2022 Bankruptcy Battleground West

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2022

ABI BATTLEGROUND WEST 2022 CROSSFIRE PANEL[1]

I. United States Trustee Fees in Large Chapter 11 Cases – Uniformity for Almost All

Issue: Whether the Amendment to the U.S. Trustee Quarterly Fees violates the uniformity requirements of the Constitution?

Pro Congress' 2017 amendment to quarterly fees did not violate the uniformity requirements of the Constitution where (1) Congress provided a solid fiscal justification for its amendment to the statute setting forth different quarterly fees in the U.S. Trustee districts (covering 48 states) as compared with Bankruptcy Administrator districts (North Carolina and Alabama); (2) the differing treatment was neither arbitrary nor irrational; and (3) the amendment was consistent with Supreme Court precedent upholding Congress' authority to enact bankruptcy laws with regional differences to resolve isolated regional problems.

Supporting Cases:

- *Siegel v. Fitzgerald (In re Circuit City Stores, Inc.)*, 996 F.3d 156 (4th Cir. 2021)[2]
- *Matter of Buffets, LLC*, 979 F.3d 366 (5th Cir. 2020)

Argument:[3]

To be constitutionally uniform, "[a] law enacted pursuant to the Bankruptcy Clause must: (1) apply uniformly to a defined class of debtors; and (2) be geographically uniform." *Ry. Labor Execs.' Ass'n v. Gibbons*, 455 U.S. 457, 473, 102 S.Ct. 1169, 71 L.Ed.2d 335 (1982)). Nonetheless, the Supreme Court has emphasized that "bankruptcy law may be uniform and yet may recognize the laws of the State in certain particulars, although such recognition may lead to different results in different States." *Gibbons*, 455 U.S. at 469. In the proper circumstances, Congress may "take into account differences that exist between different parts of the country, and ... fashion legislation to resolve geographically isolated problems." *Id.*; *see also Reg'l R.R. Reorganization Cases*, 419 U.S. 102, 159-61, 95 S.Ct. 335, 42 L.Ed.2d 320 (1974) (recognizing that Act of Congress applicable only to rail carriers in certain regions and to carriers reorganizing

[1] The opinions expressed during the panel discussion are not necessarily those of the panelists or the firms for whom they work. No comments by any of the Judges may be used in any written or oral argument.

[2] The Supreme Court of the United States granted a petition for writ of certiorari submitted by the Liquidating Trustee of the debtor. The case is *Siegel v. Fitzgerald*, 996 F. 3d 156 (4th Cir. 2021), cert. granted, (U.S. Jan. 10, 2022) (No. 21-441).

[3] Citing generally to *In re Circuit City Stores, Inc.*, 996 F.3d 156 (4th Cir.2021).

within certain time period was uniform under the Bankruptcy Clause, in that it was designed to solve specific regional problem).

There is "no uniformity problem" with Congress' 2017 quarterly fee amendment because the Constitutional uniformity requirement forbids only arbitrary regional differences in the provisions of the Bankruptcy Code. Congress has the power to enact legislation that resolves regionally isolated problems, and, when Congress determined that it needed to remedy a shortfall in funding for the Trustee districts (while there was no funding shortfall in the Administrator districts) it was entitled to do so with a fee increase in just the underfunded districts.

By increasing quarterly fees for large Chapter 11 bankruptcies in Trustee districts, Congress solved the shortfall in the program's funding. The Administrator districts, which are funded by the judiciary's general budget, did not face a similar financial issue. Because only those debtors in Trustee districts use the U.S. Trustees, Congress reasonably solved the shortfall problem with fee increases in the underfunded districts.

Precedent supports bankruptcy laws based on such distinctions. For example, in the railroad setting, the Supreme Court allowed Congress to establish a special court and enact statutes to benefit bankrupt rail carriers in the northeast and midwest, as those were the only railroads facing the problem. *See Reg'l R.R. Reorganization Cases*, 419 U.S. at 159-61.

The 2017 Amendment, is neither irrational nor arbitrary in its distinctions between UST and Administrator districts because Congress provided a solid fiscal justification for its challenged action: to ensure that the U.S. Trustee program is sufficiently funded by its debtors rather than by the taxpayers, and, thus, the 2017 Amendment does not contravene the uniformity mandate of either the Uniformity Clause or the Bankruptcy Clause.

Con Despite the Constitution's directive to establish uniform laws regarding bankruptcy cases, large chapter 11 Debtors in the 48 U.S.Trustee districts (covering 48 states) are treated differently than debtors in a Bankruptcy Administrator district (North Carolina and Alabama).

Supporting Cases:

- *Clinton Nurseries, Inc. v. Harrington (In re Clinton Nurseries, Inc.*), 998 F.3d 56 (2d Cir. 2021)
- *In re MF Global Holdings Ltd.*, 615 B.R. 415 (Bankr. S.D.N.Y. 2020)

- *John Q. Hammons 2006 LLC v. Office of the United States Trustee*, U.S. 10th Circuit Court of Appeals, No. 20-3203 (October 5, 2021)

- *USA Sales, Inc., v. Office of the U.S. Tr.*, No. 19-2133, 2021 WL 1226369, at *17 (C.D. Cal. Apr. 1, 2021);

- *In re Life Partners Holdings, Inc*., 606 B.R. 277, 286 (Bankr. N.D. Tex. 2019)

Argument:

The United States Constitution authorizes Congress to enact "uniform laws on the subject of Bankruptcies throughout the United States." Congress, however, has divided the nation's bankruptcy courts into two separate programs – 88 judicial districts where cases are administered under the US Trustee program, and 6 judicial districts (in North Carolina and Alabama) operating under the Bankruptcy Administrator program. While each program performs similar tasks, in 2017, Congress approved a 5 year increase in the amount that large Chapter 11 debtors were required to pay to the US Trustee, initially requiring them to pay the lesser of one percent (1%) or $250,000 (from a fee of $30,000) per quarter on disbursements over $1,000,000.00. This increase went effective in January 2018 and applied to cases filed before that date that were still pending and any cases filed thereafter. Initially, Congress did not require bankruptcy courts in North Carolina and Alabama to impose the additional fees creating a wide disparity exceeding $100 Million in aggregate fees in Chapter 11 cases nationwide.

