earnings of the debtor, or such portion necessary under the plan, be placed under the supervision and control of the trustee.
  - Subsection (3) would allow the debtor to modify the rights of a secured creditor, including a secured creditor with a claim against the principal residence of the debtor if the original value received from the creditor was not used to purchase the residence, but was used primarily in connection with the small business
- ***Confirmation of the Plan – Cramdown Eliminated "if"***
  - Section 1191 subsection (a) would provide that a plan may be confirmed by consent if all the requirements of section 1129(a) of the Bankruptcy Code are met, other than paragraph (15), which applies to individuals
  - Subsection (b) would provide the requirements to allow a plan to be confirmed without an impaired accepted class of creditors or over an objecting class of creditors
  - Subsection (c) provides what is required to be "fair and equitable" with respect to each class of claims or interest
  - Subsection (d) defines "disposable income"

Small Business Reorganization Ctd.

- ***Discharge***
  - Proposed Section 1192 provides that if a plan is confirmed under section 1191(b) of subchapter V, the debtor is entitled to discharge after all payments are made
- ***Modification of the Plan***
  - Section 1193 subsection (a) would allow the debtor to modify the plan prior to confirmation so long as the plan meets the requirements of section 1122 & 1123 except subsection (a)(8) of section 1123
  - Subsection (b) would allow the debtor to modify a plan confirmed by consent under section 1191(a) of subchapter V before substantial consummation if the plan continues to meet the requirements of section 1122 and 1123 except subsection (a)(8) of section 1123.
  - Subsection (c) would allow the debtor to modify a plan confirmed under section 1191(b) of subchapter V at any time within 3 years, or such longer time not exceed 5 years.
  - Subsection (d) would provide that if a plan has been confirmed by consent under section 1191(a) of subchapter V, any holder of a claim or interest that has accepted or rejected the plan is deemed to have accepted or rejected the plan as modified unless such holder changes the previous acceptance or rejection of the holder

Small Business Reorganization Ctd.

- ***Payments under the Plan***
  - Proposed section 1194(a) would provide that the trustee shall retain all payments and funds until a plan is confirmed and then distribute such payments and funds in accordance with the plan
  - Subsection (b) would provide that if a plan is confirmed through a cramdown, the trustee shall distribute payments and funds in accordance with the plan
  - Subsection (c) allows the trustee to make an adequate protection payment to a secured creditor after notice and a hearing
- ***Transactions with Professionals***
  - Section 1195 as proposed would not disqualify a profession form being retained by the debtor solely because that person holds a claim of less than $10,000 against the debtor that arose prior to commencement of the case.
- ***Preferences and Venue of Certain Proceedings***
  - ***Modification of 11 U.S.C. § 547(b).***
    - Existing Section 547(b) of the Bankruptcy Code would be modified to provide that any preference action brought by a trustee must be based on reasonably due diligence in the circumstances of the case and take into account a party's known or reasonably knowable affirmative defenses under section 547(c) of the Bankruptcy Code
  - ***Small Claims Venue.***
    - Section 1409(b) of title 28, which requires the commencement of a recovery proceedings for debt less than $10,000 be brought in the district court for the district in which the defendant resides, would be increased to $25,000

Tempnology Discussion

Mission Prod. Holdings, Inc. v. Tempnology, LLC

- The Supreme Court resolved whether rejection of an executory contract terminates the rights of a license, finding that "rejection breaches a contract but does not rescind it"
- ***Background***
  - In the underlying bankruptcy case, debtor sought to reject an agreement under § 365(a) that gave Mission Product Holdings a nonexclusive, nontransferable license to use the debtor's trademarks. Mission objected, asserting its right to retain the intellectual property license under § 365(n).
  - The bankruptcy court overruled Mission's objection, citing the absence of "trademark" from the Code's definition of "intellectual property" under § 101(35A).
- ***Mission appealed and the Bankruptcy Appellate Panel ("BAP") reversed***
  - The BAP agreed that § 365(n) did not protect trademarks.
  - However, following the Seventh Circuit in *Sunbeam Products, Inc. v. Chicago American Manufacturing*, LLC, the Panel found that rejection under § 365(a) did not necessarily terminate Mission's rights. Instead, according to the BAP and Sunbeam, § 365(g) provides a general rule: rejection merely constitutes a breach, not a rescission.
- ***The First Circuit reversed, relying in part on Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc.,***
  - In *Lubrizol*, the Fourth Circuit determined that the legislative history to § 365(g) "makes clear that the purpose of the provision is to provide only a damages remedy for the non-bankrupt party." On this, the First Circuit agreed.
  - The court additionally reasoned that the unique characteristics of trademark law favored against an alternative interpretation.
- ***Holding***
  - Court held (i) case not moot, even though full distribution; and (ii) that, with trademarks, rejection is only a material breach of the contract that puts the parties where they would have been under non-bankruptcy law. Under non-bankruptcy law, the non-breaching party has an election of remedies; it can terminate the contract, or it can elect to keep the contract in place, and sue for any damages caused by breach. Here, the licensor's breach would give rise to damages that the licensee could offset against royalty payments.

Ritzen Discussion

Ritzen Grp., Inc. v. Jackson Masonry, LLC,

- By contract, Ritzen Group intended to purchase real property from Jackson Masonry for $1.55 million. The sale collapsed on the consummation date and Ritzen sued Jackson for breach of contract. During a protracted and contentious discovery process, Jackson filed a petition for bankruptcy under chapter 11.
- In bankruptcy court, Ritzen moved for relief from the automatic stay while intermittently discussing dismissal. The court, construing the relief requested as purely stay related, denied the motion and resolved the contract claims in Jackson's favor a year later.
- Ritzen appealed. The district court denied the appeal, finding the motion for relief from the automatic stay to have been a final order requiring appeal within fourteen days under Federal Rule of Bankruptcy Procedure 8002(a).
- Ritzen appealed again. The Sixth Circuit affirmed, joining the Second, Third, Fourth, Seventh, and Tenth Circuits. Relying on the language of 28 U.S.C. § 158(a) and the Supreme Court's reasoning in Bullard v. Blue Hills Bank, the court held the appeal untimely because "(1) stay-relief motions initiate a proceeding and (2) this proceeding is terminated by an order denying stay relief."
- The court rejected the "vague" test proffered by the First Circuit in In re Atlas IT Export Corp., which "tak[es] into account the particular order's reasoning and effect [and asks] whether that edict definitively decided a discrete, fully-developed issue that is not reviewable somewhere else."

D&O Duties and Liability

Levin v. Miller

- ***Background***
  - The debtor held two subsidiary banks that ultimately failed following the 2007–2008 financial crisis.
    - Throughout 2008 and into 2009, the corporation's board—acting on the insistence of federal and state regulators and the advice of outside counsel—repeatedly directed the corporation's officers to support the subsidiary banks by raising capital and lobbying for government assistance.
    - The board also approved the corporation's annual tax allocation agreement, which provided for a consolidated federal tax return filed by the corporation on behalf of all three entities.
    - Under the tax allocation agreement, the corporation would transfer any tax refund the banks could have received had the banks filed separately as directed by nonbinding federal regulatory guidance issued in 1998.
  - However, in 2001, a bankruptcy court issued a contrary ruling, which the Second Circuit Court of Appeals affirmed, holding that a consolidated refund belongs to the parent company and any payment owed under a tax allocation agreement constitutes a debt that becomes an unsecured claim on the parent's bankruptcy estate.
    - The corporation received $76 million as a consolidated tax return in June 2009, which it transferred to the subsidiary banks three months before the corporation filed for bankruptcy under chapter 7.
    - The trustee alleged the corporate officers breached their fiduciary duty by failing to inform the board that declaring bankruptcy before transferring the tax refund would maximize the value to creditors of the holding company.
- ***Holding***
  - The court disagreed. Under principals of agency as stated in the Restatement (Third) of Agency, applicable in Indiana, an agent's duty to inform the principal is qualified by the agent's duty to comply with the principal's instruction, even if the agent believes that compliance is not in the principal's best interest.
  - Because the board clearly manifested its intention to save the banks, the officers as agents had no right—let alone a duty—to pursue bankruptcy, an approach directly at odds with the board's instructions.

D&O Duties and Liability

In re Mundo Latino Market

- ***Background***
  - The majority shareholder and vice president of a retail food and household supply market also served as a director of the corporation. The director installed a manager to open the market, hire employees, and operate the business. The market never earned a net profit, mostly due to the manager's bad acts and mismanagement. The debtor corporation filed for bankruptcy and the trustee alleged breach of the director's fiduciary duty, which the director moved to dismiss pursuant to the business judgment rule.
  - Under Delaware law, a majority shareholder acting as a shareholder does not owe any duty to manage the corporation. Likewise, a vice president does not owe any duty not specifically provided for by the bylaws of the corporation or, if not so provided, by the directors. However, corporate directors owe two fiduciary duties to their shareholders: the duty of loyalty and the duty of care.
  - At the pleading stage, an allegation of breach of fiduciary duty against an officer or director may survive the business judgment rule if the complaint sufficiently alleges one of the following scenarios:
    - the officer or director acted fraudulently or in bad faith,
    - lacked disinterested independence, or
    - closed her eyes to the corporation's affairs and completely failed to act.
  - Under the third category, ordinary care on the part of directors requires reasonable oversight and supervision.
- ***Holding***
  - The court found sufficient facts for an inference that the director's alleged inattention gave rise to liability for failure to supervise and oversee the manager.

Make Whole Premiums

In re Ultra Petroleum Corp.

- ***Background***
  - Ultra was part of a corporate group engaged in oil and gas exploration. Together, the group took on significant debt be- tween 2008 and 2011—the principal amount was close to $2.5 billion.
  - That debt was still outstanding when, between 2014 and 2016, the market price of oil dropped from $100 a barrel to just below $30 a barrel. Ultra was not immune from the travails of the oil patch; as oil's price dropped, so did Ultra's solvency. Ultra followed many of its business partners and competitors into Chapter 11 bankruptcy in April 2016. But almost as quickly as oil's price dropped, it rebounded
- This change in circumstances also shed new light on Ultra's bankruptcy case. Ultra posed a Chapter 11 plan paying all unsecured claims in full and in cash, and providing a substantial recovery for its equity owners.
  - Ultra's proposed Chapter 11 plan treated the holders of the $1.5 billion of unsecured notes (the "Noteholders") as unimpaired. As holders of unimpaired claims, the Noteholders were "conclusively presumed to have accepted the plan."
  - The Noteholders had "Make Whole Agreements." These agreements, they contended, gave them right to be paid amounts to compensate them in for Ultra paying its debts early.
  - "[T]he creditors argued the debtors owed them an additional $387 million—$201 million as the Make-Whole Amount and $186 million in postpetition interest."
- The validity of these clauses is at the heart of *Ultra's* case. If the MWP can be disallowed as unmatured interest, then the disallowance/discharge dance is begun. If the MWP are just another claim, then the dance is delayed.

Make Whole Premiums

- Although *Ultra* remanded the characterization of the contract provisions, it left little doubt as to its position. It thought the clauses were unmatured interest.
  - "First, the Make-Whole Amount is the economic equivalent of "interest." . . . . Second, the interest for which the Make-Whole Amount compensates was "unmatured" when the debtors filed their Chapter 11 petitions. . . . [and] Third, those decisions taking a different view are unpersuasive."
- This analysis pointed the court back to its determination that the Code, and not the debtor's plan, impaired the Noteholders MWP claims.
- That lead the court to hold that a debtor could confirm a plan under which it did not pay all its contractual obligations in full, so long as those obligations were subject to disallowance under Section 502(b). Court left open issue of good faith, both in confirmation and in filing.

Disallowance Under Bankruptcy Law as "Unmatured Interest" § 502(B)(2)

- ***Section 502(b)(2) disallows a claim to the extent that it is for unmatured interest. Paragraph(2) thus has two components: interest, and a lack of maturity of that interest.***
- ***Interest***
  - The Bankruptcy Code does not define "interest. But the Second circuit explained that "Interest is money 'paid to compensate for the delay and risk involved in the ultimate repayment of monies loaned.'" "Interest" has been similarly broadly defined "in contexts outside Section 502(b)(2),
    - The common element among these definitions is that fees and charges by the lender which represent bona fide payments to third parties will not be interest; payments which the lender collects for itself will be
  - The contractual characterization is not binding. Regardless of how the parties characterize a payment, the law will recharacterize it according to its substance.
  - According to the legislative history of § 502(B)(2), MWPs should count as interest. They are charges collected by the lenders related to the use of the money lent or, in the language of the federal regulation, to the "default or breach by a borrower of a condition [here, no prepayment] upon which credit was extended."
    - The main objection to this characterization was stated by Scott K. Charles and Emil A. Kleinhaus: "Treating all prepayment fees (including fixed fees) as "interest" would have the benefit of treating all compensation resulting from pre-payment clauses in the same way, thus avoiding any need to draw subtle (and, in the view of some, illusory) distinctions between "true options," on the one hand, and liquidated damages, on the other
    - This objection suffers from a constricted view of interest. Lenders with MWPs should not have their claims increased simply because of lenders' crafty drafting

Disallowance Under Bankruptcy Law as "Unmatured Interest" § 502(B)(2)

- ***Unmatured***
  - Although the Bankruptcy Code mentions this classification in Section 101(5)'s definition of "claim," it is not a separately defined term.
  - The legislative history gives some hint as to meaning. It states that "interest disallowed under this paragraph includes post petition interest that is not yet due and payable, and any portion of prepaid interest that represents an original discounting of the claim, yet that would not have been earned on the date of bankruptcy." Case law has followed this suggestion. "Case law has determined that unmatured interest includes interest that is not yet due and payable at the time of a bankruptcy filing, or is not yet earned ."
  - The legislative history also indicates that the bankruptcy filing cannot be the trigger that brings about the maturity of the obligation to pay interest.
  - This leads directly to the conclusion that MWPs are "unmatured," regardless of any automatic acceleration of the maturity date caused by the filing of the bankruptcy case.

UCC Update

Pipkin v. Sun State Oil Inc.

- ***Background***
  - Gasoline supplier enters into 10-year requirements contract with roadside convenience store ("First Buyer"). Part of deal is that supplier would "lease" two gasoline pumps to store owner for the term of the contract, with the store owner able to take title to pumps for no cost at end of deal. Agreement provides that supplier can file a financing statement with respect to the transaction; never does.
  - Store owner runs into trouble after two years. Sells station and pumps to third party. They can't make a go of it, and return the station and pumps to store owner, who finds another buyer and sells the station and the pumps to him ("Ultimate Buyer"). Gasoline supplier then retakes possession of the pumps. Claims breach of "lease," and that it was simply recovering its reversionary/ownership interest in the pumps.
  - Ultimate Buyer claims priority under § 9-317(b), which provides that a buyer takes free of an unperfected security interest of which the buyer has no knowledge.
  - The supplier claimed this was not a secured transaction, so § 9-317(b) doesn't apply. The parties' agreement called it a lease, and thus that's what it was.
- ***Holding***
  - The court rejected the formalism argument. Section 1-203 of the UCC provides for a two-prong test to determine whether a lease is really a disguised secured transaction.
  - The first prong is that the buyer/lessee has no right to terminate the agreement. That was present here
  - The second prong of Section 1-203 was easily met since the agreement allowed the First Buyer to take title to the pumps for no consideration at the end of the term of the agreement.

UCC Update

In re Pettit Oil Co.

- ***Background***
  - Pettit Oil Company was a distributor of bulk petroleum products. In 2013, Pettit entered into a consignment agreement with IPC, under which IPC was to deliver consigned fuel to designated sites so Pettit could sell the fuel to its customers. The aim was to reduce Pettit's working capital needs by outsourcing its fuel sales to IPC. In return for being able to sell its fuel at Pettit's stations, IPC paid Pettit a monthly commission.
  - As with all "true" consignments, ownership of the fuel remained with IPC until it was sold, at which time title transferred to the purchaser.
    - Whenever a customer purchased consigned fuel, Pettit prepared an invoice and instructed the customer to remit payment to IPC directly.
    - Despite this instruction, some customers continued to pay Pettit for their purchases of IPC fuel. Anticipating this might occur, the agreement provided that Pettit would "promptly forward such payment[s] to IPC," and Pettit did so regularly.
  - Nonetheless, when Pettit ultimately filed for bankruptcy, it had in its possession not just IPC fuel but also proceeds from sold fuel that had not yet been remitted to IPC.
  - These proceeds took two forms: (1) cash and (2) accounts receivable—that is, balances owed by customers that had not yet been paid.
- ***Holding***
  - As to the fuel, UCC § 9-319 is clear: under the UCC, most commercial consignments are transformed into purchase money security interests — complete with the requirement that the seller/secured party has to perfect its interest to be protected against subsequent lien creditors.
  - IPC also argued that the cash and accounts were not subject to § 9-319 since it only refers to "goods" and not "goods *and proceeds*." The court rejected this both on textual and on policy grounds.

UCC Update

In re I80 Equipment, LLC

- ***Background***
  - The UCC-1 financing statement filed by the bank to perfect a lien on all assets of a business was found to be insufficient. The security agreement executed by the debtor granted a security interest in favor of the bank in substantially all of the debtor's assets.
  - The financing statement described the collateral as "all Collateral described in First Amended and Restated Security Agreement dated March 9, 2015 between Debtor and Secured Party."
  - The security agreement was not attached to the financing statement. Pointing to UCC §9-108(b), the bank argued that its financing statement was adequate because it described the collateral by "any other method, if the identity of the collateral is objectively determinable."
  - According to the bank, other creditors were put on sufficient notice of the bank's security interest.
- ***Holding***
  - Disagreeing, the bankruptcy court reasoned that the financing statement did not describe the collateral, but rather attempted to incorporate by reference the collateral description in a document that was not attached to the financing statement.

UCC Update

Legacy Bank v. Fab Tech Drilling Equip., Inc.

- ***Background***
  - Junior judgment lien creditor filed writ of garnishment against accounts receivable owed to judgment debtor. Bank with senior security interest in debtor's collateral, including the receivables, intervened, asserting that its security interest over accounts was superior to creditor's judgment lien.
  - Judicial lien creditor argued that bank waived its security interest by:
    - (1) allowing debtor to remain in default for several years without making demand, accelerating the debt, liquidating collateral, or otherwise enforcing its security interest;
    - (2) not demanding payment until a year after judicial lien holder received a judgment against debtor and more than six months after the judicial lien holder filed the writ of garnishment; and
    - (3) making a "nominal, halfhearted demand on debtor solely to save face" before loaning debtor more than $2 million in additional funds.
- ***Holding***
  - The court held that a prior perfected security interest holder does not waive its senior security interest by failing to exercise elective remedies prior to junior judgment creditor exercising foreclosure rights: "we reject the possibility that a senior secured creditor may waive its security interest under equitable principles by not enforcing it prior to the attachment of a junior creditor's lien."

Horizontal Gifting/Absolute Priority Rule

In re Nuverra Environmental Solutions, Inc.

- ***Background***
  - The case presents the latest attempt to violate the Code's priority positions with "gifting"
  - Nuverra had approximately $500 million in debt secured by all its assets. However, its asserts were worth no more than $300 million.
  - In addition to the debt secured by the assets, Nuverra had a series of unsecured note debt of almost $41 million (the "2018 Notes") and significant trade debt, at filing, of over $11 million.
  - Nuverra filed a pre-packaged plan in 2017. It sought swift measures to confirm its plan, which essentially converted most of its secured debt to equity, and proposed a rights offering to follow confirmation.

Horizontal Gifting/Absolute Priority Rule Ctd.

- ***Background***
  - To confirm its plan, Nuverra co-opted its secured creditors to "gift" part of their distribution to two classes of unsecured creditors that would otherwise not be entitled to distributions.
  - One creditor, Hargreaves, who held about $450,000 of the 2018 Notes, objected. Even though the class in which Hargreaves found himself, Class A6, voted overwhelmingly in number (about 80%) to accept the plan, those voting in favor of the plan did not hold the required 50% of the amount of claims voting. The "gifts" were not equal. One unsecured class was to be paid in full; the other was to receive less than 6% of its claims.
    - Accordingly, Hargreaves' class, Class A6, rejected the plan, but the debtor pressed its plan, seeking cramdown.
    - Hargreaves argued that the plan did not meet Section 1129(b)(1) in that it unfairly discriminated against Class A6 given the vast difference between distributions. Hargreaves was the sole objector to confirmation.
  - The bankruptcy court agreed that there was a presumption of unfair discrimination. But it found that such discrimination was permissible given the different ways in which the 2018 Note debt and the trade debt arose, and between the future necessity of the good will and cooperation of the two classes. It confirmed the plan .
  - Hargeaves appealed.

Horizontal Gifting/Absolute Priority Rule

- **Horizontal Gifting**
  - The thrust of both the bankruptcy and district court opinions was that the value being distributed belonged to the senior secured creditors.
  - However, although bankruptcy reorganizations are negotiations, they are bounded by the Code.
  - When a senior class states it is transferring value entitled to other, but not all, junior classes, there is a sense that we are no longer dealing with gifts, but deals.
  - An order of confirmation gets the senior creditors releases. So secured creditors "toss crusts of bread to others to get them to go along; it is more likely that the hearts of secured creditors are more like the Grinch's than like Santa's."
- **Absolute Priority Rule**
  - The main point is that while unsecured claims come in many forms, they are named "unsecured" because they all share the same non-bankruptcy priority against the debtor's assets: below that of secured creditors with respect to those creditors' collateral, and above that of the debtor equity holders. That is a byproduct of the absolute priority rule.

Retention Issues

United Artists Theatre Co. v. Walton

- In *United Artists Theatre Co. v. Walton*, the Third Circuit permitted indemnification for common negligence.
- Recognizing that § 330 provides for reasonable compensation based on market driven rates, the court looked to Delaware corporate law for guidance on what qualifies as reasonable. When evaluating alleged negligence on the part of directors, Delaware courts review the decision-making process—not the result—for good faith and rationality.
- Known as the business judgment rule in corporate law, Delaware courts refrain from interfering with the advice of financial advisors if the advisors:
  - (1) have no personal interest in the outcome,
  - (2) have a reasonable awareness of available information after prudent consideration of alternative options, and
  - (3) provide the advice in good faith.
- Adapting this analysis, the Third Circuit approved as reasonable the debtors' indemnification, which protected the financial advisors from liability for common negligence while specifically excepting from indemnity any gross negligence or contractual disputes with the debtors

Retention Issues

In re Baltimore Emergency Services, II, LLC

- Applying the reasoning of United Artists, the court in *In re Baltimore Emergency Services II*, LLC set forth six limitations prior to approving the proposed indemnification agreement as reasonable.
- ***Background***
  - The debtors sought to protect the financial advisor for "any losses, claims, damages, expenses and liabilities whatsoever" except those resulting "primarily" from bad faith, gross negligence, and willful misconduct.
  - The agreement also withheld indemnification for contract or tort losses except where such losses arose "primarily" from bad faith, gross negligence, and willful misconduct. Subsequent amendments excluded claims arising "solely from . . . gross negligence or willful misconduct."
- ***Holding*** The court ordered as follows:
  - (1) removal of any limitation on exclusions for gross negligence,
  - (2) reincorporation of bad faith,
  - (3) express exclusion of contractual disputes,
  - (4) removal of any disclaimer on the financial advisor's hired services,
  - (5) affirmative recognition that the financial advisor is not protected from breaches of its fiduciary duties of loyalty and care, and
  - (6) evidence that the proposed provisions are necessary and reasonable for the debtors' reorganization.
- For purposes of the ruling, the court accepted the parties' assumption that the proposed indemnification was a market driven necessity and with the limitations discussed, approved the indemnification agreement as reasonable.

Retention Issues

- ***In re Heritage Home Group, LLC***
  - ***Background***
    - The debtors moved to retain a company to assist with sales of several businesses under §§ 105(a) and 363(b), which the trustee opposed. The court explored two camps of reasoning: a qualitative analysis and a quantitative analysis.
    - Under the qualitative approach, a "professional" is an employee with discretion or autonomy over some part of the debtor's estate.
    - Under the quantitative approach, a "professional" "play[s] a central role in the administration of the debtor proceeding, . . . not [including] those occupations which are involved in the day-to-day mechanics of the debtor's business."
    - The goal of both approaches is the same: determining whether an application for employment must adhere to the conflict of interest provisions and related disclosure requirements under § 327(a).
  - ***Holding***
    - The court in *Heritage Home* granted the debtors' motion for retention under § 363(b). The applicant's role involved recommending discounts and loss prevention strategies, providing qualified supervision, maintaining communication, establishing and monitoring accounting functions, and otherwise advising the debtors and coordinating the sales.
    - The court found that such activities did not rise to the heightened level of authority and control over the sale such that the applicant was intimately involved in the debtors' plans.

Retention Issues

- ***In re Nine West Holdings, Inc.***
  - Over the trustee's objection, the bankruptcy court in *In re Nine West Holdings, Inc.* permitted retention under § 363(b) despite the applicant's service on a board of one of the debtors.
  - The court reasoned that the director's role was administrative only and that the applicant had materially complied with the J. Alix Protocol.
  - Further, the applicant's involvement in the day-to-day operations of the business for the four previous years made continued employment necessary to the reorganization and established an absence of intimate involvement in restructuring to require an application under § 327.
- ***In re Brookstone Holdings, LLC***
  - ***Background***
    - Debtor moved to assume prepetition store closing agreement with Hilco to continue going out of business sales under the agreement.
    - The United States Trustee ("UST") filed a limited objection, asserting that Hilco was a professional for purposes of § 327(a). Hilco's obligations under the agreement included recommending pricing and discounts, advertising, supervising the sale, communicating with the debtor's store operating team, and recommending loss prevention strategies and staffing levels.
    - Debtor would pay Hilco commissions and incentive fees, and would reimburse Hilco for expenses under the terms of the agreement. The UST argued that Hilco was an auctioneer or an "other professional" as contemplated by § 327(a).
  - ***Holding***
    - The court first rejected the argument that Hiclo was an auctioneer, looking to the Oxford English Dictionary's definition. Likewise, Judge Shannon relied on the six factors set out in First Merchants to reject the argument that Hilco was an "other professional."
    - Applying the First Merchants factors, the court determined in essence that Hilco did not have sufficient autonomy or authority over the debtor's operations to constitute a professional under § 327(a) and overruled the UST's objection.

Rule 2014 Issues

In re Alpha Natural Resources, Inc.

- ***Background***
  - In ANR, the debtors applied to retain McKinsey as a turnaround advisor. Mar-Bow Value Partners, an entity owned and funded by Jay Alix, the founder of McKinsey-competitor AlixPartners, entered the case by filing a claim for $1.25 million.
  - Mar-Bow and the trustee lodged several challenges alleging inadequate disclosure. The challenges sought the identity of previously undisclosed entities and investment relationships between MIO Partners, Inc., which serves McKinsey's pension plans, and interested parties.
- ***Holding***
  - The bankruptcy court ordered an in camera review, including the trustee but excluding Mar-Bow, to enforce Rule 2014 without undermining McKinsey's business model of confidentiality.
  - Upon review, the court found McKinsey to be disinterested and the case proceeded. Mar-Bow appealed, which the district court denied on an absence of standing
- ***The Fourth Circuit affirmed and the Supreme Court denied certiorari.***

Q & A

Bankruptcy Law Letter

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"Shoot the. . .": Holes in Make Whole Premiums

By Bruce A. Markell

Introduction

There's a famous scene in *Raiders of the Lost Ark*[1] in which Indiana Jones, played by Harrison Ford, confronts an adversary dressed in all black, wielding a long and sharp scimitar. The adversary flashes his sword and twirls it with fancy moves, all with apparent evil intent. This display interrupts Indiana who is searching the bazaar frantically for Marion, his once and future girlfriend. After watching the display of swordsmanship, Indiana pulls his revolver out and nonchalantly shoots the swordsman. The adversary drops and the crowd goes wild.[2]

Legal arguments can be like that. One side thinks its theory, deeply researched, painstakingly planned, and meticulous implemented, beats all comers. It then runs into an overlooked and vastly superior force, and is defeated.

I think the current kurfuffle over make whole premiums (MWPs)[3] is destined for a similar fate. Corporate lawyers have mined state law to develop rock-solid nonbankruptcy theories, in an effort to provide legal justifications for such premiums.

What they seem to have forgotten, to paraphrase another of my favorite movies, is that "It's bankruptcy, Jake."[4] Within the Code are theories that simply eviscerate state law verities, in much the same way that Indiana Jones dispatched the black-clad swordsman.

In this issue of the *Bankruptcy Law Letter*, I want to look at MWPs and the case law interpreting them. This inquiry will look at the recent efforts to understand such clauses under nonbankruptcy law, but my main point is something simpler: there is no way MWPs are not substitutes or proxies for unmatured interest. As such, there is no way, despite all their corporate finery, that they can withstand the fatal bullet of Section 502(b)(2).[5]

Make Whole Premiums (MWPs)

MWPs seek to protect lenders from drops in interest rates. They

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are clauses in debt instruments which typically require borrowers to pay a premium or fee for the privilege of early payment, as might be the case if a borrower could obtain a loan at a lower rate in order to pay off the original, higher-interest rate loan. A borrower with an outstanding loan bearing an interest rate of 15%, for example, would love to pay off that loan if rates drop and if the borrower can now borrow a similar amount of money at 5%. But the borrower's boon is in the lender's doom; upon repayment, the lender can no longer lend out the money at the higher rate.

To protect against this loss of a high interest rate stream, lenders have insisted on MWPs. The typical MWP allows for early payment of a loan, but only if the payment is accompanied by a fee. The fee, in turn, is set in the original loan documents, and often requires payment of an amount equal to the present value of the interest that would have been paid if there were no payoff.

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The Cases

Two recent bankruptcy court cases have explored MWPs. Their analyses of the issue are illuminating. The first is Judge Drain's decision in September 2014 in *In re MPM Silicones, LLC,*[6] better known as "*Momentive*." The next case is *Energy Future Holding Corp*. (EFHC).[7] In both cases, the courts disallowed the MWP because they found that the MWP would not be enforceable under nonbankruptcy law.[8]

Momentive

Momentive was in the silicone business.[9] It had over $4.1 billion in sales in the year before bankruptcy, and employed over 4,500 people. It also had been the subject of a leveraged buyout from Apollo in 2006. It also had a lot of debt—more than 16 times its annual cash flow before taxes and depreciation.

Part of this large amount of debt was incurred in 2012, when Momentive issued two classes of senior secured notes. The first series, in the amount of $1.1 billion, was issued at an interest rate of 8.875%. The second series, in the amount of $250 million, was issued at an interest rate of 10%. Both series of notes matured in 2020, and both were secured by all or virtually all of Momentive's assets.

Momentive's disclosure statement indicated that it had a debt-free value of somewhere between $2 billion and $2.4 billion. This valuation confirmed that both series of notes were over secured. At the same time, the debt service on Momentive's debt was approximately $288 million per year, some $200 million more than its earnings before taxes and depreciation. It needed to do something.

So it filed Chapter 11. When it filed in 2014, the market had changed from 2012 when it had issued the notes—interest rates had dropped significantly. In such circumstances, it is textbook bankruptcy law that a debtor can "cram down" a secured creditor's claim by giving it a continuing lien on its collateral and a stream of payments that has a present value equal to the allowed amount of its claim. This treatment favors debtors because the interest rate necessary to discount the stream of payments will track interest rates extant at the time of the bankruptcy filing or at confirmation. Using these reduced rates, a debtor can essentially unilaterally refinance its existing debt at lower rates.

But the lenders had anticipated this. Their loan documents required Momentive to pay a MWP. The governing documents defined the MWP as follows:

> the greater of: (1) 1% of the then outstanding principal amount of such Note and (2) the excess of: (a) the present value at such redemption date of (i) the redemption price of such Note, at October 15, 2015 (such redemption price being set forth in paragraph 5 of the applicable Note) plus (ii) all required interest payments due on such Note through October 15, 2015 (excluding accrued but unpaid interest), computed using a discount rate equal to the Treasury Rate as of such redemption date plus 50 basis points; over (b) the then outstanding principal amount of such Note.[10]

Ultimately, Judge Drain disallowed the MWP, but we'll get to that. First, let's look at the other recent MWP case.

Energy Future Holdings Corp. (EFHC)

Energy Future Holdings Corp. is a Texas-based holding company. It owned TXU Energy, a retail electricity provider with more than 2 million customers in Texas, and Luminant, which is engaged largely in power generation and related mining activities and energy trading. It filed chapter 11 in April 2014 with the goal of restructuring $42 billion in debt. It is one of the largest chapter 11 cases ever.

In *EFHC*, Judge Sontchi has issued several rulings regarding several different series of notes, each of which contain MWPs.[11] At issue were three different series of notes: a first lien series of notes, a second liens series of notes, and a series of "payment-in-kind" notes. The first lien notes were issued in 2010 in the aggregate amount of $2.1 billion, and bore an interest rate of 10%. They were due in 2020. The second lien notes were issued in two series, one bearing an 11% interest rate and due in 2021, and a second bearing an 11.75% interest rate and also due in 2021. In the aggregate, the principal amount of the second lien notes was over $2.1 billion. Finally, the "payment-in-kind" notes were unsecured notes issued in two series. The first series was $2 billion in notes bearing an interest rate of 10.875%, and the second consisted of $2.5 billion in notes bearing rates ranging from 11.250% to 12.000%. Both series of notes were due in 2017.

All of the notes had MWPs. The following language was representative:

> "Applicable Premium" means, with respect to any Note on any Redemption Date, the greater of: (1) 1.0% of the principal amount of such Note; and (2) the excess, if any, of (a) the present value at such Redemption Date of (i) the redemption price of such Note at December 1, 2014 (such redemption price as set forth in the table appearing under Section 3.07(d) hereof), plus (ii) all required interest payments (calculated based on the Cash Interest rate payable on the Notes) due on such Note through December 1, 2014 (excluding accrued and unpaid interest, if any, to the redemption Date), computed using a discount rate equal to the Treasury Rate as of such Redemption Date plus 50 basis points; over (b) the principal amount of such Note.

The MWP in each of *Momentive* and *EFHC* thus incorporated as an essential element the amount interest not paid. In *Momentive*, the MWP includes the discounted value of "all required interest payments due on such Note through October 15, 2015. . . ." In *EFHC*, the MWP similarly includes the discounted value of "all required interest payments. . . due on such Note through December 1, 2014." The key feature of each MWP clause was the selection of an appropriate discount rate (based on the Treasury Rate in both cases), but the base against which the agreed discount rate was to be applied was nothing other than the aggregate amount of interest that would not be paid due to the early payment of the notes involved.

MWPs: History and Validity Under State Law

MWPs are a product of the common law rule that a borrower has no independent right to pay a loan before its stated maturity.[12] This rule, often dubbed the "perfect tender rule" then leads to negotiation, either at origination or at proposed prepayment, of the terms under which a lender will accept an early payment.[13] To insolvency and restructuring lawyers, this may sound odd: you always take the money. But outside of bankruptcy, things are different. Solvent borrowers pay a price for the privilege of paying early. This, however, begs the question as to whether the other creditors of an insolvent chapter 11 debtor should pay the same price.[14]

Under the general rule that contracts are to be enforced according to their terms, courts generally uphold MWPs between solvent parties.[15] Proffered payment before scheduled maturity need only be accepted if accompanied by the amount specified in the MWP clause.

Case law, however, has developed an exception, an exception to that exception, and an interpretive gloss on the exception to the exception.

The exception is not really an exception; it is simply an interpretation of how MWP clauses work. If the lender seeks to exercise its rights to accelerate the maturity date, such as would be practically required before a foreclosure of any security or suit on the entire amount of principal, there is no obligation to pay a MWP since it is not the borrower, but the lender, who seeks payment before scheduled maturity.[16] "By accelerating the loan, the lender elects 'to give up [its] future income stream in favor of having an immediate right to collect [its] entire debt.' "[17] Accordingly, no payment on the MWP is due.[18]

The exception to this exception is that a lender may still collect a MWP after its election to accelerate (or after any automatic acceleration) if the loan documents so provide.[19]

The interpretive gloss on this exception is that because it is an exception to an exception, the enforceability of a MWP after a lender's voluntary or automatic acceleration requires clear and explicit contractual language.[20]

Disallowance of MWPs under Section 502(b)(1)

It is on this last point that the efforts to collect MWPs in *Momentive* and *EFHC* foundered. As Judge Drain in *Momentive* saw it, the MWP had to contain "either an explicit recognition that the make-whole would be payable notwithstanding the acceleration of the loan or . . . a provision that requires the borrower to pay a make-whole whenever debt is repaid prior to its original maturity . . . ."[21] The indenture at issue in *Momentive* didn't pass this test.

In *EFHC*, Judge Sontchi found the indentures there had similar language to the indentures in *Momentive*, and thus applied the same reasoning. As a result, both *Momentive* and *EFHC* disallowed the MWP under Section 502(b)(1). In short, they found the clauses unenforceable under nonbankruptcy law.

Disallowance of MWPs under Section 502(b)(2)

As shown above, the recent trend seems to be to disallow MWPs on state law grounds under § 502(b)(1). In the long run, however, reliance on state law contract interpretation theories just encourages lenders' counsel to try and craft more specific language because existing MWPs are not specific enough. Which in turn will require more litigation in bankruptcy courts with uncertain results. To return to the opening metaphor, it just encourages the swordsman to develop more elaborate moves.

But why work that hard to dispense with MWPs in bankruptcy? Disallowance under § 502(b)(2) is easier and simpler.

Section 502(b)(2) disallows a claim to the extent that it is for unmatured interest. Paragraph (2) thus has two components: interest, and a lack of maturity of that interest.

"Interest"

Take interest first. The Bankruptcy Code does not define "interest." To start with the basics, however, *Black's Law Dictionary* defines interest as:

> The compensation fixed by agreement or allowed by law for the use or detention of money, or for the loss of money by one who is entitled to its use; esp., the amount owed to a lender in return for the use of borrowed money. Also termed finance charge.[22]

Those courts that have looked specifically at what "interest" is under Section 502(b)(1) use a similar definition. "Interest is money 'paid to compensate for the delay and risk involved in the ultimate repayment of monies loaned.' "[23] Or, as indicated by the Second Circuit, "The word 'interest' [is what is] to be paid to compensate for the delay an risk involved in the ultimate repayment of monies loaned."[24]

Outside of Section 502(b)(2), "interest" has been similarly broadly defined. In reviewing the proposed definition of interest under federal banking law in *Smiley v. Citibank*, for example, the Supreme Court had the following definition before it:

> The term 'interest' as used in 12 U.S.C. § 85 includes any payment compensating a creditor or prospective creditor for an extension of credit, making available of a line of credit, or any default or breach by a borrower of a condition upon which credit was extended. It includes, among other things, the following fees connected with credit extension or availability: numerical periodic rates, late fees, not sufficient funds (NSF) fees, overlimit fees, annual fees, cash advance fees, and membership fees. It does not ordinarily include appraisal fees, premiums and commissions attributable to insurance guaranteeing repayment of any extension of credit, finders' fees, fees for document preparation or notarization, or fees incurred to obtain credit reports." 61 Fed.Reg. 4869 (to be codified in 12 CFR § 7.4001(a)).[25]

In reviewing this language, the Court said that "[a]s an analytical matter, it seems to us perfectly possible to draw a line, as the regulation does, between (1) 'payment compensating a creditor or prospective creditor for an extension of credit, making available of a line of credit, or any default or breach by a borrower of a condition upon which credit was extended,' and (2) all other payments."[26]

State law, especially when examining usury claims, is similarly broad. As an example, when summarizing Texas usury law, a Texas federal District Court has said:

> The Texas Supreme Court has stated that "amounts charged or received in connection with a loan are not interest if they are not for the use, forbearance, or detention of money." First USA Management Inc. v. Esmond, 960 S.W.2d 625, 627 (Tex. 1997). To determine this, the Court has held that "fees which are an additional charge supported by a distinctly separate and additional consideration, other than the simple lending of money, are not interest and thus do not violate the usury laws." [First Bank v. Tony's Tortilla Factory, Inc., 877 S.W.2d 285, 287 (Tex.1994)] . Furthermore, Courts may look past the label assigned to the fee in order to determine if the fee is a service charge or disguised interest. Id.[27]

In the context of similar usury determinations, state courts have not hesitated to recharacterize parties' labels to find that charges and fees should be treated as interest despite the different label used by the parties.[28] Charges as diverse as broker's fees,[29] mandatory repurchase prices,[30] and even attorneys' fees[31] have been recharacterized as interest.

The common element among these definitions is that fees and charges by the lender which represent bona fide payments to third parties will not be interest; payments which the lender collects for itself will be. And, as emphasized in *Mims*, the contractual characterization is not binding. Courts floor substantive not formalist standards. Indeed, in *Mims*, the court held that the lender's charges for attorney's fees would be split: those fees that went to outside counsel were not counted as interest, while those fees allocable to in-house counsel were counted as interest.[32]

The allocation of payments into principal and interest components has a long history, especially in usury cases. The general policy which emerges is that payments denominated or treated as interest are not due and cannot be payable unless there is money or funds (that is, principal) outstanding. Put another way, when a borrower takes out a loan, he or she is bound to repay the principal and only that interest which accrues while any principal is outstanding. You don't pay interest if the principal amount of the debt is repaid.

The point is substantive. Regardless of how the parties characterize a payment, the law will recharacterize it according to its substance.[33] The classic example is zero coupon bonds. With such bonds, no interest is specified. A borrower receives a certain sum—say, for example, $100—and then signs a note or bond that obligates the borrower to repay a larger sum later—say $120, to complete the example. No interest is mentioned. On its face, such a transaction looks to be interest free. But courts (and Congress, for that matter) have no problem recharacterizing the difference between what is received and what is to be paid back as interest—and thus in the example, the $20 difference between value received and obligation incurred would be characterized as interest.

The legislative history of Section 502(b)(2) confirms this. It states that:

> For example, a claim on a $1,000 note issued the day before bankruptcy would only be allowed to the extent of the case actually advanced. If the original discount was 10% so that the cash advanced was only $900, then notwithstanding the face amount of note, only $900 would be allowed. If $900 was advanced under the note some time before bankruptcy, the interest component of the note would have to be pro-rated and disallowed to the extent it was for interest after the commencement of the case.[34]

Under this standard, MWPs should count as interest. They are charges collected by the lenders related to the use of the money lent or, in the language of the federal regulation discussed in *Smiley*, to the "default or breach by a borrower of a condition [here, no prepayment] upon which credit was extended." Indeed, as can be seen from the clauses used in *Momentive* and in *EFHC*, such charges are by agreement calculated with reference to interest foregone by reason of the debtor's early payment of the entire amount of principal.

The primary problem with this characterization was stated by Scott K. Charles and Emil A. Kleinhaus:

> Treating all prepayment fees (including fixed fees) as "interest" would have the benefit of treating all compensation resulting from prepayment clauses in the same way, thus avoiding any need to draw subtle (and, in the view of some, illusory) distinctions between "true options," on the one hand, and liquidated damages, on the other. The downside of such an approach, however, is that fees that bear no necessary relation to future interest—and that are even called "charges" or "fees"—would be treated no differently from damages for breach of a no call and formulas intended to estimate such damages. One relatively crude approach, under which prepayment clauses necessarily yield "charges," would be replaced with another, under which the clauses yield "interest" no matter their form.[35]

Given the definitions of interest above, this objection suffers from a constricted view of interest. In areas as diverse as usury and consumer protection, state law picks up and uses a broad definition of "interest" including all claims by the lender for fees, charges and other remittances paid directly to the lender for the lender's benefit. To the charge that such a broad interpretation of interest is not applicable to contractual clauses bargained for at arm's length by sophisticated parties, the response is one that usury law has long provided: public policy trumps individual agreements.

In addition, whatever arguments used to sustain MWPs for solvent debtors, in bankruptcy the debtor is not the party paying. Rather, the payments will come, in cases in which the debtor is insolvent, from other creditors. In such circumstances, lenders' claims of loss of a bargained for right fall in line with other creditors' similar claims—all creditors wish for continuous interest. Lenders with MWPs should not have their claims increased simply because of lenders' crafty drafting.[36]

"Unmatured"

The second element of Section 502(b)(2) is that the claim for interest be "unmatured." Although the Bankruptcy Code mentions this classification in Section 101(5)'s definition of "claim," it is not a separately defined term. The legislative history gives some hint as to meaning. It states that "interest disallowed under this paragraph includes postpetition interest that is not yet due and payable, and any portion of prepaid interest that represents an original discounting of the claim, yet that would not have been earned on the date of bankruptcy."[37]

Case law has followed this suggestion. While "[t]he Bankruptcy Code does not define 'unmatured interest,' . . . case law has determined that unmatured interest includes interest that is not yet due and payable at the time of a bankruptcy filing, or is not yet earned."[38]

The legislative history also indicates that the bankruptcy filing cannot be the trigger that brings about the maturity of the obligation to pay interest. It states that "[w]hether interest is matured or unmatured on the date of bankruptcy is to be determined without reference to any ipso facto or bankruptcy clause in the agreement creating the claim."[39] This leads directly to the conclusion that MWPs are "unmatured," regardless of any automatic acceleration of the maturity date caused by the filing of the bankruptcy case.

Liquidated Damages?

Many cases, including leading cases from Delaware, reject this analysis. Instead of viewing MWPs as substitutes for interest yet to be paid, they view them as liquidated damages, and thus a separate class of claims. In *In re Trico Marine Servs., Inc.*,[40] Judge Shannon stated that:

> Research reveals that the substantial majority of courts considering this issue have concluded that make-whole or prepayment obligations are in the nature of liquidated damages rather than unmatured interest, whereas courts taking a contrary approach are distinctly in the minority. . .This Court is persuaded by the soundness of the majority's interpretation of make-whole obligations, and therefore finds that the Indenture Trustee's claim on account of the Make-Whole Premium is akin to a claim for liquidated damages, not a claim for unmatured interest.[41]

Judge Carey soon agreed.[42]

There are two fatal objections to this reasoning. First, simply calling something liquidated damages doesn't change the character of the damages liquidated. If a MWP is a liquidated damages clause, then there must be some damages that required advance calculation. The damages represented by a MWP, however, are the present value of unpaid and unearned interest, which would be disallowed under Section 502(b)(2). If you call the clause a "liquidated interest" provision, you lose no meaning, but reveal the true character of the clause. As a result, characterizing MWP as liquidated damages is true but trivial; even when liquidated, the damages are still damages inextricably tied to and calculated by the amount of interest avoided by an early payment. Indeed, this has rightly been called a "false dichotomy."[43]

The second argument is more subtle. For a liquidated damages clause to exist, there must be some breach that leads to damages being liquidated.[44] But there is no breach outside of bankruptcy when a borrower seeks to repay a loan which is subject to a MWP. Rather, the borrower is simply electing to exercising its bargained-for option to pay early.[45] Put another way, paying early and paying the MWP is *performance*, not breach.[46] Without breach, there can be no liquidated damages. This analysis leads back to the characterization of the MWP as interest, and its status as of a bankruptcy filing as unmatured.

Conclusion

The swordsman scene in Indiana Jones was born of a rethinking the movie's story, and necessity. As related on a fan-based website, the idea originally was to have Harrison Ford's character engage in an extended fight with the swordsman. But that had certain costs. As stated by Harrison Ford:

> I was in my fifth week of dysentery. I'm riding up to the set at 5.30am and can't wait to storm up to Steven with this idea. We could save four days on this lousy location this way! Besides which, it was right and important—what is more vital in the character's mind is finding Marion; he doesn't have the time for another five-minute fight. But as was very often the case when I suggested it to Steve—"Let's just shoot the [person]"—he said he'd thought the same thing that morning.[47]

Just as it was time to rethink the scene in *Raiders*, the time has come to rethink MWPs in bankruptcy. No matter how they are sliced and diced, they are compensation for unpaid interest. As such, and regardless of their status under non-bankruptcy law, they are "unmatured interest" under the Bankruptcy Code. They should be shot and summarily disallowed.

ENDNOTES:

[1]Raiders of the Lost Ark (Paramount Pictures 1981).

[2]You can see the scene at: https://www.youtube.com/watch?v=7YyBtMxZgQs.

[3]Such clauses are often called "yield maintenance provisions" or something similar. I do not make distinctions because I do not believe that there are any substantive differences under bankruptcy law.

[4]Chinatown (Paramount Pictures 1974). The

actual line is: "Forget it, Jake. It's Chinatown."

[5]For a shorter piece advocating the same position, see Matthew I. Knepper, Lipstick On A Pig: Disallowing Make-Whole Clauses As Unmatured Interest, Am. Bankr. Inst. J., at 40 (Dec. 2012/Jan. 2013).

[6]In re MPM Silicones, LLC, 2014 WL 4436335 at *16-17 (Bankr. S.D.N.Y. 2014), order aff'd, 531 B.R. 321 (S.D.N.Y. 2015).

[7]Judge Sontchi's rulings are contained in a series of cases. In re Energy Future Holdings Corp., 513 B.R. 651, 59 Bankr. Ct. Dec. (CRR) 265 (Bankr. D. Del. 2014); In re Energy Future Holdings Corp., 527 B.R. 178 (Bankr. D. Del. 2015), order aff'd, 2016 WL 627343 (D. Del. 2016); In re Energy Future Holdings Corp., 533 B.R. 106 (Bankr. D. Del. 2015), order aff'd, 2016 WL 627343 (D. Del. 2016); In re Energy Future Holdings Corp., 539 B.R. 723, 61 Bankr. Ct. Dec. (CRR) 200 (Bankr. D. Del. 2015), order aff'd, 2016 WL 1451045 (D. Del. 2016); In re Energy Future Holdings Corp., 540 B.R. 96 (Bankr. D. Del. 2015); and In re Energy Future Holdings Corp., 540 B.R. 109 (Bankr. D. Del. 2015).

[8]For a more detailed background on the cases, see Greg M. Zipes & Gerard DiConza, Make Wholes: Have Bankruptcy Courts Identified the Yellow Brick Road Language that Leads to Creditor Oz?, 25 No. 1 J. Bankr. L. & Prac. NL Art. 4 (2016).

[9]This summary is taken from my examination of *Momentive*'s use of a cram down interest rate based on Till v. SCS Credit Corp. *See* To Market, To Market: Momentive and Secured Creditor Cram Down Interest Rates, Bankruptcy Law Letter, Vol. 36, No. 2 (Feb. 2016).

[10]In re MPM Silicones, LLC, Case No. 14-22503-rdd, 2014 WL 4436335, at *12 (Bankr. S.D.N.Y., Sept. 9, 2014), aff'd, 531 B.R. 321, (S.D.N.Y 2015), appeal pending, Dkt. No. 15-1771 (2d Cir.).

