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Business Update: Hot Topics in Business Law

CONCURRENT SESSION

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"Business Update"—Hot Topics in Business Law

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A New Look at the "New Value" Preference Defense in the Eleventh Circuit

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In *In re BFW Liquidation, LLC*, 899 F.3d 1155 (11th Cir. 2018) the Eleventh Circuit recently narrowed the circuit split on whether the new value for the "new value" defense to a preference claim under 11 U.S.C. §547(c)(4) must remain unpaid. Joining the Fourth, Fifth, Eighth, and Ninth Circuits, the Eleventh Circuit revisited its decision in *In re Jet Florida System, Inc.*, 841 F.2d 1082 (11th Cir. 1988) which had been treated as precedent for over thirty years for the proposition that the new value must remain unpaid and rejected that requirement. *In re BFW Liquidation, LLC*, 899 F.3d at 1187.

Background of *BFW.*

The Debtor in *BFW*, was a large regional grocery-store chain which purchased ice cream and related products on credit from a supplier and paid the supplier over $550,000 during the 90-day preference period. The supplier did not dispute the amount of the payments or that all of the elements of a preference under 11 U.S.C. §547(b) were met but contended that the payments were subject to the "ordinary course" defense of 11 U.S.C. §547(c)(2) and the "new value" defense of 11 U.S.C. §547(c)(4) for new product deliveries to the Debtor totaling over $435,000 during the preference period. Because the payment terms had been altered during the preference period, the Bankruptcy Court rejected the "ordinary course" defense. As to the "new value" defense, the Bankruptcy Court determined that it was bound by the Eleventh

Circuit's *Jet Florida* decision to limit the supplier's new value defense to the extent that the new value "remained unpaid" as of the filing date and held that the supplier was liable to the estate for almost $440,000. The supplier appealed, and the parties' petition for direct appeal to the circuit court was granted.

In re Jet Florida System, Inc.—Dictum.

The supplier argued that the *Jet Florida* language that the new value must remain unpaid is dictum and contrary to the statutory language. The trustee argued that *Jet Florida* was binding precedent in the Eleventh Circuit and that policy considerations support requiring the new value to remain unpaid in order to serve as a defense to preference liability even if it was not. The trustee in *Jet Florida* sought to avoid approximately $12,000 for warehouse rent payments made by the debtor during the preference period. Notwithstanding the debtor having vacated the premises prior to the preference period, the landlord asserted the new value defense because the premises were made available to the debtor albeit not used. The Bankruptcy Court's rejection of the new value defense based upon its finding that no new value had been extended was affirmed on appeal by both the district court and the Eleventh Circuit. Because new value was never an issue in the *Jet Florida* decision, the Eleventh Circuit ruled in *BFW* that its statement in *Jet Florida* requiring that the new value must remain unpaid was dictum. *In re BFW Liquidation, LLC*, 899 F.3d at 1187.

Analysis and Holding.

The Eleventh Circuit then considered whether 11 U.S.C. §547(c)(4) required the new value to remain unpaid and held, based upon the plain language of the statute as well as the statutory history, that it did not. *Id*. The court also rejected the trustee's contrary argument and concluded that policy considerations "strongly disfavor" requiring the new value to remain unpaid. *Id*. The court stated that by its plain terms, the statute only excludes "paid" new value this is paid for with "an otherwise unavoidable transfer." *Id*. at 1189. Therefore, so long as the transfer that pays for the new value is itself avoidable, that transfer is not a barrier to assertion of §547(c)(4)'s subsequent-new-value defense. *Id*.

After noting that the unambiguous plain language of 11 U.S.C. §547(c)(4) foreclosed consideration of the statutory history, the court reviewed that history anyway and determined that it bolsters its conclusion that the new value need not remain unpaid. *Id*. at 1190. The former § 60(c) allowed the defense only for unsecured new value given in good faith to the extent that "the amount of such new credit *remaining unpaid* at the time of the adjudication in bankruptcy . . . ." Id. (citing 11 U.S.C § 96(c)(1976)). When Congress repealed this provision in 1978 and replaced it with 11 U.S.C. §547(c)(4), the "remaining unpaid" language was replaced with 11 U.S.C. §547(c)(4)'s requirement that the debtor not make an otherwise unavoidable transfer to or for the benefit of" the creditor who gave the new value. *Id*. at 1191. The court noted the recommendation of the Commission on the Bankruptcy Laws established by Congress in 1970 to eliminate the "remaining unpaid" requirement and viewed this significant change as the expression of Congressional intent to change the substantive law. *Id*. at 1191-92.

The court then rejected the trustee's contention that policy considerations favor requiring the new value to remain unpaid and determined that policy considerations "strongly disfavor" this approach. *Id*. at 1192-93. Noting that debtors are generally in business to sell goods for a profit, the *BFW* court agreed with the supplier that allowing the new value to be paid encourages suppliers to continue to sell product to an ailing customer whereas the trustee's position would precipitate the debtor's demise because vendors would cease selling product to the ailing customer. *Id*. at 1193-95. The court also noted that these same considerations promote equality of treatment among creditors which is the principal aim of 11 U.S.C. §547 since encouraging vendors to continue extending credit to financially troubled customers could potentially avert the customer's filing bankruptcy altogether. *Id*. at 1195-96.

The following table is illustrative:

	Transfer from creditor to debtor	**Transfer from debtor to creditor**
Transfer 1	$1,000 in goods	
Transfer 2		$1,000 in cash
Transfer 3	$1,000 in goods	
Transfer 4		$1,000 in cash

Assuming that Transfers 1-4 occur during the preference period and that Transfers 2 and 4 are subject to preference avoidance under 11 U.S.C. §547(b), the trustee would be entitled to recover $2,000 from the creditor if the new value must remain unpaid. Under the *BFW* ruling, the creditor would be entitled to the new value defense as to Transfer 3 even though it was paid by Transfer 4 because Transfer 4 is "not unavoidable"; so the trustee is only entitled to recover $1,000 instead of $2,000. *See Id.* at 1194-95. According to the *BFW* court, creditors have "strong disincentives . . . to continue supplying an ailing customer with goods if the Trustee's position wins out . . . and the prudent vendor, sensing financial problems by the debtor, would be foolish to continue delivering goods to the debtor following Transfer 2." *Id*.