The Second Circuit in *Clinton Nurseries, Inc. v. Harrington (In re Clinton Nurseries, Inc*.), 998 F.3d 56 (2d Cir. 2021), rejected decisions of the Fourth and Fifth Circuits and found that such non-uniform fees are unconstitutional. The Tenth Circuit in *John Q. Hammons 2006 LLC v. Office of the United States Trustee*, U.S. 10th Circuit Court of Appeals, No. 20-3203 (October 5, 2021), has also found such fees to be unconstitutional.

On January 10, 2022, the Supreme Court of the United States granted a petition for writ of certiorari submitted by the Liquidating Trustee of debtor, Circuit City Stores, Inc. of the Fourth Circuit ruling in the case *Siegel v. Fitzgerald*, 996 F. 3d 156 (4th Cir. 2021), cert. granted, (U.S. Jan. 10, 2022) (No. 21-441).

The question before the Supreme Court is whether these bankruptcy fees are subject to and comply with this clause. The petitioner is the fiduciary appointed under the liquidating plan confirmed in the Circuit City bankruptcy case who is charged with, among other things, paying the US Trustee fees at issue in this appeal. The Circuit City case was pending when the additional fees were imposed. The Petitioner argues that the fee system violates the Constitution for at least two reasons. First because cases in North Carolina and Alabama were initially exempt from the increased fees, and second, when North Carolina and Alabama cases were eventually included in the fee regime, it only applied to cases commenced after the effective date of imposition of such fees thereby creating a non-uniform system which resulted in unequal treatment because cases commenced in North Carolina and Alabama before October 2018 as they would never be required to pay the additional fees.

II. Beware of What You Ask For – The Absolute but *Qualified* Right to Dismiss a Chapter 13 Case?

Issues:

1. Should the Debtor's right to dismiss a Chapter 13 Case under § 1307(b) trump a competing motion to convert under §1307(c) filed by a Creditor and/or the Trustee?

2. If a Chapter 13 Debtor enjoys an absolute right to dismiss his/her case under § 1307(b), must it be an unqualified dismissal?

Pro – Unqualified Absolute Right to Dismiss

Since Chapter 13 is a wholly voluntary and demonstrates an attempt by a debtor to repay his/her creditors, the debtor should be entitled to dismiss his/her case "at any time" under § 1307(b).

The text of 11 U.S.C. § 1307(b) is unambiguous. It provides, in relevant part: "[o]n request of the debtor at any time . . . the court *shall* dismiss a case under this chapter" (emphasis added). The term "shall" requires specific mandatory action by the court which does not allow for judicial discretion. The U.S. Court of Appeals for the Second Circuit in *Barbieri v. Raj Acquisition Corp. (In re Barbieri)*, 1999 F.3d 616, 618-620 (2nd Cir. 1999) describes the debtor's dismissal rights in § 1307(b) as an absolute right to voluntarily dismiss his/her Chapter 13 case. Additionally, the legislative history to § 1307 confirms that Congress intended to grant debtors an absolute right to dismiss a Chapter 13 case at any time: "Subsections [1307] (a) and (b) confirm, *without qualification*, the rights of a Chapter 13 debtor to convert the case to a liquidating bankruptcy case under Chapter 7 of title 11, *at any time* or to have the Chapter 13 case dismissed. Waiver of any such right is unenforceable."

The only qualification found in § 1307(b) is that the case cannot have been previously converted to Chapter 13 from Chapter 7, 11 or 12 under §§ 706, 112, or 1208. The rationale behind this restriction is that, for example, a Chapter 7 debtor is not free to automatically dismiss a Chapter 7 case under § 706; therefore, the debtor is not authorized to make an end run around § 706 by converting to Chapter 13 and then seeking a voluntary dismissal.

Even after a creditor's motion to convert the case to Chapter 7, alleging bad faith, the Court must honor the debtor's request for a voluntary dismissal. The plain language found in 1307(b) does not require the debtor to provide any reasons, explanations, motives, or show any facts supporting dismissal. If a Debtor does not want to be in a Chapter 13 case, the case must be dismissed. Judicial precedent makes clear that a bankruptcy court may not use its equitable powers under § 105(a) to contravene express provisions of the Bankruptcy Code. Not unlike the right to dismiss qualification for previously converted cases, had Congress intended for a bad faith qualification to the Debtor's absolute right to dismiss under § 1307(b) it could have provided one.

The general rule under § 349 is that dismissal of a case is without prejudice. The absolute language in § 1307(b) and the prohibition against any waiver of a voluntary dismissal right

should bar the use of conditions to a voluntary dismissal. If conditions are placed on a debtor's absolute right to dismiss, the intent of Congress to allow to a debtor to try and fail at a Chapter 13 case is threatened. Additionally, conditions at dismissal should be strictly construed if the conditions will impair the debtor's access to a future bankruptcy.

