American Bankruptcy Institute

2019 Southwest Bankruptcy Conference

Hotcakes and Hot Topics: Judges' Roundtable Q&A

Andrew A. Harnisch, Moderator
May, Potenza, Baran & Gillespie, P.C.; Phoenix

2019

JUDICIAL ROUNDTABLE Q&A SESSION

September 7, 2019

Moderator

Andrew A. Harnisch
May, Potenza, Baran & Gillespie, PC, Phoenix, AZ

Hon. Daniel P. Collins
U.S. Bankruptcy Court (D. Arizona)

Hon. Hannah L. Blumenstiel
U.S. Bankruptcy Court (N.D. California)

Hon. Bruce A. Harwood
U.S. Bankruptcy Court (D.New Hampshire)

Hon. Redfield T. Baum
U.S. Bankruptcy Court (D. Arizona)

Hon. Madeleine C. Wanslee
U.S. Bankruptcy Court (D. Arizona)

Hon. Augie Landis
U.S. Bankruptcy Court (D. Nevada)

Hon. Kevin Carey
U.S. Bankruptcy Court (D. Delaware)

Hon. David T. Thuma
U.S. Bankruptcy Court (D. New Mexico)

ABI CONFERENCE – SEPTEMBER 2019

JUDICIAL ROUNDTABLE

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2	**Hannah Blumenstiel**	Treatment of IP licenses upon rejection: *Mission Prod. Holdings, Inc. v. Tempnology LLC*, 879 F.3d 389 (1st Cir. 2018)
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1. THE HONORABLE AUGIE LANDIS

Topic: Standards for holding creditors in contempt for violations of the automatic stay: *Taggart v. Lorenzen* (*In re Taggart*), ____ U.S. ___, 139 S. Ct. 1795 (2019).

139 S.Ct. 1795
Supreme Court of the United States.

Bradley Weston TAGGART, Petitioner
v.
Shelley A. LORENZEN, Executor of the Estate of Stuart Brown, et al.

No. 18-489
|
Argued April 24, 2019
|
Decided June 3, 2019

Synopsis
Background: Former Chapter 7 debtor filed motion to hold attorney and his clients in contempt for willfully violating discharge injunction. The United States Bankruptcy Court for the District of Oregon, Randall L. Dunn, J., 2011 WL 6140521, denied motion, and also denied subsequent motion for reconsideration, 2012 WL 280726. Debtor appealed. The District Court, Mosman, J., 2012 WL 3241758, reversed. On remand, the Bankruptcy Court, Dunn, J., 522 B.R. 627, entered order awarding contempt sanctions. Appeal was taken. The Bankruptcy Appellate Panel (BAP), Jury, J., 548 B.R. 275, reversed and vacated. Both sides appealed. The Court of Appeals for the Ninth Circuit, Bea, Circuit Judge, 888 F.3d 438, affirmed. Certiorari was granted.

[Holding:] The Supreme Court, Justice Breyer, held that a bankruptcy court may hold a creditor in civil contempt for violating a discharge order if there is no fair ground of doubt as to whether the order barred the creditor's conduct, that is, if there is no objectively reasonable basis for concluding that the creditor's conduct might be lawful.

Vacated and remanded.

West Headnotes (20)

[1] **Bankruptcy**
Discharge as injunction

"Discharge order," an order that is typically entered by bankruptcy court at conclusion of bankruptcy proceeding and releases the debtor from liability for most pre-bankruptcy debts, bars creditors from attempting to collect any debt covered by the order. 11 U.S.C.A. § 524(a)(2).

1 Cases that cite this headnote

[2] **Bankruptcy**
Liquidation, Distribution, and Closing

Chapter 7 of the Bankruptcy Code permits insolvent debtors to discharge their debts by liquidating assets to pay creditors. 11 U.S.C.A. §§ 704(a)(1), 726.

Cases that cite this headnote

[3] **Bankruptcy**
Discharge as injunction

Bankruptcy court's discharge order operates as an injunction that bars creditors from collecting any debt that has been discharged. 11 U.S.C.A. § 524(a)(2).

3 Cases that cite this headnote

[4] **Bankruptcy**
Violation of discharge order

Bankruptcy court may hold a creditor in civil contempt for violating a discharge order if there is no fair ground of doubt as to whether the order barred the creditor's conduct, that is, if there is no objectively reasonable basis for concluding that the creditor's conduct might be lawful under the discharge order; based on the traditional principles that govern civil contempt, the proper standard is an objective one, not a standard akin to strict liability or a purely subjective standard, and such objective standard strikes the careful balance between interests of creditors and debtors that the Bankruptcy Code often seeks to achieve. 11 U.S.C.A. §§ 105(a), 524(a)(2).

7 Cases that cite this headnote

[5] **Statutes**
Other Law, Construction with Reference to

When a statutory term is obviously "transplanted" from another legal source, it "brings the old soil" with it.

1 Cases that cite this headnote

[6] **Injunction**
Contempt

Under traditional principles of equity practice, courts have long imposed civil contempt sanctions to coerce the defendant into compliance with an injunction or compensate the complainant for losses stemming from the defendant's noncompliance with an injunction.

Cases that cite this headnote

[7] **Bankruptcy**
Violation of discharge order

Bankruptcy statutes do not grant courts unlimited authority to hold creditors in civil contempt for violating the discharge injunction; instead, the statutes incorporate the traditional standards in equity practice for determining when a party may be held in civil contempt for violating an injunction. 11 U.S.C.A. § 524(a)(2).

3 Cases that cite this headnote

[8] **Bankruptcy**
Contempt
Contempt
Weight and sufficiency

In cases outside the bankruptcy context, civil contempt should not be resorted to where there is a fair ground of doubt as to the wrongfulness of the defendant's conduct.

3 Cases that cite this headnote

[9] **Contempt**
Civil contempt
Injunction
Contempt

Civil contempt is a severe remedy, and so principles of basic fairness require that those enjoined receive explicit notice of what conduct is outlawed before being held in civil contempt.

3 Cases that cite this headnote

[10] **Contempt**
Civil contempt

Standard for civil contempt is generally an objective one.

Cases that cite this headnote

[11] **Contempt**
Disobedience to Mandate, Order, or Judgment

Party's subjective belief that she was complying with an order ordinarily will not insulate her from civil contempt if that belief was objectively unreasonable.

Cases that cite this headnote

[12] **Contempt**
Disobedience to Mandate, Order, or Judgment

Absence of wilfulness does not relieve one from civil contempt.

1 Cases that cite this headnote

[13] **Contempt**
Disobedience to Mandate, Order, or Judgment

Subjective intent is not always irrelevant to a determination of civil contempt; civil contempt sanctions may be warranted, for example, when a party acts in bad faith.

Cases that cite this headnote

[14] **Contempt**
Disobedience to Mandate, Order, or Judgment

Party's good faith, even where it does not bar civil contempt, may help to determine an appropriate sanction.

Cases that cite this headnote

[15] **Bankruptcy**
Violation of discharge order

Under the fair ground of doubt standard, civil contempt may be appropriate when the creditor violates a discharge order based on an objectively unreasonable understanding of the discharge order or the statutes that govern its scope. 11 U.S.C.A. § 524(a)(2).

6 Cases that cite this headnote

[16] **Contempt**
Disobedience to Mandate, Order, or Judgment

Under traditional civil contempt principles, parties cannot be insulated from a finding of civil contempt based on their subjective good faith.

Cases that cite this headnote

[17] **Bankruptcy**
Purpose

A chief purpose of the bankruptcy laws is to secure a prompt and effectual resolution of bankruptcy cases within a limited period.

Cases that cite this headnote

[18] **Bankruptcy**
Automatic Stay

Automatic stay, which is entered at the outset of a bankruptcy proceeding, aims to prevent damaging disruptions to administration of the bankruptcy case in the short run. 11 U.S.C.A. § 362.

Cases that cite this headnote

[19] **Bankruptcy**
Discharge as injunction

Discharge, which is entered at the end of the bankruptcy case, seeks to bind creditors over a much longer period than the automatic stay. 11 U.S.C.A. §§ 362, 524(a)(2).

Cases that cite this headnote

[20] **Bankruptcy**
Enforcement of Injunction or Stay

Word "willful," as used in the Bankruptcy Code's automatic stay provision, is one that the law typically does not associate with strict liability, but whose construction is often dependent on the context in which it appears. 11 U.S.C.A. § 362.

Cases that cite this headnote

Syllabus[*]

Petitioner Bradley Taggart formerly owned an interest in an Oregon company. That company and two of its other owners, who are among the respondents here, filed suit in Oregon state court, claiming that Taggart had breached the company's operating agreement. Before trial, Taggart filed for bankruptcy under Chapter 7 of the Bankruptcy Code. At the conclusion of that proceeding, the Federal Bankruptcy Court issued a discharge order that released Taggart from liability for most prebankruptcy debts. After the discharge order issued, the Oregon state court entered judgment against Taggart in the prebankruptcy suit and awarded attorney's fees to respondents. Taggart returned to the Federal Bankruptcy Court, seeking civil contempt sanctions against respondents for collecting attorney's fees in violation of the discharge order. The Bankruptcy Court ultimately held respondents in civil contempt. The Bankruptcy Appellate Panel vacated the sanctions, and the Ninth Circuit affirmed the panel's decision. Applying a subjective standard, the Ninth Circuit concluded that a "creditor's good faith belief" that the discharge order "does not apply to the creditor's claim precludes a finding of contempt, even if the creditor's belief if unreasonable." 888 F. 3d 438, 444.

Held: A court may hold a creditor in civil contempt for violating a discharge order if there is *no fair ground of doubt* as to whether the order barred the creditor's conduct. Pp. 1800 – 1804——.

