AMERICAN BANKRUPTCY INSTITUTE

2017 Central States Bankruptcy Workshop

When Cases Collide

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CONCURRENT SESSION

2017

AMERICAN BANKRUPTCY INSTITUTE

When Cases Collide: When Closely Held Businesses and Individual Owners Need Bankruptcy or Insolvency Counseling

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I. Context:

When a closely held business has financial problems, its principals will also likely have financial issues. The principals may have loaned or contributed money to their company, and they likely guaranteed some of its debts. This panel discussion will look at, among other things, (1) Does confirmation of an entity's chapter 11 plan affect the guarantor's liability, (2) Joint Chapter 11 Plans, and (3) Substantively Consolidating Entities with Non-Debtor parties, including Individuals.

II. Does confirmation of an entity's chapter 11 plan affect the guarantor's liability?

A. Expressly

We all know that generally a chapter 11 plan does not affect a creditor's ability to pursue non-debtors. 11 U.S.C. §524(e)("§ 524 - Effect of discharge…(e) Except as provided in subsection (a)(3) of this section, discharge of a debt of the debtor does not affect the liability of any other entity on, or the property of any other entity for, such debt.").

A chapter 11 plan, however, may expressly try to release the liability of non-debtors. For instance, in the Sixth Circuit, the ability of a Court to confirm a plan providing for a non-debtor release is set forth in In re Dow Corning Corp., 280 F.3d 648, 658 (6th Cir.2002). In that case, the Sixth Circuit stated,

> "[W]hen the following seven factors are present, the bankruptcy court may enjoin a non-consenting creditor's claims against a non-debtor: (1) There is an identity of interests between the debtor and the third party, usually an indemnity relationship, such that a suit against the non-debtor is, in essence, a suit against the debtor or will deplete the assets of the estate; (2) The non-debtor has contributed substantial assets to the reorganization; (3) The injunction is essential to reorganization, namely, the reorganization hinges on the debtor being free from indirect suits against parties who would have indemnity or contribution claims against

> the debtor; (4) The impacted class, or classes, has overwhelmingly voted to accept the plan; (5) The plan provides a mechanism to pay for all, or substantially all, of the class or classes affected by the injunction; (6) The plan provides an opportunity for those claimants who choose not to settle to recover in full and; (7) The bankruptcy court made a record of specific factual findings that support its conclusions."

See also Moore, Owen, Thomas & Co. v. Coffey, 992 F.2d 1439, 1449 (6th Cir. 1993), as amended on denial of reh'g (Aug. 31, 1993)("Specifically, Moore argues that MOT's bankruptcy prevents the District Court from determining MOT's obligation and MOT's bankruptcy raises the possibility that MOT's obligation will be reduced by virtue of the "cram-down" provision of the Bankruptcy Code. 11 U.S.C. § 1129(b). The guaranty agreement signed by Moore provides that "Thomas O. Moore hereby personally guarantees the obligation of the Maker's debt to Payee." Moore's obligation is not affected in any way by the cram-down provision of the Bankruptcy Code").

If a claim subject to discharge has been satisfied in an entity's chapter 11, however, there is no claim that can be asserted against the guarantor. See In re Schupbach, 607 F. App'x 831, 2015 WL 2372784 (10th Cir. May 19, 2015 (Not for Publication)(" The Bank's Nondischargeability Claim was Mooted by the Confirmation Order, Which Provides that the Bank's Claim in the Individual Case Has Been Fully Satisfied"). In Schupbach, the Tenth Circuit stated,

> "'A] confirmed plan functions as a judgment with regard to those bound by the plan....' Paul v. Monts, 906 F.2d 1468, 1471 n. 3 (10th Cir.1990). Chapter 11 provides that "the provisions of a confirmed plan bind the debtor, ... and any creditor ... whether or not the claim or interest of such creditor ... is impaired under the plan and whether or not such creditor ... has accepted the plan." 11 U.S.C. § 1141(a). "When the bankruptcy court confirms a plan, its terms become binding on debtor and creditor alike. Confirmation has preclusive effect, foreclosing relitigation of any issue actually litigated by the parties and any issue necessarily determined by the confirmation order." Bullard v. Blue Hills Bank, —— U.S. ——, 135 S.Ct. 1686, 1692, 191 L.Ed.2d 621 (2015) (citation and internal quotation marks omitted) (construing comparable statutory language regarding effect of confirmation under Chapter 13). "[H]ow the confirmed plan treats a particular claim or interest is of vital importance. An affected *836 creditor ... will have only such rights postconfirmation as the drafted plan may give it." Collier on Bankruptcy ¶ 1129.01[1] (Alan N. Resnick & Henry J. Sommer, eds., 16th ed.2015); see also United States v. Richman (In re Talbot), 124 F.3d 1201, 1209 (10th Cir.1997) (noting "because creditors are limited to those rights that they are afforded by the plan, they may not take actions to collect debts that are inconsistent with the method of payment provided for in the plan" (internal quotation marks omitted)). Here, the terms of the Individual Plan itself also stated

that the rights and obligations of any entity named or referred to in the plan will be binding on such entity.

In the Nondischargeability Case, the Bank sought a ruling that a portion of its claim filed in the Individual Case was nondischargeable. But according to the confirmed Individual Plan, the Bank's claim in the Individual Case was fully satisfied by the previous transfer of real property to the Bank under the terms of the confirmed LLC Plan. Thus, once the Individual Plan was confirmed and the Confirmation Order was unchallenged on appeal, there was no remaining case or controversy regarding the Bank's nondischargeability claim."

Can a court confirm an entity's chapter 11 plan that provides that judgment creditors of the principal and entity can't modify the confirmed plan treatment for the judgment creditor by executing on the stock and then voting to modify the plan? See In re Silverman, Case No. 07-49052 (Bankr. E.D. Mich.). The Order Confirming Plan in that case provided:

During the term of this Plan, State Farm will not interfere with the Debtor's assertion of lien rights in any pending claims relative to past, present or future clients of the Debtor. By way of example and not limitation, State Farm shall not take a position if and when the Debtor seeks to assert a charging or other form of lien against payments due to or

received by any former, present or future clients, as a result of the Debtor's representation of the client. State Farm, its attorneys, assigns, representatives and agents, including, but not limited to any court officers employed in connection with its April 19, 2007 Judgment, shall not execute, seize, lien or otherwise attempt to satisfy the Judgment by taking possession of, or asserting an interest in or through the stock of the Debtor. The stock is of a professional legal corporation and cannot be held by a person other than a licensed attorney; and liquidation of the stock would impair the ability of the Debtor and all other codefendants to the Judgment to satisfy the obligations created by the Judgment.

B. Implicitly

If the entity's chapter 11 plan does not expressly provide that it affects the guarantor's liability, will it have any effect. One may argue that the guaranteed liability, as modified by the entity's confirmed chapter 11 plan, limits the exposure of the guarantor. The theory is that the guarantor guaranties the "debt", which was arguably altered by the entity's chapter 11 plan. While at least one Bankruptcy Court and one District Court have taken this position, the Tenth Circuit reversed on the theory that bankruptcy does not affect the liability of non-debtor parties generally. See In re: Gentry, No. 11-37658 MER, 2013 WL 4864503, at *7 (Bankr. D. Colo. Sept. 12, 2013), aff'd sub nom. In re Gentry, No. 13-CV-02922-REB-AP, 2014 WL 4723879 (D. Colo. Sept. 23, 2014), aff'd in part, rev'd in part and remanded, 807 F.3d 1222 (10th Cir. 2015). The District Court in Gentry held,

> "Rather, the Court agrees with the Gentrys—their obligation to SIP arises from Ball Four's obligation to SIP. Ball Four's original indebtedness to SIP was replaced by the terms of its confirmed Chapter 11 plan. As the United States District Court for the District of Colorado observed: Confirmation generally discharges the debtor from its pre-confirmation debt and substitutes the obligations of the plan for the debtor's prior indebtedness. *See* § 1141(c), (d). "The plan is essentially a new and binding contract, sanctioned by the Court, between a debtor and his pre-confirmation creditors." *In re Ernst,* 45 B.R. 700, 702 (Bankr.D.Minn.1985).[30] The confirmed Ball Four plan is a new and binding contract, substituting the previous indebtedness under the original note with the obligations in the plan. There is no question SIP is entitled to payment in full of its allowed claim under the Ball Four plan, once the litigation regarding the allowance of its claim is determined. Therefore, the Personal Guaranties obligate the Gentrys to repay the same substituted indebtedness, and not a different indebtedness under the original (now modified) loan."

Unfortunately for debtor's counsel everywhere, the Tenth Circuit didn't see things this way. Instead, the Tenth Circuit held, in In re Gentry, 807 F.3d 1222 (10th Cir. 2015),

> "In October 2010, a month after Ball Four filed for bankruptcy, FirsTier sued the Gentrys in Colorado state court to collect on the guaranties. …The Gentrys filed the necessary disclosures and an amended plan. The amended plan provided that the Gentrys' liability on the 2005 loan would be satisfied by Ball Four under its confirmed plan.[2]
>
> [fn2] The amended plan provided:
>
> > Class 6.2011 SIP–CRE/CADC Venture, LLC. The disputed unsecured claim of the Class 6 creditor is evidenced by a personal guaranty signed by the Debtors guarantying [sic] the secured claim of the Class 6 creditor which is owed to the Class 6 creditor by Ball Four. When the Class 6 creditor's disputed claim is determined to be an allowed claim by entry of a

> Final Order, the allowed unsecured claim will be paid in full by Ball Four pursuant to the terms of the confirmed Chapter 11 Plan of Reorganization of Ball Four. The Class 6 creditor's allowed unsecured claim will be paid by Ball Four as provided for in Ball Four's confirmed Plan of Reorganization.
>
> I Aplt.App. 217–18.

Despite SIP's objections, the bankruptcy court confirmed the Gentry Plan in 2013. I Aplt.App. 218. The court found, inter alia, … the language of the guaranties limited the Gentrys' liability to the amount set out in the Ball Four Plan, *id.* at 222–25. In 2014, the district court affirmed the bankruptcy court's order. ...The plan directed that Ball Four would pay the claim over the next twenty-five years, and only if Ball Four did not pay would the Gentrys be liable on their guaranties…The court also found the creditor had two safeguards in place in the event the Ball Four Plan failed. The creditor—now FB Acquisition—retains state law remedies against the Gentrys and the Gentrys' obligations will not be discharged until the loan indebtedness is paid in full. Id.

