AMERICAN BANKRUPTCY INSTITUTE

42nd Annual Alexander L. Paskay Memorial Bankruptcy Seminar

Cutting-Edge Chapter 11 Issues – 40 Years After the '78 Reform Act

Hon. Paul M. Glenn, Moderator
U.S. Bankruptcy Court (M.D. Fla.); Jacksonville

Patricia A. Redmond
Stearns Weaver Miller Weissler Alhadeff & Sitterson, P.A.
Miami

Edwin G. Rice
Bradley Arant Boult Cummings LLP; Tampa

R. Scott Shuker
Latham, Shuker, Eden & Beaudine, LLP; Orlando

Mark J. Wolfson
Foley & Lardner LLP; Tampa

BUSINESS SESSION

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Cutting-Edge Chapter 11 Issues – 40 Years After the ’78 Reform Act
How Clear is “Free and Clear” under § 363? You’re a Real Character: When Can Debt Be Recharacterized as Equity? How Can I Get a One of Those: A Third Party Release?

A panel discussion of lawyers with more than 100 years of bankruptcy experience, moderated by a bankruptcy judge who used to be a corporate lawyer. The panel will discuss recent court decisions and focus on unique issues that can arise when a debtor seeks to sell estate property “free and clear,” including whether § 363 can be used to sell real property free of an otherwise valid lease, the debate over whether and under what circumstances a bankruptcy court may rule that a facially valid loan is really subordinated equity, and whether post-Stern bankruptcy courts have the authority to grant releases to non-debtors and, if so, under what conditions.

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Mark J. Wolfson, Esq.-Panel Leader
Foley & Lardner LLP; Tampa

Written Materials:

1. Third Party Releases-Ed Rice, Primary Author
2. Recharacterization of Debt-Scott Shuker, Primary Author
3. “Free and Clear” of Leasehold Interests-Trish Redmond, Primary Author

Nonconsensual Third-Party Plan Releases

Materials Prepared by

Edwin G. Rice, Bradley Arant Boult Cummings LLP, Tampa, Florida

Plan provisions that release or limit a non-debtor's liability to another non-debtor can be a very effective tool in helping resolve certain types of chapter 11 bankruptcy cases. For example, when the debtor has an obligation to indemnify, a non-debtor third-party plan release running in favor of the prospective indemnitee may be critical in preventing an indemnification claim against the estate. Cases in which a prospective indemnitee funds a plan resulting in significant distributions to creditors presents one of the compelling situations in favor of non-debtor third-party plan release.

Generally, a non-debtor third-party release is permissible when it arises from consent of the parties. *See In re Specialty Equip. Cos., Inc.*, 3 F.3d 1043, 1047 (7th Cir. 1993).[1] However, cases where a non-debtor is forced to release their claim against another non-debtor through a release provision in a debtor's chapter 11 plan presents a very challenging and controversial issue.

I. The Minority View

Nonconsensual third-party plan releases are not legally permissible in all jurisdictions, including the Fifth, Ninth, and Tenth Circuits. *See In re Pacific Lumber Co.*, 584 F.3d 229, 252 (5th Cir. 2009); *In re Zale Corp.*, 62 F.3d 746, 760 (5th Cir. 1995); *In re Lowenschuss*, 67 F.3d 1394, 1401 (9th Cir. 1995); *In re Am. Hardwoods, Inc.*, 885 F.2d 621, 624-26 (9th Cir. 1989); *Abel v. West*, 932 F.2d 898, 899 (10th Cir. 1991); *In re W. Real Estate Fund, Inc.*, 922 F.2d 592, 600-02 (10th Cir. 1990). Courts adopting this view (the "Minority View") generally interpret section 524(e) of the Bankruptcy Code as prohibiting the discharge of debts of non-debtors, and conclude that bankruptcy courts cannot use their equitable powers under section 105(a) of the Bankruptcy Code to sidestep section 524(e) because action pursuant to section 105(a) must be in conformity with the Bankruptcy Code, not in contravention of its provisions.

[1] What constitutes consent is often a difficult issue and beyond the scope of these materials.

Courts that adopt the Minority View may also rely on section 524(g) of the Bankruptcy Code to support their conclusion that nonconsensual third-party releases are legally impermissible. Section 524(g) was added to the Bankruptcy Code by the Bankruptcy Reform Act of 1994, and provides that under certain conditions a non-debtor third-party may be released from asbestos liability. 11 U.S.C. § 524(g) These courts may reason that the explicit and limited authority granted to bankruptcy courts under section 524(g) implies that section 524(e) denies authority to release non-debtors in non-asbestos cases.