Supporting Law:

S. REP. No. 95-989, at 141 (1978)
Lexcon Inc. v. Milberg Weiss Bershad Hunes & Lerach, 523 U.S. 26 (1998)
Law v. Siegal, 571 U.S. 415 (2014)
Barbieri v. Raj Acquisition Corp. (In re Barbieri), 199 F.3d 616 (2nd Cir. 1999)
Ronald J. Smith v. U.S. Bank National Association, 2021 U.S. App. LEXIS 25295 (6th Cir. Aug. 23, 2021, No. 20-3958)
Nichols v. Marana Stockyard & Livestock Market, 10 F.4th 956 (9th Cir. 2021)
In re Williams, 435 B.R. 552 (Bankr. N.D. Ill. 2010)
In re Fulayter, 615 B.R. 808 (Bankr. E.D. Mich. 2020)
In re Madison, 184 B.R. 686 (Bankr. E.D. Pa. 1995)
Norwest Financial Tennesee, Inc. v. Coggins (In re Coggins), 185 B.R. 762 (Bankr. W.D. Tenn. 1995)
Brengettcy v. National Mortgage Co. (In re Brengettcy), 177 B.R. 271 (Bankr. W.D. Tenn. 1995)

Con – No Absolute Right to Dismiss With Competing Motion to Convert and/or Qualified Dismissals

A minority of jurisdictions still maintain that a debtor's right to dismiss is conditioned on the presence of good faith. Accordingly, a Bankruptcy Court should have discretion to either dismiss or convert a Chapter 13 case depending on which is in the best interests of the creditors and the bankruptcy estate. Failing such, the "honest debtor" requirement would be read out of the bankruptcy code. In reading sections 1307(b) and (c) in conjunction with one another, Congress could not have intended to give the debtor an absolute right to dismiss his/her Chapter 13 case. When a motion to convert is filed prior to a debtor's motion to dismiss, a hearing should be allowed to consider the merits of a conversion motion. If Chapter 13 debtors have an absolute right to dismiss, it would provide debtors with unrestricted power to prevent a conversion under § 1307(c) by simply filing a motion to dismiss whenever conversion has been requested. This would render § 1307(c) a nullity and encourage abuse of the bankruptcy system. As such, § 1307(c) operates as a limitation on a debtor's absolute right to voluntarily dismiss his/her Chapter 13 case under § 1307(b).

If debtors have an absolute right to dismiss under § 1307(b) it is not a "get-out-of chapter-13-free card." 11 U.S.C. § 349(a) controls all "roads to dismissal," including § 1307(b). Upon a finding of "cause," the court has the ability to impose conditions of prejudice on a debtor's voluntary dismissal request. "The § 349(a) power of the court 'for cause' to 'order otherwise' necessarily confers judicial discretion to impose a variety of consequences of dismissal regarding discharge of debts in the dismissed case and for future filings." Dismissal with prejudice may result in the permanent prohibition of the bankruptcy discharge

for any debt that could have been discharged in the dismissed case. Section 349(a) by its plain language, must be read as allowing a bankruptcy court, "for cause" to permanently disqualify a class of debts from discharge. Bad faith, which is cause for dismissal of a case under § 1307(c), is also cause for dismissal with prejudice under § 349(a).

Supporting Law:

Marrama v. Citizens Bank, 549 U.S. 365 (2007)
Jacobsen v. Moser (In re Jacobsen), 609 F.3d 647 (5th Cir. 2010).
Molitor v. Eidson (In re Molitor), 76 F.3d 218 (8th Cir. 1996).
In re Tatis, 72 B.R. 908 (Bankr. W.D.N.C. 1987)
In re Vieweg, 80 B.R. 838 (Bankr. E.D. Mich. 1987)
Gaudet v. Kirshenbaum INv. Co. (In re Gaudet), 132 B.R. 670 (D.R.I. 1991)
In re Cowper, 266 B.R. 669 (Bankr. W.D. Mich. 2001)
In re Crowell, 292 B.R. 541 (Bankr. E.D. Tex. 2002)
In re Mitrano, 472 B.R. 706 (Bankr. E.D. Va. 2012)
Smith v. Henley, 548 B.R. 724 (S.D. Miss. 2016)
In re Pustejovsky, 577 B.R. 671 (Bank. W.D.Tex. 2017)
Duran v. Rojas (In re Duran), 630 B.R. 797 (9th Cir. 2021)
Colonial Auto Center v. Tomlin (In re Tomlin), 105 F.3d 933 (4th Cir. 1997)
Leavitt v. Soto (In re Leavitt), 209 B.R. 935 (9th Cir. 1997)
In re Sinischo, 561 B.R. 176, (Bankr. D.Colo. 2016)

III. The Last One Standing: Does a Corporate Debtor Have the Ability to Appeal a Bankruptcy Court's Order Imposing a Trustee Without the Trustee's Consent?

A. Positions:

Pro: Yes, of course, an order imposing a trustee is one of the most significant orders a bankruptcy court can enter. A corporate debtor has a statutory right to oppose the appointment of a trustee and that right necessarily includes the ability to appeal an adverse ruling. Any other holding leads to absurd and unconstitutional results by effectively preventing appellate review as the only party that could appeal an order appointing a trustee is the trustee. That can't be right. Besides, after a trustee is appointed, the debtor remains in existence and is a separate and distinct legal entity from the trustee and the bankruptcy estate. The rule should be as follows: a debtor can act through its existing management to fulfill statutory obligations and exercise statutory rights, which includes the right to appeal the order appointing a the trustee.

Con: No, according to the U.S. Supreme Court, upon the appointment of a trustee a corporate debtor's directors are "completely ousted[.]" The debtor has standing to appeal an order resulting in a trustee. That is not the issue. However, only its new management, i.e., the trustee, can cause the debtor to exercise its standing. If an appeal with merit and that is beneficial to the estate lies, the trustee, in exercising his or her fiduciary duties, will cause the debtor to pursue it. Moreover, allowing the debtor to appeal without the trustee's consent would interfere with the trustee's duties to administer the estate as required by the Bankruptcy Code.