…FB Acquisition also claims the bankruptcy court erred in limiting the Gentrys' liability as guarantors under the Gentry Plan to the amount that Ball Four, the original borrower, is ultimately determined to owe… Guaranties act as a safeguard, assuring performance of a guarantor even if the borrower defaults. In fact, fear of a borrower's default often motivates a creditor to require a guarantor. See Restatement (Third) of Suretyship & Guaranty § 34 (1996); see also NCNB Tex. Nat'l Bank v. Johnson, 11 F.3d 1260, 1266 (5th Cir.1994) (stating that a creditor "obtains guaranties specifically to provide an alternative source of repayment" in the event of bankruptcy). Extending this rule of equivalent liability into the bankruptcy context would destroy the value of a guaranty."

Is all lost? Of course not. Perhaps the terms of repayment can be modified. At least one Court has held that a confirmed plan may modify the terms of repayment for a non-debtor guarantor. See In re Seatco, Inc., 259 B.R. 279, 283–86 (Bankr. N.D. Tex. 2001).

In that case the Seatco Court held,

> "Turning to the temporary injunction provision of the Further Modified Plan, section 11.04, that provision only restrains CIT from its efforts to collect from Kester pursuant to the Guaranty those amounts being paid to CIT under the Further Modified Plan. If the Further Modified Plan is confirmed, CIT is free to pursue Kester on the Guaranty for any amounts owing to it that are not being paid under the Plan, in one suit or from time to time, and, if the Debtor defaults

> on its plan payments to CIT after notice and an opportunity to cure, CIT may pursue Kester on the Guaranty for all amounts owing to it without further order of the Court. The temporary *284 injunction expires on its own upon an uncured default….As is clear from the terms of the Further Modified Plan itself, confirmation of that plan does not affect Kester's liability to CIT on the Guaranty. Kester remains liable to CIT for any amounts not being paid under the Further Modified Plan and for amounts to be paid under the Further Modified Plan if the Debtor defaults. Confirmation of the Further Modified Plan does not violate § 524(e) of the Bankruptcy Code. The proposed temporary injunction against CIT is necessary and appropriate to carry out the provisions of the Bankruptcy Code. The only harm to CIT from confirmation of the Further Modified Plan is that CIT would be forced to accept payment terms that it finds unacceptable. Although the payment terms are not to its liking, CIT's allowed secured claim against the Debtor is being paid in full. [FN9 The Debtor is paying CIT's allowed secured claim in full under the Further Modified Plan. However, if there are amounts owing to CIT under the Prepetition Loan Agreement that are not properly allowable against the Debtor in its bankruptcy case (and thus, are not part of CIT's allowed secured claim against the Debtor), CIT may pursue Kester now, or from time to time hereafter, for those amounts.]"

III. Joint Chapter 11 Plans

Is there any advantage to joint chapter 11 plans?

For a plan to be confirmed, it must satisfy numerous requirements, including 11 U.S.C. §1129(a)(10). Under that section, a Chapter 11 plan must be accepted by at least one class of claims that is "impaired" by the plan. A class of claims is impaired if the legal, equitable or contractual rights of class claimants are altered by the terms of the plan.

Some Courts hold that §1129(a)(10) may be satisfied so long as there is an impaired accepting class of the joint plan, though not an impaired accepting class of each debtor who has filed the joint plan. *See In re Transwest Resort Properties, Inc.,* 554 B.R 894 (D. AZ 2016).

In that case,

> "Debtors filed a joint plan of reorganization for all five Debtors and there are ten classes of claims under the plan. Five impaired classes under the plan voted in favor of it. SER 1213. Section 1129(a)(10) poses a conundrum for courts in cases where there are multiple debtors and creditors when satisfying the "impaired class" requirement: Should the court interpret the statute as mandating what is known as a "per-plan" requirement, which is satisfied by the acceptance of one impaired class for any debtor involved in the proceedings, or does § 1129(a)(10) contemplate a "per-debtor" requirement, meaning the plan must be approved by at least one impaired class for each debtor involved? Applying that question here, does the fact

that Lender is Mezzanine Debtor's only creditor and Lender did not vote for the plan, prevent the plan from going forward?

Here, the Court finds that § 1129(a)(10) applies on a per-plan basis. First, unlike the Tribune court, this Court finds the plain language of the statute to be dispositive. The statute states that "[i]f a class of claims is impaired under the plan, at least one class of claims that is impaired under the plan has accepted the plan" then the court shall confirm the plan if additional requirements are met. 11 U.S.C. § 1129(a)(10) (emphasis added). Thus, once an impaired class has accepted the plan, § 1129(a)(10) is satisfied as to all debtors because all debtors are being reorganized under a joint plan of reorganization. It is not clear to this Court as to how § 102(7) alters the plain language of § 1129(a)(10) to be read as applying on a per-debtor basis."

Contra In re Tribune Co., 464 B.R. 126 (Bankr. D. Del. 2011) (in a case involving a joint chapter 11 plan for multiple debtors that have not been substantively consolidated, section 1129(a)(10) must be satisfied with respect to each debtor). In the Tribune bankruptcy cases, competing reorganization plans were proposed to resolve all of the claims and liabilities of the over 100 affiliated Tribune debtors. One joint plan was proposed by the debtors, the creditors committee and certain lenders, and another was proposed by certain bondholders. None of the proposed joint plans was accepted by an impaired accepting class for each of the over 100 debtor entities. The Bankruptcy Court concluded that the Bankruptcy Code requires that joint plans be accepted by an impaired class for each debtor and not just one impaired class for the entire joint plan.

There are disadvantages, however, to a joint chapter 11 plan. One Court has held that a provision preventing one of the jointly administered debtors from filing a plan prevents the other jointly administered debtor from filing a chapter 11 plan. See In re Shea, Ltd., 545 B.R. 529 (Bankr. S.D. Tex. 2016). In Shea, a real estate development entity, filed a Chapter 11 bankruptcy, and then a related entity, the Social Club, Ltd. filed Chapter 11 as well, designating itself as a small business debtor. The jointly administered debtors filed a joint plan, which was not confirmed. The issue in Shea was whether the "small business debtor" limitations on plans applied to Shea, which was not a small business debtor, but a joint plan proponent.

The Shea Court stated,

"This Court finds it most pertinent to determine whether Jointly Administered Debtors have timely filed and confirmed a chapter 11 plan within the time fixed by statute. The principal issue that will assist this Court in determining such cause can be summarized by the following question: if 300 days have elapsed since the commencement of Shea and Social's bankruptcy cases, can a plan of reorganization be filed by non-debtor parties in interest pursuant to § 1121? If the answer is no, then Jointly Administered Debtors' cases must be converted or dismissed, because there is cause in that Jointly Administered Debtors cannot timely file a plan. …Section 1121(e) provides a special

carve-out from the usual chapter 11 requirements when the case has a small business designation, which Congress intended to provide to reduce the time and expense required for small business debtors to find relief in a chapter 11 while requiring those entities to move at an expedited pace to the confirmation of their plans… The terms of § 1121(e) appear very simple: in a small business case, the small business debtor has 180 days of exclusivity *537 and 300 days before which to hit the "drop dead date,"4 after which "the" plan may no longer be filed. The fly in the lotion is rendered on the question as to which parties this drop dead provision applies. A small business debtor is undoubtedly bound by the drop dead provision. However, may creditors submit a plan after the drop dead date in a jointly administered case such as the one before this Court, as the Participating Creditors have suggested? If the drop dead provision only applies to small business debtors, then Jointly Administered Debtors would enjoy the chance to have a plan filed on the Court's docket and confirmed, thus rescuing the jointly administered chapter 11 cases…. On the other hand, Social has exceeded the 300–day limitation as of January 14, 2016. As Social is unable to file a plan, and since jointly administered cases calls for jointly administered plans, Social essentially poisons the plan filing well for Shea. Therefore, the Jointly Administered Debtors are prohibited from filing a plan, but the Participating Creditors are free to submit a plan."

IV. Substantively Consolidating Entities with Non-Debtor parties, including Individuals

A. Substantive Consolidation of Entity and Non-Debtor entity

Should creditors of a non-debtor entity have to file an involuntary bankruptcy to administer the assets of the non-debtor entity through the Bankruptcy Court. Under the doctrine of substantial consolidation, non-debtor assets can be administered without the showing necessary for an involuntary bankruptcy, at least in most jurisdictions.

Courts exercising bankruptcy jurisdiction have had the authority to substantively consolidate non-debtor assets at least since 1941 when the United States Supreme Court gave tacit approval in Sampsell v. Imperial Paper & Color Corp, 313 U.S. 215, 61 S. Ct. 904, 85 L. Ed. 1293 (1941). In that case, Justice Douglas held that a bankruptcy court's power "to subordinate clams or to adjudicate equities arising out of the relationship between the [corporation's and shareholder's] creditors is complete" where the corporation "was 'nothing but a sham and a cloak' devised by [the debtor] 'for the purpose of preserving and conserving his assets' for the benefit of himself and his family, and that the corporation was formed for the purpose of hindering, delaying and defrauding his creditors."

See In re American Camshaft Specialties, Inc., 410 B.R. 765, 777–78 (Bankr. E.D. Mich. 2009).

In American Camshaft, the Bankruptcy Court traced the lineage of substantive consolidation and the competing tests,

> "Although both the corporate defendants and the Trustee rely heavily on Augie/Restivo and New Center Hospital, they each also cite to a number of other cases that discuss the concept of substantive consolidation, some involving substantive consolidation of a non-debtor with a debtor. A number of these cases articulate "tests," or list "factors," or identify "circumstances," that must be shown in order to warrant an order of substantive consolidation. Many of the opinions in these cases begin by summarizing a history of substantive consolidation, perhaps because of the absence of the term substantive consolidation in the Bankruptcy Code. Lacking any express provision in the Bankruptcy Code governing, or even mentioning, substantive consolidation, this Court too considers it necessary to first review the law that has developed regarding substantive consolidation in order to decide whether or not to grant the motion to dismiss count II of the complaint….It is a judicially created doctrine that treats separate legal entities as if they were merged into a single entity, pooling the assets and liabilities of the two entities, so that the assets of the two entities may result in a common fund available to satisfy the debts of both entities. Fundamentally, it is a judicial doctrine that has been applied by courts to ensure the equitable treatment of all creditors….ere is sufficient settled authority for a bankruptcy court to impose the equitable remedy of substantive consolidation, even on a non-debtor, in a rare case. But it is an extraordinary remedy to be utilized only where there are no other adequate remedies, particularly where the entity sought to be consolidated is not itself already a debtor in a bankruptcy case. Until the Supreme Court or the Sixth Circuit Court of Appeals enunciates a standard to determine when the elements of substantive consolidation are present, this Court will only substantively consolidate a non-debtor entity with a debtor where it is shown that either: (i) the debtor and the non-debtor entity in their pre-petition conduct disregarded the separateness of their respective entities so significantly as to lead their creditors to treat them as one legal entity; or (ii) that post-petition, the assets and liabilities of the debtor and the non-debtor entity sought to be consolidated are so hopelessly scrambled and commingled that it is impossible to separate them and tell them apart thereby resulting in harm to all creditors. The identification of these two alternative circumstances warranting substantive consolidation, one pre-petition and one post-petition, is not, in this Court's view, inconsistent with the circumstances that the Sixth Circuit identified in dicta as warranting substantive consolidation."