<u>Other Circuits.</u>

With the *BFW* decision, the Eleventh Circuit joined the Fourth, Fifth, Eighth, and Ninth Circuits in rejecting the position that 11 U.S.C. §547(c)(4) requires the new value to remain unpaid. *See In re JKJ Chevrolet, Inc.*, 412 F.3d 545, 551-52 (4th Cir. 2005); *In re Jones Truck Lines, Inc.*, 130 F.3d 323, 329 (8th Cir. 1997); *In re IRFM, Inc.*, 52 F.3d 228, 231-33 (9th Cir. 1995); *In re Toyota of Jefferson, Inc.*, 14 F.3d 1088, 1090-93, 1093 n. 2 (5th Cir. 1994). The Eleventh Circuit noted that Seventh Circuit has held "without much discussion" that the new value must remain unpaid. *Id.* at 1189, n. 9 (*citing In re Prescott*, 805 F.2d 719, 727-28 (7th Cir. 1986); *In re P.A. Bergner & Co.*, 140 F.3d 1111, 1121 (7th Cir. 1998)). The Eleventh Circuit also noted that Third Circuit ruled "in a conclusory fashion that § 547(c)(4) requires new value to remain unpaid . . . [h]owever, whether § 547(c)(4) requires new value to remain unpaid was not at issue in that case." *Id.* (*citing In re N.Y.C. Shoes, Inc.*, 880 F.2d 679, 680 (3d Cir. 1989); *In re Friedman's Inc.*, 738 F.3d 547, 551-52 (3d Cir. 2013) (concluding that the statement in *New York City Shoes* indicating that new value must remain unpaid as of the petition date was not a holding with respect to whether post-petition payments could affect a creditor's subsequent-new-value defense)). Perhaps the Third and Seventh Circuits will have an opportunity to reevaluate their positions on this issue in light of the Eleventh Circuit's *BFW* ruling.

“Equitable Mootness” Bars Appeal of Jefferson County Chapter 9 Plan Confirmation

In *Bennett v. Jefferson County, Alabama*, 899 F.3d 1240 (11th Cir. 2018), the Eleventh Circuit Court of Appeals reversed the district court’s order denying the county’s motion to dismiss the appeal of the bankruptcy court order confirming it Chapter 9 plan based upon its ruling that equitable mootness was not applicable to Chapter 9 proceedings.

Background.

Prior to the City of Detroit’s Chapter 9 filing in 2013, the Chapter 9 filing of Jefferson County, Alabama in 2011 was the largest municipal bankruptcy filing in the United States. Approximately $3.2 billion of the county’s long-term debt in excess of $4.2 billion consisted of defaulted sewer warrant debt secured only by the sewer revenues. The confirmation order entered in November 2013 was the culmination nearly five years of extensive, complex, and sometimes very contentious pre- and post-petition negotiations and litigation in state and federal courts. The confirmed plan provided in part for the issuance of $1.8 billion in new sewer warrants to pay off the reduced and discounted sewer debt also secured only by sewer revenues and included rate covenants that locked in rate increases to be paid over 40 years with the bankruptcy court retaining jurisdiction to compel such rate increases. The confirmation order was entered over the objection of certain ratepayers who appealed the confirmation order to the district court. The effective date of the plan was less than fourteen days after the entry of the confirmation order notwithstanding the provisions of Bankruptcy Rule 3020(e) which were waived on the county’s motion without objection by the ratepayers. The ratepayers filed their notice of appeal two days prior to the effective date of the plan without seeking a stay pending appeal from either the bankruptcy court or the district court and without seeking to have their appeal expedited; and the county consummated the plan and issued the new sewer warrants pursuant to the plan on the effective date notwithstanding the appeal.

The county then moved the district court to dismiss the appeal contending that the ratepayers' challenges to the confirmation order were constitutionally, statutorily, and equitably moot because of the consummation of the plan and because the transactions contemplated by and warrants issued pursuant to the plan could not be unwound. The ratepayers opposed the motion contending that their appeal was not moot arguing that the bankruptcy court could not constitutionally retain jurisdiction to conform sewer rates to the plan for the contemplated 40 years since Alabama law controlled the rate-setting process.

The district court denied the motion to dismiss holding that the appeal was not moot under Article III and that it could fashion "some form of meaningful relief." The district court also ruled that the appeal was not statutorily moot holding that 11 U.S.C. §364(e) did not apply to the issuance of the replacement sewer warrants pursuant to the plan. Lastly, the district court rejected that application of equitable mootness to a Chapter 9 confirmation order in light of the public and political interests at stake and ruled further that it would deny the motion to dismiss even if it considered equitable mootness appropriate in Chapter 9 proceedings. The district court certified its ruling for interlocutory review, and the county appealed to the Eleventh Circuit.

Analysis and Holding.