B. Supporting Cases:

The Debtor Can Exercise Appellate Standing

In re Mason, 709 F.2d 1313 (9th Cir. 1983)
Security Bldg. & Loan Ass'n v. Spurlock, 65 F.2d 768 (9th Cir. 1933)
In re Focus Media, Inc., 378 F.3d 916, 922 (9th Cir. 2004)
JNC Companies v. Meehan, 165 Ariz. 144, 145 (1990)

The Trustee Can Exercise Appellate Standing

In re C.W. Mining Co., 636 F.3d 1257, 1259 (10th Cir. 2011)
Commodity Futures Trading Com'n v. Weintraub, 471 U.S. 343 (1985)
South Edge LLC v. JPMorgan Chase Bank, N.A., 2011 WL 1626567 (D. Nev. 2011).

IV. Insider Sales: Business Judgment vs. Heightened Scrutiny

Issue: Business Judgment Standard vs. Heightened Scrutiny

Business Judgment Standard: Courts should apply the business judgment rule in evaluating sales of assets to insiders under 11 U.S.C. §363(b)(1) as they do with respect to other sales of assets under Section 363(b)(1). Sales by the debtor to insiders should be presumed to be in good faith absent evidence of misconduct.

Supporting Cases:

- *In re Lionel Corp.*, 722 F.2d 1063 (2d Cir. 1983)
- *In re Lahijani*, 325 B.R. 282 (9th Cir. BAP 2005)
- *In re Integrated Res.*, Inc., 147 B.R. 650 (S.D.N.Y. 1992)
- *In re Pomona Valley Med. Grp., Inc.*, 476 F.3d 665 (9th Cir. 2007)
- *CRTF Corp. v. Federated Dep't Stores, Inc.*, 683 F. Supp. 422 436 (S.D.N.Y. 1988)
- *In re Borders Grp., Inc.*, 453 B.R. 477 (Bankr. S.D.N.Y. 2011)
- *In re Sabine Oil & Gas Corp.*, 547 B.R. 503 (Bankr. S.D.N.Y.), *aff'd*, 562 B.R. 211 (S.D.N.Y. 2016)
- *In re Nine W. Holdings, Inc.*, 588 B.R. 678 (Bankr. S.D.N.Y. 2018)
- *In re Glob. Crossing Ltd.*, 295 B.R. 726 (Bankr. S.D.N.Y. 2003)
- *Matter of Andy Frain Servs., Inc.*, 798 F.2d 1113 (7th Cir. 1986)

Argument: For reasons of public policy and practicality, courts should apply the business judgment standard to sales to insiders, just as they do to sales to third parties. Generally, courts will apply the business judgment rule and assume that the debtor "acted prudently, on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the bankruptcy estate." *In re Pomona Valley Med. Grp., Inc.*, 476 F.3d 665, 670 (9th Cir. 2007). In applying the business judgment standard, courts will not interfere with corporate

decisions absent bad faith, self-interest, or gross negligence and will uphold a decision if it is attributable to "any rational business purpose." *In re Integrated Res.*, Inc., 147 B.R. 650, 656 (S.D.N.Y. 1992) (internal quotation omitted).

Under the laws of many states, the business judgment rule "prevents a court from second guessing such directors' business decisions." *In re Sabine Oil & Gas Corp.*, 547 B.R. 503, 556 (Bankr. S.D.N.Y.), *aff'd*, 562 B.R. 211 (S.D.N.Y. 2016). The responsibility of the debtor is to maximize the value of the insolvent corporation. *Id*; *In re Lahijani*, 325 B.R. 282, 288 (9th Cir. BAP 2005). Thus, absent any objections or evidence of misconduct what should be prioritized is maximizing the debtor's value, rather than imposing heightened scrutiny merely because a transaction is with an insider.

Indeed, courts have repeatedly noted that it is not *per se* bad faith for an insider to buy assets of the debtor, and that the purchaser's "good faith" is determined based on "the integrity of his conduct in the course of the sale proceedings." *Matter of Andy Frain Servs., Inc.*, 798 F.2d 1113, 1125 (7th Cir. 1986) (internal quotation omitted). In light of this recognition by courts, along the fact that the Bankruptcy Code itself does not prohibit sales to insiders, public policy should favor an emphasis on maximizing value of the debtor's assets, whether they are sold to an insider or an unrelated party.

Although insiders may have "greater opportunities for…inequitable conduct," insider parties may also be best positioned, and/or most motivated, to purchase assets of the debtor precisely because they are already familiar with the debtor's business and assets. *In re Roussos*, No. 2:15-AP-01404-ER, 2016 WL 5349717, at *15 (Bankr. C.D. Cal. Sept. 22, 2016). Particularly in many middle market cases, an insider may be the only party interested or able to make a purchase from the debtor. In such circumstances, it is then reasonable to apply the business judgment rule, where "[i]n the context of auctions, courts defer to a debtor's business judgment when selecting the highest and best bid." *In re Borders Grp., Inc.*, 453 B.R. 477, 482–83 (Bankr. S.D.N.Y. 2011). If the bankruptcy court serves as a gatekeeper, applying the business judgment rule, this will encourage insider participation, which may be the only viable path forward.

Furthermore, to protect the integrity of the sale process, an independent director or chief restructuring officer can be appointed under Section 363(b) to negotiate with the insider buyer and oversee the sale process. *See e.g.*, *In re Nine W. Holdings, Inc.*, 588 B.R. 678, 687 (Bankr. S.D.N.Y. 2018); *In re Enron Corp.*, No. 01-16034 (AJG), 2006 WL 1030421, at *2 (Bankr. S.D.N.Y. Apr. 12, 2006). Through the appointment of an independent fiduciary, the contemplated transactions can be arm's length and ensure that the value of the debtor's assets are maximized.