(a) This conclusion rests on a longstanding interpretive principle: When a statutory term is " 'obviously transplanted from another legal source,' " it " 'brings the old soil with it.' " *Hall* v. *Hall*, 584 U.S. ——, ——, 138 S.Ct. 1118, 1128, 200 L.Ed.2d 399. Here, the bankruptcy statutes specifying that a discharge order "operates as an injunction," 11 U.S.C. § 524(a)(2), and that a court may issue any "order" or "judgment" that is "necessary or appropriate" to "carry out" other bankruptcy provisions, § 105(a), bring with them the "old soil" that has long governed how courts enforce injunctions. In cases outside the bankruptcy context, this Court has said that civil contempt "should not be resorted to where there is [a] fair ground of doubt as to the wrongfulness of the defendant's conduct." *California Artificial Stone Paving Co. v. Molitor*, 113 U.S. 609, 618, 5 S.Ct. 618, 28 L.Ed. 1106. This standard is generally an objective one. A party's subjective belief that she was complying with an order ordinarily will not insulate her from civil contempt if that belief was objectively unreasonable. Subjective intent, however, is not always irrelevant. Civil contempt sanctions may be warranted when a party acts in bad faith, and a party's good faith may help to determine an appropriate sanction. These traditional civil contempt principles apply straightforwardly to the bankruptcy discharge context. Under the fair ground of doubt standard, civil contempt may be appropriate when the creditor violates a discharge order based on an objectively unreasonable understanding of the discharge order or the statutes that govern its scope. Pp. 1801 – 1802.

(b) The standard applied by the Ninth Circuit is inconsistent with traditional civil contempt principles, under which parties cannot be insulated from a finding of civil contempt based on their subjective good faith. Taggart, meanwhile, argues for a standard that would operate much like a strict-liability standard. But his proposal often may lead creditors to seek advance determinations as to whether debts have been discharged, creating the risk of additional federal litigation, additional costs, and additional delays. His proposal, which follows the standard some courts have used to remedy violations of automatic stays, also ignores key differences in text and purpose between the statutes governing automatic stays and discharge orders. Pp. 1802 – 1804.

888 F. 3d 438, vacated and remanded.

BREYER, J., delivered the opinion for a unanimous Court.

Attorneys and Law Firms

***1797** Janet M. Schroer, Hart Wagner, LLP, James Ray

Streinz, Streinz Law Office LLC, Hollis K. McMilan, Hollis K. McMilan, PC, Portland, OR, Nicole A. Saharsky, Andrew E. Tauber, Michael B. Kimberly, Matthew A. Waring, Minh Nguyen-Dang, Mayer Brown LLP, Washington, DC, Aaron Gavant, Mayer Brown LLP, Chicago, IL, for Respondents.

John M. Berman, Tigard, OR, Daniel L. Geyser, Geyser P.C., Dallas, TX, for Petitioner.

Daniel L. Geyser, Dallas, TX, for Petitioner.

Nicole A. Saharsky, Washington, DC, for Respondents.

Sopan Joshi for the United States as amicus curiae, by special leave of the Court, in support of neither party.

Opinion

Justice BREYER delivered the opinion of the Court.

***1799** [1]At the conclusion of a bankruptcy proceeding, a bankruptcy court typically enters an order releasing the debtor from liability for most prebankruptcy debts. This order, known as a discharge order, bars creditors from attempting to collect any debt covered by the order. See 11 U.S.C. § 524(a)(2). The question presented here concerns the criteria for determining when a court may hold a creditor in civil contempt for attempting to collect a debt that a discharge order has immunized from collection.

The Bankruptcy Court, in holding the creditors here in civil contempt, applied a standard that it described as akin to "strict liability" based on the standard's expansive scope. *In re Taggart*, 522 B. R. 627, 632 (Bkrtcy. D.Ct. Ore. 2014). It held that civil contempt sanctions are permissible, irrespective of the creditor's beliefs, so long as the creditor was " 'aware of the discharge' " order and " 'intended the actions which violate[d]' " it. *Ibid.* (quoting *In re Hardy*, 97 F. 3d 1384, 1390 (CA11 1996)). The Court of Appeals for the Ninth Circuit, however, disagreed with that standard. Applying a subjective standard instead, it concluded that a court cannot hold a creditor in civil contempt if the creditor has a "good faith belief" that the discharge order "does not apply to the creditor's claim." *In re Taggart*, 888 F. 3d 438, 444 (2018). That is so, the Court of Appeals held, "even if the creditor's belief is unreasonable." *Ibid.*

We conclude that neither a standard akin to strict liability nor a purely subjective standard is appropriate. Rather, in our view, a court may hold a creditor in civil contempt for violating a discharge order if there is *no fair ground of doubt* as to whether the order barred the creditor's conduct. In other words, civil contempt may be appropriate if there is no objectively reasonable basis for concluding that the creditor's conduct might be lawful.

I

Bradley Taggart, the petitioner, formerly owned an interest in an Oregon company, Sherwood Park Business Center. That company, along with two of its other owners, brought a lawsuit in Oregon state court, claiming that Taggart had breached the Business Center's operating agreement. (We use the name "Sherwood" to refer to the company, its two owners, and—in some instances—their former attorney, who is now represented by the executor of his estate. The company, the two owners, and the executor are the respondents in this case.)

[2] [3]Before trial, Taggart filed for bankruptcy under Chapter 7 of the Bankruptcy Code, which permits insolvent debtors to discharge their debts by liquidating ***1800** assets to pay creditors. See 11 U.S.C. §§ 704(a)(1), 726. Ultimately, the Federal Bankruptcy Court wound up the proceeding and issued an order granting him a discharge. Taggart's discharge order, like many such orders, goes no further than the statute: It simply says that the debtor "shall be granted a discharge under § 727." App. 60; see United States Courts, Order of Discharge: Official Form 318 (Dec. 2015), http:/ /www.uscourts.gov / sites / default / files /form _ b318_0.pdf (as last visited May 31, 2019). Section 727, the statute cited in the discharge order, states that a discharge relieves the debtor "from all debts that arose before the date of the order for relief," "[e]xcept as provided in section 523." § 727(b). Section 523 then lists in detail the debts that are exempt from discharge. §§ 523(a)(1)–(19). The words of the discharge order, though simple, have an important effect: A discharge order "operates as an injunction" that bars creditors from collecting any debt that has been discharged. § 524(a)(2).

After the issuance of Taggart's federal bankruptcy discharge order, the Oregon state court proceeded to enter judgment against Taggart in the prebankruptcy suit involving Sherwood. Sherwood then filed a petition in state court seeking attorney's fees that were incurred *after* Taggart filed his bankruptcy petition. All parties agreed that, under the Ninth Circuit's decision in *In re Ybarra*, 424 F. 3d 1018 (2005), a discharge order would normally cover and thereby discharge postpetition attorney's fees stemming from prepetition litigation (such as the Oregon litigation) *unless* the discharged debtor " 'returned to the fray' " after filing for bankruptcy. *Id.*, at 1027. Sherwood argued that Taggart had "returned to the fray" postpetition and therefore was liable for the postpetition attorney's fees that Sherwood sought to collect. The state trial court agreed and held Taggart liable for roughly $ 45,000 of Sherwood's postpetition attorney's fees.

At this point, Taggart returned to the Federal Bankruptcy Court. He argued that he had not returned to the state-court "fray" under *Ybarra*, and that the discharge order therefore barred Sherwood from collecting postpetition attorney's fees. Taggart added that the court should hold Sherwood in civil contempt because Sherwood had violated the discharge order. The Bankruptcy Court did not agree. It concluded that Taggart had returned to the fray. Finding no violation of the discharge order, it refused to hold Sherwood in civil contempt.

Taggart appealed, and the Federal District Court held that Taggart had not returned to the fray. Hence, it concluded that Sherwood violated the discharge order by trying to collect attorney's fees. The District Court remanded the case to the Bankruptcy Court.

The Bankruptcy Court, noting the District Court's decision, then held Sherwood in civil contempt. In doing so, it applied a standard it likened to "strict liability." 522 B. R. at 632. The Bankruptcy Court held that civil contempt sanctions were appropriate because Sherwood had been " 'aware of the discharge' " order and " 'intended the actions which violate[d]' " it. *Ibid.* (quoting *In re Hardy*, 97 F. 3d at 1390). The court awarded Taggart approximately $ 105,000 in attorney's fees and costs, $ 5,000 in damages for emotional distress, and $ 2,000 in punitive damages.

Sherwood appealed. The Bankruptcy Appellate Panel vacated these sanctions, and the Ninth Circuit affirmed the panel's decision. The Ninth Circuit applied a very different standard than the Bankruptcy Court. It concluded that a "creditor's good faith belief" that the discharge order "does not apply to the creditor's claim precludes a finding of contempt, even if the creditor's ***1801** belief is unreasonable." 888 F. 3d at 444. Because Sherwood had a "good faith belief" that the discharge order "did not apply" to Sherwood's claims, the Court of Appeals held that civil contempt sanctions were improper. *Id.*, at 445.

Taggart filed a petition for certiorari, asking us to decide whether "a creditor's good-faith belief that the discharge injunction does not apply precludes a finding of civil contempt." Pet. for Cert. I. We granted certiorari.

II

[4]The question before us concerns the legal standard for holding a creditor in civil contempt when the creditor attempts to collect a debt in violation of a bankruptcy discharge order. Two Bankruptcy Code provisions aid our efforts to find an answer. The first, section 524, says that a discharge order "operates as an injunction against the commencement or continuation of an action, the employment of process, or an act, to collect, recover or offset" a discharged debt. 11 U.S.C. § 524(a)(2). The second, section 105, authorizes a court to "issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title." § 105(a).

In what circumstances do these provisions permit a court to hold a creditor in civil contempt for violating a discharge order? In our view, these provisions authorize a court to impose civil contempt sanctions when there is no objectively reasonable basis for concluding that the creditor's conduct might be lawful under the discharge order.

A

[5]Our conclusion rests on a longstanding interpretive principle: When a statutory term is " 'obviously transplanted from another legal source,' " it " 'brings the old soil with it.' " *Hall* v. *Hall*, 584 U.S. ––––, ––––, 138 S.Ct. 1118, 1128, 200 L.Ed.2d 399 (2018) (quoting Frankfurter, Some Reflections on the Reading of Statutes, 47 Colum. L. Rev. 527, 537 (1947)); see *Field v. Mans*, 516 U.S. 59, 69–70, 116 S.Ct. 437, 133 L.Ed.2d 351 (1995) (applying that principle to the Bankruptcy Code). Here, the statutes specifying that a discharge order "operates as an injunction," § 524(a)(2), and that a court may issue any "order" or "judgment" that is "necessary or appropriate" to "carry out" other bankruptcy provisions, § 105(a), bring with them the "old soil" that has long governed how courts enforce injunctions.