The Eleventh Circuit concluded that the case was not constitutionally moot but ruled that equitable mootness applied, reversed, and remanded the case to the district court for dismissal of the ratepayers' appeal. *Id*. at 1245. The court noted that the Supreme Court has not endorsed the doctrine of equitable mootness but neither has the Supreme Court nor any court of appeals rejected it outright. *Id*. at 1247. The doctrine has emerged to provide that reviewing courts under certain circumstances may reject bankruptcy appeals if rulings have gone into effect and would be extremely burdensome, especially to non-parties, to undo. *Id*. The reference to mootness is actually a fiction, and application of the doctrine turns on equitable and prudential concerns focusing on the reasonableness of entertaining challenges to an order of the bankruptcy court more akin to forfeiture, waiver or laches. *Id.*

In deciding whether the doctrine bars an appeal the court looks at whether allowing the appeal to go forward will impinge upon actions taken in "good faith reliance on a [final and unstayed] judgment." *Id*. at 1248. The court noted that "[t]he more substantially the party aggrieved by a judgment has allowed the egg of that judgment to be scrambled—the more that people have acted in ways that render inequitable the relief sought by the aggrieved party—the less likely [the court] will be willing to consider ordering anyone to countenance 'the pains that attend any effort to unscramble the egg.'" *Id*. (*citing In re UNR Indus., Inc.*, 20 F.3d 766, 769 (7th Cir. 1994)). The court will be less likely to invoke the doctrine if the relief sought does not undermine actions that may have been taken in reliance on the judgment or if the aggrieved party sought but was unjustifiably denied a stay pending appeal. *Id*. at 1249. (As to "unscrambling the egg" in the *Jefferson County* case, see the chart prepared by the counsel for Jefferson County attached and reprinted with express permission.)

The court then turned its focus upon the applicability of the doctrine of equitable mootness to the Chapter 9 context and rejected the district court's concern about the implications of sovereignty and self-governance in the municipal bankruptcy context as opposed to the absence of such concerns in corporate or individual bankruptcies. *Id.* at 1250. The court noted that such concerns can actually cut the other way and that the court should be "*more* solicitous to the municipality that has obtained confirmation of its plan and thus be *especially inclined* to pull the trigger of equitable mootness." *Id*. at 1250-51. Notwithstanding the ratepayers' assertion of constitutionally protected rights, the court noted that even those can be waived or forfeited by a party's failure to comply with procedural rules for the assertion of those rights. *Id*. at 1251. The court joined the Sixth Circuit and the Ninth Circuit B.A.P. in extending the application of equitable mootness to the Chapter 9 context. *Id*.; *see In re City of Detroit*, 838 F.3d 792 (6th Cir. 2016); *In re City of Stockton*, 542 B.R. 261 (9th Cir. B.A.P. 2015).

Applying the doctrine to the present case, the Eleventh Circuit found critical that the ratepayers had never asked any court to stay the confirmation order, that they did not object to the waiver of the 14-day automatic stay of the, and that they did not seek to expedite their appeal. *Jefferson County, Alabama*, 899 F.3d at 1251. The confirmation order had, therefore, been in effect for more than a year before the county's appeal to the Eleventh Circuit. *Id*. Further, "the County and others had taken significant and largely irreversible steps in reliance upon the plan confirmed by the bankruptcy court. Specifically the County has issued over one billion dollars' worth of new sewer warrants and has used the proceeds to retire the old sewer warrants . . . based on a commitment—backed by and unstayed court order—to set sewer rates at particular amounts over the course of the next 40 years." *Id*. at 1252. In light of this, the court found that permitting the appeal to proceed would be inequitable or practically impossible. *Id*. Lastly, the court dismissed the ratepayers' argument that confirmation of the plan allows the present county commissioners to improperly bind future commissioners holding that such is common with any long-term decision in municipal governance. *Id*. at 1253.

<u>The Dissent.</u>

Actually there was not dissent in this case, but it is interesting that the Eleventh Circuit mentioned in reference to the district court ruling but did not address "the Supreme Court's reaffirmation of the principal that federal courts have a 'virtually unflagging' obligation to hear and decides (*sic*) cases within their jurisdiction." *Id*. at 1245. The district court did not address this issue because it ruled that equitable mootness was inapplicable to challenges to a confirmation order in Chapter 9 proceedings. *Bennett v. Jefferson County, Ala.*, 518 B.R. 613 (N.D.Ala. 2014). Having reached the contrary position, perhaps the Eleventh Circuit should have dealt with the issue.

The Eleventh Circuit also did not address the Article I/Article III issue. The argument is that to the extent equitable mootness is applied to preclude review of the exercise of Article III judicial power by Article I bankruptcy courts, the doctrine is unconstitutional. *Cf. Wellness Int'l Network, Ltd. v. Shariff*, ____ U.S. ____, 135 S.Ct. 1932 (2015); *Stern v. Marshall*, 564 U.S. 462, 131 S.Ct. 2594 (2011); *Northern Pipeline Construction Co. v. Marathon Pipe Line Co.*, 458 U.S. 350, 102 S.Ct. 2858 (1982); Anderson, *The Emperor's New Clothes* (1837). Time will tell whether the Supreme Court weighs in on the issue.

Supreme Court to Review Licensee's Rights Upon Debtor-Licensor's Rejection of License

On October 26, 2018, the Supreme Court granted certiorari in *Mission Product Holdings, Inc. v. Tempnology, LLC,* 17-1657, ___ U.S. ____ (2018) and in doing so will resolve a recently deepened circuit split on the effect of the debtor-licensor's rejection of a licensing agreement under 11 U.S.C. §365 upon the nondebtor-licensee's use of the license or trademark. In *In re Tempnology, LLC*, 879 F.3d 389 (1st Cir. 2018), the First Circuit Court of Appeals in a 2/1 panel decision ruled that trademarks did not constitute "intellectual property" as defined in 11 U.S.C. §101(35A) and joined with the Fourth Circuit in holding that the debtor's rejection of the agreement terminated the nondebtor's rights under the agreement to use the trademark.

Lubrizol.