Finally, there are other analogous situations in which heightened scrutiny is not applied. For example, heightened scrutiny is not applied to a sale to a secured creditor under Section 363(k), despite the fact that often a secured creditor may also have intimate knowledge of – and control over – the debtor through monthly reports or various other mechanisms.

Heightened Scrutiny: Though not "per se" bad faith, sales to insiders are necessarily subject to heightened scrutiny because such sales are rife with the possibility of abuse. Because insiders

have greater opportunity for inequitable conduct, application of heightened scrutiny of § 363 sales to insiders ensures good faith through full disclosure.

Supporting Cases:

- *In re Roussos, 2016 WL 5349717 (Bankr. C.D. Ca.)*
- *In re Tidal Const. Co., Inc., 446 B.R. 620, 624 (Bankr. S.D. Ga. 2009)*
- *Rickel & Associates v. Smith (In re Rickel & Associates, Inc.), 272 B.R. 74, 100 (Bankr. S.D.N.Y. 2002)*
- *In re W.A. Mallory Co., Inc.*, 214 B.R. 834, 837 (Bankr. E.D. Va. *1997*)
- *In re Bidermann Indus. U.S.A. Inc.*, 203 B.R. 547, 549 (Bankr. S.D.N.Y. 1997).
- *In re Medical Software Solutions* (BC D UT 2002) 286 BR 431, 445-446 (
- *In re Wilde Horse Enterprises, Inc.*, 136 B.R. 830, 842 (Bankr. C.D. Cal. 1991)
- *In re Betty Owens Schools, Inc.,* 1997 WL 188127, at *4 (S.D.N.Y., Apr. 17, 1997, No. 96 CIV. 3576 (PKL))

Argument:

The same heightened scrutiny standard applicable to insider transactions outside of the bankruptcy context should apply to 11 U.S.C. § 363 sales to insiders. The typical rule in sales of assets under 11 U.S.C. § 363(b)(1) is the business judgment rule, wherein the bankruptcy courts will not substitute their own views regarding a proposed sale if the sale is supported by a reasonable exercise of the debtor's business judgment. Where the sale is to an insider or insiders who stand to benefit from the sale, however, a higher standard of approval is required. In other words, "when a proposed sale of a debtor's assets would benefit an insider of the debtor, the bankruptcy court is required to give heightened scrutiny to the fairness of the value provided by the sale and to the good faith of the parties in executing the transaction." 11 U.S.C. § 363; *In re Fam. Christian, LLC*, 533 B.R. 600 (Bankr. W.D. Mich. 2015).

Under 11 U.S.C. § 101(30), the term "insider" includes, but is not limited to, relatives, directors, officers, and partners. "The true test of an 'insider' is one who has such a relationship with the debtor that their dealing with one another cannot be characterized as an arms-length transaction." *In re Montanino*, 15 B.R. 307, 310 (Bankr.N.J.1981); *In re Hollar*, 100 B.R. 892, 893 (Bankr.N.D.Ohio 1989). It is not "per se bad faith" for an insider to purchase assets of a debtor, though courts impose more rigorous examination of the sale in these circumstances. *In re Bakalis*, 220 B.R. 525, 537 (Bankr. E.D.N.Y. 1998).

Sales to insiders are subject to heightened scrutiny because insiders "usually have greater opportunities for ... inequitable conduct." *In re Roussos*, 2016 WL 5349717 (Bankr. C.D. Ca.) (*citing Fabricators, Inc. v. Technical Fabricators, Inc. (Matter of Fabricators, Inc.*, 926 F.2d 1458, 1465 (5th Cir. 1991)); *see also In re Tidal Const. Co., Inc.*, 446 B.R. 620, 624 (Bankr. S.D. Ga. 2009)("[E]ven when parties are completely forthright with the facts surrounding the transfer, §363 sales to insiders are subject to a higher scrutiny because of the opportunity for abuse.");

Rickel & Associates v. Smith (In re Rickel & Associates, Inc.), 272 B.R. 74, 100 (Bankr. S.D.N.Y. 2002) (same); *In re W.A. Mallory Co., Inc.*, 214 B.R. 834, 837 (Bankr. E.D. Va. 1997).

Application of the heightened scrutiny standard is aligned with the public policy that "the conduct of bankruptcy proceedings not only should be right but must seem right." *In re Bidermann Indus. U.S.A. Inc.*, 203 B.R. 547, 549 (Bankr. S.D.N.Y. 1997). To ensure these proceedings "seem right," bankruptcy courts examine whether the debtor has provided full disclosure of the terms of the sale. See, e.g. *In re Medical Software Solutions* (BC D UT 2002) 286 BR 431, 445-446 (sale passed heightened scrutiny evaluation where Court found no evidence of collusion between the Debtor and insiders nor an attempt to take advantage of other bidders, and Debtor and insiders made repeated and sustained attempts to market the Debtor to parties outside the sphere of insiders and where Debtor and insiders later entered into arms-length negotiations); *In re Wilde Horse Enterprises, Inc.*, 136 B.R. 830, 842 (Bankr. C.D. Cal. 1991) (in a sale to an insider, the question of good faith "turns on whether debtor breached its fiduciary duty of full disclosure."); *In re Betty Owens Schools, Inc.,* 1997 WL 188127, at *4 (S.D.N.Y., Apr. 17, 1997, No. 96 CIV. 3576 (PKL)) ("…a debtor-in-possession who proposes a sale of all of its assets to an insider must fully disclose the relationship between the buyer and seller."). "[A] debtor who proposes a sale of all of its assets to an insider must fully disclose to the court and creditors the relationship between the buyer and seller, as well as the circumstances under which the negotiations have taken place, any marketing efforts, and the factual basis upon which the debtor determined that the price was reasonable." *In re Wilde Horse Enterprises, Inc*., 136 B.R. 830, 842 (Bankr. C.D. Cal. 1991).