In re Am. Camshaft Specialties, Inc., 410 B.R. 765, 778 (Bankr. E.D. Mich. 2009)

On the other hand, some Courts have questioned whether they have jurisdiction to substantively consolidate non-debtor entities. See e.g. In re Pearlman, 462 B.R. 849 (Bankr. M.D. Fla. 2012)(" Therefore, the parties' factual disputes underlying the substantive consolidation requests of the Non–Debtors is irrelevant because, regardless of which party prevails, the Court lacks authority to order the substantive consolidation of the Non–Debtors.").

Well, at least can the entity's former attorneys represent the individuals being sued? Possibly not. See e.g. Kohut v. Lenaway (In re Lenny's Copy Center & More LLC), 515 B.R. 562 (Bankr. E.D. Mich. 2014)("And even if this Court were to allow [Law Firm] to withdraw as counsel for the Debtor in the Chapter 7 bankruptcy case, that firm and all of its attorneys still would be prohibited from representing the Defendants in this adversary proceeding, by Rule 1.9(a) of the Mich. R. of Prof'l Conduct. That is because this adversary proceeding is ''a substantially related matter'' to the Chapter 7 bankruptcy case in which [Law Firm] has represented the Debtor, and for the reasons discussed above, the Defendants' interests in this adversary proceeding ''are materially adverse to the interests of the Debtor,'' who would be the ''former client'' within the meaning of Rule 1.9(a).").

B. Continuing vitality of Sampsell v. Imperial Paper in light of Stern v Marshall

One of the leading bankruptcy treatises questions the effect of Stern v Marshall on Sampsell. See § 21:9.Substantive Consolidation of Debtor and Non-Debtor Entities, 2 Norton Bankr. L. & Prac. 3d § 21:9 ("Despite the ruling in In re LLS America, LLC, it would appear that a strong argument can be made that a bankruptcy court does not have constitutional authority to enter a final order substantively consolidating a debtor and a non-debtor entity due to the absence of statutory authority for substantive consolidation and the seizing of the non-debtor's assets that results therefrom.").

C. Substantive Consolidation of Entity and Non-Debtor Individual

What, a bankruptcy Court can substantively consolidate a bankruptcy entity with a non-filing principal. At least some Courts have held that this is proper under the right circumstances. FDIC v. Colonial Realty Co., 966 F.2d 57 (2nd Cir. 1992) (substantively consolidating a partnership with the two individual debtors who were its general partners); In re Creditors Serv. Corp., 195 B.R. 680, 684–85 (Bankr. S.D. Ohio 1996).

In Creditors Serv. Corp., the Court stated,

> "Finally, we turn to Ms. Cooley, as the Trustee has requested to join her financial affairs with the Debtor and all of the entities discussed above. Ms. Cooley is an individual who has distinct assets and liabilities, and she has not personally sought bankruptcy relief. Ms. Cooley, however, currently owns and controls the Debtor and all of the other [entities]…The analysis of shareholder and intercompany loan activity for the Debtor indicates that in 1992 and 1993, when

> the Debtor was beginning to experience financial difficulty and paid the high salaries to officers, it was simultaneously receiving loans from Ms. Cooley and MTS. During the years of 1992, 1993, 1994 and 1995, Ms. Cooley was also making loans to RKC and MTS and was receiving some repayment from those entities, according to the analyses supplied by the Defendants. Also, the record in the divorce proceeding indicates that subsequent to Mr. Cooley's relocation to Florida, MTS paid the sum of $43,121.27 on credit card obligations allegedly incurred by Mr. Cooley, while during the same period the Debtor paid the sum of $9,422.04 on other credit card obligations allegedly incurred by Mr. Cooley.All of these transactions only serve to blur the financial affairs of the entities and Ms. Cooley. They also serve to demonstrate that the financial affairs of the entities and Ms. Cooley were interdependent; i.e., salaries were paid to Ms. Cooley while she loaned money to the entities in addition to the loan transactions between the entities. All of these connections lead the Court to conclude that the individual, Ms. Cooley, is hopelessly entangled in the financial affairs of the Debtor and the other entities, and this arrangement was purposeful—for the mutual benefit of Ms. Cooley and the entities…Although the Bankruptcy Code does not specifically authorize bankruptcy courts to substantively consolidate entities and individuals, the broad equitable power detailed in section 105(a) has been recognized as the basis. *[citations omitted]…*The Court has considered all of the facts detailed above in the context of the cited case law and has come to the conclusion that substantive consolidation of all the entities and the individual, Ms. Cooley, is warranted subject to restrictions specified below."

In re Creditors Serv. Corp., 195 B.R. 680, 690–92 (Bankr. S.D. Ohio 1996).

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24th Annual Central States Bankruptcy Workshop
June 8-10, 2017
Traverse City, Michigan

When Cases Collide: When Closely Held Businesses And Individual Owners Need Bankruptcy Or Insolvency Counseling.

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INTRODUCTION

The dual representation of a closely-held company and its principals can cause various conflicts issues in insolvency proceedings that may not otherwise exist absent the insolvency. These conflicts typically are evident in the context of legal representation and the ongoing management of the related entity. In many instances, an objecting party may seize upon a conflict of interest as a strategy to disqualify counsel or seek the appointment of a trustee so as to strip a debtor of its management authority. Understanding these potential conflicts (as opposed to actual conflicts) will enable the practitioner to construct a basis for continuing with the representation of both the entity and the principals and to develop a case for the Debtors for the continuation of management without a trustee. This portion of the panel discussion will address some of these conflicts scenarios both from the perspective of identifying the true nature of a conflict of interest as well as tools that are available to deal with conflicts of interest.

LEGAL REPRESENTATION ISSUES

Many Courts refuse to approve employment of a single law firm to represent both the closely-held corporation and its principal(s). Yet, several of these same Courts will permit a single law firm to represent related Debtor entities in related bankruptcy cases. The purpose of this portion of the presentation is to set forth the varying analyses utilized in the decision of whether to approve the retention of a single law firm to represent a closely-held corporation and its principal(s). The conclusion of the speaker is that the

better approach is to permit such dual representation by a single law firm so long as there is no actual conflict of interest, as well as no material potential conflict of interest that warrants disqualification based upon the particular facts in the particular underlying cases at issue.

As with all retention issues in a bankruptcy case, the initial inquiry centers on the application of and compliance with Section 327(a) of the Bankruptcy Code. Simply put, Section 327(a) provides that the Trustee and/or Debtor may, with the Court's approval, retain a professional *only if* the professional is *both* "disinterested" *and* "does not hold or represent an interest adverse to the estate." *In Re Crivello,* 134 F.3d 831, 835 (7th Cir.1998); *In Re Roberts*, 46 B.R. 815 (Bankr.D.Utah 1985). See also, *In Re Knight-Celotex, LLC*, 695 F.3d 714, 722 (7th Cir.2012), *In Re Caesars Entertainment Operating Co., Inc., et al.,* 561 B.R. 420 (Bankr.N.D.Ill. 2015). *In Re Raymond Prof. Group, Inc.*, 421 B.R. 891, 901 (Bankr. N.D. Ill. 2009). These requirements not only must be satisfied at the time of the Court's approval of the retention but also must be maintained throughout the pendency of the case.[1] See, *Rome v. Braunstein*, 19 F.3d 54, 57-58 (1st Cir. 1994); *In Re Vebeliunas*, 231 B.R. 181, 187 (Bankr. S.D.N.Y. 1999); *In Re Granite Partners, L.P.,* 219 B.R. 22 (Bankr.S.D.N.Y. 1998). The practitioner must also realize that the requirements of Section 327(a) impose more stringent conflict of interest restraints upon the retention of professionals than are set forth in most state ethical rules that apply outside of bankruptcy. See, *In Re Hot Tin Roof, Inc.,* 205 B.R. 1000 (B.A.P. 1st Cir. 1997); *In Re Amdura Corp*., 121 B.R. 862, 866 (Bankr. D.Colo. 1990).

While a debtor has significant latitude in selecting counsel, which decision will only be overruled in rare instances,[2] the selection of Debtor's Counsel must be analyzed (and perhaps juggled) under Section 327(a) of the Bankruptcy Code. The requirements of "disinterestedness" and "no interest adverse to the estate" must be satisfied. *In Re Pillowtex, Inc.*, 304 F.3d 246, 254 (3d Cir. 2002); *In Re TMA Assoc., Ltd.,* 129 B.R. 643, 645 (Bankr. D. Colo. 1991). These requirements are essential to ensuring that all professionals retained pursuant to Orders of the Bankruptcy Court provide their professional services with "undivided loyalty" by providing "untainted advice and assistance in furtherance of their fiduciary responsibilities." *Crivello,* 134 F.3d. at 836 (quoting *Rome v. Braunstein*), 19 F.3d. at 58).

These issues and requirements are most prevalent when dealing with the dual representation of closely-held companies and their principals. In fact, the disqualification

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[1]This continuing requirement is especially important in conjunction with the concept of an actual conflict of interest vs. a potential conflict of interest discussed later.

[2]*In Re Hanckel*, 517 B.R. 609, 613 (Bankr. D.S.C. 2014). See also, *In Re Smith*, 507 F.3d 64, 71 (2d. Cir. 2007).

of Counsel for multiple Debtors is more likely in cases involving closely held companies and their principals. See, *In Re Sundance Self Storage - El Dorado LP*, 482 B.R. 613 (Bankr. E.D.Cal. 2012); *In Re Straughn*, 428 B.R. 618, 624 (Bankr. W.D.Pa. 2010). A clear understanding of conflicts law in bankruptcy cases is essential to protecting a practitioner's legal representation positions (and the right to compensation) in cases involving closely held companies and their principals.

Standards For Retention Approval

Most Courts generally disfavor the dual representation of a closely-held corporation and its principal by a single law firm when there is an intervening bankruptcy case. What is equally clear is that, even though the analysis should be identical, the likelihood of a single law firm being authorized to represent related corporate Debtor entities is greater than that same law firm being authorized to represent a closely-held Debtor corporation and its principal(s).