In *Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc.*, 756 F.2d 1043 (4th Cir. 1985), the debtor granted Lubrizol a non-exclusive license to use debtor's metal coating process technology under a technology licensing agreement. The bankruptcy court approved debtor's rejection of the agreement under 11 U.S.C. §365(a), but the district court reversed—holding that the agreement was not executory and, alternatively, that rejection could not reasonably be expected to benefit the debtor. *Id*. at 1044. Holding that the agreement was executory, finding no exception for technology licenses, the Fourth Circuit ruled that in light of the broad scope of 11 U.S.C. §365, the licensee was left only a monetary claim against the estate based upon the resulting breach of the agreement and reversed. *Id*. at 1044-48.

Congressional Response.

In response to the Lubrizol decision, Congress amended 11 U.S.C. §365 in 1988 to add new Section 365(n) to protect licensees of "intellectual property" as defined in 11 U.S.C. §101(35A). Glaringly, trademarks were excluded from the new definition of "intellectual property" which left open the question of whether the protections of new Section 365(n) extended to the rights of trademark licensees. While that specific question was left unanswered by the Seventh Circuit in *Sunbeam Products, Inc. v. Chicago American Manufacturing LLC*, 686 F.3d 372 (7^{th} Cir. 2012), its ruling created the present circuit split.

Sunbeam—Circuit Split.

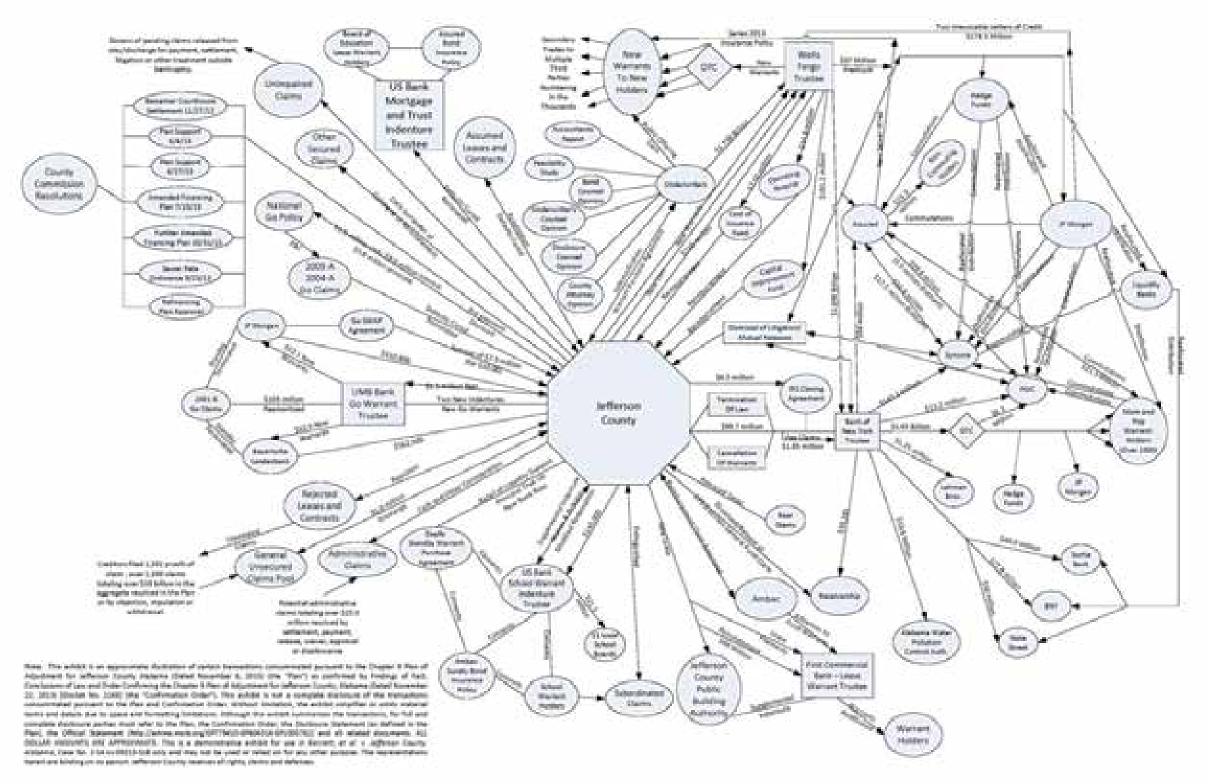
In *Sunbeam*, the trustee and purchaser of debtor's assets (including patents and trademarks) sued the company that was manufacturing fans for the debtor under a prepetition licensing agreement and "requirements contract" which the trustee had rejected contending that the license was terminated upon rejection. *Id*. at 374-75. After determining that the contract was ambiguous, the bankruptcy court ruled that the company could make as many fans as would have been needed for the term of the contract and could sell them bearing the debtor's trademarks. *Id*. at 375. Without deciding the effect of rejection of the contract, the bankruptcy court allowed the company to continue production of the branded fans based upon equitable grounds in light of the company's substantial investment in such production. *Id*.

On direct appeal the Seventh Circuit reviewed the background of *Lubrizol* and the 1988 amendments, determined that "[t]he limited definition in § 101(35A) means that § 365(n) does not affect trademarks one way or another", and declined to follow *Lubrizol. Id*. at 374-78. The *Sunbeam* court focused upon the language of 11 U.S.C. §365(g) that rejection of an executory contract "constitutes a breach of such contract" and noted that the rights of the nondebtor party are not "vaporized" and reduced to a monetary claim upon rejection. *Id*. at 376-77.

Some bankruptcy courts inferred from this omission that Congress intended to codify *Lubrizol* with respect to trademarks.

Mission Product Holdings (In re Tempnology)—Supreme Court Resolution.

The First Circuit in *Mission Product Holdings* adopted the *Lubrizol* analysis and ruled that after the Chapter 11 debtor's rejection of a licensing agreement, the distributor-licensee of debtor's cooling technology had no remaining distribution rights or rights in debtor's trademarks or logo. *In re Tempnology*, 879 F.3d 389 (1st Cir. 2018). The Supreme Court's granting certiorari on the issue of "Whether, under §365 of the Bankruptcy Code, a debtor-licensor's "rejection" of a license agreement which "constitutes a breach of such contract, " 11 U.S.C. §365(g)-terminates rights of the licensee that would survive the licensor's breach under applicable non-bankruptcy law" in *Mission Product Holdings* will resolve the circuit split on this important issue.