[6]That "old soil" includes the "potent weapon" of civil contempt. *Longshoremen v. Philadelphia Marine Trade Assn.*, 389 U.S. 64, 76, 88 S.Ct. 201, 19 L.Ed.2d 236 (1967). Under traditional principles of equity practice, courts have long imposed civil contempt sanctions to "coerce the defendant into compliance" with an injunction or "compensate the complainant for losses" stemming from the defendant's noncompliance with an injunction. *United States v. Mine Workers*, 330 U.S. 258, 303–304, 67 S.Ct. 677, 91 L.Ed. 884 (1947); see D. Dobbs & C. Roberts, Law of Remedies § 2.8, p. 132 (3d ed. 2018); J. High, Law of Injunctions § 1449, p. 940 (2d ed. 1880).

[7]The bankruptcy statutes, however, do not grant courts unlimited authority to hold creditors in civil contempt. Instead, as part of the "old soil" they bring with them, the bankruptcy statutes incorporate the traditional standards in equity practice for determining when a party may be held in civil contempt for violating an injunction.

[8] [9]In cases outside the bankruptcy context, we have said that civil contempt "should not be resorted to where there is [a] *fair ground of doubt* as to the wrongfulness of the defendant's conduct." ***1802** *California Artificial Stone Paving Co. v. Molitor*, 113 U.S. 609, 618, 5 S.Ct. 618, 28 L.Ed. 1106 (1885) (emphasis added). This standard reflects the fact that civil contempt is a "severe remedy," *ibid.*, and that principles of "basic fairness requir[e] that those enjoined receive explicit notice" of "what conduct is outlawed" before being held in civil contempt, *Schmidt v. Lessard*, 414 U.S. 473, 476, 94 S.Ct. 713, 38 L.Ed.2d 661 (1974) (*per curiam*). See *Longshoremen, supra*, at 76, 88 S.Ct. 201 (noting that civil contempt usually is not appropriate unless "those who must obey" an order "will know what the court intends to require and what it means to forbid"); 11A C. Wright, A. Miller, & M. Kane, Federal Practice and Procedure § 2960, pp. 430–431 (2013) (suggesting that civil contempt may be improper if a party's attempt at compliance was "reasonable").

[10] [11] [12]This standard is generally an *objective* one. We have explained before that a party's subjective belief that she was complying with an order ordinarily will not insulate her from civil contempt if that belief was objectively unreasonable. As we said in *McComb v. Jacksonville Paper Co.*, 336 U.S. 187, 69 S.Ct. 497, 93 L.Ed. 599 (1949), "[t]he absence of wilfulness does not relieve from civil contempt." *Id.*, at 191, 69 S.Ct. 497.

[13] [14]We have not held, however, that subjective intent is always irrelevant. Our cases suggest, for example, that civil contempt sanctions may be warranted when a party acts in bad faith. See *Chambers v. NASCO, Inc.*, 501 U.S. 32, 50, 111 S.Ct. 2123, 115 L.Ed.2d 27 (1991). Thus, in *McComb*, we explained that a party's "record of continuing and persistent violations" and "persistent contumacy" justified placing "the burden of any uncertainty in the decree ... on [the] shoulders" of the party who violated the court order. 336 U.S. at 192–193, 69 S.Ct. 497. On the flip side of the coin, a party's good faith, even where it does not bar civil contempt, may help to determine an appropriate sanction. Cf. *Young v. United States ex rel. Vuitton et Fils S. A.*, 481 U.S. 787, 801, 107 S.Ct. 2124, 95 L.Ed.2d 740 (1987) ("[O]nly the least possible power adequate to the end proposed should be used in contempt cases" (quotation altered)).

[15]These traditional civil contempt principles apply straightforwardly to the bankruptcy discharge context. The typical discharge order entered by a bankruptcy court is not detailed. See *supra*, at 1799 – 1800. Congress, however, has carefully delineated which debts are exempt from discharge. See §§ 523(a)(1)–(19). Under the fair ground of doubt standard, civil contempt therefore may be appropriate when the creditor violates a discharge order based on an objectively unreasonable understanding of the discharge order or the statutes that govern its scope.

B

The Solicitor General, *amicus* here, agrees with the fair ground of doubt standard we adopt. Brief for United States as *Amicus Curiae* 13–15. And the respondents stated at oral argument that it would be appropriate for courts to apply that standard in this context. Tr. of Oral Arg. 43. The Ninth Circuit and petitioner Taggart, however, each believe that a different standard should apply.

[16]As for the Ninth Circuit, the parties and the Solicitor General agree that it adopted the wrong standard. So do we. The Ninth Circuit concluded that a "creditor's good faith belief" that the discharge order "does not apply to the creditor's claim precludes a finding of contempt, even if the creditor's belief is unreasonable." 888 F. 3d at 444. But this standard is inconsistent with traditional civil contempt principles, under which parties cannot ***1803** be insulated from a finding of civil contempt based on their subjective good faith. It also relies too heavily on difficult-to-prove states of mind. And it may too often lead creditors who stand on shaky legal ground to collect discharged debts, forcing debtors back into litigation (with its accompanying costs) to protect the discharge that it was the very purpose of the bankruptcy proceeding to

provide.

Taggart, meanwhile, argues for a standard like the one applied by the Bankruptcy Court. This standard would permit a finding of civil contempt if the creditor was aware of the discharge order and intended the actions that violated the order. Brief for Petitioner 19; cf. 522 B. R. at 632 (applying a similar standard). Because most creditors are aware of discharge orders and intend the actions they take to collect a debt, this standard would operate much like a strict-liability standard. It would authorize civil contempt sanctions for a violation of a discharge order regardless of the creditor's subjective beliefs about the scope of the discharge order, and regardless of whether there was a reasonable basis for concluding that the creditor's conduct did not violate the order. Taggart argues that such a standard would help the debtor obtain the "fresh start" that bankruptcy promises. He adds that a standard resembling strict liability would be fair to creditors because creditors who are unsure whether a debt has been discharged can head to federal bankruptcy court and obtain an advance determination on that question before trying to collect the debt. See Fed. Rule Bkrtcy. Proc. 4007(a).

We doubt, however, that advance determinations would provide a workable solution to a creditor's potential dilemma. A standard resembling strict liability may lead risk-averse creditors to seek an advance determination in bankruptcy court even where there is only slight doubt as to whether a debt has been discharged. And because discharge orders are written in general terms and operate against a complex statutory backdrop, there will often be at least some doubt as to the scope of such orders. Taggart's proposal thus may lead to frequent use of the advance determination procedure. Congress, however, expected that this procedure would be needed in only a small class of cases. See 11 U.S.C. § 523(c)(1) (noting only three categories of debts for which creditors must obtain advance determinations). The widespread use of this procedure also would alter who decides whether a debt has been discharged, moving litigation out of state courts, which have concurrent jurisdiction over such questions, and into federal courts. See 28 U.S.C. § 1334(b); Advisory Committee's 2010 Note on subd. (c)(1) of Fed. Rule Civ. Proc. 8, 28 U.S.C. App., p. 776 (noting that "whether a claim was excepted from discharge" is "in most instances" not determined in bankruptcy court).

[17]Taggart's proposal would thereby risk additional federal litigation, additional costs, and additional delays. That result would interfere with "a chief purpose of the bankruptcy laws": " 'to secure a prompt and effectual' " resolution of bankruptcy cases " 'within a limited period.' " *Katchen v. Landy*, 382 U.S. 323, 328, 86 S.Ct. 467, 15 L.Ed.2d 391 (1966) (quoting *Ex parte Christy*, 3 How. 292, 312, 11 L.Ed. 603 (1844)). These negative consequences, especially the costs associated with the added need to appear in federal proceedings, could work to the disadvantage of debtors as well as creditors.

[18] [19] [20]Taggart also notes that lower courts often have used a standard akin to strict liability to remedy violations of automatic stays. See Brief for Petitioner 21. An automatic stay is entered at the outset of a ***1804** bankruptcy proceeding. The statutory provision that addresses the remedies for violations of automatic stays says that "an individual injured by any willful violation" of an automatic stay "shall recover actual damages, including costs and attorneys' fees, and, in appropriate circumstances, may recover punitive damages." 11 U.S.C. § 362(k)(1). This language, however, differs from the more general language in section 105(a). *Supra*, at ——. The purposes of automatic stays and discharge orders also differ: A stay aims to prevent damaging disruptions to the administration of a bankruptcy case in the short run, whereas a discharge is entered at the end of the case and seeks to bind creditors over a much longer period. These differences in language and purpose sufficiently undermine Taggart's proposal to warrant its rejection. (We note that the automatic stay provision uses the word "willful," a word the law typically does not associate with strict liability but " 'whose construction is often dependent on the context in which it appears.' " *Safeco Ins. Co. of America v. Burr*, 551 U.S. 47, 57, 127 S.Ct. 2201, 167 L.Ed.2d 1045 (2007) (quoting *Bryan v. United States*, 524 U.S. 184, 191, 118 S.Ct. 1939, 141 L.Ed.2d 197 (1998)). We need not, and do not, decide whether the word "willful" supports a standard akin to strict liability.)

III

We conclude that the Court of Appeals erred in applying a subjective standard for civil contempt. Based on the traditional principles that govern civil contempt, the proper standard is an objective one. A court may hold a creditor in civil contempt for violating a discharge order where there is not a "fair ground of doubt" as to whether the creditor's conduct might be lawful under the discharge order. In our view, that standard strikes the "careful balance between the interests of creditors and debtors" that the Bankruptcy Code often seeks to achieve. *Clark v. Rameker*, 573 U.S. 122, 129, 134 S.Ct. 2242, 189 L.Ed.2d

157 (2014).

Because the Court of Appeals did not apply the proper standard, we vacate the judgment below and remand the case for further proceedings consistent with this opinion.

It is so ordered.

All Citations

139 S.Ct. 1795, 67 Bankr.Ct.Dec. 69, Bankr. L. Rep. P 83,385, 19 Cal. Daily Op. Serv. 5034, 2019 Daily Journal D.A.R. 4745, 27 Fla. L. Weekly Fed. S 878

Footnotes

* The syllabus constitutes no part of the opinion of the Court but has been prepared by the Reporter of Decisions for the convenience of the reader. See *United States v. Detroit Timber & Lumber Co.*, 200 U.S. 321, 337, 26 S.Ct. 282, 50 L.Ed. 499.