[11]In re Energy Future Holdings Corp., 513 B.R. 651, 59 Bankr. Ct. Dec. (CRR) 265 (Bankr. D. Del. 2014); In re Energy Future Holdings Corp., 527 B.R. 178 (Bankr. D. Del. 2015), order aff'd, 2016 WL 627343 (D. Del. 2016); In re Energy Future Holdings Corp., 533 B.R. 106 (Bankr. D. Del. 2015), order aff'd, 2016 WL 627343 (D. Del. 2016); In re Energy Future Holdings Corp., 539 B.R. 723, 61 Bankr. Ct. Dec. (CRR) 200 (Bankr. D. Del. 2015), order aff'd, 2016 WL 1451045 (D. Del. 2016); In re Energy Future Holdings Corp., 540 B.R. 96 (Bankr. D. Del. 2015); and In re Energy Future Holdings Corp., 540 B.R. 109 (Bankr. D. Del. 2015).

[12]See. e.g., Abbe v. Goodwin, 7 Conn. 377, 1829 WL 36 (1829); Brown v. Cole, 14 L.J.-Ch. 167 (1845). There is some doubt as to how well established this rule was before the Nineteenth Century. Frank S. Alexander, Mortgage Prepayment: The Trial of Commonsense, 72 Cornell. L. Rev. 288, 304 (1986-1987) ("There is little evidence to support a rule prohibiting mortgage prepayment until the beginning of the nineteenth century.").

For a more comprehensive examination of the history and details of make-whole premiums, see Patrick M. Birney Toward Understanding Make-Whole Premiums in Bankruptcy, 24 No. 4 J. Bankr. L. & Prac. NL Art. 7 (2015).

[13]The history and nomenclature is more richly examined in the most compete examination of the subject to date, Scott K. Charles & Emil A. Kleinhaus, Prepayment Clauses in Bankruptcy, 15 Am. Bankr. L. Rev. 537, 541 (2007).

[14]Considerations may be quite different with solvent chapter 11 debtors. See In re Chemtura Corp., 439 B.R. 561 (Bankr. S.D. N.Y. 2010).

[15]See, e.g., Poughkeepsie Galleria Co. v. Aetna Life Ins. Co., 178 Misc. 2d 646, 648, 680 N.Y.S.2d 420 (Sup 1998).

[16]There is a corollary to this point. If the lender's acceleration is caused by the bad faith conduct of the borrower or other conduct seeking to evade the operation of the MWP, then the MWP must still be paid. In such cases, even though the lender is the one seeking early payment through acceleration of the maturity date, the MWP is still due since the cause of the lender's action was the borrower's bad faith. See Sharon Steel Corp. v. Chase Manhattan Bank, N.A., 691 F.2d 1039, 1053 (2d Cir. 1982).

[17]In re South Side House, LLC, 451 B.R. 248, 268, 55 Bankr. Ct. Dec. (CRR) 26 (Bankr. E.D. N.Y. 2011), order aff'd, Bankr. L. Rep. (CCH) P 82170, 2012 WL 273119 (E.D. N.Y. 2012) (quoting In re Solutia Inc., 379 B.R. 473, 488, 49 Bankr. Ct. Dec. (CRR) 38 (Bankr. S.D. N.Y. 2007)).

[18]George H. Nutman, Inc. v. Aetna Business Credit, Inc., 115 Misc. 2d 168, 169, 453 N.Y.S.2d 586 (Sup 1982) (citing Kilpatrick v. Germania Life Ins. Co., 183 N.Y. 163, 168-69, 75 N.E. 1124 (1905)).

[19]Northwestern Mut. Life Ins. Co. v. Uniondale Realty Associates, 11 Misc. 3d 980, 985, 816 N.Y.S.2d 831, 836 (Sup 2006) ("When a clear and unambiguous clause which calls for payment of the prepayment premium or a sum equal thereto, at any time after default and acceleration is included in the loan agreement, such clause is analyzed as liquidated damages and is generally enforceable").

[20]In re South Side House, LLC, 451 B.R. 248, 268, 55 Bankr. Ct. Dec. (CRR) 26 (Bankr. E.D. N.Y. 2011), order aff'd, Bankr. L. Rep. (CCH) P 82170, 2012 WL 273119 (E.D. N.Y. 2012) (citing In re Granite Broadcasting Corp., 369 B.R. 120, 144, 48 Bankr. Ct. Dec. (CRR) 81 (Bankr. S.D. N.Y. 2007) ("As a general rule, a lender is not entitled to prepayment consideration after a default unless the parties' agreement expressly requires it."); In re Solutia Inc., 379 B.R. 473, 488, 49 Bankr. Ct. Dec. (CRR) 38 (Bankr. S.D. N.Y. 2007) (declining to award a claim for loss of expected interest stream absent explicit language in the indenture so enti-

tling the lender); HSBC Bank USA, Nat'l Ass'n. v. Calpine Corp., 2010 WL 3835200, at *5 (S.D.N.Y. Sept. 10, 2010) (declining to allow premiums in respect of secured notes where the notes did not "specifically require a payment in the event of acceleration").

[21]In re MPM Silicones, LLC, Case No. 14-22503-rdd, 2014 WL 4436335, at *14 (Bankr. S.D.N.Y., Sept. 9, 2014), aff'd, 531 B.R. 321, (S.D.N.Y 2015), appeal pending, Dkt. No. 15-1771 (2d Cir.). Judge Drain referred to Scott K. Charles & Emil A. Kleinhaus, Prepayment Clauses In Bankruptcy, 15 Am. Bankr. Inst. L. Rev. 537, 556 (2007) and U.S. Bank National Association v. South Side House, LLC, 2012 U.S. Dist. LEXIS, 10824, at *21-24, and In re LaGuardia Associates, L.P., 2012 Bankr. LEXIS 5612, at *14-16 for examples of the level of explicitness or specificity required.

[22]Black's Law Dictionary 935 (10th ed. 2014).

[23]Thrifty Oil Co. v. Bank of America Nat. Trust and Sav. Ass'n, 322 F.3d 1039, 1046 (9th Cir. 2003) (quoting Matter of Pengo Industries, Inc., 962 F.2d 543, 546, 27 Collier Bankr. Cas. 2d (MB) 119 (5th Cir. 1992)).

[24]In re Chateaugay Corp., 961 F.2d 378, 381, 22 Bankr. Ct. Dec. (CRR) 1347, 26 Collier Bankr. Cas. 2d (MB) 1174, Bankr. L. Rep. (CCH) P 74550 (2d Cir. 1992) (quoting In re Public Service Co. of New Hampshire, 114 B.R. 800, 803, 20 Bankr. Ct. Dec. (CRR) 850, Bankr. L. Rep. (CCH) P 73424 (Bankr. D. N.H. 1990)).

[25]Smiley v. Citibank (S. Dakota), N.A., 517 U.S. 735, 740, 116 S. Ct. 1730, 1733 (1996).

[26]Smiley v. Citibank (South Dakota), N.A., 517 U.S. 735, 740, 116 S. Ct. 1730, 1733, 135 L. Ed. 2d 25 (1996).

[27]Mims v. Fidelity Funding, Inc., 307 B.R. 809, 856 (N.D. Tex. 2002). See also Parker v. Brinson Constr. Co., 78 So.2d 873 (Fla. 1955) ("Interest" generally is defined as compensation allowed by law or fixed by agreement between the parties to a loan for the use or detention of money or the forbearance to collect money that is due.).

[28]See, e.g., Pease v. Taylor, 88 Nev. 287, 291, 496 P.2d 757, 760 (1972); Durst v. Abrash, 22 A.D.2d 39, 40, 253 N.Y.S.2d 351, 352 (1st Dep't 1964), order aff'd, 17 N.Y.2d 445, 266 N.Y.S.2d 806, 213 N.E.2d 887 (1965); Taylor v. Budd, 217 Cal. 262, 265–66, 18 P.2d 333 (1933).

[29]See, e.g., Wheeler v. Superior Mortg. Co., 196 Cal. App. 2d 822, 828–29, 17 Cal. Rptr. 291, 295 (2d Dist. 1961).

[30]See, e.g., Durst v. Abrash, 22 A.D.2d 39, 40, 253 N.Y.S.2d 351, 352 (1st Dep't 1964), order aff'd, 17 N.Y.2d 445, 266 N.Y.S.2d 806, 213 N.E.2d 887 (1965).

[31]Mims v. Fidelity Funding, Inc., 307 B.R. 849, 857 (N.D. Tex. 2002).

[32]Mims v. Fidelity Funding, Inc., 307 B.R. 849, 857 (N.D. Tex. 2002).

[33]See, e.g., Thrifty Oil Co. v. Bank of America Nat. Trust and Sav. Ass'n, 322 F.3d 1039, 1047 (9th Cir. 2003) ("In deciding whether a claim includes unmatured interest, federal courts generally focus on the substance of the claim, not its form, and may rely on evidence outside the parties' agreement.").

[34]H.R.Rep. No. 95-595, 95th Cong., 1st Sess. 352-53 (1977); S.Rep. No. 95-989. 95th Cong., 2d Sess. 62 (1978).

[35]Scott K. Charles & Emil A. Kleinhaus, Prepayment Clauses In Bankruptcy, 15 Am. Bankr. Inst. L. Rev. 537, 574 (2007).

[36]"[T]he venerable principle that a bankruptcy court can refuse to award interest that accrues on a creditor's claim after the petition for bankruptcy is filed . . . is designed for cases where there is not enough money to pay all the creditors—so that there is a question whether one creditor should get interest while another doesn't even recover principal." Matter of Chicago, Milwaukee, St. Paul and Pacific R. Co., 791 F.2d 524, 529 (7th Cir. 1986).

[37]H.R.Rep. No. 95-595, 95th Cong., 1st Sess. 352 (1977); S.Rep. No. 95-989. 95th Cong., 2d Sess. 62 (1978).

[38]In re South Side House, LLC, 451 B.R. 248, 261, 55 Bankr. Ct. Dec. (CRR) 26 (Bankr. E.D. N.Y. 2011), order aff'd, Bankr. L. Rep. (CCH) P 82170, 2012 WL 273119 (E.D. N.Y. 2012). See also In re Doctors Hosp. of Hyde Park, Inc., 508 B.R. 697, 706 (Bankr. N.D. Ill. 2014) (Unmatured interest is "interest which was not yet due and payable at the time the petition was filed.") (quoting In re X-Cel, Inc., 75 B.R. 781, 788-89 (N.D. Ill. 1987)).

[39]H.R.Rep. No. 95-595, 95th Cong., 1st Sess. 352-53 (1977); S.Rep. No. 95-989. 95th Cong., 2d Sess. 62 (1978).

[40]In re Trico Marine Services, Inc., 450 B.R. 474 (Bankr. D. Del. 2011).

[41]In re Trico Marine Servs., Inc., 450 B.R. 474, 480-81 (Bankr. D. Del. 2011) (citing Noonan v. Fremont Fin. (In re Lappin Elec. Co.), 245 B.R. 326, 330 (Bankr. E.D. Wis. 2000) ("[T]his court is in agreement with a majority of courts that view a prepayment charge as liquidated damages, not as unmatured interest or an alternative means of paying under the contract.") (citations omitted); see also In re Outdoor Sports Headquarters, Inc., 161 B.R. 414, 424 (Bankr. S.D. Ohio 1993) ("Prepayment amounts, although often computed as being interest that would have been received through the life of a loan, do not constitute unmatured interest because they fully mature pursuant to the provisions of the contract.") (citations omitted); In re Skyler Ridge, 80 B.R. 500, 508 (Bankr. C.D. Cal.

1987) ("Liquidated damages, including prepayment premiums, fully mature at the time of breach, and do not represent unmatured interest.") (citation omitted)).

[42]In re Sch. Specialty, Inc., No. 13-10125 KJC, 2013 WL 1838513, at *5 (Bankr. D. Del. Apr. 22, 2013).

[43]In re Doctors Hosp. of Hyde Park, Inc., 508 B.R. 697, 706 (Bankr. N.D. Ill. 2014).

[44]See, e.g., Restatement (Second) of Contracts § 356(1) (1981), which indicates that liquidated damages are available after "breach."

[45]See West Raleigh Group v. Massachusetts Mut. Life Ins. Co., 809 F. Supp. 384, 391 (E.D. N.C. 1992) (noting that the borrower's premise that prepayment is a liquidated-damages provision "ignores the fact that there has been no breach of contract . . . [where the borrower] is attempting to voluntarily invoke a contract term—the privilege and option of prepayment," and therefore "to invoke that option it must abide by the terms of its agreement"); Carlyle Apartments Joint Venture v. AIG Life Ins. Co., 333 Md. 265, 635 A.2d 366, 373 (1994) (noting that prepayment was in accordance with the contract and not a breach); Lazzareschi Inv. Co. v. San Francisco Fed. Sav. & Loan Assn., 22 Cal. App. 3d 303, 99 Cal. Rptr. 417, 420 (1st Dist. 1971) (Prepayment is the "opposite of default.").

[46]See Megan W. Murray, Prepayment Premiums: Contracting for Future Financial Stability in the Commercial Lending Market, 96 Iowa L. Rev. 1037, 1051-53 (2011). See also River East Plaza, L.L.C. v. Variable Annuity Life Ins. Co., 498 F.3d 718 (7th Cir. 2007).

[47] http://web.archive.org/web/20080604184141/http://www.indy-net.co.uk/articles.php?article_id=4. The unexpurgated version of "[person]" is a vulgar personal description that rhymes with "trucker." Webster's Unabridged Dictionary dates the term actually used by Ford to 1598, and defines it as "an offensive or disagreeable person."

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DEAD FUNDS AND SHIPWRECKS: *ULTRA PETROLEUM*

By Bruce A. Markell

INTRODUCTION

In his dissent in *Dewnup v. Timm*, Justice Scalia quipped that "bankruptcy law has little to do with natural justice."[1] More recently, in *Ultra Petroleum Corporation v. Ad Hoc Committee of Unsecured Creditors of Ultra Resources, Incorporated (In re Ultra Petroleum Corporation) [Ultra]*,[2] Judge Andrew Oldham of the Fifth Circuit described the status of a creditor in a rare solvent bankruptcy as the "proverbial rich man who manages to enter the Kingdom of Heaven."[3]

I don't know what it is about bankruptcy that elicits such philosophical and religious observations. Favoring religion over philosophy, however, this last utterance deserves some study. And so does the case it comes from, *Ultra*, which forms the basis of this month's *Bankruptcy Law Letter*.

Ultra deals with some arcane, but fundamental, bankruptcy issues. These issues include the relationship between plan and statutory impairment, the question of interest payable by solvent estates, and then the frailty of make-whole premiums.

ULTRA PETROLEUM

Ultra was part of a corporate group engaged in oil and gas exploration.[4] Together, the group took on significant debt between 2008 and 2011—the principal amount was close to $2.5 billion.[5]

That debt was still outstanding when, between 2014 and 2016, the market price of oil dropped from $100 a barrel to just below $30 a barrel. Ultra was not immune from the travails of the oil patch; as oil's price dropped, so did Ultra's solvency. Ultra followed many of its business partners and competitors into Chapter 11 bankruptcy in April 2016.

But almost as quickly as oil's price dropped, it rebounded.

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It rose from around $30 a barrel when Ultra filed to almost $80 a barrel during Ultra's case. Ultra returned to the bright sunshine of solvency.

This change in circumstances also shed new light on Ultra's bankruptcy case. Ultra proposed a Chapter 11 plan paying all unsecured claims in full and in cash, and providing a substantial recovery for its equity owners.

Ultra's proposed Chapter 11 plan treated the holders of the $1.5 billion of unsecured notes (the "Noteholders") as unimpaired. As holders of unimpaired claims, the Noteholders were "conclusively presumed to have accepted the plan."[6]

Perhaps it is the cussedness of human nature that people don't like to be told that they are "conclusively" presumed to accept or agree to anything. The Noteholders objected.

One might wonder why. The Noteholders were to be paid their principal. They were to be paid their accrued interest. They were even to be paid postpetition interest at the federal judgment rate.

That was not enough.

The Noteholders had "Make Whole Agreements." These agreements, they contended, gave them right to be paid amounts to compensate them in for Ultra paying its debts early. They also thought Ultra was chintzy on the amount of postpetition interest it offered.

The difference was not small. As stated by the Fifth Circuit, "the creditors argued the debtors owed them an additional $387 million—$201 million as the Make-Whole Amount and $186 million in postpetition interest."[7]

I guess that's enough to fight about.

The fight proceeded on three fronts. First, the Noteholders contended that Ultra got it wrong by saying that they were "unimpaired." After all, the plan did not pay Noteholders everything they would have received under state law from a solvent debtor, and thus they *had* to be impaired. Not so fast, responded Ultra. The Bankruptcy Code does not allow claims for unmatured interest—and much of the Noteholders' objection involved whether interest accrued postpetition could be disallowed in a solvent case and thus not paid.[8] This raised the issue of "plan impairment" versus "Code impairment."

Second, while everyone agreed a solvent debtor needs to pay postpetition interest on

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prepetition claims, there was significant disagreement on the authority for such payment and over the proper rate to use. Ultra said the federal judgment rate; the Noteholders wanted their contract rate.

Finally, the parties clashed over the nature of Make-Whole obligations. Ultra essentially contended that Make Whole payments are nothing but tarted-up claims for lost interest that had not yet become due. The Noteholders responded that the parties' documents did not denominate the obligations as interest, and in any event the payments weren't for interest—rather, Ultra owed them money for early payment on a debt.

Each of these arguments deserves discussion.

"PLAN" IMPAIRMENT VERSUS "CODE" IMPAIRMENT

Non-impairment is a powerful tool. If a plan proponent "leaves unaltered the legal, equitable, and contractual rights"[9] of a claimant, then "each holder of a claim or interest of such [impaired] class [is] conclusively presumed to have accepted the plan, and solicitation of acceptances . . . is not required."[10] No solicitation; no voting. As the Fifth Circuit said in *Ultra*: "the creditor's right to vote disappears when the plan doesn't actually affect his rights."[11]

The battle is thus over the status of impairment, not its consequences. And this battle is not a new one. Sixteen years ago, in July of 2003, this publication examined the issue (and apparently came out on the wrong side of history, at least as far as *Ultra* is concerned).[12] The issue then, and the issue now, is whether alterations in legal rights effected by the Code alone count as "impairment."

This situation arises because Section 502 contains federal, bankruptcy, grounds for disallowing a claim that differ from state, nonbankruptcy, grounds. In 2003, the issue discussed in these pages was whether Section 502(b)(6)'s limitation on landlord claims counted as impairment if such claims would not be so limited outside of bankruptcy. In *Ultra*, the issue was whether the disallowance of interest unmatured at commencement counted as impairment if the plan did nothing else to the claim.

Ultra made quick work of the argument that any alteration of rights, by the plan, the Code, or something else, was impairment under Section 1124(1). As the court stated:

> Let's start with the statutory text. Section 1124(1) says "a class of claims or interests" is not impaired if "the plan . . . leaves unaltered the [claimant's] legal, equitable, and contractual rights." The Class 4 Creditors spill ample ink arguing their rights have been altered. But that's both undisputed and insufficient. The plain text of § 1124(1) requires that "the plan" do the altering. We therefore hold a creditor is impaired under § 1124(1) only if "the plan" itself alters a claimant's "legal, equitable, [or] contractual rights."[13]

Ultra supported its conclusion by noting that "[t]he only court of appeals to address the questions took the same approach," and that "[d]ecisions from bankruptcy courts across the country all run in the same direction."[14] The court also reviewed the Noteholders' counterarguments, which ran strikingly similar to this publication's 2003 position. As stated then:

> A closer inspection of the language employed in Section 1124(1) reveals "impairment by statute" to be an oxymoron. Impairment results from what the plan does, not what the statute does. A plan which "leaves unaltered" the legal rights of a claimant is one which, by definition, does not impair the creditor. A plan which leaves a claimant subject to other applicable provisions of the Bankruptcy Code does no more to alter a claimant's legal rights than does a plan which leaves a claimant vulnerable to a given state's usury laws or to federal environmental laws. The Bankruptcy Code itself is a statue which, like other statutes,

> helps to define the legal rights of persons, just as surely as it limits contractual rights.[15]

In short, "[a]ny alteration of legal rights is a consequence not of the plan but of the bankruptcy filing itself."[16] This created, as the article suggested, a false dichotomy between types of impairment:

> [The] cap is implicated by the Code concept of an "allowed" claim under § 502—terminology employed expressly elsewhere in defining creditors' voting rights (see Bankruptcy Code § 1126(a)), but not in § 1124(1)—an omission suggesting that "plan impairment versus Code impairment" is a false dichotomy, and Code impairment is a relevant alteration of "the legal, equitable, and contractual rights" of the holder of a "claim" for purposes of § 1124(1).[17]

To this argument, *Ultra* had a novel response. In essence, it found that bankruptcy law is as much of the warp and woof of contract rights as is any other law. One consequence of this view is that unmatured interest limitations and landlord rent caps are "baked" into nonbankruptcy (usually state) law claims from their inception, and thus are not restrictions or limitations placed on mature rights that happen to wander into a bankruptcy court. In support of this, the Fifth Circuit stated: " 'The Bankruptcy Code itself is a statute which, like other statutes, helps to define the legal rights of persons.' "[18]

Finally, the Noteholders argued that the elimination of Section 1124(3) in 1994 supported their view. Before 1994, Section 1124(3) had provided that a creditor's claim was not impaired if the plan paid "the *allowed amount* of such claim."[19] Reading this language, a bankruptcy court[20] had allowed a solvent debtor to avoid paying postpetition interest since all the statute required for nonimpairment was payment of the allowed amount of the claim, with the adjective "allowed" apparently confined to the Bankruptcy Code sense of the term. From this, the Noteholders argued that allowance or disallowance under the Bankruptcy Code should not play any role in the impairment analysis.

Again, *Ultra* summarily disposed of the argument. It read the 1994 repeal as being directed at one specific problem: the avoidance of interest on claims when the debtor was solvent. Unmentioned, said the court, were the other decisions regarding the construction of "impairment."[21] With almost a sneer, the court noted that "[e]ven for those who think legislative history can be relevant to statutory interpretation, this particular history is not."[22]

SOLVENT DEBTOR EXCEPTION

Impairment under the Code goes to many things: the right to receive a disclosure statement,[23] the right to vote on a Chapter 11 plan,[24] and the right to receive at least as much as could be expected if the debtor had liquidated instead of reorganized.[25] But even if impaired, the general consensus is that creditors should receive postpetition interest on their claims if the debtor proves solvent; that is, if it has more assets than debts.[26]

Ultra found this consensus rooted in early English history.[27] Under early bankruptcy statutes[28] and practice,[29] no interest was paid on claims to the extent that such interest accrued after the fling of a bankruptcy case. One of the earlier statements of this view was in *In re Bennet*:

> Commissioners, after a man becomes a bankrupt, compute interest upon debts no lower than the date of the commission, because it is a dead fund, and in such a shipwreck, if there is a salvage of part to each person, in this general loss, it is as much as can be expected.[30]

Most English cases concurred,[31] as did Blackstone.[32] Early state insolvency statutes and federal receivership[33] cases also followed this trend. As stated in the New York case of *In re Murray:*[34]

> Equality among creditors is equity; and where interest is recoverable either upon the express

> agreement of the parties or as legal damages, for the non-payment of the debt when it should have been paid, the creditors are all entitled to participate in the distribution of the fund, rateably, in proportion to the amount due to them respectively for principal and interest up to the date of the assignment. In settling the tableau of distribution, therefore, the interest upon those debts which bear interest or upon which it is recoverable as damages, upon settled legal principles, should be computed to that time; and if any debts are not then due, and which are not upon interest, a proper discount should be made.[35]

But what if the shipwreck unexpectedly contains a chest of gold? Blackstone's answer, citing one case,[36] was that creditors then became entitled to post-commission interest.[37] American state courts tended to agree.[38] Theories for this change ranged from simple fairness, to administrative convenience. In any event, despite its seeming rarity, cases popped up in which the estates were or became solvent. Courts uniformly awarded post-commission interest to creditors.

This principal seems to have endured from early modern English law[39] to at least the 20th century. At the beginning of the 20th century, Justice Holmes observed, perhaps with too much generality, that:

> We take our bankruptcy system from England, and we naturally assume that the fundamental principles upon which it was administered were adopted by us when we copied the system, somewhat as the established construction of a law goes with the words where they are copied by another state.[40]

As a consequence, modern American law followed early English law and did not pay interest on post-commission claims, even though neither England or the United States codified this principle.[41] As summarized in *American Iron & Steel Mfg. Co. v. Seaboard Air Line Ry.*, the rule in insolvency proceedings such as receiverships regarding the payment of interest with respect to the general receiverships and interest

> did not prevent the running of interest during the receivership; and if, as a result of good fortune or good management, the estate proved sufficient to discharge the claims in full, interest as well as principal should be paid. Even in bankruptcy, and in the face of the argument that the debtor's liability on the debt and its incidents terminated at the date of adjudication, and as a fixed liability was transferred to the fund, it has been held, in the rare instances where the assets ultimately proved sufficient for the purpose, that creditors were entitled to interest accruing after adjudication.[42]

THE RUNNING DICHOTOMY

Ultra's analysis of the issue of interest during a case's pendency turns on a dichotomy developed early in the case: interest accrued *as part of* a claim versus interest accrued *on a* claim. The distinction mirrors to a certain extent the court's treatment of impairment, looking at what the Bankruptcy Code provides and what a plan actually does after the Code has made its changes. In the court's view, interest *as part of* a claim is primarily a function of nonbankruptcy law. The question is whether interest would accrue had bankruptcy not been filed. An example might be postpetition interest on an overdue bill otherwise characterized as an administrative expense, or on an oversecured claim.[43]

Interest *on a claim* is, by contrast, inherently a bankruptcy issue. It is interest that accrues on fully allowed claims from and after commencement of the bankruptcy case. As stated by the court: "That interest never existed before bankruptcy; rather, it arises only after bankruptcy has transmogrified a debt obligation into a bankruptcy award."[44]

As the court concedes, interest *on a claim* is rare, arising only when the debtor's estate is sufficient to pay all claims. An example might be an oversecured claim. Take, as an illustration, a claim of $100 secured by $200 in collateral, and bearing a contract interest rate of 10% interest. Assume the bankruptcy proceeding takes one year. Under Section 506(b), we know that interest *is part of* the claim, and so at the end of the year the creditor's allowed claim would be $110.[45] Assume further that manna falls from heaven, and the estate has funds left after paying all allowed claims. Is the holder of the $110 claim entitled to additional interest as compensation for the delay in receipt of funds? And if so, at what interest rate? Given the creditor's oversecured position, the tendency might be to allow interest *on the claim*. If the prevailing interest rate were 5%, this might add $5.25 to the creditor's recovery.[46] In short, the creditor would receive something like compound, rather than simple, interest.[47]

Here's where the dichotomy presents a conundrum. Assume that an estate has sufficient funds to pay all allowed claims. Is interest then payable on all claims only with respect to claims allowed under the Bankruptcy Code (that is, for example, without taking into account any disallowed unmatured interest), or does the process now calculate what the claim would have been under nonbankruptcy law (before Code disallowance), and allow interest on that larger claim?[48]

To see the problem concretely, take the prior example, but take away any security for the claim. After a year of proceedings, the $100 claim would still be $100. Section 502(b)(2) would disallow any interest unmatured as of the commencement of the case. If the estate were solvent, would postpetition interest *on the claim* then be calculated on the Code-allowed amount of $100, or the nonbankruptcy accrual of $110? That is, would the unsecured creditor in an insolvent estate be paid the same as the oversecured secured creditor, or would it receive a lesser amount?[49] Under nonbankruptcy law, of course, a solvent debtor would owe the same to both. If impairment is part of the claims process from origination, then it would seem that interest on the claim should be interest on the claim as allowed by the Bankruptcy Code; that is, on the $100 amount.

THE CONSEQUENCES OF CODE IMPAIRMENT IN SOLVENT CASES

Ultra's conception of disallowance of interest utilizing this dichotomy raises some troublesome issues. First, it would appear to be based on incomplete history. *Ultra* is correct that English law after 1705 did not allow interest to accrue against the estate after the Chancellor issued his commission of bankruptcy, although English courts did make an exception for solvent estates. But that history is of odd applicability to present day Chapter 11. Debtors of that earlier time had to be human merchants; no consumer debtors and no corporations were eligible (or even existent). Debtors could not initiate bankruptcy; that was made a possibility only in the United States with the 1867 Act. More importantly, for the point regarding interest accrual, English law on interest changed in 1825. The English Bankrupts Act of 1825 provided for contractual interest to date of payment (not the date of commission) for creditors of solvent estates, and interest at 5% for non-contract creditors (primarily those liable on bonds or bills of exchange).[50]

American courts, especially the Supreme Court, continued to view interest accrual following bankruptcy to be legitimate and controlled by nonbankruptcy law (although its disallowance with respect to creditor allocation was a matter of federal bankruptcy law). As noted in *Johnson v. Norris*[51], a case *Ultra* cites:

> The [bankruptcy] statute contains no express provision that answers the question involved in this case. There is in court a fund amounting to $88,432.81 [after payment of all claims with interest to the date of filing]. The court must give directions as to its disposition. Whether we are governed by the apparent intention of Congress as shown by the general

> purpose of the bankruptcy law, or by the general principles of equity, the result would be the same. The bankrupts should pay their debts in full, principal and interest to the time of payment, whenever the assets of their estates are sufficient. The balance then remaining should be returned to the bankrupts.[52]

This view continued in *Vanston Bondholders Protective Committee v. Green*. There, an oversecured creditor claimed not only postpetition interest, but interest on unpaid postpetition interest. Although the creditor was oversecured, and thus there were funds to cover this claim, the estate was otherwise insolvent. Rather than award the compound interest, the Court affirmed the award of simple interest only, based not on statutory principles—there were none—but on equitable principles.

> The extra [compound] interest covenant may be deemed added compensation for the creditor or, what is more likely, something like a penalty to induce prompt payment of simple interest. In either event, first mortgage bondholders would have been enriched and subordinate creditors would have suffered a corresponding loss, because of a failure to pay when payment had been prohibited by a court order entered for the joint benefit of debtor, creditors, and the public. Such a result is not consistent with equitable principles. For legal suspension of an obligation to pay is an adequate reason why no added compensation or penalty should be enforced for failure to pay.[53]

While Congress essentially overruled *Vanston* by adopting Section 506(b) in the 1978 Code, the general rule regarding accrual and payment of interest was not. In enacting Section 502(b)(2), the legislative history indicated that "Section 502(b)[2] thus contains [a] principle[] of *present* law. . . . interest stops accruing [against the estate] at the date of the filing of the petition, because any claim for unmatured interest is disallowed under this paragraph [(2)]"[54]

Thus, the claim for postpetition interest is not automatically eliminated by the fact that Section 502(b)(2) permits its disallowance (which given that disallowance under Section 502(b) is not mandatory, would have been odd).[55] Rather, interest continues to accrue against the debtor unless and until a statutory provision—such as Section 502(b)(2)—gives a party in interest a basis to seek disallowance, or until a statutory discharge—such as Section 1141—bars its enforcement.

To illustrate this point, take the case of a denial of a discharge. No one doubts that interest continues to accrue against the debtor during the pendency of that debtor's bankruptcy case even though a discharge is not forthcoming (as would be the case if the debtor were any entity in Chapter 7 other than a human)[56] or if the debtor were to liquidate as part of a Chapter 11 plan.[57] The same applies to interest accrual for nondischargeable claims as well. Collection of a student loan may be staying during a Chapter 13 case, but interest continues to accrue at the contract rate regardless of what the Chapter 13 plan provides.[58]

These examples illustrate that the claims allowance process is by and among those interested in the bankruptcy estate.[59] This typically includes only creditors, as most cases are filed by insolvent debtors. As in dischargeability litigation, however, a claim may be limited for purposes of distribution from property of the estate, but unlimited against the debtor once the bankruptcy case is closed.

This explains why Chapter 7 has a provision for payment of interest to creditors, and for a return of estate property to the debtor if still solvent after payment of interest. This completes all possibilities for distribution of property of the estate. They key is the usurpation of contract rates for the interest to be paid in favor of a standard, albeit ambiguous, rate specified in Section 726(a)(5). In liquidations, that is what creditors can expect, and that is the rate that preempts contrary private contract rates. Exactly what that rate is, and what benchmark it incorporates, is something *Ultra* remanded to the bankruptcy court.[60]

THE WAY OUT: GOOD FAITH PLANS

The provision of a standard rate is consonant with set priorities and with adoption of a pro rate default distribution. It makes estate administration administratively convenient.

Chapter 11, however, was designed to allow creditors to vary Chapter 7's waterfalls, at least within certain limits and with creditor approval. Notwithstanding the absolute priority rule, for example, a class of creditors can vote for a plan that distributes funds to equity holders without the payment in full of the claims of all members of that class. A corollary of this is that non-impaired creditors cannot complain about a plan that preserves exactly the very rights they had under nonbankrptcy law.

Ultra upsets this apple cart by holding that impairment by the Code is not impairment by a plan. In essence a plan proponent can affect the amount and validity of nonbankruptcy claims using purely federal grounds and still treat the creditor as unimpaired. *Ultra* thus makes it possible to use federal standards to reduce state law rights without concomitantly giving the affected creditor a say.

This state of affairs is probably unobjectionable in most cases. For insolvent debtors, *Ultra's* reading of Section 1124 simply works a reallocation of property of the estate among creditors, using principles embodied in various paragraphs of Section 502(b). But when the debtor is solvent, this creates issues of fairness.

In solvent cases, the issue becomes whether the debtor can couple claim disallowance procedures with the discharge of disallowed claims to increase its payments under a plan at the expense of its creditors. *Ultra* seems to say it can, although it ultimately remanded this issue to the bankruptcy court to determine in the first instance.[61]

Ultra reaches its conclusion in part by holding that "[t]he pre-Code solvent-debtor exception allowed creditors to recover interest *as part of* a claim. The Code, by contrast, requires solvent debtors to pay post-petition interest *on* a claim."[62] As indicated above, this conclusion may not withstand analysis when compared against cases in which a discharge is denied. Otherwise, a debtor ineligible for a discharge could very well game the system and seek robust and durable disallowance of postpetition interest.

A better way to look at the problem is through the lens of good faith. *Ultra* came close to this perspective when it noted that cases could be dismissed for bad faith.[63] But one need not go that far. Section 1129(a)(3) provides that confirmation requires the plan proponent to show that the plan was filed in good faith. It is not much a stretch to categorize a debtor's effort to avoid nonbankruptcy law through the interposition of a Chapter 11 is bad faith. That fear goes back to *Johnson v. Norris*,[64] where the court noted that allowing a solvent debtor to stop the accrual of interest would not be within the spirit of the Bankruptcy Act. As the court stated, "A construction of the act that would give it to the bankrupt, and leave unpaid interest on debts due from the bankrupt, would seem strangely inequitable."[65]

The stakes are somewhat different in Chapter 11. As seen above, interest continues to accrue *against the debtor* during the pendency of a Chapter 11 case. It is the discharge that makes the interest uncollectible against the debtor, not Section 502(b)(2). So the modern fear is not that the claims allowance process can be used unfairly, but that the claims allowance process, when tied to the discharge, can yield "strangely inequitable" results.

If plans seek to employ this double whammy, they are no doubt "strangely inequitable," and hence not in good faith. Under the Code, good faith is "is generally interpreted to mean that there exists 'a reasonable likelihood that the plan will achieve a result consistent with the objectives and purposes of the Bankruptcy Code.' "[66] A plan filed which deprives creditors of interest accrued against the debtor through the use of disallowance and discharge does not meet this standard.

An analogue exists in Chapter 13. Under that Chapter, debtors sometimes file "zero-payment" plans under which no creditors other than administrative expense holders are paid. Many courts have found that this use of Chapter 13 to be indicative (although not conclusive) of a lack of good faith.[67] Similar logic should be applied to plans such as Ultra's.

Ultra went straight from inequity to dismissal. But a plan's inequity may not require dismissal. Unlike Chapter 13, Chapter 11 does not require a *case* to be filed in good faith for confirmation;[68] only the filing of a *plan* need meet that requirement.[69] Denial of confirmation usually leads to a different and complying plan being filed.[70] Especially when the debtor is solvent, there are innumerable ways to construct such a plan. Only when it appears that the debtor cannot or will not file a plan that can be confirmed should the court consider dismissal.[71]

MAKE WHOLE PREMIUMS[72]

The last issue dealt with by *Ultra* was the status of its Noteholders' Make-Whole Premiums (MWP). In actuality, the validity of these clauses is at the heart of *Ultra's* case. If the MWP can be disallowed as unmatured interest, then the disallowance/discharge dance is begun. If the MWP are just another claim, then the dance is delayed.

DISALLOWANCE UNDER NON-BANKRUPTCY LAW—§ 502(B)(1)

Although *Ultra* remanded the characterization of the contract provisions, it left little doubt as to its position. It thought the clauses were unmatured interest. The court stated its position succinctly:

> First, the Make-Whole Amount is the economic equivalent of "interest." . . . . Second, the interest for which the Make-Whole Amount compensates was "unmatured" when the debtors filed their Chapter 11 petitions. . . . [and] Third, those decisions taking a different view are unpersuasive.[73]

While these views may be correct interpretations of MWPs, this analysis pointed the court back to its determination that the Code, and not the debtor's plan, impaired the Noteholders MWP claims. That lead the court to the cramped position that a debtor could file bankruptcy intending to pay less than what would be owed under nonbankruptcy law and its owners could still participate and receive dividends in the case—subject only to bad faith dismissal.

This position raises issues not for *Ultra*, but for other cases. No one denies that Ultra *filed* its bankruptcy in good faith given the fluctuating price of oil. Its motive for filing was not to file the plan it ultimately filed. That lessens the sting and possibility of potential dismissal. One would have to connect the filing of a plan in bad faith to "cause" under Section 1112(b)(4) in order to complete that logic. Filing a plan in bad faith, however, is already accounted for in Section 1129(a)(3) as grounds for denial of confirmation, it would seem to not fit as cause under Section 1112(b).

Much more relevant is the effect of MWP on other creditors in the vast majority of cases in which the debtor is not solvent. There, the equitable bases of allowance and disallowance have far more applicability. Just as the Court in *Vanston Bondholders* found it inequitable to award compound rather than simple interest when doing so would reduce the recoveries of other creditors, so does the characterization of MWP as unmatured interest better characterize MWPs and allow for larger recoveries for other creditors.

DISALLOWANCE UNDER BANKRUTPCY LAW AS "UNMATURED INTEREST"—§ 502(B)(2)

Many cases initially examine MWPs on state law grounds under § 502(b)(1). A current example is *In re 1141 Realty Owner LLC*.[74] There, the "Debtor objected arguing that the Yield Maintenance Default Premium is unenforceable as a matter of New York law . . . ."[75] After a long and thoughtful opinion, the court overruled the objection and found it consistent with New York law.

But, with all respect, why work that hard to dispense with MWPs in bankruptcy? Disallowance under § 502(b)(2) is easier and simpler.

Section 502(b)(2) disallows a claim to the extent that it is for unmatured interest. Paragraph(2) thus has two components: interest, and a lack of maturity of that interest.

"INTEREST"

Take interest first. The Bankruptcy Code does not define "interest." *Black's Law Dictionary* defines interest as:

> The compensation fixed by agreement or allowed by law for the use or detention of money, or for the loss of money by one who is entitled to its use; esp., the amount owed to a lender in return for the use of borrowed money. Also termed finance charge.[76]

Those courts that have looked specifically at what "interest" is under Section 502(b)(1) use a similar definition. "Interest is money 'paid to compensate for the delay and risk involved in the ultimate repayment of monies loaned.' "[77] Or, as indicated by the Second Circuit, "The word 'interest' [is what is] to be paid to compensate for the delay an risk involved in the ultimate repayment of monies loaned."[78]

Outside of Section 502(b)(2), "interest" has been similarly broadly defined. In reviewing the proposed definition of interest under federal banking law, for example, the Supreme Court had the following definition before it:

> The term 'interest' as used in 12 U.S.C. § 85 includes any payment compensating a creditor or prospective creditor for an extension of credit, making available of a line of credit, or any default or breach by a borrower of a condition upon which credit was extended. It includes, among other things, the following fees connected with credit extension or availability: numerical periodic rates, late fees, not sufficient funds (NSF) fees, overlimit fees, annual fees, cash advance fees, and membership fees. It does not ordinarily include appraisal fees, premiums and commissions attributable to insurance guaranteeing repayment of any extension of credit, finders' fees, fees for document preparation or notarization, or fees incurred to obtain credit reports." 61 Fed.Reg. 4869 (to be codified in 12 CFR § 7.4001(a)).[79]

In reviewing this language, the Court said that "[a]s an analytical matter, it seems to us perfectly possible to draw a line, as the regulation does, between (1) 'payment compensating a creditor or prospective creditor for an extension of credit, making available of a line of credit, or any default or breach by a borrower of a condition upon which credit was extended,' and (2) all other payments."[80]

State law, especially when examining usury claims, is similarly broad. As an example, when summarizing Texas usury law, a Texas federal District Court has said:

> The Texas Supreme Court has stated that "amounts charged or received in connection with a loan are not interest if they are not for the use, forbearance, or detention of money." First USA Management Inc. v. Esmond, 960 S.W.2d 625, 627 (Tex. 1997). To determine this, the Court has held that "fees which are an additional charge supported by a distinctly separate and additional consideration, other than

the simple lending of money, are not interest and thus do not violate the usury laws." [First Bank v. Tony's Tortilla Factory, Inc., 877 S.W.2d 285, 287 (Tex.1994)] . Furthermore, Courts may look past the label assigned to the fee in order to determine if the fee is a service charge or disguised interest. Id.[81]

The common element among these definitions is that fees and charges by the lender which represent bona fide payments to third parties will not be interest; payments which the lender collects for itself will be. And, as emphasized in *Mims*, the contractual characterization is not binding. Courts adopt substantive not formalist standards. Indeed, in *Mims*, the court held that the lender's charges for attorney's fees would be split: those fees that went to outside counsel were not counted as interest, while those fees allocable to in-house counsel were counted as interest.[82]

The allocation of payments into principal and interest components has a long history, especially in usury cases. The general policy which emerges is that payments denominated or treated as interest are not due and cannot be payable unless there is money or funds (that is, principal) outstanding. Put another way, when a borrower takes out a loan, he or she is bound to repay the principal and only that interest which accuses while any principal is outstanding. You don't pay interest after the principal amount of the debt is repaid.

The point is substantive. Regardless of how the parties characterize a payment, the law will recharacterize it according to its substance.[83] The classic example is zero coupon bonds. With such bonds, no interest is specified. A borrower receives a certain sum—say, for example, $100—and then signs a note or bond that obligates the borrower to repay a larger sum later—say $120, to complete the example. No interest is mentioned. On its face, such a transaction looks to be interest free. But courts (and Congress, for that matter) have no problem recharacterizing the difference between what is received and what is to be paid back as interest—and thus in the example, the $20 difference between value received and obligation incurred would be characterized as interest.

The legislative history of Section 502(b)(2) confirms this. It states that:

> For example, a claim on a $1,000 note issued the day before bankruptcy would only be allowed to the extent of the case actually advanced. If the original discount was 10% so that the cash advanced was only $900, then notwithstanding the face amount of note, only $900 would be allowed. If $900 was advanced under the note some time before bankruptcy, the interest component of the note would have to be pro-rated and disallowed to the extent it was for interest after the commencement of the case.[84]

Under this standard, MWPs should count as interest. They are charges collected by the lenders related to the use of the money lent or, in the language of the federal regulation, to the "default or breach by a borrower of a condition [here, no prepayment] upon which credit was extended." Such charges are by agreement calculated with reference to interest foregone by reason of the debtor's early payment of the entire amount of principal.

The main objection to this characterization was stated by Scott K. Charles and Emil A. Kleinhaus:

> Treating all prepayment fees (including fixed fees) as "interest" would have the benefit of treating all compensation resulting from prepayment clauses in the same way, thus avoiding any need to draw subtle (and, in the view of some, illusory) distinctions between "true options," on the one hand, and liquidated damages, on the other. The downside of such an approach, however, is that fees that bear no necessary relation to future interest—and that are even called "charges" or "fees"—would be treated no differently from damages for breach of a no call and formulas intended to estimate such damages. One relatively crude approach, under which prepayment clauses necessarily

> yield "charges," would be replaced with another, under which the clauses yield "interest" no matter their form.[85]

Given the definitions of interest above, this objection suffers from a constricted view of interest. In areas as diverse as usury and consumer protection, a broad definition of "interest" picks up and includes all claims by the lender for fees, charges and other remittances paid directly to the lender for the lender's benefit. To the charge that such a broad interpretation of interest is not applicable to contractual clauses bargained for at arm's length by sophisticated parties, the response is one that usury law has long provided: public policy trumps individual agreements.

Whatever arguments used to sustain MWPs for solvent debtors, in bankruptcy the debtor is not the party paying. Rather, the payments come, in cases in which the debtor is insolvent, from other creditors. In such circumstance, lenders' claims of loss of a bargained for right fall in line with other creditors' similar claims—all creditors wish for continuous interest. Lenders with MWPs should not have their claims increased simply because of lenders' crafty drafting.[86]

"UNMATURED"

The second element of Section 502(b)(2) is that the claim for interest be "unmatured." Although the Bankruptcy Code mentions this classification in Section 101(5)'s definition of "claim," it is not a separately defined term. The legislative history gives some hint as to meaning. It states that "interest disallowed under this paragraph includes postpetition interest that is not yet due and payable, and any portion of prepaid interest that represents an original discounting of the claim, yet that would not have been earned on the date of bankruptcy."[87]

Case law has followed this suggestion. While "[t]he Bankruptcy Code does not define 'unmatured interest,' . . . case law has determined that unmatured interest includes interest that is not yet due and payable at the time of a bankruptcy filing, or is not yet earned."[88]

The legislative history also indicates that the bankruptcy filing cannot be the trigger that brings about the maturity of the obligation to pay interest. It states that "[w]hether interest is matured or unmatured on the date of bankruptcy is to be determined without reference to any ipso facto or bankruptcy clause in the agreement creating the claim."[89] This leads directly to the conclusion that MWPs are "unmatured," regardless of any automatic acceleration of the maturity date caused by the filing of the bankruptcy case.

LIQUIDATED DAMAGES?

Many cases, including leading cases from Delaware, however, reject this analysis. Instead of viewing MWPs as substitutes for interest yet to be paid, they view them as liquidated damages, and thus a separate class of claims. In *In re Trico Marine Servs., Inc.*,[90] Judge Shannon stated that:

> Research reveals that the substantial majority of courts considering this issue have concluded that make-whole or prepayment obligations are in the nature of liquidated damages rather than unmatured interest, whereas courts taking a contrary approach are distinctly in the minority. . .This Court is persuaded by the soundness of the majority's interpretation of make-whole obligations, and therefore finds that the Indenture Trustee's claim on account of the Make-Whole Premium is akin to a claim for liquidated damages, not a claim for unmatured interest.[91]

Judge Carey soon agreed.[92]

There are two fatal objections to this reasoning. First, simply calling something liquidated damages doesn't change the character of the damages liquidated. If a MWP is a liquidated damages clause, then there must be some damages that required advance calculation. The damages represented by a MWP, however, are the present value of unpaid and unearned interest, which would be disallowed under Section 502(b)(2). If you call the clause a "liquidated interest" provision, you lose no meaning, but reveal the true character of the clause. As a result, characterizing MWP as liquidated damages is true but trivial; even when liquidated, the damages are still damages inextricably tied to and calculated by the amount of interest avoided by an early payment. Indeed, this has rightly been called a "false dichotomy."[93]

The second argument is more subtle. For a liquidated damages clause to exist, there must be some breach that leads to damages being liquidated.[94] But there is no breach outside of bankruptcy when a borrower seeks to repay a loan which is subject to a MWP. Rather, the borrower is simply electing to exercising its bargained-for option to pay early.[95] Put another way, paying early and paying the MWP is performance, not breach.[96] Without breach, there can be no liquidated damages. This analysis leads back to the characterization of the MWP as interest, and its status as of a bankruptcy filing as unmatured.

CONCLUSION

Modern courts fall back on lofty metaphors when describing bankruptcy and its effects. Justice Scalia invoked bankruptcy's distance from natural justice; Judge Oldham refers to the Biblical aphorism that it is difficult for rich men to enter heaven.

Old English law was more earthy. Bankrupt debtors were shipwrecks, and their assets a dead fund. In threading the needle for the rich men before him in *Ultra*, Judge Oldham slipped by fusing the optional bankruptcy disallowance of unmatured interest into fixed state law principles regarding the accrual and payment of interest. Contrary to his suggestion, interest continues to accrue *against the debtor* during the pendency of a bankruptcy, although perhaps not against the bankruptcy estate. Cases in which a discharge is not granted or denied illustrate this point.

A better resolution was at hand. Plan proponents who use claims disallowance and discharge to reach results in solvent Chapter 11 cases that do not mirror what would happen if bankruptcy were not filed are presumptively in bad faith. They do not achieve results consistent with the objectives and purposes of the Bankruptcy Code, if for no other reason that such results give incentives to solvent companies to file bankruptcies to thwart the accrual of interest. If a plan that seeks such an end is not in good faith, then confirmation should be denied under Section 1129(a)(3).

Denial of confirmation allows the court to retain control and jurisdiction over the debtor while simultaneously allowing plan proponents to provide their own plans for dividing the bankruptcy estate. Creditors can then vote, and the confirmation standards of Section 1129 can decide the outcome. That is surely more on point with the Bankruptcy Code's objectives and purposes.

ENDNOTES:

[1]Dewsnup v. Timm, 502 U.S. 410, 435, 112 S. Ct. 773, 116 L. Ed. 2d 903, 22 Bankr. Ct. Dec. (CRR) 750, 25 Collier Bankr. Cas. 2d (MB) 1297, Bankr. L. Rep. (CCH) P 74361A (1992) (Scalia, J., dissenting).

[2]In re Ultra Petroleum Corporation, 913 F.3d 533, 66 Bankr. Ct. Dec. (CRR) 187 (5th Cir. 2019).

[3]In re Ultra Petroleum Corporation, 913 F.3d 533, 537, 66 Bankr. Ct. Dec. (CRR) 187 (5th Cir. 2019).

[4]The group included a holding company and two subsidiaries. In re Ultra Petroleum Corporation, 913 F.3d 533, 537, 66 Bankr. Ct. Dec. (CRR) 187 (5th Cir. 2019).

[5]The debt was incurred by a subsidiary and guaranteed by the parent and by another subsidiary. It consisted of about $1.5 billion of

unsecured notes and close to $1 billion in a revolving credit facility.

[6]11 U.S.C.A. § 1126(f).

[7]In re Ultra Petroleum Corporation, 913 F.3d 533, 538, 66 Bankr. Ct. Dec. (CRR) 187 (5th Cir. 2019). As the court broke it down, "This amount includes $106 million in interest on the outstanding principal under the notes, $14 million in interest on the Make-Whole Amount, and $66 million in interest on the outstanding principal under the Revolving Credit Facility, all accruing after the debtors filed their petitions." *Id.* at 538 n.1.