County Commission Resolutions
Unimpaired Claims
US Bank Mortgage and Trust Indenture Trustee
Other Secured Claims
Assumed Leases and Contracts
National Go Policy
2005-A 2004-A Go Claims
New Warrants To New Holders
DTC
Wells Fargo Trustee
Jefferson County
UMB Bank Go Warrant Trustee
Rejected Leases and Contracts
General Unsecured Claims Pool
Administrative Claims
Subordinated Claims
Jefferson County Public Building Authority
First Commercial Bank – Lease Warrant Trustee
Warrant Holders
Ambac

It's All About Percentages: Delaware's Take on Unfair Discrimination in Cramdown Plans

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In *In re Tribune Media Co.*, 587 B.R. 606 (D. Del. 2018), Judge Sleet of the Delaware District Court affirmed the Bankruptcy Court's confirmation of the debtors' Chapter 11 plan, holding that the lower court properly determined that it was not required to enforce prepetition subordination agreements. The District Court noted that while a large amount of money was at issue, the percentage difference of 2.3% in recovery for senior noteholders was insignificant and immaterial to be considered unfairly discriminatory for purposes of cramming down the plan. The District Court also affirmed the lower court's ruling that the Swap Claim associated with the debtors' leveraged buyout was entitled to seniority under the subordination agreements. *In re Tribune Media Co.*, 587 B.R. 606 (D. Del. 2018).

Background

In December 2007, the Tribune Company ("Tribune") and its affiliates, owners of operators of newspapers, television stations, and media properties (including the *Chicago Tribune* and the *Los Angeles Times*), had completed a leveraged buyout (LBO) of the company. *Id.* at 610. Following the LBO, Tribune's debt included (1) $10.2 billion in LBO debt, (2) $1.2 billion in "Senior Notes," for which Law Debenture Trust Company of New York & Deutsche Bank Trust served as indenture trustee ("Indenture Trustee"), (3) approximately $1 billion in subordinated debt, and (4) $265 million in "Other Parent Claims," which included a $151 million claim ("Swap Claim") from the termination of an interest rate swap tied to the LBO. *Id.*; *In re Tribune Media Co.*, 799 F.3d 272, 274 (3d Cir. 2015).

In December 2008, Tribune and several of its subsidiaries ("Debtors") filed for voluntary Chapter 11 protection. *Tribune*, 587 B.R. at 610. Various stakeholders proposed plans of reorganization, with the Debtors submitting a plan ("Plan") that was eventually confirmed and consummated over the objections of dissenting creditors. Parties representing the interests of certain pre-LBO debt objected and argued that the Plan unfairly discriminated against certain classes of senior noteholders. *Id.* at 611.

On appeal, the Delaware District Court affirmed the Bankruptcy Court's confirmation and found the appeals of the parties to be equitably moot. *Id.* at 609-10. The Third Circuit affirmed the District Court's decision in part, but found the appeal from the Indenture Trustee not equitably moot and remanded to the lower court for a determination on the merits. *Id.* at 610.

The Indenture Trustee represented senior noteholders ("Class 1E Creditors") who were party to a subordination agreement with two subordinated notes—PHONES notes and EGI notes. *Id.* According to the agreement, any recovery by PHONES and EGI noteholders would be payable to Class 1E Creditors if Tribune went bankrupt. *Id.* However, the Plan disregarded this agreement and provided that any recovery from these notes would be distributed pro rata between Class 1E Creditors and Class 1F, which consisted over about 700 creditors, mostly consisting of individuals and small business trade creditors. *Id.* at 610-11. The difference between the Indenture Trustee's desired recovery under the subordination agreement and the one consummated under the Plan was 2.3%, which the Bankruptcy Court found to be immaterial and therefore, not unfairly discriminatory. *Id.* at 611.

Furthermore, the Swap Claim was deemed by the Bankruptcy Court to be a senior debt under the subordination agreement like the LBO itself, further reducing the alleged discrimination against the Indenture Trustee to only 0.9% of the initial recovery percentage since the Swap Claim was due to share in the subordinated recoveries. *Id.*

Analysis and Holding

The Delaware District Court applied a clear error review for the Bankruptcy Court's determination that the alleged discrimination was immaterial and *de novo* review for the Bankruptcy Court's interpretation of Section 1129 and relevant portions of the Bankruptcy Code. *Id.* at 612. On appeal, the Indenture Trustee made three key arguments: (1) that the Bankruptcy Court erred in its interpretation of § 1129(b)(1) by not enforcing the subordination agreements; (2) even if the subordination agreements were not enforceable, the Bankruptcy Court erred in its determination that the Plan did not "discriminate unfairly" against senior noteholders; and (3) that the Bankruptcy Court erred in finding the Swap Claim to be senior debt under the subordination agreement. *Id.* at 612-13.

The Indenture Trustee initially argued that the Bankruptcy Court erred in its reading of § 1129(b)(1) because the statutory text of § 510(a) requires strict enforcement of subordination agreements. *Id.* at 613. The District Court agreed with the Bankruptcy Court's interpretation, which turned on the plain meaning of the word "notwithstanding" in § 1129(b)(1) to mean "in spite of" or "without prevention or obstruction from or by." *Id.* Additionally, the District Court addressed the Indenture Trustee's argument regarding the legislative history of the "notwithstanding" language in § 1129(b)(1) and found that the US Supreme Court has held that legislative history has no role in the interpretation of an ambiguous statute, which is not the case here as it found only one plausible reading of the statute. *Id.* at 614-616 (citing *Exxon Mobil Corp. v. Allapattah Servs., Inc.*, 545 U.S. 546, 568 (2005)). The District Court also concluded that adopting the Indenture Trustee's interpretation would require a court to enforce alleged subordination agreements without assessing the economic harms, an inconsistency with bankruptcy courts' flexibility when inquiring whether a Chapter 11 plan unfairly discriminates. *Id.* at 615. As such, the District Court found that the Bankruptcy Court was permitted to confirm the Plan over the objection of a dissenting class so long as the Plan did not discriminate unfairly and is fair and equitable, even if the Plan did not completely enforce a subordination agreement. *Id.* at 616.