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139 S.Ct. 1795
Supreme Court of the United States.

Bradley Weston TAGGART, Petitioner
v.
Shelley A. LORENZEN, Executor of the Estate of Stuart Brown, et al.

No. 18-489
|
Argued April 24, 2019
|
Decided June 3, 2019

Synopsis

Background: Former Chapter 7 debtor filed motion to hold attorney and his clients in contempt for willfully violating discharge injunction. The United States Bankruptcy Court for the District of Oregon, Randall L. Dunn, J., 2011 WL 6140521, denied motion, and also denied subsequent motion for reconsideration, 2012 WL 280726. Debtor appealed. The District Court, Mosman, J., 2012 WL 3241758, reversed. On remand, the Bankruptcy Court, Dunn, J., 522 B.R. 627, entered order awarding contempt sanctions. Appeal was taken. The Bankruptcy Appellate Panel (BAP), Jury, J., 548 B.R. 275, reversed and vacated. Both sides appealed. The Court of Appeals for the Ninth Circuit, Bea, Circuit Judge, 888 F.3d 438, affirmed. Certiorari was granted.

[Holding:] The Supreme Court, Justice Breyer, held that a bankruptcy court may hold a creditor in civil contempt for violating a discharge order if there is no fair ground of doubt as to whether the order barred the creditor's conduct, that is, if there is no objectively reasonable basis for concluding that the creditor's conduct might be lawful.

Vacated and remanded.

West Headnotes (20)

[1] **Bankruptcy**
Discharge as injunction

"Discharge order," an order that is typically entered by bankruptcy court at conclusion of bankruptcy proceeding and releases the debtor from liability for most pre-bankruptcy debts, bars creditors from attempting to collect any debt covered by the order. 11 U.S.C.A. § 524(a)(2).

1 Cases that cite this headnote

[2] **Bankruptcy**
Liquidation, Distribution, and Closing

Chapter 7 of the Bankruptcy Code permits insolvent debtors to discharge their debts by liquidating assets to pay creditors. 11 U.S.C.A. §§ 704(a)(1), 726.

Cases that cite this headnote

[3] **Bankruptcy**
Discharge as injunction

Bankruptcy court's discharge order operates as an injunction that bars creditors from collecting any debt that has been discharged. 11 U.S.C.A. § 524(a)(2).

3 Cases that cite this headnote

[4] **Bankruptcy**
Violation of discharge order

Bankruptcy court may hold a creditor in civil contempt for violating a discharge order if there is no fair ground of doubt as to whether the order barred the creditor's conduct, that is, if there is no objectively reasonable basis for concluding that the creditor's conduct might be lawful under the discharge order; based on the traditional principles that govern civil contempt, the proper standard is an objective one, not a standard akin to strict liability or a purely subjective standard, and such objective standard strikes the careful balance between interests of creditors and debtors that the Bankruptcy Code often seeks to achieve. 11 U.S.C.A. §§ 105(a), 524(a)(2).

7 Cases that cite this headnote

[5] **Statutes**
Other Law, Construction with Reference to

When a statutory term is obviously “transplanted” from another legal source, it “brings the old soil” with it.

1 Cases that cite this headnote

[6] **Injunction**
Contempt

Under traditional principles of equity practice, courts have long imposed civil contempt sanctions to coerce the defendant into compliance with an injunction or compensate the complainant for losses stemming from the defendant’s noncompliance with an injunction.

Cases that cite this headnote

[7] **Bankruptcy**
Violation of discharge order

Bankruptcy statutes do not grant courts unlimited authority to hold creditors in civil contempt for violating the discharge injunction; instead, the statutes incorporate the traditional standards in equity practice for determining when a party may be held in civil contempt for violating an injunction. 11 U.S.C.A. § 524(a)(2).

3 Cases that cite this headnote

[8] **Bankruptcy**
Contempt
Contempt
Weight and sufficiency

In cases outside the bankruptcy context, civil contempt should not be resorted to where there is a fair ground of doubt as to the wrongfulness of the defendant’s conduct.

3 Cases that cite this headnote

[9] **Contempt**
Civil contempt
Injunction
Contempt

Civil contempt is a severe remedy, and so principles of basic fairness require that those enjoined receive explicit notice of what conduct is outlawed before being held in civil contempt.

3 Cases that cite this headnote

[10] **Contempt**
Civil contempt

Standard for civil contempt is generally an objective one.

Cases that cite this headnote

[11] **Contempt**
Disobedience to Mandate, Order, or Judgment

Party’s subjective belief that she was complying with an order ordinarily will not insulate her from civil contempt if that belief was objectively unreasonable.

Cases that cite this headnote

[12] **Contempt**
Disobedience to Mandate, Order, or Judgment

Absence of wilfulness does not relieve one from civil contempt.

1 Cases that cite this headnote

[13] **Contempt**
Disobedience to Mandate, Order, or Judgment

Subjective intent is not always irrelevant to a determination of civil contempt; civil contempt sanctions may be warranted, for example, when a party acts in bad faith.

Cases that cite this headnote

[14] **Contempt**
Disobedience to Mandate, Order, or Judgment

Party's good faith, even where it does not bar civil contempt, may help to determine an appropriate sanction.

Cases that cite this headnote

[15] **Bankruptcy**
Violation of discharge order

Under the fair ground of doubt standard, civil contempt may be appropriate when the creditor violates a discharge order based on an objectively unreasonable understanding of the discharge order or the statutes that govern its scope. 11 U.S.C.A. § 524(a)(2).

6 Cases that cite this headnote

[16] **Contempt**
Disobedience to Mandate, Order, or Judgment

Under traditional civil contempt principles, parties cannot be insulated from a finding of civil contempt based on their subjective good faith.

Cases that cite this headnote

[17] **Bankruptcy**
Purpose

A chief purpose of the bankruptcy laws is to secure a prompt and effectual resolution of bankruptcy cases within a limited period.

Cases that cite this headnote

[18] **Bankruptcy**
Automatic Stay

Automatic stay, which is entered at the outset of a bankruptcy proceeding, aims to prevent damaging disruptions to administration of the bankruptcy case in the short run. 11 U.S.C.A. § 362.

Cases that cite this headnote

[19] **Bankruptcy**
Discharge as injunction

Discharge, which is entered at the end of the bankruptcy case, seeks to bind creditors over a much longer period than the automatic stay. 11 U.S.C.A. §§ 362, 524(a)(2).

Cases that cite this headnote

[20] **Bankruptcy**
Enforcement of Injunction or Stay

Word "willful," as used in the Bankruptcy Code's automatic stay provision, is one that the law typically does not associate with strict liability, but whose construction is often dependent on the context in which it appears. 11 U.S.C.A. § 362.

Cases that cite this headnote

*Syllabus**

Petitioner Bradley Taggart formerly owned an interest in an Oregon company. That company and two of its other owners, who are among the respondents here, filed suit in Oregon state court, claiming that Taggart had breached the company's operating agreement. Before trial, Taggart filed for bankruptcy under Chapter 7 of the Bankruptcy Code. At the conclusion of that proceeding, the Federal Bankruptcy Court issued a discharge order that released Taggart from liability for most prebankruptcy debts. After the discharge order issued, the Oregon state court entered judgment against Taggart in the prebankruptcy suit and awarded attorney's fees to respondents. Taggart returned to the Federal Bankruptcy Court, seeking civil contempt sanctions against respondents for collecting attorney's fees in violation of the discharge order. The Bankruptcy Court ultimately held respondents in civil contempt. The Bankruptcy Appellate Panel vacated the sanctions, and the Ninth Circuit affirmed the panel's decision. Applying a subjective standard, the Ninth Circuit concluded that a "creditor's good faith belief" that the discharge order "does not apply to the creditor's claim precludes a finding of contempt, even if the creditor's belief if unreasonable." 888 F. 3d 438, 444.

Held: A court may hold a creditor in civil contempt for violating a discharge order if there is *no fair ground of doubt* as to whether the order barred the creditor's conduct. Pp. 1800 – 1804——.

(a) This conclusion rests on a longstanding interpretive principle: When a statutory term is " 'obviously transplanted from another legal source,' " it " 'brings the old soil with it.' " *Hall* v. *Hall*, 584 U.S. ——, ——, 138 S.Ct. 1118, 1128, 200 L.Ed.2d 399. Here, the bankruptcy statutes specifying that a discharge order "operates as an injunction," 11 U.S.C. § 524(a)(2), and that a court may issue any "order" or "judgment" that is "necessary or appropriate" to "carry out" other bankruptcy provisions, § 105(a), bring with them the "old soil" that has long governed how courts enforce injunctions. In cases outside the bankruptcy context, this Court has said that civil contempt "should not be resorted to where there is [a] fair ground of doubt as to the wrongfulness of the defendant's conduct." *California Artificial Stone Paving Co. v. Molitor*, 113 U.S. 609, 618, 5 S.Ct. 618, 28 L.Ed. 1106. This standard is generally an objective one. A party's subjective belief that she was complying with an order ordinarily will not insulate her from civil contempt if that belief was objectively unreasonable. Subjective intent, however, is not always irrelevant. Civil contempt sanctions may be warranted when a party acts in bad faith, and a party's good faith may help to determine an appropriate sanction. These traditional civil contempt principles apply straightforwardly to the bankruptcy discharge context. Under the fair ground of doubt standard, civil contempt may be appropriate when the creditor violates a discharge order based on an objectively unreasonable understanding of the discharge order or the statutes that govern its scope. Pp. 1801 – 1802.

(b) The standard applied by the Ninth Circuit is inconsistent with traditional civil contempt principles, under which parties cannot be insulated from a finding of civil contempt based on their subjective good faith. Taggart, meanwhile, argues for a standard that would operate much like a strict-liability standard. But his proposal often may lead creditors to seek advance determinations as to whether debts have been discharged, creating the risk of additional federal litigation, additional costs, and additional delays. His proposal, which follows the standard some courts have used to remedy violations of automatic stays, also ignores key differences in text and purpose between the statutes governing automatic stays and discharge orders. Pp. 1802 – 1804.

