AMERICAN BANKRUPTCY INSTITUTE

2022 Winter Leadership Conference

PLENARY SESSION

Great Debates

Resolved: Bankruptcy courts do not have the authority to approve nonconsensual releases of direct claims held by third parties against nondebtors as part of a chapter 11 plan or reorganization.

Pro: **Hon. Eugene R. Wedoff (ret.)**
Oak Park, Ill.

Con: **Marshall S. Huebner**
Davis Polk & Wardwell LLP; New York

Resolved: Trustee requests of debtors for documents and information beyond that already required by the Code and Rules should not be routinely undertaken, but instead should be limited to inquiries suggested by issues arising in specific cases.

Pro: **Tiffany L. Carroll**
Office of the U.S. Trustee; San Diego

Con: **Gary R. Stickell**
Gary R. Stickell, Attorney at Law; Phoenix

Resolved: The Seventh Circuit was wrong in *Sheehan v. Breccia Unlimited Co. (In re Sheehan)*, 21-2946 (7th Cir. Sept. 9, 2022), when it barred U.S. bankruptcy courts from stopping foreign creditors from taking action against a debtor's assets abroad when the U.S. court has no general or specific personal jurisdiction over the creditors.

Pro: **Hon. Christopher S. Sontchi (ret.)**
Delaware ADR; Hockessin, Del.

Con: **Hon. David R. Jones**
U.S. Bankruptcy Court (S.D. Tex.); Houston

2022

Do Bankruptcy Courts Have Constitutional Authority to Approve Nonconsensual, Third-Party Releases?

14 January 2020

Yes, says the Third Circuit. The Third Circuit recently held that the Bankruptcy Court has the authority to confirm a chapter 11 plan which contains nonconsensual, third-party releases when such releases are integral to the successful reorganization. The court's decision in *In re Millennium* holds that, when the third-party releases are integral to the restructuring of the debtor-creditor relationship, the Bankruptcy Court has the constitutional authority to approve nonconsensual, third-party releases.

Background

Following a Federal investigation, the Dept. of Justice ("DOJ") sued the debtors, Millennium Lab Holdings II and its affiliates ("Millennium"), for violation of various laws, and the Center for Medicare and Medicaid Services ("CMS") notified Millennium that it would be revoking its billing privileges. To avoid the destruction of its business, Millennium entered into a settlement agreement with the DOJ and CMS agreeing to pay $256 million, of which $50 million was paid as an upfront deposit.

Quickly thereafter, however, Millennium realized that it lacked the liquidity to fund the settlement as well as meet its obligations under its

$1.825 billion credit agreement. Negotiations with an ad hoc group of lenders followed. The negotiations, as described by the Court, were "highly adversarial," "extremely complicated," at arms-length where the parties were represented by "sophisticated and experienced professionals." These negotiations eventually resulted in the Restructuring Support Agreement, which was reflected in the debtors' chapter 11 prepackaged plan of reorganization. The Restructuring Support Agreement provided that the shareholders will contribute $325 million and would transfer 100% of their equity interests to the company's lenders in exchange for full releases from all claims.

Voya, one of the lenders, objected to the confirmation of the plan because it intended to assert misrepresentation claims against Millennium's equity holders related to the credit agreement. The Bankruptcy Court overruled Voya's objection, and Voya challenged the Bankruptcy Court's decision by arguing it lacked constitutional authority to confirm a plan releasing Voya's claims against non-debtor third-parties under the Supreme Court's decision in *Stern v. Marshall.* The District Court affirmed, and Voya appealed.

Discussion

The question before the Third Circuit was whether the Bankruptcy Court possessed the constitutional authority to confirm a chapter 11 plan of reorganization which included nonconsensual, third-party releases and injunctions designed to enforce them. Analyzing *Stern v. Marshall* and the facts of the case, the Third Circuit held that it did.

Stern v. Marshall

In *Stern*, the Supreme Court continued the evolution of its jurisprudence regarding the scope of, and limitations on the Bankruptcy Court's constitutional authority. The Third Circuit in *Millennium* drew three main points from *Stern. First*, even when the

bankruptcy court acts in one of the designated "core proceedings" categories, it may still violate Article III of the Constitution and therefore exceed its constitutional authority. Therefore, concluding that the bankruptcy court proceedings constituted core does not end the matter; the decision still must be reviewed for compliance with Article III.

Second, in *Stern*, the Supreme Court found that a bankruptcy court can resolve a matter that is integral to the restructuring of the debtor-creditor relationship. Specifically in *Stern*, the Supreme Court held that the bankruptcy court had authority to decide matters stemming from the bankruptcy itself or that would necessarily be resolved in the claims allowance process.

Third, courts should focus on the content of the proceedings rather than on the category of "core" proceedings at issue. As the Third Circuit explained, *Stern* did not declare all counterclaims to be beyond the scope of the bankruptcy court's authority; rather, it held that those counterclaims that do not stem from the bankruptcy, or are not necessarily resolved in the claims allowance process, are not integral to the debtor-creditor relationship.

Applying Stern to the Facts

Turning to the specific facts of the case, the Third Circuit found that the Bankruptcy Court was authorized to confirm a chapter 11 plan containing nonconsensual, third-party releases because the releases were absolutely critical to the successful reorganization of the debtors. The release provisions were highly negotiated and were necessary to the success of the reorganization. Based on the record before it, the Third Circuit concluded that "[a]bsent [the shareholders'] payment, the company could not have paid the government, with the result that liquidation, not reorganization, would have been Millennium's sole

option. Restructuring in this case was possible only because of the release provisions," and the shareholders were only willing to enter to effectuate the transaction in exchange for the releases. The Third Circuit noted that both the Bankruptcy Court and District Court had found that the "deal to avoid corporate destruction would not have been possible without the third-party releases." Accordingly, the releases were absolutely integral to a successful reorganization.

Voya's main argument was that the centrality of the release to the plan was irrelevant because its RICO and fraud claims against the shareholders do not stem from the bankruptcy nor would they be resolved in the claims allowance process. The Court rejected the argument because *Stern* did not limit matters central to the restructuring only to matters involving the claims allowance process.

Voya's other challenge rested on the floodgates argument; that a ruling allowing the Bankruptcy Court to approve a nonconsensual, third-party release will be manipulated and abused allowing bankruptcy courts to "approve release simply because [lenders] demand them." Recognizing that the argument is not without force, the Court cautioned that plans including such releases must meet exacting standards and bankruptcy courts should be cautious in approving them.

Implications

The Third Circuit's decision in *Millennium* is an important development in understanding the scope of the Bankruptcy Court's authority under *Stern*, as well as the conditions that justify a nonconsensual, third-party release in the Third Circuit. We also believe that the opinion will be influential in cases outside the Third Circuit.

Read the opinion >>

Location: USA

Authors Shmuel Vasser Cara Kaplan

Firm: Dechert LLP

Tags USA Insolvency & Restructuring Litigation Dechert LLP Medicare Medicaid US Department of Justice Third Circuit

Original Article

https://s3.amazonaws.com/documents.lexology.com/f756df64-0e00-4ebb-a185-1a367a2087b6.pdf?AWSAccessKeyId=AKIAVYILUYJ754JTDY6T&Expires=1660953300&Signature=

PUBLICATIONS ›

NEWSLETTERS ›

ABI INTERNATIONAL BOARD COMMITTEE ›

Benchnotes

By Christina Sanfelippo, Patrick A. Clisham and Aaron M. Kaufman

Coordinating Editor
Christina Sanfelippo
Cozen O'Connor
Chicago

Coordinating Editor
Patrick A. Clisham
Engelman Berger, PC
Phoenix

Coordinating Editor
Aaron M. Kaufman
Gray Reed; Dallas

Christina Sanfelippo is an associate with Cozen O'Connor in Chicago. Patrick Clisham is the managing shareholder of Engelman Berger, PC in Phoenix and a member of ABI's Board of Directors. Aaron Kaufman is a partner with Gray Reed in Dallas.

SDNY Finds No Statutory Authority for Third-Party, Nonconsensual Releases of Direct Claims

The U.S. District Court for the Southern District of New York recently ruled that the Bankruptcy Code does not authorize a bankruptcy court to order the nonconsensual release of third-party direct claims against nondebtors in connection with the confirmation of a chapter 11 plan.[1] In so holding, the court vacated confirmation of the debtors' reorganization plan.

The plan in *In re Purdue Pharma LP* provided for broad releases of particularized or direct claims — including claims predicated on fraud, misrepresentation and willful misconduct under various state consumer protection statutes — to all members of the Sackler families, as well as a variety of trusts, partnerships and corporations associated with the family and the people who run and advise those entities (the "shareholder releases").[2] The court was careful to reiterate that the claims at issue under the shareholder releases were *not* derivative claims. Accordingly, the court's findings speak to a very narrow range of claims that might be asserted against the Sacklers.

In concluding that it was statutorily authorized to approve the shareholder releases, the bankruptcy court relied on §§ 105(a), 1123(a)(5) and (b)(6), and 1129 of the Bankruptcy Code, together with its "residual authority."[3] On appeal, the district court found that the Code sections relied on by the bankruptcy court, whether read separately or together, do not confer any substantive right to approve the nonconsensual release of nonderivative third-party claims against nondebtors.[4] Rather, each of the cited sections confers on the bankruptcy court *only* the power to enter orders that carry out other, substantive Code provisions. Notably, the district court reviewed the shareholder releases *de novo* because it concluded that the bankruptcy court lacked authority to give final approval to those releases, even though they were incorporated into a reorganization plan.[5]

After an extensive survey of Second Circuit precedent on the subject of nonconsensual, third-party releases of direct claims, the district court determined that § 105(a), standing alone, does not confer authority on the bankruptcy court to approve the shareholder releases.[6] Section 105(a) does not authorize a bankruptcy court "to create substantive rights that are otherwise unavailable under applicable law."[7] Rather, it confers on the bankruptcy court only the power to enter orders that carry out other substantive Code provisions. The district court concluded that the authority to approve the shareholder releases must ultimately derive from some other Code provision.[8]

Turning to the remaining Code provisions cited by the bankruptcy court, the district court found § 1123(b)(6), which authorizes a plan to "include any other appropriate provision not inconsistent with the applicable provisions of this title," to be substantively analogous in form to § 105(a). As a result, the district court reasoned that § 1123(b)(6) cannot be read to confer any substantive authority on the bankruptcy court.[9] The district court also noted that certain aspects of the shareholder releases violated § 1123(b)(6) because those aspects were inconsistent with other Code provisions.[10] The shareholder releases granted releases to nondebtors for claims — such as claims for fraud or willful and malicious conduct or claims for civil penalties payable to and for the benefit of governmental units — that could not be released in favor of the debtors themselves.