Turning to the Indenture Trustee's argument that the Bankruptcy Court mistakenly held that the Plan did not unfairly discriminate against senior noteholders, the District Court analyzed various methods used by courts to determine whether a proposed plan of reorganization unfairly discriminates against a dissenting class. *Id.* at 616-18. The District Court agreed with the Bankruptcy Court's decision to apply the Markell rebuttable presumption test ("Markell Test"), which allows for a presumption of unfair discrimination to be rebutted when there is an allegation of a materially lower percentage recovery by showing that the dissenting class, outside of bankruptcy, would receive less than the class receiving a greater recovery. *Id.* at 617. As previously noted, the difference in recovery for the Indenture Trustee under the Plan was at most 2.3% lower than the recovery under the subordination agreement. *Id.* at 611. The District Court agreed with the Bankruptcy Court, which concluded that the alleged discriminatory effect was immaterial and, therefore, no rebuttable presumption of unfair discrimination arose. *Id.* at 618.

Finally, the District Court affirmed the lower court's finding that the Swap Claims were senior debt entitled to shared recovery under the subordination agreement. *Id.* at 618-19. While the Indenture Trustee asserted that that the Swap Claim did not qualify as "Senior Indebtedness" (as defined in the PHONES agreement) or as a "Senior Obligation" (as defined in the EGI agreement), the District Court disagreed. *Id.* at 619-20. The Swap Claim was deemed as "Debt" in Tribune's financial statements and was accounted for as either short-term or long-term debt, not an accrued expense. *Id.* at 620-21. Additionally, the Swap Claim was incurred in connection with the LBO, clearly outside the "ordinary course of business". *Id.* at 621. As such the Bankruptcy Court found the Swap Claim to fall squarely within the definitions of senior indebtedness found in the PHONES and EGI agreements respectively and the District Court agreed. *Id.*

Takeaways

Given that the Bankruptcy Code does not define unfair discrimination and that the Third Circuit has yet to address what standard to apply, this case provides some insight into the methods used by courts to determine whether a plan of reorganization unfairly discriminates against dissenting classes of creditors. *Id.* at 618; *Compare In re Dow Corning Corp.*, 244 B.R. 696, 700 n. 3 (Bankr. E.D. Mich. 1999) (listing other cases that apply the traditional four-factor test) *with Tribune*, 587 B.R. at 617-18 *and In the Matter of Greate Bay Hotel & Casino. Inc.*, 251 B.R. 213, 231 (Bankr. D.N.J. 2000). Additionally, the District Court's analysis on the materiality of the percentage difference provides a reference point for stakeholders in assessing the economic impacts of proposed plans of reorganization with discriminatory economic harms on different classes. As rationalized by the District Court in finding no unfair discrimination with the Plan, "[w]hile the actual amount of money at issue is large, the percentage difference is not significant or material." *Tribune*, 587 B.R. at 618. The District Court's affirmation of the Bankruptcy Court's findings highlights the broad discretion afforded to courts in deciding whether to enforce prepetition subordination agreements, so long as the economic impact of the consummated plan does not offend the test for determining unfair discrimination.

The Texas Supreme Court Takes on a $63 Million Executory Contract Dispute

A recent decision from the Texas Supreme Court highlighted the interaction between state and bankruptcy law and put a spotlight on standard plan catchall provisions for the assumption and rejection of executory contracts. This $63 million case began in a Houston state court and eventually meandered its way to the United States Supreme Court on a cert petition that was recently denied.

Bankruptcy Background

ConocoPhillips and Alma Energy (the eventual debtor) swapped oil and gas properties in January 1994 under an Exchange Agreement pursuant to which each party indemnified the other for any environmental claims related to the swapped properties. The agreement provided that the mutual indemnities would "survive ... the transfer of the Assets."

In 1999, Alma filed Chapter 11 in Louisiana bankruptcy court. After a court-approved auction, Alma entered into a purchase agreement (the "APA") on May 3, 2000, in which the buyer (a predecessor of Noble Energy) agreed to buy certain oil and gas interests described in an Exhibit "A" to the APA, which included the properties Alma had received from ConocoPhillips under the 1994 Exchange Agreement. The buyer also agreed to buy "[a]ll [Alma's] rights and interests in and to all ... agreements ... in any way associated with the Assets, including but not limited to, those Material Contracts ... described on Exhibit 'D'." The Exchange Agreement, though "associated with the Assets," was not listed on Exhibit D to the APA, nor was it listed in Alma's Schedules or mentioned in any way in the bankruptcy case.

The debtor later filed a chapter 11 plan on July 24, 2000 that authorized "[a]ll transfers of assets anticipated or provided for under the [APA]" and also contained several provisions regarding executory contracts but, again, did not mention the Exchange Agreement. Section 10.9 of the Plan provided that executory contracts not specifically rejected at closing were to be "assumed and assigned to [the buyer]." The list of 132 contracts that the buyer designated for rejection on August 4, 2000 did not list the Exchange Agreement. The bankruptcy court's August 31, 2000 Confirmation Order "approved and confirmed in all respects" the Plan and the APA.