[8]No one contended that Ultra's cases were filed in bad faith. Apparently, no one contended that use of nonimpairment for a solvent debtor violated the confirmation requirement that "[t]he plan has been proposed in good faith." 11 U.S.C.A. § 1129(a)(3).

[9]11 U.S.C.A. § 1124(1).

[10]11 U.S.C.A. § 1126(f).

[11]In re Ultra Petroleum Corporation, 913 F.3d 533, 540, 66 Bankr. Ct. Dec. (CRR) 187 (5th Cir. 2019).

[12]Impairment Under § 1124(1): The Fallacious Distinction Between Plan Impairment and Code Impairment, Bankruptcy Law Letter, at 7 (July 2003).

[13]Ultra Petroleum Corp. v. Ad Hoc Committee of Unsecured Creditors of Ultra Resources, Inc. (In re Ultra Petroleum Corp.), 913 F.3d 533, 540 (5th Cir. 2019).

[14]In re Ultra Petroleum Corporation, 913 F.3d 533, 540, 66 Bankr. Ct. Dec. (CRR) 187 (5th Cir. 2019).

[15]Impairment Under § 1124(1): The Fallacious Distinction Between Plan Impairment and Code Impairment, Bankruptcy Law Letter, at 8 (July 2003).

[16]Impairment Under § 1124(1): The Fallacious Distinction Between Plan Impairment and Code Impairment, Bankruptcy Law Letter, at 8 (July 2003).

[17]Impairment Under § 1124(1): The Fallacious Distinction Between Plan Impairment and Code Impairment, Bankruptcy Law Letter, at 9 (July 2003).

[18]In re Ultra Petroleum Corporation, 913 F.3d 533, 541, 66 Bankr. Ct. Dec. (CRR) 187 (5th Cir. 2019) (quoting In re American Solar King Corp., 90 B.R. 808, 819-20, 18 Bankr. Ct. Dec. (CRR) 270, 20 Collier Bankr. Cas. 2d (MB) 547 (Bankr. W.D. Tex. 1988)).

[19]11 U.S.C.A. § 1124(3) (1988) (emphasis added).

[20]See In re New Valley Corp., 168 B.R. 73, 25 Bankr. Ct. Dec. (CRR) 947 (Bankr. D. N.J. 1994).

[21]In re Ultra Petroleum Corporation, 913 F.3d 533, 541, 66 Bankr. Ct. Dec. (CRR) 187 (5th Cir. 2019).

[22]In re Ultra Petroleum Corporation, 913 F.3d 533, 541, 66 Bankr. Ct. Dec. (CRR) 187 (5th Cir. 2019).

[23]11 U.S.C.A. § 1126(f).

[24]11 U.S.C.A. § 1126(f).

[25]Under Chapter 11, the best interest of creditors test of Section 1129(a)(7) does not apply to nonimpaired creditors, as it applies only "[w]ith respect to each *impaired* class of claims or interest . . . ." *Id.* (emphasis supplied).

[26]See In re Ultra Petroleum Corporation, 913 F.3d 533, 549, 66 Bankr. Ct. Dec. (CRR) 187 (5th Cir. 2019).

[27]Put aside for a moment the seeming antinomy of disparaging specific legislative history in favor of selective culling of centuries-old English chancery cases.

[28]This problem arose only after 1705, when debtors first received the possibility of a discharge. *An act to prevent frauds frequently committed by bankrupts*, 4 Anne c.17, § 7 (1705). Without a discharge, creditors could pursue their claims after conclusion of the bankruptcy proceedings, with their claims unaffected by the process except for any payments received.

[29]See 1 William Cooke, The Bankrupt Laws 181 (4th ed. 1799).

[30]In re Bennett, 2 Atk. 527, 529, 27 Eng. Rep. 716, 717 (1743) (Ch.).

[31]In re Mills, 2 Ves. Jun. 294, 30 Eng. Rep. 640 (1793) (Ch.); In re Rooke, 1 Atk. 244, 26 Eng. Rep. 156 (1753) (Ch.); In re Marlar, 1 Atk. 150, 26 Eng. Rep. 97 (1746) (Ch.); Bromley v. Goodere, 1 Atk. 75, 26 Eng. Rep. 49 (1743) (Ch.); 1 William Cooke, The Bankrupt Laws 181 (4th ed. 1799).

[32]2 William Blackstone, Commentaries on the Law of England *488 (1765).

[33]American Iron & Steel Mfg. Co. v. Seaboard Air Line Ry., 233 U.S. 261, 266-67, 34 S. Ct. 502, 58 L. Ed. 949 (1914); Johnson v. Nor-

ris, 190 F. 459, 463-65 (C.C.A. 5th Cir. 1911).

[34]In re Murray, 6 Paige Ch. 204, 3 N.Y. Ch. Ann. 956, 1836 WL 2637 (N.Y. Ch. 1836).

[35]In re Murray, 6 Paige Ch. 204, 205-06, 1836 WL 2637 (N.Y. Ch. 1836).

[36]The case was In re Rooke, 1 Atk. 244, 26 Eng. Rep. 156 (1753) (Ch.).

[37]"[I]n case of a surplus left after payment of every debt, such interest shall again revive, and be chargeable on the bankrupt, or his representatives." 2 William Blackstone, Commentaries on the Law of England *488 (1765).

[38]See, e.g., In re Murray, 6 Paige Ch. 204, 206, 3 N.Y. Ch. Ann. 956, 1836 WL 2637 (N.Y. Ch. 1836) (citing 1 Deacon's Law of Bank. 269) ("I know of no principle, either legal or equitable, which can deprive the creditors of the full amount due to them respectively, including the interest to the time of payment, or so far as the fund will go. The payment of subsequent interest upon those debts which originally drew interest by the agreement of the parties, was allowed even under the bankrupt laws after the principal debts proved under the commission had been fully paid."). See also Clemons v. Clemons' Estate, 69 Vt. 545, 548, 38 A. 314, 315 (1897) ("It is true, the statute provides that, upon debts subject to the payment of interest, interest shall be computed to the date of filing the petition. It is matter of convenience that a time should be fixed for that purpose, and the time chosen is as convenient as any; but the statute does not mean that interest shall in no event be computed to a later date, for obviously it should be when, for instance, the assets are more than enough to pay the face of the debts as allowed.").

[39]After American independence, English law codified the right to post-commission interest if there was a surplus, with the rate being either the contract rate, or if there was no rate, 4%. The Bankrupts Act, 6 Geo. IV. c. 16, § 132 (1825) (Eng.).

[40]Sexton v. Dreyfus, 219 U.S. 339, 344 (1911). Among other things, the generalization obscures the fact that, among other things, American law pioneered debtor-originated discharge and composition statutes that allowed majorities of creditors to bind minority creditors. English law also assumed human debtors, either for themselves or their partnerships, and corporate debtors were unheard of—at least until the English read the American Bankruptcy Act of 1868.

[41]1 William Cooke, The Bankrupt Laws 181 (4th ed. 1799):

> But there is no direction in the act for the purpose, and it has been used only as the best method of settling the proportion among the creditors, that they may have a rate-like satisfaction; nor does the certificate operate as a discharge of the fund before vested is the assignees, thereby to deprive the creditors of subsequent interest, but extends only to any remedy to be taken against the person of the bankruptcy or his future effects.

[42]American Iron & Steel Mfg. Co. v. Seaboard Air Line Ry., 233 U.S. 261, 266-67 (1914).

[43]11 U.S.C.A. § 506(b).

[44]In re Ultra Petroleum Corporation, 913 F.3d 533, 542, 66 Bankr. Ct. Dec. (CRR) 187 (5th Cir. 2019).

[45]If compound interest is allowable, the claim would be $110.52. The formula for compound interest is $A = P(1 + r/n)^{nt}$

[46]I arrive at this through some simplifying assumptions. If interest accrues evenly over the year, the amount against which interest would be assessed would be $105. Five percent of that is $5.25.

[47]If compound interest is used to calculate the claim, the interest as part of the claim would be $10.52. If 5% additional compound interest were to accrue on the claim based on an average claim of $105.26, the end claim would be $110.66, a difference of 14 cents.

[48]Pre-Code jurisprudence would not have permitted this in an insolvent case. See Vanston Bondholders Protective Committee v. Green, 329 U.S. 156, 166-67, 67 S. Ct. 237, 91 L. Ed. 162 (1946) (disallowing compound interest to an oversecured creditor in an insolvent case).

[49]Of course, one way to equalize the payments would be to recognize that allowing interest on interest in the oversecured setting double-counts in a perverse way—nonbankruptcy principles would accrue interest on a claim and then bankruptcy principles would compound that interest.

[50]The Bankrupts Act, 6 Geo. IV. c. 16, § 132 (1825) (Eng.). See also 1 Edward E. Deacon, The Law And Practice Of Bankruptcy: As Altered By The New Act (6 Geo. 4. C. 16.): With A Collection Of Forms And Precedents In Bankruptcy And Practical Notes 270-272 (1827).

[51]Johnson v. Norris, 190 F. 459 (C.C.A. 5th Cir. 1911).

[52]Johnson v. Norris, 190 F. 459, 466 (5th Cir. 1911).

[53]Vanston Bondholders Protective Comm. v. Green, 329 U.S. 156, 166-67 (1946).

[54]Report of the Committee on the Judiciary, House of Representatives, to Accompany H.R. 8200, H.R. Rep. No. 595, 1st Sess. 353 (1977) (emphasis and material in brackets supplied).

[55]Section 502 simply states that a party may object, not that an estate representative must object. Under this statutory scheme, courts may not independently object; it is a purely party driven process. In re White, 908 F.2d 691, 693, Bankr. L. Rep. (CCH) P 73520 (11th Cir. 1990); 9 Collier on Bankruptcy ¶ 3007.01 (Richard Levin & Henry Sommer, ed., 16th ed., 2018).

[56]Section 727(a)(1) precludes a Chapter 7 discharge to any entity other than an individual.

[57]11 U.S.C.A. § 1141(d)(3).

[58]8 Collier on Bankruptcy ¶ 1328.02 (Richard Levin & Henry Sommer, ed., 16th ed., 2018). See generally Bruning v. U.S., 1964-2 C.B. 500, 376 U.S. 358, 84 S. Ct. 906, 11 L. Ed. 2d 772, 64-1 U.S. Tax Cas. (CCH) P 9330, 13 A.F.T.R.2d 962 (1964) (tax debt); In re Monahan, 497 B.R. 642, 70 Collier Bankr. Cas. 2d (MB) 415, 112 A.F.T.R.2d 2013-6158 (B.A.P. 1st Cir. 2013) (postpetition interest on priority tax claim); In re Foross, 242 B.R. 692, 35 Bankr. Ct. Dec. (CRR) 110, 43 Collier Bankr. Cas. 2d (MB) 754 (B.A.P. 9th Cir. 1999) (postpetition interest on alimony, maintenance and support claims not discharged by Chapter 13 discharge).

[59]This perspective was recognized by a commentator on early English bankruptcy law:

> But there is no direction in the act for the purpose, and it has been used only as the best method of settling the proportion among the creditors, that they may have a rate-like satisfaction; nor does the certificate operate as a discharge of the fund before vested is the assignees, thereby to deprive the creditors of subsequent interest, but extends only to any remedy to be taken against the person of the bankruptcy or his future effects.

1 William Cooke, The Bankrupt Laws 181 (4th ed. 1799).

[60]In re Ultra Petroleum Corporation, 913 F.3d 533, 545-46, 66 Bankr. Ct. Dec. (CRR) 187 (5th Cir. 2019). I will leave the determination of the best interpretation of what rate of interest Section 726(a)(5) requires for another time.

[61]In re Ultra Petroleum Corporation, 913 F.3d 533, 546-47, 66 Bankr. Ct. Dec. (CRR) 187 (5th Cir. 2019).

[62]In re Ultra Petroleum Corporation, 913 F.3d 533, 546-47, 66 Bankr. Ct. Dec. (CRR) 187 (5th Cir. 2019).

[63]In re Ultra Petroleum Corporation, 913 F.3d 533, 546-47, 66 Bankr. Ct. Dec. (CRR) 187 (5th Cir. 2019).

[64]Johnson v. Norris, 190 F. 459 (C.C.A. 5th Cir. 1911).

[65]Johnson v. Norris, 190 F. 459, 463 (C.C.A. 5th Cir. 1911).

[66]Matter of Madison Hotel Associates, 749 F.2d 410, 424-25, 12 Bankr. Ct. Dec. (CRR) 616, 11 Collier Bankr. Cas. 2d (MB) 771 (7th Cir. 1984) (quoting In re Nite Lite Inns, 17 Bankr. 367, 370 (Bankr. S.D. Cal. 1982)). See also In re American Capital Equipment, LLC, 688 F.3d 145, 158, 56 Bankr. Ct. Dec. (CRR) 223, 67 Collier Bankr. Cas. 2d (MB) 1701, Bankr. L. Rep. (CCH) P 82300, 2012 A.M.C. 2583 (3d Cir. 2012) ("A plan is proposed in good faith only if it will 'fairly achieve a result consistent with the objectives and purposes of the Bankruptcy Code.' "); In re Bd. of Directors of Telecom Argentina, S.A., 528 F.3d 162, 174, 50 Bankr. Ct. Dec. (CRR) 12, Bankr. L. Rep. (CCH) P 81248 (2d Cir. 2008) ("Under § ?1129(a)(3), a plan will be found in good faith if it 'was proposed with honesty and good intentions and with a basis for expecting that a reorganization can be effected.' ") (citing In re Koelbl, 751 F.2d 137, 139, 12 Bankr. Ct. Dec. (CRR) 1006, 11 Collier Bankr. Cas. 2d (MB) 1208, Bankr. L. Rep. (CCH) P 70182 (2d Cir. 1984); 7 Collier on Bankruptcy ¶ 1129.02[3][a][ii][A] (Richard Levin & Henry Sommer, ed., 16th ed., 2018)

[67]Many courts find zero-payment plans—in which the debtor seeks to discharge debt in Chapter 13 paying only administrative expenses, to be lacking in good faith. See, e.g., Ingram v. Burchard, 482 B.R. 313, 317 (N.D. Cal. 2012) ("a debtor does not meet the good faith requirement . . . where, as here, the debtor makes no effort to repay any debts other than to counsel, a plan which would pay something on some debts is feasible, and the debtor's purpose in filing a Chapter 13 is to

achieve a result forbidden under Chapter 7."); In re Lattimore, 69 B.R. 622, 625 (Bankr. E.D. Tenn. 1987) ("a plan proposing zero payment for unsecured claims is an abuse of the purpose and spirit of Chapter 13"); In re Heywood, 39 B.R. 910, 911, 12 Bankr. Ct. Dec. (CRR) 7, 11 Collier Bankr. Cas. 2d (MB) 135 (Bankr. W.D. N.Y. 1984) (Chapter 13 plan listing only secured debts remaining after Chapter 7 discharge with no provisions for payments to discharged unsecured creditors is not submitted in good faith).

At least one circuit court, however, has found, probably correctly, that a zero-payment plan is not a per se abuse of the system, Matter of Metz, 820 F.2d 1495, 1498-99, 17 Collier Bankr. Cas. 2d (MB) 63, Bankr. L. Rep. (CCH) P 71881 (9th Cir. 1987) (rejected by, In re Russo, 94 B.R. 127, 20 Collier Bankr. Cas. 2d (MB) 119 (Bankr. N.D. Ill. 1988)).

[68]11 U.S.C.A. § 1325(a)(7).

[69]11 U.S.C.A. § 1129(a)(3).

[70]There is some analogy to Chapter 9, which provides for plans, but no discharge. The purpose of bankruptcy in such cases is in part to provide a cauldron in which deals can be made without the rapid disintegration of the debtor.

[71]See 11 U.S.C.A. § 1112(b)(4)(J) (cause for dismissal exists when there is a "failure to file a disclosure statement, or to file or confirm a plan, within the time fixed by this title or by order of the court").

[72]Much of this section is taken, word for word, from an earlier Bankruptcy Law Letter. "Shoot the. . .": Holes in Make Whole Premiums, Bankruptcy Law Letter, at 4-7 (May 2016).

[73]Ultra Petroleum Corp. v. Ad Hoc Committee of Unsecured Creditors of Ultra Resources, Inc. (In re Ultra Petroleum Corp.), 913 F.3d 533, 547-48 (5th Cir. 2019).

[74]In re 1141 Realty Owner LLC, 2019 WL 1270818 (Bankr. S.D. N.Y. 2019).

[75]In re 1141 Realty Owner LLC, 2019 WL 1270818, at *2 (Bankr. S.D. N.Y. 2019).

[76]Black's Law Dictionary 935 (10th ed. 2014).

[77]Thrifty Oil Co. v. Bank of America Nat. Trust and Sav. Ass'n, 322 F.3d 1039, 1046 (9th Cir. 2003) (quoting Matter of Pengo Industries, Inc., 962 F.2d 543, 546, 27 Collier Bankr. Cas. 2d (MB) 119 (5th Cir. 1992)).

[78]In re Chateaugay Corp., 961 F.2d 378, 381, 22 Bankr. Ct. Dec. (CRR) 1347, 26 Collier Bankr. Cas. 2d (MB) 1174, Bankr. L. Rep. (CCH) P 74550 (2d Cir. 1992) (quoting In re Public Service Co. of New Hampshire, 114 B.R. 800, 803, 20 Bankr. Ct. Dec. (CRR) 850, Bankr. L. Rep. (CCH) P 73424 (Bankr. D. N.H. 1990)).

[79]Smiley v. Citibank (S. Dakota), N.A., 517 U.S. 735, 740, 116 S. Ct. 1730, 1733 (1996).

[80]Smiley v. Citibank (South Dakota), N.A., 517 U.S. 735, 116 S. Ct. 1730, 135 L. Ed. 2d 25 (1996).

[81]Mims v. Fidelity Funding, Inc., 307 B.R. 809, 856 (N.D. Tex. 2002). See also Parker v. Brinson Constr. Co., 78 So.2d 873 (Fla. 1955) ("Interest" generally is defined as compensation allowed by law or fixed by agreement between the parties to a loan for the use or detention of money or the forbearance to collect money that is due.).

[82]Mims v. Fidelity Funding, Inc., 307 B.R. 809, 857 (N.D. Tex. 2002).

[83]See, e.g., Thrifty Oil Co. v. Bank of America Nat. Trust and Sav. Ass'n, 322 F.3d 1039, 1047 (9th Cir. 2003) ("In deciding whether a claim includes unmatured interest, federal courts generally focus on the substance of the claim, not its form, and may rely on evidence outside the parties' agreement.").

[84]H.R. Rep. No. 595, 95th Cong., 1st Sess. 352-53 (1977); S. Rep. No. 989. 95th Cong., 2d Sess. 62 (1978).

[85]Scott K. Charles & Emil A. Kleinhaus, Prepayment Clauses In Bankruptcy, 15 Am. Bankr. Inst. L. Rev. 537, 574 (2007).

[86]"[T]he venerable principle that a bankruptcy court can refuse to award interest that accrues on a creditor's claim after the petition for bankruptcy is filed . . . is designed for eases where there is not enough money to pay all the creditors—so that there is a question whether one creditor should get interest while another doesn't even recover principal." Matter of Chicago, Milwaukee, St. Paul and Pacific R. Co., 791 F.2d 524, 529 (7th Cir. 1986).

[87]H.R.Rep. No. 95-595, 95th Cong., 1st Sess. 352 (1977); S.Rep. No. 95-989. 95th Cong., 2d Sess. 62 (1978).

[88]In re South Side House, LLC, 451 B.R. 248, 261, 55 Bankr. Ct. Dec. (CRR) 26 (Bankr. E.D. N.Y. 2011), order aff'd, Bankr. L. Rep. (CCH) P 82170, 2012 WL 273119 (E.D. N.Y. 2012). See also In re Doctors Hosp. of Hyde

Park, Inc., 508 B.R. 697, 706 (Bankr. N.D. Ill. 2014) (Unmatured interest is "interest which was not yet due and payable at the time the petition was filed.") (quoting In re X-Cel, Inc., 75 B.R. 781, 788-89 (N.D. Ill. 1987)).

[89]H.R.Rep. No. 95-595, 95th Cong., 1st Sess. 352-53 (1977); S.Rep. No. 95-989. 95th Cong., 2d Sess. 62 (1978).

[90]In re Trico Marine Services, Inc., 450 B.R. 474 (Bankr. D. Del. 2011).

[91]In re Trico Marine Servs., Inc., 450 B.R. 474, 480-81 (Bankr. D. Del. 2011) (citing Noonan v. Fremont Fin. (In re Lappin Elec. Co.), 245 B.R. 326, 330 (Bankr. E.D. Wis. 2000) ("[T]his court is in agreement with a majority of courts that view a prepayment charge as liquidated damages, not as unmatured interest or an alternative means of paying under the contract.") (citations omitted); see also In re Outdoor Sports Headquarters, Inc., 161 B.R. 414, 424 (Bankr. S.D. Ohio 1993) ("Prepayment amounts, although often computed as being interest that would have been received through the life of a loan, do not constitute unmatured interest because they fully mature pursuant to the provisions of the contract.") (citations omitted); In re Skyler Ridge, 80 B.R. 500, 508 (Bankr. C.D. Cal. 1987) ("Liquidated damages, including prepayment premiums, fully mature at the time of breach, and do not represent unmatured interest.") (citation omitted)).

[92]In re School Specialty, Inc., 2013 WL 1838513 (Bankr. D. Del. 2013).

[93]In re Doctors Hosp. of Hyde Park, Inc., 508 B.R. 697 (Bankr. N.D. Ill. 2014).

[94]See, e.g., Restatement (Second) of Contracts § 356(1) (1981), which indicates that liquidated damages are available after "breach."

[95]See West Raleigh Group v. Massachusetts Mut. Life Ins. Co., 809 F. Supp. 384, 391 (E.D. N.C. 1992) (noting that the borrower's premise that prepayment is a liquidated-damages provision "ignores the fact that there has been no breach of contract . . . [where the borrower] is attempting to voluntarily invoke a contract term—the privilege and option of prepayment," and therefore "to invoke that option it must abide by the terms of its agreement"); Carlyle Apartments Joint Venture v. AIG Life Ins. Co., 333 Md. 265, 635 A.2d 366, 373 (1994) (noting that prepayment was in accordance with the contract and not a breach); Lazzareschi Inv. Co. v. San Francisco Fed. Sav. & Loan Assn., 22 Cal. App. 3d 303, 99 Cal. Rptr. 417, 420 (1st Dist. 1971) (Prepayment is the "opposite of default.").

[96]See Megan W. Murray, Prepayment Premiums: Contracting for Future Financial Stability in the Commercial Lending Market, 96 Iowa L. Rev. 1037, 1051-53 (2011). See also River East Plaza, L.L.C. v. Variable Annuity Life Ins. Co., 498 F.3d 718 (7th Cir. 2007).

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Recent Cases in the Intersection of Bankruptcy and the Uniform Commercial Code

I. Scope and Creation

A. Lease, Smeesh: Pipkin v Sun State Oil Inc.

Pipkin v Sun State Oil Inc., 2018 WL 4871132 (Ala., Sept. 21, 2018) (not yet released for publication)

Hoo boy. Complicated facts. Gasoline supplier enters into 10-year requirements contract with roadside convenience store ("First Buyer"). Part of deal is that supplier would "lease" two gasoline pumps to store owner for the term of the contract, with the store owner able to take title to pumps for no cost at end of deal. Agreement provides that supplier can file a financing statement with respect to the transaction; never does.

Store owner runs into trouble after two years. Sells station and pumps to third party. They can't make a go of it, and return the station and pumps to store owner, who finds another buyer and sells the station and the pumps to him ("Ultimate Buyer").

Gasoline supplier then retakes possession of the pumps. Claims breach of "lease," and that it was simply recovering its reversionary/ownership interest in the pumps.

Ultimate Buyer claims priority under § 9-317(b), which provides that a buyer takes free of an unperfected security interest of which the buyer has no knowledge.

The supplier claimed this was not a secured transaction, so § 9-317(b) doesn't apply. The parties' agreement called it a lease, and thus that's what it was.

The court rejected the formalism argument. Section 1-203 of the UCC provides for a two-prong test to determine whether a lease is really a disguised secured transaction.

The first prong is that the buyer/lessee has no right to terminate the agreement. That was present here, even though the supplier claimed that the agreement could be terminated by mutual agreement. This argument was silly, and the court found it as such:

> [Supplier] argues that because [First Buyer] did not pay the consideration remaining for the life of the agreement and because [Supplier] did not force [First Buyer] to do so, [First Buyer] had a right to terminate the consideration to be paid under the PSA. This does not follow. [W]hat matters is whether the terms of the PSA meet the requirements of § 7-1-203(b), not whether the PSA was actually enforced as written. . . . The plain language of the PSA provides that [First Buyer] did not have a right to discontinue the consideration it owed under the agreement. Therefore, the PSA satisfies the first prong of the test in § 7-1-203(b) for qualifying as a security interest.

The second prong of Section 1-203 was easily met since the agreement allowed the First Buyer to take title to the pumps for no consideration at the end of the term of the agreement. As the court concluded:

> the PSA clearly provided that IMAS would become the owner of the gasoline pumps without further consideration following the completion of the term of the agreement. Thus, the PSA satisfied both prongs of the bright-line test in § 7-1-203(b) for "[a] transaction in the form of a lease creat[ing] a security interest."

> Moreover, the PSA all but expressly declares that it is not a true lease but rather a disguised security agreement given that section 3(d) of the PSA specifically provides that "a UCC-1 Financing Statement governing the loaned equipment" should be "fil[ed] with the Florida [sic] Secretary of State," a provision for which [Supplier] provides no explanation

B. Consigned to the Dustbin: IPC (USA), Inc. v. Ellis (In re Pettit Oil Co.)

IPC (USA), Inc. v. Ellis (In re Pettit Oil Co.), 917 F.3d 1130 (9th Cir. 2019)

Pettit Oil Company was a distributor of bulk petroleum products. In 2013, Pettit entered into a consignment agreement with IPC, under which IPC was to deliver consigned fuel to designated sites so Pettit could sell the fuel to its customers. The aim was to reduce Pettit's working capital needs by outsourcing its fuel sales to IPC. In return for being able to sell its fuel at Pettit's stations, IPC paid Pettit a monthly commission.

As with all "true" consignments, ownership of the fuel remained with IPC until it was sold, at which time title transferred to the purchaser. Whenever a customer purchased consigned fuel, Pettit prepared an invoice and instructed the customer to remit payment to IPC directly. Despite this instruction, some customers continued to pay Pettit for their purchases of IPC fuel. Anticipating this might occur, the agreement provided that Pettit would "promptly forward such payment[s] to IPC," and Pettit did so regularly. Nonetheless, when Pettit ultimately filed for bankruptcy, it had in its possession not just IPC fuel but also proceeds from sold fuel that had not yet been remitted to IPC. These proceeds took two forms: (1) cash and (2) accounts receivable—that is, balances owed by customers that had not yet been paid.

It is undisputed that IPC never filed a financing statement or otherwise perfected its interests in the consigned fuel, the accounts receivable, or the cash.

IPC claimed title under common law to the fuel, the cash and the receivables. It lost on each.

As to the fuel, UCC § 9-319 is clear: under the UCC, most commercial consignments are transformed into purchase money security interests — complete with the requirement that the seller/secured party has to perfect its interest to be protected against subsequent lien creditors. Perfection is easy; you generally filing a financing statement and pay a filing fee of around $30. If no financing statement is filed, however, the interest is unperfected and the trustee wins under § 544(a).

IPC also argued that the cash and accounts were not subject to § 9-319 since it only refers to "goods" and not "goods *and proceeds*." The court rejected this both on textual and on policy grounds. As the court stated:

> The problem with this strained reading of section 9-319 is that it ignores numerous references throughout the U.C.C. that treat a consignment as a security interest for all practical purposes. See, e.g., U.C.C. § 9-102(a)(73)(C) (defining "[s]ecured party" to include a "consignor"); U.C.C. § 1-201(b)(35) (defining "[s]ecurity interest" to include "any interest of a consignor") (emphasis added); U.C.C. § 9-102(a)(12)(C) (defining "[c]ollateral" to mean "the property subject to a security interest" that includes "goods that are the

> subject of a consignment"). The most natural reading of these provisions is that a consignor's interest in goods (and the related proceeds) is a security interest for all purposes—including for purposes of perfection and priority—unless the U.C.C. specifically says otherwise. . . .
>
> Although IPC argues the result should be different because it retained title to the proceeds, the U.C.C. is clear that IPC's retention of title does not matter. Section 9-202 of the U.C.C. states that "[e]xcept as otherwise provided with respect to consignments ... , the provisions of [Article 9] with regard to rights and obligations apply whether title to collateral is in the secured party or the debtor." Retention of title affects the remedies IPC could employ to recover the goods in the event of default, but title is irrelevant to whether IPC or the Trustee has priority in the goods and proceeds. See U.C.C. § 9-202, cmt. 3.a.
>
> Our conclusion that the term "goods" in section 9-319 includes the proceeds of those goods is bolstered by the policy rationale underlying these rules. To the outside world, goods and proceeds held by a consignee appear to be owned by the consignee, and creditors might reasonably believe as much when they decide to lend the consignee money. The perfection and priority rules—which require that the consignor publicly announce its interest in the consigned goods or else go to the back of the line when the consignee goes bankrupt—serve to protect unwary creditors and prevent "secret liens" in the goods that might otherwise dissuade such lending. See In re Valley Media, Inc., 279 B.R. 105, 125 (D. Del. Bankr. 2002) ("The purpose of ... 9-319(a) is to protect general creditors of the consignee from claims of consignors that have undisclosed consignment arrangements with the consignee that create secret liens on the inventory."). A ruling that "proceeds" are outside the scope of the perfection rules would disrupt the delicate balance the U.C.C. drafters struck between the interests of consignors and the interests of the consignee's other creditors. IPC has not provided a convincing basis for disrupting this intended balance.

C. It's Mexacali, Jake: Norte v Umami Sustainable Seafood Inc.

Norte v Umami Sustainable Seafood Inc., 2019 WL 2000369 (2d Cir., May 7, 2019)

Lenders took security interest in moveable equipment under Mexican law. Equipment was in Mexico, and documents creating lien were denominated as "Mortgages." After complicated transactions, Debtors asserted Lender's tortious interference with their business after Lenders repossessed collateral. On appeal, the Debtors claimed they were entitled to a specification of collateral under § 9-210, as the Mortgages apparently chose New York law to govern.

The court responded:

> N.Y. U.C.C. § 9-210 requires a secured party to comply with a debtor's request for an accounting within 14 days of receiving such request. N.Y. U.C.C. § 9-210(b). The district court denied Plaintiffs-Appellees leave to amend their complaint on grounds of futility because it concluded that New York law did not govern the parties' security agreement. Under the N.Y. U.C.C., "[i]f a

transaction does not bear an appropriate relation to the forum State, then that State's Article 9 will not apply." Official Comment 9 to N.Y. U.C.C. § 9-109.

We agree with the district court that New York law should not govern a claim that fundamentally concerns the Mortgages. N.Y. U.C.C. Article 9 is titled "Secured Transactions," and the express purpose of section 9-210 is to "provide[ ] a procedure whereby a debtor may obtain from a secured party information about the secured obligation and the collateral in which the secured party may claim a security interest." Official Comment 2 to N.Y. U.C.C. § 9-210 (emphasis added). Therefore, the district court did not err in focusing its choice-of-law analysis on the Mortgages rather than the underlying Credit Agreement.

As the district court observed, "[w]hile the loan documents are governed by New York law, this is without question a Mexican-centric transaction, especially insofar as the Mortgages—which do nothing more than grant the lender rights in the collateral, which is located in Mexico—are concerned." Sp. App. 68 (internal quotation marks omitted). The Mortgages are express creatures of Mexican law, "granted under the provisions of (i) Article 92 of the General Law of Communications of the United Mexican States, (ii) ... the Navigation Law of the United Mexican States, (iii) and under ... the Second Part of the Fourth Book of the Civil Code for the Federal District of the United Mexican States." App. 175. Moreover, Mexico is Marnor's "principal place of business, the place where the security for the loan is located, and the place where the parties envisioned enforcement of the Mortgages taking place." Sp. App. 36. The clear centrality of Mexico to the parties' security agreements means that the N.Y. U.C.C. does not impose obligations on the parties' performance of those agreements. The district court properly denied Plaintiffs-Appellees leave to add this claim on that basis.

II. Perfection

A. A Rose By Any Other Name — Puerto Rico: In re Fin. Oversight & Mgmt. Bd. for Puerto Rico

In re Fin. Oversight & Mgmt. Bd. for Puerto Rico, 914 F.3d 694 (1st Cir. 2019)

Under § 9-506 of Article 9, a financing statement is seriously misleading, and hence not effective, if a search under the debtor's "correct" name would not reveal the financing statement containing something other than the "correct" name. So if the debtor's correct name is "Mighty, LLC" and the financing statement lists the debtor's name as "Mighty, Inc.," the question is whether a search under "Mighty, LLC" would reveal the financing statement listing "Mighty, Inc." In most states, this would not be seriously misleading, since most state search systems disregard 'noise' endings such as "Inc.", "LLC", "LLP" and the like, and would only index and search under "Mighty."

But what if the name isn't clear. In this case, the name was fixed in Spanish, and the text was translated into English, but inconsistently. As the court indicated:

The official English translation, on its face, repeatedly translates the exact same

> Spanish name in two different ways. Both "Retirement System for Employees" and "Employees Retirement System," are used, seemingly interchangeably, throughout the translated Act as codified. No provision of the Act states, nor even suggests, that the ERS name is used as a trade name or nickname rather than an official, legal name. We do not agree with the System that one English name (the RSE name) is official and the other (the ERS name) is merely a trade name, which would be insufficient.

As a consequence, both names were "correct," and the financing statement was valid.

B. Describe It Any Way You Want, But Describe It — Puerto Rico: In re Fin. Oversight & Mgmt. Bd. for Puerto Rico

In re Fin. Oversight & Mgmt. Bd. for Puerto Rico, 914 F.3d 694 (1st Cir. 2019)

It is basic Article 9 law that a financing statement must identify the collateral. That should be simple, right? But transactional lawyers love words, and love to provide their own definitions of words. They also love to provide endless cross-references.

This time it almost cost them. At issue were financing statements filed in 2008, with amendments filed in 2015. As the court described the 2008 descriptions:

> The 2008 Financing Statements described the collateral as "[t]he pledged property described in the Security Agreement attached as Exhibit A hereto and by reference made a part thereof." The Security Agreement, Exhibit A, was attached to each of the 2008 Financing Statements as filed but, as said, did not itself describe the "Pledged Property" except as it purported to do by reference to an unattached other document. That is, the Resolution, which contained the full definition of "Pledged Property" and other key terms, was not attached. The 2008 Financing Statements do not otherwise describe or define the "Pledged Property" (meaning the collateral). In short, the documents filed with the P.R. Department of State described the collateral only by stating that it was "Pledged Property" described in a document that could only be found somewhere outside the P.R. Department of State.

Oops. Something was collateral, but searchers could not say what. This was insufficient. Again, as stated by the court:

> Here, as said, the 2008 Financing Statements do not describe even the type(s) of collateral; instead, they describe the collateral only by reference to an extrinsic document located outside the UCC filing office, and that document's location is not listed in the financing statement. This at best gives an interested party notice about an interest in some undescribed collateral, but does not adequately specify what collateral is encumbered. That is, an interested party knowing nothing more than this does not have "actual knowledge" and has not "received a notice," see P.R. Laws Ann. tit. 19, § 451(25)(a)-(b) (2008), of the collateral at issue. Requiring interested parties to contact debtors at their own expense about encumbered collateral, with no guarantee of a timely or accurate answer, would run counter to the notice purpose of the UCC.13 See, e.g., In re Quality Seafoods, Inc., 104 B.R. 560, 561 (Bankr. D. Mass. 1989).

The lenders' bacon (well, collateral) was saved from the fire by the 2015 amendments to the financing statement. These did not refer to non-existent documents. As the court noted:

> As to the collateral description requirement, under the new Article 9, a collateral description of personal property is sufficient "whether or not it is specific, if it reasonably identifies what is described," id. § 2218(a), but a "[s]upergeneric description [is] not sufficient," id. § 2218(c). One of the "[e]xamples of reasonable identification," id. § 2218(b), under Article 9 is a "[s]pecific listing" of the collateral, id. § 2218(b)(1).
>
> Here, the Financing Statement Amendments described the collateral as "[t]he Pledged Property and all proceeds thereof and all after-acquired property as described more fully in Exhibit A attached hereto and incorporated by reference." Exhibit A, in turn, contained a detailed definition of "Pledged Property." Each of the relevant capitalized terms in the definition of "Pledged Property" -- "Revenues," "Funds," "Accounts," "Subaccounts," "Fiscal Agent," "Debt Service Reserve Account," and "Resolution" -- is also defined in Exhibit A. The definition of "Pledged Property" satisfied one of the "[e]xamples of reasonable identification" by providing a "[s]pecific listing" of the collateral. Id. It therefore suffices as a description of collateral.

Other than the fact that the court missed the point that, under the 2001 version of Article 9 a financing statement *can* provide a "super generic" description of collateral (such as "all assets"), it got it right.

C. Another Failed Incorporation of External Document: In re I80 Equipment, LLC

In re I80 Equipment, LLC, 591 B.R. 353 (Bankr. C.D. Ill. 2018)

The UCC-1 financing statement filed by the bank to perfect a lien on all assets of a business was found to be insufficient. The security agreement executed by the debtor granted a security interest in favor of the bank in substantially all of the debtor's assets. However, the financing statement described the collateral as "all Collateral described in First Amended and Restated Security Agreement dated March 9, 2015 between Debtor and Secured Party."

The security agreement was not attached to the financing statement. Pointing to UCC §9-108(b), the bank argued that its financing statement was adequate because it described the collateral by "any other method, if the identity of the collateral is objectively determinable." According to the bank, other creditors were put on sufficient notice of the bank's security interest. Disagreeing, the bankruptcy court reasoned that the financing statement did not describe the collateral, but rather attempted to incorporate by reference the collateral description in a document that was not attached to the financing statement.

As stated by the court:

> The statutory provisions, however, make clear that the notice required to be

> given by a financing statement is notice of the specific items of collateral themselves, of the kinds or types of property subject to the security interest, or that the debtor has granted a blanket lien on "all assets" or "all personal property." A financing statement that fails to contain any description of collateral fails to give the particularized kind of notice that is required of the financing statement as the starting point for further inquiry. Other courts recognize that the mere filing of a financing statement does not trigger a duty for third parties to inquire into the terms of the underlying security agreement. Rather, it is only when the financing statement contains a sufficient description of the collateral that the duty to pursue further inquiry arises. Holladay House, 387 B.R. at 696; In re I.A. Durbin, 46 B.R. 595, 601 (Bankr. S.D. Fla. 1985).
>
> By authorizing usage of a supergeneric description in financing statements, the drafters of Revised Article 9 drew a line in the sand at that point for the most general type of collateral description that could be used in order to sufficiently indicate the collateral. The drafters could have gone one step further by authorizing a mere reference to the underlying security agreement as an acceptable method of identifying the collateral. They did not do so, however, and neither will this Court.

In re I80 Equip., LLC, 591 B.R. 353, 363–64 (Bankr. C.D. Ill. 2018)

D. Inadvertent Filing of Termination Statement: In re Wheeler

In re Wheeler, 580 B.R. 719 (Bankr. W.D. Ky. 2017)

A bank loan processor that handled the bank's financing statements inadvertently filed a termination statement with respect to an outstanding loan secured by security interests held by the bank. As a result of the filing, the bank lost the perfected status of its security interest in the debtor's assets. The bank contended that the inadvertent filing was ineffective to terminate its security interest. However, the bankruptcy judge concluded that the relevant question was not whether the filing was inadvertent but whether it was authorized. If the usual person handling such statements filed the termination statement, as was the case here, then the filing was authorized. What applies to GM, applies here as well.

E. Oops — In re Motors Liquidation Co.: In re Motors Liquidation Co

In re Motors Liquidation Co., 596 B.R. 774 (Bankr. S.D.N.Y. 2019)

What a difference a filing makes. In 2008, General Motors lenders allowed a UCC termination statement to be filed on a $1.5 billion loan supposed to be secured by equipment. That was not its intent; it was a mistake. But both the Delaware Supreme Court and the Second Circuit Court of Appeals held that the mistake didn't matter; the financing statement was terminated, and the secured interest was unperfected.

This all happened, however, after GM pursued debtor in possession financing and a Section 363 sale. The lenders were repaid as if their security interest was valid — subject, however, to the rights of the unsecured creditors' committee to challenge the lien.

The trust created in GM's plan to pursue avoiding powers actions sought to claw back from the lenders the difference between the payment they received and what they should have received as unsecured creditors.

The lender imposed an "earmarking" defense — the DIP loan, they contended was supported by an order requiring them to be paid. In short, the DIP loan earmarked their payoff.

The bankruptcy court disagreed. It granted summary judgment to the trust and eliminated the defense.

The court first noted that earmarking was not something normally seen in a Section 544 action. It then noted that DIP financing order made the payment subject to any avoiding powers action. The sockdolager, however, was that even if earmarking applied, the doctrine requires that the transfer not diminish the debtor's estate – "earmarking," as traditionally understood, provides a defense because the funds related to an earmarked transfer are never "really" the debtors. Here, however, there was a significant diminishment, thus precluding the earmarking doctrine, and dooming the lender's defense.

As the court stated:

> The Court refuses to apply a judge-made equitable doctrine to undermine equality of distribution, one of the most fundamental tenets of bankruptcy law. See Begier v. I.R.S., 496 U.S. 53, 58, 110 S.Ct. 2258, 110 L.Ed.2d 46 (1990) ("Equality of distribution among creditors is a central policy of the Bankruptcy Code. According to that policy, creditors of equal priority should receive pro rata shares of the debtor's property."); Bentley v. Boyajian (In re Bentley), 266 B.R. 229, 240 (1st Cir. BAP 2001) ("The principle of equality of distribution has been carried forward as one of the guiding principles of the Bankruptcy Code."). To the extent that the Term Lenders are unsecured, equality of distribution dictates that they receive the same treatment as the unsecured creditors . . . . Applying the earmarking doctrine to the subject transfers would inevitably prejudice the AAT and lead to inequality of distribution.

In re Motors Liquidation Co., 596 B.R. 774, 787–88 (Bankr. S.D.N.Y. 2019).

F. What's in an Individual's Name?: Pierce v. Farm Bureau Bank (In re Pierce)

Pierce v. Farm Bureau Bank (In re Pierce), 581 B.R. 912 (Bankr. S.D. Ga. 2018)

The secured creditor filed a financing statement listing the debtor's name as "Kenneth Pierce." However, the debtor's unexpired driver's license in Georgia identified him as "Kenneth Ray Pierce." In his Chapter 12 bankruptcy case, the debtor objected to the creditor's secured claim, arguing that the financing statement did not correctly identify him by his full name. As a result, the debtor argued, the financing statement was seriously misleading, with the result that the creditor's interest was unperfected.

Under Georgia's UCC, a financing statement is sufficient with respect to an individual debtor only if it provides the full name of the individual as shown on the driver's license. The creditor argued that there were actually two names on the driver's license—the printed name as well as the signed name (the debtor signed the driver's license under the name "Kenneth Pierce"). The creditor posited that a financing statement showing either of the two names would suffice. The bankruptcy court believed that allowing both the printed name and the signed name to fulfill the individual name requirement would be at odds with the Georgia legislature's intent in its 2010 amendments to Georgia's Article 9. Signatures are often illegible, the court noted, and the use of the printed name on the driver's license ensures simplicity and predictability.

The court also rejected the argument that the error in the name was minor and not seriously misleading, as a search conducted under "Kenneth Ray Pierce" in the Georgia Superior Court Clerks' Cooperative Authority, using standard search logic, failed to disclose the creditor's filing. As the court noted:

> Farm Bureau Bank contends that the standard search logic employed by the Georgia Superior Court Clerks' Cooperative Authority discloses its Financing Statement. However, Farm Bureau Bank's exhibits only reflect searches under the name "Kenneth Pierce," which is not the Debtor's correct name. (Dckt. 116–2, pp. 1–3). The Debtor, on the other hand, provides uncontradicted exhibits showing that a search under his correct name, "Kenneth Ray Pierce," does not disclose the Financing Statement. (Dckt. 118–1, Exhibits A–B). Accordingly, Farm Bureau Bank has failed to carry its burden of proof on this safe harbor defense.

In re Pierce, 581 B.R. 912, 923 (Bankr. S.D. Ga. 2018).

Note: Georgia's search logic appears to be significantly different than the search logic used in many other states. Often, with respect to individual's names, the search logic ignores middle names.

G. Collateral Not Where It Should Be: In re 8760 Service Group, LLC

In re 8760 Service Group, LLC, 586 B.R. 44 (Bankr. W.D. Mo. 2018)

At issue was whether the following description in a financing statement was seriously misleading because it could be read to limit the collateral of the secured party to items at a specific location: "all accounts receivable, inventory, equipment, and all business assets located at 1803 W. Main Street, Sedalia, Mo."

The debtor had very little property at that particular location. A second secured party filed a financing statement covering substantially all of the debtor's assets. When the debtor filed for Chapter 11 relief, a dispute arose over the relative priority over the security interests of the two secured parties. The bankruptcy court ruled in favor of the first to file, concluding that its security interest in equipment was not limited to equipment located at the specific address. The financing statement's collateral description could be read in one of two ways—the first, that the address restricted all described collateral and the second that the commas and the addition of the second "all" limited the address restrictor only to "business assets."

Finding that the description was sufficient to put the second secured party on inquiry notice and relying upon ProGrowth Bank Inc. v. Wells Fargo Bank, N.A., 558 F.3d 809 (8th Cir. 2009), the bankruptcy court found that the collateral description was not seriously misleading and was sufficient to put the second secured party on inquiry notice. As the court noted:

> [W]hen a collateral description contained in a financial statement could reasonably be interpreted to cover the collateral at issue, a reasonably prudent creditor should consider itself on notice that its collateral may have a prior lien attached and should inquire further into the extent of such prior lien

A question not raised by the facts, but is interesting nonetheless, is whether a security agreement (not a financing statement) containing the same collateral description would lead to the same result. A good argument exists that it would *not*, given that the purpose of a collateral description in a security agreement is to identify what assets are being encumbered, as opposed to putting the debtor on notice of what might be taken as collateral.

III. Enforcement

A. Post-Petition Lapse of Perfection: In re Essex Const., LLC

In re Essex Const., LLC, 591 B.R. 630 (Bankr. D. Md. 2018)

On the date of the debtor's bankruptcy, the senior secured creditor held a first priority, duly perfected security interest. After the bankruptcy case was commenced, the senior secured creditor's security interest lapsed. However, the senior secured creditor did not file a continuation statement, as permitted by Section 362(b)(3) of the Bankruptcy Code (authorizing the filing of a continuation statement post-petition without the necessity of obtaining stay relief). A junior secured creditor argued that, as a result of the lapse of perfection of the senior secured creditor's security interest, the lien of the junior secured party was elevated to a first position. The bankruptcy court disagreed, ruling for the senior secured creditor.

Under the so-called "freeze rule," valid liens that exist at the time of commencement of a bankruptcy case are preserved and do not lose their validity post-petition absent specific provisions to the contrary in the Bankruptcy Code. The bankruptcy court noted that the freeze rule has been applied to perfection of security interests as well as to their validity. Applying that rule, the bankruptcy court determined that, while outside of bankruptcy the lapse of the senior secured creditor's financing statement would result in the junior creditor having priority, the rule dictated that the senior secured creditor's interest, which was prior on the petition date, would continue to have priority despite a post-petition lapse of its financing statement.

B. It Ain't Yours Anymore, Bub: Abele Tractor And Equipment Co Inc v Schaeffer

Abele Tractor And Equipment Co Inc v Schaeffer, 167 A.D.3d 1256, 91 N.Y.S.3d 54 (N.Y. App. 2018)

Lender took security interest in construction equipment. Security agreement contained provision prohibiting sale of collateral without lender's consent.

Debtor sold some equipment to Buyer (some non-certificate of title dump trucks). Lender incensed. Hires repo guy to take equipment, and repo guy does without even bothering to comply with Article 9's rules on repossession.

Lender claimed Buyer had no standing because of provision in security agreement that prohibited sale, and thus Buyer could not claim protections of Article 9. It was as thought the buyer was a thief without formal rights in the collateral.

Court resoundingly rejects. A clause prohibiting transfer does not remove the power to sell; it only gives rise to an action for breach. As the court noted:

> [W]e agree with plaintiff that Supreme Court erred in concluding that plaintiff was not a debtor, as defined by UCC 9–102(a)(28)(A), to which Trustco owed independent duties under UCC article 9 (see e.g. UCC 9–625[c][1]). A debtor is "a person having an interest, other than a security interest or other lien, in the collateral, whether or not the person is an obligor" (UCC 9–102[a][28][A]) who, therefore, has "a stake in the proper enforcement of a security interest by virtue of their non-lien property interest (typically, an ownership interest) in the collateral" (McKinney's Cons Law of NY, Book 62½, UCC 9–102, Official Comment at 353 [2016 ed]). The bill of sale, by which Paige sold and conveyed the equipment to plaintiff, was effective to transfer title to the equipment, except the titled vehicles, when it was executed (see UCC 2–401[3][b]; see also Goodrich v. WFS Financial, Inc., 2007 WL 607390, *2, 2007 U.S. Dist LEXIS 11620, *6–7 [ND N.Y.2007]). This transfer was effective, notwithstanding the provisions of the security agreement that prohibited the sale of the equipment without Trustco's consent (see UCC 9–401[b]).

Result: Buyer had possible exposure on all sorts of causes of action against Lender, including tortious interference with contract and tortious interference with prospective business relations claims.

C. So, When Should We Sue?: Delaney v First Financial of Charleston Inc.

Delaney v First Financial of Charleston Inc., 2019 WL 2022647 (S.C., May 8, 2019)

Lender has perfected security interest in consumer's truck. Lender sends defective notice of private sale after default, which debtor receives. Over seven months later, Lender sells truck at a foreclosure sale.

More than three years after sending notice but less than three years from the sale of the truck, Debtor filed suit against Lender, seeking to represent a class of individuals who had received notice that allegedly failed to comply with certain requirements in Article 9. Accordingly, Debtor asserted he was entitled to the statutory penalty under section 36-9-625(c)(2) of the South Carolina Code (2003). Lender moved to dismiss, asserting the applicable three-year statute of limitations had expired.

South Carolina Supreme Court decides the cause of action did not accrue until sale, despite the fact that the breach was in the earlier-given notice.