II. <u>The Majority View</u>

The majority view (the "Majority View") is that nonconsensual plan releases running in favor of non-debtor third parties are legally permissible under certain limited circumstances. The Second, Third, Fourth, Sixth, Seventh, and Eleventh Circuits have adopted the Majority View. *In re Metromedia Fiber Network, Inc.*, 416 F.3d 136, 141-43 (2d Cir. 2005); *In re Cont'l Airlines*, 203 F.3d 203, 211-213 (3d Cir. 2000); *In re A.H. Robins Co., Inc.*, 880 F.2d 694, 702 (4th Cir. 1989); *Nat'l Heritage Found., Inc. v. Highbourne Found.*, 760 F.3d 344, 351 (4th Cir. 2014); *In re Dow Corning Corp.*, 280 F.3d 648, 657-58 (6th Cir. 2002); *In re Airadigm Commc'ns, Inc.*, 519 F.3d 640, 656 (7th Cir. 2008); *In re Seaside Eng'g & Surveying, Inc.*, 780 F.3d 1070, 1078 (11th Cir. 2015). Courts have not, however, adopted a uniform standard to determine under what circumstances a nonconsensual third-party plan release should be approved. Courts adopting the Majority View, in seeming recognition of the controversial nature of nonconsensual third-party plan releases, recognize that these releases are reserved for unusual cases and should not be issued lightly. *E.g., Seaside*, 780 F.3d at 1078.

A seminal case in the area of nonconsensual third-party plan releases is *In re Master Mortgage Investment Fund, Inc.*, 168 B.R. 930 (Bankr. W.D. Mo. 1994). In *Master Mortgage* the bankruptcy court set out a five factor test that some courts have adopted to determine whether a nonconsensual third-party plan release should be approved. *Id.* at 935. The five factors identified in *Master Mortgage* include:

- There is an identity of interests between the debtor and the third party, usually an indemnity relationship, such that a suit against the third party is, in essence, a suit against the debtor or will deplete assets of the estate.
- The non-debtor third party has contributed substantial assets to the reorganization.
- The release is essential to the reorganization, and without it there would be little likelihood of success.
- A substantial majority of the creditors agree to the release, specifically, the impacted class or classes, have "overwhelmingly" voted to accept the proposed plan treatment.
- The plan provides a mechanism for the payment of all, or substantially all, of the claims of the class or classes affected by the release.

Id.

In *Master Mortgage*, the bankruptcy court stated that these factors were not an "exclusive list of considerations, nor are they a list of conjunctive requirements." *Id.* It further explained that rather than providing for a "rigid factor test" to be applied in all circumstances, that courts have engaged in a fact specific review, weighing the equities of each case. *Id.* It also explained that because nonconsensual third-party releases are a "rare thing," bankruptcy courts have "discretionary" authority to issue them "only upon a showing exceptional circumstances." *Id.* at 937.

The Sixth Circuit in *Dow* also concluded that nonconsensual third-party plan releases may be appropriate in "unusual circumstances" where the following seven factors are present:

- There is an identity of interests between the debtor and the third party, usually an indemnity relationship, such that a suite against the third party is, in essence, a suit against the debtor or will deplete assets of the estate.

- The third party has contributed substantial assets to the reorganization.
- The release is essentially 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.
- The impacted class, or classes, has overwhelmingly voted to accept the plan.
- The plan provides a mechanism to pay for all, or substantially all, of the class or classes being affected by the release.
- The plan provides an opportunity for those claimants who choose not to settle to recover in full.
- The bankruptcy court made a record of specific factual findings that support its conclusions.

280 F.3d at 658. The *Dow* factors are the same as the *Master Mortgage* factors, except for the addition of the last two. The application of the *Dow* factors is also different than *Master Mortgage* because all the factors in *Dow* must be met.

The Eleventh Circuit adopted the Majority View in *Seaside*, and stated that: "We also agree, however, with the majority view that such bar orders ought not to be issued lightly, and should be reserved for those unusual cases in which such an order is necessary for the success of the reorganization, and only in situations in which such an order is fair and equitable under all the facts and circumstances. The inquiry is fact intensive in the extreme." 780 F.3d. at 1078-79. The Eleventh Circuit adopted the seven factor *Dow* test, and explained that bankruptcy courts have discretion to determine which factors are relevant in each case and that the *Dow* factors are a nonexclusive list of considerations. *Id*. at 1079.

Ultimately the Eleventh Circuit determined that the bankruptcy court did not abuse its discretion, finding that the application of the *Dow* factors showed that the plan releases were appropriate. *Id.* at 1079-81. The particular facts in *Seaside* that demonstrated the appropriateness of the plan release were: (1) an identity of interest between the debtor and third party (in this case former principals of the debtors who would be key employees of the reorganized debtor); (2) no new value to the debtor from the released parties other than their contribution of labor; (3) absent the bar order, litigation would likely continue that would cease any hope of a successful reorganization; (4) the objecting party would be paid in full for its share in the debtor; (5) the bankruptcy court made thorough factual findings in reaching its decision; (6) the fairness and equity of the release in that the bankruptcy court required the debtor to cease its sanctions litigation against the objecting party; and (7) a narrowly tailored form of release that only covered claims arising from the chapter 11 case, but not claims for fraud, gross negligence, and willful misconduct. *Id.*