The district court similarly found that § 1123(a)(5), which provides that a reorganization plan must provide adequate means for its implementation, does not confer a substantive right.[11] Relying on *Dairy Mart*, the district court rejected the notion that since the debtors required funding to implement the plan, and that funding could only be obtained from the Sacklers on condition of a release and an injunction, the release and injunction were authorized under § 1123(a)(5).[12] Section 1123(a)(5) does not authorize a court to give its approval to something that the Bankruptcy Code does not otherwise authorize simply because doing so would ensure funding for a plan. Finally, the district court found no authority under § 1129(a)(1) for the approval of the shareholder releases, because § 1129(a)(1) is simply another highly general provision.[13]

After concluding that no statutory authority exists for the approval of the shareholder releases, the district court considered the debtors' argument that the bankruptcy court had statutory authority to approve the releases because no Code provision expressly prohibits them. The district court rejected the debtors' argument on several grounds.

1 *In re Purdue Pharma LP*, No. 21 CV 7532 (CM), 2021 WL 5979108(S.D.N.Y. Dec. 16, 2021), certificate of appealability granted, No. 21 CV 7532 (CM), 2022 WL 121393 (S.D.N.Y. Jan. 7, 2022). *See also* Paul R. Hage, "'The Great Unsettled Question': Nonconsensual Third-Party Releases Deemed Impermissible in *Purdue*," XLI *ABI Journal* 2, 12-13, 43-45, February 2022, *available at* abi.org/abi-journal.
2 *Purdue* at *48.
3 *Id.* at *35.
4 *Id.* at *62.
5 *Id.* at *39.
6 *Id.* at *60.
7 *Id.* at *56 (citing *New England Dairies Inc. v. Dairy Mart Convenience Stores Inc. (In re Dairy Mart Convenience Stores Inc.)*, 351 F.3d 86, 92 (2d Cir. 2003)).
8 *Id.* at *61.
9 *Id.* at *62.
10 *Id.*
11 *Id.* at *64.
12 *Id.* (citing *Dairy Mart*, 351 F.3d at 92).
13 *Id.* at *65.

First, the notion that statutory authority can be inferred from congressional silence is inconsistent with the comprehensiveness of the Code's federal bankruptcy scheme.[14] Second, the district court explained that it did not expect Congress to have thought it necessary to expressly forbid the types of releases found in the shareholder releases because if the nondebtors were debtors in their own cases, the bankruptcy court would be barred from authorizing the very same releases under the Code.[15] Third, the district court rejected the contention that Congress has been silent on the subject of nonconsensual, third-party releases, noting that Congress enacted § 524(g) and (h) and elected to limit Code-based authority to release third-party claims against nondebtors to asbestos litigation.[16] Finally, under the general/specific cannon of statutory construction, the general Code provisions relied upon by the bankruptcy court cannot be used to expand the specific authority to order releases conferred by Congress under § 524(g).[17]

The final argument considered by the district court was whether the shareholder releases were authorized under the bankruptcy court's residual authority. The district court concluded that "residual statutory authority" does not exist and that the bankruptcy court's equitable powers can only be exercised within the confines of the Bankruptcy Code.[18]

Miscellaneous

• *In re Robinson*, --- B.R. ---, 2021 WL 3713850 (Bankr. D. Kan. 2021) (bankruptcy court overruled objection by U.S. Trustee to confirmation of a subchapter V reorganization plan, arguing that plan was not consensual plan under 11 U.S.C. § 1191(a), as all classes of creditors were impaired but no creditors voted on plan; bankruptcy court found that under Tenth Circuit precedent in *In re Ruti-Sweetwater Inc*., 836 F.2d 1263 (10th Cir. 1988), non-objecting and non-voting creditor is deemed to have accepted reorganization plan for purposes of satisfying 11 U.S.C. § 1129(a)(8) and avoiding cramdown requirements of § 1129(b)(1), but such deemed acceptance does not constitute "actual acceptance" requirement of at least one class of claims under § 1129(a)(10); in context of subchapter V case, however, bankruptcy court found that requirement of satisfying § 1129(a)(10) would be superfluous given satisfaction of § 1129(a)(8) under Tenth Circuit's holding in *Sweetwater*; as a result, plan could be confirmed as consensual plan under § 1191(a));

• *In re Steen*, --- B.R. ---, 2021 WL 2877515 (Bankr. N.D. Tex. 2021) (bankruptcy court found that attorney's services in connection with defending chapter 13 debtor in nondischargeability proceeding were beneficial and necessary to debtors' estate or debtors, as required for fees to be compensable; according to bankruptcy court, dischargeability complaint was core bankruptcy matter, challenging most basic benefit sought by individuals in bankruptcy that had to be resolved);

• *In re Dean*, --- F.4th ---, 2021 WL 5801273 (5th Cir. Dec. 7, 2021) (court of appeals dismissed appeal by individual chapter 7 debtor because bankruptcy court's order approving chapter 7 trustee's litigation funding agreement with creditor "does not affect whether [the debtor's] debts will be discharged;" accordingly, court concluded that debtor lacked bankruptcy standing to appeal order, as he could not show how funding agreement would "directly, adversely, and financially impact him");

• *In re 461 7th Ave. Market Inc*., 2021 WL 5917775 (2d Cir. Dec. 15, 2021) (court of appeals affirmed denial of stay pending appeal of bankruptcy court's order converting chapter 11 case to chapter 7; district court properly held that appellee made "strong showing" of success on merits given that "there was no real factual dispute as to whether [the debtor] had the financial ability to make the alterations necessary to assume the lease"; without ability to assume lease, reorganization was futile; based on these findings, district court did not err in concluding that appellee was likely to succeed on appeal, and bankruptcy court did not violate debtor's due-process rights by ruling without evidentiary hearing given the lack of genuine factual dispute);

• *Dillworth v. Diaz (In re Bal Harbour Quarzo LLC)*, --- B.R. ---, 2021 WL 5753708 (Bankr. S.D. Fla. Dec. 3, 2021) (court granted motion to dismiss, with leave to amend, concluding that complaint failed to allege plausible bases to avoid fraudulent transfers made by nondebtor entities and beyond general four-year lookback period; specifically, plaintiff did not allege that defendants were bound by a certain state court default order finding nondebtor transferors to be debtor's alter-ego, nor did plaintiff affirmatively allege "plausible substantive allegations" that would give rise to a finding that nondebtor transferors were, in fact, debtor's alter-ego under Florida law; for older transfers, plaintiff failed to identify "triggering creditor" that would have had standing to avoid transfers outside of four-year lookback period under Florida law; thus, court granted motion to dismiss, in part, with leave to amend);

• *In re Legare-Doctor*, --- B.R. ---, 2021 WL 5712149 (Bankr. D.S.C. Dec. 1, 2021) (Bankruptcy Rule 3002.1 applies to reverse mortgages in chapter 13 cases, particularly where secured creditor asserts secured claim for advances made to pay debtor's delinquent taxes and insurances; secured creditor sought repayment for these advances but did not comply with disclosure requirements under Rule 3002.1(c); such violation caused harm to chapter 13 debtor by forcing debtor to respond to motion for stay relief and amend plan to account for undisclosed advances; court held that special remedies under Rule 3002.1(i) were warranted; specifically, court precluded secured creditor from asserting claim for advances in present chapter 13 case *and* from collecting advances from debtor after debtor obtained § 1328 discharge; court also awarded attorneys' fees);

• *In re Rickerson*, --- B.R. ---, 2021 WL 5905974 (Bankr. W.D. Pa. Dec. 14, 2021) (individual chapter 11 debtor did not qualify for subchapter V designation because she failed to carry her burden of proving eligibility under 11 U.S.C. § 1182(1)(A), which required her to show that she was "engaged in commercial or business activities" and had

continued on page 54

14 *Id.*
15 *Id.* at *66.
16 *Id.*
17 *Id.* at *67-68.
18 *Id.* at *68-69.

ABI EXCLUSIVE

JANUARY 19, 2022

Another District Judge Emphatically Rejects a Plan with Non-Debtor Third-Party Releases

> A district judge in Virginia holds that third-party, non-debtor releases must be approved by district judge under Stern and must comply with the strictures of Federal Rule 23.

In a scorching opinion, a district judge in Richmond, Va., set aside confirmation of a chapter 11 plan that contained "extremely broad third-party (non-debtor) releases."

District Judge David J. Novak said that the releases in the appeal before him "represent the worst of this all-too-common practice, as they have no bounds." He described the releases as barring the claims

> of *at least* hundreds of thousands of potential plaintiffs not involved in the bankruptcy . . . , shielding an incalculable number of individuals associated with the Debtors . . . for an unspecified time period stretching back to time immemorial . . . .” [Emphasis in original.]

Judge Novak said that the bankruptcy court “exceeded the constitutional limits of its authority . . . , ignored the mandates of the Fourth Circuit . . . , and offended the most fundamental precepts of due process.”