888 F. 3d 438, vacated and remanded.

BREYER, J., delivered the opinion for a unanimous Court.

Attorneys and Law Firms

***1797** Janet M. Schroer, Hart Wagner, LLP, James Ray

Streinz, Streinz Law Office LLC, Hollis K. McMilan, Hollis K. McMilan, PC, Portland, OR, Nicole A. Saharsky, Andrew E. Tauber, Michael B. Kimberly, Matthew A. Waring, Minh Nguyen-Dang, Mayer Brown LLP, Washington, DC, Aaron Gavant, Mayer Brown LLP, Chicago, IL, for Respondents.

John M. Berman, Tigard, OR, Daniel L. Geyser, Geyser P.C., Dallas, TX, for Petitioner.

Daniel L. Geyser, Dallas, TX, for Petitioner.

Nicole A. Saharsky, Washington, DC, for Respondents.

Sopan Joshi for the United States as amicus curiae, by special leave of the Court, in support of neither party.

Opinion

Justice BREYER delivered the opinion of the Court.

***1799** [1]At the conclusion of a bankruptcy proceeding, a bankruptcy court typically enters an order releasing the debtor from liability for most prebankruptcy debts. This order, known as a discharge order, bars creditors from attempting to collect any debt covered by the order. See 11 U.S.C. § 524(a)(2). The question presented here concerns the criteria for determining when a court may hold a creditor in civil contempt for attempting to collect a debt that a discharge order has immunized from collection.

The Bankruptcy Court, in holding the creditors here in civil contempt, applied a standard that it described as akin to "strict liability" based on the standard's expansive scope. *In re Taggart*, 522 B. R. 627, 632 (Bkrtcy. D.Ct. Ore. 2014). It held that civil contempt sanctions are permissible, irrespective of the creditor's beliefs, so long as the creditor was " 'aware of the discharge' " order and " 'intended the actions which violate[d]' " it. *Ibid.* (quoting *In re Hardy*, 97 F. 3d 1384, 1390 (CA11 1996)). The Court of Appeals for the Ninth Circuit, however, disagreed with that standard. Applying a subjective standard instead, it concluded that a court cannot hold a creditor in civil contempt if the creditor has a "good faith belief" that the discharge order "does not apply to the creditor's claim." *In re Taggart*, 888 F. 3d 438, 444 (2018). That is so, the Court of Appeals held, "even if the creditor's belief is unreasonable." *Ibid.*

We conclude that neither a standard akin to strict liability nor a purely subjective standard is appropriate. Rather, in our view, a court may hold a creditor in civil contempt for violating a discharge order if there is *no fair ground of doubt* as to whether the order barred the creditor's conduct. In other words, civil contempt may be appropriate if there is no objectively reasonable basis for concluding that the creditor's conduct might be lawful.

I

Bradley Taggart, the petitioner, formerly owned an interest in an Oregon company, Sherwood Park Business Center. That company, along with two of its other owners, brought a lawsuit in Oregon state court, claiming that Taggart had breached the Business Center's operating agreement. (We use the name "Sherwood" to refer to the company, its two owners, and—in some instances—their former attorney, who is now represented by the executor of his estate. The company, the two owners, and the executor are the respondents in this case.)

[2] [3]Before trial, Taggart filed for bankruptcy under Chapter 7 of the Bankruptcy Code, which permits insolvent debtors to discharge their debts by liquidating ***1800** assets to pay creditors. See 11 U.S.C. §§ 704(a)(1), 726. Ultimately, the Federal Bankruptcy Court wound up the proceeding and issued an order granting him a discharge. Taggart's discharge order, like many such orders, goes no further than the statute: It simply says that the debtor "shall be granted a discharge under § 727." App. 60; see United States Courts, Order of Discharge: Official Form 318 (Dec. 2015), http:/ /www.uscourts.gov / sites / default / files /form _ b318_0.pdf (as last visited May 31, 2019). Section 727, the statute cited in the discharge order, states that a discharge relieves the debtor "from all debts that arose before the date of the order for relief," "[e]xcept as provided in section 523." § 727(b). Section 523 then lists in detail the debts that are exempt from discharge. §§ 523(a)(1)–(19). The words of the discharge order, though simple, have an important effect: A discharge order "operates as an injunction" that bars creditors from collecting any debt that has been discharged. § 524(a)(2).

After the issuance of Taggart's federal bankruptcy discharge order, the Oregon state court proceeded to enter judgment against Taggart in the prebankruptcy suit involving Sherwood. Sherwood then filed a petition in state court seeking attorney's fees that were incurred *after* Taggart filed his bankruptcy petition. All parties agreed that, under the Ninth Circuit's decision in *In re Ybarra*, 424 F. 3d 1018 (2005), a discharge order would normally cover and thereby discharge postpetition attorney's fees stemming from prepetition litigation (such as the Oregon litigation) *unless* the discharged debtor " 'returned to the fray' " after filing for bankruptcy. *Id.*, at 1027. Sherwood argued that Taggart had "returned to the fray" postpetition and therefore was liable for the postpetition attorney's fees that Sherwood sought to collect. The state trial court agreed and held Taggart liable for roughly $ 45,000 of Sherwood's postpetition attorney's fees.

At this point, Taggart returned to the Federal Bankruptcy Court. He argued that he had not returned to the state-court "fray" under *Ybarra*, and that the discharge order therefore barred Sherwood from collecting postpetition attorney's fees. Taggart added that the court should hold Sherwood in civil contempt because Sherwood had violated the discharge order. The Bankruptcy Court did not agree. It concluded that Taggart had returned to the fray. Finding no violation of the discharge order, it refused to hold Sherwood in civil contempt.

Taggart appealed, and the Federal District Court held that Taggart had not returned to the fray. Hence, it concluded that Sherwood violated the discharge order by trying to collect attorney's fees. The District Court remanded the case to the Bankruptcy Court.

The Bankruptcy Court, noting the District Court's decision, then held Sherwood in civil contempt. In doing so, it applied a standard it likened to "strict liability." 522 B. R. at 632. The Bankruptcy Court held that civil contempt sanctions were appropriate because Sherwood had been " 'aware of the discharge' " order and " 'intended the actions which violate[d]' " it. *Ibid.* (quoting *In re Hardy*, 97 F. 3d at 1390). The court awarded Taggart approximately $ 105,000 in attorney's fees and costs, $ 5,000 in damages for emotional distress, and $ 2,000 in punitive damages.

Sherwood appealed. The Bankruptcy Appellate Panel vacated these sanctions, and the Ninth Circuit affirmed the panel's decision. The Ninth Circuit applied a very different standard than the Bankruptcy Court. It concluded that a "creditor's good faith belief" that the discharge order "does not apply to the creditor's claim precludes a finding of contempt, even if the creditor's ***1801** belief is unreasonable." 888 F. 3d at 444. Because Sherwood had a "good faith belief" that the discharge order "did not apply" to Sherwood's claims, the Court of Appeals held that civil contempt sanctions were improper. *Id.*, at 445.

Taggart filed a petition for certiorari, asking us to decide whether "a creditor's good-faith belief that the discharge injunction does not apply precludes a finding of civil contempt." Pet. for Cert. I. We granted certiorari.

II

[4]The question before us concerns the legal standard for holding a creditor in civil contempt when the creditor attempts to collect a debt in violation of a bankruptcy discharge order. Two Bankruptcy Code provisions aid our efforts to find an answer. The first, section 524, says that a discharge order "operates as an injunction against the commencement or continuation of an action, the employment of process, or an act, to collect, recover or offset" a discharged debt. 11 U.S.C. § 524(a)(2). The second, section 105, authorizes a court to "issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title." § 105(a).

In what circumstances do these provisions permit a court to hold a creditor in civil contempt for violating a discharge order? In our view, these provisions authorize a court to impose civil contempt sanctions when there is no objectively reasonable basis for concluding that the creditor's conduct might be lawful under the discharge order.

A

[5]Our conclusion rests on a longstanding interpretive principle: When a statutory term is " 'obviously transplanted from another legal source,' " it " 'brings the old soil with it.' " *Hall* v. *Hall*, 584 U.S. ——, ——, 138 S.Ct. 1118, 1128, 200 L.Ed.2d 399 (2018) (quoting Frankfurter, Some Reflections on the Reading of Statutes, 47 Colum. L. Rev. 527, 537 (1947)); see *Field v. Mans*, 516 U.S. 59, 69–70, 116 S.Ct. 437, 133 L.Ed.2d 351 (1995) (applying that principle to the Bankruptcy Code). Here, the statutes specifying that a discharge order "operates as an injunction," § 524(a)(2), and that a court may issue any "order" or "judgment" that is "necessary or appropriate" to "carry out" other bankruptcy provisions, § 105(a), bring with them the "old soil" that has long governed how courts enforce injunctions.

[6]That "old soil" includes the "potent weapon" of civil contempt. *Longshoremen v. Philadelphia Marine Trade Assn.*, 389 U.S. 64, 76, 88 S.Ct. 201, 19 L.Ed.2d 236 (1967). Under traditional principles of equity practice, courts have long imposed civil contempt sanctions to "coerce the defendant into compliance" with an injunction or "compensate the complainant for losses" stemming from the defendant's noncompliance with an injunction. *United States v. Mine Workers*, 330 U.S. 258, 303–304, 67 S.Ct. 677, 91 L.Ed. 884 (1947); see D. Dobbs & C. Roberts, Law of Remedies § 2.8, p. 132 (3d ed. 2018); J. High, Law of Injunctions § 1449, p. 940 (2d ed. 1880).

[7]The bankruptcy statutes, however, do not grant courts unlimited authority to hold creditors in civil contempt. Instead, as part of the "old soil" they bring with them, the bankruptcy statutes incorporate the traditional standards in equity practice for determining when a party may be held in civil contempt for violating an injunction.