In *Seaside*, the Eleventh Circuit recognized that the Circuit had already spoken on the validity of non-debtor releases in *In re Munford*, 97 F.3d 449 (11th Cir. 1996) and advised that *Munford* was the controlling case providing that non-debtor third party releases are appropriate under certain circumstances. *Id.* at 1076-77. The court recognized, however, that the facts in *Munford* were different than in *Seaside*, because the non-debtor third-party release in *Munford* arose in the context of bankruptcy court approval of a settlement that contained the requirement of a third-party release or bar order that prevented the non-settling defendants from pursuing contribution or indemnity claims against the settling defendant. *Id.*

The Eleventh Circuit recently had the opportunity to reaffirm the power of bankruptcy courts to issue third-party releases or bar orders in *In re Fundamental Long Term Care, Inc.*, 873 F.3d 1325 (11th Cir. 2017). In *Fundamental,* the bankruptcy court dismissed with prejudice a single defendant, among many, after providing the plaintiffs with an opportunity to comprehensively amend their complaint. *Id.* at 1329. The bankruptcy court followed up the dismissal with a final judgment in favor of the dismissed defendant. *Id.* at 1333. After a twelveday bench trial, the plaintiffs and remaining defendants settled the lawsuit for $24 million. *Id.* at 1329. The bankruptcy court approved the settlement as fair and equitable on the condition that the plaintiffs be permanently enjoined from pursuing any additional claims against the dismissed defendant and issued a permanent injunction prohibiting the plaintiffs from "pursuing claims against [the dismissed defendant] arising out of the nucleus of facts set forth in the adversary complaint in this proceeding." *Id.* at 1329, 1334. As authority to issue the injunction, the bankruptcy court relied on the All Writs Act, 28 U.S.C. § 1651, which states that federal courts "may issue all writs necessary or appropriate in aid of their respective jurisdictions agreeable to the usages and principals of law." *Id.* at 1338.

The plaintiffs appealed the bankruptcy court's issuance of the permanent injunction, as well as the dismissal of plaintiffs' claims. *Id.* at 1329. The plaintiffs argued, among other things, that the bankruptcy court lacked jurisdiction to issue the permanent injunction. *Id*. at 1336. The Eleventh Circuit recognized that the All Writs Act is limited by the Anti-Injunction Act, which provides:

> A court of the United States may not grant an injunction to stay proceedings in a State court except [1] as expressly authorized by Act of Congress, or [2] where necessary in aid of its jurisdiction or [3] to perfect or effectuate its judgments.

Id. at 1338. (quoting 28 U.S.C. §§ 2283).[2] The Eleventh Circuit affirmed the bankruptcy court's issuance of the permanent injunction after concluding that (1) the bankruptcy court had subject matter jurisdiction under 28 U.S.C. § 1334(b) to issue the injunction, and (2) the permanent injunction met the second and third exceptions to the Anti-Injunction Act. *Id.* at 1348. Accordingly, the Eleventh Circuit has been consistent regarding the jurisdiction of bankruptcy

[2] The court recognized that because the plaintiffs were unequivocal about their intent to continue to pursue state action against the dismissed defendant, the necessity of the permanent injunction to aid the bankruptcy court's jurisdiction was clear. *Id*. at 1340.

courts to issue nonconsensual third-party releases and injunctions. However, neither *Munford, Seaside,* nor *Fundamental* addressed the constitutional authority issue raised by *Stern* and discussed below.

Three opinions from the Bankruptcy Court for the Middle District of Florida illustrate the application of factors used to analyze the appropriateness of a nonconsensual third-party release: *In re HWA Properties, Inc.*, 544 B.R. 231 (Bankr. M.D. Fla. 2016) (Delano, J.), *In re GunnAllen Financial, Inc.*, 443 B.R. 908 (Bankr. M.D. Fla. 2011) (Williamson, J.), and *In re Transit Group, Inc.*, 286 B.R. 811 (Bankr. M.D. Fla. 2002) (Jennemann, J.). *In HWA Properties,* Judge Delano declined to approve a plan that incorporated at third-party bar order where: (1) there was a lack of identity of interest between the debtor and third party because the continuation of litigation against the third party would not impact the estate; (2) the parties benefitting from the bar order had not made a substantial contribution to the debtor's reorganization; (3) the impacted class of creditors had not overwhelmingly voted to accept the plan; (4) the plan did not provide a mechanism to pay all or substantially all the claims or class of claims affected by the injunction; and (5) the plan did not provide an opportunity for claimants who choose not to settle to recover in full. 544 B.R. at 241-43.