D. Don't Sell Early: Manshadi v Bleggi

Manshadi v Bleggi, 2019 WL 1489270 (Ohio Ct. App., March 19, 2019)

In a complicated set of facts, a Lender had repossessed medical equipment taken as collateral for various loans. It then sent a notice of disposition to the Debtor, which read:

> Please be advised that EH National Bank f/k/a Excel National Bank will sell all the medical equipment of Galexco, LLC, listed on Exhibit A, privately, sometime after August 3, 2014.
>
> You are entitled to an accounting of the unpaid indebtedness secured by the property that we intend to sell. You may request an accounting by contacting Terry Tarrant at (951) 491-6535.

The trial court held that the notice was valid, relying on the fact that the Debtors had received notice of the pending sale of the collateral and had waived the opportunity for an accounting of the unpaid indebtedness. However, the notices clearly state that the sale of the assets by private sale would occur "after August 3, 2014." It is also undisputed that the Article 9 sale of the assets to Appellees was executed on July 23, 2014. As the sale predated the notification of sale date by nearly two weeks, on its face the notification does not provide reasonable notice of the disposition of Debtors' collateral and violates the mandates of the UCC.

As the court noted:

> This is especially evident because Appellants were not involved in negotiations for, or party to, the contract of sale from Excel to Appellees. Although this argument was not raised by either party, this is a genuine issue of material fact regarding the validity of the disposition of all of the collateralized equipment, both damaged and undamaged, that forms the basis of Appellants' conversion claim. No accounting was asked for, or done, because the property subject to the accounting had already been sold.

E. You Still Gotta Account Even After Waiver: Hutzenbiler v RJC Investment Inc

Hutzenbiler v RJC Investment Inc., 439 P.3d 378 (Mont. 2019)

Debtor brought action against secured creditor, which sold debtor's mobile home after she relinquished all rights to it, asserting that creditor failed to provide for accounting of results of resale of mobile home and failed to pay her surplus proceeds.

The Release read in its entirety as follows:

> I/We Charlene L. Hutzenbiler herby [sic] release all rights to the manufactured home located at 8 Lapin St. N, Billings, MT 59105 described by serial number HY12485 am [sic] releasing myself and removing my name off of the contract currently in place with RJC Investment, Inc. and Cherry Creek Development, Inc. I am fully aware that by signing this I am completely removing my rights to all aspects of the home and I will not be entitled to any rights of this home or refund of all money applied to the home including but not limited to the down

> payment, and all payments made on the home and the lot up to this day.

RJC resold the mobile home in February 2016, without notice to Hutzenbiler, for $45,500. Hutzenbiler's counsel requested an accounting of the sale from RJC, but RJC failed to provide one. RJC did not refund any surplus to Hutzenbiler and claims none was owed. Hutzenbiler sued RJC for failing to provide for an accounting of the results of the resale of the mobile home pursuant to § 30-9A-616(2)(a)(ii), MCA; for failing to pay her the surplus proceeds of the mobile home's resale pursuant to § 30-9A-615(4)(a), MCA;

The District Court alternatively held that even if Article 9 does apply, the Release constituted full satisfaction of the parties' respective obligations under the contract in accordance with § 30-9A-620(1), MCA. Hutzenbiler argues that the Release did not satisfy the requirements of strict foreclosure because the Release did not contain any language releasing the claims of RJC. Hutzenbiler adds that the Release was signed before she was in default, and strict foreclosure therefore is not permitted. RJC responds that the undisputed facts establish strict foreclosure in compliance with the statute.

The Montana Supreme Court initially held that the release did not specifically cover the right to an accounting, and thus that right was not released. Same for the right to receive a surplus

So the lender, RJC, then claimed that it had essentially performed a strict foreclosure under § 9-620. If correct, the Lender thus accepted the collateral in full for all claims.

The Montana Supreme Court rejected this argument. It said:

> "[T]here must be mutual agreement between the parties; the statute does not allow a creditor to obtain a debtor's relinquishment of rights without accepting the collateral in satisfaction of the debt and waiving its right to pursue a deficiency." Kapor, ¶ 24. "Although explicit language may not be required, the document must indicate at least that [the creditor] was giving up its right to seek a deficiency from [the debtor] or was accepting the collateral in full satisfaction of the obligation." Kapor, ¶ 27. . . .
>
> Kapor requires a like conclusion in this case. Whether Hutzenbiler was or was not in default, the plain language of the Release is insufficient for strict foreclosure. As in Kapor, RJC did not include any language in the Release that it accepted the collateral in satisfaction of the obligation, that it released Hutzenbiler from all her obligations, or that it relinquished its right to pursue a deficiency judgment against her if the mobile home sold for less than the owed principal.

Without these mandatory provisions, the Debtor escaped summary judgment and was allowed to proceed to trial on its claims that the Lender did not comply with Article 9.

F. "Trace and Recapture"? Senior Secured Interest in Accounts Survives Disregard of Default: Legacy Bank v. Fab Tech Drilling Equip., Inc

Legacy Bank v. Fab Tech Drilling Equip., Inc., 566 S.W.3d 922 (Tex. App. 2018)

Junior judgment lien creditor filed writ of garnishment against accounts receivable owed to judgment debtor. Bank with senior security interest in debtor's collateral, including the receivables, intervened, asserting that its security interest over accounts was superior to creditor's judgment lien.

Judicial lien creditor argued that bank waived its security interest by (1) allowing debtor to remain in default for several years without making demand, accelerating the debt, liquidating collateral, or otherwise enforcing its security interest; (2) not demanding payment until a year after judicial lien holder received a judgment against debtor and more than six months after the judicial lien holder filed the writ of garnishment; and (3) making a "nominal, halfhearted demand on debtor solely to save face" before loaning debtor more than $2 million in additional funds.

The court held that a prior perfected security interest holder does not waive its senior security interest by failing to exercise elective remedies prior to junior judgment creditor exercising foreclosure rights: "we reject the possibility that a senior secured creditor may waive its security interest under equitable principles by not enforcing it prior to the attachment of a junior creditor's lien."

In so holding, the court looked to the comments to Article 9:

> The official comments to Section 9.610 of the UCC expressly support the trace and recapture approach. BUS. & COM. § 9.610 cmt. 5. Although the official comments following the Code provisions are not law, "they are persuasive authority concerning interpretation of the statutory language." Lockhart Sav. & Loan Ass'n v. RepublicBank Austin, 720 S.W.2d 193, 195 (Tex. App.—Austin 1986, writ ref'd n.r.e). Comment No. 5 to Section 9.610 is entitled "Disposition by Junior Secured Party." BUS. & COM. § 9.610 cmt. 5. It provides that "the disposition by a junior [creditor does] not cut off a senior's security interest." Id. Rather, "[t]he holder of a senior security interest is entitled, by virtue of its priority, to take possession of collateral from the junior secured party and conduct its own disposition." Id. Unless the senior secured party has authorized the disposition free and clear of its security interest, the senior's security interest ordinarily will survive the disposition by the junior. Id. Thus, comment five stands for the proposition that, while a junior security interest holder is entitled to exercise its disposition rights, it does so subject to senior security interest holders who are then allowed to later recover collateral from the junior creditor. See id.

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THE CLOCK STRIKES THIRTEEN: THE BLIGHT OF HORIZONTAL GIFTING

by Bruce A. Markell

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INTRODUCTION

You can get away with a lot if you adroitly substitute soft terms for hard concepts. Politicians know this. "Undocumented immigrants" get more leeway than "border infiltrators;" "collateral damage" sounds a lot nicer that "killing civilians." And in the current political dialogue, "alternate facts" beats out "lies."

Euphemisms are not confined to political discourse. The current euphemism in use in reorganization circles is "gifting." Ah, gifting. Images of presents wrapped in shiny paper and free of any reciprocity, bestowed on a special day, dance through the imagination.

Gifting in reorganizations, however, is state-sanctioned bribery.

In this issue of the *Bankruptcy Law Letter*, I want to sketch out a short history of "gifting," and criticize a recent Delaware district court opinion incorrectly embracing it in the context of unfair discrimination.[1] This criticism is painful. Why? Before making its errors, the court adopted a test for unfair discrimination I suggested many years ago.[2] That doesn't happen too often in an academic's life. I thus have to thread the needle of praising one part of the opinion as brilliant while declaiming another as inept. All along, I am reminded of a clock that seems to keep perfect time, but then strikes thirteen; in addition to giving the wrong time, this error calls into question the belief that the clock was perfect before. So too here, although I think the court gets its concept of unfair discrimination right, its botched application and approval of gifting makes me question whether my original article still makes sense.

THE "GIFTING" CONCEPT

Start with the concept of "gifting." Gifting is a technique employed in nonconsensual confirmation in which one class transfers, or "gifts," part of the distribution it expects to receive under the Chapter 11 plan to another class. Gifting is typically used by senior creditors to gain some kind of cooperation from a junior class, in the form of support during the confirmation process, support for the

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reorganized debtor after confirmation, or both. These pages have talked often about gifting, and have been fairly universal in its condemnation. As our esteemed editor-in-chief, Ralph Brubaker, wrote in these pages in 2011, the "gifting" exception is "manifestly inconsistent . . . with both the text of Code § 1129(b)(2)(B)(ii) and the common law origins of the absolute priority rule."[3]

But Ralph is not only perspicacious, but prescient as well.[4] In his 2011 piece, he stated:

> Indeed, after *DBSD* [the Second Circuit case which rejected gifting] one might be tempted to declare inter-class give-ups dead (or at least mortally wounded). That, however, would clearly be premature and would vastly underestimate the resourcefulness of the Chapter 11 bar (after all, the Supreme Court has prohibited inter-class "gifting" repeatedly since 1868!). The Chapter 11 bar is most adept at exploiting potential porousness in Chapter 11's distributional norms, and means for evading DBSD are readily available.[5]

These past examinations of gifting dealt with "vertical" gifting; that is, when a senior class proposes to skip an intermediate class with its gift, with the effect that a recipient junior class receives more than the skipped intermediate class. This occurs, for example, when a senior secured class gifts to an equity class, and omits an intermediate class of unsecured creditors. This form of gifting has been condemned by both the Second and the Third Circuits.[6]

The latest attempt to evade this general proscription has to do with "horizontal" gifting; that is, where a senior secured class proposes to transfer part of its plan distribution to some, but not all, classes of unsecured creditors. In other words, under horizontal gifting, a court is asked to approve a plan under which creditors with equal priority against the debtor will receive unequal distributions depending solely on the whim of a senior creditor.

NUVERRA

The case which presents the latest attempt to violate the Code's priority positions with "gifting" is *Hargreaves v. Nuverra Env'tl Solutions, Inc. (In re Nuverra Env'tl Solutions, Inc.)*.[7]

FACTS

The facts of *Nuverra* are not unusual. Nuverra had approximately $500 million in debt secured by all its assets. Its assets, however, were worth no more than $300 million.[8] In addition to the debt secured by the assets, Nuverra had a series of unsecured note debt of almost $41 million (the "2018 Notes") and significant trade debt, at filing, of over $11 million.[9]

Nuverra filed a pre-packaged plan in 2017. It sought swift measures to confirm its plan, which essentially converted most of its secured debt to equity, and proposed a rights offering to follow confirmation.

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To confirm its plan, Nuverra co-opted its secured creditors to "gift" part of their distribution (or, more likely, Nuverra's secured creditors likely co-opted Nuverra to file a plan with this gift) to two classes of unsecured creditors that would otherwise not be entitled to distributions if strict priority were maintained, or if the secured creditors had foreclosed outside of bankruptcy. These two classes were the 2018 Notes and the trade debt. The gift, however, was disparate; the 2018 Note holders would get a "gift" with a value equal to about 4% to 6% of their debt, while the trade debt's gift would be much more generous: 100%.[10] Indeed, such trade debt would be unimpaired under Section 1124 by the reorganization plan, and might even be paid 100% with interest.[11]

One creditor, Hargreaves, who held about $450,000 of the 2018 Notes, objected. Even though the class in which Hargreaves found himself, Class A6, voted overwhelmingly in number (about 80%) to accept the plan, those voting in favor of the plan did not hold the required 50% of the amount of claims voting. Accordingly, Hargreaves' class, Class A6, rejected the plan.[12]

The debtor pressed its plan, however seeking cramdown. Hargreaves argued that the plan did not meet Section 1129(b)(1) in that it unfairly discriminated against Class A6 given the vast difference between distributions. Hargreaves was the sole objector to confirmation.[13]

The bankruptcy court agreed that there was a presumption of unfair discrimination.[14] But it found that such discrimination was permissible given the different ways in which the 2018 Note debt and the trade debt arose, and between the future necessity of the good will and cooperation of the two classes. It confirmed the plan.[15]

Hargreaves, but no other 2018 Note holder, appealed to the district court. After the bankruptcy court denied Hargreaves' request for a stay pending appeal, the district court denied it as well.[16] The debtor thereafter moved to dismiss the appeal as equitably moot.

THE DISTRICT COURT'S OPINION

A little over a year later, the District Court rendered its decision on the merits. In an opinion with alternate holdings, the court held first that the appeal was equitably moot.[17] This article is not concerned with the correctness of the equitable mootness argument; that may be for another day.[18]

After finding the appeal equitably moot, the court then affirmed on the merits as an alternate holding. As that part of the opinion is rife with problems, that part of the court's analysis the focus of this short article.

Correct on the Presumption of Unfair Discrimination

The District Court focused first on the presence of unfair discrimination. Quoting from an old article of mine,[19] the court found that there was a rebuttable presumption of unfair discrimination when there is:

> (1) a dissenting class; (2) another class of the same priority; and (3) a difference in the plan's treatment of the two classes that results in either (a) a materially lower percentage recovery for the dissenting class (measured in terms of the net present value of all payments), or (b) regardless of percentage recovery, an allocation under the plan of materially greater risk to the dissenting class in connection with its proposed distribution.[20]

Applying this test, the court found that Hargreaves' Class A6 was a dissenting class, that as a class of unsecured creditors, there were other classes of the same priority (primarily trade creditors), and that Class A6's 4%-6% recovery was "materially lower" than the trade creditors' 100%.[21] On this, the court was correct.[22]

Wrong on Rebutting the Presumption

This holding, however, was not rocket science. No one could credibly maintain that the plan provided for equivalent recoveries. The troubling question was whether the context of the case justified this disparity of recovery; that is, whether this discrimination in treatment was "fair" or "unfair."

The court was correct when it indicated that my earlier article said nothing about how "gifting" would affect the analysis.[23] The simple reason is that I did not anticipate that such an argument could be legitimately made. I did indicate the following, which the court repeated:

> the plan proponent can rebut the presumption of unfairness by proving that the difference in treat-

> ment is attributable to differences in the prepetition status of the creditors.[24]

This thought was directed at what Congress seemed to focus on in discussing the unfair discrimination requirement: contractual subordination.[25] It also picked up on the Code's creation of claims for deficiency non-recourse debt in chapter 11,[26] and allowed that such organic difference could justify different treatment.[27]

The main point is that while unsecured claims come in many forms, they are named "unsecured" because they all share the same non-bankruptcy priority against the debtor's assets: below that of secured creditors with respect to those creditors' collateral, and above that of the debtor equity holders. That is a byproduct of the absolute priority rule.

It is a feature of non-bankruptcy law that trade claims, litigation claims, secured lenders' deficiency claims, judgment claims, and unsecured financing claims all have the same priority against the debtor's assets. That monolithic status, however, does not lead to a rule that all unsecured claims should be treated identically. The drafters of the Code knew this, and permitted flexible classification in Section 1122. That section states what claims *can't* be combined with other claims, not what must be separated. Such flexible classification supports to flexible treatment in a plan. Different classes, even if of the same priority, can receive different treatment. And different treatment is sometimes necessary for consensus. As an example, deficiency claims for secured debt may have the same priority as trade claims,[28] but many consensual plans distinguish between the two, usually to ensure that the plan is feasible and complies with Section 1129(a)(11).

But must identical treatment be given to claims with identical priority when there isn't consent? The clear answer is no. Section 1129(b)(1) prohibits "*unfair* discrimination." The use of the adjective "unfair" gives rise to the presumption that there can be "fair" discrimination. And, broadly, my prior article identified three areas of "fair" discrimination: when the plan treatment is not materially different; when the plan treatment recognizes non-bankruptcy differences in the claims (such as subordination or non-recourse status); or when the differential treatment is commensurate with tangible contributions to the reorganization effort.

In *Nuverra*, the plan proponent could not maintain that the treatment was essentially the same. The disparity was too large. But it did try to justify the disparity by arguing that Class A6 was financial debt, arising differently from trade debt, and that treating trade creditors through any other method than non-impairment would threaten the reorganization, both in the short and in the long term.

Neither argument is convincing. To say that funded debt is different from trade debt is true but trivial. The differences dissolve when you realize that both types of indebtedness are treated the same in state court enforcement; unsecured trade debt gets no leg up over unsecured bank debt.[29] Indeed, enforcement against the debtor outside of bankruptcy requires all unsecured debt—whether it be trade debt, deficiency claims, or unsecured loans—to be reduced to judgment, as only judgments can serve as the basis for seizure and sale of a debtor's property. If nonbankruptcy law essentially treats such debts as the same, it beggars justification to use this empty distinction against non-consenting lenders in bankruptcy.

The real argument seems to be that trade debt is necessary for the reorganization's success, and thus may be treated more favorably. That may be true. As an empirical observation, however, it should be subject to proof. And as a justification for lowering the recovery of a dissenting class, there should be some requirement of commensurate gains and losses.[30]

In *Nuverra*, however, there was none. Nuverra's Chief Restructuring Officer,[31] who had only been CRO for a little over three months at the time,[32] was the only witness at confirmation. He could not specify one unsecured creditor who had indicated that payment in full of prepetition debt would be required to obtain post petition services. As stated:

> I can't speculate to their [unsecured trade creditors] willingness to do business with Nuverra or not, in the future. *They may be willing to do business with us; they may not. I can't—I can't speak to what somebody may do in the future*. . . .

> I think we, as a debtor, have actively managed our vendor pool as aggressively as we can and tried to work with them to provide services—for them to provide services to us on a go-forward basis. *But to the extent of how they view Nuverra as a credit risk or as a responsible party to do business with in the future, I'm not prepared to speculate on that*.[33]

He could only surmise that Nuverra dealt with smaller creditors in remote areas, and that their refusal to deal might increase costs, as the reorganized debtor would have to acquire the same products or services elsewhere.[34] He never indicated whether these "remote" trade creditors had any other business to substitute for the lost business from Nuverra.

He also never quantified the amount of trade debt that would not continue to do business with Nuverra if their prepetition claims were not paid in full. It was basically taken on faith that the trade would spurn Nuverra in mass if full payment was not offered.

He also referred generally to the necessity of not even contacting trade creditors with ballots; the cost would be too high.[35] Perhaps that was true, but no testimony was given as to the amount of cost, or the time that would be saved (especially after confirmation was delayed to address comments of the unsecured creditors committee).

As a result, the only evidence of contributions by trade creditors that might justify discrimination was provided by a short-term hired gun, who could provide no example of negotiations with creditors, let alone negotiations what indicated such disparity was required to secure future business on fair terms.

Perhaps the largest disconnect was that the CRO testified that under the plan the payment to the unsecured creditors would be $4 million, even though the amount of trade debt at the beginning of the case was closer to $12 million; during the 70 days between the filing of the case and the confirmation hearing, the bankruptcy court had permitted some $7 million of unsecured prepetition claims to be paid.[36]

The history of unfair discrimination cases tracks somewhat the new value corollary for the absolute priority rule. Outside contributions matter in the fairness determination; they can justify disparate treatment. But as with new value, the deviation from fairness permitted by outside contributions has to be commensurate with the value of the contributions. And that means they have to be valued. That was part and parcel of my 1998 article. As I said:

> Yet sometimes payment in full of trade claims is necessary to reorganize. If so, however, then the dissenting class is entitled to at least some proof that the value represented by the participation of the favored class in the reorganization is equivalent to the disparity in treatment. For example, if any reorganization would completely fail without participation by the favored class, then the maximum value of the participation is the going concern value. *A showing of the value of the participation is necessary to distinguish a situation of genuine need for discrimination from a ruse designed to channel reorganization value to friends.*[37]

Nuverra seemed to miss this part.

HORIZONTAL "GIFTING"

Aside from giving only a glancing analysis of the accepted ways to dispel presumptions of unfair discrimination, it appears that the basic thrust of both the bankruptcy and district court opinions was that the value being distributed belonged to the senior secured creditors. After all, it wasn't the debtor that was engaged in discrimination, it was the secured creditors. Treating this expectation as a property right, both courts saw nothing wrong with those senior creditors giving away their property. It was theirs to gift, right?

Wrong. The *Oxford English Dictionary* indicates that a gift is "[s]omething, the possession of which is transferred to another without the expectation or receipt of an equivalent; a donation, present."[38] A better description in *Nuverra* would be a bribe, and a bribe that distorted the boundaries of permissible reorganizations. The amount of the value allocated to junior classes was negotiated in return for plan support. These negotiations continued up until the week before confirmation.[39]

Although bankruptcy reorganizations are negotiations, they are bounded by the Code. When a senior class states it is transferring value it is entitled to other, but not all, junior classes, there is a sense that we are no longer dealing with gifts, but deals. And perhaps that would not be so bad. Confirm the plan, and then the senior party can distribute whatever it wants to whomever it wants. Or have the senior creditor foreclose before bankruptcy and distribute value. After all, if senior creditors in Nuverra were owed $500 million, and Nuverra's value was only $300 million, what is the case doing in bankruptcy anyway? With that type of disparity, why can't the secured creditor just do what it wants—the assumption is that the secured creditors are the de facto owners of the debtor.

But an order of confirmation gets the senior creditors something. Releases. Injunctions against pesky unsecured creditors nipping at secured creditors' heels in numerous state courts. A central forum to resolve all claims. And more. So secured creditors toss crusts of bread to others to get them to go along; it is more likely that the hearts of secured creditors are more like the Grinch's than like Santa's.

CONDEMNATION OF "GIFTING" GENERALLY

Both past and present history indicate that this type of bargaining in bankruptcy is impermissible. Why? It varies too widely from the types of reorganizations Congress had in mind when they drafted the Bankruptcy Code. There is little doubt that Congress can (and does) change non-bankruptcy priorities in bankruptcy.[40] State law yields to federal. But this power has not been implemented absolutely. Congress permitted reorganization within the template set by the Code. That includes not approving plans that unfairly discriminate against dissenting classes.

The argument that secured creditors are beneficent is not new, and that gifting plans they "approve" should be confirmed to enable the debtor's business to continue, albeit under new ownership. In equity receiverships, bondholders and shareholders made similar arguments based upon procedural standing and contractual freedom. Since the encumbered assets were insufficient to satisfy the bondholders, unsecured creditors who lacked standing to challenge the foreclosure, even if they prevailed, would get nothing. Further, bondholders had the right to give their assets to the old shareholders after they had foreclosed.

The Supreme Court responded directly to these arguments in *Louisville Trust Co. v. Louisville N.A. & C. Ry. Co*. in 1899.[41] Against the background of a fraudulent conveyance challenge, the Court rejected the standing and contractual freedom arguments, stating that "a court . . . can never rightfully become the mere silent register of the agreements of mortgagee and mortgagor."[42] As stated previously in these pages[43] and elsewhere,[44] allocating value vertically among classes just was not fair, or in contemplation of the Code. Creditors ought not to be able to change results Congress picked by bribes to out-of-the-money classes.

Both the bankruptcy and the district courts acknowledged this history, but sought to distinguish it. Nuverra, it was contended, was a case of *horizontal* gifting. All the prior cases were *vertical* gifting; that is, the senior creditor sought to skip an intermediate class with the value transferred. In particular, the Third Circuit strongly condemned vertical gifting in *In re Armstrong World Indus., Inc.*,[45] and the Second Circuit had followed suit in *In re DBSD North America, Inc.*[46] Vertical gifting then, as cases have recognized, violates the absolute priority rule. And we can't tolerate anything violating a rule with "absolute" in its title.[47]

THE FALSE DISTINCTION: HORIZONAL VS. VERTICAL "GIFTING"

In *Nuverra*, the problem was not absolute priority, but "unfair" discrimination. Since there were no binding Third Circuit cases on horizontal gifting, the vertical gifting cases were deemed inapposite.[48]

This line of argument is problematic, if not just wrong. The same statutory provision—Section 1129(b)(1)—contains both the absolute priority rule (as a part of the requirement that a nonconsensual plan be "fair and equitable"), and the unfair discrimination prohibition. So nothing in the statute would set the requirements apart or make one more powerful than the other. Moreover, if one studies the history of the unfair discrimination requirement, it is plain that it means just as much to the integrity and structure of chapter 11 reorganization as does the absolute priority rule.

THE HISTORY OF "UNFAIR DISCRIMINATION"

Unfair discrimination, like the absolute priority rule, has its origins in the railroad receiverships of the late 19th and early 20th centuries.[49] The first reorganizations arose in equity receiverships of large corporations, in which diverse bodies of secured creditors attempted to recover a portion of their massive investments.[50] The rules were fluid and complex, but followed a standard pattern. The companies in financial distress, usually railroads, were made subject to a receivership. The nominal purpose of the receivership was the foreclosure of the mortgages or other security interests held by secured creditors. These secured creditors were, by and large, holders of what would today be publicly-issued bonds.[51]

Since these debts were enormous, the standard foreclosure on the court-house steps could never have returned a meaningful recovery. In the place of a public auction, "reorganization managers" would form a syndicate of existing bondholders and existing equityholders who were willing and able to purchase the property in foreclosure by canceling their existing indebtedness and infusing new cash to pay other secured creditors. Once acquired by the syndicate, the property would be placed, pursuant to a prenegotiated plan of reorganization, in a new entity, which would then carry on the business of the old debtor. The capital structure of the new entity would have been approved in the receivership. Although the effect of this type of reorganization might have been to eliminate unsecured creditors from participation, the device was not intended to be fraudulent; it simply appeared to all of the proponents that the highest and best use of a railroad with a fixed track was to continue to keep trains running on that track.[52]

Nevertheless, this alliance of secured creditors and equity holders often ran afoul of then-existing fraudulent transfer laws, and unsecured creditors used those laws to challenge the foreclosure process, contending that the price paid for the railroad by the syndicate was less than fair value. Those skirmishes gave rise to the absolute priority rule, now found in the "fair and equitable" requirement in § 1129(b)(1). Unsecured creditors, however, were not the only ones who found fault with the procedure. Reorganization plans often took advantage of concentrations of ownership, and isolated minorities of secured creditors or shareholders to their disadvantage and to the advantage of the majority.

Ring v. New Auditorium Pier Co.[53] illustrates this tactic. Ring held $5,000 of a $75,000 bond issue secured by an amusement park that was losing money. Other bondholders, primarily one Tilyou, devised a plan whereby the mortgage securing the bonds would be foreclosed and the property sold to a new corporation. This new corporation would be capitalized by issuing $110,000 in new bonds, guaranteed by a solvent company controlled by Tilyou. Old bondholders were approached and were offered the opportunity to exchange their old bonds on a dollar for dollar basis for bonds in the new company.

Tilyou approached Ring with the plan; Ring equivocated on whether he would exchange. Tilyou then proceeded without him, causing a foreclosure of the mortgage—without notice to Ring—and a transfer of the amusement park to the new corporation for a price of $10,000 paid at the foreclosure. Ring was then offered his proportionate share of the $10,000. Instead of taking the $10,000, Ring sued to obtain bonds in the new corporation. In essence, he alleged that he was entitled to share fairly in the "true" sale, as opposed to the foreclosure sale.

The court agreed. It essentially found that, in equity, Ring was entitled to the true proceeds of the sale; namely, the bonds in the new corporation given to all the other holders of the old bonds[54]

In *Ring* and other similar cases,[55] the spurned minorities appealed to the equity origins of the receivership, alleging successfully that equity could not sanction a process that was not open to all. In this protean sense, unfair discrimination began as a device to ensure equal treatment for all creditors and shareholders. This made sense: creditors held debt instruments which were identical; equity holders held undivided interests that were indistinguishable except for the amount held. Thus, the rule arose that reorganization plans—the financing template for the new entity—were fair only if they offered equal participation to all similarly situated creditors and shareholders. And the equality of opportunity had to be real; facially neutral plans that took advantage of quirks or other qualities of ownership were condemned,[56] as were plans in which certain creditors received consideration outside of the plan or composition under circumstances in which it appeared that their assent was bought.[57]

THE RISE OF UNFAIR DISCRIMINATION IN EQUITY RECEIVERSHIPS

The cases thus recognized that regardless of the effect on other classes of creditors and stakeholders, reorganizations had to be fair within each class created. To modern readers, these cases might suggest a neat and appealing dichotomy: vertical equity ("fair and equitable")—preserving expectations among classes of creditors and equity holders of different priority, and horizontal equity (no "unfair discrimination")—preserving expectations that similarly situated creditors and equity holders will receive similar opportunities. However, there clearly was no formal recognition of such a dichotomy in the legal language of the time.[58]

The prevailing looseness of language was present when Congress first opened up the Bankruptcy Act to railroads in 1933. Prior to 1933, railroads were not eligible to be bankrupts under the Bankruptcy Act of 1898. In adding § 77 to the Act which permitted railroads to be debtors, Congress stated that, in order to confirm a plan, the plan could not unfairly discriminate and had to be "fair."[59] A year later, when extending bankruptcy relief to municipalities, Congress added the words "and equitable" to "fair."[60]

A little over a month later, Congress used this revised language in adding § 77B to the Act, which extended bankruptcy reorganization relief to corporations generally.[61] Section 77B's confirmation requirements mirrored the municipal reorganization act: it required that, to be confirmed, plans had to be "fair and equitable, and not discriminate unfairly."[62] A year later, in 1935, Congress amended the railroad reorganization provision—§ 77—to conform to this formulation.[63] To complete the cycle, after the Supreme Court invalidated the municipal arrangements provisions in 1936, Congress reenacted and slightly changed the provisions in 1937,[64] again using both "fair and equitable" and "unfair discrimination" concepts.[65]

DELETION BY THE CHANDLER ACT

In 1938, Congress overhauled the corporate reorganization sections of the Bankruptcy Act. The Chandler Act of 1938[66] repealed the single reorganization section, § 77B, and inserted three new chapters in its place. Congress intended the first, Chapter X, to do the bulk of the work of reorganizing public companies. The second chapter, Chapter XI, continued and formalized the composition provisions formerly found in § 12 of the Act. The third chapter, Chapter XII, dealt primarily with real estate partnerships.

Each of these revisions omitted the prohibition of unfair discrimination, inserting in its place a requirement that "the plan [be] fair and equitable, and feasible." In explaining this omission, the legislative history simply said:

> Subsection (2) of Section 221, derived from Section 77B(f)(1), provides, as a condition to confirmation of a plan, that the judge be satisfied that it is "fair and equitable," and "feasible." Implicit in the former phrase is a prohibition against any unfair discrimination in the plan in favor of any creditors or stockholders and the express statement to that effect in Section 77B is therefore unnecessary.[67]

Congress thus collapsed the requirement of no unfair discrimination into the "fair and equitable" requirement,[68] which certainly was consistent with the way commentators of that time seemed to treat the principle.[69]

The Chandler Act did not, however, change the reorganization provisions related to railroads (§ 77, placed in Chapter VIII) or municipal arrangements (placed in Chapter IX). Those sections kept their unfair discrimination components. The developments after 1938 regarding these components are few, but telling as to the core content of unfair discrimination.

UNFAIR DISCRIMINATION IN MUNICIPAL ARRANGEMENTS AFTER THE CHANDLER ACT

During the 1940s, Justice Douglas wrote about the unfair discrimination requirement twice: once in 1940 in *American United Mutual Life Insurance Co. v. City of Avon Park*,[70] and again in 1946 in *Mason v. Paradise Irrigation District*.[71]

In *Avon Park*, a city had worked out a refunding plan for outstanding bonds with one R.E. Crummer & Co. Under the plan, Crummer acted as the city's sole agent, absorbed all expenses incident to the refunding, and obtained the necessary consents for the city's arrangement—either by securing votes of the existing bondholders or by purchasing the outstanding bonds and then voting them in favor of the plan. Crummer ultimately bought a number of bonds at an average price of 53% of face value. When voting time came, the plan received the assent of 69% of outstanding bonds, which met the statutory two-thirds requirement.

A creditor challenged the plan. In particular, he challenged Crummer's financial arrangement with the city. The challenge pointed out that Crummer was a creditor of the city, since it held bonds both before and after the solicitation. Under its deal, however, Crummer received more than the new bonds issued in replacement of the old bonds; it also received the fees negotiated with the city (which were to be charged to the surrendering bondholders) and the profits associated with the purchase of the bonds at discount, and it then exchanged them at a higher rate under the plan. Although the lower court had approved as reasonable the fees to be charged to the surrendering bondholders, it did not approve the profits Crummer made on exchanges of bonds in the arrangement. In upholding the challenge to Crummer's compensation, Justice Douglas held that the profit Crummer made on its bonds constituted unfair discrimination.[72]

In making this statement, Justice Douglas traced the origins of the unfair discrimination requirement to early compositions and to the bankruptcy policy of ratable distributions to creditors. Since the court below had not passed on the reasonableness of the profits Crummer was to make on the bond and coupon purchases, no one could say with any certainty that Crummer was not using its position with the city to obtain a greater return on its claim as a creditor of the city. In short, unfair discrimination determinations require courts to consider all consideration received by a creditor on account of its claim, whether explicitly provided for in the plan or not. And, if that consideration is proportionately higher than what is paid to other creditors of the same priority, there is a presumption of unfair discrimination.

Six years later Justice Douglas authored another unfair discrimination opinion under Chapter IX. In *Mason v. Paradise Irrigation District*,[73] the Reconstruction Finance Corporation (RFC) had assisted the Paradise Irrigation District, first by agreeing to lend it money to compromise its bonded indebtedness, and then by buying up outstanding bonds and voting them in favor of the arrangement. Under the arrangement, however, the RFC received new 4% bonds in the principal amount of the cash it advanced to buy the outstanding bonds; those bondholders who did not sell to the RFC received cash in the amount of 52.521% of their claims.

A nonselling bondholder objected. It argued that the RFC was like Crummer in *Avon Park*—a majority bondholder who was to profit through the purchase of claims and the subsequent exchange of them for valuable interest-bearing obligations. Unlike *Avon Park*, however, Justice Douglas did not see unfair discrimination.

The first point of difference was that the RFC would not make a profit on the principal amount of the bonds. In exchange for each $1,000 bond bought for $525.21, it received $525.21 worth of new bonds.[74] Moreover, unlike *Avon Park*, this arrangement was open and disclosed to all.

In addition, however, the Court advanced a new justification. The RFC had taken a risk in financing the arrangement, and there should be some reward for that risk. If discrimination in treatment was the means of reimbursement for this risk, then that discrimination could not be unfair. As put by the Court:

> The Reconstruction Finance Corporation contributes something that Mason does not. It furnishes the underwriting which makes the refinancing possible. It gives something of value for the preferred treatment which it receives. The other security holders of the same class give nothing new. That difference warrants a difference in treatment.[75]

The Court concluded its unfair discrimination analysis by noting that "it is impossible for us to say that, although a difference in treatment was warranted, any discrimination in favor of the Reconstruction Finance Corporation was so great as to be unfair."[76]

After looking, I have found no appellate case from 1946 through 1975 involving the issue of the content of unfair discrimination. In 1975, however, Congress undertook to revise the law of municipal arrangements. In so doing, it retained the unfair discrimination requirement. In explaining this requirement, the House Report on the bill stated:

> This paragraph also requires that the plan not discriminate unfairly in favor of any creditor or class of creditors. This is another aspect of the fair and equitable rule, more specifically stated. It prohibits special treatment of any creditor, such as a fiscal agent or resident of the taxing district.[77]

As support for this statement, the Report cites *Avon Park*. Congress thus saw some independent content in unfair discrimination, that of preserving equality of treatment through the prohibition of special treatment. This thought, however, was soon to be forgotten.

THE 1978 CODE'S RESURRECTION OF UNFAIR DISCRIMINATION IN CORPORATE REORGANIZATIONS

When the job of revising bankruptcy law started in the early seventies, unfair discrimination was something of a lost child. The original Commission Report only twice mentioned the requirement: once in an historical context;[78] and once as a carryover of the requirement for municipal arrangements.[79]

The current version of "unfair discrimination" first appeared mid-way through the enactment of the Code in the House version of the bill;[80] it originally had no counterpart in the Senate version. In its initial version, it did not apply to secured claims or to equity interests.[81] In the floor comments just preceding adoption, the most the sponsors could say was that it was included for "clarity."[82] Just what was clarified is, unfortunately, unclear.

The House Report accompanying the bill which first contained the unfair discrimination language stated that "[t]he criterion of unfair discrimination is not derived from the fair and equitable rule or from the best interests of creditors test."[83] This statement must be seen as odd, given Congress' remarks regarding municipal arrangements just two years earlier, in which unfair discrimination was said to be a derivative of the fair and equitable principle. Moreover, and most puzzlingly, the only examples in the legislative history involve contractual subordination.[84] These examples assume that without the unfair discrimination requirement, a plan proponent could manipulate the consideration in a plan involving subordinated debt so as to unfairly discriminate against creditors of equal rank.[85]

If all the Report meant to say is that a disparity in percentage recovery is presumptively unfair discrimination, this was a roundabout, almost otiose, way of saying it. Subordination is a concept most often used in adjusting priorities among creditors, whether it be subordination adjusting liquidation priorities between secured creditors, or be it subordination of priority imposed upon creditors as a consequence of their prepetition actions. In either case, these typical uses of subordination involve moving the creditor up or down—vertically, as it were—in priority. These types of movement are regulated by § 510(a).

In the unfair discrimination context, however, the presumption is that all similarly situated creditors should share the same priority. Creditors can and do employ subordination agreements to vary this presumption, but the potential confusion resulting from the broad applicability of subordination to both horizontal and vertical relationships makes the congressional examples unfortunate choices for explication. When this layer of unnecessary detail is removed, all the legislative history indicates is that disparities in recovery are presumptively unfair discrimination, not a particularly novel concept.

All of this inquiry leads back to the floor comments indicating that the requirement was reinserted after a 40 year hiatus for "clarity." These comments are consistent with the notion that Congress intended nothing novel, and that the search for the proper limits of the rule ought to canvass the past. Yet, given the other additions to the Code, it seems odd that clarity was needed. *Avon Park*'s concern with undisclosed compensation seemed to be met by the expanded definition of "insider" and the inclusion of § 1129(a)(4) and (5) relating to the disclosure and approval of insider compensation.[86] Section 510(a) specifically codified recognition of subordination agreements.

But what is clear is that Congress did not intend nonconsensual cramdown to allow plan proponents to impose nonconsensual subordination arrangements on creditors of equal priority. There is much a bankruptcy court can do in reorganizations, but rank discrimination with priority ranks cannot stand.

CONCLUSION

Gifting is a blight on reorganizations. It is court-sanctioned graft, in which senior creditors co-opt the powerful and carefully balanced reorganization system to their own ends. Ignoring the historic and textual requirement of unfair discrimination on false claims of dispensing "gifts" distorts the system Congress crafted. It should be stopped.

ENDNOTES:

[1]In re Nuverra Environmental Solutions, Inc., 590 B.R. 75 (D. Del. 2018).

[2]Bruce A. Markell, A New Perspective on Unfair Discrimination in Chapter 11, 72 AM. BANKR. L.J. 227 (1998). The Association of the Bar of the City of New York took issue with parts of the test in The Committee on Bankruptcy and Corporate Reorganization of the Association of the Bar of the City of New York, Making the Test for Unfair Discrimination More "Fair": A Proposal, 58 BUS. LAW. 83 (2002). They gave me the kind courtesy of a reply at Bruce A. Markell, Slouching Toward Fairness: A Reply to the ABCNY's Proposal on Unfair Discrimination, 58 BUS. LAW. 109 (2002).

[3]Ralph Brubaker, Taking Chapter 11's Distribution Rules Seriously: "Inter-Class Gifting is Dead! Long Live Inter-Class Gifting!," Bankr. L. Letter, April 2011, at 10. See also Christopher W. Frost, Update: When the DBSD Reorganization Plan Lost, Almost Everyone Won, Bankr. L. Letter, October 2011; Ralph Brubaker, Inter-Class Give-Ups in a Chapter 11 Plan of Reorganization: Remembering the Origins of the Absolute Priority Rule, Bankr. L. Letter, June 2005.

[4]I've used these 25 cent words to make Ralph go to the dictionary.

[5]Ralph Brubaker, Taking Chapter 11's Distribution Rules Seriously: "Inter-Class Gifting is Dead! Long Live Inter-Class Gifting!," Bankr. L. Letter, April 2011, at 2.

[6]In re DBSD North America, Inc., 634 F.3d 79, 65 Collier Bankr. Cas. 2d (MB) 201, Bankr. L. Rep. (CCH) P 81933 (2d Cir. 2011); In re Armstrong World Industries, Inc., 432 F.3d 507, 45 Bankr. Ct. Dec. (CRR) 222, 55 Collier Bankr. Cas. 2d (MB) 789, Bankr. L. Rep. (CCH) P 80434 (3d Cir. 2005).

[7]In re Nuverra Environmental Solutions, Inc., 590 B.R. 75 (D. Del. 2018).

[8]In re Nuverra Environmental Solutions, Inc., 590 B.R. 75, 79 (D. Del. 2018).

[9]3 Appendix Of Appellant David Hargreaves at Tab 28, pp. A1753-54, In re Nuverra Environmental Solutions, Inc., 590 B.R. 75 (D. Del. 2018) (reprinting Transcript of the Confirmation Hearing held on July 21, 2017, pp. 32-33).

[10]In re Nuverra Environmental Solutions, Inc., 590 B.R. 75, 80 (D. Del. 2018).

[11]In re Nuverra Environmental Solutions, Inc., 590 B.R. 75, 80 (D. Del. 2018).

[12]In re Nuverra Environmental Solutions, Inc., 590 B.R. 75, 80 n.4 (D. Del. 2018).

[13]In re Nuverra Environmental Solutions, Inc., 590 B.R. 75, 80 (D. Del. 2018).

[14]In re Nuverra Environmental Solutions, Inc., 590 B.R. 75, 80-81 (D. Del. 2018).

[15]In re Nuverra Environmental Solutions, Inc., 590 B.R. 75, 81 (D. Del. 2018).

[16]In re Nuverra Environmental Solutions, Inc., 2017 WL 3326453 (D. Del. 2017).

[17]In re Nuverra Environmental Solutions, Inc., 590 B.R. 75, 89 (D. Del. 2018).

[18]The District Court seemed to take a constricted and crabbed view of its equitable powers to correct errors, and appeared to have thought that victory for Hargreaves meant changing the rights of non-appellants aa well.

[19]Bruce A. Markell, A New Perspective on Unfair Discrimination in Chapter 11, 72 Am. Bankr. L.J. 227 (1998).

[20]In re Nuverra Environmental Solutions, Inc., 590 B.R. 75, 90 (D. Del. 2018) (quoting Bruce A. Markell, A New Perspective on Unfair Discrimination in Chapter 11, 72 Am. Bankr. L.J. 227, 249 (1998)).

[21]In re Nuverra Environmental Solutions, Inc., 590 B.R. 75, 90 (D. Del. 2018).

[22]In re Nuverra Environmental Solutions, Inc.,

590 B.R. 75, 90 (D. Del. 2018).

[23]In re Nuverra Environmental Solutions, Inc., 590 B.R. 75, 90 (D. Del. 2018).

[24]In re Nuverra Environmental Solutions, Inc., 590 B.R. 75, 91-92 (D. Del. 2018) (quoting Bruce A. Markell, A New Perspective on Unfair Discrimination in Chapter 11, 72 Am. Bankr. L.J. 227, 250 (1998).

[25]H.R. REP. NO. 95-595, at 414-18 (1977), reprinted in 1978 U.S.C.C.A.N. 5963, 6370-74.

[26]See 11 U.S.C.A. § 1111(b)(1).

[27]Bruce A. Markell, A New Perspective on Unfair Discrimination in Chapter 11, 72 Am. Bankr. L.J. 227, 250 (1998).

[28]With respect to a lender's deficiency claim, section 77B permitted, but did not mandate, the court to "classify as an unsecured claim, the amount of any secured claim in excess of the value of the security therefor . . . ." Act of June 7, 1934, ch. 424, § 77B(b)(5), 48 Stat. 911, 916; 11 U.S.C.A. § 597 (repealed 1979). Chapter X was more specific; it stated that the court "shall . . . determine summarily the value of the security and classify as unsecured the amount in excess of such value." 11 U.S.C.A. § 197 (repealed 1979). See also Bruce A. Markell, Clueless on Classification: Toward Removing Artificial Limits on Chapter 11 Claim Classification, 11 BANKR. DEV. J. 1, 10 (1995).

[29]One might quibble that UCC § 2-702 gives trade debt better standing when the debtor is teetering on insolvency, but that is a provision that benefits only a few creditors who trade near insolvency. The greater mass of trade debt reaps no benefit from it.

[30]On these points, early cases recognized these principles. See Matter of LeBlanc, 622 F.2d 872, 879, 7 Bankr. Ct. Dec. (CRR) 1235, 23 C.B.C. 436 (5th Cir. 1980) (upholding creditor plan which paid unsecured claims of trade creditors forty percent and unsecured insider claims nothing); In re 11,111, Inc., 117 B.R. 471, 478 (Bankr. D. Minn. 1990) (same). But see In re ARN LTD. Ltd. Partnership, 140 B.R. 5, 13, Bankr. L. Rep. (CCH) P 74580 (Bankr. D. D.C. 1992) ("Separate classification on the basis of the insider or equity holder status of the creditor does not alone warrant unequal treatment unless equitable subordination principles apply.").

[31]The CRO was Robert D. Albergotti, a Managing Director in the Global Turnaround and Restructuring Group of AlixPartners LLP. 3 Appendix Of Appellant David Hargreaves at Tab 24, p. A1656, In re Nuverra Environmental Solutions, Inc., 590 B.R. 75 (D. Del. 2018) (reprinting Declaration of Robert D. Albergotti In Support of the Memorandum Of Law In Support of an Order Approving (i) The Adequacy of the Disclosure Statement; (ii) Prepetition Solicitation Procedures; and (iii) Confirmation of the Prepackaged Plan).

[32]3 Appendix Of Appellant David Hargreaves at Tab 24, p. A1656-57, In re Nuverra Environmental Solutions, Inc., 590 B.R. 75 (D. Del. 2018) (reprinting Declaration of Robert D. Albergotti In Support of the Memorandum Of Law In Support of an Order Approving (i) The Adequacy of the Disclosure Statement; (ii) Prepetition Solicitation Procedures; and (iii) Confirmation of the Prepackaged Plan).

[33]3 Appendix Of Appellant David Hargreaves at Tab 28, p. A1757-58; A1760, In re Nuverra Environmental Solutions, Inc., 590 B.R. 75 (D. Del. 2018) (reprinting Transcript of the Confirmation Hearing held on July 21, 2017, p. 36-37; 39) (all emphasis supplied).

He also stated that:

> I think I could provide some insight based on prior experiences I've had with other companies like Nuverra, but specifically related to Nuverra, I don't know if I can specifically say that one vendor would do business with Nuverra in the future versus another.

3 Appendix Of Appellant David Hargreaves at Tab 28, p. A1760, In re Nuverra Environmental Solutions, Inc., 590 B.R. 75 (D. Del. 2018) (reprinting Transcript of the Confirmation Hearing held on July 21, 2017, p. 39). This testimony was confirmed and elaborated upon on redirect, but no direct parallels between the unnamed other companies and Nuverra were given.

[34]He testified that:

> In a number of locations that Nuverra operates in, it's typically smaller towns with very limited vendor—a very limited vendor base, so if we were to lose access to one vendor, the company would probably have to go, you know, miles further and incur additional costs beyond its current cost base..

3 Appendix Of Appellant David Hargreaves at Tab 28, p. A1781, In re Nuverra Environmental Solutions, Inc., 590 B.R. 75 (D. Del. 2018) (reprinting Transcript of the Confirmation Hearing held on July 21, 2017, p. 61).

[35]His testimony was that:

> [W]e needed to move with as fast as speed as possible through Chapter 11, not only to avoid paying associated fees that would be due to our ABL lenders, but also to preserve what little trade credit the company did have remaining and ensure that the customer relationship or the vendor relationships in these geographies are preserved as best as possible.

3 Appendix Of Appellant David Hargreaves at Tab 28, pp. A1781, In re Nuverra Environmental Solutions, Inc., 590 B.R. 75 (D. Del. 2018) (reprinting Transcript of the Confirmation Hearing held on July 21, 2017, pp. 61). See also id. at Tab 28, p. 1739 ("Impairing all unsecured creditors, given the timing of this case, would have not really been feasible. We needed to get in and out as quickly as

possible . . . .").

[36]The testimony is unequivocal:

Q Okay. At the start of the case, the aggregate claim amount for the unsecured creditors was 11.8 million; is that right?
A That's correct.
Q So the debtors have paid 7.5 million?
A Approximately, yes.
Q And those creditors were paid under a critical vendors order entered by this Court?
A I believe that Mr. Sosnick pointed out that it was not a critical vendor motion; it was effectively an all-trade motion or a motion to pay general business claims.
Q Okay. We'll call it an all trade—"all business claims" motion. But they were paid pursuant to that order, right?
A That's correct. Or other orders that the Court may have entered.

3 Appendix Of Appellant David Hargreaves at Tab 28, pp. A1753-54, In re Nuverra Environmental Solutions, Inc., 590 B.R. 75 (D. Del. 2018) (reprinting Transcript of the Confirmation Hearing held on July 21, 2017, pp. 32-33).

[37]Bruce A. Markell, A New Perspective on Unfair Discrimination in Chapter 11, 72 AM. BANKR. L.J. 227, 260 (1998) (emphasis supplied) (citing In re Kliegl Bros. Universal Elec. Stage Lighting Co., Inc., 149 B.R. 306, 309, 28 Collier Bankr. Cas. 2d (MB) 575, Bankr. L. Rep. (CCH) P 75098 (Bankr. E.D. N.Y. 1992) (better treatment of unsecured claim of union was justified on the basis that "the Debtor's ability to continue to operate a union shop is absolutely critical to its ability to function successfully in its industry."); Matter of Bouy, Hall and Howard and Associates, 141 B.R. 784, 793 (Bankr. S.D. Ga. 1992) (permissible to separately classify and pay unsecured creditor before payment in cash to secured creditor since unsecured creditor was necessary franchisor and had agreed to accept cure payments over 36 month period); In re Richard Buick, Inc., 126 B.R. 840 (Bankr. E.D. Pa. 1991) (priority treatment of vendor claims justified based on testimony that vendor would not deal with reorganized debtor unless claims paid in full)).

[38]Oxford English Dictionary, "gift," def. 3a, available at http://www.oed.com./view/Entry/78177?rskey=NTQirg&result=1&isAdvanced=false#eid

[39]3 Appendix Of Appellant David Hargreaves at Tab 28, pp. A1731, In re Nuverra Environmental Solutions, Inc., 590 B.R. 75 (D. Del. 2018) (reprinting Transcript of the Confirmation Hearing held on July 21, 2017, p. 10).