V. Making Laws to Make Dollars: Should Bankruptcy Courts Permit Third-Party Releases and Divisive Mergers?

Issue: Third Party Releases and Divisional Mergers

A. Positions:

Pro: Divisional mergers and third-party releases do not *per se* violate the Bankruptcy Code or the important policies it embodies. No provision of the Bankruptcy Code prohibits either Divisional mergers or third-party releases. Both doctrines should be reserved for extraordinary cases and as necessary to facilitate reorganization and equitable resolutions for all stakeholders.

Divisional mergers, aka the "Texas Two Step," are a creature of state law. Assuming applicable state law is satisfied, the debt-laden newco may be a "debtor" bankruptcy. Divisional mergers have been used in tandem with § 524(g) of the Bankruptcy Code to efficiently and equitably resolve current and future asbestos claims (as only bankruptcy can do). If the strategy is abused, then the Bankruptcy Courts are more than adequately situated to address it based on the facts and circumstances of a particular case and they have a number of tools to do so (dismissal, stay relief, or denial of confirmation).

As held by the Unites States Supreme Court, Bankruptcy Courts are empowered to confirm plans that include appropriate provisions that are not otherwise inconsistent with the Bankruptcy Code. Third-party releases are not expressly prohibited by any provision of the Bankruptcy Code, § 524 included, and can significantly increase creditor recoveries. Circuits permitting third-party releases do so cautiously and only after an exacting standard is satisfied. The discretion to permit third-party releases should be left to the sound discretion of the Bankruptcy Courts.

Con: Bankruptcy Courts cannot grant third-party releases and should not permit bankruptcy cases by the *loser* of a divisional merger to file bankruptcy.

As clearly stated by Judge McMahon, the Bankruptcy Code does not authorize third-party releases, neither by its express text nor in its silence. In fact, as held by the Ninth Circuit, § 524 of the Bankruptcy Code expressly forecloses such relief by permitting a discharge of only the debtor. It is that simple. The Bankruptcy Courts lack the power to force one non-debtor to release its claims against another, one who has not been required to shoulder the burden of bankruptcy.

Divisional mergers, while authorized by the law of some states, are rooted in bad faith. Divisional mergers permit a corporation to divide itself in two, transferring all of its assets to one entity and saddling its debts on another. Like third party releases, the availability of divisional mergers in a few, but not all states, leads to abuse of the bankruptcy system and rampant forum shopping. Bankruptcy Courts should not further a state-sanctioned fraudulent transfer defined to strand creditors with a inadequately capitalized debtor.

B. Supporting Cases:

Permitting Third-Party Releases

United States v. Energy Res. Co., 495 U.S. 545 (1990)
In re Seaside Eng'g & Surveying, Inc., 780 F.3d 1070 (11th Cir. 2015)
In re Millennium Lab Holdings II, LLC., 945 F.3d 126 (3d Cir. 2019)
In re Drexel Burnham Lambert Grp., Inc., 960 F.2d 285 (2d Cir. 1992)
In re A.H. Robins Co., Inc., 880 F.2d 694 (4th Cir. 1989)

Permitting Divisional Merger Bankruptcies

In re Bestwall, LLC, 606 B.R. 243 (Bankr. W.D.N.C. 2019)
In re DBMP, LLC, 2021 WL 3552350 (Bankr. W.D.N.C. 2021)
In re Aldrich Pump LLC, 2021 WL 3729335(Bankr. W.D.N.C. 2021)

Rejecting Third-Party Releases

In re Purdue Pharma, L.P., 2021 WL 5979108 (S.D.N.Y. 2021)
In re Lowenschuss, 67 F.3d 1394 (9th Cir.1995)
In re American Hardwoods, Inc., 885 F.2d 621 (9th Cir.1989)
In re Western Real Estate Fund, Inc., 922 F.2d 592 (10th Cir.1990)

Criticizing Divisional Mergers

In re LTL Mgmt. LLC, 2021 WL 5343945 (Bankr. W.D.N.C. 2021)

Faculty

Hon. Martin R. Barash is a U.S. Bankruptcy Judge for the Central District of California in Woodland Hills and Santa Barbara, sworn in on March 26, 2015. He brings more than 20 years of legal experience to the bench. Prior to his appointment, Judge Barash had been a partner at Klee, Tuchin, Bogdanoff & Stern LLP in Los Angeles since 2001, where he represented debtors and other parties in chapter 11 cases and bankruptcy litigation. He first joined the firm as an associate in 1999. Earlier in his career, Judge Barash worked as an associate of Stutman, Treister & Glatt P.C. in Los Angeles. He also has served as an adjunct professor of law at California State University, Northridge. Following law school, Judge Barash clerked for Hon. Procter R. Hug, Jr. of the U.S. Court of Appeals for the Ninth Circuit from 1992-93. He is a former ABI Board member, for which he served on its Education Committee, and he is a former member of the Board of Governors of the Financial Lawyers Conference. In addition, he is a judicial director of the Los Angeles Bankruptcy Forum and a frequent panelist and lecturer on bankruptcy law. He also is a co-author of the national edition of the *Rutter Group Practice Guide: Bankruptcy*. Judge Barash received his A.B. *magna cum laude* in 1989 from Princeton University and his J.D. in 1992 from the UCLA School of Law, where he served as member, editor, business manager and symposium editor of the *UCLA Law Review*.