Referring to what he called the “ubiquity of third-party releases” approved by a bankruptcy judge in Richmond who “regularly approves third-party releases,” Judge Novak said that “[t]his recurrent practice contributes to major companies like [the debtor] using the permissive venue provisions of the Bankruptcy Code to file for bankruptcy here.”

Citing the U.S. Trustee, Judge Novak said that “the Richmond Division (just the division, not the entire Eastern District of Virginia) joins the District of Delaware, the Southern District of New York, and the Houston Division of the Southern District of Texas as the venue choice for 91% of the ‘mega’ bankruptcy cases.”

On the penultimate page of his 88-page opinion reversing and remanding, Judge Novak directed the chief bankruptcy judge to reassign the chapter 11 case to another bankruptcy judge outside of the Richmond division. If there is another appeal after remand, Judge Novak said that the new appeal would be assigned to him.

Takeaways

On December 16, District Judge Colleen McMahon in New York vacated confirmation of the Purdue Pharma LLP chapter 11 plan, holding that the court had no statutory power to impose non-consensual releases of creditors’ direct claims against non-debtor third parties. *In re Purdue Pharma LP*, 21-07532, 2021 BL 482465, 2021 WL 5979108 (S.D.N.Y. Dec. 16, 2021). To read ABI’s report, **click here**.

The January 13 opinion by Judge Novak goes beyond Judge McMahon's more narrow preservation of creditors' direct claims against non-debtors. Readers may draw some of the following conclusions from Judge Novak's opinion.

- Third-party releases are virtually impermissible when the releasing parties are receiving no consideration under the chapter 11 plan and the creditors do not manifest actual consent, under high standards for what constitutes actual consent.
- Just providing creditors with an ability to opt out does not make the release consensual as a matter of fact and law.
- The limited power of a bankruptcy judge under Article I of the Constitution requires that third-party releases be approved by district judges, and confirmation orders with third-party releases should be reports and recommendations.
- The procedure for approval of third-party releases in a chapter 11 plan must comply with Federal Rule 23, which deals with class actions. Among other things, creditors who are losing the right to sue must be involved in negotiations on the plan and must be adequately represented.
- Like the Eighth Circuit, which limited the doctrine of equitable mootness almost to the vanishing point, equitable mootness will not protect third-party releases from appellate review.
- A creditor who opts out has no standing to appeal.

Judge Novak's opinion is required reading for anyone involved in chapter 11 practice. He gathers together authorities that are either hostile to or limit third-party releases.

However, Judge Novak does not proscribe third-party releases altogether. Indeed, he could not in view of *Behrmann v. Natl. Heritage Found. Inc.*, 663 F.3d 704 (4th Cir. 2011), where the Fourth Circuit adopted the Sixth Circuit's approach to approval of third-party releases and rejected the idea that Section 524(e) bars them outright.

The Facts

The debtors were Mahwah Bergen Retail Group, Inc. and affiliates. Together, they operated 2,800 retail stores with names like Ann Taylor, LOFT and Lane

Bryant. The debtors had about $1.6 billion in secured debt and perhaps $800 million in unsecured debt.

In chapter 11, they sold the business in three sales for more than $650 million. The chapter 11 plan paid some secured creditors and set aside $7.25 million in cash for unsecured creditors.

Before bankruptcy, plaintiffs filed a securities class action suit in New Jersey against the debtors and several individuals, including the debtors' former chief executive and former chief financial officer. The district court had not certified the class before the chapter 11 filing brought the suit to a halt.

As confirmed by the bankruptcy court, the plan included "extremely broad" releases that "cover any type of claim that existed or could have been brought against anyone associated with the Debtors as of the effective date of the plan," Judge Novak said.

At the confirmation hearing, Judge Novak said that the bankruptcy court focused on the claims that would be released against the former CEO and CFO in the class action. The bankruptcy court, he said, "ignored all of the other potential claims (both federal and state claims) released against others covered by the releases."

The plan allowed creditors and shareholders to opt out of the releases. Shareholders were not receiving any consideration under the plan, although they would be released from any claims that the debtors might hold against those who did not opt out.

The debtors sent notices and opt-out forms to some 300,000 parties believed to be in the putative class. Almost 600 opted out, representing 0.2% of the class. Notice was published in two newspapers with nationwide publication.

Other than shareholders, the bankruptcy court did not require that notice and opt-out forms be sent to anyone else who would be giving releases, including employees, consultants, accountants, attorneys for the debtors or any of their affiliates, lenders, owners or shareholders.

The named plaintiffs in the class action opted out for themselves and attempted to opt out for the class. The bankruptcy court declined to allow the plaintiffs to opt out for the class.

The plan also contained exculpation clauses in favor of the debtors, the creditors' committee, committee members, shareholders who did not opt out, the term loan agent and anyone related to them.

The class plaintiffs and the U.S. Trustee unsuccessfully objected to confirmation and filed appeals. They also unsuccessfully sought stays pending appeal from both the bankruptcy court and the district court.

Standing to Appeal

The debtors agreed that the U.S. Trustee had standing to appeal but challenged the appellate standing of the class plaintiffs.

Citing the Second Circuit and other appellate authority, Judge Novak said that the class plaintiffs could not establish individualized harm because they opted out and preserved their claims. Thus, the U.S. Trustee had standing to appeal but not the class plaintiffs.

The Constitution and Third-Party Releases

Judge Novak framed the question as whether the bankruptcy court had constitutional authority to impose third-party releases. He said that the releases covered "an extraordinarily vast range of claims held by an immeasurable number of individuals against a broad range of potential defendants." Other than the claims against the former CEO and CFO, Judge Novak said that the bankruptcy court "ignored all of the other potential claims that it terminated in approving the releases."

Delving into the statutory and constitutional power underlying the releases, Judge Novak said that the "bankruptcy court lacks any authority to act on it" if "the claim has no relation to a case under title 11." In that regard, he said that the bankruptcy court "engaged in none of the content-based analysis demanded by" *Stern v. Marshall*, 564 U.S. 1058 (2011).

Judge Novak did not pause to determine whether the released claims were "core" or "noncore." He said "it takes only a cursory review . . . to find released claims that the Bankruptcy Court lacked authority to adjudicate." The first example he gave was the class suit against the former CEO and CFO, because the former officers had no involvement in the chapter 11 case.

Releasing claims, Judge Novak said, "amounts to adjudication of the claims for *Stern* purposes," citing Judge McMahon's *Purdue* opinion. He went on to say that the bankruptcy court had no *in rem* jurisdiction over third-party claims not against the estate or property of the estate."

Referring to Section 105(a) and the plenary power of a bankruptcy court to confirm a plan, Judge Novak said that "Article III simply does not allow third-party non-debtors to bootstrap any and all of their disputes into a bankruptcy case to obtain relief."

Next, Judge Novak dealt with the argument that the bankruptcy court had authority to issue the releases because the failure to opt out amounted to consent. He said that Supreme Court authorities "do not permit a finding of consent based on *inaction*." [Emphasis in original.] He could not "discern any actions undertaken by the Releasing Parties to support a finding that they knowingly and voluntarily consented to Article I adjudication of the claims that they released."

Judge Novak held that the bankruptcy court "erred in adjudicating the *Stern* claims without the knowing and voluntary consent of the Releasing Parties."

Consequences of a *Stern* Violation

Because the bankruptcy court exceeded its power under *Stern*, Judge Novak vacated the confirmation order and treated the bankruptcy court's decision as a report and recommendation. Saying that the bankruptcy court's opinion "lacks any meaningful factfinding," Judge Novak made his own factual findings based on the record from the confirmation hearing.

In the future, Judge Novak said it would "preferable" for a bankruptcy court to issue a report and recommendation, identifying "with specificity the claims

and individuals released and provid[ing] detailed findings . . . to ensure that the released claims are truly integral to the reorganization."

Judge Novak rejected the bankruptcy court's findings and made five single-spaced pages of findings of his own. He said that the third-party releases were "nonconsensual both as a matter of fact and a matter of law." He also found that the former CEO and CFO were not integral to the reorganization.

The Circuit Split on Third-Party Releases

Judge Novak cited the Fifth, Ninth and Tenth Circuits for prohibiting third-party releases under Section 524(e). He cited other circuits, like the Second and Third, that permit releases in rare cases.

In *Behrmann*, *supra*, the Fourth Circuit followed the test laid down by the Sixth Circuit for third-party releases. He ruled that the failure to opt out did not amount to the level of consent required by *Behrmann*.

Judge Novak said that the bankruptcy court "failed to conduct any *Behrmann* analysis." He said that the released parties gave no substantial contribution as required by *Berhmann*. In addition, the releases were not essential to the reorganization and were not "overwhelmingly" approved by the affected class.

"Because the Plan extinguishes these claims entirely without giving any value in return, this weights strongly against granting the Releases," Judge Novak said.

Beyond *Behrmann*, Judge Novak said that "no court" would have found the instant settlement "fair, reasonable and adequate under Rule 23." No one represented the interests of those who were giving releases, and the releases did not result from negotiations with those on whom releases were imposed. Instead, he said, the negotiations only occurred between those who would benefit from the releases. Furthermore, he found that the releases given by the debtor to shareholders "lacked any value and [were] purely fictional."

Judge Novak went on to hold that the third-party releases failed three of the four elements required to afford due process under Rule 23. "Accordingly," he

said, allowing releases only based on the failure to opt out "does not comport with due process." He voided the third-party releases and held them unenforceable.

Severability

After confirmation, the plan said in substance that the releases were not severable from the remainder of the plan. Before confirmation, however, the releases were severable, Judge Novak said.

Again treating the confirmation order as a report and recommendation, Judge Novak examined the record and found that they did not "form an integral part of the Plan." Stepping into the shoes of the bankruptcy court, he severed the releases.

Equitable Mootness

The debtors argued for dismissal of the appeal as equitably moot, but Judge Novak found four reasons why the appeal was not equitably moot.

"First and foremost," he said, the confirmation order was no longer a final order, and equitable mootness does not apply when the confirmation order has been converted to a report and recommendation.