[40]See generally 11 U.S.C.A. § 503(b).

[41]174 U.S. 674 (1899).

[42]Louisville Trust Co. v. Louisville, N.A. & C. Ry. Co., 174 U.S. 674, 688-89, 19 S. Ct. 827, 43 L. Ed. 1130 (1899).

In *Louisville Trust,* as in *Nuverra*, the disparity in treatment was significant. As set forth in the case on remand, former preferred shareholders received a priority right to subscribe to $100 worth of new common stock and $7.50 of new preferred upon surrender of $100 old preferred and payment of $7.50. Farmers' Loan & Trust Co. v. Louisville, N.A. & C. Ry. Co., 103 F. 110, 127 (C.C.D. Ind. 1900). Holders of old common received a similar right to subscribe; they could receive $100 of new common and $7.50 of new preferred upon surrender of $300 of old common stock and payment of $7.50. Id. Since the old equity securities were practically worthless-five months after the initiation of the receivership the common was trading for "a fraction of a cent" per share, and the preferred was trading at one to two cents per share, id. at 128-the exchange was quite a bargain for the equity holders.

The Supreme Court instructed the lower court to examine the transaction more closely for the fraud hinted at by this disparity. On remand, the trial judge seemingly took umbrage at the Supreme Court's intimations that he had not properly discharged his duties. See id. at 118-20. At any rate, the judge adopted the master's report, id. at 128, which explicitly found that there "was no fraud or fraudulent intent or fraudulent conspiracy on the part of the [bondholders'] trustees, the bondholders, the bondholders' committee, the stockholders or [the debtor]." Id. at 112.

[43]Ralph Brubaker, Taking Chapter 11's Distribution Rules Seriously: "Inter-Class Gifting is Dead! Long Live Inter-Class Gifting!," Bankr. L. Letter, April 2011, at 10. See also Christopher W. Frost, Update: When the DBSD Reorganization Plan Lost, Almost Everyone Won, Bankr. L. Letter, October 2011; Ralph Brubaker, Inter-Class Give-Ups in a Chapter 11 Plan of Reorganization: Remembering the Origins of the Absolute Priority Rule, Bankr. L. Letter, June 2005.

[44]Amy Timm, Note, The Gift That Gives Too Much: Invalidating A Gifting Exception To The Absolute Priority Rule, 2013 U. Ill. L. Rev. 1649.

[45]In re Armstrong World Industries, Inc., 432 F.3d 507, 45 Bankr. Ct. Dec. (CRR) 222, 55 Collier Bankr. Cas. 2d (MB) 789, Bankr. L. Rep. (CCH) P 80434 (3d Cir. 2005).

[46]In re DBSD North America, Inc., 634 F.3d 79, 65 Collier Bankr. Cas. 2d (MB) 201, Bankr. L. Rep. (CCH) P 81933 (2d Cir. 2011).

[47]Sarcasm intended.

[48]In re Nuverra Environmental Solutions, Inc., 590 B.R. 75, 98-99 (D. Del. 2018).

[49]This section draws heavily from my two previous articles, Bruce A. Markell, Owners, Auctions, and Absolute Priority in Bankruptcy Reorganizations, 44 STAN. L. REV. 69, 74-84 (1991) and Bruce A. Markell, A New Perspective on Unfair Discrimination in Chapter 11, 72 Am. Bankr. L.J. 227 (1998).

[50]By 1915 over one-half of all railroad debt securities had been in default at one time or another. WILLIAM Z. RIPLEY, RAILROADS: FINANCE & ORGANIZATION 374 (1915). Writers during this time seemed to embrace a fairly constant estimate that about one in seven railroads were in receivership at any one time during the later part of the nineteenth century and continuing through the early part of this century. Paul D. Cravath, Reorganization of Corporations, in 1 SOME LEGAL PHASES OF CORPORATE FINANCING, REORGANIZATION AND REGULATION 153, 154 (1917); John Franklin Crowell, Railway Receiverships in the United States, 7 YALE REV. 319, 319 (1898).

[51]As of 1906, there were over $18 billion of railroad securities outstanding, which included both debt and equity securities. WILLIAM Z. RIPLEY, RAILROADS: FINANCE & ORGANIZATION 62-63 (1915).

[52]Bruce A. Markell, Owners, Auctions, and Absolute Priority in Bankruptcy Reorganizations, 44 STAN. L. REV. 69, 74-84 (1991); 2 ARTHUR STONE DEWING, THE FINANCIAL POLICY OF CORPORATIONS 1238-54 (5th ed. 1953).

[53]Ring v. New Auditorium Pier Co., 77 N.J. Eq. 422, 77 A. 1054 (Ch. 1910).

[54]The lack of notice to Ring was essential to the court's opinion. "[A] foreclosure could properly have been utilizable to cut off the interests of any of the bondholders of the old company who, being fully advised of the proposed reorganization, chose to trust to the results of a sale in foreclosure rather than to join in the reorganization scheme. But to serve this last purpose I am clearly of the opinion that such bondholders, before they can be considered as having been cut off, must have been fully notified of all relevant facts." Id. at 1059.

[55]See, e.g., Southern Pac. Co. v. Bogert, 250 U.S. 483, 39 S. Ct. 533, 63 L. Ed. 1099 (1919); Fearon v. Bankers' Trust Co, 238 F. 83 (C.C.A. 3d Cir. 1916); Investment Registry v. Chicago & M.E.R. Co., 212 F. 594 (C.C.A. 7th Cir. 1913).

[56]See, for example, Eagleson v. Pacific Timber Co., 270 F. 1008, 1011 (D. Del. 1920), in which the court set aside a corporate reorganization that included: (i) a share for share exchange of common stock; (ii) a purchase of new preferred stock at ten dollars per share; and (iii) a requirement that those holding both common and preferred stock would have to purchase preferred stock before being allowed to exchange their common stock. The court stated the rationale of the decision as follows:

> As the holders of more than half of the common stock . . . had none or practically no preferred stock, while many persons, including the plaintiff and the interveners, held substantially equal amounts of preferred and common stock, it is manifest that the plan of reorganization was for the benefit of the majority, to the detriment of the minority, and consequently unfair and fraudulent.

Id.

[57]See, e.g., Investment Registry v. Chicago & M.E.R. Co., 212 F. 594, 605, 608 (C.C.A. 7th Cir. 1913) (dealing with a situation in which controlling bondholders paid off, at a premium, certain dissident bondholders so that they would not bid at a foreclosure sale). In that case, the court refused to confirm the sale (and subsequent reorganization) and stated a general rule for syndicate sales of large enterprises involving dissenting bondholders:

> When such a controversy is on, the chancellor in our opinion not only has the right but owes the duty of being vigilant to see, on the one hand, that a dissenter be not permitted to create a maneuvering value in his bonds by opposing confirmation, and, on the other, that the majority does not use its power, unique in sales of this class, to oppress a helpless minority.

Id. at 610. See also In re M. & H. Gordon, 245 F. 905, 906 (S.D. N.Y. 1917) (confirmation of composition plan denied where debtor agreed to pay the accounting and investigative expenses of a particular creditor in order to obtain that creditor's vote in favor of the plan); In re Weintrob, 240 F. 532, 534 (E.D. N.C. 1917) (confirmation of twenty-five percent composition plan denied where the favorable vote of one claim, necessary for the confirmation, was obtained by purchasing the claim at face value).

[58]See, e.g., In re Barclay Park Corp., 90 F.2d 595 (C.C.A. 2d Cir. 1937) (holding that a plan which allocated equity interests in an insolvent debtor to existing equity holders violated the unfair discrimination provision of § 77B of the Bankruptcy Act).

[59]Act of March 3, 1933, ch. 204, § 77(g), 47 Stat. 1467, 1479.

[60]Act of May 24, 1934, ch. 345, § 80(e), 48 Stat. 798.

[61]Act of June 7, 1934, ch. 424, § 77B, 48 Stat. 911, 912.

[62]Id. § 77B(f)(1).

[63]Act of Aug. 27, 1935, ch. 774, § 77(e)(1), 49 Stat. 911, 918.

[64]The 1937 provisions regarding municipal arrangements were initially placed in Chapter X of the 1898 Act. Act of Aug. 16, 1937, ch. 657, 50 Stat. 654. The Chandler Act moved them to Chapter IX in 1938. Act of June 22, 1938, ch. 575, § 3(a), 52 Stat. 840, 939.

[65]Act of Aug. 16, 1937, ch. 657, § 83(e), 50 Stat. 654.

[66]Act of June 22, 1938, ch. 575, 52 Stat. 840.

[67]S. REP. NO. 75-1916, at 35-36 (1938) (Senate Report No. 1916 accompanied H.R. 8046, which was the bill ultimately enacted). See also ANALYSIS of H.R. 12889, 74TH CONG. 78 n.2 (Comm. Print

1936) [hereinafter ANALYSIS OF H.R. 12889].

[68]Congress dropped the "fair and equitable" requirement from Chapter XI and Chapter XII arrangements in 1952, without adding back in any notions of unfair discrimination. See Act of July 7, 1952, ch. 579, § 35, 66 Stat. 420, 433.

[69]See, e.g., ANALYSIS OF H.R. 12889, supra note 28, at 78 n.2 (stating the position of the National Bankruptcy Conference that confirmation standard be simply that the plan be "equitable," on the grounds that " '[e]quitable' would include 'fair,' and would also prevent unfair discrimination in favor of any class of creditors or stockholders."); THOMAS FINLETTER, THE LAW OF BANKRUPTCY REORGANIZATION 461-72 (1939); 2 JOHN GERDES, CORPORATE REORGANIZATIONS § 1080 (1936); Note, Classification of Claims in Debtor Proceedings, 49 YALE L.J. 881 (1940).

[70]American United Mut. Life Ins. Co. v. City of Avon Park, Fla., 311 U.S. 138, 61 S. Ct. 157, 85 L. Ed. 91, 136 A.L.R. 860 (1940).

[71]Mason v. Paradise Irr. Dist., 326 U.S. 536, 66 S. Ct. 290, 90 L. Ed. 287 (1946).

[72]As stated by the Court:

> Beyond that is the question of unfair discrimination to which we have adverted. Compositions under Ch. IX, like compositions under the old s. 12, 11 U.S.C.A. s. 30, envisage equality of treatment of creditors. Under that section and its antecedents, a composition would not be confirmed where one creditor was obtaining some special favor or inducement not accorded the others, whether that consideration moved from the debtor or from another. . .. That rule of compositions is but part of the general rule of 'equality between creditors' (Clarke v. Rogers, 228 U.S. 534, 548, 33 S. Ct. 587, 591, 57 L.Ed. 953) applicable in all bankruptcy proceedings. That principle has been imbedded by Congress in Ch. IX by the express provision against unfair discrimination.

Avon Park, 311 U.S. at 147.

[73]Mason v. Paradise Irr. Dist., 326 U.S. 536, 66 S. Ct. 290, 90 L. Ed. 287 (1946).

[74]This analysis assumes that the 4% face rate on the bonds represented what today would be called a market rate of interest. If the 4% rate represented an above-market rate of return, there would have been a benefit to the RFC in addition to simple repayment of its costs in purchasing the old bonds. The Court recognized this possibility, but found no evidence to support it: "The Reconstruction Finance Corporation receives new and refunding bonds in the face amount of its cash advances. It is, of course, possible that 52.521 cents in cash may not be as advantageous an offer as 52.521 cents in new and refunding bonds. But there is no showing that it is not." Mason v. Paradise Irr. Dist., 326 U.S. 536, 543, 66 S. Ct. 290, 90 L. Ed. 287 (1946).

[75]Mason v. Paradise Irr. Dist., 326 U.S. 536, 543, 66 S. Ct. 290, 90 L. Ed. 287 (1946).

[76]Mason v. Paradise Irr. Dist., 326 U.S. 536, 543, 66 S. Ct. 290, 90 L. Ed. 287 (1946).

[77]H.R. REP. NO. 94-686, at 33 (1975).

[78]1 Comm'n On The Bankr. Laws Of The U.S., Report Of The Commission On The Bankruptcy Laws Of The United States, H.R. Doc. No. 93-137, at 255 (1973).

[79]1 Comm'n On The Bankr. Laws Of The U.S., Report Of The Commission On The Bankruptcy Laws Of The United States, H.R. Doc. No. 93-137, at 269 (1973).

[80]See H.R. 8200, 95th Cong. § 1129(b)(2)(B)(iv) (1977).

[81]It only appeared in paragraph (2) relating to unsecured claims, and was absent from paragraph (1) relating to secured claims and paragraph (3) relating to equity interests. See id.

[82]"The requirement of the House bill that a plan not 'discriminate unfairly' with respect to a class is included for clarity; the language in the House report interpreting that requirement, in context of subordinated debentures, applies equally under the requirements of section 1129(b)(1) of the House amendment." 124 CONG. REC. 32,407 (1978) (statement of Rep. Edwards); id. at 34,006 (statement of Sen. DeConcini).

[83]H.R. REP. NO. 95-595, at 417 (1977), reprinted in 1978 U.S.C.C.A.N. 5963, 6373.

[84]H.R. REP. NO. 95-595, at 414-18 (1977), reprinted in 1978 U.S.C.C.A.N. 5963, 6370-74. Indeed, the lack of further guidance is surprising given the review of unfair discrimination in the context of the 1976 revisions to municipal arrangements.

[85]The floor managers of the bill that became the Code confirmed the applicability of the House Report's examples, even though the bill reported on by the House was different from the bill ultimately adopted. "[T]he language in the House report interpreting that requirement, in context of subordinated debentures, applies equally under the requirements of section 1129(b)(1) of the House amendment." 124 CONG. REC. 32,407 (1978) (statement of Rep. Edwards); id. at 34,006 (statement of Sen. DeConcini).

[86]See also 11 U.S.C.A § 1123(a)(4), which requires all members of a class to receive identical treatment under the plan.

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THE NOT-SO-TERRIBLE "Ts": *TEMPNOLOGY* AND *TAGGART*

By Bruce A. Markell

I. INTRODUCTION

Every year it seems, the Supreme Court takes up some provision of the Bankruptcy Code. And every year, practitioners, academics, and judges moan about the results. Generalist courts, so the story goes, can't understand the nuances of bankruptcy practice, and thus their decisions are at odds with everyday realities.

But bankruptcy is not a closed system unaffected by the rest of common or statutory law. Contract law, property law and even tort law are essential parts of bankruptcy administration. Questions are raised, however, when litigants in bankruptcy cases claim that normal common law or statutory rules don't apply to them. They think that reorganizations can trump property law; that the discharge can vaporize rights. And in many cases, they're right. Cramdown vexes secured creditors, and litigants curse the disintegrating effects of a defendant's discharge.

Many times, however, they're just wrong. In the absence of explicit text in the Code, standard common law and statutory rules are the presumption, not the exception. It's akin to playing baseball on a football field. For the most part, the rules work the same, but every once in a while you have to bend or break a rule because the boundaries of the playing field aren't an exact fit. Home runs in one park are ground-rule doubles in another.

This year's Supreme Court docket produced and clarified two such situations: *Mission Products Holdings, Inc. v. Tempnology, LLC*[1] dealt with the intersection of rejection under Section 365 and trademark law, while *Taggart v. Lorenzen*[2] incorporated non-bankruptcy understandings of civil contempt when interpreting the "injunction" language in Section 524.

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This issue of the *Bankruptcy Law Letter* looks at how these two cases have melded interpretations of non-bankruptcy law into our understanding of some of the Code's most basic concepts. The upshot will be that, well, it could be worse, and probably isn't that bad.

II. *TEMPNOLOGY*

A. THE BACKGROUND

As the Court categorized it, *Tempnology* is a "case arises from a licensing agreement gone wrong."[3] Tempnology manufactured clothing and accessories designed to keep the wearer cool when used in exercise. It marketed those products under the brand name "Coolcore," using trademarks (e.g., logos and labels) to distinguish the gear from other similar athletic apparel.

In 2012, Tempnology signed an agreement with Mission Product Holdings, Inc. regarding its products and its intellectual property. In this agreement, Tempnology granted Mission the non-exclusive right to manufacture and sell certain patented and trademarked Tempnology products throughout the world and the exclusive right to sell a subset of those patented and trademarked products within the United States. The agreement also granted Mission a non-exclusive, worldwide license to use Tempnology's trademarks on the Tempnology products Mission distributed.

For its part, Tempnology agreed that within Mission's exclusive territory, primarily the United States, Tempnology would not sell the licensed products, or license others to sell them.

The agreement was set to expire in July 2016. It provided that either party could terminate the agreement at any time before then, subject to a two-year winding down process, or immediately, if there were cause. On June 30, 2014, Mission exercised its right to terminate the agreement without cause. The next month, Tempnology purported to terminate the Agreement for cause and immediately stopped performing under the agreement.

In June 2015, an arbitrator ruled that Tempnology's purported termination for cause was improper and that the agreement remained in effect throughout the wind-down period—until July 1, 2016. A second phase of arbitration was set to address Mission's claim that Tempnology had breached the Agreement by failing to perform. Before that could happen, however, on September 1, 2015, Tempnology filed a Chapter 11 bankruptcy. This froze the arbitration proceedings.

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The day after its bankruptcy filing, Tempnology moved to reject the 2012 agreement with Mission under § 365(a). Although Mission objected, the bankruptcy court granted the motion, but noted that its order was "subject to Mission['s] election to preserve its rights under . . . § 365(n)."

Tempnology then filed a motion asking the bankruptcy court to determine the scope of the rights Mission would retain after rejection of the agreement. The bankruptcy court noted that there was "no . . . dispute []" that Section 356(n) allowed Mission to retain its non-exclusive, worldwide license to use Tempnology's *patents* post-rejection, but held that rejection of the 2012 agreement had terminated Mission's trademark license and exclusive-distribution rights.

The upshot of this ruling was that Mission could not market the products related to the patents it had licensed, since it no longer could label them with the "Coolcore" trademark. Mission appealed to the Bankruptcy Appellate Panel, which adopted the Seventh Circuit's view on rejection of trademark licenses expressed in *Sunbeam Products, Inc. v. Chicago Manufacturing, LLC*,[4] and reversed. Tempnology then appealed to the First Circuit. That court reversed the Bankruptcy Appellate Panel, rejected *Sunbeam*, and adopted instead the somewhat discredited Fourth Circuit opinion in *Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc.*[5] This created a circuit split, which the Court granted certiorari to resolve.

B. THE OUTCOME

Tempnology's strategy was straightforward. It figured that if it could reject the trademark license, then the license would go away. Mission would then have to renegotiate and pay more to monetize the intellectual property it had licensed. After all, that's the purpose of chapter 11, right? Allow the debtor to take every advantage of the statute to reorganize. If Mission was damaged, well, it could be paid in bankruptcy dollars because all damage claims would be pre-petition claims.

Not so fast. Tempnology's argument rested on the premise that rejection of an executory contract effectively terminates it. That, however, does not track the Code. As the Court noted, its analysis started "with the text of the Code's principal provisions on rejection—and find that it does much of the work."[6] In particular, the Code itself tells us what rejection is, and it is not automatic termination or cancellation.

What is it? As the Justice Kagan, speaking for an eight-member majority of the Court, stated:

> Section 365(g) describes what rejection means. Rejection "constitutes a breach of [an executory] contract," deemed to occur "immediately before the date of the filing of the petition." Or said more pithily for current purposes, a rejection is a breach. And "breach" is neither a defined nor a specialized bankruptcy term. It means in the Code what it means in contract law outside bankruptcy. . . . So the first place to go in divining the effects of rejection is to non-bankruptcy contract law, which can tell us the effects of breach.[7]

So what does non-bankruptcy contract law do? If the breach is material, the non-breaching party has an election of remedies. It, and only it, can elect to terminate the contract for the material breach. Or, it can elect to reserve its right to damages, and keep the contract in place. As the Court put it:

> So if the not-yet debtor was subject to a counterparty's contractual right (say, to . . . use a trademark), so too is the trustee or debtor once the bankruptcy petition has been filed. The rejection-as-breach rule (but not the rejection-as-rescission rule) ensures that result. By insisting that the same counterparty rights survive rejection as survive breach, the rule prevents a debtor in bankruptcy from recapturing interests it had given up.[8]

Mission therefore had the right to continue its rights under its license with Tempnology. That is, it could continue to use the trademarks on the goods it was producing pursuant to the licensed intellectual property; it could continue to market and sell athletic clothing with the "Coolcore" trademark. It just had to keep up its end of the bargain—paying the agreed license fee and protecting the mark as required in the license. Of course, it could also offset any payments owed to Tempnology by the amount of damages caused by Tempnology's breach.

The holding is thus deceptively simple. Rejection is breach. Breach is defined by applicable non-bankruptcy contract law. That law says that a breacher cannot benefit from its breach. As a result, non-breaching parties—non-debtors in executory contracts—can elect to terminate the executory contract, or can elect to continue it. Since they are not in breach, they get to choose.

What do debtors get out of this? The Code allows them to classify any damages from their rejection, their breach, as pre-petition damages, and pay them in bankruptcy dollars.

So what's the deceptive part of this? Well, the Court gives us a good view from high altitude, but the details on the ground give a much more nuanced picture.

C. SECTION 365 AND DEFINITION

The first issue is definitional. Section 365 applies only to "executory" contracts. As the court explains, an executory contract is a mixed asset and liability. Non-executory contracts will tend to be "claims"—obligations against the bankruptcy estate from which the estate gains little or nothing from their performance.

Justice Kagan starts her analysis by stating that "[a] contract is executory if "performance remains due to some extent on both sides."[9] That formulation, however, although taken straight from *NLRB v. Bildisco & Bildisco,*[10] is somewhat at odds with the test used by most courts of appeal. The more common test, named after Vern Countryman, the Harvard professor who taught or influenced most of the senior partners practicing bankruptcy today, is slightly different. Professor Countryman's definition of executory contract was: "A contract under which the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing performance of the other."[11]

What's the difference? Professor Countryman's definition requires the breach be a material breach, not just any breach of a duty of performance. The difference has been debated, with some courts finding the omission significant.[12]

No circuit court, however, ever adopted a literal interpretation of what the Supreme Court has said. There are good reasons for this. First, *Bildisco's* formulation basically incorporates the legislative history of the Code,[13] and that history is consistent with the Countryman test.[14] Second, and more importantly, if the remaining duties of one party are not material, the breach of those duties would not give the non-breaching party the power to terminate the contract. It would simply give a right for damages.

D. SECTION 365 AND TRADEMARKS

As simple as the initial take on *Tempnology* may be, a deeper analysis of the opinion raises significant concerns. Although the opinion is relatively clear about the effect of the rejection of a trademark license, it is silent on the effect of rejection on the ownership and administration of the trademark itself. A trademark is property, and is subject to statutory duties of control and protection in order to maintain its validity. Does rejection of a license affect these residual property rights of debtors/licensors? This matters. If a rejection releases a debtor from all ongoing and future *contract* obligations to the non-debtor, does *Tempnology* affect the non-contract aspects of the debtor/licensor's trademark rights? If not, *Tempnology* may thus represent a battle won, but a war lost, for the non-debtor licensee.

1. REJECTION AS IRRELEVANT TO PROPERTY RIGHTS GRANTED

The basic concern starts with the fact that, regardless of the non-debtor's election to continue or terminate the license, the debtor is still the owner of the trademark. If it cannot terminate the license, however, the debtor/licensor likely has little or no incentive to maintain the mark.[15] The debtor/licensor presumably sought to reject the license because it was not profitable for the estate. That lack of profitability will remain after rejection, and indeed may be made worse by the non-debtor/license's ability to offset damages caused by the rejection against any license fees owed.

So what's a debtor/licensor to do? If pure economics drives the decision, it does nothing. After all, one aspect of private property is the right to waste it—investment bankers can continue to light their cigars with $100 bills if they want. The debtor/licensor's inability to renegotiate a losing license through rejection leads to the conclusion that the debtor/owner/licensor should not invest any more in a losing proposition. Moreover, the Code will classify any damages flowing from its decision to reject its responsibilities with respect to the trademark will be classified as pre-petition damages, and payable in bankruptcy dollars.

In a perverse way, the debtor/licensor can thus obtain through economics what the Court denied under the Code. If the non-debtor/licensee wants or needs to use the license, it will have to pay the licensor to not undermine or waste the trademark. Not surprisingly, that is just what Tempnology wanted to do. Unless the non-debtor/licensor can, under non-bankruptcy law can enjoin the debtor/licensor to protect the mark—which would be directly contrary the principles underlying Section 365—then the debtor/licensor can threaten rejection, followed by abandonment and waste, and get the same result as if it could terminate or vaporize the license.[16]

This outcome was foreseen by at least one amici, the American Intellectual Property Law Association. Its brief laid out the following scenario:

> As another example, suppose a trademark license allows the licensee to manufacture a bottled beverage by adding carbonation and water to a proprietary syrup provided by the licensor, using the trademark on the bottled product. Assume further the license does not have any express quality control provisions, stating only how much syrup the licensee must purchase and requiring that it be diluted and carbonated by a certain amount. Even in the absence of an express quality control provision, the end product, the bottled drink, will be of known quality assured by the use of the proprietary syrup. If the licensor no longer manufactures syrup, it must be clear the licensee cannot substitute a different syrup, even if the agreement is silent, because the use of the proprietary syrup is fundamental to ensuring the licensed product meets the licensor's quality control standards.
>
> A bankruptcy court would have the authority to clarify the contract in this manner and forbid the licensee from using a different syrup. If it means the licensee can no longer create bottled drinks, the licensee's only remedy is monetary relief for the licensor's breach in failing to provide the syrup. The licensee does not have the latitude to create an altogether different drink with a different syrup and then sell it under the formerly licensed mark. Even though the bankruptcy court may make such a determination, the ruling is not based on bankruptcy law, rather the ruling is based on non-bankruptcy law applicable to the license in question and the Code's provision prohibiting specific performance against the debtor.[17]

That leads us to the non-bankruptcy law of trademarks and their licensing, and their protection. The effective licensing of a trademark requires that the trademark owner monitor and exercise control over the quality of the goods sold to the public under cover of the trademark.[18] In this area, the key distinction is that while rejection sheds the *contractual* obligations owed to the non-debtor/licensee, it does nothing to the non-contractual obligations under trademark law to maintain quality and control of the goods or services covered by the mark. As the First Circuit's opinion recognized:

> Trademarks, unlike patents, are public-facing messages to consumers about the relationship between the goods and the trademark owner. They signal uniform quality and also protect a business from competitors who attempt to profit from its developed goodwill. The licensor's monitoring and control thus serve to ensure that the public is not deceived as to the nature or quality of the goods sold. . . . Importantly, failure to monitor and exercise this control results in a so-called "naked license," jeopardizing the continued validity of the owner's own trademark rights. [J. Thomas] McCarthy, [McCarthy on Trademarks & Unfair Competition] § 18:48 [(5th ed. 2017)]; see also Eva's Bridal Ltd. v. Halanick Enters., Inc., 639 F.3d 788, 790 (7th Cir. 2011) ("[A] naked license abandons a mark."); Restatement (Third) of Unfair Competition § 33 ("The owner of a trademark, trade name, collective mark, or certification mark may license another to use the designation. . . . Failure of the licensor to exercise reasonable control over the use of the designation by the licensee can result in abandonment. . . .").[19]

As a result, an adroit debtor could mask a strategy for renegotiation of a license by threatening rejection coupled with an indication that the debtor would thereafter abandon or terminate the trademark. This strategy works so long as the damages for the debtor's termination are characterized as pre-petition claims. If the license is critical to the licensee, it will renegotiate.

2. SO WHAT'S DIFFERENT FROM PATENTS AND COPYRIGHTS

Another unanswered question is the difference between trademarks and the types of intellectual property covered by Section 365(n).[20] When Congress added Section 365(n) to the Code, it expressly excluded trademarks from its scope.[21]As a result, rejection of any intellectual property except a trademark must adhere to Section 365(n)'s statutory framework, while rejection of trademark licenses revert to regular executory contract analysis.

There are some obvious differences. Unlike other types of executory contracts, Section 365(n)(4) explicitly requires the licensee to adhere to the license until rejection. There are also express protections of any exclusivity granted to licensees in Section 365(n)(3)(B).[22] More importantly, in the event of breach of an executory contract related to intellectual property, Section 365(n)(2) obliterates the licensee's right to offset the damages resulting from the rejection against any royalty payments.[23] For trademarks, however, the normal rules of set-off continue to apply.[24]

This last distinction is the one that casts *Tempnology* as a double victory for trademark licensees. Not only do they retain the option, which they had under non-bankruptcy law, of keeping the license in place, they can now deduct their damages arising from rejection from any royalties or other payments due under the rejected contract. Of course, this offset right is counterbalanced by the debtor's ability to abandon the mark, and then classify any resulting damages as pre-petition claims.

E. MOOTNESS

Before leaving *Tempnology*, there is one more small point to ponder. *Tempnology* was an 8-1 decision, with Justice Gorsuch in the minority. Justice Gorsuch did not openly disagree with the majority; rather, he thought the case moot, and that the certiorari petition should have denied on the basis that it had been improvidently granted.

1. NO LICENSE; NO DAMAGE

As Justice Gorsuch phrased the issue: "After the bankruptcy court ruled, the license agreement expired by its own terms, so nothing we might say here could restore Mission's ability to use Tempnology's trademarks."[25] A form of that argument is often raised in bankruptcy in appeals from orders granting relief from the automatic stay. In these cases, Bank has mortgage on Debtor's house. Debtor files, and Bank obtains relief from stay. Debtor appeals the stay ruling, but does not obtain a stay pending appeal. Bank forecloses and sells to third party who is not a party to the appeal. If the appeal concerns only the propriety of the stay relief, the appeal is constitutionally moot. There is nothing a court can do on remand to undo the legal error since the property is no longer property of the estate—it is now the property of a stranger to the proceeding and to the appeal. On remand, the court could not order that person to return the property, and thus correcting any error in the granting of relief is moot. Without any relief possible, there is no case or controversy, and thus no jurisdiction under the constitution to redress the bankruptcy court's error.[26]

Was Tempnology's case analogous?

Mission responded by claiming that it would seek damages from Tempnology's estate. That usually suffices to preserve a case and controversy. Because courts like to have as broad as jurisdiction as the Constitution permits, constitutional mootness tends to be construed in a manner resembling construction of the rule against perpetuities: any construction of the facts that arguably presents a litigable issue is sufficient to preserve the power to hear. Whether the court, in an exercise of prudence, will actually hear the dispute is another matter; there are a host of prudential doctrines for not hearing a matter, the most notorious being equitable mootness.

The majority accepted Mission's argument. As it stated, "[u]ltimate recovery on that [damages] demand may be uncertain or even unlikely for any number of reasons, in this case as in others. But that is of no moment. If there is any chance of money changing hands, Mission's suit remains live."[27]

And so a damages claim would seem to work; after all, it did sway the eight other justices. But not Justice Gorsuch. His argument was as follows:

> But it's far from clear whether even this theory can keep the case alive. A damages claim "suffices to avoid mootness only if viable," which means damages must at least be "legally available for [the alleged] wrong." 13C C. Wright, A. Miller, & E. Cooper, Federal Practice and Procedure § 3533.3, p. 22 (3d ed. 2008). Yet, as far as Mission has told us, Tempnology did nothing that could lawfully give rise to a damages claim. After all, when Tempnology asked the bankruptcy court to issue a declaratory ruling on a question of law, it was exercising its protected "First Amendment right to petition the Government for redress of grievances." Bill Johnson's Restaurants, Inc. v. NLRB, 461 U. S. 731, 741, 103 S.Ct. 2161, 76 L.Ed.2d 277 (1983). And petitioning a court normally isn't an actionable wrong that can give rise to a claim for damages. Absent a claim of malice (which Mission hasn't suggested would have any basis here), the ordinary rule is that " 'no action lies against a party for resort to civil courts' " or for "the assertion of a legal argument." Lucsik v. Board of Ed. of Brunswick City School Dist., 621 F. 2d 841, 842 (CA6 1980) (per curiam); see, e.g., W. R. Grace & Co. v. Rubber Workers, 461 U. S. 757, 770, n. 14, 103 S.Ct. 2177, 76 L.Ed.2d 298 (1983); Russell v. Farley, 105 U. S. 433, 437-438, 26 L.Ed. 1060 (1882).[28]

Tempnology pushed this view by pointing out that all it did was ask for a clarification ruling; as there was no injunction enforcing the bankruptcy court's views on rejection, any cessation of potentially infringing activity was caused by Mission's prudence, not by Tempnology. The Court quickly eliminated the claimed issue of a lack of a specific injunction:

> Mission need not have flouted a crystal-clear ruling and courted yet more legal trouble to preserve its claim. Cf. 13B Wright & Miller § 3533.2.2, at 852 ("[C]ompliance [with a judicial decision] does not moot [a case] if it remains possible to undo the effects of compliance," as through compensation). So last, Tempnology claims that it bears no blame (and thus should not have to pay) for Mission's injury because all it did was "ask[ ] the court to make a ruling." Tr. of Oral Arg. 34-35. But whether Tempnology did anything to Mission amounting to a legal wrong is a prototypical merits question, which no court has addressed and which has no obvious answer. That means it is no reason to find this case moot.[29]

What Tempnology and Justice Gorsuch seemed to be arguing is that a litigant who sues without malice to obtain a declaration that it is not causing harm obtains immunity for any harm caused during the pendency of the lawsuit. With all due respect, that's madness.

What Justice Gorsuch conflates is the ability to sue for redress with the redress requested. No one will punish or assess damages against Tempnology for the *act* of seeking rejection or for the *act* of filing a complaint seeking clarification about rejection. That discussion has no price of admission. But if the pendency of the lawsuit coincides with ongoing injury, the lawsuit's pendency certainly doesn't absolve the plaintiff for the ongoing and accumulating damages. Otherwise, as in *Tempnology*, one party in breach can sue towards the end of a contract's maturity, and limit its damages simply by filing suit.

Put pithily, while no one is mulcted because she filed a lawsuit, no one obtains immunity for damages by filing it either. At least eight justices understood this point.

2. EQUITABLY MOOT?

What Justice Gorsuch might have been thinking that the case was equitably moot; that is, technically alive, but of no use to anyone. As stated in the majority opinion, the Tempnology estate had already made a final distribution. "Here, Tempnology notes that the bankruptcy estate has recently distributed all of its assets, leaving nothing to satisfy Mission's judgment."[30] To paraphrase Gertrude Stein, on remand there will be no there there.[31]

The majority dealt with this issue by pointing out that "courts often adjudicate disputes whose 'practical impact' is unsure at best, as when 'a defendant is insolvent.' . . . . And Mission notes that if it prevails, it can seek the unwinding of prior distributions to get its fair share of the estate. . . . So although this suit 'may not make [Mission] rich,' or even better off, it remains a live controversy—allowing us to proceed."[32]

Given the length of time to resolve any complicated bankruptcy, and the number of appellate levels parties have to wade through to get to the Supreme Court, it is small breath of fresh air that eight justices rejected Justice Gorsuch's view of mootness.

III. *TAGGART*

At issue in *Taggart v. Lorenzen*,[33] was the remedy for violation of the bankruptcy discharge found in Section 524.

A. BACKGROUND

Bradley Taggart had an interest in an Oregon limited liability company, Sherwood Park Business Center. The operating agreement for that company gave the members of the company rights of first refusal if any member wished to transfer his or her interest in the company. Notwithstanding this provision, Taggart transferred his interest to his attorney, allegedly in breach of the right of first refusal.

Sherwood, along with several other members,[34] then sued Taggart and his attorney for the breach of the operating agreement. On the eve of trial, Taggart filed a chapter 7 bankruptcy and received a discharge. After Taggart received his discharge, the Oregon state court proceeded to enter judgment against him in the still pending lawsuit over the breach of the right of first refusal (the plaintiffs had continued it against Taggart's attorney as the transferee of the interests). Sherwood then filed a petition in state court seeking attorney's fees from Taggart (and the other defendants) that Sherwood had incurred after Taggart filed his bankruptcy petition.

Existing Ninth Circuit precedent allows nondebtors to sue discharged debtors over discharged debts if they continue pre-petition litigation after receiving their discharge; in short, the Ninth Circuit holds that a debtor cannot "return to the fray" using the discharge as a sword and not a shield. Sherwood contended that Taggart returned to the fray; Taggart disagreed. The state trial court agreed Taggart had "returned to the fray," and held Taggart liable for roughly $45,000 of Sherwood's postpetition attorney's fees.

At this point, Taggart returned to bankruptcy. He contended he had not returned to the fray, and thus was protected by his discharge. He also sought to hold Sherwood in civil contempt for violation of his discharge order.

The Bankruptcy Court disagreed. It found Taggart had returned to the fray, and thus refused to hold Sherwood in civil contempt. Taggart appealed, and the federal district court, sitting as an appellate court, held that Taggart had not returned to the fray. Based on that finding, it held that Sherwood violated the discharge order by trying to collect attorney's fees.

On remand, the bankruptcy court followed the mandate and held Sherwood in civil contempt because Sherwood had been " 'aware of the discharge' " order and " 'intended the actions which violate[d]' " it.[35] As part of its civil contempt holding, the bankruptcy court awarded Taggart approximately $105,000 in attorney's fees and costs, $5,000 in damages for emotional distress, and $2,000 in punitive damages.

Sherwood appealed. This time, the appeal went to the Ninth Circuit's Bankruptcy Appellate Panel. It vacated the sanctions.

On further appeal, the Ninth Circuit affirmed the Bankruptcy Appellate Panel. The Ninth Circuit applied a very different standard than the Bankruptcy Court. It concluded that a "creditor's good faith belief" that the discharge order "does not apply to the creditor's claim precludes a finding of contempt, even if the creditor's belief is unreasonable."[36] Because Sherwood had a "good faith belief" that the discharge order "did not apply" to Sherwood's claims, the Court of Appeals held that civil contempt sanctions were improper.[37]

Taggart then filed a petition for certiorari, which the Court granted.

B. THE REFERENCE TO CIVIL CONTEMPT GENERALLY

The Court reviewed the petition in fairly bloodless terms. It first noted that

> "[t]wo Bankruptcy Code provisions aid our efforts to find an answer. The first, section 524, says that a discharge order 'operates as an injunction against the commencement or continuation of an action, the employment of process, or an act, to collect, recover or offset' a discharged debt. 11 U.S.C. § 524(a)(2). The second, section 105, authorizes a court to "issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title." § 105(a)."[38]

The combination of these two sections lead the court to look outside the Code for answers.

Why? The simple answer is that neither of these sections states the standard to be applied. Instead, the sections explicitly incorporate existing judicial concepts of an "injunction" as buttressed by "any order, process, or judgment."

So the Court looked outside the Code and melded into the Code the standard for civil contempt found in regular civil litigation. As the Court put it, "[i]n our view, these provisions authorize a court to impose civil contempt sanctions when there is no objectively reasonable basis for concluding that the creditor's conduct might be lawful under the discharge order."[39]

Justice Breyer, speaking for a unanimous Court, justified this borrowing on some old learning emanating from Justice Frankfurter. As Justice Breyer noted, "[w]hen a statutory term is " 'obviously transplanted from another legal source,' " it " 'brings the old soil with it.' "[40] The statutory term transplanted here was Section 524(a)'s use of "injunction," as bolstered by Section 105's indication that a bankruptcy court may issue any "order" or "judgment" that is "necessary or appropriate" to "carry out" other bankruptcy provisions.

The "old soil" includes the "potent weapon" of civil contempt.[41] Since the Congress did not specify a different standard in Section 524, the Court engaged in the presumption that "the bankruptcy statutes incorporate the traditional standards in equity practice for determining when a party may be held in civil contempt for violating an injunction."[42]

What is that standard? The Court resorted to a standard it had stated in an 1885 case:

> In cases outside the bankruptcy context, we have said that civil contempt "should not be resorted to where there is [a] *fair ground of doubt* as to the wrongfulness of the defendant's conduct." California Artificial Stone Paving Co. v. Molitor, 113 U.S. 609, 618, 5 S.Ct. 618, 28 L.Ed. 1106 (1885) (emphasis added).[43]

The Ninth Circuit had found that an unreasonable but subjective belief of compliance protected the creditor.[44] The Supreme Court indicated that this was in error. The standard for civil contempt

> is generally an objective one. We have explained before that a party's subjective belief that she was complying with an order ordinarily will not insulate her from civil contempt if that belief was objectively unreasonable. As we said in McComb v. Jacksonville Paper Co., 336 U.S. 187, 69 S.Ct. 497, 93 L.Ed. 599 (1949), "[t]he absence of wilfulness does not relieve from civil contempt." Id., at 191, 69 S.Ct. 497.[45]

Subjective belief is not irrelevant. The Court indicated, in dicta, that bad faith, even if objectively justified, can violate this standard, and the culpability, and punishment, of any contemnor may often turn on whether the contemnor proceeded in erroneous good faith.[46]

C. ADAPTING CIVIL CONTEMPT TO BANKRUPTCY

How will this play out in bankruptcy? The Court gave a few hints. It first noted that the standard discharge order is pretty sparse. To understand its scope, you have to understand the words and structure, and the exceptions, contained in many provisions of the Code. Could this complexity alone provide a defense?

The Court seemed to signal no. When looking at the application of the civil standard for contempt to the discharge, the Court said: "Under the fair ground of doubt standard, civil contempt therefore may be appropriate when the creditor violates a discharge order based on an objectively unreasonable understanding of the discharge order or the statutes that govern its scope."[47]

The use of "or" seems to reflect an understanding that, in many cases, a discharge can be subject to several general exceptions (found in Section 727(a)) or specific exceptions (found in Section 523(a)(1)-(19)). One would hope under this standard that it would be "objectively unreasonable" to believe a discharge doesn't cover a debt incurred by fraud if the creditor had not sought a determination of nondischargeability in bankruptcy court within the tight timeframes provided in Section 523(c) and Bankruptcy Rules 4004(a) and 4007(c). But I suppose counsel will test this proposition ultimately.

There is little doubt that the Court could have selected a standard more favorable to a debtor. Taggart argued for the standard used by the bankruptcy court: that a finding of civil contempt could be based upon the creditor's awareness of the discharge order and its intention to take the actions that violated the order. The Court, however, believed that this standard was not consonant with the general federal standard for civil contempt, being too much like strict liability. "Because most creditors are aware of discharge orders and intend the actions they take to collect a debt, this standard would operate much like a strict-liability standard."[48] And a strict liability standard, the Court asserted, would be contrary to the expeditious remedy Congress intended, as it would "risk additional federal litigation, additional costs, and additional delays."[49]

D. WHAT NOW? OR, WHY DO THE LOSERS THINK THEY STILL HAVE A CASE?

The Ninth Circuit did not apply the correct standard, and so the Court remanded the case.

This raises the question: if Taggart won at the Supreme Court, should he win at the Ninth Circuit? Maybe not. Sherwood's counsel has been quoted as stating that the Court's opinion "allows creditors to pursue legitimate non-discharged debts while protecting debtors from harassment and minimizing the time and expense of bankruptcy proceedings."[50] Under this standard, the lawyer indicated her belief that her clients " 'acted reasonably every step of the way, and they do not deserve to be held in contempt of court. We are confident that the Ninth Circuit will recognize that on remand.' "[51]

This reaction underscores, at least from a bankruptcy perspective, potential problems with simple incorporation of non-bankruptcy concepts into construction of the Code's text. If a debtor has to fight whether creditor conduct was based on an "objectively unreasonable understanding of the discharge order" or whether there was a "fair ground of doubt as to the wrongfulness of the defendant's conduct," then the discharge's protection has come with a cost, and a risk. The vast majority of discharges entered are in favor of consumers who have paid a flat fee to their lawyer. *Taggart* now relegates vindication of the discharge to that lawyer, who may or may not be willing to pursue questionable creditor conduct for a future contingent payment.

IV. CONCLUSION

Tempnology and *Taggart* settle some questions arising in bankruptcy through a common strategy: they incorporate doctrine from non-bankruptcy law to resolve issues in bankruptcy. *Tempnology* looks to contract law to resolve issues of breach of a trademark license; *Taggart* looks to general federal practice for the standard to be applied to Section 524(a)'s statutory injunction.

This approach explicitly rejects bankruptcy exceptionalism; that is, it disdains using bankruptcy policy to resolve questions regarding doctrine or statutory interpretation relating to disputes in bankruptcy. Overall, this can be easily justified by Congress' reliance on and use of non-bankruptcy concepts such as "breach" and "injunction" in drafting the Code. After all, Congress could easily have expanded the Code's text if it wanted a different result than that provided by non-bankruptcy law. From this perspective, *Tempnology* and *Taggart* simply do what Congress intended—

construe words in the Code the way courts are used to construing them.

While this approach may have saved ink at the law printer, *Tempnology* and *Taggart* illustrate that these savings might have been illusory, offset by the ink spilled in efforts to understand how those general concepts are to be applied in everyday bankruptcy practice.

Yet the ultimate results in *Tempnology* and *Taggart* will tend to affect bankruptcy practice only at the margins. *Tempnology* will bring some measure of certain to trademarks in bankruptcy, and although *Taggart* is not as protective of debtors as it could be, it at least erases the errant Ninth Circuit view. In all, the generalist Court did about as well as could be expected. Better results, at least from the bankruptcy perspective, await better drafting.

ENDNOTES:

[1]Mission Product Holdings, Inc. v. Tempnology, LLC, 139 S. Ct. 1652, 67 Bankr. Ct. Dec. (CRR) 51 (2019).

[2]Taggart v. Lorenzen, 139 S. Ct. 1795, 67 Bankr. Ct. Dec. (CRR) 69 (2019).

[3]Mission Product Holdings, Inc. v. Tempnology, LLC, 139 S. Ct. 1652, 1658, 67 Bankr. Ct. Dec. (CRR) 51 (2019).

[4]Sunbeam Products, Inc. v. Chicago American Mfg., LLC, 686 F.3d 372, 56 Bankr. Ct. Dec. (CRR) 189, 67 Collier Bankr. Cas. 2d (MB) 1808, 103 U.S.P.Q.2d 1421, Bankr. L. Rep. (CCH) P 82303 (7th Cir. 2012).

[5]Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc., 756 F.2d 1043, 12 Bankr. Ct. Dec. (CRR) 1281, 12 Collier Bankr. Cas. 2d (MB) 310, 226 U.S.P.Q. 961, Bankr. L. Rep. (CCH) P 70311 (4th Cir. 1985).

[6]Mission Product Holdings, Inc. v. Tempnology, LLC, 139 S. Ct. 1652, 1661, 67 Bankr. Ct. Dec. (CRR) 51 (2019).

[7]Mission Prod. Holdings, Inc. v. Tempnology, LLC, No. 17-1657, 2019 WL 2166392, at *5 (U.S. May 20, 2019).

[8]Mission Prod. Holdings, Inc. v. Tempnology, LLC, No. 17-1657, 2019 WL 2166392, at *6 (U.S. May 20, 2019).

[9]Mission Product Holdings, Inc. v. Tempnology, LLC, 139 S. Ct. 1652, 1658, 67 Bankr. Ct. Dec. (CRR) 51 (2019) (quoting N.L.R.B. v. Bildisco and Bildisco, 465 U.S. 513, 522, n. 6, 104 S. Ct. 1188, 79 L. Ed. 2d 482, 11 Bankr. Ct. Dec. (CRR) 564, 9 Collier Bankr. Cas. 2d (MB) 1219, 5 Employee Benefits Cas. (BNA) 1015, 115 L.R.R.M. (BNA) 2805, Bankr. L. Rep. (CCH) P 69580, 100 Lab. Cas. (CCH) P 10771 (1984)).

[10]N.L.R.B. v. Bildisco and Bildisco, 465 U.S. 513, 522, n. 6, 104 S. Ct. 1188, 79 L. Ed. 2d 482, 11 Bankr. Ct. Dec. (CRR) 564, 9 Collier Bankr. Cas. 2d (MB) 1219, 5 Employee Benefits Cas. (BNA) 1015, 115 L.R.R.M. (BNA) 2805, Bankr. L. Rep. (CCH) P 69580, 100 Lab. Cas. (CCH) P 10771 (1984).

[11]Vern Countryman, Executory Contracts in Bankruptcy, 57 Minn. L. Rev. 439, 446 (1973).

[12]See, e.g., In re Baird, 567 F.3d 1207, 1211, 51 Bankr. Ct. Dec. (CRR) 189, 61 Collier Bankr. Cas. 2d (MB) 1460, Bankr. L. Rep. (CCH) P 81497 (10th Cir. 2009).

[13]Note 6 of Bildisco quotes and cites the legislative history as the source of its working definition. N.L.R.B. v. Bildisco and Bildisco, 465 U.S. 513, 522, n. 6, 104 S. Ct. 1188, 79 L. Ed. 2d 482, 11 Bankr. Ct. Dec. (CRR) 564, 9 Collier Bankr. Cas. 2d (MB) 1219, 5 Employee Benefits Cas. (BNA) 1015, 115 L.R.R.M. (BNA) 2805, Bankr. L. Rep. (CCH) P 69580, 100 Lab. Cas. (CCH) P 10771 (1984).

[14]H.R. Rep. No. 595, 95th Cong., 1st Sess. 347 (1977); S. Rep. No. 989, 95th Cong., 2d Sess. 58 (1978).

[15]I am dealing with the extreme case here. It may very well be that the license is profitable, but not as profitable as it might otherwise be. The debtor/licensor's incentives may be different in such a case.

[16]As noted by the amicus brief of the American Intellectual Property Law Association:

> Of course, if the debtor/licensor fails to fulfill its quality-control obligation altogether following rejection, a clever licensee could try to take advantage of the situation by electing to retain the license following rejection and then arguing the debtor-licensor has abandoned the mark by failure to exercise control. . . .As a general rule, [however,] a trademark licensee is estopped from challenging the validity of the licensor's title because the licensee has recognized the va-

lidity of the licensor's ownership by agreeing to the license. See, e.g., John C. Flood of Va., Inc. v. John C. Flood, Inc., 642 F.3d 1105, 1110 (D.C. Cir. 2011); Seven-Up Bottling Co. v. Seven-Up Co., 561 F.2d 1275, 1279-80 (8th Cir. 1977). But see Idaho Potato Comm'n v. M & M Produce Farm & Sales, 335 F.3d 130, 137 (2d Cir. 2003) (invoking public interest to reject licensee estoppel provision in certification mark license).

Brief of the American Intellectual Property Law Association as Amicus Curiae in Support of Neither Party, at 18-19, Mission Product Holdings, Inc. v. Tempnology, LLC, 139 S. Ct. 1652, 67 Bankr. Ct. Dec. (CRR) 51 (2019).

[17]Brief of the American Intellectual Property Law Association as Amicus Curiae in Support of Neither Party, at 24, Mission Prod. Holdings, Inc. v. Tempnology, LLC, No. 17-1657, 2019 WL 2166392 (U.S. May 20, 2019).