State Court Lawsuit Background

In May 2010 (10 years post-confirmation), ConocoPhillips and others were sued in Louisiana for environmental damages, and ConocoPhillips sought indemnity from Noble Energy (the buyer's successor) under the terms of the Exchange Agreement, and Noble ultimately refused to provide such indemnity.

In May 2012, ConocoPhillips sued Noble in Houston state court for breach of the Exchange Agreement and sought to recover $63 million from Noble (which represented the amount it paid to settle the suit in 2011). During the discovery phase, Noble raised for the first time that the Exchange Agreement related to Alma's bankruptcy case and that bankruptcy provided Noble with a variety of defenses to the ConocoPhillips's indemnity lawsuit. Both sides then moved for summary judgment.

The trial court denied ConocoPhillips' motion and granted Noble's on the theory that the Exchange Agreement was not assigned to Noble. Accordingly, the Houston state court determined that Noble was not obligated to indemnify ConocoPhillips for its $63 million loss.

Appeals Background

ConocoPhillips appealed the Houston state court's decision to the Texas Court of Appeals court. The court of appeals reversed and rendered summary judgment for ConocoPhillips, holding that the Exchange Agreement was an executory contract that was assumed by Alma and assigned to Noble's predecessor in the bankruptcy case under the terms of the APA and the Plan. The court of appeals also rendered a $63 million judgment to ConocoPhillips against Noble.

Noble then filed a petition for review before the Texas Supreme Court, which was ultimately granted. On June 23, 2017, in a 5-3 split, the Texas Supreme Court issued its ruling affirming the Texas court of appeals. Noble petitioned for rehearing, but the request was denied.

On April 16, 2018, Noble filed a cert petition in the United States Supreme Court. The U.S. Supreme Court denied the cert petition on October 1, 2018.

Texas Supreme Court Decision

In a split decision, the Texas Supreme Court determined that the Exchange Agreement that contained the indemnity obligation was assumed and assigned to Noble in Alma's bankruptcy case. The court followed a plain meaning reading of § 10.9 of the Plan that provided that "all executory contracts not expressly rejected" were to be assumed and assigned to the buyer. The court reasoned that the provision envisioned that executory contracts not specifically referenced were to be assumed and assigned to the buyer. The court further noted the APA provided that Noble was not required to close if the plan did not materially conform to the APA, and yet Noble closed on the APA post-confirmation. The Texas Supreme Court rejected Noble's argument that under Fifth Circuit law catchall assumed-unless-rejected provisions are unenforceable (citing *In re O'Connor*, 258 F.3d 392, 401 (5th Cir. 2001)).

One of Noble's primary arguments at the Supreme Court stage was that it was unaware of the Exchange Agreement during Alma's bankruptcy and the Exchange Agreement was not disclosed. The dissent was persuaded by Noble's non-disclosure argument and determined that Exchange Agreement could not accordingly be explicitly assumed.

Implications

This case presents several interesting legal and practical implications regarding executory contract treatment. First, Noble and the dissent called into question "boilerplate" or catch-all provision that appears in nearly every chapter 11 plan: "all executory contracts not expressly assumed are rejected," or vice versa. Noble argued that buyers would be wary of bankruptcy asset purchases if they could be hoodwinked by taking assignment of undisclosed agreements. But Noble's predecessor could have bargained for a different catch all provision—i.e., instead of taking an assignment of all executory contracts not expressly rejected, it could have insisted that all executory contracts not expressly assumed are rejected. In fact, Noble's predecessor listed over 500 contracts in an exhibit to the APA. The assignment of contracts to Noble could have been limited to that list.

This case also highlights the interaction between state and bankruptcy law. Noble argued that the indemnity obligation related to alleged environmental damaged that occurred before Alma's bankruptcy, i.e., before Noble's predecessor purchased the assets in 2000. But under Texas law, an indemnity obligation does not arise until the indemnity obligation is fixed and certain, e.g., because of a judgment or settlement. *Ingersoll-Rand Co. v. Valero Energy Corp.*, 997 S.W.2d 203, 205 (Tex. 1999). Once the executory contract containing the indemnity agreement was assumed and assigned to the buyer, the buyer is required to perform obligations that arise after the date of assumption/assignment. Thus, Noble was liable for the indemnity obligation that triggered in 2011 (11 years after the contract's assignment in bankruptcy) when ConocoPhillips settled the environmental lawsuit for $63 million.

"Recent Developments in Case Law Relating to Third Party Releases"

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Issue 1: Implied Consent and Method of Consent

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 Court held that 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 and Commentary:
    - This decision is significant because the Second Circuit has been one of the circuits willing to enforce non-consensual third-party releases to date; 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*.

Summary of Key Points:

- Bankruptcy courts are giving greater scrutiny to implied consent in third-party releases.
- The inquiry into implied consent is fact-specific and depends on the opt-out mechanism.

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Issue 2: Jurisdiction

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 and Commentary:
    - The Court analyzed whether it had "related to" jurisdiction under 28 U.S.C. § 1334. The opinion cited to precedent that the "touchstone" 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 Midway Gold US, Inc., 575 B.R. 475 (Bankr. D. Colo. 2017)

- Background:
    - The third-party release provided a broad release of all claims, "whether known or unknown, foreseen or unforeseen," by non-objecting creditors against the debtor, the committee, the lenders and all their directors, officers, employees and professionals "in any way related to" the debtors, the plan or the chapter 11 case.
    - The U.S. Trustee objected to the third-party release, arguing that the Tenth Circuit law categorically precludes granting non-debtor releases. Even if the releases are not categorically precluded, the Trustee argues they cannot be approved because the "opt-out" provisions are impermissible.