One of three approaches is ordinarily implemented by a Court when deciding the issue of dual representation of a closely-held Debtor corporation and its principal(s) by the same Counsel. These approaches may be summarized as follows:

1. Some Courts adopt a *per se* prohibition against the simultaneous representation of both the corporate Debtor and its principal. *In Re Wynne Residential Asset Mgmt. LLC*, 2009 WL 5169371 at *4 (Bankr.W.D.N.C. 2009); *In Re Innomed Labs, LLC*, 2008 WL 276490 at *7 (S.D.N.Y. 2008). See also, *In Re Kendavis Indus. Intntl., Inc.,* 91 B.R. 742, 754 (Bankr. N.D. Tex 1988). One Court, in *dicta*, stated that

> As a practical matter, given the nature of the relationship between a sole shareholder and the related corporation, it is difficult to imagine a situation where both parties in separate Chapter 11 cases could be represented by a single attorney.

Straughn, 428 B.R. at 628.[3]

2. Other Courts have adopted a *presumption* that it is improper to permit a single law firm to represent both the closely-held company and its principal(s). *In Re*

[3]Yet, despite this comment, the *Straughn* Court rejected a *per se* disqualification approach to the issue in favor of the case by case approach of determining the particular effect of a potential conflict in each particular case.

Parkway Calabasas Ltd., 89 B.R. 832, 835-837 (Bankr. C.D. Cal. 1988). This presumption, if rebutted, may result in the approval of the retention of the single law firm for both clients.

3. Yet, other Courts evaluate this retention issue involving multiple representation on a case-by-case basis to determine whether either an actual conflict exists (in which case, retention will be denied)[4] or merely a potential conflict exists. [5] In the case of a potential conflict, the Court will determine, within its discretion as provided in Section 327 of the Bankruptcy Code, whether, based upon the particular facts of the case, the potential conflict warrants disqualification. The Court should not disqualify proposed Counsel merely on the appearance of a conflict alone. Something more is required as not every conceivable conflict warrants disqualification of proposed Counsel.[6] *Straughn, 428 B.R. at 624; In Re Marvel Entertainment Group, Inc.,* 140 F.3d 463, 476 (3rd Cir. 1998). See also, *In Re Congoleum Corp.,* 426 F.3d 675, 692 (3rd Cir. 2005); *Pillowtex,* 304 F.3d at 251; *In Re BH & P, Inc.,* 949 F.2d 1300, 1310 (3rd Cir. 1991).

The Case By Case Approach seems to be the most reasonable way to determine whether the dual representation of a closely-held company and its principal(s) should be authorized under Section 327(a) of the Bankruptcy Code. Under the Case By Case Approach, the existence of a potential conflict of interest will be analyzed to determine whether proposed Counsel is "disinterested" or "holds or represents an interest adverse to the estate." *In Re HML Enterprises, LLC*, 2016 WL 5939737 at *6 (Bankr.E.D.Tex. 2016); *In Re Perrysburg Marketplace Co.,* 176 B.R. 797 (Bankr. N.D. Ohio 1994); *In Re Profe*ssional *Development Corp.*, 140 B.R. 467 (W.D.Tenn. 1992); *In Re Huddleston*, 120 B.R. 399 (E.D.Tex. 1990); *In Re O'Connor*, 52 B.R. 892 (W.D.Okla. 1985). See also, *In Re Chardon, LLC,* 536 B.R. 791 (Bankr. N.D. Ill. 2015); *In Re Rental Systems, LLC,* 511

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[4]Obvious examples of an actual conflict of interest include when one estate is indebted to the other, *Straughn*, 428 B.R. at 626 and when proposed Counsel seeks to represent a limited partnership as well as the general partner. *In Re W.F. Develop. Corp.,* 905 F2d 883 (5th Cir. 1990). Conversely, an actual conflict of interest may not exist simply because the principal has guaranteed an obligation of the Debtor corporation. See, for example, *In Re Adelphia Communications Corp.,* 342 B.R. 122 (S.D.N.Y 2006) (no conflict based upon mere fact that Counsel was representing multiple Debtors in multiple bankruptcy cases); Michael P. Richman and John A Simon, *Navigating Disinterestedness and Disclosure Issues In Multi-Debtor Representations,* 27-Sept.Am.Bankr. Inst.J. 32 (2008).

[5] In rejecting the assertion of Debtors' Counsel in the *Caesars Entertainment* case, Judge Goldgar noted that there is no legal authority for the position that the requirements of Section 327(a) of the Bankruptcy Code are satisfied when proposed Counsel has no actual conflict of interest. *Caesars Entertainment*, 561 B.R. at 431.

[6]This third approach will be referred to in these materials as the "Case By Case Approach".

B.R. 882 (Bankr. N. D. Ill. 2014); *In Re Gluth Bros. Constr., Inc.,* 459 B.R. 351 (Bankr.N.D. Ill. 2011).

The Disclosure Requirement

While the determination of whether a conflict of interest may be actual, potential or disqualifying, the requirement of disclosure of any conflict, actual or potential, is abundantly clear, unequivocal and necessary. Under Rule 2014 of the Federal Rules of Bankruptcy Procedure, all relevant information and conflicting connections must be disclosed in a timely manner in the form of a verified statement. Disclosures must be detailed and accurate enough to enable the Court to evaluate and determine the extent of any potential conflict of interest. *In Re Park-Helena Corp.,* 63 F.3d 877 (9th Cir. 1995); *In Re Southmark Corp.,* 181 B.R. 291 (Bankr.N.D. Tex. 1995).

Failure to meet the requirements of Rule 2014(a) of the Federal Rules of Bankruptcy Procedure is, in and of itself, enough to disqualify Counsel, deny compensation or order disgorgement of fees. *Rome v. Braunstein*, 63 F.3d at 881; *In Re EWC, Inc.,* 138 B.R. 276, 280 (Bankr. W.D.Okla. 1992); *In Re Rusty Jones, Inc.,* 134 B.R. 321, 341 (Bankr.N.D.Ill. 1991). Importantly, there is a continuing and affirmative duty on behalf of a retained attorney to monitor any conflicts and to provide an updated Rule 2014 disclosure as circumstances change. *In Re Sauer*, 191 B.R. 402, 408 (Bankr.D.Neb. 1995); *In Re Tinley Plaza,* 142 B.R. at 278; *In Re Diamond Mortgage,* 135 B.R. at 89-90.

The importance of disclosure not only must be observed but also simply cannot be underestimated. This is particularly true when seeking the approval of dual representation of closely-held Debtor corporations and their principals. The fact intensive analysis undertaken by the Court in the Case By Case Approach necessarily has its roots in the Rule 2014 affidavit and the evidence flowing therefrom. A proper, complete Rule 2014 affidavit with full disclosure of any and all conflicts can only enhance the likelihood of a finding by the Court that the potential conflict is not disqualifying. Conversely, a less than complete Rule 2014 affidavit will likely expose Counsel to disqualification and other adverse consequences such as denial and/or disgorgement of compensation. The practitioner should fully and completely make all required statements and disclosures in the Rule 2014 affidavit and, when in doubt, disclose, disclose, disclose!

Strategies To Diminish
The Possibility of Disqualification

When an actual conflict of interest exists, the professional will not be permitted to simultaneously represent both the closely-held company and its principal(s). Therefore, the essential initial step is for Counsel to objectively discern whether an actual conflict is apparent in the related cases. If a reasonable determination is made by Counsel that the conflicting connections are only potentially disqualifying, then Counsel should prepare the case for establishing that the potential conflict of interest should not prohibit Counsel from the proposed dual representation. The preparation of this fact intensive case can be built around the disclosures required under Section 327(a) of the Bankruptcy Code and Rule 2014 of the Federal Rules of Bankruptcy Procedure. This type of preparation effort will insure that the proper disclosures are being made and that the relevant facts will support a finding that disqualification is unwarranted.

When preparing this case, Counsel should give consideration to retaining Special Counsel to serve in the event a potential conflict blossoms into an actual conflict. Additionally, while a committee of unsecured creditors is typically unlikely in cases involving closely-held companies and their principals, in the event such a committee is appointed, the committee's duties (as well as that of committee's Counsel) could, under certain circumstances include some of the legal services that may otherwise be undertaken by Debtor's Counsel with the dual representation. At a minimum, the committee and its Counsel can serve as a "watchdog" to monitor the potential conflict. A more extreme (and perhaps expensive) tool is to consent to the appointment of an examiner to separately review and monitor the nature and extent of the potential conflicts of interest. The Court may find that these types of safeguards may enable the Court to conclude that the dual representation can be authorized.

Notably, client waivers are of no use or benefit in curing conflicts issues in Bankruptcy Court, even though such waivers would be effective in non-bankruptcy matters. See, *In Re Jore Corp.,* 298 B.R. 703 (Bankr.D.Mont. 2003); *In Re Envirodyne Indus., Inc.,* 150 B.R. 1008, 1016 (Bankr.N.D. Ill. 1993); *In Re Tinley Plaza Assocs.,* 142 B.R. 272, 278 (Bankr.N.D.Ill. 1992); *In Re Diamond Mortgage Corp.,* 135 B.R. 78, 90 (Bankr.N.D.Ill. 1990).

An important aspect of the analysis of potential conflicts of interest is the realization that there is a possibility of early disqualification. As a result, the prudent action for Counsel, in addition to analyzing the potential conflicts and preparing to establish that these potential conflicts are not disqualifying, is to fully advise the client of the conflicts issue, the possibility of disqualification and the costs associated with disqualification.

Moreover, additional Counsel should be identified early so that if disqualification occurs, there will be no lapse in the continuity of representation.

CONFLICTS OF INTEREST CAN CAUSE CORPORATE GOVERNANCE ISSUES FOR AFFILIATED DEBTORS

Conflicts of interest can also pose significant problems for affiliated Debtors (in addition to the problems that proposed Counsel may face) which affect corporate governance and the continued ability for the affiliated Debtors to maintain control over their assets and business operations. These types of conflicts issues most often arise in the context of a motion for the appointment of a trustee under Section 1104 of the Bankruptcy Code.[7] As with the effect of conflicts of interest upon the Debtors' selection of a single law firm as Counsel to all Debtors, affiliated Debtors should also be informed of the impact of such conflicts upon their chosen reorganization/liquidation strategy. This advice necessarily includes a discussion of the ramifications of the potential for the appointment of a trustee or examiner.