[18]See 3 J. Thomas McCarthy, McCarthy on Trademarks & Unfair Competition § 18:48 (5th ed. 2017) ("Thus, not only does the trademark owner have the right to control quality, when it licenses, it has the duty to control quality.").

[19]Mission Product Holdings, Inc. v. Tempnology, LLC (In re Tempnology, LLC), 879 F.3d 389, 403-04 (1st Cir. 2018), rev'd, Mission Prod. Holdings, Inc. v. Tempnology, LLC, No. 17-1657, 2019 WL 2166392 (U.S. May 20, 2019).

[20]"Intellectual property" is defined in Section 101(35A) as:

(A) trade secret;

(B) invention, process, design, or plant protected under title 35;

(C) patent application;

(D) plant variety;

(E) work of authorship protected under title 17; or

(F) mask work protected under chapter 9 of title 17;

to the extent protected by applicable nonbankruptcy law.

[21]The Senate Report on section 365(n) noted:

> [T]he bill does not address the rejection of executory trademark, trademark, trade name or service mark licenses by debtor-licensors. While such rejection is of concern because of the interpretation of [§] 365 by the Lubrizol court and others, . . . such contracts raise issues beyond the scope of this legislation. In particular, trademark, trade name and service mark licensing relationships depend to a large extent on control of the quality of the products or services sold by the licensee. Since such matters could not be addressed without more extensive study, it was determined to postpone congressional action in this area and to allow the development of equitable treatment of this situation by bankruptcy courts.

S. Rep. No. 505, 100th Cong., 2d Sess. 5 (1988).

[22]Section 365(n)(3)(B) provides that the estate must "not interfere with the rights of the licensee as provided in such contract, or any agreement supplementary to such contract, to such intellectual property (including such embodiment) including any right to obtain such intellectual property (or such embodiment) from another entity."

[23]11 U.S.C.A. § 365(n)(2)(C).

[24]See In re Communication Dynamics, Inc., 382 B.R. 219, 232, 49 Bankr. Ct. Dec. (CRR) 160 (Bankr. D. Del. 2008) ("the Court concludes that for purposes of section 553, a rejection damages claim is a pre-petition claim subject to setoff against any pre-petition debt owed by the creditor to the debtor."); but see In re Delta Air Lines, 341 B.R. 439, 447, 46 Bankr. Ct. Dec. (CRR) 73 (Bankr. S.D. N.Y. 2006) (because Section 553 provides that " 'this title [including Sections 365(g) and 502(g)] does not affect any right of a creditor to offset' mutual debts that arose pre-petition under non-bankruptcy state law. If it means anything, this language must mean that Sections 365(g) and 502(g) of 'this title' do not affect whatever right or lack of right a creditor had pre-petition to offset against a debtor, so that if a creditor had no offset rights pre-petition, the Bankruptcy Code does not create a right to offset.").

[25]Mission Product Holdings, Inc. v. Tempnology, LLC, 139 S. Ct. 1652, 1667, 67 Bankr. Ct. Dec. (CRR) 51 (2019) (Gorsuch, J., dissenting).

[26]Is there a difference if the Bank forecloses and credit bids its debt, and takes title? Yes. Now the bank, as a party to the appeal and the titleholder to the property, can be compelled on remand to not sell the property, and to rescind the foreclosure. Relief is possible.

[27]Mission Product Holdings, Inc. v. Tempnology, LLC, 139 S. Ct. 1652, 1660, 67 Bankr. Ct. Dec. (CRR) 51 (2019).

[28]Mission Prod. Holdings, Inc. v. Tempnology, LLC, No. 17-1657, 2019 WL 2166392, at *10 (U.S. May 20, 2019) (Gorsuch, J., dissenting).

[29]Mission Prod. Holdings, Inc. v. Tempnology, LLC, No. 17-1657, 2019 WL 2166392, at *5 (U.S. May 20, 2019).

[30]Mission Product Holdings, Inc. v. Tempnology, LLC, 139 S. Ct. 1652, 1661, 67 Bankr. Ct. Dec. (CRR) 51 (2019).

[31]Gertrude Stein, Everybody's Autobiography 289 (1927). Stein was referring to Oakland, her childhood home, and how it was no longer, and could never be, the same.

[32]Mission Product Holdings, Inc. v. Tempnology, LLC, 139 S. Ct. 1652, 1661, 67 Bankr. Ct. Dec. (CRR) 51 (2019).

[33]Taggart v. Lorenzen, 139 S. Ct. 1795, 67 Bankr. Ct. Dec. (CRR) 69 (2019). Disclaimer: I joined an amicus brief that urged the Court to adopt the standard used by the bankruptcy court. We didn't prevail.

[34]The Supreme Court referred to all respondents as "Sherwood," and so do I.

[35]In re Taggart, 522 B.R. 627, 632, 72 Collier Bankr. Cas. 2d (MB) 1347 (Bankr. D. Or. 2014).

[36]In re Taggart, 888 F.3d 438, 444, 65 Bankr. Ct. Dec. (CRR) 145, Bankr. L. Rep. (CCH) P 83243 (9th Cir. 2018), cert. granted, 139 S. Ct. 782, 202 L. Ed. 2d 511 (2019).

[37]In re Taggart, 888 F.3d 438, 445, 65 Bankr. Ct. Dec. (CRR) 145, Bankr. L. Rep. (CCH) P 83243 (9th Cir. 2018), cert. granted, 139 S. Ct. 782, 202 L. Ed. 2d 511 (2019).

[38]Taggart v. Lorenzen, 139 S. Ct. 1795, 1801, 67 Bankr. Ct. Dec. (CRR) 69 (2019).

[39]Taggart v. Lorenzen, 139 S. Ct. 1795, 1801, 67 Bankr. Ct. Dec. (CRR) 69 (2019).

[40]Taggart v. Lorenzen, 139 S. Ct. 1795, 1801, 67 Bankr. Ct. Dec. (CRR) 69 (2019) (quoting Hall v. Hall, 138 S. Ct. 1118, 1128, 200 L. Ed. 2d 399, 100 Fed. R. Serv. 3d 179 (2018) (in turn quoting Frankfurter, Some Reflections on the Reading of Statutes, 47 Colum. L. Rev. 527, 537 (1947)).

[41]Taggart v. Lorenzen, 139 S. Ct. 1795, 1801, 67 Bankr. Ct. Dec. (CRR) 69 (2019) (quoting International Longshoremen's Ass'n, Local 1291 v. Philadelphia Marine Trade Ass'n, 389 U.S. 64, 76, 88 S. Ct. 201, 19 L. Ed. 2d 236, 66 L.R.R.M. (BNA) 2433, 56 Lab. Cas. (CCH) P 12253, 1967 A.M.C. 2251, 11 Fed. R. Serv. 2d 1454 (1967)).

[42]Taggart v. Lorenzen, 139 S. Ct. 1795, 1801, 67 Bankr. Ct. Dec. (CRR) 69 (2019).

[43]Taggart v. Lorenzen, 139 S. Ct. 1795, 1801-1802, 67 Bankr. Ct. Dec. (CRR) 69 (2019) (emphasis in original).

[44]This is sometimes referred to the "Golden Retriever" standard; Golden Retrievers often hold fast to their owners despite all objective evidence that the owners do not care for their dog.

[45]Taggart v. Lorenzen, No. 18-489, 2019 WL 2331303, at *4 (U.S. June 3, 2019).

[46]Taggart v. Lorenzen, 139 S. Ct. 1795, 1802, 67 Bankr. Ct. Dec. (CRR) 69 (2019).

[47]Taggart v. Lorenzen, 139 S. Ct. 1795, 1802, 67 Bankr. Ct. Dec. (CRR) 69 (2019).

[48]Taggart v. Lorenzen, 139 S. Ct. 1795, 1803, 67 Bankr. Ct. Dec. (CRR) 69 (2019).

[49]Taggart v. Lorenzen, 139 S. Ct. 1795, 1803, 67 Bankr. Ct. Dec. (CRR) 69 (2019).

[50]Jonathan Randles, "Supreme Court Says 'Objectively Unreasonable' Debt Collectors Can Be Punished," Wall St. J. (June 3, 2019), accessed at https://www.wsj.com/articles/supreme-court-says-objectively-unreasonable-debt-collectors-can-be-punished-11559597745?shareToken=std2527baf996f494fa4c8fbdb140a4f08.

[51]Jonathan Randles, "Supreme Court Says 'Objectively Unreasonable' Debt Collectors Can Be Punished," Wall St. J. (June 3, 2019), accessed at https://www.wsj.com/articles/supreme-court-says-objectively-unreasonable-debt-collectors-can-be-punished-11559597745?shareToken=std2527baf996f494fa4c8fbdb140a4f08.

https://legal.thomsonreuters.com/

"When you come to a Fork in the Road, do you take it?"[1]

Removal of State Court Actions to Bankruptcy Court

An issue arises involving the lien priority of a state court judgment that was apparently ineffectively docketed against a borrower (and its real estate) in state court. Well after the judgment was obtained, a deed of trust was recorded once the lender conducted a lien search, which of course came back clean. A state court declaratory judgment action is filed by the judgment lien creditor to determine the validity of its judgment lien and its priority. The deed of trust is presumably in first lien position, and the beneficiary and the trustees under the deed of trust are thus made a defendant in the state court action, along with the judgment lien debtor -- the owner of the real estate in question. The borrower/judgment lien debtor files for Chapter 11, and the beneficiary of the deed of trust wants to remove the state court litigation to the bankruptcy court to be litigated in that forum. Can it be done? How is it done? Is a notice of removal filed in the district court? The bankruptcy court? Can you go either place? Does it matter?

I. Removal of Cases to Bankruptcy Court in General

28 U.S.C. § 1334 establishes subject matter jurisdiction in the United States District Courts for all cases "under title 11," and extends it as well to "all civil proceedings . . . related to cases under title 11." 28 U.S.C. § 1334(a)-(b). Congress further established that the district court can refer all cases in bankruptcy and any and all related proceedings arising under, in , or related to cases in bankruptcy, to the bankruptcy court. 28 U.S.C.§ 157(a). Most district courts have a local Rule or standing order making such a referral. "Related to" jurisdiction is, however, not without its limits.

As stated in *O'Halloran v. Island View Crossing II (In re Island View Crossing)*, 598 B.R. 552 (Bankr. E.D. Pa. 2019), "[t]he iconic test for determining whether a matter is sufficiently 'related to' the bankruptcy case to create subject matter jurisdiction is: whether *the outcome of that proceeding could conceivably have any effect on the estate being administered in bankruptcy* . . . An action is related to bankruptcy if the outcome could alter the debtor's rights, liabilities, options, or freedom of action (either positively or negatively) and which in any way impacts upon the handling and administration of the bankrupt estate. *Pacor, Inc. v. Higgins*, 743 F.2d 984, 994 (3d Cir. 1984) (emphasis in original) (citations omitted), overruled on other grounds by *Things Remembered, Inc. v. Petrarca*, 516 U.S. 124, 116 S.Ct. 494, 133 L.Ed.2d 461 (1995)"; see also *Valley Historic Ltd. P'ship v. Bank of N.Y.,* 486 F.3d 831, 836 (4th Cir. 2007) (emphasis removed) (quoting *In re Celotex Corp.,* 124 F.3d 619, 625 (4th Cir. 1997)). "In *Celotex Corp. v. Edwards,* 514 U.S. 300, 307, 115 S.Ct. 1493, 1499, 131 L.Ed.2d 403 (1995), the Supreme Court expressed agreement with the view of the Third Circuit in *Pacor* . . . that by Congress' choice of words in § 1334(b) 'Congress intended to grant comprehensive jurisdiction to the bankruptcy courts so that they might deal efficiently and expeditiously with all matters connected with the bankruptcy estate. . . .' " *In re Celotex Corp.,* 124 F.3d 619, 625 (4th Cir.

[1] Apologies to Yogi Berra. The Yogi Book: I Really Didn't Say Everything I Said! by Yogi Berra, Page 48, Workman Publishing, New York. 1998.

1997) (internal quotation marks omitted). "[T]he court is mindful that 'common sense cautions against an open-ended interpretation of the "related to" statutory language "in a universe where everything is related to everything else," ' *Matter of FedPak Sys., Inc.,* 80 F.3d 207, 214 (7th Cir. 1996) (quoting Gerald T. Dunne, *The Bottomless Pit of Bankruptcy Jurisdiction,* 112 Banking L.J. 957, 957 (Nov.-Dec.1995))." *Wingate v. Insight Health Corp.*, No. 7:13cv00142, 2013 WL 1951897, at *3 (W.D. Va. May 10, 2013).

In turn, Section 1452 is one of several statutes comprising Chapter 89 of the U.S. Code, which is entitled "District Courts; Removal of Cases from State Courts."[2] 28 U.S.C. § 1452, the "bankruptcy removal statute," is entitled "Removal of claims related to bankruptcy cases" and provides as follows:

> (a) A party may remove any claim or cause of action in a civil action other than a proceeding before the United States Tax Court or a civil action by a governmental unit to enforce such governmental unit's police or regulatory power, to the district court for the district where such civil action is pending, if such district court has jurisdiction of such claim or cause of action under section 1334 of this title.
>
> (b) The court to which such claim or cause of action is removed may remand such claim or cause of action on any equitable ground. An order entered under this subsection remanding a claim or cause of action, or a decision to not remand, is not reviewable by appeal or otherwise by the court of appeals under section 158(d), 1291, or 1292 of this title or by the Supreme Court of the United States under section 1254 of this title.

28 U.S.C. § 1452.

Neither a motion nor a court order is required to effect removal of a state court action. Removal is accomplished by filing a notice of removal with the "clerk" (we'll get to that later). Federal Rule of Bankruptcy Procedure 9027 describes the method and timing of the removal as follows:

> (1) *Where Filed; Form and Content*. A notice of removal shall be filed with the clerk for the district and division within which is located the state or federal court where the civil action is pending. The notice shall be signed pursuant to Rule 9011 and contain a short and plain statement of the facts which entitle the party filing the notice to remove, contain a statement that upon removal of the claim or cause of action the party filing the notice does or does not consent to entry of final orders or

[2] "Although the bankruptcy removal statute is part of the chapter of the United States Code dealing with removal of *state court* actions, courts have interpreted 28 U.S.C. § 1452 as authorizing removal to district courts from other federal courts, such as the Court of Federal Claims, the local courts of the District of Columbia, or the territorial courts of Guam. *Quality Tooling, Inc. v. United States*, 47 F.3d 1569, 1572 (Fed. Cir. 1995); *Centrust Sav. Bank v. Love*, 131 B.R. 64, 66–67 (S.D. Tex. 1991)." *Curtis v. Shpak (In re Curtis)*, 571 B.R. 441, 444 n.2 (B.A.P. 9th Cir. 2017)(emphasis in original).

judgment by the bankruptcy court, and be accompanied by a copy of all process and pleadings.

(2) *Time for Filing; Civil Action Initiated Before Commencement of the Case Under the Code*. If the claim or cause of action in a civil action is pending when a case under the Code is commenced, a notice of removal may be filed only within the longest of (A) 90 days after the order for relief in the case under the Code, (B) 30 days after entry of an order terminating a stay, if the claim or cause of action in a civil action has been stayed under §362 of the Code, or (C) 30 days after a trustee qualifies in a chapter 11 reorganization case but not later than 180 days after the order for relief.

(3) *Time for Filing; Civil Action Initiated After Commencement of the Case Under the Code*. If a claim or cause of action is asserted in another court after the commencement of a case under the Code, a notice of removal may be filed with the clerk only within the shorter of (A) 30 days after receipt, through service or otherwise, of a copy of the initial pleading setting forth the claim or cause of action sought to be removed, or (B) 30 days after receipt of the summons if the initial pleading has been filed with the court but not served with the summons.

Fed. R. Bankr. P. 9027(a)(1)-(3); *see also In re Celotex Corp.,* 124 F.3d at 629 (noting that the Bankruptcy Rules apply to cases grounded on related-to jurisdiction).

II. <u>**Where should the Removal Notice be Filed**</u>?

A. The Bankruptcy Court?

The District Court referred all cases in bankruptcy and any and all related proceedings arising under, in, or related to cases in bankruptcy, to the bankruptcy court and the district court entered an order to that effect. Some district courts make the referral by local rule. It has to be filed in the bankruptcy court, right?

Not so fast. In *Morgan v. Bruce*, No. H87-0001(W), 1993 WL 786892 (S.D. Miss. Feb. 1, 1993), the district court observed that Section 1471 (the predecessor to Section 1452) formerly provided that: "[a] party may remove any claim or cause of action in a civil action, . . . to the *bankruptcy court* for the district where such civil action is pending, if the bankruptcy courts have jurisdiction over such claim or cause of action." (emphasis added). *Morgan*, at *4. *Morgan* went on to observe that "[i]n 1984, this statute was repealed by Congress and replaced with § 1452(a) in light of the United States Supreme Court decision of *Northern Pipeline Construction Co. v. Marathon Pipe Line Co.,* 458 U.S. 50, 102 S.Ct. 2858, 73 L.Ed.2d 598 (1982), which declared various parts of the bankruptcy statutes unconstitutional because Congress had improperly placed Article III powers with Article I Bankruptcy Courts. The current version of § 1452(a) now reads that removal shall be 'to the district court' in place of 'to the bankruptcy court.' This distinction is the primary cause of current conflict among federal courts concerning the place for filing a removal petition from state court." *Morgan,* at *4. Looking back to 1985, *Morgan* observed that "while the statute for removal directed one to file a removal petition with the District Court, the procedural rule enacted to effectuate § 1452(a) told litigants to file their removal petitions with the clerk of the Bankruptcy Court." *Id.* The bankruptcy rules were amended in 1987, and although the old language of 9027 was modified, it failed to clearly dovetail with the language of Section 1452(a).[3] *Morgan* specifically rejected the arguments that the automatic referral to the bankruptcy court was sufficient to allow for direct removal to that court, or that a bankruptcy court as a "unit" of the district court is able to accept a direct removal. *Id.*

So, why is this in recent developments? *Morgan* was recently followed by *In re VC Macon*, Case No. 18-04802, AP No. 19-00004 (Bankr. S.D. Miss. March 7, 2019)(Olack, J.). In *VC Macon*, the debtor filed a Chapter 11, and a state court action was filed against a guarantor of an obligation evidenced by a note made by the debtor. The debtor was not a party to the state court action. Thereafter, the debtor filed a notice of removal of the state court action with the bankruptcy court, under a theory the guarantor had asserted state law and contractual indemnity obligations. In the removal notice, the debtor asserted that the matter was a core proceeding and arises out of, or relates to, the main case. The bankruptcy court held a show cause hearing to determine whether it had subject matter jurisdiction, and limited the issue to whether the case was improperly removed to bankruptcy court. Following *Morgan*, the bankruptcy court noted a split between the Northern and Southern Districts of Mississippi. In the Northern District, cases are routinely removed to bankruptcy court. In the Southern District, the *Morgan* rationale prevails and cases are removed to the district court. Judge Olak in *VC Macon* followed *Morgan*, and found *Morgan* to be consistent with *Stern v. Marshall*, 564 U.S. 462 (2011), where the U.S. Supreme Court expressed reluctance to allow bankruptcy judges to wield dispositive authority over state-law claims. *VC Macon* held in Stern, "the Supreme Court considered the constitutional limitations that Article III imposed on 28 U.S.C. § 157(b) and held that the statute violated Article III to the extent the statute authorized a bankruptcy court to enter a final judgment on an issue that did not 'stem from the bankruptcy itself' or that would not 'necessarily be resolved in the claims allowance process.' . . . *Stern* illustrates that the removal issue here implicates more that a question of statutory interpretation." *VC Macon,* at p.10 (citations omitted). *VC Macon* found the removal directly to bankruptcy court improper and of no effect, and remanded the case back to state court.[4]

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[3] In *Morgan*, the district court declined to hold the bankruptcy court lacked jurisdiction or authority over the removed matter, and held the removal was harmless error. However, the district court noted that the litigant who challenged the bankruptcy court's jurisdiction had agreed to remove the case directly to the bankruptcy court and did not object to the bankruptcy court's authority until after it received an adverse ruling from the bankruptcy court.

[4] Mississippi is not unique in having an intra-district district split. Although the court is aware of no published opinions on the subject, the practice in the Western District of Virginia has been to remove matters directly to the bankruptcy court. However, in the Eastern District of Virginia, at least one district court has ruled that the district court is the proper place to remove a state court action, as opposed to bankruptcy court. See *LMRT Associates, LC v. MB Airmont Farms, LLC*, 447 B.R. 470, 473 n. 6 (E.D. Va. 2011).

B. The District Court?

VC Macon, Morgan, and *LMRT* all make it clear that the district court is the way to go, right? How about United States District Court for the District of Maryland's Local Rule 407, which provides as follows: "Removals under 28 U.S.C. § 1452 or § 1441 in cases related to bankruptcy cases should be filed with the *Bankruptcy Clerk*." (emphasis added). As provided above, Federal Rule of Bankruptcy Procedure 9027 describes the method and timing of the removal as follows: "(1) *Where Filed; Form and Content*. A notice of removal shall be filed with the clerk for the district and division within which is located the state or federal court where the civil action is pending." The definition of clerk under the Bankruptcy Rules provides that "'Clerk' means bankruptcy clerk if one has been appointed, otherwise the clerk of the district court." Fed. R. Bankr. P. 9001(3). What kind of clerk does your court have?

Or, how about *In re Coastal Plains, Inc.,* 338 B.R. 703 (Bankr. N.D. Tex. 2006), which observed that "[t]he majority of federal courts, on the other hand, allow state cases to be removed directly to the bankruptcy court without first being routed through the district court. *See AG Indus., Inc. v. AK Steel Corp.* (*In re AG Indus., Inc.*), 279 B.R. 534 (Bankr. S.D. Ohio 2002); *Eyecare of S. California v. Urrea (In re Eyecare of S. California)*, 258 B.R. 765 (Bankr. C.D. Cal. 2001); *Lone Star Indus., Inc. v. Liberty Mut. Ins.,* 131 B.R. 269 (D. Del. 1991); *Citicorp Sav. of Illinois v. Chapman (In re Chapman)*, 132 B.R. 153 (Bankr. N.D. Ill. 1991); *In re Boyer,* 108 B.R. 19 (Bankr. N.D. N.Y. 1988); *Aztec Indus., Inc. v. Standard Oil Co.* (*In re Aztec Indus., Inc.*), 84 B.R. 464 (Bankr. N.D. Ohio 1987); *Gianakas v. Exch. Nat'l Bank of Chicago* (*In re Gianakas*), 56 B.R. 747 (N.D. Ill. 1985). The primary bases for the decisions of these courts are an expanded definition of the term 'district court' and the practicality of not requiring an additional, unnecessary step in the removal process." *Coastal Plains, Inc.,* 338 B.R. at 710–11 (N.D. Tex. 2006). In other words, they followed the "unit" of the district court rational that *Morgan* and *VC Macon* expressly rejected.

C. Is it "No Harm, No Foul?"

Morgan and *VC Macon* did not think so. However, in *Meritage Homes Corp. v. JP Morgan Chase Bank, N.A.,* 474 B.R. 526 (Bank. S.D. Ohio 2012), Judge Hoffman offered a middle approach. In *Meritage*, Judge Hoffman recognized both sides of the split of authority. However, *Meritage* held that the "court need not choose a side in this debate," electing to decide a different issue. *Id.* at 534.[5]

Meritage observed that

[5] *Meritage* raised whether a bankruptcy court has authority to enter a final order remanding or transferring a state court action without the consent of the parties in a non-core matter, or whether the court must submit a report and recommendation to the district court. *Meritage* elected to do the latter.

[a]lthough the United States Court of Appeals for the Sixth Circuit has not addressed the issue, decisions of several other federal courts of appeals support the proposition that the removal of a state court action directly to a bankruptcy court does not require remand and does not result in the bankruptcy court lacking jurisdiction to at least hear the matter. *See Townsquare Media, Inc. v. Brill,* 652 F.3d 767, 770 (7th Cir. 2011) (holding that a state court action "was properly removed" even though it was removed to the bankruptcy court, and stating: "Although section 1452(a) provides for removal to the district court rather than to the bankruptcy court, Bankruptcy Rule 9027, buttressed by standing orders in the district courts (including the district court for the Southern District of Indiana), transfers removed suits from district court to bankruptcy court."); *Geruschat v. Ernst Young LLP (In re Seven Fields Dev. Corp.),* 505 F.3d 237, 246–47 & n. 8 (3d Cir. 2007) ("[W]e do not categorize this filing issue [arising from removal of an action directly to the bankruptcy court] as relating to the bankruptcy court's subject matter jurisdiction. . . . In any event. . . . Federal Rule of Bankruptcy Procedure 9027(a)(1) permits the filing of a notice of removal with the 'clerk,' a term that Rule 9001(3) defines as 'bankruptcy clerk,' and 28 U.S.C. § 1452(a) permits removal to the 'district court,' an entity of which the bankruptcy court is a unit. 28 U.S.C. § 151. . . . We also point out that the Western District of Pennsylvania has a general order referring all bankruptcy cases and proceedings filed in the district to the bankruptcy judges. . . ."); *Specialty Mills, Inc. v. Citizens State Bank,* 51 F.3d 770, 773 n. 4 (8th Cir. 1995) ("The fact that the state court action was removed directly to the bankruptcy court rather than the district court did not deprive the bankruptcy court of jurisdiction."); *Creasy v. Coleman Furniture Corp.,* 763 F.2d 656, 661 n. 5 (4th Cir. 1985) ("We believe . . . that the [Bankruptcy Amendments and Federal Judgeship Act of 1984], which vests the bankruptcy jurisdiction in the district courts on the effective date of the Act, enables the district court to exercise jurisdiction over a removed action even though technically the case was removed to a bankruptcy court, not a district court, as long as the removal is otherwise proper.").[6] *See also Calvary Baptist Temple v. Church Mortg. Acceptance Co., LLC,* 2011 WL 2457405, at *1 (S.D.Ga. June 16, 2011) ("Courts disagree over whether [28 U.S.C. § 1452(a)] requires removal only to the district court for referral to the bankruptcy court or, instead, allows removal directly to the bankruptcy court.... The Court need not decide this issue, and no party has argued that this Court is without jurisdiction to rule on Plaintiff's Motion to Remand. Consistent with the Bankruptcy Judge's report and recommendation, the Court finds that a remand on merely procedural grounds would be a 'waste of judicial resources' and likely result in a second notice of removal to the district court, automatic referral to the bankruptcy court, and a substantially similar and duplicative order by this or the bankruptcy court.").

[6] Is *Creasy* still good law on this point since Bankruptcy Rule 9027(a) was amended in 1987?

Meritage, at 534–35 (Bankr. S.D. Ohio 2012).

III. What are the Lessons here?

The answer is clear as mud. However, know your local rules and practices. The safest route would appear to be to file the notice of removal citing to *Morgan* and *LMRT* in the district court, even if a local rule, practice, or culture provides otherwise. Perhaps the analysis is similar to a statute of limitations problem. It could be a three year limitation. It could be five. If you file within three, you never have to worry about the five.

Nevertheless, be prepared for a call from the clerk of either the district court or the bankruptcy court saying, "that's not the way we do it here." The author has received that phone call. If you stand your ground, the matter (hopefully) should be referred to the bankruptcy court in a fairly timely manner.

Case Law Update for Third Party Releases[1]

I. Implied Consent

In re Aegean Marine Petroleum Network Inc., No. 18-13374, 2019 WL 1527968 (Bankr. S.D.N.Y. Apr. 8, 2019).

- **Background**: Creditors objected to a release provision that the debtor sought to impose on a non-consensual basis. The Plan included an exculpation provision meant to protect court-supervised fiduciaries and other parties from claims based on the restructuring.
    - The broad language released all listed parties from any liability for claims related to any act based on the Chapter 11 cases, the restructuring support agreement, the disclosure statement, the plan, the plan supplement, or "any restructuring transaction, contract, instrument, release, or other agreement or document created or entered into in connection with the disclosure statement or the Plan."
- **Holding**: The exculpation provision insulating "certain parties" from claims related "in any way" to the debtors, "with no exceptions for claims alleging fraud or willful misconduct" could not be confirmed.
- **Reasoning**: "[T]hird-party releases are not a merit badge that somebody gets in return for making a positive contribution to a restructuring. They are not a participation trophy, and they are not a gold star for doing a good job." Releases are intended to immunize certain parties from claims where doing so is important to accomplish restructuring. The court reviewed trends in proposing increasingly broad third-party releases before acknowledging that *Metromedia* required confirmation only in "rare" and "unusual" circumstances. Unlike prior cases, the debtor provided few details that would allow the court to assess the claims being released, their connection to the reorganization, and whether they were necessary to restructuring.
- **Notes:**
    - Like *SunEdison*, this case provides an example of a Southern District of New York case that appears to throttle the use of non-consensual releases.
    - Because releases are granted in return for contributions to reorganization, the court's discussion suggests that a debtor must identify more specifically the benefit gained through the release.

In re CJ Holding Co., 597 B.R. 597 (S.D. Tex. 2019).

- **Background**: The debtor's non-debtor corporate parent sought to enforce a third-party release to enjoin an ex-employee of the debtor from pursuing sexual harassment, discrimination, and retaliation claims against the parent company. The ex-employee received notice of the bar date but never filed a proof of claim and did not object to confirmation of the Chapter 11 Plan.

[1] Case notes from *SunEdison* and *Millennium Lab Holdings* were included from last year's ABI third-party release update prepared by Jane VanLare, partner at Cleary Gottlieb Steen & Hamilton LLP. The assistance of Judge Black's term law clerk, Christopher Hurley, in updating these materials is greatly appreciated.

  - The release provision in the plan expressly included the debtor's parent company as a "released party," and categorized the ex-employee as a "releasing party."
- **Holding**: The court deemed the ex-employee to have consented to the nondebtor release provisions of the plan.
- **Reasoning**: Although the ex-employee did not file a claim, he could have objected or otherwise participated in the case. Under Fifth Circuit precedent, a creditor who does not object to confirmation of a Chapter 11 Plan may not then appeal the confirmation order based on the doctrine of claim preclusion. Accordingly, by failing to file a proof of claim, object to the plan, or attend the hearing on plan confirmation, the Debtor was deemed to have consented to the release provision.
- **Notes**:
  - Although the Fifth Circuit has been restrictive in allowing release provisions in Chapter 11 plans, the district court affirmed the bankruptcy court's decision to confirm the plan with this third-party release.

In re SunEdison, Inc., 576 B.R. 453 (Bankr. S.D.N.Y. 2017).

- **Background**: As part of its Chapter 11 plan, the SunEdison debtors sought approval of certain third-party releases, and included creditors who failed to vote on the plan as releasing parties, on the grounds that such creditors could be deemed to have consented to the releases.
  - The plan defined "releasing parties" as "to the fullest extent permitted by law, all Holders of Claims entitled to vote for or against the Plan that do not vote to reject the Plan."
- **Holding**: The plan may not grant third-party release of claims of non-voting creditors.
- **Reasoning**: The debtors failed to show that the non-voting parties should be deemed to have consented to the releases. Analyzing the issue of deemed consent as a contractual issue, the Court found that the notice in the disclosure statement and ballots stating that failing to vote would constitute implicit consent did not impose a duty to speak on creditors and therefore applied the general rule that, absent a duty to speak, silence does not constitute consent.
- **Notes**:
  - The Second Circuit has previously allowed enforcement of non-consensual third-party releases; however, this opinion may indicate that courts in the Second Circuit will continue to narrow the scope of enforceability of such releases.
  - It is also notable that the Court raised the issue *sua sponte*.

II. Jurisdiction/Constitutional Authority

In re CJ Holding Co., 597 B.R. 597 (S.D. Tex. 2019). (*cont'd*)

- **Background**: An ex-employee of the debtor attempted to sue the debtor's parent company. The parent company argued that the release provisions in the debtor's Chapter 11 Plan effectively enjoined the suit. In response, the ex-employer argued that the bankruptcy court did not have subject-matter jurisdiction, as his claims against the parent company were not "related to" the bankruptcy proceeding.

- **Holding**: The record supported the bankruptcy court's finding that it had "related to" jurisdiction over the ex-employee's claims.
- **Reasoning**: A bankruptcy court has "related to" jurisdiction where the result of the proceeding could have any effect on the bankruptcy estate. In this case, the ex-employee brought claims against the debtor's parent company for harassment and discriminatory conduct during his employment with the debtor. The court recognized that any claims based upon the debtor's conduct, even those brought against the parent company, could ultimately burden the debtor with the costs of litigation; for example, the expense of time-consuming discovery.

In re Fraser's Boiler Service, Inc., Nos. 3:18-CV-05638, 3:18-CV-05637, 2019 WL 1099713 (W.D. Wash. Mar. 8, 2019).

- **Background**: Fraser's, a company that used to manufacture industrial boilers but now exists to pay asbestos claims, filed bankruptcy to sell its insurance policies back to its original insurers. The bankruptcy court approved the sale free and clear of claims related to the policies and enjoined any such claims.
- **Holding**: The bankruptcy court lacked authority to enjoin the third-party claims, as the Ninth Circuit has prohibited all third-party releases.
- **Reasoning**: Ninth Circuit precedent held that third-party releases granted pursuant to § 105(a) were inconsistent with § 524(e), which provides that "discharge of a debt of the debtor does not affect the liability of any other entity on . . . such debt." The district court considered arguments that the Ninth Circuit's decision in *American Hardwoods*, 885 F.2d 621 (9th Cir. 1989), left open the possibility of exceptions to its general rule, but noted that the Circuit's more recent decision in *In re Lowenschuss*, 67 F.3d 1394 (9th Cir. 1995), effectively prohibited all third-party releases. Because the Bankruptcy Code was amended to include only a single exception in § 524(g), third-party releases are prohibited unless they satisfy the requirements § 524(g).

In re Kirwan Offices S.A.R.L., 592 B.R. 489 (S.D.N.Y. 2018).

- **Background**: Two of the three shareholders of the Chapter 11 debtor proposed a plan that included exculpation and injunction clauses enjoining any person from trying to sue the two shareholders on account of any events arising from the bankruptcy proceeding and reorganization. The bankruptcy court confirmed the plan and the third shareholder appealed, arguing that the bankruptcy court lacked subject matter jurisdiction and constitutional authority to consider whether the appellees breached the shareholder agreement governing the parties' legal relationship.
- **Holding**: The bankruptcy court has both core and non-core jurisdiction over the exculpation provisions in the plan and holds the constitutional authority necessary to confirm the plan as proposed.
- **Reasoning**:

    - Release provisions in Chapter 11 Plans do not address the merits of released claims, but effectively cancels those claims to permit reorganization. Moreover, when a bankruptcy court considers a release as part of a plan of reorganization, confirmation of which is a core proceeding and "integral to the integrity of the bankruptcy proceeding," the bankruptcy court had core jurisdiction over the matter.
    - As for constitutional authority, the district court acknowledged that a bankruptcy court cannot enter final orders on non-core matters, or ones that are not "integral to the restructuring of the debtor-creditor relationship." (quoting *Stern v. Marshall*, 564 U.S. 462, 497 (2011)). Nonetheless, it reasoned that the release of the appellant's claim was vital to the debtor's reorganization.
- **Notes**:
    - Before beginning its discussion, the Court identified the current split regarding a bankruptcy court's jurisdictional basis to consider involuntary third-party releases. It then adopted for the Southern District of New York the view that "[a] bankruptcy court acts pursuant to its core jurisdiction when it considers the involuntary release of claims against a third party, non-debtor in connection with the confirmation of a proposed plan of reorganization."
    - The Court also briefly considers the matter of whether the appellant consented to the release provision. It suggested that the appellant acted in bad faith throughout the proceedings in bankruptcy court and noted that where "a party knowingly fails to participate in a proceeding, he impliedly consents to the entry of a final order in that proceeding."

In re SunEdison, Inc., 576 B.R. 453 (Bankr. S.D.N.Y. 2017). (*cont'd*)

- **Background**: The third-party releases included past and future claims against an expansive list of third parties and also extended to a list of unidentified current and former affiliates, employees and advisors of the identified released third parties.
- **Holding**: The Court held it has limited jurisdiction to grant broad third-party releases. Specifically, it does not have jurisdiction over third-party claims that would not give rise to contribution or indemnification against the debtor's estate.
- **Reasoning**:
    - The Court considered whether it had jurisdiction over the proposed release of creditors' unasserted claims against third parties and whether exercise of such jurisdiction would be proper. The Court noted that even if a bankruptcy court has jurisdiction over releases of third-parties' unasserted claims, exercise of such jurisdiction is proper only in rare and unique circumstances.
    - The Court concluded that it did not have jurisdiction over third-party claims that would not give rise to contribution or indemnification claims against the debtor's estate because such claims do not have a "conceivable effect" on the estate for purposes of a bankruptcy court's "related to" jurisdiction.
- **Notes**:

- The Court analyzed whether it had "related to" jurisdiction under 28 U.S.C. § 1334. The opinion cited to precedent that the "touchstone" issue for bankruptcy jurisdiction over a non-debtor's claim is whether the "outcome might have any conceivable effect on the bankruptcy estate."
- The Court relied on the framework established by the Second Circuit in *Deutsche Bank AG v. Metromedia Fiber Network, Inc.*, 416 F.3d 136 (2d Cir. 2006), which held nonconsensual third-party releases are proper only in "rare and unique circumstances."

In re Millennium Lab Holdings II, LLC, 575 B.R. 252 (Bankr. D. Del. 2017), *aff'd* 591 B.R. 559 (D. Del. 2018).

- **Background**: Chapter 11 Plan included a non-consensual third-party release that released common law fraud and RICO claims against the debtor's former equity holders. The creditors argued that the bankruptcy court did not have authority to grant the releases pursuant to the Supreme Court's 2011 ruling in *Stern v. Marshall*, 564 U.S. 462 (2011). The creditor argued that granting the release in this case would be tantamount to adjudicating a state law claim.
- **Holding**: *Stern* analysis is inapplicable to a plan confirmation because the "operative proceeding" in this case was the confirmation of a plan, and not the underlying lawsuit.
- **Reasoning**:
  - Both the bankruptcy court and district court reasoned that approving the release was not an adjudication of the creditor's state-law claim on the merits. The releases had only a collateral impact on the RICO lawsuit, because they provided the shareholders with a defense in that lawsuit.
  - A bankruptcy order that merely "impacts a litigant's state law claim" does not violate *Stern.* Additionally, because "confirmation of plans is an enumerated core proceeding," the bankruptcy court has "statutory authority to enter a final judgment."
- **Notes**:
  - The bankruptcy court read *Stern* as largely consistent with the Supreme Court's decision in *Northern Pipeline Construction Co. v. Marathon Pipe Line Co.*, 458 U.S. 50 (1982). The bankruptcy court also cited a number of other Delaware bankruptcy court opinions that interpreted *Stern* narrowly.

The Small Business Reorganization Act of 2019

On April 9, 2019, Sen. Charles Grassley (R-IA) introduced Senate Bill 1091, the Small Business Reorganization Act of 2019 ("SBRA"). At present, the SBRA has bi-partisan support in the Senate, with co-sponsors including Sen. Sheldon Whitehouse (D-RI), Sen. Thom Tills (R-NC), Sen. Amy Klobuchar (D-MN), Sen. Ernst Joni (R-IA), Sen. Richard Blumenthal (D-CT), and Sen. Marsha Blackburn (R-TN). The Bill was referred to the Senate Judiciary Committee upon introduction. A similar bill was introduced in the House by Rep. Doug Collins (R-GA) and Rep. David Cicilline (D-RI) late in the last Congress, but no action was taken on the 2018 bill before the new Congress came into office If the SBRA gets traction in the Senate, a companion bill is expected to be introduced in the House.

A summary of the bill provided by Senate Judiciary staff provides that "Chapter 11 was designed for administering complex business reorganizations involving multi-million dollar companies. Despite containing several provisions specifically focused on small business debtors, there has been a significant amount [of] research showing that Chapter 11 may still create difficulties for small businesses, including high costs, monitoring deficits, and procedural roadblocks. The SBRA will add a new subchapter V to Chapter 11 to address these issues, leading to more successful restructurings, reducing liquidations, and increasing recoveries to creditors."

One of the intended goals of the bill is to increase a debtor's ability to negotiate a successful reorganization and retain control of the business. In furtherance of that goal, the SBRA makes the following modifications and additions to Chapter 11:

I. The Debtor

The "debtor" under new subchapter V means a "small business debtor." 11 U.S.C. § 1182.[1] That term is defined in the Bankruptcy Code as a person engaged in commercial or business activity that has aggregate or noncontingent liquidated secured and unsecured debts as of the filing date of not more than $2,566,050.[2] See 11 U.S.C. § 101(51D).

[1] The references to the proposed new code sections are to their proposed Title 11 section numbers.

[2] Pursuant to 11 U.S.C. § 104, the debt limit was indexed upward on April 1, 2019 to $2,725,625. https://www.federalregister.gov/documents/2019/02/12/2019-01903/revision-of-certain-dollar-amounts-in-the-bankruptcy-code-prescribed-under-section-104a-of-the-code.

II. The Trustee

If the United States Trustee has appointed a standing trustee, that individual shall serve as a trustee in a subchapter V case. If there is no standing trustee, the United States Trustee shall appoint a disinterested person to serve as the trustee in the case. 11 U.S.C. § 1183.[3]

Pursuant to paragraphs (2), (5), (6), (7), and (9) of Section 704(a) of the Bankruptcy Code, the trustee in a SBRA case will (i) be accountable for all property received; (ii) examine proofs of claims and object to the allowance of any claim that is improper; (iii) if advisable, oppose the discharge of the debtor; (iv) furnish such information concerning the estate and the estate's administration as necessary; and (v) make a final report and file a final account of the administration of the estate with the court and the United States Trustee. 11 U.S.C. § 1183(b)(1).

The trustee would perform the duties under paragraphs (3), (4), and (7) of section 1106(a) of the Bankruptcy Code. Those duties include investigating the acts, conduct, assets, liabilities, and financial condition of the debtor, the operation of the debtor's business and the desirability of the continuance of such business, and any other matter relevant to the case or the formulation of a plan. The trustee would file a statement of any investigation conducted, including anything related to fraud, dishonesty, incompetence, misconduct, mismanagement, or irregularity in the management of the debtor's affairs and transmit a copy or a summary to any creditors' committee or equity security holders' committee, to any indenture trustee, and to such other entity as the court designates. Further, after confirmation of a plan, the trustee would file such reports as are necessary or as the court orders. 11 U.S.C. § 1183(b)(2).

The trustee would appear and be heard at the status conference and any hearing concerning the value of property subject to a lien, confirmation of a plan, modification of a plan after confirmation, or the sale of property of the estate. 11 U.S.C. § 1183(b)(3).

The trustee would ensure the debtor makes timely payments required by a plan. 11 U.S.C. § 1183(b)(4).

If the debtor ceases to be a debtor in possession, the trustee would file periodic operating reports under section 704(a)(8) of the Bankruptcy Code, including operating the business of the debtor. 11 U.S.C. § 1183(b)(5).

If there is a claim for a domestic support obligation with respect to the debtor, the trustee would perform the duties specified in section 704(c) of the Bankruptcy Code. 11 U.S.C. § 1183(b)(6).

The trustee is also charged with the ability to facilitate the development of a consensual plan. 11 U.S.C. § 1183(b)(7).

The trustee's duties would terminate when the plan has been substantially consummated, unless reappointed by the United States Trustee for cause. Notice of substantial consummation

[3] Presumably this will be done by the Bankruptcy Administrator in Alabama and North Carolina, which do not have United States Trustees.

of the plan is to be given by the debtor to the trustee, the United States Trustee, and all parties in interest, no later than 14 days after substantial confirmation has occurred. 11 U.S.C. § 1183(c)(1), (2).

III. Rights and Powers of a Debtor in Possession

Proposed Section 1184 would provide the debtor in possession with all the rights and powers of a trustee, including operating the business of the debtor, other than the right to compensation under section 330 of the Bankruptcy Code and the duties specified in paragraphs (2) (file the list of creditors and schedules and statements), (3) (investigate the debtor), and (4) (file a statement of any investigation) of section 1106(a) of the Bankruptcy Code, of a trustee. 11 U.S.C. § 1184.

IV. Removal of a Debtor in Possession

Subsection (a) of proposed Section 1185 would allow a party in interest to seek removal of the debtor in possession for cause, including fraud, dishonesty, incompetence, or gross mismanagement of the affairs of the debtor, either before or after the date of commencement of the case, or for failure to perform the obligations of the debtor under a plan confirmed under subchapter V. Proposed subsection (b) would allow a party in interest to seek reinstatement of the debtor in possession. 11 U.S.C. § 1185.

V. Property of the Estate

Subsection (a) of proposed Section 1186 provides that in addition to property set forth under section 541 of the Bankruptcy Code, property of the estate also includes property the debtor acquires, and earnings for services performed by the debtor, after the commencement of the case but before the case is closed, dismissed, or converted to a case under chapter 7, 12, or 13. Subsection (b) provides that the debtor shall remain in possession of all property of the estate unless the debtor is removed under section 1185 of subchapter V or as provided in a confirmed plan or an order confirming a plan. 11 U.S.C. § 1186.

VI. Reporting Requirements

Proposed Section 1187(a) would require that the debtor file the most recent balance sheet, statement of operations, cash-flow statement, and Federal income tax return or a statement made under penalty of perjury that no balance sheet, statement of operations, or cash-flow statement has been prepared and no Federal tax return has been filed. Proposed subsection (b) would require the debtor to (i) comply with the financial reporting requirements of section 308 of the Bankruptcy Code, (ii) attend meetings scheduled by the court or the United States Trustee, including initial debtor interviews, scheduling conferences, and meetings of creditors convened under section 341 of the Bankruptcy Code, (iii) timely file all schedules and statements of financial affairs, file all postpetition financial and other reports required by the Federal Rules of Bankruptcy Procedure or by local rule of the district court, (iv) maintain insurance customary and appropriate to the industry, (v) timely file tax returns and other required government filings and timely pay all taxes entitled to administrative expense priority except those being contested by appropriate proceedings being diligently prosecuted, and (vi) allow the United States Trustee to inspect the debtor's business premises, books, and records.

Subsection (c) of proposed Section 1187 would provide that if the court orders that the disclosure statement requirement under section 1225 of the Bankruptcy Code applies, then section 1125(f) shall also apply, allowing the debtor to use the plan as the disclosure statement, submit a plan based on a standard form, and have a disclosure statement conditionally approved subject to final approval at a combined disclosure statement/plan confirmation hearing. 11 U.S.C. § 1187.

VII. Status Conference

Proposed Section 1188(a) would provide that the court should hold a status conference not later than 60 days after the order for relief is granted in the case. Proposed subsection (b) would allow the court to extend the 60 day deadline based on circumstances for which the debtor should not justly be held accountable, and subsection (c) requires the debtor to file a report detailing the debtor's efforts to attain a consensual plan of reorganization not later than 14 days prior to the status conference. 11 U.S.C. § 1188.

VIII. Filing of the Plan

Subsection (a) of proposed Section 1189 provides that only a debtor may file a plan, and subsection (b) provides that the debtor shall file the plan not later than 90 days after the order for relief is entered in the case. The court may extend the 90 day deadline based on circumstances for which the debtor should not justly be held accountable. 11 U.S.C. § 1189.

IX. Contents of the Plan

Subsection (1) of proposed Section 1190 would require that a plan include a brief history of the business operations of the debtor; a liquidation analysis, and projections with respect to the ability of the debtor to make payments under the proposed plan. Subsection (2) would require that the plan provide that all future earnings of the debtor, or such portion as necessary under the plan, be placed under the supervision and control of the trustee. Subsection (3) would allow the debtor to modify the rights of a secured creditor, including a secured creditor with a claim against the principal residence of the debtor if the original value received from the creditor was not used to purchase the residence, but was used primarily in connection with the small business. 11 U.S.C. § 1190.

X. Confirmation of the Plan – Cramdown Eliminated "if"

Subsection (a) of proposed Section 1191 would provide that a plan may be confirmed if all the requirements of section 1129(a) of the Bankruptcy Code are met, other than paragraph (15), which applies to individuals. In addition, subsection (b) would allow a plan to be confirmed without an impaired accepted class of creditors or over an objecting class of creditors, *provided that all* (i) the other requirements of section 1129(a) of the Bankruptcy Code are met, (ii) the plan does not discriminate unfairly, and (iii) is "fair and equitable" with respect to each impaired class of claims or interests that has not accepted the plan.

Subsection (c) provides that for a plan to be "fair and equitable" with respect to each class of claims or interest, it must include the following requirements: (i) satisfy section 1129(b)(2)(A) of the Bankruptcy Code, which sets forth the standard for a fair and equitable treatment of a dissenting class of secured creditors, (ii) provide that all the projected disposable income (defined below) of the debtor to be received in the 3-year period, or such longer period not to exceed 5 years as the court may fix, will be applied to make payments under the plan or the value of property to be distributed under the plan in the 3-year period, or such longer period not to exceed 5 years as the court may fix, is not less than the projected disposable income of the debtor, (3) provide that the debtor will, or there is a reasonable likelihood that the debtor will, be able to make all payments under the plan, and (iv) contain appropriate remedies in the event payments are not made, which may include the liquidation of nonexempt assets.

Subsection (d) defines "disposable income" as the income that is received by the debtor and that is not reasonably necessary to be expended for: the maintenance or support of the debtor or a dependent of the debtor; a domestic support obligation that first becomes payable after the commencement of the case; or for the payment of expenditures necessary for the continuation, preservation, or operation of the business of the debtor. 11 U.S.C. § 1191.

XI. Discharge

Proposed Section 1192 provides that if a plan is confirmed under section 1191(b) of subchapter V, the debtor is entitled to a discharge as soon as practicable after completion by the debtor of all payments due within the first 3 years of the plan, or such longer period not to exceed 5 years as the court may fix, unless the court approves a written waiver of discharge. The discharge does not apply to debts where the last payment is due after the first 3 years of the plan, or such other time not to exceed 5 years fixed by the court, or debts specified under section 523(a) of the Bankruptcy Code. 11 U.S.C. § 1192.

XII. Modification of the Plan

Proposed subsection 1193(a) would allow the debtor to modify the plan prior to confirmation, if the plan continues to meet the requirements of Bankruptcy Code sections 1122 (classification of claims or interests) and 1123 (contents of a plan), with the exception of subsection (a)(8) of section 1123 (relating to individuals). In turn, Subsection (b) would allow the debtor to modify a plan confirmed under section 1191(a) of subchapter V before substantial consummation if the plan continues to meet the requirements of Bankruptcy Code sections 1122 (classification of claims or interests) and 1123 (contents of a plan), with the exception of subsection (a)(8) of section 1123 (relating to individuals). Circumstances would be required to warrant the modification and the modification must be approved by the court under section 1191(a) of subchapter V.