[8] [9]In cases outside the bankruptcy context, we have said that civil contempt "should not be resorted to where there is [a] *fair ground of doubt* as to the wrongfulness of the defendant's conduct." ***1802** *California Artificial Stone Paving Co. v. Molitor*, 113 U.S. 609, 618, 5 S.Ct. 618, 28 L.Ed. 1106 (1885) (emphasis added). This standard reflects the fact that civil contempt is a "severe remedy," *ibid.*, and that principles of "basic fairness requir[e] that those enjoined receive explicit notice" of "what conduct is outlawed" before being held in civil contempt, *Schmidt v. Lessard*, 414 U.S. 473, 476, 94 S.Ct. 713, 38 L.Ed.2d 661 (1974) (*per curiam*). See *Longshoremen*, *supra*, at 76, 88 S.Ct. 201 (noting that civil contempt usually is not appropriate unless "those who must obey" an order "will know what the court intends to require and what it means to forbid"); 11A C. Wright, A. Miller, & M. Kane, Federal Practice and Procedure § 2960, pp. 430–431 (2013) (suggesting that civil contempt may be improper if a party's attempt at compliance was "reasonable").

[10] [11] [12]This standard is generally an *objective* one. We have explained before that a party's subjective belief that she was complying with an order ordinarily will not insulate her from civil contempt if that belief was objectively unreasonable. As we said in *McComb v. Jacksonville Paper Co.*, 336 U.S. 187, 69 S.Ct. 497, 93 L.Ed. 599 (1949), "[t]he absence of wilfulness does not relieve from civil contempt." *Id.*, at 191, 69 S.Ct. 497.

[13] [14]We have not held, however, that subjective intent is always irrelevant. Our cases suggest, for example, that civil contempt sanctions may be warranted when a party acts in bad faith. See *Chambers v. NASCO, Inc.*, 501 U.S. 32, 50, 111 S.Ct. 2123, 115 L.Ed.2d 27 (1991). Thus, in *McComb*, we explained that a party's "record of continuing and persistent violations" and "persistent contumacy" justified placing "the burden of any uncertainty in the decree ... on [the] shoulders" of the party who violated the court order. 336 U.S. at 192–193, 69 S.Ct. 497. On the flip side of the coin, a party's good faith, even where it does not bar civil contempt, may help to determine an appropriate sanction. Cf. *Young v. United States ex rel. Vuitton et Fils S. A.*, 481 U.S. 787, 801, 107 S.Ct. 2124, 95 L.Ed.2d 740 (1987) ("[O]nly the least possible power adequate to the end proposed should be used in contempt cases" (quotation altered)).

[15]These traditional civil contempt principles apply straightforwardly to the bankruptcy discharge context. The typical discharge order entered by a bankruptcy court is not detailed. See *supra*, at 1799 – 1800. Congress, however, has carefully delineated which debts are exempt from discharge. See §§ 523(a)(1)–(19). Under the fair ground of doubt standard, civil contempt therefore may be appropriate when the creditor violates a discharge order based on an objectively unreasonable understanding of the discharge order or the statutes that govern its scope.

B

The Solicitor General, *amicus* here, agrees with the fair ground of doubt standard we adopt. Brief for United States as *Amicus Curiae* 13–15. And the respondents stated at oral argument that it would be appropriate for courts to apply that standard in this context. Tr. of Oral Arg. 43. The Ninth Circuit and petitioner Taggart, however, each believe that a different standard should apply.

[16]As for the Ninth Circuit, the parties and the Solicitor General agree that it adopted the wrong standard. So do we. The Ninth Circuit concluded that a "creditor's good faith belief" that the discharge order "does not apply to the creditor's claim precludes a finding of contempt, even if the creditor's belief is unreasonable." 888 F. 3d at 444. But this standard is inconsistent with traditional civil contempt principles, under which parties cannot ***1803** be insulated from a finding of civil contempt based on their subjective good faith. It also relies too heavily on difficult-to-prove states of mind. And it may too often lead creditors who stand on shaky legal ground to collect discharged debts, forcing debtors back into litigation (with its accompanying costs) to protect the discharge that it was the very purpose of the bankruptcy proceeding to

provide.

Taggart, meanwhile, argues for a standard like the one applied by the Bankruptcy Court. This standard would permit a finding of civil contempt if the creditor was aware of the discharge order and intended the actions that violated the order. Brief for Petitioner 19; cf. 522 B. R. at 632 (applying a similar standard). Because most creditors are aware of discharge orders and intend the actions they take to collect a debt, this standard would operate much like a strict-liability standard. It would authorize civil contempt sanctions for a violation of a discharge order regardless of the creditor's subjective beliefs about the scope of the discharge order, and regardless of whether there was a reasonable basis for concluding that the creditor's conduct did not violate the order. Taggart argues that such a standard would help the debtor obtain the "fresh start" that bankruptcy promises. He adds that a standard resembling strict liability would be fair to creditors because creditors who are unsure whether a debt has been discharged can head to federal bankruptcy court and obtain an advance determination on that question before trying to collect the debt. See Fed. Rule Bkrtcy. Proc. 4007(a).

We doubt, however, that advance determinations would provide a workable solution to a creditor's potential dilemma. A standard resembling strict liability may lead risk-averse creditors to seek an advance determination in bankruptcy court even where there is only slight doubt as to whether a debt has been discharged. And because discharge orders are written in general terms and operate against a complex statutory backdrop, there will often be at least some doubt as to the scope of such orders. Taggart's proposal thus may lead to frequent use of the advance determination procedure. Congress, however, expected that this procedure would be needed in only a small class of cases. See 11 U.S.C. § 523(c)(1) (noting only three categories of debts for which creditors must obtain advance determinations). The widespread use of this procedure also would alter who decides whether a debt has been discharged, moving litigation out of state courts, which have concurrent jurisdiction over such questions, and into federal courts. See 28 U.S.C. § 1334(b); Advisory Committee's 2010 Note on subd. (c)(1) of Fed. Rule Civ. Proc. 8, 28 U.S.C. App., p. 776 (noting that "whether a claim was excepted from discharge" is "in most instances" not determined in bankruptcy court).

[17]Taggart's proposal would thereby risk additional federal litigation, additional costs, and additional delays. That result would interfere with "a chief purpose of the bankruptcy laws": " 'to secure a prompt and effectual' " resolution of bankruptcy cases " 'within a limited period.' " *Katchen v. Landy*, 382 U.S. 323, 328, 86 S.Ct. 467, 15 L.Ed.2d 391 (1966) (quoting *Ex parte Christy*, 3 How. 292, 312, 11 L.Ed. 603 (1844)). These negative consequences, especially the costs associated with the added need to appear in federal proceedings, could work to the disadvantage of debtors as well as creditors.

[18] [19] [20]Taggart also notes that lower courts often have used a standard akin to strict liability to remedy violations of automatic stays. See Brief for Petitioner 21. An automatic stay is entered at the outset of a ***1804** bankruptcy proceeding. The statutory provision that addresses the remedies for violations of automatic stays says that "an individual injured by any willful violation" of an automatic stay "shall recover actual damages, including costs and attorneys' fees, and, in appropriate circumstances, may recover punitive damages." 11 U.S.C. § 362(k)(1). This language, however, differs from the more general language in section 105(a). *Supra*, at ——. The purposes of automatic stays and discharge orders also differ: A stay aims to prevent damaging disruptions to the administration of a bankruptcy case in the short run, whereas a discharge is entered at the end of the case and seeks to bind creditors over a much longer period. These differences in language and purpose sufficiently undermine Taggart's proposal to warrant its rejection. (We note that the automatic stay provision uses the word "willful," a word the law typically does not associate with strict liability but " 'whose construction is often dependent on the context in which it appears.' " *Safeco Ins. Co. of America v. Burr*, 551 U.S. 47, 57, 127 S.Ct. 2201, 167 L.Ed.2d 1045 (2007) (quoting *Bryan v. United States*, 524 U.S. 184, 191, 118 S.Ct. 1939, 141 L.Ed.2d 197 (1998)). We need not, and do not, decide whether the word "willful" supports a standard akin to strict liability.)

III

We conclude that the Court of Appeals erred in applying a subjective standard for civil contempt. Based on the traditional principles that govern civil contempt, the proper standard is an objective one. A court may hold a creditor in civil contempt for violating a discharge order where there is not a "fair ground of doubt" as to whether the creditor's conduct might be lawful under the discharge order. In our view, that standard strikes the "careful balance between the interests of creditors and debtors" that the Bankruptcy Code often seeks to achieve. *Clark v. Rameker*, 573 U.S. 122, 129, 134 S.Ct. 2242, 189 L.Ed.2d

157 (2014).

Because the Court of Appeals did not apply the proper standard, we vacate the judgment below and remand the case for further proceedings consistent with this opinion.

It is so ordered.

All Citations

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Footnotes

* The syllabus constitutes no part of the opinion of the Court but has been prepared by the Reporter of Decisions for the convenience of the reader. See *United States v. Detroit Timber & Lumber Co.*, 200 U.S. 321, 337, 26 S.Ct. 282, 50 L.Ed. 499.

American Bankruptcy Institute

First Circuit Splits with the Ninth over Good Faith Defense to Discharge Violation

"Seven weeks apart, two circuits reach diametrically different conclusions about good faith as a defense to an intentional act that violates the discharge injunction."

Over a comprehensive dissent, the First Circuit ruled that the Internal Revenue Service intentionally violates the discharge injunction when an IRS employee knows there was a discharge but nonetheless "takes an intentional action" later found to violate the discharge, even if the IRS had a good faith belief that its action did not violate the discharge.

The First Circuit's June 7 opinion represents a stark split with a decision handed down by the Ninth Circuit less than seven weeks ago: *Lorenzen v. Taggart (In re Taggart)*, 888 F.3d 438 (9th Cir. April 23, 2018), petition for panel rehearing and rehearing *en banc* filed June 6, 2018. Although the First Circuit dissent cited *Taggart*, the majority did not.

The First Circuit's dissent underscores an arguably longstanding circuit split on the question of whether good faith is a defense to an alleged violation of the discharge injunction.

The majority opinion for the First Circuit, holding that good faith is not a defense to contempt, was written by Circuit Judge Norman H. Stahl. Joining the majority opinion was retired Supreme Court Associate Justice David H. Souter, sitting by designation. The dissent was by Circuit Judge Sandra L. Lynch.

The Facts in the First Circuit

The debtor filed a chapter 7 petition and received a discharge. The IRS was aware of the discharge.