Creditors have sought the appointment of a Chapter 11 trustee where there is an inherent, irresolvable conflict of interest. *In Re LHC, LLC,* 497 B.R. 281 (Bankr.N.D.Ill. 2013); *In Re SunCruz Casinos, LLC,* 298 B.R. 821 (Bankr. S.D.Fla. 2003). The basis for the appointment of a Chapter 11 trustee stems from the fact that any Debtor serves as a fiduciary to creditors which requires the Debtor to observe its duties of care, loyalty and impartiality. *In Re Eurospark Industries, Inc.,* 424 B.R. 621, 627 (Bankr.E.D.N.Y. 2010); *In Re Bowman*, 181 B.R. 836, 843 (Bankr.D.Md. 1995); *In Re Bellevue Place Assoc.,* 171 B.R. 615, 623 (Bankr.N.D. Ill.); *In Re Microwave Products of America, Inc.,* 102 B.R. 666 (Bankr.W.D. Tenn. 1989). As stated by the *Bowman* Court "The duties to avoid self-dealing, conflicts of interest and the appearance of impropriety are encompassed in the concept of loyalty." *Bowman*, 181 B.R. at 843. And, as stated by the Court in *Bellevue Place*, the mere inability to fulfill these fiduciary duties by a debtor-in-possession due to a conflict of interest is itself cause to appoint a trustee. *Bellevue Place*, 171 B.R. at 623.

There is a strong preference for the retention of current management in a closely-held entity because the Debtor's good will and reputation is closely aligned with its principals. *LHC,* 497 B.R. at 296; *In Re 4 C Solutions, Inc.,* 289 B.R. 354, 370 (Bankr.C.D.Ill. 2003). The mere fact that Debtors have multiple roles as owner, landlord,

[7]Although in fewer instances, the existence of conflicts of interest could also result in the conversion or dismissal of the case(s) under Section 1112(b) of the Bankruptcy Code or the appointment of an examiner under Section 1104 of the Bankruptcy Code.

tenant and even creditors is typically insufficient to warrant the appointment of a trustee. However, when these multiple roles make it impossible for the Debtors to fulfill their fiduciary duties as Debtors in Possession, there is no viable alternative to the appointment of a Chapter 11 trustee. *SunCruz Casinos,* 298 B.R. at 832.[8] See also, *In Re BLX Group, Inc.,* 419 B.R. 457, 472 (Bankr.D.Mont. 2009).

Clearly, much care and preparation should be taken in the cases of closely-held companies and their principals so as to avoid falling prey to the litigation strategy of the appointment of a trustee based upon perceived conflicts of interest. As with proposed Counsel, if actual conflicts exist, the appointment of a trustee will not only be likely, but probably required. On the other hand, in the event that the conflicts are merely "potential", a case should be built on the particular facts of the case that the extreme remedy[9] of the appointment of a trustee should give way to the strong preference for the retention of current management in closely-held corporations. The ultimate success of the cases of the closely-held corporation and its principals are likely dependent upon the continuation of existing management continuing to operate the business.

CONCLUSION

Except in extreme situations of actual conflicts, denying the dual representation of a closely-held company and its principal(s) by a single law firm ignores the practical realities of the business world. Undoubtedly, proposed Counsel for a closely-held Debtor company typically takes his instructions from the principals who guaranteed the corporate obligations, invested money in the company and, at times, among other things, leased the space to the company from which it operates its business. Should these simple facts disqualify one law firm from representing the closely-held company and its principals? Should these same simple facts result in the appointment of a trustee or some other form of relief that strips these types of Debtors of their businesses, their assets and their opportunity to reorganize and restructure?

The answer to these questions should be a resounding No! The use of the Case By Case Approach coupled with an understanding of how to successfully defend against

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[8]Notably, as with the determination of the issues in the Case By Case Approach, whether a trustee should be appointed is a fact intensive determination that must be made on a case by case basis. *4 C Solutions*, 289 B.R. at 370.

[9]The decision on whether to appoint a trustee is an extraordinary remedy that requires clear and convincing proof. *In Re Sundale, Ltd.,* 400 B.R. 890 (Bankr.S.D.Fla. 2009). The appointment of a trustee should be the exception and not the rule. *In Re Sharon Steel Corp.,* 871 F.2d 1217, 1225 (3d Cir. 1989).

a motion for the appointment of a trustee can achieve such a result. And, with this result, the success of the cases of a closely-held corporation and its principals will be protected (if not enhanced) while limiting the already major fees and expenses associated with bankruptcy cases.

AMERICAN BANKRUPTCY INSTITUTE

24th Annual Central States Bankruptcy Workshop
June 8-10, 2017
Traverse City, Michigan

When Cases Collide: Application of the Absolute Priority Rule in Individual Chapter 11 Cases

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INTRODUCTION

The application of the absolute priority rule in individual Chapter 11 cases has been the source of many conflicting opinions, in substantially every circuit in the United States. The basis of the dispute has been whether or not, after BAPCPA, the absolute priority rule applies to individual debtors in Chapter 11. Understanding the conflicting views will assist the practitioner in determining whether or not an individual Chapter 11 is a viable option for your client.

ABSOLUTE PRIORITY RULE

The Supreme Court ruled in the case of *Norwest Bank of Worthington vs. Alhers,* 485 F. U.S. 197 (1998), that the absolute priority rule applied in individual Chapter 11 cases. Obviously, this ruling was pre BAPCPA and the amendments enacted under BAPCPA caused courts, and attorneys alike, to question whether or not that ruling had been abrogated by the amendments. This discussion and conflict was spurred by changes to § 1129(b)(2)(B)(ii) read in conjunction with a new § 1115 which changes dealt exclusively with individual Chapter 11 debtors. Under BAPCPA, § 1129(b)(2)(B)(ii) was amended to read as follows:

> "the holder of any claim or interest that is junior to the claims of such class will not receive or retain under the plan on account of such

junior claim or interest any property, except that in a case in which the debtor is an individual, the debtor may retain property included in the estate under section 1115, subject to the requirements of subsection (a)(14) of this section." (emphasis added)

The added language, appears at the end of that section and has been the source of much discussion.

In conjunction with the additional language in § 1129(b)(2)(B)(ii), as part of BAPCPA, the new § 1115 which was added, states as follows:

> (a) In a case which the debtor is an individual, property of the estate includes, in addition to the property specified in section 541—
>
> > (1) all property of the kind specified in section 541 that the debtor acquires after the commencement of the case but before the case is closed, dismissed, or converted to a case under chapter 7, 12, or 13, whichever occurs first; and
> >
> > (2) earnings from 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, whichever occurs first.
>
> (b) Except as provided in section 1104 or a confirmed plan or order confirming a plan, the debtor shall remain in possession of all property of the estate.

The conflict between the circuits arises out of the interplay between 1129(b)(2)(B)(ii) and the added § 1115 which defines property of the estate in an individual Chapter 11 case. The portion of § 1115 which has given rise to this discussion states in paragraph (ii) that the holder of any claim or interest junior to the claims of such class shall not receive or retain any property on account of such junior claim or interest **except that in a case in which the debtor is an individual, the debtor may retain property included in the estate under § 1115, subject to subsection (a)(14) of this section**. (emphasis added)

Some courts have interpreted this added language to permit individual Chapter 11 debtors to retain property of the estate under § 1115, over the rejection of a dissenting class of creditors who have objected on the basis that such a

retention violates the absolute priority rule. The scope of this exception has been the basis for much contention and has resulted in dissension in the courts, regarding the application of absolute priority rule. The split in authority is often referred to as the "Broad View" and the "Narrow View" interpretation of these statutes.

Section 1115 defines property of the estate for an individual Chapter 11 debtor in a manner which is different than property of the estate for all other Chapter 11 debtors. Section 1115 of the Bankruptcy Code states that property of the estate in an individual Chapter 11, "in addition to the property of the estate specified in § 541 to earnings from services performed by the debtor after the commencement of the case." and adds to that property of the estate definition an individual's post-petition income. This phrase has been the basis of the disparate court decisions. Courts have ruled that the post-petition earnings, at a minimum, are property of the estate in an individual Chapter 11.

The conflict between the Broad View and the Narrow View, interpreting these sections, often centers around the word "included". Some courts have considered that, if the word "included", as inserted in 1129(b)2)(B)(ii), means that property of the estate includes only the property which is added by § 1115, then it should be construed narrowly to include post-petition income, thereby excluding the property defined in § 541 ("Narrow View"). If the word "included" in § 1115 entirely replaces § 541, courts have held that the relevant code section should be broadly interpreted and that the absolute priority rule does not apply to individual Chapter 11 debtors ("Broad View").

NARROW VIEW INTERPRETATION OF STATUTE

The Narrow View taken by the courts, indicates that the language added by BAPCPA only excepted future earnings and post-petition property from the absolute priority rule. The 10th Circuit, 9th Circuit, 6th Circuit, and 4th Circuit, as well as various bankruptcy courts, have adopted this view. An examination of the reasoning included in this case law follows on a court by court basis. It is worth noting that every circuit court which has addressed these issues has adopted the Narrow View, resulting in application of the absolute priority rule to individual Chapter 11 debtors.

A. Sixth Circuit. *Ice House AM., LLC v. Cardin*, 751 F.3d 734 (6th Cir. 2014). In this case, the bankruptcy court in Tennessee adopted the Broad View and ruled that the absolute priority rule was abrogated with respect to individual

debtors who filed for Chapter 11. The 6th Circuit disagreed with that ruling and reversed, stating that the absolute priority rule does apply to individual Chapter 11 debtors.

In this case, the debtor's assets included a home valued at $420,000.00, ice machines and equipment values at $320,000.00 and a vehicle valued at $30,000.00. After consideration of the bank's mortgages on the debtor's home and equipment, debtors still had more than $200,000.00 in equity in his assets. The plan proposed to allow him to obtain all of the assets after paying off the secured loans. The plan also required the debtor to make a single payment of $124,000.00 towards Ice House's unsecured claim of approximately $1,500,000.00. The plan also required the debtor to pay the amount of any disposable income he earned during the five years following the plan confirmation. *Ice House* and the United States Trustee objected to the plan based on the fact that the plan violated the absolute priority rule.

The *Ice House* court ruled that:

> "Section 1115 cannot take into the estate property that was already there. And long before Congress enacted the 2005 amendments, § 541 had already brought into the estate "all legal or equitable interests of the debtor in property as of the commencement of the case." What § 1115 adds to that pile of legal and equitable interest—and thus what § 1115 takes into the estate—is property "that the debtor acquires *after* the commencement of the case[.]" 11 U.S.C. § 1115(a) (/statute/11-usc-1115-property-of-the-estate) (emphasis added). (We recently read parallel language in Chapter 13 precisely the same way. *See In re Seafort*, 669 F3d 662, 667 (/case/seafort-v-burden-in-re-seafort#p667) (6th Cir. 2012) (" § 541 fixes property of the estate as of the date of filing, while § 1306 adds to the 'property of the estate' property interest which arise post-petition.")) Thus, it is only *that* property-property acquired after the commencement of the case, rather than property acquired before then-that "the debtor may retain" when his unsecured creditors are not full paid. 11 U.S.C. § 1129(b)(2)(B)(ii) (/statute/11-usc-1129-confirmation-of-plan)."