Second, equitable mootness does not apply when the government, via the U.S. Trustee, is representing absent individuals.

"Not only did the parties craft a release that would extinguish the rights of countless individuals, they did so in a way that would insulate the release from judicial review," Judge Novak said. He refused to "apply the doctrine of equitable mootness against the Trustee when the Trustee seeks to protect the rights of absent individuals."

Third, the "seriousness" of the bankruptcy court's "errors counsels against a finding of equitable mootness."

Fourth, effective relief was available. Judge Novak said he could sever the releases without altering any creditor's recovery "or affect[ing] the bankruptcy estate in any way."

Applying the factors to the appeal at hand, Judge Novak observed that equitable mootness "is all too often invoked to avoid judicial review, as Debtors seek to do here," citing the recent Eighth Circuit opinion that limited equitable mootness dramatically. *FishDish LLP v. VeroBlue Farms USA Inc. (In re VeroBlue Farms USA Inc.)*, 6 F.4th 880 (8th Cir. Aug. 5, 2021). To read ABI's report, **click here**.

Judge Novak refused to allow nonseverability or equitable mootness "to preclude appellate review of plainly erroneous release provisions."

The Exculpation Provisions

Contrasted to the releases, Judge Novak said that the plan's exculpation provisions provided protection to "court professionals who acted reasonably while carrying out their responsibilities."

Judge Novak remanded for the bankruptcy court to narrow the exculpation clause to cover "fiduciaries who have performed necessary and valuable duties."

Remand

Judge Novak's order vacated the confirmation order, voided the third-party releases, severed the third-party releases from the plan, and voided the exculpation clause.

Judge Novak remanded the case to another bankruptcy judge with instructions to redraft the exculpation clause and "then to proceed with confirmation of the Plan without the voided Third-Party Releases."

Another Appeal?

It is unclear whether Judge Novak's ruling is a final order appealable to the Fourth Circuit. Does the remand call for merely ministerial actions by the bankruptcy court that would allow an appeal?

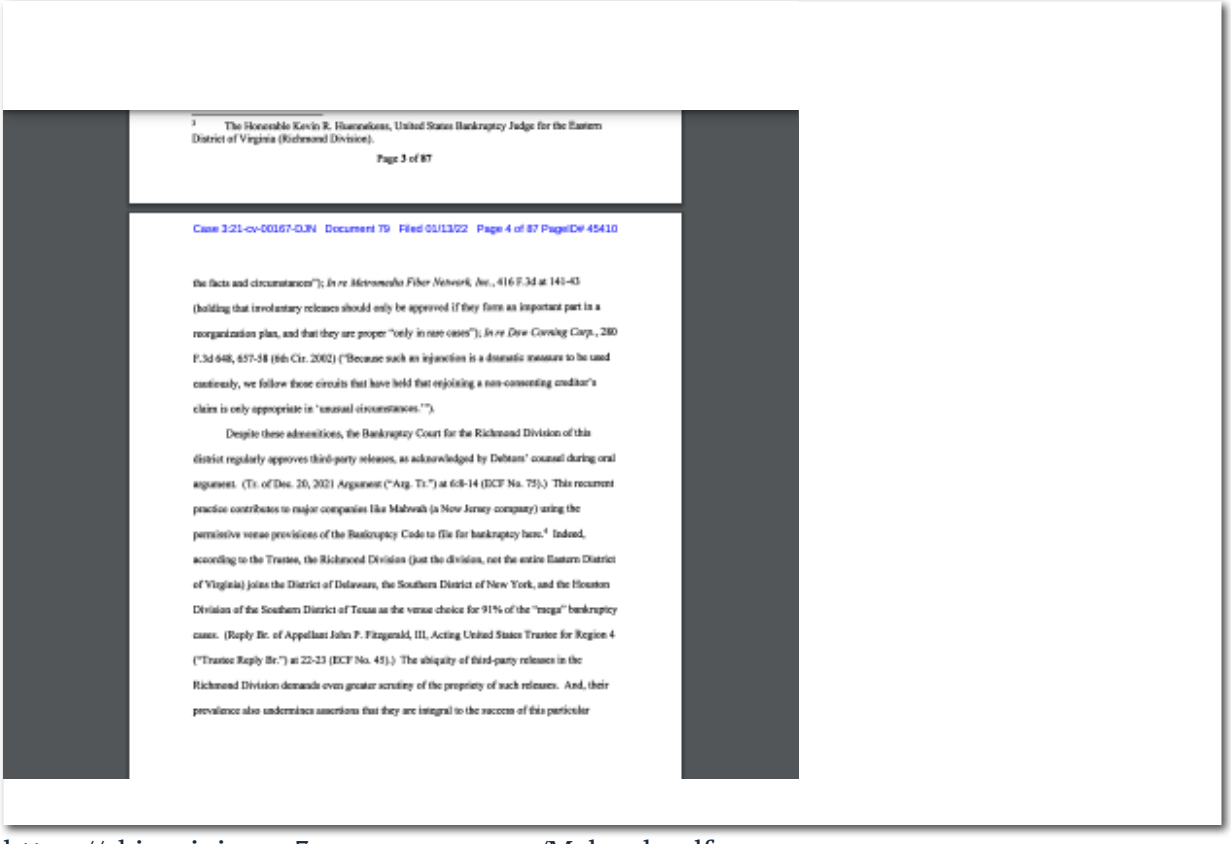
The parties may not appeal again if they decide they can live without the broad releases that Judge Novak voided.

Judge-Shopping Curtailed in the E.D. of Va.

Like the Southern District of New York, the Eastern District of Virginia has adopted a local order that goes into effect on February 15: For chapter 11 debtors with more than $100 million in liabilities, the cases will be assigned randomly to a bankruptcy judge in the district without regard to the division in which the petition was filed.

Opinion Link

PREVIEW



[3] The Honorable Kevin R. Huennekens, United States Bankruptcy Judge for the Eastern District of Virginia (Richmond Division).

Page 3 of 87

Case 3:21-cv-00167-DJN Document 79 Filed 01/13/22 Page 4 of 87 PageID# 45410

the facts and circumstances"); *In re Metromedia Fiber Network, Inc.*, 416 F.3d at 141-43 (holding that involuntary releases should only be approved if they form an important part in a reorganization plan, and that they are proper "only in rare cases"); *In re Dow Corning Corp.*, 280 F.3d 648, 657-58 (6th Cir. 2002) ("Because such an injunction is a dramatic measure to be used cautiously, we follow those circuits that have held that enjoining a non-consenting creditor's claim is only appropriate in 'unusual circumstances.'").

Despite these admonitions, the Bankruptcy Court for the Richmond Division of this district regularly approves third-party releases, as acknowledged by Debtors' counsel during oral argument. (Tr. of Dec. 20, 2021 Argument ("Arg. Tr.") at 6:8-14 (ECF No. 75).) This recurrent practice contributes to major companies like Mahwah (a New Jersey company) using the permissive venue provisions of the Bankruptcy Code to file for bankruptcy here.[4] Indeed, according to the Trustee, the Richmond Division (just the division, not the entire Eastern District of Virginia) joins the District of Delaware, the Southern District of New York, and the Houston Division of the Southern District of Texas as the venue choice for 91% of the "mega" bankruptcy cases. (Reply Br. of Appellant John P. Fitzgerald, III, Acting United States Trustee for Region 4 ("Trustee Reply Br.") at 22-23 (ECF No. 45).) The ubiquity of third-party releases in the Richmond Division demands even greater scrutiny of the propriety of such releases. And, their prevalence also undermines assertions that they are integral to the success of this particular

https://abi-opinions.s3.amazonaws.com/Mahwah.pdf

Case Details

Case Citation	Patterson v. Mahwah Bergen Retail Group Inc., 21-167 (E.D. Va. Jan. 13, 2022).
Case Name	Patterson v. Mahwah Bergen Retail Group Inc.
Case Type	Business
Court	4th Circuit Virginia Virginia Eastern District
Bankruptcy Tags	Claims Bankruptcy Litigation Plan Confirmation Business Reorganization Govt. Claims/Sovereign Immunity

Trustee Talk

By Lon A. Jenkins

Oh, Did I Forget to Mention...?

Considering Judicial Estoppel: Intentional Concealment or Inadvertent Omission?

Coordinating Editor
Lon A. Jenkins
Office of the Chapter 13 Trustee (D. Utah); Salt Lake City

Lon Jenkins has been the standing chapter 13 trustee for the District of Utah since September 2015. He previously practiced for more than 30 years in primarily chapter 11 reorganizations and bankruptcy litigation, representing creditors, chapter 11 trustees, creditors' committees and indenture trustees.

In order for a debtor to obtain the significant benefits and protections available under the Bankruptcy Code, little is required of a debtor.[1] However, a singularly critical obligation requires a debtor to accurately and truthfully disclose all assets and liabilities to the court, creditors and trustee, including a full disclosure of "claims against third parties, whether or not you have filed a lawsuit or made a demand for payment."[2] But if a debtor fails to disclose such "claims against third parties," can the debtor subsequently be precluded from pursing claims against third parties in a civil lawsuit?

This question has given rise to differing approaches among the circuit courts in determining when judicial estoppel should prevent a debtor's prosecution of a civil claim. Recent circuit decisions, including the Eleventh Circuit's decision in *Slater v. United States Steel Corp.*,[3] suggest that courts might be less inclined to apply judicial estoppel, focusing on the debtor's actual intent in failing to disclose and the potential harm to innocent creditors by barring pursuit of a civil claim.