Similarly, in *GunnAllen*, Judge Williamson declined to approve a bar order after concluding that the bar order: (1) was not essential to the settlement; (2) extinguished independent causes of action against non-debtors that could possibly make creditors whole; and (3) forced creditors to accept a distribution of less than 25%. 443 B.R. at 916-17. Judge Williamson explained that "[t]he true beneficiaries under the settlement are not the [creditors], but rather, the numerous individuals accused of causing their substantial losses through improper conduct. . . .

The absence of the payment of any meaningful consideration by the released parties has been a key consideration by courts in considering whether to approve bar orders." *Id.*

Judge Jennemann, in *Transit*, approved a third-party plan release running in favor of a lender who provided substantial post-petition financing and exit financing, and had agreed to subordinate much of its debt in exchange for an equity position in the reorganized debtor. 286 B.R. at 818. The court recognized that the post-petition lender had taken on a huge risk regarding the debtor's future profitability while existing creditors were to receive distributions under the plan. *Id.* The court further recognized that the post-petition lender had made the reorganization possible. *Id.* Judge Jennemann, however, declined to approve third-party plan releases running in favor (1) a senior secured lender that did not aid the reorganization; (2) members of the unsecured creditor committee; (3) the debtor's current officers; and (4) a subsidiary of the debtor, finding that these releases were not fair or necessary. *Id.* at 819-20.

III. Constitutional Authority – The *Stern* Issue

A developing issue in the area of nonconsensual third-party plan releases regards the constitutional authority of bankruptcy courts to issue a final order approving a plan that includes a nonconsensual third-party release of state law or non-bankruptcy law claims.

In *In re Millennium Lab Holdings, II, LLC,* the Bankruptcy Court for the District of Delaware confirmed the debtors' chapter 11 plan, overruling the objection of certain lenders to, among other things, the inclusion of a nonconsensual third-party plan releases that barred their state law fraud claims and RICO claims against certain equity holders of the debtor. 542 B.R. 703 (Bankr. D. Del. 2016).

On appeal, the lenders argued that the bankruptcy court lacked constitutional authority under Article III of the Constitution to release their state law fraud and RICO claims against other non-debtors, relying on the Supreme Court's ruling in Stern.[3] *In re Millennium Lap Holdings II, LLC*, 242 F. Supp. 3d 322 (D. Del. 2017). The district court determined that the bankruptcy court had statutory "related to" subject matter jurisdiction over the lenders' released claims; however, it also determined that the bankruptcy court must have Article III constitutional authority to enter a final order discharging the lenders' non-bankruptcy claims against non-debtors without the lenders' consent. *Id*. at 338. Because the bankruptcy court did not consider its constitutional authority, the district court remanded the case to bankruptcy court to make a determination on the constitutional issue. *Id*.[4]

In its remand, the district court seemed to side with the lenders and observed that pursuant to the ruling in *Stern*, the lenders state common law and RICO claims are non-bankruptcy claims between non-debtors, and that the lenders "appear to be entitled to Article III adjudication." *Id.* at 339. The district court was persuaded by the argument that the third-party plan release was "tantamount to resolution of those claims on the merits." *Id.*

On remand, in a lengthy opinion, the bankruptcy court determined that it had both subject matter jurisdiction and constitutional adjudicative authority to approve the nonconsensual release of the lenders' non-bankruptcy common law fraud and RICO claims against non-debtors. *In re Millennium Lab Holdings II, LLC*, 575 B.R. 252, 255 (Bankr. D. Del 2017). Rather than focus on the nature of the claim or dispute that was being adjudicated or resolved (i.e., the state law fraud and RICO claims), the bankruptcy court focused on the nature of the proceeding before the bankruptcy court (i.e., confirmation of a plan pursuant to section 1129 of the Bankruptcy Code) in

[3] *Stern v. Marshal*, 564 U.S. 462 (2011). *In Stern*, the Supreme Court held that the bankruptcy court lacked the constitutional authority to enter a final judgment on a state law counterclaim that is not resolved in the process of ruling on a creditor's proof of claim. *Id.* at 503.
[4] The district court also declined to resolve the debtor's motion to dismiss the appeal on equitable mootness grounds until after the jurisdictional issue was decided. *Id.* at 337.

determining whether it had constitutional authority to approve nonconsensual third party releases. *Id.* at 271.

The lenders argued that the "operative proceeding" for determining the constitutional authority issue was the district court lawsuit in which they had already asserted their state law fraud claims and RICO claims against the non-debtors, and because the claims asserted in their district court lawsuit were non-bankruptcy claims similar to the type of claim presented in *Stern*, the bankruptcy court lacked constitutional authority to enter a final order that would effectively adjudicate them by enjoining their prosecution. *Id.* at 260. The bankruptcy court rejected this argument and concluded that the "operative proceeding for purposes of a constitutional analysis is confirmation of a plan," and because the release was considered in the context of plan confirmation, the bankruptcy court had the constitutional authority to release the lenders' claims. *Id.* at 271-72. In reaching its decision, the bankruptcy court recognized that confirmation of a plan was a "proceeding at the core of bankruptcy law" and a "quintessential core proceeding," and stated that "in confirming a plan, even one with releases, the judge is applying a federal standard." *Id.* (internal quotation marks and alterations omitted).