Subsection (c) would allow the debtor to modify a plan confirmed under section 1191(b) of subchapter V at any time within 3 years, or such longer time not to exceed 5 years, as fixed by the court, if the plan continues to meet the requirements under section 1191(b). Circumstances would have to warrant the modification and the modification must be approved by the court under section 1191(b) of subchapter V. Subsection (d) would provide that if a plan has been confirmed under section 1191(a) of subchapter V, any holder of a claim or interest that has accepted or rejected the plan is deemed to have accepted or rejected, as the case may be, the plan as modified, unless, within the time fixed by the court, such holder changes the previous acceptance or rejection of the holder. 11 U.S.C. § 1193.

XIII. Payments under the Plan

Proposed Section 1194(a) would provide that the trustee shall retain all payments and funds until a plan is confirmed and then distribute such payments and funds in accordance with the plan. If a plan is not confirmed, the trustee shall return any payments and funds to the debtor after deducting any unpaid administrative claims under section 503(b) of the Bankruptcy Code, any adequate protection payments due to a secured creditor, and any fees owed to the trustee. Subsection (b) provides that if a plan is confirmed through cramdown, the trustee shall distribute payments and funds in accordance with the plan. Subsection (c) allows the trustee to make an adequate protection payment to a secured creditor after notice and a hearing. 11 U.S.C. § 1194.

XIV. Transactions with Professionals

Section 1195 as proposed would not disqualify a professional from being retained by the debtor solely because that person holds a claim of less than $10,000 against the debtor that arose prior to commencement of the case. 11 U.S.C. § 1195.

XV. Preferences and Venue of Certain Proceedings

The following provisions were not in early drafts of the bill, but were added later before the final bill was filed. They are not confined to small business cases.

A. Modification of 11 U.S.C. § 547(b)

Existing Section 547(b) of the Bankruptcy Code would be modified to provide that any preference action brought by a trustee must be based on reasonable due diligence in the circumstances of the case and take into account a party's known or reasonably knowable affirmative defenses under section 547(c) of the Bankruptcy Code.

B. Small Claims Venue

Section 1409(b) of title 28, which requires the commencement of a recovery proceeding for a debt (excluding a consumer debt) less than $10,000 be brought in the district court for the district in which the defendant resides, would be increased to $25,000.

2019 ABI Southeast Bankruptcy Workshop
Business Update[1]

I. **Debtor in Possession Financing: DIP financing order did not establish validity or priority of third-party claim.** Schwartz v. J.J.F. Mgmt. Servs., Inc., No. 18-2160, 2019 WL 1890984, at *5 (4th Cir. Apr. 29, 2019). This appeal arose from a longstanding battle between J.J.F. Management Services and its subsidiary, Rent-a-Wreck America ("RAWA"), and David Schwartz, a RAWA territorial franchise owner. The district court awarded Schwartz $84,000 against RAWA for contempt. RAWA then filed for bankruptcy, staying Schwartz's collection efforts. The bankruptcy court approved debtor in possession ("DIP") financing with J.J.F. but ultimately dismissed the case, finding that RAWA was not insolvent and did not file its petition in good faith. Once the stay lifted, Schwartz garnished two RAWA deposit accounts. J.J.F. claimed a superior interest in the accounts, citing the DIP order. The district court sought evidence of J.J.F.'s bona fide interest in the accounts under Maryland law. J.J.F. produced a copy of the DIP order but did not offer evidence of any advances under the approved DIP loans or previous collection attempts. The district court found for Schwartz and the Fourth Circuit affirmed, holding "that J.J.F. had not produced evidence that money ever changed hands between J.J.F. and RAWA." In the absence of any evidence that the lien secured any debt or that any money actually had been advanced or was owed, no claim of bona fide interest would carry.

II. **Subject Matter Jurisdiction: no derivative standing for unsecured creditors' committee as against an LP or LLC.** Gavin/Solmonese LLC v. Citadel Energy Partners, LLC, (In re Citadel Watford City Disposal Partners), Ch. 11 Case No. 15-11323-KJC, Adv. Proc. No. 17-50024-KJC (Bankr. D. Del. May 2, 2019). The debtors—a limited partnership formed under Delaware law, two limited liability companies formed under North Dakota law, and one limited liability company formed under Wyoming law—filed a petition for bankruptcy under chapter 11. Pursuant to a proposed plan of liquidation, the debtors sought to create a liquidation trust and to appoint a trustee. The trust agreement provided that the trustee would be "authorized and empowered" to pursue any causes of action, "including all pending adversary proceedings . . . involving Trust Assets" and would be "substituted as the real party in interest in any such action, commenced by or against the Debtors, the Debtors estate or the Creditors' Committee." The unsecured creditors' committee commenced this adversary proceeding on February 6, 2017, asserting breaches of fiduciary duties against defendants. The plan was confirmed on February 23 and became effective on March 9, 2017. On April 17, the trustee moved to amend the caption to the adversary proceeding in order to list the trustee and not the committee. The court granted the motion. Defendants then moved to dismiss for lack of standing. Relying on the internal affairs doctrine as applicable in Delaware, the court reviewed the laws of each entity and determined that the trustee did not have derivative standing to assert the complaint. Under Delaware partnership law, as well as the limited liability company acts of North Dakota and Wyoming, a plaintiff must be a partner or an assignee of a partnership interest, or a member or manager respectively, at the time of bringing the action. Here, the committee did not have derivative standing to bring the causes of action at the time the claim was filed and, as such, neither did the trustee.

[1] These materials were prepared by Jamey M. Lowdermilk, law clerk to Benjamin A. Kahn, United States Bankruptcy Judge for the Middle District of North Carolina. Ms. Lowdermilk received her undergraduate Bachelor of Arts degree from The University of the South-Sewanee, a Master's of Science in Applied Economics and Statistics from Clemson University, and a Juris Doctor with Honors from the University of North Carolina School of Law. After completion of her clerkship, Ms. Lowdermilk will join Brooks, Pierce, McLendon, Humphrey & Leonard, LLP as an associate.

III. Retention Issues

A. **Advising debtor and managing sales not "professional" under § 327(a).** In re Heritage Home Grp., LLC, 2018 WL 4684802 (Bankr. D. Del. Sept. 27, 2018). The debtors moved to retain a company to assist with sales of several businesses under §§ 105(a) and 363(b), which the trustee opposed. The court explored two camps of reasoning: a qualitative analysis and a quantitative analysis. See In re First Merchants Acceptance Corp., No. 97-1500 JJF, 1997 WL 873551, at *2 (D. Del. Dec. 15, 1997). Under the qualitative approach, a "professional" is an employee with discretion or autonomy over some part of the debtor's estate. Under the quantitative approach, a "professional" "play[s] a central role in the administration of the debtor proceeding, . . . not [including] those occupations which are involved in the day-to-day mechanics of the debtor's business." Id. The goal of both approaches is the same: determining whether an application for employment must adhere to the conflict of interest provisions and related disclosure requirements under § 327(a). Such analysis adheres to the J. Alix Protocol, which encompasses key ethical and disclosure components for retention applications pursuant to a settlement with the United States Trustee Program: (1) independence from the corporation's board, (2) absence of any actual conflict of interest, (3) disclosure of connections with parties and professionals, and (4) court review of proposed fees as reasonable. See Clifford J. White III, et al., The Future of the USTP's CRO "Protocol," XXXVII Am. Bankr. Inst. J. 9, 60 (Sept. 2018). Under the J. Alix Protocol, trustees typically resolve concerns without formal objections. However, over the trustee's objection, the bankruptcy court in In re Nine West Holdings, Inc., 588 B.R. 678 (Bankr. S.D.N.Y. 2018), permitted retention under § 363(b) despite the applicant's service on a board of one of the debtors. Id. at 685. The court reasoned that the director's role was administrative only and that the applicant had materially complied with the J. Alix Protocol. Further, the applicant's involvement in the day-to-day operations of the business for the four previous years made continued employment necessary to the reorganization and established an absence of intimate involvement in restructuring to require an application under § 327. Id. at 692-95. Relying on Nine West, the court in Heritage Home granted the debtors' motion for retention under § 363(b). The applicant's role involved recommending discounts and loss prevention strategies, providing qualified supervision, maintaining communication, establishing and monitoring accounting functions, and otherwise advising the debtors and coordinating the sales. The court found that such activities did not rise to the heightened level of authority and control over the sale such that the applicant was intimately involved in the debtors' plans.

B. **Business conducting going out of business sales not a professional.** In re Brookstone Holdings Corp., 592 B.R. 27 (Bankr. D. Del. 2018). Debtor moved to assume prepetition store closing agreement with Hilco to continue going out of business sales under the agreement. The United States Trustee ("UST") filed a limited objection, asserting that Hilco was a professional for purposes of § 327(a). Hilco's obligations under the agreement included recommending pricing and discounts, advertising, supervising the sale, communicating with the debtor's store operating team, and recommending loss prevention strategies and staffing levels. Debtor would pay Hilco commissions and incentive fees, and would reimburse Hilco for expenses under the terms of the agreement. The UST argued that Hilco was an auctioneer or an "other professional" as contemplated by § 327(a). The court first rejected the argument that Hiclo was an auctioneer, looking to the Oxford English Dictionary's definition. Likewise, Judge Shannon relied on the six factors set out in First Merchants to reject the argument that Hilco was an "other professional." Applying the First Merchants factors, the court determined in essence that Hilco did not have sufficient autonomy or authority over the debtor's operations to constitute a professional under § 327(a) and overruled the UST's objection.

C. **Qualified indemnification approved for a financial advisor subject to the court's authority.** In re Morehead Mem'l Hosp., Ch. 11 Case No. 17-10775, ECF No. 184 (Bankr. M.D.N.C. Aug. 29, 2017). While recent decisions permit indemnification under certain circumstances, courts initially expressed skepticism. See, e.g., In re Drexel Burnham Lambert Grp., Inc., 133 B.R. 13 (Bankr. S.D.N.Y. 1991) (finding indemnification inconsistent with professionalism in that trustees hire professionals for their special expertise and such professionals should be especially diligent in meeting the standard of care for exercising their expertise). In United Artists Theatre Co. v. Walton, the Third Circuit permitted indemnification for common negligence. 315 F.3d 217 (3d Cir. 2003). Recognizing that § 330 provides for reasonable compensation based on market driven rates, the court looked to Delaware corporate law for guidance on what qualifies as reasonable. When evaluating alleged negligence on the part of directors, Delaware courts review the decision-making process—not the result—for good faith and rationality. Known as the business judgment rule in corporate law, Delaware courts refrain from interfering with the advice of financial advisors if the advisors (1) have no personal interest in the outcome, (2) have a reasonable awareness of available information after prudent consideration of alternative options, and (3) provide the advice in good faith. Adapting this analysis, the Third Circuit approved as reasonable the debtors' indemnification, which protected the financial advisors from liability for common negligence while specifically excepting from indemnity any gross negligence or contractual disputes with the debtors.

Applying the reasoning of United Artists, the court in In re Baltimore Emergency Services II, LLC set forth six limitations prior to approving the proposed indemnification agreement as reasonable. 291 B.R. 382 (Bankr. D. Md. 2003). The debtors sought to protect the financial advisor for "any losses, claims, damages, expenses and liabilities whatsoever" except those resulting "primarily" from bad faith, gross negligence, and willful misconduct. The agreement also withheld indemnification for contract or tort losses except where such losses arose "primarily" from bad faith, gross negligence, and willful misconduct. Subsequent amendments excluded claims arising "solely from . . . gross negligence or willful misconduct." The court ordered as follows: (1) removal of any limitation on exclusions for gross negligence, (2) reincorporation of bad faith, (3) express exclusion of contractual disputes, (4) removal of any disclaimer on the financial advisor's hired services, (5) affirmative recognition that the financial advisor is not protected from breaches of its fiduciary duties of loyalty and care, and (6) evidence that the proposed provisions are necessary and reasonable for the debtors' reorganization. For purposes of the ruling, the court accepted the parties' assumption that the proposed indemnification was a market driven necessity and with the limitations discussed, approved the indemnification agreement as reasonable.

Following United Artists and Baltimore, the court in Morehead granted limited indemnification. The debtor's financial advisor sought to limit its liability pursuant to several documents in its engagement application. In what the financial advisor referred to as its "standard" consulting terms, ¶1.(a) indemnified the advisor against any third party claims arising from but not limited to misrepresentations or false or incomplete information provided by the debtor. Subparagraph (b) limited the debtor's recovery against the advisor "for any claim, including but not limited to, [the advisor's] negligence, [from] exceed[ing] the fee it receives for the portion of the work giving rise to such liability." Subparagraph (d) applied the terms of ¶1 to any claim regardless of its nature, including contract, except where the advisor "committed willful or reckless misconduct, or gross negligence." In ¶8, the advisor committed to performance on a reasonable professional efforts basis. Paragraph 9.(c) contemplated parties having to sign a release in order to receive information developed by the advisor. The retention application also included certain "additional" terms. Paragraph 2 outlined business risk allocations, which would apply regardless of the nature of the claim, including but not limited to claims in contract. Subparagraph (a) provided that liability "for all claims, including but not limited to the [advisor]'s own negligence, shall not exceed the fees payable for the portion of the work giving rise to such liability." Under subparagraph (b), the debtor released the advisor for liability from consequential damages. Subparagraph (c) required the debtor to hold the advisor harmless for any liability "associated with any claim arising from or relating to: . . . (ii) any third party claims related to Services provided under this Agreement." Paragraph 11 required the parties to waive any right to a jury should a dispute arise and further compelled arbitration if the earlier provisions proved prohibited by law.

The court expressed concern about the breadth of certain indemnification provisions and the absence of key terms in others, and required evidence on market standards for releases of consequential damages. The court noted the inconsistency arising from the advisor's warranty under ¶9, which contradicted the limitations provided for in ¶1 as to third parties. Initially, the court granted the application on an interim basis, providing that any right to indemnity and release would not arise and therefore did not apply until such claims came before the court. Further, the court reserved final determination of the reasonableness of the fees proposed once the advisor filed applications under §§ 328, 330, and 331. By final order, the court struck ¶1.(a) and (c) of the consulting terms and ¶2.(c) of the tax terms, inserting revised language with express exclusions for gross negligence, willful misconduct, or fraud. The court revised ¶1.(b) of the consulting terms and ¶2.(a) of the tax terms with a sentence limiting the advisor's total liability to the amount received as payment for all services under the agreement. The court deleted ¶2.(b) in its entirety. The court added that nothing provided in the modifications of ¶1.(a) would be construed to limit the advisor's obligations under the warranty provided in ¶8. Finally, the court struck ¶11 of the tax terms and reiterated the court's authority over the allowance, disallowance, or disgorgement of professional fees in the case. Pursuant to those modifications, the court approved the advisor's engagement application.

D. "Connections" under Rule 9014 include related entities invested in case. By mediated settlement, the United States Trustee Program (USTP) agreed to release McKinsey Recovery & Transformation Services from actual or potential claims of noncompliance with Rule 9014 in exchange for McKinsey's disgorgement of $15 million. Old ANR, LLC., ECF No. 43, Miscellaneous Proceeding No. 19-00302-KRH (Bankr. E.D. Va. Apr. 18, 2019) ("Old ANR"). The settlement resolved pending allegations in three bankruptcy cases: (1) In re Alpha Nat. Res., Inc., Ch. 11 Case No. 15-33896 (Bankr. E.D. Va. Aug. 3, 2015) ("ANR"), (2) In re SunEdison, Inc., et al., Ch. 11 Case No. 16-10992 (Bankr. S.D.N.Y. Apr. 21, 2016), and (3) Westmoreland Coal Co., Ch. 11 Case No. 18-35672 (Bankr. S.D. Tx. Oct. 9, 2018).

In ANR, the debtors applied to retain McKinsey as a turnaround advisor. Mar-Bow Value Partners, an entity owned and funded by Jay Alix, the founder of Mckinsey-competitor AlixPartners, entered the case by filing a claim for $1.25 million.[2] Mar-Bow and the trustee lodged several challenges alleging inadequate disclosure. The challenges sought the identity of previously undisclosed entities and investment relationships between MIO Partners, Inc., which serves McKinsey's pension plans, and interested parties. The bankruptcy court ordered an in camera review, including the trustee but excluding Mar-Bow, to enforce Rule 9014 without undermining McKinsey's business model of confidentiality. Upon review, the court found McKinsey to be disinterested and the case proceeded. Mar-Bow appealed, which the district

[2] As described by the bankruptcy court, "Mar-Bow held less than 0.025% of the Debtors' pre-Petition Date debt." OLD ANR, 2019 WL 2179717, at *7 n.24. Jay Alix, initially a principal of Mar-Bow, now sits on the investment firm's board and holds approximately one third of its stock.

court denied on an absence of standing. Mar-Bow Value Partners, LLC v. McKinsey Recovery & Transformation Servs. US, LLC, No. 3:16CV799, 2017 WL 4414155, at *2 (E.D. Va. Sept. 30, 2017). The Fourth Circuit affirmed and the Supreme Court denied certiorari. 736 F. App'x 412, 413 (4th Cir. 2018) (finding no reversible error), cert. denied sub nom. No. 18-974, 2019 WL 342275 (U.S. Apr. 22, 2019).

Meanwhile, in 2018, Mar-Bow moved to reopen the case, alleging McKinsey indirectly profited from the debtors' confirmed plan due to investments made by MIO. The trustee supported the motion and, following a hearing, the court reopened the case and ordered the in camera disclosures docketed on the public record. Old ANR, ECF No. 2 (Bankr. E.D. Va. Jan. 16, 2019). Subsequently, based on similar allegations in SunEdison and Westmoreland, the courts in all three cases ordered mediation between the USTP and McKinsey. By settlement, McKinsey agreed to pay $15 million with $5 million distributed to the reorganized debtors in ANR and SunEdison and $5 million distributed to the bankruptcy estates in Westmoreland. The USTP released McKinsey from all claims in which the USTP alleged failure to comply with Rule 9014. The release applied to fourteen bankruptcy cases pending across the country, though the USTP reserved its right to object to McKinsey's disinterestedness or its retention in Westmoreland on any grounds other than its past retention-related disclosures.

The ABI's National Ethics Task Force addressed the issue faced by McKinsey some years ago. According to the Task Force,

> the purpose of Rule 2014(a) is to provide the court and the United States trustee with information to determine whether the professional's employment is in the best interest of the estate. . . . Rule 2014 disclosures are to be strictly construed and failure to disclose relevant connections is an independent basis for the bankruptcy court to disallow fees or to disqualify the professional from the case.

Lois R. Lupica & Nancy B. Rapoport, Am. Bankr. Inst., Final Report of the ABI Nat'l Ethics Task Force 1 (2013). As a result, professionals must disclose actual and potential conflicts of interest without exercising discretion as to which connections may be "relevant." See also In re Gluth Bros. Const., Inc., 459 B.R. 351, 364 (Bankr. N.D. Ill. 2011) ("No matter how trivial a connection appears to the professional seeking employment, it must be disclosed.'") (quoting In re Envirodyne Indus., Inc., 150 B.R. 1008, 1021 (Bankr. N.D. Ill. 1993)).

By proposal, the Report describes the universe of connections for actual or potential conflicts as including, in addition to the debtor and other categories, any creditors of the estate; parties that are or were insiders of the debtor within two years prepetition; and any investment banker for any outstanding security of the debtor. The report then defined a relevant connection as any connection within that universe that generated a material amount of income or transfers within two years prepetition; involved or was related to property of the estate with a material value; or involved a material business venture with the person or entity. Finally, any threshold used to determine materiality would be set forth in the professional's application for review.

IV. **Executory contracts: rejection under § 365(a) does not terminate licensee's trademark rights if such rights would survive the licensor's breach under applicable nonbrankruptcy law.** Mission Prod. Holdings, Inc. v. Tempnology, LLC, No. 17-1657, --- U.S. ---, 2019 WL 2166392, at *2 (U.S. May 20, 2019) (finding that "rejection breaches a contract but does not rescind it"). The Supreme Court resolved a specific question in Tempnology—whether rejection of an executory contract terminates the rights of a licensee—on which the circuits disagreed. In the underlying bankruptcy case, debtor sought to reject an agreement under § 365(a) that gave Mission Product Holdings a nonexclusive, nontransferable license to use the debtor's trademarks. Mission objected, asserting its right to retain the intellectual property license under § 365(n). The bankruptcy court overruled Mission's objection, citing the absence of "trademark" from the Code's definition of "intellectual property" under § 101(35A). Mission appealed and the Bankruptcy Appellate Panel reversed.

The BAP agreed that § 365(n) did not protect trademarks. However, following the Seventh Circuit in Sunbeam Products, Inc. v. Chicago American Manufacturing, LLC, 686 F.3d 372 (7th Cir. 2012), the Panel found that rejection under § 365(a) did not necessarily terminate Mission's rights. Instead, according to the BAP and Sunbeam, § 365(g) provides a general rule: rejection merely constitutes a breach, not a rescission. The First Circuit reversed, relying in part on Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc., 756 F.2d 1043 (4th Cir. 1985). In Lubrizol, the Fourth Circuit determined that the legislative history to § 365(g) "makes clear that the purpose of the provision is to provide only a damages remedy for the non-bankrupt party." Id. at 1048. On this, the First Circuit agreed. The court additionally reasoned that the unique characteristics of trademark law favored against an alternative interpretation.

The Supreme Court reversed and remanded, siding with the Seventh Circuit's reasoning in Sunbeam. The Court first addressed Tempnology's argument that the case was moot. In the intervening years, the licensing agreement expired by its own terms. Mission, however, asserted a claim for damages as lost profits. Writing for the majority, Justice Kagan found such a claim, even if tenuous in both efficacy and collectability, constitutes "a live controversy." Justice Gorsuch dissented in five paragraphs, counseling against reaching the merits "where [the Court's] jurisdiction is so much in doubt." Tempnology, 2019 WL 2166392, at *10. For Justice Gorsuch, Mission's claim for damages was too speculative given that "petitioning a court normally isn't an actionable wrong that can give rise to a claim for damages."

On the merits, the Court began with the Code, citing § 365(g)'s statement that rejection constitutes a breach. The Court then looked to contract law for a definition of breach: an event that permits the injured party to "elect to continue the contract or refuse to perform further." Id. (quoting 13 R. Lord, Williston on Contracts § 39:32, pp. 701-02 (4th ed. 2013)). Thus, debtor's rejection of the executory contract with Mission did not terminate the license to use the trademarks. By "preserving [the licensee's] rights, Section 365 reflects a general bankruptcy rule: The estate cannot possess anything more than the debtor itself did outside bankruptcy." Id. The Court next addressed Tempnology's assertion that the absence of "trademark" from § 365(n) indicated Congress's intent to treat trademarks differently. Not so, according to Congress: when § 365(n) was added, Congress explained that the addition "'corrects [Lubrizol's] perception' that 'Section 365(n) was ever intended to be a mechanism for stripping innocent licensee[s] of rights.'" Id. at *7 (quoting S. Re. No. 100-505, pp. 2-4 (1988)). Similarly, the Court dispensed with Tempnology's arguments about the uniqueness of trademark law by relying on the explicit directions provided by §§ 365(a) and (g). Accordingly,

> [t]hrough rejection, the debtor can escape all of its future contract obligations, without having to pay much of anything in return. But in allowing rejection of those contractual duties, Section 365 does not grant the debtor an exemption from all the burdens that generally applicable law—whether involving contracts or trademarks—imposes on property owners.

Id. at *8 (citation omitted).

V. Corporate Officer & Director Duties

A. Officer's duty to comply with board's lawful instructions supersedes duty to inform. Levin v. Miller, 900 F.3d 856 (7th Cir. 2018). The debtor, an Indiana corporation, held two subsidiary banks that ultimately failed following the 2007–2008 financial crisis. Throughout 2008 and into 2009, the corporation's board—acting on the insistence of federal and state regulators and the advice of outside counsel—repeatedly directed the corporation's officers to support the subsidiary banks by raising capital and lobbying for government assistance. The board also approved the corporation's annual tax allocation agreement, which provided for a consolidated federal tax return filed by the corporation on behalf of all three entities. Under the tax allocation agreement, the corporation would transfer any tax refund the banks could have received had the banks filed separately as directed by nonbinding federal regulatory guidance issued in 1998. However, in 2001, a bankruptcy court issued a contrary ruling, which the Second Circuit Court of Appeals affirmed, holding that a consolidated refund belongs to the parent company and any payment owed under a tax allocation agreement constitutes a debt that becomes an unsecured claim on the parent's bankruptcy estate. The corporation received $76 million as a consolidated tax return in June 2009, which it transferred to the subsidiary banks three months before the corporation filed for bankruptcy under chapter 7. The trustee alleged the corporate officers breached their fiduciary duty by failing to inform the board that declaring bankruptcy before transferring the tax refund would maximize the value to creditors of the holding company. The court disagreed. Under principals of agency as stated in the Restatement (Third) of Agency, applicable in Indiana, an agent's duty to inform the principal is qualified by the agent's duty to comply with the principal's instruction, even if the agent believes that compliance is not in the principal's best interest. Because the board clearly manifested its intention to save the banks, the officers as agents had no right—let alone a duty—to pursue bankruptcy, an approach directly at odds with the board's instructions.

B. Director may be liable for inadequate supervision of officers or other employees. In re Mundo Latino Market Inc., 590 B.R. 610 (Bankr. S.D.N.Y 2018). The majority shareholder and vice president of a retail food and household supply market also served as a director of the corporation. The director installed a manager to open the market, hire employees, and operate the business. The market never earned a net profit, mostly due to the manager's bad acts and mismanagement. The debtor corporation filed for bankruptcy and the trustee alleged breach of the director's fiduciary duty, which the director moved to dismiss pursuant to the business judgment rule. Under Delaware law, a majority shareholder acting as a shareholder does not owe any duty to manage the corporation. Likewise, a vice president does not owe any duty not specifically provided for by the bylaws of the corporation or, if not so provided, by the directors. However, corporate directors owe two fiduciary duties to their shareholders: the duty of loyalty and the duty of care. At the pleading stage, an allegation of breach of fiduciary duty against an officer or director may survive the business judgment rule if the complaint sufficiently alleges one of the following scenarios: the officer or director acted fraudulently or in bad faith, lacked disinterested independence, or closed her eyes to the corporation's affairs and completely failed to act. Under the third category, ordinary care on the part of directors requires reasonable oversight and supervision. The court found sufficient facts for an inference that the director's alleged inattention gave rise to liability for failure to supervise and oversee the manager.

C. Once insolvent, officer and director fiduciary duties extend to creditors, not shareholders. In re Tribune Co. Fraudulent Conveyance Litig., 2019 WL 294807 (S.D.N.Y. Jan. 23, 2019). Tribune Company, a Delaware corporation, negotiated a leveraged buyout with a private equity investor in 2007. The buyout involved two steps: first, Tribune would borrow $7 billion and execute a tender offer, purchasing approximately half of the company's outstanding shares; then, Tribune would borrow another $3.7 billion, purchasing its remaining shares. Under the second step, Tribune would become a private company wholly owned by the investor's holding company. The accounting firm hired to provide a solvency opinion for the buyout declined to do so due to anticipated liabilities that would exceed assets by $300 million. The firm refused to incorporate projected tax savings because no case law supported such incorporations when determining solvency. Tribune terminated this accounting firm's engagement to issue a solvency opinion. Instead, the firm provided a "viability opinion" asserting Tribune's capacity to pay its debts following the buyout based on projected tax savings. A majority of Tribune's eleven-member board, which included seven independent directors not serving as officers of Tribune and not affiliated with the family trusts holding a third of Tribune's stock, approved the buyout on April 1, 2007. No director cast a dissenting vote.

Step one of the leveraged buyout closed on June 4, 2007, relying on a solvency opinion from a "lesser known" accounting firm that included the projected tax savings and ignored the debt associated with the second step of the buyout. The lesser known firm refused to issue a solvency opinion for the second step without assurances that Tribune would be able to refinance debts maturing in 2014 and 2015. Tribune misrepresented its capacity to refinance those debts, the lesser known firm issued a solvency opinion, and the buyout closed on December 20, 2007, without a second vote by the directors. Tribune filed for bankruptcy a year later and the trustee sought recovery from the independent directors for breaches of their fiduciary duties in the leveraged buyout. The directors moved to dismiss the trustee's claims because they did not earn any more per share from the leveraged buyout as compared with any other shareholder. Under Delaware law, directors owe two overlapping fiduciary duties to the corporation: the duty of care and the duty of loyalty. The duty of loyalty requires directors to act in the best interest of the corporation and to remain free of conflicts of interest when making a corporate decision. Ordinarily a director's fiduciary duties extends to the corporation and its shareholders. However, once a corporation is insolvent, the corporation's creditors replace its shareholders as the residual beneficiaries of any increase in value. The court denied the motion to dismiss, reiterating the gravamen of the rule: a director of an insolvent corporation is interested in a transaction if the director receives a personal benefit not shared by all of the insolvent corporation's creditors.

VI. Recent Appellate Court Decisions

A. **Postpetition attorneys' fees allowed as part of unsecured claim.** Summitbridge Nat'l Invs. III, LLC v. Faison, 915 F.3d 288 (4th Cir. 2019). The Fourth Circuit joined the Second and Ninth Circuits, finding that neither § 502(b) nor § 506(b) prohibits an unsecured claim for postpetition attorneys' fees arising out of a prepetition contract. In the underlying bankruptcy, the debt arose prepetition pursuant to several promissory notes secured by farmland. Under the notes, the debtor agreed to pay reasonable attorneys' fees if the notes ever were placed with an attorney for collection. The confirmed chapter 11 plan provided for payment of the creditor's claim, including a portion of the postpetition attorneys' fees, up to the value of the farmland. The creditor filed an unsecured claim for the remainder of the fees, and the debtor objected. The bankruptcy court sustained the objection, holding that the Code does not permit unsecured claims for postpetition fees. The district court affirmed.

The Fourth Circuit reversed, applying the Supreme Court's reasoning in Travelers Casualty & Surety Co. of America v. Pacific Gas & Electric Co., 549 U.S. 443 (2007). The Travelers Court expressly rejected the Code's purported disallowance of postpetition fees incurred while litigating federal bankruptcy law. Citing the absence of textual support under § 502(b), the Court reiterated its general presumption: "claims enforceable under applicable state law will be allowed in bankruptcy unless they are expressly disallowed." Id. at 452. The Fourth Circuit similarly rejected the debtor's arguments in Summitbridge, concluding that § 502(b) does not disallow a claim absent one of the nine enumerated exceptions. That the creditor's fees were contingent on a postpetition event, in this case collection by an attorney, did not remove the fees from the definition of a claim under § 101(5)(A). 915 F.3d at 292 (describing how "[w]hat matters is that the right to those fees arose pre-petition"). Likewise, that § 502(b) directs determination of the claim amount as of the petition date, in this case an amount of zero, did not bar recovery. Neither Travelers nor a consistent reading of § 502 requires disallowing claims based on absence of value as of the petition date. The Fourth Circuit also rejected the debtor's reliance on § 506(b) because "[s]ection 506(b) has nothing to do with the allowance or disallowance of claims." Id. at 293 ("What § 506 is concerned with, as its title makes equally clear, is the 'secured status' of claims already allowed or presumed allowed.").

B. **Mortgagee held an enforceable lien against real property despite mistakenly filing a satisfaction of the lien and a cancellation of the satisfaction prepetition, and the postpetition sale of the underlying property did not render moot the appeal of bankruptcy court's order determining the efficacy of the mortgagee's lien.** Trinity 83 Dev., LLC v. Colfin Midwest Funding, LLC, 917 F.3d 599 (7th Cir. 2019). The mortgagee's agent mistakenly filed a satisfaction of the mortgage prepetition. The mortgagor continued to pay the underlying obligation and, discovering the mistake, the mortgagee recorded a cancellation of the satisfaction prepetition. The bankruptcy court held that the lien was enforceable and retained its priority because there was no intervening lien filed against the property. After the bankruptcy court's ruling, but prior to its appeal, the property was sold and the court provided the buyer the protections of § 363(m). Relying on In re River West Plaza-Chicago, LLC, 664 F.3d 668 (7th Cir. 2011), the mortgagee argued that § 363(m) "blocks not only a request to upset the sale but also any possibility of ordering the recipient of the sale's proceeds to turn that money over to the bankruptcy estate, . . . which makes an appeal moot." 917 F.3d at 601.

The Seventh Circuit first resolved the role of § 363(m) on appeal, overruling two previous decisions. River West held that in the absence of a stay pending appeal, § 363(m) provides a "statutory guarantee of finality" of the sale, including any access to sale proceeds. 664 F.3d at 671-72 (relying on In re Sax, 796 F.2d 994, 998 (7th Cir. 1986)). Because the § 363 sale concluded in the underlying bankruptcy without a stay pending appeal, the River West court dismissed the appeal as moot. Id. On similar facts, the Trinity panel disagreed. The court distinguished between constitutional mootness and a statutory bar to relief. 917 F.3d at 601. "Section 363(m) does not say one word about the disposition of the proceeds of a sale or lease," a "subject within the control of the bankruptcy court." By its holding, Trinity overrules River West and Sax. The panel circulated the opinion "before release to all active judges [and n]one wanted to hear the appeal en banc." Id. at 603 (citing Fed. Circuit R. 40(e)). Reaching the merits, the court affirmed the bankruptcy court's determination of the efficacy of the loan under Illinois law, which "treats a mistaken release of a mortgage as ineffective between the mortgagor and the mortgagee . . . ." Id. The court further affirmed that the filing of the mistaken cancellation did not constitute a waiver of rights. Id.

C. **Proof of claim not res judicata as to liability where claims did not arise from same operative facts.** Trs. of Operating Eng'rs Local 324 Pension Fund v. Bourdow Contracting, Inc., 919 F.3d 368 (6th Cir. 2019). The plaintiff pension fund sought recovery from Bourdow Trucking, Inc. ("Trucking") for withdrawal liability pursuant to a terminated collective bargaining agreement. Trucking filed for bankruptcy under chapter 7, staying the plaintiff's collection efforts. The plaintiff filed a proof of claim in the amount of $1.2 million. Trucking did not object and the plaintiff received $52,000 on its claim. Meanwhile, several of Trucking's employees created the defendant new entity, Bourdow Contracting, Inc. ("defendant"). The plaintiff alleged that defendant was an alter ego of Trucking and sought to recover from the defendant for the unsatisfied withdrawal liability. Both parties moved for summary judgment. The district court ruled for the plaintiff in an amount of $3.2 million, the withdrawal liability, less the claim payment plus interest and fees. The defendant appealed, arguing that the plaintiff's claim was res judicata as to the amount of withdrawal liability. The Sixth Circuit joined the Second and Ninth Circuits in holding that "an uncontested proof of claim . . . allowed pursuant to 11 U.S.C. § 502(a) is a final judgment on the merits for purposes of res judicata, with or without a separate court order specifically allowing the claim." Id. at 383.

Despite finding that an undisputed, deemed allowed claim is res judicata, the Sixth Circuit affirmed the district court's judgment because it held that the claims did not arise out of the same operative facts. "A claim is barred by the res judicata [or claim preclusive] effect of prior litigation if all of the following elements are present: '(1) a final decision on the merits by a court of competent jurisdiction; (2) a subsequent action between the same parties or their privies; (3) an issue in the subsequent action which was litigated or which should have been litigated in the prior action; and (4) an identity of the causes of action.'" Id. at 380 (quoting Browning v. Levy, 283 F.3d 761, 771 (6th Cir. 2002)). Because the plaintiff's claims on appeal focused on the circumstances surrounding the alter ego claim, rather than the amount of any withdrawal liability, the "claims did not arise out of, and were not created by, the same operative facts." Id. at 384. By footnote, the court added "that collateral estoppel—which does not require an identity of the causes of action—may have been a more successful argument" for the defendant. Id. at 384 n.9. The defendant did raise collateral estoppel, but not until its reply brief, thus waiving the argument. Id. at 380 n.6.

D. Equity holder of involuntary debtor lacks standing to seek damages under § 303(i). Matter of 8Speed8, Inc., 921 F.3d 1193 (9th Cir. 2019). The appellee and another entity each owned half of the debtor corporation's shares. The appellant owned 50% of the debtor's stock. The appellee filed an involuntary bankruptcy case in which the debtor never appeared. Instead, the appellant moved on behalf of the debtor to dismiss the filing and sought costs, fees, and damages under § 303(i). The appellee conceded that dismissal was appropriate. The bankruptcy court granted dismissal but denied any expenses or damages, concluding that the appellee lacked standing. The district court affirmed as did the Ninth Circuit. The court held that "§ 303(i) limits standing to recover statutory damages resulting from an involuntary bankruptcy proceeding to the debtor." Id. at 1195 (citing Miles v. Okum (In re Miles), 430 F.3d 1083, 1093-94 (9th Cir. 2005)). The appellant's attempted distinction—that the debtor had appeared in Miles whereas the appellant was the only party to defend the debtor in the case at hand—did not persuade the court. Relying on § 305, the court determined that the appellant's "valiant" efforts were unnecessary given the power of a bankruptcy court to dismiss an involuntary petition sua sponte. Thus, in the court's view, the appellant proceeded at their own risk. Id. at 1195-96. Judge Bennett dissented, arguing that "Miles says nothing about a non-debtor who obtains a dismissal for the debtor and requests that damages be awarded to the debtor under § 303(i)(2)." Given that § 303(i)'s fee-shifting and damages provisions serve to deter frivolous filings for the benefit of both debtors and courts, Judge Bennett disapproved of the absolute denial of a third-party's standing to recover. On the facts of the case—the alleged governance deadlock prohibiting the debtor from appearing, the close relationship between the debtor and the appellant, and the appellant's appearance in the case and subsequent attempts at recovery on behalf of the debtor—Judge Bennett would have remanded.

VII. Pending Matter Before the Supreme Court: Whether an order denying a motion for relief from the automatic stay is a final order under 28 U.S.C. § 158(a)(1). Ritzen Grp., Inc. v. Jackson Masonry, LLC, No. 18-938, 2019 WL 266853, at *1 (U.S. May 20, 2019) (granting certiorari). By contract, Ritzen Group intended to purchase real property from Jackson Masonry for $1.55 million. The sale collapsed on the consummation date and Ritzen sued Jackson for breach of contract. During a protracted and contentious discovery process, Jackson filed a petition for bankruptcy under chapter 11. In bankruptcy court, Ritzen moved for relief from the automatic stay while intermittently discussing dismissal. The court, construing the relief requested as purely stay related, denied the motion and resolved the contract claims in Jackson's favor a year later. Ritzen appealed. Ritzen Grp., Inc. v. Jackson Masonry, LLC, No. 3:17-CV-00806, 2018 WL 558837, at *1-4 (M.D. Tenn. Jan. 25, 2018). The district court denied the appeal, finding the motion for relief from the automatic stay to have been a final order requiring appeal within fourteen days under Federal Rule of Bankruptcy Procedure 8002(a). Id. at *5. Ritzen appealed again.

The Sixth Circuit affirmed, joining the Second, Third, Fourth, Seventh, and Tenth Circuits. In re Jackson Masonry, LLC, 906 F.3d 494, 503 (6th Cir. 2018) (citing 1 Collier on Bankruptcy ¶ 5.09 (16th ed. 2014)). Relying on the language of 28 U.S.C. § 158(a) and the Supreme Court's reasoning in Bullard v. Blue Hills Bank, -- U.S. --, 135 S. Ct. 1686, 191 L. Ed. 2d 621 (2015), the court held the appeal untimely because "(1) stay-relief motions initiate a proceeding and (2) this proceeding is terminated by an order denying stay relief." Id. at 500. The court rejected the "vague" test proffered by the First Circuit in In re Atlas IT Export Corp., which "tak[es] into account the particular order's reasoning and effect [and asks] whether that edict definitively decided a discrete, fully-developed issue that is not reviewable somewhere else." 761 F.3d 177, 185 (1st Cir. 2014) (describing how, like the Third Circuit, the court found "it possible that in some cases an order denying stay relief may lack finality"). The Sixth Circuit found that such a test forces "the parties [to] constantly guess. . . . Appellate deadlines cannot serve their purpose when their trigger is unclear." Jackson at 503.

JENNER&BLOCK

Recent Developments in Bankruptcy Law, January 2019

(Covering cases reported through 593 B.R. 68 and 910 F.3d 1300)

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Recent Developments in Bankruptcy Law, January 2019

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1. AUTOMATIC STAY

1.1 Covered Activities

1.2 Effect of Stay

1.2.a **Stay tolls foreclosure period for full period of the stay.** The mortgagee accelerated the debtor's mortgage note before bankruptcy. Under state law, a mortgagee has four years after acceleration to file a foreclosure action. The mortgagee here filed a foreclosure action 127 days late. The automatic stay was in effect for 127 days, including both the day the bankruptcy petition was filed and the day the stay terminated by entry of the discharge. Section 108(c) provides "if applicable nonbankruptcy law … fixes a period for commencing … an action" that is stayed by section 362, "then such period does not expire until … the end of such period, including any suspension of such period occurring on or after the commencement of the case." State law here does not have a specific tolling provision that provides for tolling (suspension) during the automatic stay but does accept the common law tolling principle as an applicable law that section 108(c) may incorporate. The common law principle prohibits counting against a person the time during which the person is prevented from exercising a legal remedy. Here, the mortgagee was prevented on the day the debtor filed the petition and on the day the stay terminated. The law does not split a day. Therefore, the deadline to file the foreclosure action was tolled for the full 127 days. *HSBC Bank USA, N.A. v. Crum*, 907 F.3d 199 (5th Cir. 2018).

1.2.b **Section 108(c) extends the time to renew a judgment lien.** Before bankruptcy, the creditor obtained a judicial lien against the debtor to enforce a judgment. By its term, the lien expired one year after it arose, unless renewed. The debtor filed bankruptcy within the one-year period. The creditor did not renew the lien. Section 108(c) extends until 30 days after notice of termination or expiration of the automatic stay any "period for commencing or continuing a civil action … on a claim against the debtor" that has not expired before the date of the filing of the petition. Section 362(a)(1) stays "the commencement or continuation" of an action "that was or could have been commenced before bankruptcy to recover a prepetition claim;" section 362(a)(2) stays "the enforcement against the debtor … of a judgment obtained before" bankruptcy; and section 362(a)(4) stays "any act to … enforce any lien against property of the estate." The attempt to enforce a judgment is a continuation of the civil action. Therefore, the renewal of the judicial lien is a continuation of the action, and section 108(c) extends the renewal deadline. A dissent argues that a judgment terminates the civil action, that the automatic stay deals separately with continuation and enforcement, and section 108(c) covers only continuation. *Daff v. Good (In re Swintek)*, 906 F.3d 1100 (9th Cir. 2018).

1.2.c **Section 108(b) does not extend the time to exercise a purchase option.** The debtor had an option to purchase real property, which expired one hour after the commencement of the case and which it was unable to exercise timely because it lacked sufficient financing. Section 108(b) extends for at least 60 days a deadline fixed under an agreement that has not expired by the commencement of the case to "file any pleading, demand, notice, or proof of claim or loss, cure a default, or perform any other similar act." "Similar" means having common characteristics or very much alike or comparable. Exercising an option and purchasing property is not similar to filing a pleading, notice, demand, or claim or curing a default. Because the agreement permitted but did not require the debtor to purchase by the deadline, the debtor's failure to do so was not a "default" that could be cured with the 60-day period. Therefore, section 108(b) does not extend the time for the debtor in possession to exercise the option. *In re 1075 S Yukon, LLC*, 590 B.R. 527 (Bankr. D. Colo. 2018).

1.3 Remedies

1.3.a **Debtor may recover fees for appealing denial of fees for stay violation.** After the creditor violated the automatic stay, the debtor moved for sanctions, including attorneys' fees. The bankruptcy court awarded fees that did not account for several days of the attorney's work. The debtors appealed to the district court, which remanded for the bankruptcy court to calculate the fees. The bankruptcy court awarded a substantial amount more but not for the attorney's appellate work, on the ground that a request for such fees was then pending in the district court. The district court denied the request, and the debtors appealed to the court of appeals. Section 362(k) requires the court to award "actual damages, including costs and attorneys' fees," to an individual injured by a willful violation of the automatic stay. Without the prospect of an attorneys' fees award, most individual debtors would lack the means to seek redress for stay violations. Moreover, the risk of a fee award acts as a deterrent to stay violations. Neither function operates effectively if the debtor may not recover fees for pursuing the damages and fees claim to final judgment. Therefore, the court must award attorneys' fees to the debtor for pursuing or defending an appeal from an order under section 362(k). *Easley v. Collections Serv. Of Nev.*, 910 F.3d 1286 (9th Cir. 2018).

2. AVOIDING POWERS

2.1 Fraudulent Transfers

2.1.a **Section 548(c)'s "futility exception" to the good faith defense does not apply under Texas law.** A receiver sued a Ponzi scheme investor under the Texas Uniform Fraudulent Transfer Act (TUFTA) to avoid and recover the investor's withdrawals from the scheme. Like Bankruptcy Code section 548(c), TUFTA gives a fraudulent transfer defendant a defense if the defendant received the transfer for value and in good faith. A transferee who had inquiry notice of the fraud does not take in good faith, unless the transferee actually conducts a diligent investigation and does not uncover the fraud. Section 548(c) permits the transferee a defense if the transferee shows a diligent investigation would not have uncovered the fraud, that is, if the investigation would have been futile. Under TUFTA, if the transferee had inquiry notice, then failure to investigate prevents a good faith finding no matter what the investigation might or might not have revealed. The Bankruptcy Code futility exception does not apply. *Janvey v. GMAG, L.L.C.*, ___ F.3d ___, 2019 U.S. App. LEXIS 759 (5th Cir. Jan. 9, 2019).

2.2 Preferences

2.3 Postpetition Transfers

2.4 Setoff

2.4.a **Federal interest in equality of distribution supersedes any state law right of triangular setoff.** The debtor owed a prepetition creditor $6.9 million. The creditor's affiliate owed the debtor $9.2 million. The debtor's and the creditor's prepetition agreement authorized the creditor and its affiliates to offset any amounts owed by one or more of them to the debtor or its affiliates. Section 553(a) permits setoff of mutual debts between a debtor and a creditor. Mutuality requires that the debts be between the same parties in the same capacities. Nonbankruptcy law governs property rights and obligations between the debtor and its creditors, unless a federal interest requires otherwise. The federal interest in equality of distribution among creditors supersedes any nonbankruptcy law that would enforce a contract between the debtor and a creditor that permits triangular setoff, whether directly or by treating the affiliate as a third-party beneficiary of the contract. *In re Orexigen Therapeutics, Inc.*, ___ B.R. ___, 2018 Bankr. LEXIS 3579 (Bankr. D. Del. Nov. 13, 2018).

2.5 Statutory Liens

2.6 Strong-arm Power

2.7 Recovery

2.7.a **Under section 550(a), a payroll service is a conduit, not an initial transferee.** The debtor, which conducted a fraudulent business, paid its payroll through a payroll service, which accepted funds from the debtor into an account that held only client payroll funds, not any of the service's own funds, and issued payments to employees solely at the debtor's direction, as required under the debtor-service contract. The trustee sued the service to avoid and recover payroll payments the debtor made to the service as fraudulent transfers. Section 550(a)(1) permits the trustee to recover an avoided transfer from an initial transferee but not from a mere conduit of a transfer. A conduit is one who does not have actual control over the transferred property and acted in good faith and as an innocent participant in the transfer. Here, the payroll service segregated client funds and, by contract, was required to use them only for the client's payroll. It did not have any control over the funds. As a payroll service that only issued payments at the client's express instructions and did not have any visibility into or control over the client's business, it was an innocent participant in the transfers. Therefore, it was a conduit, not an initial transferee that would be liable for recovery of the payments. *Luria v. ADP, Inc. (In re Taylor, Bean & Whitaker Mortgage Corp.)*, ___ B.R. ___, 2018 Bankr. LEXIS 3407 (Bankr. M.D. Fla. Nov. 1, 2018).

3. BANKRUPTCY RULES

4. CASE COMMENCEMENT AND ELIGIBILITY

4.1 Eligibility

4.2 Involuntary Petitions

4.2.a **Court dismisses involuntary chapter 11 petition by non-recourse noteholders against CDO.** A structured finance vehicle known as a Collateralized Debt Obligation raised funds by issuing series of non-recourse notes with contractually-specified priorities and used the funds to purchase loans issued by unrelated entities, which secured the CDO's notes and whose payments would be used to pay its notes. The indenture for the CDO's notes contained detailed provisions for liquidation of the CDO after default. After it defaulted on its Series B notes, investors purchased 100% of its Series A-1 notes and 34% of its Series A-2 notes and, after waiving their collateral to the extent of $15,775, filed an involuntary chapter 11 petition against the CDO. They then filed a motion to terminate exclusivity to file a liquidating plan. Section 303(b) permits an involuntary petition against a person by "three or more entities, each of which is … a holder of a claim against such person … [that] aggregate at least $15,775 more than the value of any lien on property of the debtor." Section 102(2) provides "'claim against the debtor' includes claim against property of the debtor." Section 1111(b)(1) provides a "claim secured by a lien on property of the estate shall be allowed or disallowed under section 502 of this title the same as if the holder of such claim had recourse against the debtor on account of such claim, whether or not such holder has such recourse," with exceptions relating to sale of property or treatment under a plan. Because section 1111(b)(1) provides for conversion of non-recourse claims into recourse claims for purposes of allowance or disallowance under section 502, it does not apply to determining whether a holder of a non-recourse claim holds an unsecured claim. Because section 303(b) refers to unsecured claims "against such person" rather than against the debtor, section 102(2) does not apply by its terms and does not make the holder of a non-recourse claim eligible as a holder of a claim against the debtor. Moreover, a bankruptcy court may dismiss an involuntary chapter 11 case for cause under section 1112, even if the petitioners qualify. Here, the chapter 11 case would supplant the carefully negotiated liquidation provisions in the CDO's indenture, which the petitioning creditors accepted by purchasing their notes, would disadvantage junior creditors, and would serve no rehabilitative purpose for the static investment pool alleged debtor. Therefore, the court also dismisses the petition for cause. *In re Taberna Preferred Funding IV, Ltd.*, ___ B.R. ___, 2018 Bankr. LEXIS 3557 (Bankr. S.D.N.Y. Nov. 8, 2018).