The court went on to say that:

> "In summary, what the 2005 amendment to § 1129(b)(2)(B)(ii) accomplishes is straightforward: the amendment maintains the pre-

2005 scope of the absolute-priority rule, thus limiting the rule's scope to pre-petition property, even as the definition of "property of the estate" expands to include post-petition property in § 1115."

Under this reading, "what § 1115 takes into the estate is property 'that the debtor acquires *after* the commencement of the case,'" and it is only "*that* property" that "'the debtor may retain' when his unsecured creditors are not fully paid." *Id.* At 739 (quoting 11 U.S.C. §§ 1115(a), 1129(b)(2)(B)(ii)."

B. Ninth Circuit. *Zachary v. Cal. Bank & Trust,* 811 F.3d 1191 (9th Cir. 2016). In this case, the 9th Circuit Court of Appeals overturned the BAP opinion in *In re Friedman*, 466 B.R. 471 (9th Cir. BAP 2012), holding that the absolute priority rule is still effective in individual chapter 11 bankruptcies, after the enactment of BAPCPA. The *Zachary* case also overturned a number of bankruptcy court opinions, including *In re Gbadebo*, 431 B.R. 222 (Bankr. N.D. Cal. 2010), *In re Shat*, 424 B.R. 854 (Bankr. D. Nev. 2010).

The circuit court in the *Zachary* case agreed with *Ice House* in the 6th Circuit stating that:

"Three provisions of the post-BAPCPA Bankruptcy Code intertwine to implement the absolute priority rule. First, § 541, which was not altered by BAPCPA, defines an estate in bankruptcy as "comprised of all" the property enumerated in that section, "wherever located and by whomever held," including "all legal or equitable interest of the debtor in property *as of the commencement of the case*." 11 U.S.C. § 541(a) (/statute/11-usc-541-property-of-the-estate), (a)(1) (emphasis added). Under this section, the "property of the estate," and, therefore, the property subject to the absolute priority rule in Chapter 11 cases, is "the property the debtor owned 'as of the commencement of the case.'" *Ice House*, 751 F.3d at 737 (/case/ice-house-am-llc-v-cardin#p737)-38 (quoting 11 U.S.C. § 541(a)(1) (/statute/11-usc-541-property-of-the-estate)).

The second relevant provision is § 1115, which was added in 2005 by BAPCPA. Pub.L. No. 109-8, § 321, 119 Stat. 23, 9495 (2005). Section 1115, which only applies to individual chapter 11 proceedings, adds to the § 541 "property of the estate" certain property obtained by the debtor "after the commencement of the case":"

The *Zachary* court ruled that this section was also intertwined with § 541, as well as the BAPCPA amendment to the absolute priority rule, which was cited above. The court indicated that § 1129(b)(2)(B)(ii) "plainly create an exception to the absolute priority rule that applies on to a chapter 11 "case in which the debtor is an individual." But the question is, what is the exception's scope? Or, put another way, what property may an individual chapter 11 debtor retain "without running afoul of the absolute priority rule?"

The *Zachary* court agreed with the Narrow View that the BAPCPA amendments had "the effect of allowing individual Chapter 11 debtors to retain property and earnings acquired after the commencement of the case that would be otherwise excluded under § 541(a)(6) and (7)." "Under this view, an individual debtor may not cram down a plan that would permit the debtor to retain prepetition property that is not excluded from the estate by § 541, but may cram down a plan that permits the debtor to retain only post-petition property."

C. Other Circuits. Adhering to the narrow review, are as follows:

1) Tenth Circuit. *Dill Oil Co. v. Stephens*, 704 F.3d 1279 (10th Cir. 2013). In the *Dill* case, the bankruptcy court ruled that the absolute priority rule was not applicable in the individual chapter 11's. The debtor exercised its right to appeal directly to the BAP which sua sponte, issued an order for direct appeal to the circuit court due to the fact that the case presented a question of public importance, for which there is no controlling law. The *Dill* court reversed the bankruptcy court and adopted the Narrow View indicating that the absolute priority rule was abrogated with respect to individual chapter 11 debtors. The circuit court reversed this rule and therefore, as part of the ruling, reversed the case of *In re Roedemeier*, 374 B.R. 264 (Bankr. D. Kan. 2007). This reversal is worth noting due to the fact that this case is often cited as a case supporting a broader interpretation of the statute.

This court did find that language to be ambiguous, and stated that the fact that there was such broad disagreement about the language was strong evidence of this ambiguity. The court then turned to the legislative history and intent, but found that the resources were so sparse that they were ambiguous as well. Without any further information on which to base their decision, the *Stephens* court held the presumption was against implied repeal controlling and decided that the absolute priority rule was still applicable. *In re Stephens*, 704 F.3d 1279, 1285. This was considered especially true in cases of bankruptcy law and in

the instant case because Congress had previously repealed the absolute priority rule and did so explicitly. *Id.*

2) Fourth Circuit. In *In re Maharaj*, 681 F.3d 558 (4th Cir. 2012), the 4th Circuit also adopted the narrow interpretation of the statute.

This court began its discussion with an in depth analysis of the history of the absolute priority rule, from its inception as a judicial doctrine to it repeal in 1952, and its rebirth in the 1978 Bankruptcy Reform Act.

The *Maharaj* court considered the reasoning of various other courts in regards to why they had made their decisions. It stated that a common thread running through the narrow view cases was their belief that if Congress had intended to abrogate the absolute priority rule they could have done so in a much simpler way, either by raising the debt limits in Chapter 13 or simply saying the rule did not apply in Chapter 11 individual cases. *In re Maharaj*, 681 F.3d 558, 566. The court also took issue with the Broad View argument that § 1115 would be rendered trivial by a narrow reading, and instead stated that this amendment was very valuable in that it continues to add post-petition property to the estate for non-individual cases and extends the automatic Chapter 11 stay to post-petition earnings in individual cases while subjecting those earnings to various tests for confirmation of a Chapter 11 plan. *Id* at 570. In support of its decision to adopt the narrow view this court stressed the Supreme Court's view that implied repeal is strongly disfavored, especially in the bankruptcy context. No clear indication of an intent to overturn the absolute priority rule can be found in the legislative history of BAPCPA. House Reports of the BAPCPA included deliberate discussion when Congress intended to change longstanding bankruptcy practice, but no mention of abrogating the absolute priority rule under the relevant sections. *Id* at 572.

Finally, the court dismissed the arguments of the debtors that this made confirmation of a plan that retains some pre-petition property impossible and their policy arguments, stating that BAPCPA was not designed to enhance the "fresh start" of debtors. *Id* at 573.

3) Fifth Circuit. In *In re Lively*, 717 F.3d 406 (5th Cir. 2014), the 5th Circuit Court of Appeals also adopted the narrow interpretation of the statute.

In an interesting twist on the Broad View arguments, the *Lively* court agreed that BAPCPA amendments were designed to bring Chapter 11 filings into line with Chapter 13 filings, but in doing so, were meant to impose greater

requirements on Chapter 11 filers, rather than lessen the burden of the absolute priority rule. The court states:

> "A plain reading of § 1129(b)(2)(B)(ii) in light of § 1115(a) is that both provisions were adopted when BAPCPA was passed in order to coordinate individual debtor reorganization cases to some extent with Chapter 13 cases, whose debt limit may throw debtors like Lively into a Chapter 11 reorganization. See 11 U.S.C. § 109(e). Had Chapter 11 remained unaltered, Lively could reorganize in Chapter 11 under more favorable terms than those available to chapter 13 debtors"
> *In re Lively*, 717 F.3d 406, 409 (5th Cir. 2013).

The court also briefly stated that if a plain meaning analysis was not sufficient. The great weight of precedent regarding statutory interpretation made the narrow view the only acceptable choice. Repeals by implication are disfavored and require a clear and manifest intent by the legislature. *Id* at 410.

D. Georgia Bankruptcy Court, Middle District. In addition to the circuit court cases, there is a detailed and well reasoned opinion that was entered in *In re Rogers* case (14-40219, 2016 WL 3583299 (Bankr. M.D. Ga. June 24, 2016)). In the *Rogers* case, the opinion related to approval of the debtor's disclosure statement. The court denied the approval of that disclosure statement based on the fact that it violated the absolute priority rule. That opinion provides a detailed analysis of the various courts and how they have approached this issue.

BROAD VIEW ON INTERPRETATION OF STATUTE

Comparatively few cases have adopted the Broad View, and some that have been foundations for the Broad View (*In re Friedman*) have been overturned. Almost all of them are widely cited, but have received significant negative treatment.

It is also worth noting that the broader view interpretation of the statutes has not been adopted by any circuit court nor has it been adopted by any bankruptcy or district court in recent years. The following courts have adopted the Broad View and that analysis is included in the opinion set out in the following cases:

A. Ninth Circuit. In *In re Friedman*, 466 B.R. 471 (B.A.P. 9th Cir. 2012) overruled by *Zachary v. California Bank & Trust*, 811 F.3d 1191 (9th Cir. 2016). **THIS CASE WAS OVERRULED BY *ZACHARY V. CALIFORNIA* CITED ABOVE.** The court stated that the language "included in" is not a term of limitation, this court held that a plain reading of § 1115 also included the § 541 property mentioned in § 1115. *Id* at 482. In simplified terms this court held that because 1129(b)(2)(B)(ii) references § 1115 and § 1115 references § 541, both pre-petition and post-petition property can be retained by a debtor using a cramdown and the absolute priority rule is inapplicable in individual debtor cases. The *Zachary* court held this was the most natural and plain reading of the statute. This court also argued that the legislative history indicates that the intent of BAPCPA amendments was to make chapter 11 filings more similar to Chapter 13 filings. *Id* at 482-483. The court supported this by stating that various amended sections resemble Chapter 13 sections, such as § 1129(a)(15) resembling § 1325(b) and 1141(d)(5)(A) resembling 1328(a). *Id.* The court further criticized that "when decisions have gone further than exercising the a plain reading of the statute, they have entered into speculative analysis that is fatally flawed". *Id* at 483. This court held that because the reading of the statute was plain there was no need to resort to "legislative history and spirited analytics" **(AGAIN, THE 9TH CIRCUIT OVERTURNED THE BAP IN THIS CASE IN *ZACHARY V. CALIFORNIA* CITED ABOVE).**

B. Nebraska. In *In Re Tegeder*, 369 B.R. 477 (Bankr. D. Neb. 2007), the Nebraska Bankruptcy Court adopted the Broad View interpretation of the statute.

C. Indiana. *In re Johnson*, 402 B.R. 851 (Bankr. N.D. Ind. 2009). The *Johnson* court does not discuss or argue the absolute priority rule being abrogated, simply states that it no longer applies to individual cases (no citation except to 11 U.S.C. 1129(b)(2)(B)).