A debtor who fails to disclose a claim against a third party and subsequently attempts to pursue that claim in a lawsuit might be precluded from doing so by application of the doctrine of judicial estoppel. The U.S. Supreme Court has succinctly explained the doctrine of judicial estoppel: "Where a party assumes a certain position in a legal proceeding, and succeeds in maintaining that position, he may not thereafter, simply because his interests have changed, assume a contrary position, especially if it be to the prejudice of the party who has acquiesced in the position formerly taken by him."[4] The Supreme Court has emphasized that judicial estoppel is intended not to protect the litigants, but rather "to protect the integrity of the judicial process"[5] and prevent litigants from "playing fast and loose with the courts."[6]

In a bankruptcy case, invoking judicial estoppel to bar pursuit of a valuable civil claim can lead to harsh — and perhaps unintended — consequences. For example, the debtor's creditors, who are innocent of wrongdoing, might be deprived of recovery from a potentially valuable claim; an appointed trustee might be prevented from pursuing the action; an alleged wrongdoer (the defendant) might be undeservedly relieved of liability for an alleged bad act; and, indeed, a debtor who suffered serious harm might receive no recompense.

On the other hand, honest and full financial disclosure by a debtor is essential to the integrity of the judicial process, so debtors should not be rewarded for concealing assets from creditors.[7] Given these important competing concerns, courts increasingly focus on whether the debtor *actually intended* to mislead the court by failing to disclose a claim or lawsuit. In the process, recent decisions weigh the interests of creditors and reject the established test for assessing a debtor's "inadvertence," which may give rise to an unwarranted inference that the debtor intended to mislead the court based solely on a nondisclosure.

In *New Hampshire v. Maine*,[8] the Supreme Court announced a three-part test for application of judicial estoppel. Judicial estoppel should be applied if three factors are present: (1) the party's later position must clearly be inconsistent with its earlier position; (2) the court was persuaded to accept the party's earlier position such that judicial acceptance of the inconsistent position in the later proceeding leads to the perception that one of the courts was misled; and (3) the party seeking to assert the inconsistent position would enjoy an unfair advantage over the opposing party if not estopped.[9] However, the Court cautioned that these factors are neither "exhaustive" nor constitute "inflexible prerequisites." Particularly relevant to the courts' present analyses, the Court instructed that "[w]e do not question that it [might] be appropriate to resist application of judicial estoppel '*when a party's prior position was based on inadvertence or mistake*.'"[10]

Most recently, the Eleventh Circuit considered the application of judicial estoppel in *Slater v. United States Steel Corp.*[11] In this case, the court concluded that the debtor's failure to disclose

1 *See Eastman v. Union Pac. R.R. Co.*, 493 F.3d 1151, 1159 (10th Cir. 2007) ("[I]n exchange for these benefits, the [B]ankruptcy [C]ode required only that [the debtor] fully and accurately disclose his financial status.").
2 Official Form 106A/B, line 33.
3 871 F.3d 1174 (11th Cir. 2017).
4 532 U.S. 742, 749 (2001) (quoting *Davis v. Wakelee*, 156 U.S. 680, 689 (1895)).
5 *Id.* at 749 (citations omitted).
6 *Ryan Operations GP v. Santiam-Midwest Lumber Co.*, 81 F.3d. 355, 358 (3d Cir. 1996) (citation omitted).
7 *See In re Coastal Plains Inc.*, 179 F.3d 197, 208 (5th Cir. 1999).
8 532 U.S. 742 (2001).
9 *Id.* at 750.
10 *Id.* at 753 (quoting *John S. Clark Co. v. Faggert & Frieden PC*, 65 F.3d 26, 29 (4th Cir. 1995) (emphasis added)).
11 871 F.3d 1174 (11th Cir. 2017).

employment-discrimination claims in her bankruptcy case was "inadvertent"; therefore, pursuit of those claims by the debtor would not be barred. Pre-petition, Sandra Slater had commenced an employment-discrimination lawsuit against her former employer but did not disclose the lawsuit in her chapter 7 schedules. Subsequently, faced with a motion to dismiss based on judicial estoppel in the civil case, Slater contended that her nondisclosure in her bankruptcy case was inadvertent because she mistakenly understood that only lawsuits filed *against her* needed to be disclosed. She immediately amended her schedules.

Nonetheless, the trial court barred prosecution of the claims based on judicial estoppel, relying on well-established precedent that a debtor's nondisclosure is inadvertent *only if* the debtor (1) lacks knowledge of the claim or (2) has no motive to conceal the claim.[12] Otherwise, the debtor's intent to conceal is inferred.

Applying the two-prong test, the district court found that the debtor both knew about her civil claims and had a motive to conceal them in her bankruptcy case, because she could receive a no-asset discharge and a potential monetary windfall. Accordingly, it was determined that Slater intended to "make a mockery of the judicial system,"[13] so her claims were barred.

On appeal, the Eleventh Circuit reversed. The court rejected the two-prong test for a debtor's "inadvertence," criticizing the "flawed reasoning" of previous Eleventh Circuit precedent, which had

> endorsed an inference that a plaintiff who failed to disclose a lawsuit in a Chapter 7 bankruptcy intended to manipulate the judicial system because the omission was not inadvertent. In effect, we treated the fact that the plaintiff could potentially benefit from the non-disclosure as sufficient to establish that the plaintiff, in fact, intended to deceive the court.[14]

Under the established test for inadvertence, "[n]o plaintiff who omitted civil claims from bankruptcy disclosures will be able to show that he acted inadvertently because ... [the] plaintiff will always have knowledge of his pending civil claim and a potential to conceal it due to the very nature of bankruptcy."[15] Instead, *Slater* formulated six nonexhaustive factors to assess a debtor's intent: (1) the debtor's level of sophistication; (2) whether and under what circumstances the debtor amended the disclosures; (3) whether bankruptcy counsel was told about the civil claim before filing the disclosures; (4) whether the trustee or creditors were aware of the civil claim before the disclosures were amended; (5) whether the debtor identified other lawsuits to which the debtor was party; and (6) any findings or actions by the bankruptcy court after the nondisclosure was discovered.[16] Weighing these factors, the court concluded that Slater's nondisclosure was likely inadvertent and excused her omission.

The court expressed concern that merely inferring a debtor's intent to prevent pursuit of a claim "risk[s] harm to innocent creditors"[17] and might provide the civil defendant with "an unjustified windfall":[18] "[E]quity cannot condone a defendant's avoidance of liability through a doctrine premised upon intentional misconduct without establishing such misconduct."[19]

In *Ah Quin v. County of Kauai Dept. of Transp.*,[20] the Ninth Circuit adopted similar reasoning in declining to apply judicial estoppel in order to prevent prosecution of a debtor's undisclosed employment-discrimination lawsuit. In this case, the debtor had reopened her bankruptcy case, amended her schedules to disclose the omitted claim and sought to vacate her discharge. The Ninth Circuit chastised the district court for applying the wrong legal standard in concluding that judicial estoppel was compelled: "The district court's belief that it was *bound* to preclude [the] Plaintiff from bringing her discrimination claim is mistaken and fundamentally at odds with equitable principles. Judicial estoppel is a discretionary doctrine, applied on a case-by-case basis."[21]

The Ninth Circuit disregarded the two-prong test for inadvertence, stating, "The relevant inquiry is, more broadly, the plaintiff's subjective intent when filling out and signing bankruptcy schedules."[22] Moreover, inquiry into a debtor's subjective intent may avoid the unintended consequences of inferring intent:

> [W]hen the plaintiff/debtor has reopened the bankruptcy proceedings and has corrected the initial filing error, the narrow interpretations of "mistake" and "inadvertence" do not apply ... the application of judicial estoppel in this case would do nothing to protect the integrity of the courts, would inure to the benefit only of an alleged bad actor, and would eliminate any prospect that [the] Plaintiff's unsecured creditors might have of recovering.[23]

In two post-*New Hampshire* decisions, *Eubanks v. CBSK Financial Group Inc*.[24] and *Spaine v. Community Contacts Inc*.,[25] the Sixth and Seventh Circuits both reversed lower court decisions applying judicial estoppel to bar debtors' civil lawsuits. Important to the *Eubanks* decision was that the debtors had eventually amended their schedules, informed the trustee of the claims at the § 341 meeting, and sought to contact the trustee about the status of the claims. The Sixth Circuit warned that judicial estoppel should be applied narrowly to "avoid impinging on the truth-seeking function of the court, because the doctrine precludes a contradictory position without examining the truth of either statement."[26]

The Seventh Circuit in *Spaine* questioned inferring a debtor's intention to conceal based on a mere nondisclosure where the debtor alleged that she had verbally disclosed her claim to the bankruptcy judge and trustee. A debtor's

12 *See Burnes v. Pemco Aeroplex Inc.*, 291 F.3d. 1282, 1287 (11th Cir. 2002); *Barger v. City of Cartersville, Ga.*, 348 F.3d 1289, 1295 (11th Cir. 2003).
13 *Slater*, 871 F.3d at 1181. Slater noted that the Eleventh Circuit employs a two-part test: (1) whether the party took an inconsistent position; and (2) whether the inconsistent position was calculated to make a mockery of the judicial system.
14 *Id.* at 16-17. The Eleventh Circuit extended the test for assessing a debtor's inadvertence to chapter 13 cases. 871 F.3d at 1182 (citation omitted).
15 *Id.* at 1189.
16 *Id.* at 1185.
17 *Slater*, 871 F.3d at 1187.
18 *Id.*
19 *Id.* at 1188.
20 733 F.3d 267 (9th Cir. 2013).
21 *Id.* at 272.
22 *Id.* at 276-77.
23 733 F.3d at 276.
24 385 F.3d 894 (6th Cir. 2004).
25 756 F.3d 542 (7th Cir. 2014).
26 *Id.* at 897.

continued on page 73

Trustee Talk: Estoppel: Intentional Concealment or Inadvertent Omission?

from page 29

knowledge of a claim, coupled with the "universal motive"[27] of a bankruptcy debtor to conceal assets, without more, the court urged, should not compel an inference that the debtor intended to conceal the claim.