Among his $600,000 in total debt, the debtor owed the IRS about $550,000 in taxes. The IRS had a good faith basis for believing that the taxes were not dischargeable under Section 523(a)(1)(C) because the debtor, allegedly, had willfully attempted to evade payment of the taxes. The IRS therefore took the position that the tax debt was not automatically discharged under Section 523(c)(1). Thus, the IRS did not object to the dischargeability of the debt before the debtor received his general discharge.

After entry of the general discharge, the IRS repeatedly notified the debtor of its belief that the taxes were not automatically discharged. After the IRS eventually levied against an account receivable owing to the debtor, he filed an adversary proceeding in bankruptcy court seeking a declaration that the debt indeed had been discharged. Allegedly because of mental infirmities afflicting the assistant U.S. Attorney (AUSA) who represented the IRS, the government presented insufficient evidence, leading the bankruptcy judge to grant summary judgment declaring that the taxes were discharged. The IRS did not appeal the ruling that the debt was discharged.

The debtor later filed a complaint against the IRS under 26 U.S.C. § 7433(e), seeking sanctions for willful violation of the discharge injunction by issuing levies against his assets. In defense, the IRS argued there was no willful violation because the government reasonably believed that the debt was not discharged.

The bankruptcy judge found a willful violation and ruled in favor of the debtor. On appeal, the district court remanded for the bankruptcy court to consider the AUSA's mental impairment.

On remand, the IRS and the debtor reached a partial settlement narrowing the issues. To avoid extensive litigation over the AUSA's mental impairment and whether his impairment would give the government a defense, the IRS agreed that the debtor could have $175,000 in damages if an appellate court ultimately were to rule that a reasonable belief that the debt was excepted from discharge was not a defense to contempt.

The bankruptcy court decided that good faith was not a defense and ruled against the IRS. The district court affirmed, and the IRS appealed.

The Majority Opinion

Given the stipulation limiting the issue on appeal, Judge Stahl said the appeals court would decide whether the IRS's good faith belief meant there was no willful violation of the discharge injunction under Section 7433(e).

Adopted in 1998, Section 7433(e) allows a taxpayer to recover damages from the U.S. if the IRS, in connection with the collection of taxes, "willfully violates any provision of" the automatic stay under Section 362 of the Bankruptcy Code or Section 524 and its injunction barring the collection of discharged debt.

Judge Stahl said that the statute defines neither "willfully" nor the phrase "willfully violates." To find a meaning for the terms, he surveyed the definition given those words by the circuit courts when the statute was adopted in 1998.

Although the dissenter disagreed about unanimity among the courts of appeals, Judge Stahl said that the circuit courts agreed that the "phrase 'willful violation' had an established meaning in the context of violations of the automatic stays [*sic*] as of 1998: a creditor willfully violated the automatic stay if it knew of the automatic stay and took an intentional action that violated the automatic stay. A good faith belief in a right to the property was not relevant to determining whether the creditor's violation was willful."

Judge Stahl next concluded that Congress intended to give the same meaning to violations of the discharge injunction, in part because "the plain language of Section 7433(e) does not distinguish between" violations of the automatic stay and discharge.

Although Judge Stahl said he was relying "primarily" on what Congress understood "willful violation" to mean in 1998 on adopting Section 7433(e), he said that later First Circuit decisions hewed to the same definition for violations of both the automatic stay and the discharge injunction.

Although the dissenter disagreed, Judge Stahl said that his definition of "willful violation" did not entail an overbroad interpretation of the wavier of sovereign immunity in Section 7433(e).

The IRS contended that Judge Stahl's interpretation would force the government to seek a declaration about the dischargeability of debts for tax fraud, even though Section 523(a)(1)(C) excepts them from discharge automatically.

Judge Stahl rejected the argument, finding "policy considerations" against "allowing the IRS to attempt to collect purportedly discharged debts without facing potential consequences." He said the IRS had several alternatives.

First, the IRS could have filed an objection to the dischargeability of the debt, although it was not required to do so before the entry of the general discharge. Second, the IRS could have filed an adversary proceeding and sought a declaration about dischargeability before beginning collection activity.

Third, the IRS could have attempted to collect the debt, as it had done in the case at bar, and gamble that the bankruptcy court would find for the government and rule that the taxes were not discharged.

The Dissent

In dissent, Judge Lynch said that her panel was handing down the first circuit court opinion construing "willfully violates" in Section 7433(e). The majority, she said, "gets this one wrong."

Judge Lynch said her circuit was the first to deprive the government of sovereign immunity when acting "on a reasonable and good faith belief." In Section 7433(e), she found no indication of a waiver of immunity "where the IRS acts reasonably and in good faith," even if the belief turns out to be erroneous.

Rather than following circuit law, Judge Lynch would have adopted the approach of the Supreme Court where she said the justices held in the context of Section 523 that a willful injury includes only acts that "were specifically intended to cause injury, not all intentional acts that resulted in injury."

Of special significance, Judge Lynch disagreed with the majority's statement that the circuits were in agreement before 1998. Although the majority opinion reflected the holding of seven circuits, she said that the First, Fifth and Sixth Circuits would allow a good faith defense to an alleged willful stay violation. Where she said the "majority attempts to deny the existence of this circuit split," Judge Lynch said that those three circuits "had held that the mere knowledge of a stay was insufficient to show a 'willful violation.'"

In addition to older authority from those three circuits, she cited *Taggart*, decided by the Ninth Circuit on April 23. She read the Ninth Circuit as allowing a good faith defense. "Indeed," she said, "the Ninth Circuit does not even impose a reasonableness requirement." For ABI's discussion of *Taggart*, click here.

Judge Lynch placed significant reliance on Section 523(a)(1)(C), which does not "require the IRS to first obtain a judicial determination that an exception to discharge applies." The subsection, she said, "means that Congress chose not to require that the IRS seek a pre-collection determination from the bankruptcy court." [Emphasis in original.]

"Given that Congress created this exception to discharge and did not require the IRS to seek a pre-collection determination that the tax debts are not dischargeable, there is no reason to say that the IRS should incur the risk of having damages found against it even if it acted on a reasonable and good faith belief," Judge Lynch said.

Are There Grounds for *Certiorari*?

The First Circuit's decision and *Taggart* are very much at odds. The Ninth Circuit permits a good faith defense to a discharge violation, while the First Circuit does not.

Should the losing parties in either circuit petition for *certiorari*, they surely will claim there is a circuit split. However, the majority on the First Circuit found no circuit split, although the dissenter did.

By ruling on Section 7433(e), the First Circuit was not construing the same statute as the Ninth. If a *certiorari* petition is based on divergent opinions by the two circuits just seven weeks apart, the justices might shy away from granting the petition because the underlying statutes are not the same.

However, there surely is a lack of clarity about the availability of a good faith defense when a panel of the First Circuit cannot agree on whether there is a circuit split. The Supreme Court might decline to grant *certiorari* until there is a decision more starkly raising a circuit split. *Taggart* might become a better vehicle for *certiorari* after the Ninth Circuit disposes of the pending petition for rehearing and rehearing *en banc*.

Although the dissent in the First Circuit says there is a circuit split about the good faith defense generally, the dissenter also said her panel was the first appeals court to rule on Section 7433(e). Even though the underlying issue is applicable to Sections 362 and 524 of the Bankruptcy Code, the Supreme Court might not be inclined to grant *certiorari* to the First Circuit and review the first decision on Section 7433(e).

All things considered, *Taggart* therefore might be the better vehicle for *certiorari*. The debtor in *Taggart* contends that the Ninth Circuit's opinion represents a split with the Fourth and Eleventh Circuits on the availability of a good faith defense.

If there is a petition for *certiorari* in *Taggart*, the Supreme Court may request the opinion of the U.S. Solicitor General on whether to grant or deny the petition, known as a CVSG for "consider the views of the Solicitor General." A CVSG would allow the government to weigh in on the existence of a split (or not) and presumably urge the justices to review the case.

Given the outcome in the First Circuit, the government well may urge a grant of *certiorari* in *Taggart*, especially if *certiorari* to the First Circuit is less likely.

Either case would enable the Supreme Court to rule on a fundamental, recurring issue in bankruptcy law: Does good faith allow a creditor to escape the consequences of an intentional violation of the principal relief a debtor obtains through bankruptcy?

Opinion Link: Opinion Link

Judge Name: Norman H. Stahl, David H. Souter, Sandra L. Lynch

Case Citation: IRS v. Murphy, 17-1601 (1st Cir. June 7, 2018)

Case Name: IRS v. Murphy

Case Type: Consumer

Court: 1st Circuit

Bankruptcy Tags: Consumer Bankruptcy
Discharge/Dischargeability
Bankruptcy Taxation
Govt. Claims/Sovereign Immunity

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2. THE HONORABLE HANNAH BLUMENSTIEL

Topic: Treatment of IP licenses upon rejection: *Mission Prod. Holdings, Inc. v. Tempnology LLC*, 879 F.3d 389 (1st Cir. 2018)

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By Melissa A. Martinez[*] and Monique Bair DiSabatino[**]

Mission Product Holdings, Inc. v. Tempnology, LLC: First Circuit Rules on Treatment of Trademark Rights Following Rejection

On January 12, 2018, the United States Court of Appeals for the First Circuit issued its opinion in *Mission Product Holdings, Inc. v. Tempnology, LLC (In re Tempnology, LLC),*[1] holding that Tempnology, LLC's rejection of a marketing and distribution agreement with Mission Product Holdings, Inc. left Mission with only a prepetition damages claim, and not the right to continue exercising exclusive distribution rights or the right to continue using its trademark license.

On October 26, 2018, the United States Supreme Court granted certiorari to decide whether a debtor-licensor's rejection of a license agreement pursuant to § 365 of the Bankruptcy Code terminates the licensee's rights under the agreement. The Supreme Court's decision will hopefully resolve a long-standing circuit split among the First, Fourth and Seventh Circuits on the issue.