Hon. Neil W. Bason is a U.S. Bankruptcy Judge for the Central District of California in Los Angeles, appointed in 2011. While in private practice at Howard Rice Nemerovski Canady Falk & Rabkin, P.C. and Duane Morris LLP, he represented a wide variety of interests in commercial bankruptcy and insolvency matters, including secured and unsecured creditors, trustees, receivers, debtors/borrowers, guarantors, prospective asset-purchasers, and other parties in interest. Before that, he clerked for Hon. Dennis Montali, U.S. Bankruptcy Judge for the Northern District of California and Chief Judge of the Bankruptcy Appellate Panel of the Ninth Circuit. Judge Bason received his J.D. *magna cum laude* from Boston University School of Law in 1988, where he was a note editor on its law review.

Hon. Sheri Bluebond is a U.S. Bankruptcy Judge for the Central District of California in Los Angeles, appointed Feb. 1, 2001. She served as Chief Bankruptcy Judge for the district from Jan. 1, 2015, through Dec. 31, 2018. Previously, Judge Bluebond was a partner with Irell & Manella LLP in Los Angeles from 1995-2001, where she co-chaired its Creditors' Rights and Insolvency Group, and specialized in bankruptcy, debtor/creditor relations and business litigation, representing debtors in possession and trustees as well as secured and unsecured creditors. From 1991-95, she was a shareholder with Murphy, Weir & Butler, and she was also an associate for Gendel, Raskoff, Shapiro & Quittner from 1983-91. Judge Bluebond is a Fellow of the American Bankruptcy College and a member of the Los Angeles County Bar Association, the American Bar Association and ABI. She currently serves on the Executive Committee and the Bankruptcy Committee of the Commercial Law and Bankruptcy Section of the Los Angeles County Bar Association and the Board of Governors of the Los Angeles Bankruptcy Forum, and has at various times served on the Board of Trustees of Jewish Big Brothers Big Sisters of Los Angeles/Camp Max Straus, the Board of Governors of the Financial Lawyers Conference, the Board of Directors of the Turnaround Management Association and the Board of Trustees for the Los Angeles County Bar Association. Judge Bluebond received her undergraduate degree from the University of California at Los Angeles in 1982 and her J.D. from the University of California at Los Angeles School of Law in 1985.

Hon. Julia W. Brand is a U.S. Bankruptcy Judge for the Central District of California in Los Angeles, appointed on Oct. 24, 2011. On Dec. 1, 2016, she was appointed to the Ninth Circuit Bankruptcy Appellate Panel. Before taking the bench, Judge Brand practiced primarily with Katten Muchin Rosenman, LLP, Brownstein, Hyatt, Farber & Schreck, LLP, and Danning Gill, Diamond & Kollitz, LLP, where she represented debtors, creditors and unsecured creditors' committees in chapter 11 cases. She was a charter member of the Southern California Network of the International Women's Insolvency and Restructuring Confederation, and she served as Network co-chair from 2007 through 2010 and as Communications chair in 2011. Judge Brand received her B.A. from the University of California in 1981 and her J.D. from the University of Southern California School of Law in 1985.

John-Patrick M. Fritz is a partner at Levene, Neale, Bender, Yoo & Golubchik L.L.P. in Los Angeles and advises clients as chapter 11 debtors in possession, purchasers, post-petition lenders, creditors, committees, and litigants in bankruptcy-related matters. He is also a subchapter V trustee. Mr. Fritz represents clients in all industries, including start-ups, intellectual property-based companies, hotels and hospitality, commercial real estate, food production, restaurants, retail, manufacturing, construction, and entertainment and film. For many years, he has served on the board of directors for the Los Angeles Bankruptcy Forum, the board of governors and executive committee of the Financial Lawyers Conference, and the advisory board for ABI's annual Bankruptcy Battleground West program. Mr. Fritz is a regular panel speaker on bankruptcy and restructuring issues for various professional and business organizations, and he has been named a "Super Lawyer" and "Rising Star" by *Super Lawyers* magazine. He previously served as a judicial law clerk to Hon. Maureen A. Tighe from 2007-09 before joining the firm as an associate in 2009. Mr. Fritz received his undergraduate degree *cum laude* and with honors from Tufts University, and his J.D. *magna cum laude* from Southwestern Law School, where he was in the top 5 percent of his class. Mr. Fritz studied abroad for one year in Kyoto, worked for the Japanese government in Japan for two years, and is proficient in Japanese.

Aaron J. Malo is a partner in Sheppard Mullin's Finance and Bankruptcy Practice Group in Costa Mesa, Calif., and leads the firm's Bankruptcy Litigation team. He primarily represents creditors, including lending institutions, equity groups, financial services corporations, equipment lessors, landlords and real estate developers. Mr. Malo has experience in all aspects of bankruptcy and workout proceedings, and has served as lead trial counsel for significant jury and bench trials in both state and federal courts. He frequently writes, teaches and lectures on bankruptcy, litigation and creditors' rights issues. Previously, he taught bankruptcy law at the Orange County campus of Golden Gate University's Graduate School of Taxation. Mr. Malo is committed to community service and the provision of *pro bono* legal services. He has served on the Public Law Center's board of directors since 2006 and on that organization's executive board since 2013, and he served as president of the PLC's board of directors in 2017. Mr. Malo leads the Orange County office's *pro bono* efforts, in which capacity he helped pioneer a new collaboration between Sheppard Mullin, the Public Law Center and Children's Hospital of Orange County that serves the families of ill children seeking treatment. He also has handled significant *pro bono* cases protecting the interests of veterans, immigrants and exploited persons. In 2021, Mr. Malo received the Anti-Defamation League's Marcus Kaufman Jurisprudence Award, a recognition presented annually to attorneys who make outstanding contributions to the legal profession and to the community. In 2019, he received the Peter M. Elliott Award, an award given annually to a lawyer who demonstrates substantial knowledge of bankruptcy law, possesses the high level of honesty, integrity and ethics, and who serves to improve access to

justice. In addition, he served a four-year term as a lawyer representative to the Ninth Circuit Judicial Conference (2010-14), has served on the Orange County Bankruptcy Forum's board of directors since 2007, was among the founding members of the Central District of California Bankruptcy Bar Advisory Committee (founded in 2009), joined the board of directors of the Orange County chapter of the Federal Bar Association in 2019, and was recently reappointed to serve a second term on the Central District of California Attorney Admissions Fund Board. Mr. Malo received his undergraduate degree with departmental honors from Stanford University in 1992 and his J.D. from the University of California, Hastings College of the Law in 1995, where he was managing editor of the *Hastings International & Comparative Law Review*.