In addition to assessing a debtor's actual intention in failing to disclose a claim, courts have weighed the plight of innocent creditors in applying judicial estoppel. Historically, the Tenth and Fifth Circuits appear to have been most inclined to judicially estop debtors' lawsuits. However, more recent decisions in those circuits suggest a reluctance to invoke judicial estoppel if creditors will be harmed. Two Tenth Circuit decisions, *Anderson v. Seven Falls Co*.[28] and *Eastman v. Union Pacific Railroad Co*.[29] (including one very recent decision), are demonstrative.

In *Anderson*, the Tenth Circuit embraced an inference that the debtor had intended to conceal her claim. Notwithstanding that the debtor had taken pre-petition actions to preserve her personal-injury claim, she failed to disclose it in her schedules or at the § 341 meeting. Post-petition, the debtor commenced a lawsuit but made no supplemental disclosure. Upon learning of the lawsuit, the trustee successfully moved to be substituted as the plaintiff. Although the debtor would be estopped from pursing the claim, the district court limited its application to protect creditors: "'[T]o the extent [the plaintiff's] personal-injury claims were necessary to satisfy the trustee's debts,' judicial estoppel does not apply to a compliant bankruptcy trustee."[30]

In *Eastman v. Union Pacific Railroad Co*., relied upon by *Anderson*, the Tenth Circuit also barred a debtor's pursuit of an undisclosed personal-injury lawsuit. As in *Anderson*, the creditors in *Eastman* were made whole through the chapter 7 trustee's settlement with co-defendants in the debtor's civil lawsuit, so barring the debtor from pursuing the lawsuit would not harm innocent creditors. Significantly, the court stated that application of judicial estoppel would be inappropriate against the trustee, "as the real party-in-interest had not engaged in contradictory litigation tactics."[31] Since the debtor in *Eastman* had expressly denied that the lawsuit existed, once the trustee abandoned the litigation following a payment in full to the creditors, the court easily precluded the debtor from pursuing the lawsuit.

The Fifth Circuit in *In re Superior Crewboats Inc*.[32] applied judicial estoppel to bar the debtors' undisclosed personal-injury lawsuit, but did not address the trustee's standing or the impact on creditors. There, the debtors had actively misled the trustee about the viability of the lawsuit, causing the trustee to abandon the claim. Therefore, the court held that the trustee's motion to be substituted in the lawsuit had been rendered moot, and the debtors were barred from prosecuting the lawsuit. Four years later, however, the Fifth Circuit in *Kane v. National Union Fire Ins. Co*.[33] declined to apply judicial estoppel to a debtor's undisclosed personal-injury claim, distinguishing *Superior Crewboats* because the *Kane* trustee had not abandoned the claim and was the real party-in-interest. Mindful of the interests of creditors, the *Kane* court observed, "[T]he only way the Kanes' creditors would be harmed is if judicial estoppel were applied to bar the Trustee from pursuing the claim against Defendants on behalf of the estate."[34]

In *Reed v. City of Arlington*,[35] the Fifth Circuit upheld a district court ruling that judicially estopped a debtor from collecting a $1 million undisclosed FMLA judgment but permitted the trustee to collect the judgment in an amount sufficient to pay creditors in full. The court noted that the trustee had become the real party-in-interest upon the debtors' bankruptcy filing and the trustee had not abandoned the lawsuit, therefore the debtor's "post-petition misconduct does not adhere to the Trustee."[36] The court reasoned that judicial estoppel "must be applied in such a way as to deter dishonest debtors, whose failure to fully and honestly disclose all their assets undermines the integrity of the bankruptcy system, while protecting the rights of creditors to an equitable distribution of the assets of the debtor's estate."[37]

Conclusion

Courts have demonstrated an increasing inclination to preserve a debtor's undisclosed causes of action for the benefit of creditors, either by assessing a debtor's actual intent to conclude that a debtor's failure to disclose was inadvertent, or by reasoning that while a nondisclosing debtor should be punished, a debtor's misconduct should not be imputed to an innocent trustee who is charged with maximizing an estate for the benefit of creditors. Because the trustee's real party-in-interest status might well be an important consideration, trustees should conduct a thorough inquiry before abandoning a cause of action or lawsuit. abi

27 *Id.* at 548 (citing *Ah Quin*, 733 F.3d at 276-77).
28 696 Fed. App'x 341 (10th Cir. 2017).
29 493 F.3d 1151 (10th Cir. 2007).
30 696 Fed. App'x at 344.
31 493 F.3d at 1155 n.3.
32 374 F.3d 330 (5th Cir. 2004).
33 535 F.3d 380 (5th Cir. 2008).
34 *Id.* at 387.
35 650 F.3d 571 (5th Cir. 2011).
36 *Id.* at 574.
37 *Id.*

Rule 2004 Discovery Severely Limited After Invocation of Fifth Amendment Privilege Against Self-Incrimination

Committee: Commercial Fraud

David M. Guess

Bienert, Miller & Katzman, PLC; San Clemente, Calif.

Date Created: Fri, 2019-01-11 11:58

6

Bankruptcy attorneys usually think of Rule 2004 of the Federal Rules of Bankruptcy Procedure as a near-unstoppable discovery tool that can be used by a debtor-in-possession (DIP), panel trustee or liquidating trustee to obtain documents needed to evaluate and successfully prosecute claims against insiders and others.[1] This tool is a much-needed one, particularly in cases of insider malfeasance, where the insider — not the DIP or trustee — has the needed books and records. The all-powerful Rule 2004 meets its match, however, when faced with the Fifth Amendment privilege against self-incrimination.

In *In re HJH Consulting Group Inc.*,[2] the chapter 11 debtors sought extensive documents pursuant to Rule 2004 from a nondebtor — a former executive of the debtors — who they

alleged committed fraud and breached his fiduciary duty.[3] As the executive invoked the Fifth Amendment privilege against self-incrimination, Chief Bankruptcy Judge Ronald B. King ruled that the debtors were only entitled to the executive's and his franchise's tax returns and W-2 forms from the last four years.[4] The bankruptcy court was particularly keen to protect the executive's Fifth Amendment privilege given the existence of an ongoing, parallel criminal investigation of the executive.[5] The opinion is a thoughtful, thorough and nuanced application of the law on Fifth Amendment privilege in the bankruptcy context.

The Act of Production Doctrine

As noted by the bankruptcy court, the Fifth Amendment privilege may be invoked even where the testimony itself is not directly incriminating. If the witness "believes the testimony provided may travel down the road of possible self-incrimination,"[6] that is enough. It follows then that "Fifth Amendment protections are explicitly extended to protect individuals from being compelled to personally produce documents if the production itself would have testimonial aspects that could be self-incriminating."[7] "[T]he act of production itself may implicitly communicate statements of fact, such as the existence of documents, the defendant's possession and control of the documents, and the documents' authenticity."[8] This is known as the Act of Production Doctrine.

Exceptions: The Foregone Conclusion and the Required Records Doctrines

The primary exceptions to the Act of Production Doctrine are the Foregone Conclusion Doctrine and the Required Records Doctrine.[9] Under the former exception, "the Fifth Amendment privilege does *not* apply where the existence and location of a particular document is a 'foregone conclusion.'"[10] "When those testimonial aspects are absent — control and authenticity are not at issue — the matter is not one of testimony, but merely of surrender."[11] Thus, where the DIP or trustee knows that a third party "prepared documents and delivered them, but is not requiring that the [witness] authenticate or verify them, the risk of self-incrimination is almost nonexistent, absent additional facts. The existence was already known, and the authenticity is verified through the [third party] who created the document instead of through the [witness]."[12] Under the latter exception, the Fifth Amendment is not a proper basis to avoid the production of records required by law to be kept or disclosed to a

public agency. "[R]ecords *not* required by law to be kept or disclosed to a public agency are protected."[13]

The bankruptcy court determined that the Foregone Conclusion Doctrine did not apply because the debtors failed to meet their burden to show its applicability to any documents requested.[14] "The moving party must demonstrate the document's existence and possession are, indeed, foregone conclusions not requiring any declaration of control, authenticity, or actuality. To do so, the moving party must establish its prior awareness and bears the burdens of production and proof on the questions of possession and existence of the documents."[15] Notably, speculation and surmise as to documents is not enough. Even a well-founded general allegation that "'a businessman such as respondent will always possess [certain] general business and tax records'" is insufficient.[16]

The Required Records Doctrine did apply, but only as to the executive's and his franchise's tax returns and W-2 forms from the last four years, as those were the only documents sought that were "required by law to be kept or disclosed to a public agency."[17] Other general business and older tax records and the other extensive documents and communications sought did not have to be produced.[18]

Practical Impacts of Fifth Amendment Invocation

Where an individual with key documents sought by a DIP or trustee appears likely to invoke the Fifth Amendment in response to a Rule 2004 document production request, the DIP or trustee may have little choice but to seek the documents elsewhere,[19] toll the statute of limitations pending the criminal investigation or proceeding, or commence an adversary proceeding within the statute of limitations but then immediately seek to stay that proceeding pending the criminal investigation or proceeding.[20] Although delay is usually the enemy of maximizing estate value and ensuring prompt distributions to creditors, there may be a silver lining. A host of documents and information (including smoking gun documents or testimony, the identification of key witnesses, stipulated and adjudicated facts, and jury verdicts and convictions) may come out of the criminal proceeding, transforming a perhaps initially difficult adversary proceeding into a slam-dunk one, all at the cost, expense and effort of Uncle Sam.

A Parting Warning

Lest anyone be too tempted to invoke the Fifth Amendment, however, the bankruptcy court cautioned that, "[u]nlike in a criminal proceeding, invoking the Fifth Amendment in a civil case allows, but does not require, courts to draw an adverse inference.... Thus, the invocation in a civil — including bankruptcy — case does not come without a price: individuals must balance the benefit of protection from self-incrimination against the risk of negative inferences in the civil action."[21]

---

[1] *See, e.g., In re Enron Corp.*, 281 B.R. 836, 840 (Bankr. S.D.N.Y. 2002) ("As a general proposition, Rule 2004 examinations are appropriate for revealing the nature and extent of the bankruptcy estate ... and for discovering assets, examining transactions, and determining whether wrongdoing has occurred.... In this regard, courts have recognized that Rule 2004 examinations are broad and unfettered and in the nature of fishing expeditions.") (citations and internal quotation marks omitted).