- Holding:
    - Judge Romero held that the Tenth Circuit does not absolutely bar third-party releases. Instead, the Court must analyze the "breadth of the release prohibition" to determine if it is permissible.
    - The Court held it does not have "arising in" jurisdiction.
        - "Arising in" jurisdiction cannot be satisfied solely on account of the releases being included in a proposed Chapter 11 plan.
        - While confirmation of plans are expressly "core proceedings" within the Bankruptcy Code, the Court held that "[t]here must be some independent statutory basis for the Court to exercise jurisdiction over the third-parties' disputes before the Court may adjudicate them."
    - The Court held it does not have "related to" jurisdiction.
        - Adopting a similar approach to *SunEdison*, the *Midway Gold* Court explained that "related to" jurisdiction only exists where "the disputes subject to releases or injunctions would have an effect, for example through indemnification or some other form of post-confirmation liability, on the debtor's property or the administration of the estate."
        - Contribution by a third party to the restructuring does not automatically establish "related to" jurisdiction over the third-party claims. *Id.* at 520.
    - The Court did not reach the issue of whether the parties consented to the releases, since it held it lacked jurisdiction to grant the releases.
- Notes and Commentary:
    - The plan explicitly stated the released claims are claims "related to the Debtors." The Court found this language insufficient to establish jurisdiction.
    - The Court also emphasized that a third party cannot "purchase" a release by making a contribution under the plan. The Court was concerned that "a debtor could create subject matter jurisdiction over any non-debtor third-party by structuring a plan in such a way that it depended on third-party contributions."

In re Millennium Lab Holdings II, LLC, 575 B.R. 252 (Bankr. D. Del. Oct. 3, 2017), *aff'd* 2018 WL 451941 (D. Del. Sept. 21, 2018)

- Background:
    - The 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 led by Voya 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). Voya argued that granting the release in this case is tantamount to adjudicating a state law claim.
- Result:
    - The bankruptcy court held it had jurisdiction to grant the release.
    - The bankruptcy court's jurisdictional holding was affirmed by the district court. *See In re Millennium Lab Holdings II, LLC*, 2018 WL 4521941 (D. Del. Sept. 21, 2018).

- 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 RICO lawsuit.
- Reasoning:
  - Because "confirmations of plans is an enumerated core proceeding," the bankruptcy court has "statutory authority to enter a final judgment."
  - The bankruptcy court read the *Stern* decision as largely consistent with the Supreme Court's 1982 decision in *Northern Pipeline Constr. 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 interprets *Stern* narrowly.
  - Both the bankruptcy and district court reasoned that approving the release was NOT an adjudication of Voya's state-law claim on the merits. The releases only have a collateral impact on the RICO lawsuit, because it provides the shareholders with a defense in that lawsuit. A bankruptcy order that merely "impacts a litigant's state law claim" does not violate *Stern*.

Summary of Key Points:

- There are several ways to attack a bankruptcy court's jurisdiction to approve third-party releases. *SunEdison* and *Midway Gold* involved "arising in" and "related to" elements of section 1334 of the Bankruptcy Code, while *Millennium Lab* addressed whether granting the release would violate *Stern*.
- The divergent approaches of *Midway Gold* and *Millenium Lab* illustrate two opposing concerns:
  - The *Midway Gold* court worried that broad third-party releases could lead to the Court acquiring "infinite jurisdiction," such that any party could "bootstrap" their claim into the bankruptcy case by placing a release in the proposed plan. *Midway Gold*, 575 B.R. at 519.
  - The *Millenium Lab* court emphasized that adopting Voya's interpretation of *Stern* would "dramatically change the division of labor between the bankruptcy and district courts." Specifically, the court seemed to be concerned that any § 363 sale of assets in which a buyer seeks to avoid successor liability would require adjudication by a district court simply because it affects the rights of a non-debtor. *Millenium Lab II*, 575 B.R. at 285-86.

Issue 3: Third-Party Releases in a Chapter 15 Proceeding

In re Avanti Communications Group PLC, Case No. 18-10458, 2018 WL 1725544 (Bankr. S.D.N.Y. Apr. 9, 2018)

- Background:
  - Avanti Communications Group was engaged in a U.K. proceeding to approve a scheme of arrangement that restructured its debt. To ensure the scheme would be enforced in the United States, Avanti filed a petition for recognition under chapter 15 in a SDNY bankruptcy court.
  - Over 98% of the impaired creditors voted to approve the foreign scheme. The issue was whether the U.S. bankruptcy court should enforce the releases against the "small number of non-voting impaired creditors."
  - No objections were filed in the case.
- Holding:
  - The Court recognized the foreign proceeding and agreed to bind parties, including non-voting creditors, to third-party releases in the scheme.
  - The Court held that the proper analysis for approving a third-party release in a chapter 15 proceeding is different than in a chapter 11 case. The correct inquiry in a chapter 15 proceeding is "whether to recognize and enforce the foreign court order based on comity."
- Reasoning:
  - The Court concluded creditors had a "full and fair opportunity to vote on, and be heard" in the U.K. scheme.
  - The Court emphasized the creditor-friendly nature of U.K. law, noting that U.K. law does not provide a "cramdown" mechanism and only binds creditors "when a majority in number representing not less than 75% in value of each class vote in favor of the scheme."
  - The discretionary relief a court may order after recognizing a foreign proceeding is "exceedingly broad" under section 1521(a) of the Bankruptcy Code.
  - The Court emphasized that the scheme was "overwhelmingly approved" by 98.3% of the impaired creditors. The Court used the overwhelming support for the scheme to distinguish *Avanti* from a Fifth Circuit case which declined to approve third-party releases in a chapter 15 proceeding.
- Notes and Commentary:
  - This is one of the first cases in the Second Circuit to approve a third-party release in a chapter 15 proceeding.
  - The opinion suggests that approving third-party releases in a chapter 15 proceeding requires an analysis of 1) the foreign law (specifically whether it provides creditors with sufficient process and opportunities to be heard) and 2) whether the foreign restructuring received enough support from creditors to justify binding non-voting creditors.