Robert S. Marticello is a founding partner of Smiley Wang-Ekvall, LLP in Los Angeles, where he focuses his practice on business bankruptcy matters and related litigation. He represents virtually all parties in chapter 11 bankruptcy cases and out-of-court restructurings, including debtors, committees, secured and unsecured creditors, equityholders, trustees, asset-purchasers and others. Mr. Marticello has represented clients in a broad range of industries, such as real estate, nonprofit, retail, restaurant and technology, and has represented clients in multiple forums throughout the U.S. He is also experienced in representing plaintiffs and defendants in bankruptcy avoidance actions and plaintiffs in nondischargeability actions. Mr. Marticello was honored as one of ABI's first "40 Under 40." In 2012, he was selected to participate in the National Conference of Bankruptcy Judges' Next Generation Program. Mr. Marticello has also been consistently selected as a "Rising Star" in *Super Lawyers* and has been recognized by *The Best Lawyers in America* for multiple years running. He also is a frequent speaker and author on insolvency issues and has presented on current and expected trends in real estate related bankruptcies and the hospitality industry. Mr. Marticello has served as an officer and director of a number of professional organizations. He is co-chair of the Lawyer Representatives to the Ninth Circuit Judicial Conference, and director of both the Federal Bar Association (Orange County Chapter) and the Turnaround Management Association (Southern California Chapter). Mr. Marticello was the president of the California Bankruptcy Forum from 2015-16. He previously was a director of the Orange County Bankruptcy Forum from 2008-11 and served as its president from 2010-11. Mr. Marticello clerked for Hon. John E. Ryan in the U.S. Bankruptcy Court for the Central District of California from August 2005 to February 2007, and for Hon. Robert N. Kwan in the U.S. Bankruptcy Court for the Central District of California from March to August 2007. Mr. Marticello received his undergraduate degree from California State University Chico and his J.D. *magna cum laude* from Californian Western School of Law in 2005, where he was a member of the *California Western Law Review*.

Robyn B. Sokol is a partner with Leech Tishman Fuscaldo & Lampl LLC in Pasadena, Calif., and and a member of the firm's Business Restructuring & Insolvency Practice Group. She also leads the firm's Court Appointed Trustee and Receivers Group and regularly advises clients on business reorganizations, creditors' rights and bankruptcy law, and all related transactions and litigation. Ms. Sokol has served as lead counsel in scores of trials, evidentiary hearings and motions in bankruptcy and other courts throughout the U.S. Her work includes negotiating, drafting, analyzing and reviewing loan documents; real and personal property leases; purchase agreements; and licensing agreements. Ms. Sokol represents businesses in the manufacturing, marketing, retail, entertainment, finance, golf, hospitality, insurance, real estate, shipping and health care industries. She regularly represents financial institutions, corporations, creditors' committees, chapter 7 and 11 trustees, and secured and unsecured creditors. She has successfully defended preference actions filed against various entities,

including a national insurance company, publication house, manufacturers and a shipping company. As part of her comprehensive bankruptcy and creditors' rights practice, she represents chapter 7 and 11 debtors, and counsels mid-sized corporations and individual debtor clients in reorganizations. Previously, Ms. Sokol clerked for Hon. Robin Riblet in the U.S. Bankruptcy Court for the Central District of California and served as a floating judicial law clerk for Judges Ahart, Lax, Lasarow, March and Zurzolo. She is a member of the State Bar of California, the Los Angeles County Bar Association and the Los Angeles Bankruptcy Forum (for which she served as board member from 2016-19), and she is on the advisory board of ABI's Bankruptcy Battleground West program. Ms. Sokol received her B.S. *cum laude* in finance and real estate from the University of Colorado at Boulder in 1986, where she was a member of Beta Gamma Sigma and the Golden Key National Honor Society, and her J.D. in 1991 from Boston University School of Law, where she was a member of the Defenders Clinical Program, a case and note editor for the *Probate Journal*, and an advisor and judge for the Esdaile Moot Court Competition.

Randye B. Soref is a principal at Polsinelli PC in Los Angeles, where she focuses her practice on distressed companies. She has a national practice representing clients in all aspects of bankruptcy proceedings and out-of-court restructurings, including reorganizations, corporate workouts, creditors' rights, bankruptcy litigation and assignments for the benefit of creditors. Ms. Soref routinely represents chapter 11 debtors, committees, creditors, sellers, buyers and liquidating trustees, and advises on bankruptcy strategy, counseling, reorganization, enforcement of debt instruments and litigation. She has been lead attorney for nationally known distressed intellectual property, retail and apparel companies, including e-commerce companies. She has also been the lead attorney in numerous distressed health care matters involving large nationally based hospitals, health plans, health care providers and skilled nursing facilities, as well as patient care ombudsmen appointed by the U.S. Trustee, whom she counsels regarding privacy related issues. Ms. Soref's services include loan workouts, negotiating and documenting debtor-in-possession financing, plan confirmation, § 363 sales, obtaining relief from the automatic stay, assignments for the benefit of creditors and successfully litigating multi-million dollar post-confirmation liquidating trust claims. She received her B.A. from Hofstra University and her J.D. from California Western School of Law.