The bankruptcy court also relied on recent Third Circuit cases that focused on the "operative proceeding" utilized in the bankruptcy case and the related relief sought under the Bankruptcy Code, rather than the non-debtor's state law claims or rights that were being impacted. *Id.* at 276-79. The bankruptcy court cited *In re Lazy Days' RV Center Inc.*, 724 F.3d 418 (3d Cir. 2013), in which the Third Circuit upheld a bankruptcy court's constitutional jurisdiction to determine that a landlord could not refuse to honor a purchase option in its lease with the reorganizational debtor because anti-assignment provisions are unenforceable under section 365(f) of the Bankruptcy Code. *Id.* It also cited *In re Linear Electric Co.*, 852 F.3d 313 (3d Cir. 2017).

where the Third Circuit concluded that *Stern* did not prohibit a bankruptcy judge from entering a final order enforcing the automatic stay and discharging construction liens filed by a non-debtor against property owned by another non-debtor because the debtor's claims, which were asserted through a motion to enforce automatic stay, were claims arising under federal bankruptcy law, and thus outside the scope of *Stern. Id.* at 277-78.

The bankruptcy court also based its decision on its conclusion that the lenders' interpretation of *Stern* would change dramatically the division of labor between the bankruptcy courts and the district courts. *Id.* at 285-87.

There are at least two recent cases where the bankruptcy court has taken an opposite approach in deciding its jurisdiction to approve a nonconsensual third party plan release. In *In re Midway Gold US, Inc.*, the bankruptcy court focused on the claims that could be brought between the non-debtor third parties in analyzing its jurisdiction, not the nature of proceeding before the court (i.e., plan confirmation). 575 B.R. 475 (Bankr. D. Colo. 2017). After analyzing the extent and nature of the proposed release, the court determined that it lacked subject matter jurisdiction to enjoin or adjudicate the disputes of the non-debtor third party through confirmation of a plan. *Id.* at 521. In reaching its decision, the bankruptcy court was concerned that non-debtor third parties would be able to "bootstrap" their disputes into bankruptcy court, and stated: "'If proceedings over which the Court has no independent jurisdiction could be metamorphosized into proceedings within the Court's jurisdiction by simply including their release in a proposed plan, this Court could acquire infinite jurisdiction.'" *Id.* at 519 (quoting *In re Dig. Impact, Inc.*, 223 B.R. 1, 11 (Bankr. N.D. Okla. 1998)). The court concluded that "[the] fact the non-debtor Released Parties may have contributed financially to the proposed Plan is insufficient alone for the Court to find it can exercise (related to) jurisdiction over the claims and Causes of Actions being released." *Id.* at 520.

Similarly, in *In re SunEdison, Inc.*, No. 16-10992 (SMB), 2017 WL 5176651 (Bankr. S.D. N.Y. Nov. 8, 2017), the court determined that it did not have subject matter jurisdiction to approve certain non-debtor third-party releases in a chapter 11 plan. *Id.* at *7. In reaching its decision, the court focused on the nature of the released claims, rather than the nature of the proceeding or context in which approval of the non-debtor third party release was sought (i.e., a confirmation hearing). In determining its jurisdiction, the court stated:

> In assessing a court's jurisdiction to enjoin a third party dispute under a plan, the question is not whether the court has jurisdiction over the settlement that incorporates the third party release, but whether it has jurisdiction over the attempts to enjoin the creditors' unasserted claims against the third party.

Id. at *5.

In analyzing their jurisdiction to approve the proposed releases, the courts in *Midway* and *SunEdison* each considered whether and to what extent the released parties had rights of indemnification against the debtor, and in both cases the courts found that the released parties did not have sufficient indemnification rights against the debtor to provide "related to" subject matter jurisdiction. If these courts had found a form of release that was narrowly tailored to specific rights of indemnification against the debtor, then they may have concluded that they had "related to" statutory subject matter jurisdiction to approve the release.[5]

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[5] *In Midway* and *SunEdison* the courts analyzed whether they had subject matter jurisdiction (i.e., statutory jurisdiction) to approve certain non-debtor third-party releases, not whether they had constitutional authority to approve the releases. However, this is seemingly a distinction without a difference regarding the issue whether a court should focus on the nature of the claim sought to be released or the nature of the proceeding before the bankruptcy court.

You're a Real Character:
When Can Debt be Recharacterized as Equity?

I. **Recharacterization of Debt**: Recharacterization cases "turn on whether a debt actually exists, not on whether the claim should be equitably subordinated." *Bayer Corp. v. Masco Tech, Inc.* (*In re AutoStyle Plastics, Inc.*), 269 F.3d 726, 748 (6th Cir. 2001) (citations omitted). In a recharacterization analysis, if the court determines that the advance of money is equity and not debt, the claim is recharacterized and the effect is subordination of the claim "as a proprietary interest because the corporation repays capital contributions only after satisfying all other obligations of the corporation." *Id*. at p. 749.