[2] *In re HJH Consulting Group Inc.*, 2018 WL 4090594 (Bankr. W.D. Tex. Aug. 24, 2018).

[3] *Id.* at *1.

[4] *Id.* at *1 and *7.

[5] *Id.* at *1-*3.

[6] *Id.* at *2 (citing *United States v. Burr*, 25 F. Cas. 38, 40 (C.C.D. Va. 1807)).

[7] *Id.* at *3 (citing *Fisher v. United States*, 425 U.S. 391, 410 (1976)).

[8] *Id.* (citing *United States v. Hubbell*, 530 U.S. 27, 36 (2000)).

[9] *Id.* at *4. A third exception, not at issue in *HJH Consulting Group*, is "where the possible testimony has been deemed not to be self-incriminating after an *in camera* review." 2018 WL 4090594, at *6-*7.

[10] *Id.* (citing *Fisher*, 425 U.S. at 411) (emphasis in original).

[11] *Id.*

[12] *Id.* (citing *Hubbell*, 530 U.S. at 44-45).

[13] *Id.* (citing *United States v. Doe*, 465 U.S. 605, 607 n.3 (1984)) (emphasis in original).

[14] *Id.*

[15] *Id.* (citing cases).

[16] *Id.* at *5 (quoting *Hubbell*, 530 U.S. at 45).

[17] *Id.* at *4 and *6.

[18] *Id.* at *6.

[19] *Id.* (suggesting some communications might be more easily obtained from the debtors' employees).

[20] *Id.* at *3 (while there is an ongoing criminal investigation or proceeding, "in some instances, discovery should be deferred, questions must be omitted, or the proceeding should be stayed").

[21] *Id.* at *2 (citing *Baxter v. Palmigiano*, 425 U.S. 308, 318 (1976)); *see also, e.g., In re Martinez*, 500 B.R. 608, 615-16 (Bankr. N.D. Cal. 2013) (discussing when an adverse inference is and is not appropriate).

ABI EXCLUSIVE

SEPTEMBER 16, 2022

Seventh Circuit Limits a U.S. Court's Jurisdiction over Creditors Abroad

> Foreign creditors not subject to 'specific personal jurisdiction' in the U.S. can violate the automatic stay with impunity.

While U.S. bankruptcy courts are reorganizing large companies headquartered and operating chiefly abroad, the Seventh Circuit laid down rules barring U.S. bankruptcy courts from stopping foreign creditors from taking action against a debtor's assets abroad when the U.S. court has no general or specific personal jurisdiction over the creditors.

The debtor was a U.S. citizen who borrowed money from a bank in Ireland to purchase stock in an Irish company and real property in Ireland. The debtor gave the bank a lien on the stock and real property to secure the loan.

After the debtor defaulted on the loan, the bank sold the loan to an Irish purchaser, whom we shall call the creditor. The creditor began foreclosure proceedings in Ireland. After lengthy litigation, the Irish court appointed an Irish receiver to take possession and sell the stock and the real property.

Before the receiver sold the collateral, the debtor filed a chapter 11 petition in Chicago, notified the creditor and the receiver about the bankruptcy, and demanded that the receiver return possession of the property to the debtor. The creditor and the debtor declined.

So, the debtor filed an adversary proceeding in the Chicago bankruptcy court, contending that the creditor and the receiver were violating the automatic stay. The debtor wanted the bankruptcy court to return possession of the collateral to the debtor.

The receiver and the creditor filed a motion to dismiss for lack of personal jurisdiction. The bankruptcy court granted the motion, and the district court agreed that the bankruptcy court lacked personal jurisdiction over the receiver and the creditor. The debtor appealed to the circuit.

In an opinion on September 7, Circuit Judge Ilana Rovner affirmed.

The appeal was measured against the demands of due process that a defendant from elsewhere must have minimum contacts with the forum and that maintenance of the suit must not offend notions of fair play and substantial justice.

Neither the receiver nor the creditor had any connections with Illinois, but the debtor contended that the bankruptcy court's *in rem* jurisdiction over the collateral conferred personal jurisdiction over the defendants.

The debtor's argument went nowhere. Judge Rovner conceded that the U.S. court had jurisdiction over the property in Ireland, but she said that a U.S. bankruptcy court cannot enforce the stay abroad unless the court has personal jurisdiction over the party holding the property.

Next, the debtor tried a legal fiction: The debtor's property abroad is subject to the legal fiction of being located in Illinois. Based on the fiction, the debtor contended that the actions by the receiver and the creditor "must have occurred (fictionally) in Illinois," Judge Rovner said.

Judge Rovner saw no authority for the idea "linking personal jurisdiction to *in rem* jurisdiction." Instead, she said the court must have either general or specific personal jurisdiction over the party. The debtor admitted that there was no general jurisdiction over the defendants, who were Irish citizens and conducted business in Ireland.

So, Judge Rovner turned to specific personal jurisdiction. She said it requires that the defendants must have "purposefully directed their actions at the forum state" and that the alleged injury must have arisen from forum-state activities. In addition, the exercise of jurisdiction must comport with notions of fair play and substantial justice.

Granted, the defendants had contacts with the debtor, but "the defendants' minimum contacts must be with the forum itself and not merely with a person who resides there," Judge Rovner said. Similarly, she said, the "focus on a defendant's activities means that it is not enough that the defendant took some action that ultimately had an effect on the plaintiff in the forum."

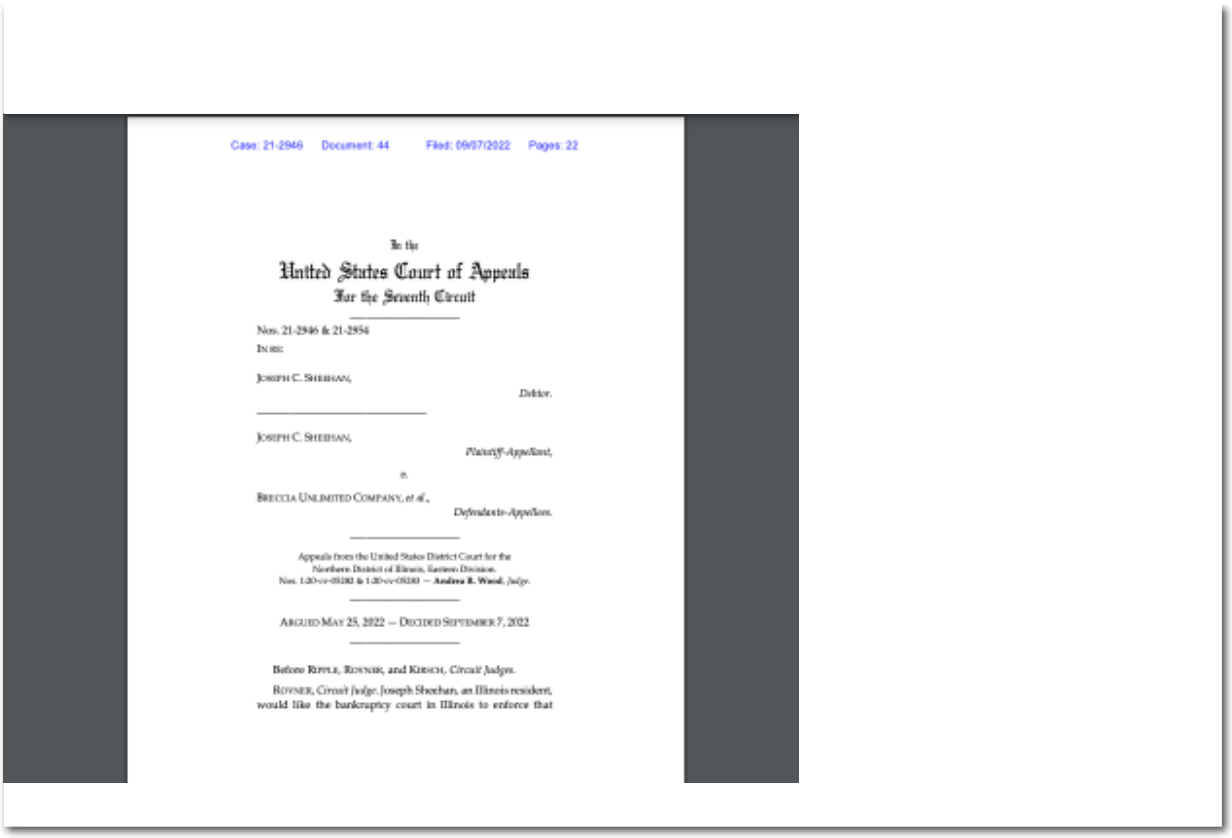
Focusing on the facts, Judge Rovner said that the "Irish defendants directed their activity at Irish property located in Ireland and which served as collateral for a loan made by an Irish bank . . . . None of the defendants did anything to reach out to the United States and affiliate themselves with the United States or Illinois." She said that specific personal jurisdiction "cannot be based on the plaintiff's mere presence in the forum or on the 'unilateral activity' of a plaintiff."

Likewise, Judge Rovner said, "the fact that the defendants could have foreseen that their conduct would affect [the debtor] in Illinois was insufficient to establish personal jurisdiction."

Concluding that the creditor and the receiver had no minimum contacts with the U.S., Judge Rovner upheld dismissal and therefore had no reason to decide whether exercising personal jurisdiction would violate notions of fair play and substantial justice.

Opinion Link

PREVIEW



Case: 21-2946 Document: 44 Filed: 09/07/2022 Pages: 22

In the
United States Court of Appeals
For the Seventh Circuit

Nos. 21-2946 & 21-2954
IN RE:

JOSEPH C. SHEEHAN,
Debtor.