D. Florida. The Bankruptcy Court in the Middle District of Florida11th Circuit adopted the Broad View interpretation of the status in *SPCP Group v. Biggins*, 465 B.R. 316 (2011).

E. Connecticut. In *In Re Bullard*, 358 B.R. 541 (Bankr. D. Conn. 2007), the Bankruptcy Court in Connecticut adopted the Broad View. The court adopts a view that the post-petition income and property are retainable under § 1115, and does not rule on the effect of BAPCPA amendments to pre-petition property. *In re Bullard*, 358 B.R. 541, 544-545, n.10. The Court does state that a commentator has suggested that pre-petition property may be retained but the court explicitly

stated that it "expresses no opinion on that point". *Id* at n10. It also offered two cases for comparison in which BAPCPA did not apply. *Id.*

F. Arkansas. In *In re O'Neal*, 490 B.R. 837 (Bankr. W.D. Ark. 2013), *O'Neal* based the majority of its decision to accept the Broad View on the theory that the BAPCPA amendments would be illogical to adopt unless Congress wanted to make Chapter 11 work more like Chapter 13. Because Chapter 13 does not include an absolute priority rule, BAPCPA must have intended to abrogate it.

This court also drew direct comparisons to § 1306, stating:

> "Section 1115 is written word for word like section 1306 and courts interpreting section 1306 have never bifurcated this section into two species of property as the narrow view does in individual Chapter 11. To read section 1115 and section 1129(b)(2)(B)(ii) as exempting only future income from the absolute priority rule renders ineffective any practical application of section 1115, especially in light of the additional requirements of section 1129(a)(15)(B). When considered in the context of all the applicable sections, section 1115 accomplishes nothing of substance under the narrow view"

In re O'Neal, 490 B.R. 837, 851 (Bankr. W.D. Ark. 2013).

Finally this court described the narrow view as illogical because the requirement to commit five years of disposable income to their plans was meaningless if the means of producing that income (pre-petition property) was removed from the debtors.

G. Kansas. In *In re* Roedemeier, 374 B.R. 264 (Bankr. D. Kan. 2007), the court declined to follow *In re Stephens.* The court stated that the effect of reading 1129(b)(2)(B)(ii) would be greatly limited by the narrow reading, essentially preventing a debtor from retaining any pre-petition property because *Norwest Bank Worthington v. Ahlers* made it so that the new value or new money exception to the absolute priority rule was limited to money or money's worth. This would prevent the debtor from using post-petition earnings derived from their labor to satisfy creditors in the eyes of this court. This in turn would make it almost impossible for an individual debtor to retain any pre-petition property. The court also stated that without an abrogation of the absolute priority rule, the amendments to Chapter 11 under BAPCPA would have little purpose, citing to various provisions such as § 1123(a)(8), 1129(a)(15), and 1127(e), and citing to a source that compares them to Chapter 13 provisions. *In re Roedemeier*, 374 B.R. 264,

275-276 (citing 5 Keith M. Lundin, *Chapter 13 Bankruptcy, 3d Ed.*, § 368.1 at pp. 368–1 to 368–5 (2000 & Supp.2006)).

CONCLUSION

It is clear that most circuit courts are interpreting the interplay between § 1129(b)(2)(B)(ii) and § 1115 narrowly, thereby ruling that the absolute priority rule does apply. Based on the fact that all circuit courts that have ruled on this issue have adhered to the Narrow View and the bankruptcy court cases which adhere to the Broad View have not been decided in recent years.

As a result of this interpretation, particularly if you in a circuit where the Narrow View is the rule of law, you need to determine whether or not your client can successfully confirm a Chapter 11 plan. If the debtor is in the position to pay money to creditors the present value of all non-exempt assets over the five year period or liquidate assets to meet that requirement, a Chapter 11 for an individual may be successful. Many practitioners are seeing this issue arise with individuals who are guarantors of a large amount of debt, as a result of their association with a failed business, or farmers that cannot meet the debt limitations in a Chapter 12. A careful analysis of this case law will assist you in advising your client and determining whether or not a Chapter 11 can be successful.

American Bankruptcy Workshop

24th Annual Central States Bankruptcy Workshop
June 8-10, 2017
Traverse City, Michigan

When Cases Collide: When Closely Held Businesses and Individual Owners Seek Bankruptcy Protection

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INTRODUCTION

This paper lays the groundwork for other portions of this presentation having to do with conflicts of interest and the absolute priority rule by examining three cases that address different issues that can arise when both an entity and its owner file bankruptcy.

CASE DISCUSSION

1. *In re John J. Mendolia and Nicolina M. Mendolia*, 2015 WL 475966 (Bankr. N.D.N.Y. 2015): Is an Avoidance Action Barred by the Business's Plan

This case presents an interesting analysis of what can happen to avoidance actions held by the trustee of a chapter 7 estate against businesses owned by the chapter 7 debtors when the businesses filed chapter 11 cases. The facts were as follows:

a. January 2012: The Franchise Entities Are Struggling and File Chapter 11

The Mendolias (husband and wife) were the sole owners and officers of three entities operating as Arby's franchises (the "Franchise Entities"). The Mendolias had worked at the Franchise Entities since 1988. By 2012, however, the Franchise Entities were struggling financially. In January 2012, the Franchise Entities' food supplier revoked its credit terms and stated all deliveries must be paid for in advance.

On or about January 9, 2012, the Mendolias closed on the sale of their lake home and deposited the sale proceeds (approximately $51,000) into the Franchise Entities' general

operating accounts, where the funds were used to pay the food supplier. On January 19, the Franchise Entities filed petitions under Chapter 11.

b. February 2012: Then the Owners – the Mendolia's – File Chapter 7

On February 16, 2012, the Mendolias filed a joint petition under chapter 7. The Mendolias described the sale of their lake home and the transfer of the proceeds to the Franchise Entities on their Statement of Financial Affairs. A trustee was appointed on February 17, 2012.

c. January/March 2013: The Franchise Entities File Their Plan and Disclosure Statement

Approximately one year later, on January 29, 2013, the Franchise Entities filed their First Amended Joint Plan of Reorganization and First Amended Disclosure Statement. The Mendolia's Trustee in the chapter 7 case received notice of the plan and disclosure statement, but took no action (did not object, did not file a proof of claim, did not file a motion for allowance of an administrative expense claim).

On March 11, 2013, the bankruptcy court in the Franchise Entities' case confirmed the Plan of Reorganization, and on May 1, 2013, the Franchise Entities' bankruptcy cases were closed. The Plan provided that the Mendolias would be permitted to purchase the common stock of the Franchise Entities by paying $833.33 per share (about $5000 total) to the Trustee of their individual case. In addition, the Disclosure Statement provided that pursuant to 1141(a) "the [Franchise Entities] Debtors shall be discharged from any debt that arose before confirmation of the Plan." *Id.* at *3. The Plan similarly provided for the "revesting of property of the estates in the hands of the Franchise Defendants 'free and clear of all Claims and of the rights and interests of all Creditors.'" *Id.*

d. February 2014: The Chapter 7 Trustee Commences An Adversary Proceeding Against the Franchise Entities

Then on February 14, 2014, the chapter 7 Trustee commenced an adversary action against the Franchise Entities, contending that the Mendolia's 2012 transfer of $51,000 (the lake house sale proceeds) to the Franchise Entities constituted a fraudulent transfer under Section 548 of the Bankruptcy Code. The Franchise Entities moved for summary judgment, arguing that the claim under Section 548 was discharged by the confirmation of their Plan.

The Court began its analysis by noting that the avoidance action came into existence only when the Mendolias filed their joint petition under chapter 7, making it a post-petition claim in the Franchise Entities' chapter 11 case (because the Mendolia's filed their personal case after the Franchise Entities filed their cases). Furthermore, the Court stated both parties conceded that when an avoidance action arose post-petition, that avoidance action constituted an administrative expense claim. *Id.* at *5.

The chapter 7 Trustee made several arguments as to why the Section 548 claim should survive summary judgment:

(1) The Trustee was not a "creditor" as that term is defined under the Bankruptcy Code § 101(10);

(2) the Plan required payment of all administrative expense claims in full pursuant to 11 U.S.C. § 1129(a)(9)(A);

(3) The Trustee's claim was not discharged under Section 1141(d) because the Trustee was not bound by Section 1141(a) of the Bankruptcy Code since he did not acquire property under the Plan and he was not an equity holder (as a successor to the Mendolia's).

The Court did not address all of the arguments, finding it did not need to because it was "unequivocally convinced" by the Franchise Entities' argument that the Trustee's claim was discharged by operation of law pursuant to 11 U.S.C. § 1141(d). *Id*. at *6.

Section 1141(d) provides that "confirmation of a plan" discharges the debtor "from any debt that arose before the date of such confirmation . . ." The Trustee argued it was not bound by Section 1141(d), citing *In re Nuttall Equip.Co.*, 188 B.R. 732 (Bankr. W.D.N.Y. 1995), which held that allowed administrative expense claims and pre-confirmation administrative expense claims arising out of the ordinary course of business for which no request for payment is ever made pre-confirmation are excepted from the discharge (because to conclude otherwise would result in a "logical absurdity").

The Court explicitly rejected the reasoning of *Nuttall*, following instead the Bankruptcy Court in the Southern District of Ohio, in *In re Eagle-Picher Industries*, 278 B.R. 437, 448 (Bankr. S.D. Ohio 2002). The court in *Eagle-Picher* stated:

> This court perceives no such logical absurdity. The respective Code sections here under discussion are clearly stated and not inconsistent. Section 1129(a)(9)(A) by its express language deals with administrative expense claims filed pre-confirmation. The injunction in § 1141(d) by its express terms bars the assertion post-confirmation of claims based on acts pre-confirmation and makes no exception for administrative expense claims.

The Trustee also argued that Sections 1141(d) and 1141(a) are "co-dependent," meaning the discharge injunction in 1141(d) only applies to the parties identified in 1141(a), citing *In re Worldcom*, 546 F.2d 211 (2d Cir. 2008). The court declined to find *Worldcom* persuasive, concluding it was distinguishable on its facts and the Trustee was relying on non-binding dicta. Moreover, the Court independently reviewed Sections 1141(a) and (d) and concluded they are not co-dependent, and instead they serve different purposes. Specifically, the Court stated Section 1141(a) controls the relationship between the debtor and all parties holding claims against the debtor by dictating that terms of the plan and confirmation order control the method, timing and amount of payments to be made, while Section 1141(d) discharges any other right to payment that may have been held by a claimant.