A. ***Montclair* Factors** [*See Montclair, Inc. v. Commissioner of Internal Revenue,* 318 F.2d 38 (5th Cir. 1963)]

1. The names given to the certificates evidencing the indebtedness
2. The presence or absence of a maturity date
3. The source of the payments
4. The right to enforce the payment of principle and interest
5. Participation in management
6. A status equal to or inferior to that of regular corporate creditors
7. The intent of the parties
8. Thin or inadequate capitalization
9. Identity of interest between creditor and stockholder
10. Payment of interest only out of dividend money
11. The ability of the corporation to obtain loans from outside lending institutions.

The *Montclair* court stated that thin capitalization alone will not justify designating indebtedness as capital, but also recognized that this factor need not be ignored in determining whether all of the facts authorize the inference of an intent to make a capital contribution. Evidence which may tend to prove that a transaction was a contribution to a capital may be of many sorts.

In *Montclair*, a closely-held corporation claimed deductions on its income tax returns for interest payments made to a corporate insider. The alleged loan agreement was oral, there was no fixed maturity date, the interest rate was not agreed upon except as to the prevailing rate, there was no written obligation to evidence the indebtedness, and the loan was frequently subordinated to loans made by banks. The court found reclassification appropriate on these facts.

B. ***Multiponics* Under-Capitalization Analysis** [*See In re Multiponics, Inc.*, 622 F.2d 709 (5th Cir. 1980)]

1. Capitalization is inadequate if, in the opinion of a skilled financial analyst, it (the capitalization) would definitely be insufficient to support a business of the size and nature of the bankrupt in light of the circumstances existing at the time the bankrupt was capitalized.
2. Capitalization is inadequate if, at the time when the advances were made, the bankrupt could not have borrowed a similar amount of money from an informed outside source."

The *Multiponics* court stated that a stockholder's loans to his company will be treated as capital contributions when, under the equities, a company is deemed undercapitalized. The court cautioned, however, that the mere fact of an insider loan may be insufficient to warrant subordination. *Multiponics, Inc.*, 622 F.2d at 717; See also *In re Herby's Foods, Inc.*, 2 F.3d 128, 133 (5th Cir. 1993); (where insiders conceded that a court is authorized to re-characterize a loan as an equity contribution even when circumstances do not warrant equitable subordination).

C. ***N & D Properties* "No other lender" test** [*Estes v. N&D Properties, Inc.*, 799 F.2d 726, 730 (11th Cir. 1986)]

1. In *N&D Properties*, the 11th Circuit approved recharacterization and held, "Shareholder loans may be deemed capital contributions in one of two circumstances: where the trustee proves initial under-capitalization or where the trustee proves that the loans were made when no other disinterested lender would have extended credit." *Citing In re Multiponics, Inc.*, 622 F.2d 709 (5th Cir. 1980).

2. Thereafter, in *Diasonics, Inc. v. Ingalls*, 121 B.R. 626 (Bankr. N.D.Fla. 1990), Judge Killian applied the under-capitalization theory of subordination. Judge Killian articulated the following standard: shareholder loans may be deemed capital contributions in one of two circumstances: where the trustee proves initial under-capitalization or the trustee proves that the loans were made when no other disinterested lender would have extended credit. The court further determined that when a claim is a capital contribution and not a debt, equitable subordination is not relevant. Subordination is appropriate when the claimant is undeniably a creditor, but for reasons of equity should be relegated to a rank inferior to that of general creditors.

   Diasonics was decided on summary judgment in an adversary proceeding brought by an unsecured creditor to reclassify debt as equity or alternatively for equitable subordination. The court found that the loans were properly classified as an equity capital contribution. The court supported its holding by noting that the insider loans were made when no other disinterested lender would have extended credit. All other lenders would have required the insiders to subordinate their loans before the banks would extend credit to the debtor. Further, the insiders loaned five times the amount of money that any of the disinterested lenders had agreed to advance. The court stated that this clearly demonstrated that the debtor could not obtain additional financing based upon its own financial strength. The court stated that while calling the advances debt the insiders had consistently treated their loans as equity when seeking additional financing.

D. **Recharacterization of purchased debt**.

A few recent cases have addressed whether a debt or mortgage originated by a third party but later purchased can be recharacterized.