JOSEPH C. SHEEHAN,
Plaintiff-Appellant,

v.

BRECCIA UNLIMITED COMPANY, *et al.*,
Defendants-Appellees.

Appeals from the United States District Court for the Northern District of Illinois, Eastern Division.
Nos. 1:20-cv-05282 & 1:20-cv-05283 — **Andrea R. Wood**, *Judge.*

ARGUED MAY 25, 2022 — DECIDED SEPTEMBER 7, 2022

Before RIPPLE, ROVNER, and KIRSCH, *Circuit Judges.*

ROVNER, *Circuit Judge.* Joseph Sheehan, an Illinois resident, would like the bankruptcy court in Illinois to enforce that

https://abi-opinions.s3.amazonaws.com/Sheehan.pdf

Case Details

Case Citation	Sheehan v. Breccia Unlimited Co. (In re Sheehan), 21-2946 (7th Cir. Sept. 9, 2022)
Case Name	Sheehan v. Breccia Unlimited Co. (In re Sheehan)
Case Type	Business
Court	7th Circuit
Bankruptcy Tags	Venue/Jurisdiction Business Reorganization

Faculty

Tiffany L. Carroll is the Acting U.S. Trustee for Region 15 in San Diego, covering the Southern District of California, the Districts of Hawaii and Guam, and the Northern Mariana Islands. She became the Assistant U.S. Trustee in the San Diego office, covering the Southern District of California in 2005 after serving as a trial attorney and attorney advisor for the U.S. Trustee Program since 1991. In December 2000, Ms. Carroll received the Executive Office for U.S. Trustee's Director's Award for Excellence in Legal Advocacy. She received her her undergraduate degree from Pitzer College in Claremont, Calif., and her J.D. from Seattle University School of Law in Tacoma, Wash.

Marshall S. Huebner co-heads Davis Polk & Wardwell LLP's Insolvency and Restructuring Group in New York, where he focuses his practice on corporate restructuring and insolvency law. He advises purchasers, companies and boards of directors in many non-public distressed matters, and has provided risk-management and bankruptcy advice on derivative products and other complex transactions. Mr. Huebner has authored numerous articles on bankruptcy law, including the bankruptcy chapter of the leading guide to broker-dealer regulation, and is a contributing editor for the *Collier Bankruptcy Practice Guide*. He is a member of the National Bankruptcy Conference and a Fellow in the American College of Bankruptcy. In addition, he is one of only five U.S. lawyers to have been twice named a "Dealmaker of the Year" by *The American Lawyer*. Mr. Huebner served as lead counsel to the Federal Reserve Bank of New York and to the U.S. Department of the Treasury with respect to their $182 billion in multiple financings and 79.9% equity stake in AIG. He is also counsel to the joint administrators and liquidators of Lehman Brothers International and its U.K. Lehman affiliates. Mr. Huebner was lead counsel to Citibank, as bank agent, in *Lyondell* in the largest private DIP financing in U.S. history. He has also routinely advised purchasers, companies and boards of directors in many non-public distressed matters, and provides risk-management and bankruptcy advice on derivatives products and other complex transactions to clients such as Morgan Stanley, J.P. Morgan, Citibank, Goldman Sachs, Credit Suisse and Bank of America Securities. Mr. Huebner testified by invitation before the House Judiciary Subcommittee on Commercial and Administrative Law on how to restructure the Bankruptcy Code to strike a better balance between debtors' needs for reorganization tools and the needs of and issues facing employees of companies in chapter 11. He graduated *magna cum laude* from Princeton University in 1988, where he was awarded Fulbright and Rotary Scholarships, and he received his J.D. from Yale Law School, where he was awarded a Ford Foundation Fellowship and was a senior editor of the *Yale Law Journal*.

Hon. Christopher S. Sontchi is a retired U.S. Bankruptcy Judge for the District of Delaware in Wilmington, initially appointed in 2006, and a professional neutral with Delaware ADR in Hockessin, Del. He also served a term as the court's Chief Judge. Judge Sontchi was recently appointed as an International Judge of the Singapore International Commercial Court. He is a frequent speaker in the U.S. and abroad on issues relating to corporate reorganizations, and he has been a Lecturer in Law at The University of Chicago Law School. In addition, he has taught corporate bankruptcy to international judges through the auspices of the World Bank and INSOL International. Judge Sontchi is a member of the International Insolvency Institute, Judicial Insolvency Network, National Conference of Bankruptcy Judges, ABI and INSOL International. He was recently appointed to the International Advisory Council of the Singapore Global Restructuring Initiative and the Founders'

Committee of The University of Chicago Law School's Center on Law and Finance. Judge Sontchi has testified before Congress on the safe harbors for financial contracts, and has published articles on creditors' committees, valuation, asset sales and safe harbors. Prior to his appointment, he was in private practice, representing a wide variety of nationally based enterprises with diverse interests in most of the larger chapter 11 reorganization proceedings filed in Delaware. Judge Sontchi served on the ABI Commission to Study the Reform of Chapter 11's Financial Contracts, Derivatives and Safe Harbors Committee and testified on safe harbors for financial contracts before the Subcommittee on Regulatory Reform, Commercial and Antitrust Law of the House Committee on the Judiciary. Following law school, Judge Sontchi clerked for Hon. Joseph T. Walsh in the Delaware Supreme Court. He received his B.A. Phi Beta Kappa with distinction in political science from the University of North Carolina at Chapel Hill and his J.D. from the University of Chicago Law School.

Gary R. Stickell is a sole practitioner with Gary R. Stickell, Attorney at Law in Phoenix, and represents individuals in bankruptcy. A leader in the Arizona bankruptcy community, he co-founded and serves on the board of the Arizona Consumer Bankruptcy Counsel. Mr. Stickell was an inaugural Master of the Arizona Bankruptcy American Inn of Court and served as a member of the Court's Education Committee and Uniform Practices Committee. He also regularly provides guidance and advice at the bankruptcy court's Self-Help Center. Mr. Stickell speaks regularly on consumer bankruptcy topics. In recognition of efforts to mentor and educate lawyers new to the practice of consumer bankruptcy, he received the 2010 Award of Special Merit from the State Bar of Arizona. He also was honored as a Member of the Year by the Arizona Consumer Counsel in 2011, and he received the *Pro Bono* Distinguished Service Award from the Bankruptcy Section of the Arizona State Bar for his "extraordinary efforts to establish the Chapter 13 Expert Panel." In addition to his membership in Arizona Consumer Bankruptcy Counsel, Mr. Stickell is a member of ABI, the National Association of Consumer Bankruptcy Attorneys and the NACTT Academy. He has been licensed to practice in Arizona since 1982. Mr. Stickell received his Bachelor's degree from George Washington University and his J.D. in 1981 from Boston University.

Hon. J. Kate Stickles is a U.S. Bankruptcy Judge for the District of Delaware in Wilmington, appointed on April 6, 2021. Previously, she was member of Cole Schotz P.C.'s Bankruptcy and Corporate Restructuring Department in its Wilmington, Del., office and practiced in the areas of corporate bankruptcy, insolvency and creditors' rights, having represented debtors, official committees, creditors, examiners and trustees in chapter 11 cases. Judge Stickles has been named in *Chambers USA: America's Leading Lawyers for Business* since 2010 and has been listed in *The Best Lawyers in America* and in *Delaware Super Lawyers* in the area of Bankruptcy and Creditor-Debtor Rights Law. She served as counsel to chapter 11 debtors in a variety of industries, including manufacturing and distribution, telecommunications, health care and media, in some of Delaware's most significant bankruptcy cases. Judge Stickles has published in, and served as a contributing editor for, the *ABI Journal* and has also published in *The Americas Restructuring and Insolvency Guide*, the ABI Bankruptcy Litigation Committee eNewsletter and the ABI Commercial Fraud Committee eNewsletter. Judge Stickles is active in the Bankruptcy Section of the Delaware State Bar Association, having served as the Section's chair (2010-11), vice chair Commercial Bankruptcy (2009-10) and secretary (2008-09). She is also a member of the Delaware Views from the Bench Advisory Board and the International Women's Insolvency & Restructuring Confederation (IWIRC), for which she served as director-at-large from 2010-11. Judge Stickles received her B.A. in political science and communications from Western Maryland College and her J.D. from Temple University School of Law.

Hon. Eugene R. Wedoff served as a U.S. Bankruptcy Judge for the Northern District of Illinois in Chicago from 1987-2015 and as chief judge from 2002-07. A former ABI Chairman and President, he served on ABI's Commission on Consumer Bankruptcy and devotes his present legal practice exclusively to *pro bono* representations in bankruptcy appeals. Judge Wedoff presided over the chapter 11 reorganization of United Air Lines, was a member of the Advisory Committee on Bankruptcy Rules from 2004-14 and served as its chair after 2010. His work on the Rules Committee involved both the implementation of the means test forms and creation of the national form for chapter 13 plans. Judge Wedoff was the president of the National Conference of Bankruptcy Judges from 2013-14 and also served as a member of the NCBJ's Board of Governors as its secretary and as chair of its education committee. Judge Wedoff is a Fellow in the American College of Bankruptcy, as well as a member of the National Bankruptcy Conference. He is the author of the chapter on professional employment in Queenan, Hendel and Hillinger, *Chapter 11 Theory and Practice* (LRP Publications 1994) and was an associate editor of the *American Bankruptcy Law Journal*. Judge Wedoff is a frequent lecturer and served as a member of the Federal Judicial Center's Committee on Bankruptcy Judge Education. In 2016, he received the Judge William L. Norton Jr. Judicial Excellence Award; in 2009, he received the Lawrence P. King Award from the Commercial Law League; and in 1995, he received the Excellence in Education Award from the NCBJ. Judge Wedoff graduated from the college and law school of the University of Chicago.