Thus, the Bankruptcy Court granted the Franchise Entities' motion for summary judgment, finding the Trustee's avoidance action barred by confirmation of the Franchise Entities' plans. The Bankruptcy Court was affirmed by the United States District Court, *In re Mendolia*, 2016 WL 1248888 (N.D.N.Y. 2016), and the Second Circuit, *In re Mendolia*, 2017 WL 219085 (2d Cir. Jan. 19, 2017).

The Second Circuit affirmed on different grounds. It stated that Section 1141 was not applicable to post-petition administrative expense claims so it did not opine on whether Section 1141(a) and 1141(d) were co-dependent. Instead, it held that an administrative claim is governed by Section 503. With respect to the plan at issue, it held that the plan expressly discharged all claims and rights and interests, which included the avoidance claim. Moreover, the Second Circuit also distinguished *Worldcom*, explaining that the alleged fraudulent transfer liability at issue in that case arose after plan confirmation.

* * *

2. *In re Seaside Engineering & Surveying, Inc.,* 780 F.3d 1070 (11th Cir. 2015): The State of the Law on Non-Debtor Releases

This decision by the United States Court of Appeals for the Eleventh Circuit present an analysis of the bankruptcy court's authority to issue non-consensual non-debtor releases as part of a plan of reorganization.

The underlying facts in this case were as follows: Seaside Engineering & Surveying, Inc. ("Seaside") started two ancillary real estate businesses (sister companies) that received a loan from Vision-Park Properties LLC and SE Property Holdings, LLC (collectively, "Vision"). Vision's loans to the two ancillary businesses were guaranteed by five individuals who were also the principal shareholders of Seaside. The two sister companies defaulted on their loans from Vision, and Vision filed suit against the individuals to recover on the personal guaranties.

Upon commencement of the suits by Vision to recover on the personal guaranties, three of the individuals filed for protection under chapter 7, and each listed their Seaside stock as a non-exempt personal asset. The trustee for one of the individual chapter 7 debtors held an auction to sell the shares of Seaside. Vision was the winning bidder at the auction. Once Vision's purchase of the Seaside shares was confirmed by the bankruptcy court in the chapter 7 case, Seaside filed chapter 11. Seaside proposed a plan whereby it would emerge from bankruptcy as Gulf Atlantic, LLC ("Gulf"). The Seaside plan proposed that Gulf would be owned by four members, which would be the family trusts of the four individual managers. Any other owners of Seaside (namely, primarily Vision) would receive a promissory note bearing interest at 4.25% in exchange for their shares and would be excluded from ownership in Gulf. The bankruptcy court approved the plan of reorganization and the district court affirmed.

On appeal to the 11th Circuit, Vision raised a number of issues objecting to Seaside's plan including the plan's provision for a release of claims:

> As part of the Reorganization Plan, the bankruptcy court approved releases of claims against non-debtors:
>
> [N]one of the Debtor, . . . Reorganized Debtor, Gulf Atlantic . . . (and any officer or directors or members of the aforementioned [entities]) and any of their respective Representatives (the "Releasees") shall have or incur any liability to any Holder of a Claim against or Interest in Debtor, or any other party-in-interest . . . for any act, omission, transaction or other occurrence in connection with, relating to, or arising out of the Chapter 11 Case. . . .

Id. at 1076. This provision had the effect of releasing the individuals from their personal guarantees. The bankruptcy court confirmed the plan, and the district court affirmed the bankruptcy court.

The Court took up the issue of non-debtor releases, observing that it had spoken at least once before on the validity of non-debtor releases and the issue warranted "significant discussion." The Court began by observing that it had upheld the issuance of non-debtor releases in *In re Munford*, 97 F.3d 449 (11th Cir. 1996), and thus concluded that the Circuit permits them "at least under some circumstances." In *Munford*, the non-debtor release made a settlement possible pursuant to which the settlement proceeds funded the bankruptcy estate. The Court in *Seaside* said while no settlement was at issue as in *Munford*, the releases at issue prevent claims against non-debtors that would "undermine the operations of, and doom the possibility of success for, the reorganized entity, Gulf." *Id.* at 1077.

The 11th Circuit then examined the status of non-debtor releases in other circuits, explaining that the circuits are split. The Court cited 5-84 *Colliers Bankruptcy Practice Guide* ¶ 84.02[1][c][v] for the position of the circuits: the Ninth and Tenth Circuits represent the "minority view" and prohibit such releases. The Court stated the Fifth Circuit in the minority view too; and the majority view, which permits such releases in certain circumstances, is practiced in the Second, Third, Fourth, Sixth, and Seventh Circuits. And the First, Eleventh and D.C. Circuits have "indicat[ed] that they agree with the 'pro-release' circuits."

The Court then followed *In re Dow Corning Corp.*, 280 F.3d 648, 658 (6th Cir. 2002), wherein the Sixth Circuit established a seven factor test to guide bankruptcy courts in determining whether non-debtor releases are appropriate:

> When the following seven factors are present, the bankruptcy court may enjoin a non-consenting creditor's claims against a non-debtor: (1) There is an identity of interests between the debtor and the third party, usually an indemnity relationship, such that a suit against the non-debtor is, in essence, a suit against the debtor or will deplete the assets of the estate; (2) The non-debtor has contributed substantial assets to the reorganization; (3) The injunction is essential to the reorganization, namely, the reorganization hinges on the debtor being free from indirect suits against parties who would have indemnity or

> contribution claims against the debtor; (4) The impacted class, or classes, has overwhelmingly voted to accept the plan; (5) The plan provides a mechanism to pay for all, or substantially all, of the class or classes affected by the injunction; (6) The plan provides an opportunity for those claimants who choose not to settle to recover in full; and (7) The bankruptcy court made a record of specific factual findings that support its conclusions.

The Court then stated the factors should be considered non-exclusive, and should be applied flexibly and only where "essential, fair, and equitable." *Id.* at 1079.

The Court then reviewed the bankruptcy court's findings in applying the *Dow* factors under an abuse of discretion standard, and concluded the bankruptcy court made "thorough factual findings. . . [that] are amply supported by the evidence." On the first factor, the Court found that the non-debtor releases in favor of the individuals would allow the new entity emerging from bankruptcy – i.e., Gulf – to avoid depleting its assets defending against voluminous litigation. The Court agreed with the bankruptcy court that "time is money" for engineers. If the individual principals were preoccupied with additional lawsuits, it would interrupt their labor intensive work and lead to a deterioration of Gulf.

With regard to the second factor, the bankruptcy court acknowledged that none of the individuals contributed any new value to the reorganized debtor other than their labor. Nevertheless, the bankruptcy court stated that "the contribution of their services to the reorganized debtor is the very life blood of the reorganized debtor." *Id.* at 1080. The 11th Circuit agreed.

With regard to the third factor, the bankruptcy court found that the injunction was "absolutely essential." The Court agreed, stating that "[w]e agree that, without the bar order, the litigation would likely continue, bleeding Gulf dry and dashing any hope for a successful reorganization." *Id.*

With regard to the fourth factor, the courts acknowledged that Vision rejected the plan, but the plan provided that the equity holders would be paid in full. This fact also related to the fifth factor.

With regard to the sixth factor, the bankruptcy court concluded the factor was inapplicable and the Circuit Court did not disagree.

And as for the seventh factor, the Court held that the bankruptcy court made ample factual findings and did not abuse its discretion.

In the end, in upholding the non-debtor releases, the Court stated, "This case has been a death struggle, and the non-debtor releases are a valid tool to halt the fight." *Id.* at 1081.

* * *

3. *In re Gentry*, 807 F.3d 1222 (10th Cir. 2015): Does the Business Debtor's Plan Treatment Affect What Happens to the Personal Guaranties?

In this case, the United States Court of Appeals for the Tenth Circuit examined whether an obligation that is modified under a chapter 11 plan is also modified for purposes of a corresponding guaranty. The facts of this case were as follows:

Susan and Larry Gentry were the sole officers, directors and shareholders of a corporation ("Ball Four") that ran a sports complex in Colorado. In 2005 Ball Four received a $1.9 million loan from FirsTier Bank (the "Lender"). The loan was evidenced by a note that was secured by Ball Four's assets and also personally guaranteed by the Gentry's. Ball Four struggled to pay the loan, and after four years Ball Four stopped making payments. The Lender commenced foreclosure proceedings against Ball Four. In response, Ball Four filed a voluntary petition under chapter 11 in September 2010.

In October 2010, a month after Ball Four filed chapter 11, the Lender sued the Gentrys in state court to collect on their personal guaranties.

In the Ball Four bankruptcy proceeding, Ball Four proposed a plan of reorganization that provided that the Lender's allowed claim would be paid in full, plus six percent interest, over twenty-five years with a five-year balloon payment, and the Lender would retain its lien until it was paid in full. That said, the precise amount of the Lender's claim was disputed and until that was resolved, Ball Four was not required to make any payments to the Lender. Ball Four's plan was confirmed by the Bankruptcy court in August 2011.

Then, still facing litigation with the Lender (FirsTier or its successors) over the personal guaranties, the Gentrys filed a voluntary petition for chapter 11 in November 2011. The Gentrys proposed an amended plan that provided that the liability on their guarantees to the Lender would be satisfied by Ball Four under its confirmed plan.

The bankruptcy court confirmed the Gentry's plan (over the Lender's objections).

The Lender appealed the confirmation of the Gentry's plan, challenging (among other issues) whether the Gentry's personal liability on the guarantees would match Ball Four's liability under the Ball Four confirmed plan. Both the bankruptcy court and the district court held that the Gentry's liability matched Ball Four's liability, as it would be determined and then paid under the Ball Four confirmed plan.

The Tenth Circuit disagreed. It held that bankruptcy "changes the calculation." *Id.* at 1227. Specifically, the Court stated that under Section 524(e) of the Bankruptcy Code, the discharge of a borrower's liability does not affect a guarantor's liability. The Court stated that to hold otherwise would "impair a guaranty." *Id.* Lastly, the Court found three provisions in the guaranties that could create a greater obligation by the guarantors: First, the Gentry's promised to pay all of the principle amount outstanding, whether barred or unenforceable against Ball Four. Second, the Gentrys waived any defenses arising because of the cessation of Borrower's

liability for any cause. And third, the Gentrys agreed not to assert any deductions to the amount owed through setoff, counterclaim or other method.

In concluding, the Tenth Ciruit stated, "[a] bankruptcy court can grant a discharge, but a discharge does not extinguish the underlying debt rather it changes the debtor's liability for that debt. This distinction is important. In confirming the Ball Four Plan, the bankruptcy court did not modify Ball Four's indebtedness but its liability for that indebtedness. Therefore, the indebtedness remains unchanged – and that is what the Gentrys guaranteed." *Id.* at 1228.

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