1. In *In re Daufuskie Island Properties, LLC*, 431 B.R. 649, 656-657 (Bankr. D. SC. 2010), a creditor filed an adversary proceeding challenging a secured debt. Plaintiff sought recharacterization of a related company mortgage and note based on an allegation that there were no required interest payments and the debtor was inadequately capitalized. However, the bankruptcy court noted the mortgage of the challenged debt was through an assignment of an existing mortgage and the lender did not have a "formal ownership" interest in debtor. Moreover, the challenged debt was a one time financing and the lender did not continue to provide capitalization. Given these factors, the court did not recharacterize the debt.
2. However, the Fourth Circuit has ruled that the transaction or situation to be reviewed for purposes of recharacterization is not necessarily the inception of the debt, but rather the time the claimant acquired the debt. *In re: Province Grande*

Olde Liberty, LLC, No. 15-1669, 2016 WL 4254917, at *3 (4th Cir. Aug. 12, 2016). In the *Province* case, the claimant had acquired an existing note and mortgage prior to the debtor filing bankruptcy. *See id.* at *2. Upon the debtor filing bankruptcy, two creditors sought to have the claimant's claim recharacterized as equity instead of debt. *See id.* The claimant argued that the relevant transaction to apply the recharacterization analysis was the original loan made to the debtor, not when the claimant purchased the existing debt. *See id.* The court ruled that the relevant transaction to be reviewed for purposes of a recharacterization analysis is the transaction which forms "the substance of the transaction" and concluded that the claimant's loan purchase was, in effect, a settlement and satisfaction of the existing loan. *See id. at* *2-3. The court stated:

> The bankruptcy court's broad recharacterization power is "integral to the consistent application of the Bankruptcy Code." *In re Official Committee of Unsecured Creditors for Dornier Aviation (North America), Inc.*, 453 F. 3d 225, 233 (2006). "A bankruptcy court's equitable powers have long included the ability to look beyond form to substance." *Id.* The recharacterization decision itself rests on the "*substance of the transaction"* involved. *Id.* at 232. (emphasis in original). *See id.*

The U.S. Supreme Court recently declined to grant certification of the Fourth Circuits ruling.

The 363(f) Sales and Unexpired Leases: The *Precision Industries* and *Spanish Peaks* Cases

A. Introduction

What is the effect of sale order entered under Section 363(f) on existing, unexpired leases? On the one hand, Section 363(f) authorizes the sale of estate property, free and clear of *any* interests in such property. On the other hand, Section 365 governs lease rejections and provides remedies for the tenants of bankrupt landlords. In an effort to resolve the apparent conflict, several bankruptcy courts have held that:

> [S]ection 365 trumps section 363 under the canon of statutory construction that the specific prevails over the general. They further reason that the legislative history regarding § 365 evinces a clear intent on the part of Congress to protect a tenant's estate when the landlord files bankruptcy, and that the protection would be nugatory, if the property could be sold free and clear of the leasehold under section 363.

Matter of Spanish Peaks Holdings II, LLC, 872 F.3d 892, 898 (9th Cir. 2017)(internal citations omitted). At least two Courts, however, have adopted a different view. Moreover, the Seventh and Ninth Circuits have adopted what is referred to as the "minority approach." Utilizing the minority approach, both the Seventh and Ninth Circuits have determined that Section 363(f) allows for the sale of estate property, free and clear of lessee's interest, provided that the lessee, *upon request*, is granted adequate protection.

B. Precision Industries – The 7th Circuit's Approach

In the Seventh Circuit, we have the case of *Precision Indus., Inc. v. Qualitech Steel SBQ, LLC*, 327 F.3d 537 (7th Cir. 2003). In *Precision*, the Debtors owned and operated a steel mill in Indiana. Prior to filing for bankruptcy, the Debtors entered into a land lease. After the Petition Date (but before the expiration of the lease at issue), the Debtor sold substantially of its of assets through a bankruptcy auction under Section 363(f). The lessee of the land lease did not object to the sale, nor did it ask for adequate protection. After some post-sale disputes, however, an issue arose as to whether the lessee's lease survived the sale, and the matter was brought back before the Bankruptcy Court. After a series of lower-court rulings, the case was appealed to the Seventh Circuit.

In conducting its analysis, the Seventh Circuit first turned to the plain language of Section 363(f). The statute allows a trustee to sell property free and clear of *any interest* in such property, if certain conditions are met. The Court concluded that the term "any interest" was sufficiently broad to include a lessee's possessory interest as lessee. *Precision Indus., Inc. v. Qualitech Steel SBQ, LLC*, 327 F.3d 537, 545 (7th Cir. 2003)(concluding "that the term 'any interest' as used in section 363(f) is sufficiently broad to include Precision's possessory interest as a lessee"). Accordingly, because a lessee's interest in property as a lessee qualifies as an "interest" for the purposes of Section 363(f), the Court determined that Section 363(f) clearly authorized the sale of the Debtor's property, free and clear of any such interest. *Id*. at 546 (stating that "[b]ecause Precision's right to possess the property as a lessee qualifies as an interest for purposes of section 363(f), the statute on its face authorized the sale of Qualitech's property free and clear of that interest"). This, of course, does not leave a lessee without any recourse or rights; a lessee can always request adequate protection under Section 363(e). *See* 11 U.S.C. § 363(e)(stating that "[n]otwithstanding any other provision of this section, at any time, on request of an entity that has an interest in property used, sold, or leased, or proposed to be used, sold, or leased, by the trustee, the court, with or without a hearing, shall prohibit or condition such use, sale, or lease as is necessary to provide adequate protection of such interest").