4.3 Dismissal

5. CHAPTER 11

5.1 Officers and Administration

5.1.a **Section 1114 applies to Coal Act retiree benefits in a chapter 11 section 363(b) sale.** The 1992 Coal Act requires coal mines to contribute to funds to provide retiree medical benefits. The debtor coal mine filed chapter 11 and sought approval of a sale of substantially all its assets to a buyer that was newly-formed by the debtor's secured lenders. The buyer conditioned the sale on the DIP's termination of retiree benefits under section 1114. Section 1114 permits the court to approve an agreement providing for modification, or to order modification, of retiree benefits if modification is, among other things, necessary "to permit the reorganization of the debtor." "Retiree benefits" are "payments … for the purpose of providing or reimbursing payments … for medical … benefits … under any plan, fund or program … maintained or established in whole or in part by the debtor." Based on a detailed examination of the Coal Act, its history, section 1114, and its history, the court concludes that despite the statutory requirement that coal employers fund retiree benefits, the debtor's obligations qualify as payments "under any plan, fund or program … maintained … in whole or in part by the debtor." Modification must be necessary "to permit reorganization." Chapter 11 permits a going concern sale. In this case, the sale effectively exchanged secured claims for equity, as in a classic going concern reorganization. More generally, a going concern sale, even not to existing creditors, is a form of business reorganization. As such, section 1114 permits modification of retiree benefits as part of a going concern sale undersection 363(b). *United Mine Works of Am. Combined Benefit Fund v. Toffel (In re Walter Energy, Inc.)*, ___ F.3d ___, 2018 U.S. App. LEXIS 36567 (11th Cir. Dec. 27, 2018).

5.2 Exclusivity

5.3 Classification

5.4 Disclosure Statement and Voting

5.5 Confirmation, Absolute Priority

5.5.a **A plan does not impair a class of claims when the Code, not the plan, disallows the claims.** The debtor became solvent during the case because of rising commodity prices. It proposed a plan that provided for payment in cash in full of the principal owing on its notes, excluding postpetition interest and a make-whole amount. A class of claims is impaired unless the plan does not alter its legal, equitable or contractual rights. Section 502(b)(2) disallows claims for postpetition interest. Because the Code, not the plan, disallows the postpetition interest claim, the class is not impaired. Section 1141(d) discharges the debtor upon plan confirmation, including for unpaid postpetition interest, but still the Code, not the plan, does the work. *Ultra Petroleum Corp. v. Ad Hoc Committee of Unsecured Creditors (In re Ultra Petroleum Corp.),* ___ F.3d ___, 2019 U.S. App. LEXIS 1617 (5th Cir. Jan. 17, 2019).

6. CLAIMS AND PRIORITIES

6.1 Claims

6.1.a **Court disallows make-whole claim as postpetition interest; remands to determine rate of postpetition interest in a solvent case.** The debtor's plan proposed payment of the noteholders' claims in cash in full with whatever amount of postpetition interest and contractual make-whole amount is required for the class to be unimpaired. Section 502(b)(2) disallows claims for postpetition interest *as part of* a claim. Whether a claim is for unmatured postpetition interest is based on economic realities, not formalities. A make-whole payment is the economic equivalent of interest and compensates a creditor for lost future interest. Therefore, section

502(b)(2) disallows a make-whole amount as well as the contractual postpetition interest on the claims. Section 1129(a)(7), which requires that a plan provide at least as much as a liquidation, allows postpetition interest "at the legal rate" *on* all allowed claims, through indirect incorporation of section 726(a)(5). Section 726(a)(5) differs from the pre-Code "solvent debtor" exception, which required payment of contractual interest as part of a claim before any surplus could be returned to the debtor, in that it applies to all claims, not just those whose contract provided for interest, applies to interest on, not as part of, the claim, and uses the legal, rather than the contractual, rate. But section 1129(a)(7), and therefore section 726(a)(5), do not apply to a class of claims that is not impaired. Therefore, the creditors are entitled to the make-whole amount if and only if the solvent debtor exception survives the Code. The court of appeals remands to determine that question. The parties agreed that the creditors are entitled to postpetition interest, based on Congress' repeal of former section 1124(3), which courts have read to deny postpetition interest to an unimpaired class, but did not agree on the rate. The court identifies two possible approaches: the legal rate under 28 U.S.C. § 1961(a), which allows interest at the legal rate on a money judgment, and equity, which might provide a right to postpetition interest at an appropriate equitable rate. The court of appeals remands to determine the appropriate rate. *Ultra Petroleum Corp. v. Ad Hoc Committee of Unsecured Creditors (In re Ultra Petroleum Corp.),* ___ F.3d ___, 2019 U.S. App. LEXIS 1617 (5th Cir. Jan. 17, 2019).

6.1.b **Court disallows default interest rate as unenforceable penalty.** The debtor's loan agreement provided a default interest rate of 5% over the nondefault rate. The debtor and the bank did not negotiate over the default rate, and the bank made no effort when it issued the loan to determine what its damages, such as administrative or funding costs or loss in the loan's value, might be if the debtor defaulted or whether the default interest rate bore any relation at all to anticipated damages resulting from a default. After bankruptcy, the debtor in possession objected to the allowance of default interest. Applicable nonbankruptcy law requires that a liquidated damages amount "must represent the result of a reasonable endeavor by the parties to estimate a fair average compensation for any loss that may be sustained." An amount disproportionate to that amount is an unenforceable penalty. Because the bank here made no effort to estimate damages or loss resulting from the default, the default interest rate is an unenforceable penalty. The court disallows the claim to that extent. *In re Altadena Lincoln Crossing, LLC*, ___ B.R. ___, 2018 Bankr. LEXIS 2018 (Bankr. C.D. Cal. July 3, 2018).

6.2 Priorities

6.2.a **Section 364(c)(1) superpriority claims are not subordinate to administrative claims incurred under chapter 7 after conversion.** The court permitted a chapter 11 debtor in possession to obtain credit from a supplier on a superpriority basis under section 364(c)(1). The case converted to chapter 7. Section 364(c)(1) permits obtaining credit "with priority over any or all administrative expenses of the kind specified in section 503(b) or 507(b)." Section 726(b) provides "a claim allowed under section 503(b) of this title incurred under [chapter 7 after conversion from another chapter] has priority over a claim allowed under section 503(b) of this title incurred under any other chapter of this title," but does not refer to section 364 at all. Claims with superpriority under section 364(c)(1) are not administrative claims allowable under section 503(b); they are a special category of claims with priority over section 503(b) administrative claims. Therefore, they are not subordinate to section 503(b) administrative claims incurred under chapter 7 after conversion. *In re Happy Jack's Petroleum, Inc.*, ___ B.R. ___, 2018 Bankr. LEXIS 3424 (Bankr. D. Neb. Nov. 7, 2018).

6.2.b **Secured lender with actual knowledge of a consignment is junior to the consignor.** The debtor established a consignment program for its suppliers. About 10% of its goods were received under the program. One consignor filed a UCC-1 statement to perfect its interest in its consigned goods, but the filing had lapsed by the time of the debtor's bankruptcy. The debtor borrowed under a secured lending facility. When the lender filed its own UCC-1, it had actual knowledge of the consignor's interest, as the interest was listed in the loan agreement. After bankruptcy, the debtor in possession sold some of the consigned goods. The consignor and the secured lender each claimed the proceeds. A consignment is subject to the U.C.C.'s priority and perfection rules. A consignor must perfect, usually by filing a UCC-1, to retain priority in its goods or their proceeds. A delivery of goods to a merchant for sale is a consignment if the merchant deals in those kinds of goods and is not generally known by its creditors to be substantially engaged in selling goods of others. If a merchant is generally so known, then the delivery is not a consignment, and the deliverer need not perfect to prevail over perfected security interests. A UCC-1 gives constructive notice of a security interest in the debtor's property and protects creditors against secret liens. A creditor who has actual knowledge of a consignment takes its interest subject to the consignment interest: it would be anomalous to subject a creditor with constructive notice to a consignor's interest but not a creditor with actual knowledge, as the protection against secret liens is the same. Therefore, the court orders the sale proceeds paid to the consignor. *TSA Stores, Inc. v. Performance Apparel Corp. (In re TSAWD Holdings, Inc.)*, ___ B.R. ___, 2018 Bankr. LEXIS 3680 (Bankr. D. Del. Nov. 26, 2018).

6.2.c **Creditor may not offset PACA trust claim against debt owing to the debtor.** The debtor and the creditor were both perishable agricultural commodity purchasers and sellers. They traded between themselves, setting up offsetting credits and debits. When the debtor filed bankruptcy, the debtor owed the creditor $205,000, and the debtor owed the creditor $263,000. The debtor had assets derived from the purchase and resale of perishable agricultural commodities. The creditor claimed the right of setoff and asserted the $58,000 balance of its claim against those assets. The Perishable Agricultural Commodities Act creates a floating trust over all a debtor/purchaser's assets in favor of sellers to the debtor of such commodities. The trust assets are not property of the estate but are held solely in trust for the sellers. As such, the creditor had a claim against the trust assets for $263,000. A creditor may offset debts and credits, but they must be mutual, that is, between the same parties in the same capacity. The creditor's claim was against the trust, not against the debtor, and so could not be offset. The creditor was required to pay its debt to the debtor's estate and share pro rata with other PACA creditors in the PACA trust on its claim against the debtor. *The PACA Trust Creditors v. Genecco Produce Inc.*, ___ F.3d ___, 2019 U.S. App. LEXIS 627 (2d Cir. Jan. 9, 2019).

7. CRIMES

8. DISCHARGE

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8.3 Environmental and Mass Tort Liabilities

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9.1.a **Ordinary course modification of ordinary course executory contract does not require court approval.** The debtor had contracted in the ordinary course of its business to manufacture a boat for a buyer. After bankruptcy, the debtor in possession and the buyer agreed to modify the specifications for the boat. Section 365 permits the DIP to assume or reject an executory contract. It provides the DIP a one-sided option to deal with the contract; the counterparty remains bound until the DIP elects. When the DIP and the counterparty agree to modify a contract, the DIP no longer wields section 365's coercive powers, so the protections of the counterparty are not necessary. Where the contract and the modification are in the ordinary course of the debtor's business, section 363(c) permits the DIP to modify the contract. The court enforces the modification and permits the buyer to take possession of the board in accordance with the modified contract. *In re Stiletto Mfg., Inc.*, 588 B.R. 762 (Bankr. E.D. N.C. 2018).

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10.4 Reaffirmations and Redemption

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11.1 Jurisdiction

11.1.a **Plan's exclusive jurisdiction provision does not trump contract's arbitration clause.** The debtor's prepetition contract provided for arbitration of all disputes arising out of or related to the contract or to any transactions contemplated under the contract. The chapter 11 plan rejected the contract, preserved all claims against the counterparty, vested the claims in a liquidating trust, granted the bankruptcy court exclusive jurisdiction over litigation of the claims "to the fullest extent permitted by law," and preserved all the counterparty's rights and defenses. The Federal Arbitration Act validates arbitration agreements and requires the federal courts to enforce them. Fed. R. Civ. Proc. 8(c)(1) (made applicable by Bankruptcy Rule 7008) provides a right to arbitrate is an affirmative defense. The plan's exclusive jurisdiction provision does not supersede the arbitration provision, because the "extent permitted by law" limitation and the preservation of the counterparty's rights and defenses protect the counterparty's right to arbitrate, which is an affirmative defense. Therefore, the court orders arbitration of the claim. *Paragon Litigation Trust v. Noble Corp PLC (In re Paragon Offshore PLC)*, 588 B.R. 735 (Bankr. D. Del. 2018).

11.1.b **Bankruptcy court may not, under 28 U.S.C. § 1631, transfer an action over which is does not have jurisdiction.** After confirmation, the liquidating trustee filed an action against a third party. The defendant moved to dismiss for want of post-confirmation jurisdiction. The bankruptcy court granted the motion. The trustee moved to transfer the case under 28 U.S.C. § 1631 to a district court in which the action could have been brought. Section 1631 requires "a court as defined in section 610 of this title [that does not have] jurisdiction … if it is in the interest of justice, [to] transfer such action … to any other such court in which the action … could have been brought." Section 610 defines "court" to include the district courts but not the bankruptcy courts. The bankruptcy court is a unit of the district court, which hears matters the district court refers to it. The reference order covers only matters over which the bankruptcy courts have jurisdiction. Because the bankruptcy court did not have jurisdiction, the action was not referred, and the bankruptcy court lacked any authority to act on the litigation. Therefore, it could not transfer the action to another court. *Troisio v. Erickson (In re IMMC Corp.)*, 909 F.3d 859 (3d Cir. 2018).

11.1.c **Withdrawal of proof of claim does not defeat bankruptcy court's equitable jurisdiction.** The creditor filed a proof of claim. The trustee sued the creditor to avoid and recover a fraudulent transfer. The creditor withdrew its claim and moved for withdrawal of the reference on the ground that the bankruptcy court did not have authority to issue a final judgment on an avoiding power claim. Section 502(d) mandates disallowance of a claim of a creditor that has received and not returned an avoidable transfer and has not returned it to the estate. The bankruptcy court may determine the allowability of a claim, including a section 502(d) objection, under its equitable jurisdiction, which precludes a creditor's right to a jury trial on the avoiding power claim, because the allowability determination necessarily determines avoidability. A court's jurisdiction and authority is determined when the action is commenced. Because the creditor's claim was on file when the trustee brought the avoiding power action, the court then had authority to determine the allowability of the claim, including whether the creditor had received an avoidable transfer. The creditor's withdrawal of its claim did not change that authority or divest the bankruptcy court of its equitable authority to rule on the avoidability complaint. *Picard v. BAM L.P. (In re Bernard L. Madoff Inv. Secs. LLC)*, ___ B.R. ___, 2019 Bankr. LEXIS 127 (Bankr. S.D.N.Y. Jan. 18, 2019).

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12. PROPERTY OF THE ESTATE

12.1 Property of the Estate

12.1.a **Corporate officers do not have a fiduciary duty to advise a board against the board's direction.** Based on pressure from federal and state regulators and advice from its counsel, the debtor bank holding company's board of directors determined to support its bank operating subsidiaries, whatever the effect on the holding company. The holding company received a large tax refund, which it invested in the bank. The holding company's officers did nothing to inform the board about alternative uses of the refund and whether an early bankruptcy filing might preserve the refund for the holding company and its creditors. Ultimately, the bank failed and was taken over by the regulators. The holding company filed bankruptcy. The trustee sued the officers for breach of fiduciary duty for failing to investigate alternatives for the refund and how it might help the holding company and to inform the board of the alternatives. A claim for breach of fiduciary duty requires the existence of a fiduciary relationship, a breach of the resulting duty, and harm to the beneficiary. A corporate officer is a fiduciary to the corporation. Their duties are determined under agency law, which requires an agent to provide the principal with complete information. However, the duty is not absolute. If the principal (here, the board), after due consideration, directs a course of action, the agent need not provide information to the principal that does not support that course of action nor hire experts to second-guess the principal's decision. Accordingly, the court dismisses the complaint. *Levin v. Miller*, 990 F.3d 856 (7th Cir. 2018).

12.1.b **Directors do not violate duty of loyalty by declaring a dividend to all shareholders two years before insolvency.** The Delaware LLC debtor suffered an insured accident, which destroyed the equipment that made the debtor competitive. Its directors, who also served as directors of its parent and were either members or representatives of members of the parent, determined to accept an insurance settlement and change their business model, rather than use the insurance proceeds to rebuild the equipment. Within months, they authorized distributions from the debtor to its parent, which authorized distributions to its members. Over the two years following the decision to accept the insurance settlement, the debtor lost money, opened a credit line with a new lender, and ultimately failed and filed bankruptcy. The creditors' committee sued the directors for breach of fiduciary duty. Under Delaware law, fiduciary duty includes the duties of care and of loyalty, exercised in good faith. A director breaches the duty of loyalty if the director has a conflict of interest and would stand to benefit from a decision in a way not shared by all shareholders or if the director acts in bad faith, which is conduct worse than gross negligence and involves a decision that cannot be understood as in the corporation's interest. A wholly-owned subsidiary exists to serve its parent, and its directors owe no duty to the subsidiary other than what the parent directs, unless the subsidiary is insolvent. Here, the directors did not have a conflict, because their actions, though benefitting themselves, benefitted all shareholders (members) equally. Nor did insolvency two years later affect the directors' duties when they made their decisions, because the debtor was not yet in financial trouble. The court dismisses the claims against the directors for breach of the duty of loyalty. *Official Comm. of Unsecured Creditors v. Meltzer*, 589 B.R. 6 (D. Me. 2018).

12.1.c **LLC debtor's trustee may not recover tax refunds paid after bankruptcy to LLC members.** Before bankruptcy, the debtor LLC distributed cash to its members to pay their taxes for two calendar years on the income of the LLC. As a pass-through entity, the LLC's income was attributed to the members for tax purposes. After bankruptcy, the members filed amended tax returns, seeking and obtaining a refund of the amounts paid for those two prior years. The trustee sued the members to recover the refunds either by turnover under section 542 as property of the estate or based on a conversion theory. Because the LLC distributed the cash before bankruptcy, the cash was not property of the estate. The LLC was not a tax-paying entity; all its income and expenses were attributed to its members, and it is not entitled to file a return or claim a refund. Therefore, the tax refunds do not belong to the estate, and the members' amendments to their prior returns did not effect a conversion. *The Finley Group v. Roselli (In re REDF Marketing, LLC)*, 589 B.R. 534 (Bankr. W.D.N.C. 2018).

12.1.d **Court recognizes limits on a shareholder's and vice president's duties of care and loyalty.** The debtor's principal investor and majority shareholder served as a director and vice president but was not involved at all in the operation or management of the business and had no particular duties as vice president. However, in the beginning, she authorized someone to start and operate the business. She did not actively supervise or manage him or the business operations. The business failed as a result of his mismanagement, self-dealing, and dishonesty. A majority shareholder does not owe fiduciary duties to a corporation, only to minority shareholders in dealings at the shareholder level. A vice president is a fiduciary who owes a duty of care, good faith, and loyalty to the corporation, but without specific duties delegated to the vice president in the operation and management of the corporation, a vice president does not breach those duties by inaction. A director owes a duty of care, good faith, and loyalty to the corporation. A failure to supervise and to take reasonable steps to inform oneself may constitute a breach of the duty of care. Therefore, the court dismisses the trustee's claims against the investor as shareholder and vice president, but not as director. *Geltzer v. Bedke (In re Mundo Latino Market Inc.)*, 590 B.R. 610 (Bankr. S.D.N.Y. 2018).

12.1.e **Court measures directors' breach of duty of loyalty to insolvent corporation by benefit to creditors, not shareholders or corporation.** The directors approved an LBO that rendered the debtor insolvent. The transaction benefitted the directors as shareholders to the same extent as other shareholders, but creditors ultimately suffered. The trustee sued them for breach of fiduciary duty. A director owes a duty of due care and loyalty, which includes a duty of good faith, to the corporation and its shareholders. However, when the corporation becomes insolvent, the creditors become the residual beneficiaries of the duty. "Because the duty of loyalty compels directors to maintain 'an undivided and unselfish loyalty to the <u>corporation</u>[,]' <u>Guth v. Loft, Inc.</u>, 5 A.2d 503, 510 (Del. 1939) (emphasis supplied), a director of an insolvent corporation is interested in a transaction if he or she receives a personal benefit not shared by all of the insolvent corporation's creditors." Therefore, the complaint adequately alleges that the directors breached their duty of loyalty. *In re Tribune Co. Fraudulent Conveyance Litigation*, ___ B.R. ___ (S.D.N.Y. Jan. 23, 2019).

12.2 Turnover

12.3 Sales

12.3.a **Court overrules objection to a credit-bid claim absent a showing that the reduced price would have resulted in a different sale.** Before bankruptcy, the debtor engaged an investment banker to sell its business as a going concern. Ultimately, the debtor's private equity owner teamed with another financial firm to form a partnership to bid on the purchase. The bid included a credit bid of the PE firm's prepetition second lien debt and of the debtor in possession financing provided by the partnership. No other bidders appeared. After the sale, the Creditors Committee, which had reserved rights to challenge the second lien claim's allowance and priority, the DIP financing, and certain terms of the sale, sought to subordinate or disallow the DIP financing claim.

In its complaint, the Committee did not allege that any other bidder would have bid at all, let alone for an amount that would have been the highest bid after disallowing or subordinating the DIP claim portion of the credit bid. Because disallowance or subordination would not have made a difference in the sale, the Committee does not state a claim on which relief can be granted, and the court dismisses the complaint. *Official Comm. Of Unsecured Creditors v. Victory Park Cap. Advs., LLC (In re Katy Indus., Inc.)*, 590 B.R. 628 (Bankr. D. Del. 2018).

13. TRUSTEES, COMMITTEES, AND PROFESSIONALS

13.1 Trustees

13.2 Attorneys

13.3 Committees

13.4 Other Professionals

13.4.a **GOB sale advisor is not a professional person.** Immediately before bankruptcy, the debtor contracted with a firm that specializes in conducting or advising on going-out-of-business sales for retail merchants. The agreement required the firm to advise on pricing, timing, staffing coordination, accounting, and communication relating to the DIP's planned retail GOB sales, but the DIP retained full authority over these matters. The agreement also permitted the firm to sell furniture, fixtures, and equipment and receive a 15% commission. The prices for the retail sales and the FF&E sales were fixed, not subject to bidding or negotiation, with the DIP fixing the retail prices, and the firm fixing the FF&E prices. Section 327(a) authorizes the employment of "appraisers, auctioneers, or other professional persons" subject to certain requirements and conditions. An auctioneer is one who conducts sales by bidding and sale to the highest bidders. A court determines whether a firm is an "other professional person" based on six factors: control or management of assets that are significant to the reorganization, involvement in negotiating a plan, direct relationship to the debtor's routine business operations, discretion to exercise professional judgment in part of administering the estate, extent of involvement in administration, and degree of specialized knowledge or skill employed. Here, the firm did not accepts bids for assets and so was not an auctioneer. The firm did not control assets significant to the reorganization, was not involved in plan negotiations, had no discretion to administer the estate, and was not involved in administering the estate. Although the firm had specialized knowledge and skill, that factor is largely meaningless, since substantially all who work for any business requires specialized knowledge and skill. The work was not related to the debtor's routine operations, but that factor alone does not predominate in these circumstances. Therefore, the firm is not a section 327(a) "professional person." *In re Brookstone Holdings Corp.*, 592 B.R. 27 (Bankr. D. Del. 2018).

13.5 United States Trustee

14. TAXES

15. CHAPTER 15—CROSS-BORDER INSOLVENCIES

15.1.a **Court recognizes Curacao insurance rehabilitation proceeding.** Curacao law permits a Curacao court, on short notice and after hearing from the insurance regulator and the insurance company, in "the interest of the joint creditors," to issue an order authorizing the regulator to seize and control an insolvent insurance company with a view to continuing its operations and rehabilitating it. Here, the regulator sought the order on July 3, the court gave notice of a hearing on July 4 at 10:00 AM, on July 4 at 10:30 AM, adjourned the hearing to July 4 at 2:15 PM, heard from the regulator and the company, and issued the decree. The court later appointed a foreign representative, who sought recognition under chapter 15 of the Curacao rehabilitation proceeding as a foreign main proceeding. In the chapter 15 case, the foreign representative and the objector disputed whether creditors are entitled to participate in the Curacao proceeding. To grant recognition, the court must find, among other things, that the foreign proceeding is a collective proceeding in which the debtor's assets and affairs are subject to the control or supervision of a foreign court. A proceeding is collective if it considers the rights of and obligations to all creditors, rather than a single creditor or a single group of similarly-situated creditors. Because the proceeding expressly provides that it be conducted in the interest of joint creditors, the proceeding is collective in nature, whether or not the creditors may participate. Section 1502(3) defines "foreign court" as "a judicial or other authority competent to control or supervise a foreign proceeding." An administrative agency is an "other authority" as provided in the definition. The Curacao regulator has authority to control and supervise the debtor in the rehabilitation proceeding. Therefore, the proceeding meets the requirement of supervision or control by a foreign court. Under section 1506, a court may not recognize a foreign proceeding if doing so would be manifestly contrary to the public policy of the United States. Courts must construe the limitation narrowly. Lack of due process would meet the standard. The Curacao court heard the insurance company, though on shortened notice, and many U.S. state insurance regulations permit seizure and rehabilitation *ex parte*. Therefore, the limited notice to the insurance company of the Curacao proceeding was not manifestly contrary to U.S. public policy. *In re ENNIA Caribe Holding N.V.*, ___ B.R. ___, 2018 Bankr. LEXIS 3986 (Bankr. S.D.N.Y. Dec. 20, 2018).

15.1.b **Financial contract safe harbor prohibits a foreign representative from avoiding a transfer under foreign avoiding powers.** In a chapter 15 case, the foreign representative brought an action to recover transfers the debtor made before its foreign liquidation to non-U.S. persons to redeem the debtor's own securities. The actions were based on the foreign jurisdiction's avoiding power statutes that were similar to the Code's preference and fraudulent transfer provisions. Section 546(e) prohibits a trustee from avoiding a prepetition transfer by, to, or for the benefit of a financial institution or financial participant in connection with a securities contract, unless the transfer is avoidable under section 548(a)(1)(A) (actual fraudulent transfer). The section 546(e) safe harbor is designed to prevent the ripple effects in the financial markets of unwinding certain financial transactions. Section 561(d) extends the safe harbor "to limit avoidance powers to the same extent as in a proceeding under chapter 7 or 11." Because a foreign representative may not exercise the Code's avoiding powers, section 561(d) must apply to a foreign representative's attempt to use foreign avoiding powers in a chapter 15 case. Therefore, section 561(d) limits a foreign representative's ability to recover property covered by the section 546(e) safe harbor, and the foreign representative may not avoid a transfer in connection with a securities contract to a financial institution or financial participant. *Fairfield Sentry Ltd. v. Theodoor GGC Amsterdam (In re Fairfield Sentry Ltd.)*, ___ B.R. ___, 2018 Bankr. LEXIS 3827 (Bankr. S.D.N.Y. Dec. 6, 2018).

JENNER&BLOCK

Recent Developments in Bankruptcy Law, April 2019

(Covering cases reported through 596 B.R. 773 and 914 F.3d 1310)

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Recent Developments in Bankruptcy Law, April 2019

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JENNER&BLOCK

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1.1 Covered Activities

1.1.a **Contract parties may not contract out of the automatic stay by agreeing that a party is a "forward contract merchant."** The debtor supplied electricity to its customers under long-term contracts. The contract with a customer who used electricity to manufacture metal auto parts specified the contract was a forward contract, the parties were both "forward contract merchants" as defined in the Bankruptcy Code, and upon a default (including a bankruptcy filing) by either party, the other party could terminate the contract. An exception to the automatic stay permits a forward contract merchant to terminate a forward contract. The Bankruptcy Code defines forward contract merchant as "an entity the business of which consists in whole or in part of entering into forward contracts as or with merchants in a commodity." A contractual term that purports to designate a legal status for a contract party is not effective to override a statutory definition of that status. Therefore, the court must determine, without reference to the contract, whether the customer is a forward contract merchant. *In re FirstEnergy Solutions Corp.*, 596 B.R. 631 (Bankr. N.D. Ohio 2019).

1.1.b **Electricity end user is not a forward contract merchant to whom the automatic stay exception applies.** The debtor supplied electricity under a long-term contract to a customer who used electricity to manufacture metal auto parts. An exception to the automatic stay permits a forward contract merchant to terminate a forward contract. The Bankruptcy Code defines forward contract merchant as "an entity the business of which consists in whole or in part of entering into forward contracts as or with merchants in a commodity." Electricity is a commodity. A merchant is one who engages in a business for profit. To qualify as a forward contract merchant, the entity must purchase or sell the commodity to generate a profit. Simply purchasing a commodity for end use in a business does not qualify the purchaser as a merchant. Therefore, the customer is not a forward contract merchant, and the automatic stay exception does not apply. *In re FirstEnergy Solutions Corp.*, 596 B.R. 631 (Bankr. N.D. Ohio 2019).

1.1.c **Failure to halt state court contempt proceeding to collect prepetition debt violates the automatic stay.** The state court ordered the debtor to pay a property settlement to his former wife by a specified date or appear for a hearing a week later to sentence him for contempt. He failed to pay, and he filed a chapter 13 case before the sentencing hearing. At the sentencing hearing, the state court judge determined she was not restrained by the automatic stay and sentenced the debtor to 30 days in jail, subject to release upon payment of the property settlement amount. The wife's lawyer made no attempt to stay or delay the sentencing hearing. The debtor brought an action against the wife and her lawyer for violating the automatic stay. The stay prohibits any act or the commencement or continuation of any proceeding to collect a prepetition debt. Courts have created exceptions to the automatic stay for contempt proceedings to protect the dignity of the nonbankruptcy court. In this case, the clear purpose of the sentencing hearing was to coerce payment of the property settlement, not to protect the state court's dignity. Creditors have the burden to prevent stay violations. Because the wife and her lawyer did nothing to stay or delay the contempt hearing, whose sole purpose was to collect the prepetition property settlement debt, they violated the automatic stay. *Wohleber v. Skurko (In re Wohleber)*, 596 B.R. 554 (6th Cir. B.A.P. 2019).

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2.6.b **Court limits rights of holders of municipal special revenue bonds.** The municipal debtor had pledged special revenues (primarily highway tolls) to an indenture trustee to secure revenue bonds. After the debtor filed a municipal bankruptcy case, the bond insurer, as the bondholders' subrogee, sought to require the debtor to continue to turn over the special revenue. Section 552(a) cuts off a prepetition security interest on postpetition revenues. However, section 928(a) provides, "Notwithstanding section 552(a) …, special revenues acquired by the debtor after the commencement of the case shall remain subject to any lien resulting from" a prepetition security agreement. Section 928(a) does not require the debtor to continue to turn over postpetition revenues; it only negates section 552(a)'s effect and preserves the security interest on postpetition revenues. Section 922(d) provides the automatic stay does not stay the application of pledged special revenues to payment of debt secured by those revenues. However, it does not provide blanket stay relief to permit bondholders secured by special revenues to collect special revenues nor require the debtor to turn them over. *Assured Guaranty Corp. v. Financial Oversight & Mgmt. Board (In re Financial Oversight & Mgmt. Board)*, ___ F.3d ___, 2019 U.S. App. LEXIS 8981 (1st Cir. Mar. 26, 2019).

2.7 Recovery

2.7.a **Section 550(a)(2) applies to a foreign subsequent transfer.** The Ponzi scheme debtor fraudulently transferred property to foreign investors, who transferred some of the property to their own investors. The trustee avoided the transfers under section 548(a)(1)(A) and sued under section 550(a)(2) to recover the subsequent transfers. There is a presumption against extraterritorial application of a statute. An action may proceed under a statute only if Congress clearly indicated its intent that the statute apply extraterritorially or if the action involved a domestic application of the statute. To determine whether an action involves a domestic application, the court must look at the statute's focus, which is the overriding purpose of the statute or the conduct it seeks to regulate and the parties it seeks to protect. Here, section 550(a)(2) works, and must be read, in tandem with section 548(a)(1) to regulate the harm to the estate and other creditors from the initial fraudulent transfer. Because the initial transfer was made in the United States by a domestic debtor, the application of section 550(a)(2) here involves a domestic application of the statute. *In re Picard*, 917 F.3d 85 (2d Cir. 2019).

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6. CLAIMS AND PRIORITIES

6.1 Claims

6.1.a **Court allows postpetition attorneys' fee claim to undersecured creditor.** The undersecured creditor asserted a claim under the note for postpetition attorneys' fees that would be enforceable under applicable nonbankruptcy law. Section 502(b) provides a claim is allowed unless one of nine enumerated exceptions to allowance apply. None of them disallows attorneys' fees. "Claim" includes a right to payment that is contingent or unliquidated. Even though section 502(b) requires the claim to be determined as of the petition date and the creditor had not incurred postpetition attorneys' fees as of that date, the creditor's fee claim was contingent as of the petition date. The fees became fixed and liquidated during the case and before the final order on allowance, so awaiting the fixing or liquidation of the claim would not delay the case's administration, which is the trigger for section 502(c) estimation. Therefore, the court could allow the claim in the actual amount rather than simply estimating the contingent claim under section 502(c). Section 506(b) allows a claim for attorneys' fees on an oversecured claim. Its function is to fix the secured status of the fee claim and should not be read to override section 502(b), which requires allowance if none of the nine enumerated conditions are met. Therefore, the court allows the creditor's claim for postpetition attorneys' fees. *Summitbridge Nat'l Invs. III, LLC v. Faison*, 915 F.3d 288 (4th Cir. 2019).

6.1.b **Court refuses to enforce unconditional guarantee that violates public policy.** The debtor leased aircraft under a financing lease; the debtor's parent issued an unconditional guarantee. The lease contained a liquidated damages provision that was designed to ensure the lessor received a full return of its investment plus an IRR of 4%. Section 504 of Article 2A of the U.C.C. permits a liquidated damages provision "that is reasonable in light of the then anticipated harm caused by the default or other act or omission." The liquidated damages provision effectively required the debtor to assume the risk of market value loss over the course of the lease and so was not related to the anticipated harm the lessor might suffer upon a default. As such, it was not reasonable and was instead a penalty that is unenforceable as a matter of public policy. Courts typically enforce an unconditional guarantee despite the unenforceability of the guaranteed obligations, except where enforcement would violate public policy. Accordingly, the guarantee is also unenforceable for the same reason as the lease's damages provision. *In re Republic Airways Holdings Inc.*, ___ B.R. ____, 2019 Bankr. LEXIS 407 (Bankr. S.D.N.Y. Feb. 14, 2019).

6.2 Priorities

6.2.a **Trustee may avoid consignor's unperfected interest in proceeds of consigned goods.** The debtor sold the consignor's goods but had not yet paid the consignor the proceeds of sale when the debtor filed bankruptcy. The consignor had not perfected its interest in the goods by the filing of a UCC-1. A consignment is subject to the U.C.C.'s priority and perfection rules. A consignor must perfect, usually by filing a UCC-1, to retain priority in its goods or their proceeds. A delivery of goods to a merchant for sale is a consignment if the merchant deals in those kinds of goods and is not generally known by its creditors to be substantially engaged in selling goods of others. If a merchant is generally so known, then the delivery is not a consignment, and the deliverer need not perfect to prevail over perfected security interests. Here, the debtor was not generally known to be substantially engaged in selling consigned goods, so the supplier's interest in the goods was unperfected and avoidable by the trustee under section 544(a). The UCC treats unperfected consignments the same as unperfected security interests. An interest in proceeds is perfected only if the interest in the goods was perfected. Therefore, the trustee may avoid the supplier's claimed interest in the proceeds. *IPC (USA), Inc. v. Ellis (In re Pettit Oil. Co.)*, 917 F.3d 1130 (9th Cir. 2019).

6.2.b **True consignment requires that debtor purchase at least 20% of its inventory on consignment.** The debtor maintained a program for its suppliers who wished to sell on consignment. About 14% of the debtor's inventory was purchased that way. The debtor also had a term loan secured by a lien on its inventory. The term loan lender perfected its security interest by filing a UCC-1. One consignor filed a UCC-1 to perfect its interest in its consigned inventory only a month before the bankruptcy. The lender did not know the consignor was selling goods on consignment, and the consignor did not give the lender direct notice of its interest once it filed its UCC-1. After bankruptcy, the debtor in possession sold some of the consigned goods. The consignor and the secured lender each claimed the proceeds. A consignment is subject to the U.C.C.'s priority and perfection rules. A consignor must perfect, usually by filing a UCC-1, to retain priority in its goods or their proceeds. A delivery of goods to a merchant for sale is a consignment if the merchant deals in those kinds of goods and is *not* generally known by its creditors to be substantially engaged in selling goods of others. If a merchant is generally so known or if the competing secured creditor actually knows, then the delivery is not a consignment, and the deliverer need not perfect to prevail over perfected security interests. The courts use a 20% rule of thumb to determine whether a merchant is substantially engaged in selling goods of others. Here, the debtor purchased only 14% of its inventory on consignment.

Therefore, the consignor's sale was not a true consignment, and the consignor had to file a UCC-1 to perfect its security interest in the goods. Since it filed its UCC-1 after the lender did so, the lender's security interest has priority and is entitled to the sale proceeds. *TSA Stores, Inc. v. Sport Dimension (In re TSAWD Holdings, Inc.)*, ___ B.R. ___, 2019 Bankr. LEXIS 1181 (Bankr. D. Del. April 12, 2019).

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8.3 Environmental and Mass Tort Liabilities

9. EXECUTORY CONTRACTS

9.1.a **Deemed rejection in a chapter 7 case under section 365(d)(1) applies to unscheduled contracts and leases.** Before bankruptcy, the debtor settled patent litigation that claimed the debtor's machines infringed a patent. Under the settlement, the debtor received a license to use its machines for a royalty. The debtor did not list the license agreements in it schedules or statements of financial affairs. More than 60 days after the debtor's chapter 7 petition, the trustee sold the debtor's assets to its secured lender. The sale included a generic assignment under section 365 of all executory contracts. The licensor later learned of the sale and sought to enjoin the purchaser's use of the machines. Under section 365(d)(1), an executory contract is deemed rejected in a chapter 7 case if the trustee does not assume it within 60 days after the order for relief. Unlike section 554 which addresses abandonment of property and does not apply to contracts and leases, section 365(d)(1) does not contain an exception for contracts or leases the debtor does not schedule. Therefore, the licenses were deemed rejected before the sale. *RPD Holdings, L.L.C. v. Tech Pharmacy Servs. (In re Provider Meds, L.L.C.)*, 907 F.3d 845 (5th Cir. 2018).

10. INDIVIDUAL DEBTORS

10.1 Chapter 13

10.2 Dischargeability

10.3 Exemptions

10.4 Reaffirmations and Redemption

11. JURISDICTION AND POWERS OF THE COURT

11.1 Jurisdiction

11.1.a **Bankruptcy court may not enjoin insurers' claims against settling insurer.** The debtor owned several insurance policies that funded asbestos claims against the debtor. The debtor's insurers had equitable contribution claim against each other and had entered into a cost sharing agreement that apportioned defense and indemnity costs. In its chapter 11 case, the debtor in possession proposed to sell one of the policies to the issuing insurer, free and clear of all claims of other insurers, so that the issuing insurer would no longer be liable to the other insurers for any claims arising from injured parties' claims against the debtor, and to enjoin the other insurers from pursuing any such claims. Section 105(a) grants the bankruptcy court the power to issue orders necessary or appropriate to carry out the provisions of the Bankruptcy Code. In *In re American Hardwoods, Inc.*, 885 F.2d 621 (9th Cir., 1989), and *In re Lowenschuss*, 67 F.3d 1394 (9th Cir. 1995), the Ninth Circuit held section 524(e) deprives bankruptcy courts of the power to release third party claims, that is, claims against others. That rule applies even in the context of a proposed sale under section 363(f) free and clear of interests. Therefore, the court may not enjoin the other insurers' claims against the settling insurer as part of the sale. *In re Fraser's Boiler Serv., Inc.* ___ B.R. ___, .2019 U.S. Dist. LEXIS 37840 (W.D. Wash. March 8, 2019).

11.2 Sanctions

11.3 Appeals

11.3.a **Appeal of settlement that is part of a sale is moot.** The trustee litigated with an adverse claimant over ownership of property. A buyer offered to purchase the property but demanded clear title. The trustee agreed to a settlement with the adverse claimant, resulting in payment of portion of the sale price and release of all claims between the trustee and the adverse claimant. The sale and the settlement were each conditioned on the other. The bankruptcy court approved both in a single order. An unsecured creditor appealed the approval of the settlement. A court of appeals may dismiss a bankruptcy appeal on equitable mootness grounds if the challenged transaction is substantially consummated and would be too complex to unwind. This transaction is simple and could be unwound, so the court denies the trustee's motion to dismiss on equitable mootness grounds. Section 363(m) provides that a reversal on appeal of an order under section 363 approving a sale does not affect the validity of the sale. Neither the Code nor the Bankruptcy Rules provide a similar provision for a settlement approval. However, here, because the sale and the settlement were conditioned on each other and the settlement was an essential part of the sale, section 363(m) prevents appellate review. *New Indus., Inc. v. Byman (In re Sneed Shipbuilding, Inc.)*, 914 F.3d 1000 (5th Cir. 2019).

11.3.b **Section 363(m) does not prevent appeal of an order determining distribution of sale proceeds.** The secured lender mistakenly released its lien long before bankruptcy but corrected its error before bankruptcy. After the property was sold in the bankruptcy, the debtor in possession sought to keep the sale proceeds, free of the lender's secured claim. The bankruptcy court ruled for the lender; the DIP appealed. Section 363(m) prevents the reversal or modification of a sale approval order from affecting the validity of a sale to a good faith buyer. Mootness is a constitutional doctrine that deprives a federal court of jurisdiction when the issues are no longer live or the parties lack a cognizable interest in the outcome. Section 363(m) provides a rule of decision, but does not make a live dispute moot or prevent a bankruptcy court from deciding what should be done with sale proceeds. Because state law here permits a mortgagee to correct a mistaken release before a third party relies on the mistake, the lender properly corrected the mistake and is entitled to the sale proceeds. *Trinity 83 Devel, LLC v. ColFin Midwest Funding, LLC*, 917 F.3d 599 (7th Cir. 2019).

11.4 Sovereign Immunity

11.4.a **Section 106's sovereign immunity abrogation does not apply to Indian tribes.** The trustee sued an Indian tribe to avoid and recover a fraudulent transfer. Indian tribes have sovereign immunity. Congress may abrogate a tribe's sovereign immunity, but only by a clear and unequivocal statement. Inference or implication from legislative language does not suffice. In every instance in which the courts have found abrogation of an Indian tribe's sovereign immunity, Congress has referred expressly to Indians or tribes. Section 106(a) abrogates sovereign immunity of governmental units. Section 101 defines "governmental unit" as the "United States; State; Commonwealth; … foreign state; … or other foreign or domestic government." A tribe is domestic and it is a government. Syllogistically, therefore, it is a domestic government. However, no prior Supreme Court case has referred to an Indian tribe as a "domestic government." Therefore, including Indian tribes within the phrase "domestic government" would require inference or implication, which would be inadequate to bring them within the section's scope. The court dismisses the avoiding power action against the tribe. *Buchwald Cap. Advisors, LLC v. Sault St. Marie Tribe (In re Greektown Holdings, LLC)*, 917 F.3d 451(6th Cir. 2019).

12. PROPERTY OF THE ESTATE

12.1 Property of the Estate

12.1.a **Direct injury claim to former CEO is not property of the estate.** The debtor's former CEO claimed the debtor's principal secured lender, through its control of the board and the debtor's funding, caused the debtor to fire him prepetition. The dismissal entitled him to severance payments, which the debtor could not pay. After bankruptcy, the debtor settled with the lender, releasing all claims against the lender. The former CEO later sued the lender in state court for recovery of his severance payments. Where an act directly injures the debtor, the claim for damages is property of the estate, which any other person indirectly or derivatively injured by the act may not bring. By contrast, a direct injury claim that does not involve any harm to the debtor is not property of the estate and may be brought by the creditor or other party in interest that the act harmed. Even if the act also harms the debtor, as long as the third party's injury is not derivative of the debtor's injury, the third party may independently bring a claim. Here, the former CEO's injury of loss of severance payments did not depend on injury to the debtor; he was injured independently by the lender's act. Therefore, the claim is not property of the estate, and the CRO may bring it. *Meridian Cap. CIS Fund v. Burton (In re Buccaneer Res., L.L.C.)*, 912 F.3d 291 (5th Cir. 2019).

12.1.b **Shareholder derivative action is property of the estate.** After chapter 11, the debtor corporation's sole shareholder sued a competitor for damages under the Ohio RICO statute, which expressly permits a party "directly or indirectly" injured by corrupt conduct to sue for damages. Ordinarily, a shareholder may not sue directly for damages to a corporation but may sue only in a derivative action in the name of the corporation. In authorizing an action by a party indirectly injured, the Ohio legislature did not intend to supplant this body of corporate law. The shareholder could sue only derivatively, as the claim for damages under the Ohio RICO statute belonged to the corporation. Because it belonged to the corporation, upon the corporation's bankruptcy filing, the claim became property of the estate. The shareholder's lawsuit was an act to obtain possession or control of property of the estate and so violated the automatic stay. *Lowe v. Bowers (In re Nicole Gas Prod., Ltd.)*, 916 F.3d 566 (6th Cir. 2019).

12.1.c **Court may grant creditors derivative standing in a chapter 7 case.** The chapter 7 trustee agreed to sell the debtor's causes of action against managers and other insiders and the estate's causes of action to avoid and recover fraudulent transfers to creditors who had been pursuing similar lawsuits before bankruptcy. Sections 548 and 544(b) authorize the trustee to bring avoiding power claims. The Court of Appeals had previously ruled that a bankruptcy court may authorize a chapter 11 creditors committee to bring such claims derivatively on behalf of the estate in certain circumstances, such as when "the Code's envisioned scheme has broken down." The same rationale applies in a chapter 7 case. As in a chapter 11 case, section 503(b)(3)(B), which authorizes compensation to a committee acting on behalf of the estate, applies in a chapter 7 case and recognizes and rewards the practice, as long as the court has previously authorized the action. The court's equitable powers exist equally in chapter 7, and the public policy goals in a chapter 11 case of maximizing creditor recoveries and equality of treatment are the same in a chapter 7 case. *Claridge Assoc., LLC v. Schepis (In re Pursuit Cap. Mgmt., LLC)*, 595 B.R. 631 (Bankr. D. Del. 2018).

12.1.d **Post-bankruptcy death terminates debtor's joint tenancy and deprives trustee of interest in property.** On the petition date, the debtor owned real property in joint tenancy with his wife with right of survivorship. Before the trustee sold the debtor's interest in the property, the debtor died. Applicable non-bankruptcy law applies to determine property interests unless some federal interest requires otherwise. Federal law does not include any property ownership rules; state law governs ownership of property of this kind. Under state law, upon death, the full ownership of the property vests in the wife under the right of survivorship. That divests the estate of any further interest in the property. *Cohen v. Chernushin (In re Chernushin)*, 911 F.3d 1265 (10th Cir. 2018).

12.2 Turnover

12.3 Sales

12.3.a **Section 363(f) does not authorize sale free and clear of claims among third parties.** The debtor owned several insurance policies that funded asbestos claims against the debtor. The debtor's insurers had equitable contribution claim against each other and had entered into a cost sharing agreement that apportioned defense and indemnity costs. In its chapter 11 case, the debtor in possession proposed to sell one of the policies to the issuing insurer, free and clear of all claims of other insurers, so that the issuing insurer would no longer be liable to the other insurers for any claims arising from injured parties' claims against the debtor, and to enjoin the other insurers from pursuing any such claims. Section 363(f) permits sale of property of the estate free and clear of other interests. Courts have construed this authority broadly to encompass any "obligations that may flow from ownership of property or … that are connected to, or arise from, the property being sold." Third party claims that are not against the debtor are not interests in property of the estate unless they are truly derivative of the debtor's own claims or they seek compensation directly from policy proceeds the debtor owns. Here, the inter-insurer claims arise only from rights among the insurers and not from any relationship to the debtor or its property. Therefore, section 363(f) does not authorize sale free and clear of the insurers' claims against the settling insurer. *In re Fraser's Boiler Serv., Inc.* ___ B.R. ___, .2019 U.S. Dist. LEXIS 37840 (W.D. Wash. March 8, 2019).

13. TRUSTEES, COMMITTEES, AND PROFESSIONALS

13.1 Trustees

13.1.a ***Barton* doctrine protects trustees of an asbestos trust.** Asbestos claimants brought an action in state court for breach of fiduciary duty against the trustees of a trust established under a chapter 11 plan to pay future asbestos claimants. The trustee removed the action to the district court, which transferred venue to the bankruptcy court where the chapter 11 case was pending. Under *Barton v. Barbour*, 104 U.S. 126 (1881), a plaintiff may not sue a receiver except in the appointing court. Courts have extended the *Barton* doctrine to protect bankruptcy trustees and liquidating trusts created under a chapter 11 plan. The doctrine's purposes are to ensure consistent and equitable administration of the estate, to protect against judgments issued outside of the appointing court, and to permit the appointing court to exercise appropriate supervisory authority over the trustee. Those considerations apply equally to a trust created under a plan to pay future asbestos claims. Therefore, the doctrine prohibits the filing of an action against the trustees except in the bankruptcy court. Because the plaintiffs filed the action without leave of the bankruptcy court, the court dismisses the action. However, preventing the plaintiffs from bringing their claim at all would defeat the supervisory purpose of the doctrine, so the court dismisses without prejudice. *Smith v. Hilton (In re Swan Transp. Co.)*, 596 B.R. 127 (Bankr. D. Del. 2018).

13.2 Attorneys

13.3 Committees

13.4 Other Professionals

13.5 United States Trustee

13.5.a **Increase in U.S. Trustee fees is temporarily unconstitutional.** In October 2017, Congress increased quarterly U.S. Trustee fees for chapter 11 cases, effective January 1, 2018. The increase did not apply in the non-U.S. Trustee districts of Alabama and North Carolina. In those districts, the Judicial Conference determines Bankruptcy Administrator fees, which had been previously set in the same amounts as U.S. Trustee fees. The Judicial Conference increased fees in those districts effective October 1, 2018 to the same amounts as Congress imposed in U.S. Trustee districts effective January 1, 2018. The Constitution authorizes Congress to enact uniform laws on the subject of bankruptcies. Although different results in bankruptcy cases are permissible based on underlying state law, Congress may not enact different results in different parts of the country. By increasing U.S. Trustee fees in only 48 states, Congress enacted a non-uniform bankruptcy law. Therefore, the increase violates the Uniformity Clause for the nine months between January and October 2018 when the fees in the two states were different, and the estate is not required to pay the increased fees during that time. *In re Buffets, LLC*, ___ B.R. ___, 2019 Bankr. LEXIS 396 (Bankr. W.D. Tex. Feb. 8, 2019).

14. TAXES

15. CHAPTER 15—CROSS-BORDER INSOLVENCIES

15.1.a **Foreign debtor need not seek chapter 15 recognition as a condition to a recognition of the foreign insolvency judgment.** The debtor commenced a CCAA proceeding in Canada to restructure its obligations. The Canadian court set a claims bar date, gave notice to creditors, and ultimately sanctioned an arrangement that converted debt to equity and discharged securities fraud claims against the debtor and its CEO. U.S. securities fraud plaintiffs knew of the CCAA proceeding and the bar date but chose instead to commence an action in New York against the debtor and its CEO for U.S. securities law violations. The defendants moved to dismiss on international comity grounds. Comity is particularly appropriate in connection with foreign insolvency proceedings and should be granted when the foreign proceeding satisfies fundamental due process standards and when granting comity would not violate any U.S. laws or public policies. A CCAA proceeding involves notice to creditors and an opportunity to be heard and similar treatment of similarly situated creditors and so satisfies fundamental due process requirements. Nothing in the CCAA proceeding or the sanction order, including the release of the CEO from securities fraud claims, violates fundamental U.S. law or public policy. Although the debtor could have sought recognition under chapter 15 in the United States of the CCAA proceeding, its failure to do so does not preclude a U.S. court from giving the Canadian court the recognition that the United States allows to the acts of a foreign nation. Therefore, the court dismisses the action against the debtor and its CEO on grounds of international comity. *EMA Garp Fund v. Banro Corp.*, ___ B.R. ___, 2019 U.S. Dist. LEXIS 27387 (S.D.N.Y. Feb. 21, 2019).