Utilizing the above analysis, the Court concluded that "[w]here estate property under lease is to be sold, section 363 permits the sale to occur free and clear of a lessee's possessory interest—***provided that the lessee (upon request) is granted adequate protection for its interest.***" *Id*. at 548 (emphasis added). On the other hand, "[w]here the property is not sold, and the debtor remains in possession thereof but chooses to reject the lease, section 365(h) comes into play and the lessee retains the right to possess the property." *Id*.

C. Spanish Peaks – The 9th Circuit's Approach

More recently, Ninth Circuit Court of Appeals addressed the same issue in *Matter of Spanish Peaks Holdings II, LLC*, 872 F.3d 892 (9th Cir. 2017). In *Spanish Peaks*, the Debtor was a resort in Big Sky, Montana. Among the Debtor's obligations were unexpired leases for a restaurant space and separate, commercial real estate. Facing a shrinking real estate market and mounting operational losses, the Debtor filed for Chapter 7 bankruptcy prior to the expiration of the leases. Subsequent to the Petition Date, the Trustee proposed to sell substantially all of the Debtor's real and personal property through an auction. The Trustee represented that the proposed sale would be free and clear of all liens, claims and encumbrances, other than those specifically mentioned in the sale motion. The leases for the restaurant and commercial space were *not* mentioned as those encumbrances that would survive the sale. Therefore, the lessees objected to the sale, stating that the Trustee could not sell the property free and clear of their leasehold interests. The lessees did not, however, request adequate protection under Section 363(e). The sale was ultimately approved by the Bankruptcy Court and affirmed by the District Court.

On appeal to the Ninth Circuit, the Court adopted the Seventh Circuit's "minority approach" which broadly defines the term "interest" to include "any interest" as referenced in 363(f). The 9th Circuit also "agree[d] with the Seventh Circuit that sections 363 and 365 do not conflict." *Matter* *of Spanish Peaks Holdings II, LLC*, 872 F.3d 892, 899 (9th Cir. 2017). Moreover, "section 363 governs the sale of estate property, while section 365 governs the formal rejection of a lease. Where there is a sale, but no rejection (or a rejection, but no sale), there is no conflict." *Id*. Additionally, while "[a] sale of property free and clear of a lease may be an effective rejection of the lease in some everyday sense, but it is not the same thing as the 'rejection' contemplated by section 365." *Id*.

The Court also took its analysis another step further by likening the 363(f) sale in *Spanish Peaks* to a foreclosure sale under Montana law (which would have governed the *Spanish Peaks* property in a state court foreclosure). Under Section 363(f)(1), a Trustee may sell estate property free and clear of any interest in such property if "applicable nonbankruptcy law permits sale of such property free and clear of such interest." *Id*. at 900 (citing 11 U.S.C. § 363(f)(1)). And applying Montana law, "a foreclosure sale to satisfy a mortgage terminates a subsequent lease on the mortgaged property." *Id*. citing *Ruby Valley Nat'l Bank v. Wells Fargo Delaware Trust Co.*, 373 Mont. 374, 317 P.3d 174, 178 (2014). The *Spanish Peaks* Court noted that "had [the Debtor] not declared bankruptcy, we can confidently say that there would have been an actual foreclosure sale. Such a sale would have terminated the [] leases. Section 363(f)(1) does not require an actual or anticipated foreclosure sale. It is satisfied if such a sale would be legally permissible." *Id*.

Therefore, the Court ruled that Section 363(f)(1) authorized the sale of the Debtor's property, free and clear of the leases. And because the trustee did not formally reject the leases, section 365 was not implicated.

As an aside, the Court also made an interesting observation about the legislative intent behind Section 365. The Court stated that their analysis:

> …highlights a limitation inherent in the "majority" approach. We agree that section 365 embodies a congressional intent to protect lessees. But that intent is not absolute; it exists alongside other purposes and sometimes conflicts with them. To some extent, protecting lessees reduces the value of the estate—property presumably fetches a lower price if it is subject to a lease—and is therefore contrary to the goal of maximizing creditor recovery, another core purpose of the Code. The statutory text is the best assurance we have that we are balancing competing purposes in the way Congress intended.

Id. at 900–01 (internal citation omitted).

D. Conclusion

Bankruptcy practitioners should err on the side of caution when analyzing the effect of a Section 363(f) sale on unexpired leases. For those practitioners representing lessees in sale situations, it is dangerous to assume that the Court will automatically prevent the extinguishment of a tenant's lease. Although the Seventh and Ninth Circuits appear to be in the minority, the better practice is for tenants request adequate protection to ensure that they are compensated for their leasehold rights.