I. Background on § 365 and the Circuit Split

Section 365 of the Bankruptcy Code permits a trustee or a debtor-in-possession to seek court approval to reject an executory contract or unexpired lease. Specifically, the statute provides that "the trustee, subject to the court's approval, may assume or reject any executory contract or unexpired lease of the debtor."[2]

If a debtor-in-possession rejects a contract, then the counterparty will typically be left with a prepetition damages claim against the debtor for breach of contract, and *no*t the ability to compel the debtor's further performance.[3]

A. Lubrizol

In 1985, in *Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc.*,[4] the United States Court of Appeals for the Fourth Circuit considered the rejection framework of § 365 in the context of an intellectual property license granted by a debtor. In *Lubrizol*, the debtor moved to reject the technology license agreement under § 365. The United States Bankruptcy Court for the Eastern District of Virginia granted the rejection motion. On appeal, the United States District Court for the Eastern District of Virginia reversed and remanded. The debtor then appealed to the Fourth Circuit. The Fourth Circuit reasoned that the term "executory contract" in § 365 includes intellectual property licenses and that the effect of rejection was to terminate the license. Upon rejection, the licensee could only seek monetary damages through a prepetition unsecured claim, and could not continue to use the licensed technology or seek specific performance by the debtor.

B. Enactment of § 365(n)

Three years after *Lubrizol,* Congress enacted § 365(n) to protect licensees of intellectual property. Section 365(n) states:

> (n)(1) If the trustee rejects an executory contract under which the debtor is a licensor of a right to intellectual property, the licensee under such contract may elect—
>
> (A) to treat such contract as terminated by such rejection if such rejection by the trustee amounts to such

a breach as would entitle the licensee to treat such contract as terminated by virtue of its own terms, applicable nonbankruptcy law, or an agreement made by the licensee with another entity; or
(B) to retain its rights (including a right to enforce any exclusivity provision of such contract, but excluding any other right under applicable nonbankruptcy law to specific performance of such contract) under such contract and under any agreement supplementary to such contract, to such intellectual property (including any embodiment of such intellectual property to the extent protected by applicable nonbankruptcy law), as such rights existed immediately before the case commenced, for—
(i) the duration of such contract; and
(ii) any period for which such contract may be extended by the licensee as of right under applicable nonbankruptcy law.[5]

In effect, § 365(n)(1) gave licensees of intellectual property the option to either (1) treat a debtor's rejection as a termination of a license agreement and assert a claim for prepetition rejection damages (which is a remedy already afforded to non-debtor counterparties under § 365(g)), or (2) retain its rights to use intellectual property as those rights existed prepetition.

Along with the enactment of § 365(n), Congress amended the definition of "intellectual property" under § 101(35A) to include six categories of intellectual property:

- Trade secrets
- Inventions, processes, designs, or plants protected under title 35
- Patent applications
- Plant varieties
- Work of authorship protected under title 17; or
- Mask work protected under chapter 9 of title 17; to the extent protected by applicable nonbankruptcy law.

Notably absent from this list are trademarks or service marks. However, Congress stated in its accompanying report that this omission was intentional to allow for the additional study of trademarks and service marks. With this, Congress left open the issue of how trademark rights are to be treated upon rejection.

C. Sunbeam

In 2012, the United States Court of Appeals for the Seventh Circuit visited the issue of rejection of intellectual property agreements under § 365, and ultimately took a different approach than the Fourth Circuit in *Lubrizol*. In *Sunbeam Products, Inc. v. Chicago American Manufacturing, LLC*,[6] the Chapter 7 trustee and a purchaser of the debtor's patents and trademarks brought an adversary proceeding against a company to which the debtor had outsourced production of a product, alleging trademark and patent infringement. The adversary proceeding raised a dispute about whether the outsource company was acting within the scope of the intellectual property license previously granted to it by the debtor and whether, upon the trustee's rejection of the contract, the license terminated.

The Seventh Circuit, in a matter of first impression, held that the trustee's rejection of the contract did not eliminate the outsource company's license to sell the particular product and use the debtor's trademark. In so holding, the Seventh Circuit rejected *Lubrizol*'s view that rejection of a trademark license terminates the nondebtor's rights to the trademark. Instead, the court reasoned that the effect of rejection of a trademark license is breach, and, in such circumstances, the nondebtor party has rights that remain under nonbankruptcy law. The court stated: "rejection is not the functional equivalent of a rescission, rendering void the contract and requiring that the parties be put back in the positions they occupied before the contract was formed … . It merely frees the estate from the obligation to perform and has absolutely no effect upon the contract's continued existence."[7]

II. *Tempnology*: Facts and Procedural History

On November 21, 2012, Mission and Tempnology, LLC (the "Debtor") executed a marketing and distribution agreement (the "Agreement"), which provided Mission with three categories of rights: (1) exclusive and non-exclusive distribution rights for certain of the Debtor's manufactured products; (2) a non-exclusive license to the Debtor's intellectual property, expressly excluding any rights to the Debtor's trademarks; and (3) a non-exclusive, non-transferrable, limited license to use the Debtor's trademarks and logo for a limited purpose. Mission sought to terminate the Agreement in 2014, which triggered a two-year wind-down period under the terms of the Agreement.

On September 1, 2015, the Debtor filed a voluntary Chapter 11 petition. The following day, the Debtor moved to reject the Agreement under § 365(a). Mission objected, arguing that pursuant to § 365(n), Mission could retain its intellectual property license, its exclusive distribution rights, and its rights under the limited trademark license, notwithstanding rejection.

The United States Bankruptcy Court for the District of New Hampshire granted the Debtor's motion to reject the Agreement, subject to Mission's election to preserve its rights under § 365(n). The Debtor then moved for a determination of the applicability and scope of Mission's rights under § 365(n). The Debtor conceded that Mission retained the non-exclusive intellectual property license under § 365(n), but argued that Mission could not retain the exclusive distribution rights or the non-exclusive trademark license. The bankruptcy court agreed, concluding that Mission did not retain the exclusive distribution rights or the non-exclusive trademark license following rejection. The court explained that § 365(n) only protects intellectual property rights, and Mission's exclusive distributorship did not fall within that category, even if the branded products that were being distributed utilized a patent. Moreover, as to the trademark rights, the court reasoned that Congress' decision to leave trademarks out of the definition of intellectual property in § 101(35A) meant trademark licenses were unprotected from rejection.

Mission appealed to the Bankruptcy Appellate Panel for the First Circuit. The BAP affirmed the bankruptcy court on the exclusive distribution rights issue, but diverged when it came to the non-exclusive trademark license. While the BAP agreed that § 365(n) failed to protect Mission's rights to the Debtor's trademarks, it disagreed as to the *effect* of that conclusion. Following the reasoning of the Seventh Circuit in *Sunbeam*, the BAP held that because § 365(g) of the Code deems the effect of rejection to be a breach of contract, and because a licensor's breach of a license agreement in the non-bankruptcy context does not necessarily terminate the licensee's rights, rejection under § 365 likewise did not eliminate Mission's rights. An appeal to the First Circuit followed.

III. The First Circuit's Ruling

A. Were the Exclusive Distribution Rights Affected by the Debtor's Rejection of the Agreement?

The first issue addressed by the court of appeals in *Tempnology* was whether rejection of the Agreement terminated Mission's exclusive distribution rights. Mission's position was that its exclusive distribution rights were protected by the "any exclusivity provision" reference in § 365(n)(1)(B). Mission contended that the reference to exclusivity in § 365(n)(1)(B) meant that the retention of rights provided for in § 365(n) applied to *any* exclusivity provision in the Agreement, regardless whether such provision granted an intellectual property right.

The First Circuit disagreed. The court explained that a debtor may seek to reject executory contracts under Bankruptcy Code § 365(a) and that § 365(n)(1) focuses on a "subset of ***that*** universe"—i.e., executory contracts in which a debtor is the licensor of a right to intellectual property—in providing that a licensee may retain its rights upon rejection of a license.[8] The court reasoned that subsection 365(n)(1)(B) protects only a license to use intellectual property, and *not* an exclusive right to sell a product just because that right appears in the same contract as an intellectual property license. The court held that because the only exclusive right afforded to Mission under the Agreement was the right to sell certain products that used a patent, not the right to use the patent itself, Mission's exclusive distribution rights did not survive rejection.[9]

B. Did Mission Retain the Trademark License Following Rejection of the Agreement?

The second issue before the First Circuit in *Tempnology* was whether Mission retained its rights to use the Debtor's trademarks following rejection of the Agreement. On this issue, the court affirmed the bankruptcy court and held that Mission's trademark license was *not* protected by § 365(n) after rejection.

In reaching this conclusion, the First Circuit disagreed with the Seventh Circuit's reasoning in *Sunbeam* that rejection of a license agreement constitutes a breach of contract that frees the debtor from the obligation to perform but does not "vaporize" the nondebtor counterparty's rights to continue using the license.

The First Circuit found this outcome problematic in light of the fact that "effective licensing of a trademark requires that the trademark owner … monitor and exercise control over the quality of the goods sold to the public under cover of the trademark."[10] Indeed, under the Seventh Circuit's approach, Mission's continued use of the Debtor's trademark would force the Debtor to choose between performing executory obligations under the Agreement that would arise from continuation of the license or risking the loss, or diminishing value, of the trademark. The court explained that *Sunbeam*'s approach ignored the burdens that would be imposed on debtors to monitor and enforce licenses—burdens inconsistent with the purposes of contract rejection under § 365.

The First Circuit further reasoned that *Sunbeam*'s limitations on contract rejection would invite "further leakage." After all, if trademark rights could survive rejection, why couldn't exclusive distribution rights survive as well? The court ultimately concluded that the best approach would be a categorical one, which would leave trademark licenses unprotected from court-approved rejection, unless and until decided otherwise by Congress.[11]

IV. Conclusion

Following the decision in *Tempnology*, the circuit split facing the Supreme Court can be summarized as follows: (i) the Fourth Circuit's view in *Lubrizol*, which provided that upon rejection, a license is terminated; (ii) the Seventh Circuit's view in *Sunbeam*, under which rejection of a license agreement only extinguishes the licensor's obligations, and not the license itself, thus the licensee maintains its right to use the license after rejection notwithstanding that the debtor is freed of its obligations; and (iii) the First Circuit's view in *Tempnology*, under which rejection of a trademark license agreement terminates the agreement, and the licensee's only recourse is a prepetition damages claim.

Certainly, the results of the *Lubrizol* and *Tempnology* decisions are severe since, in equating rejection to termination, a licensee's rights are completely cut-off. This seems inconsistent with what Congress intended in enacting § 365(n) given the statutory note recommending further exploration of the trademarks issue. While complete termination of a licensee's rights alleviates the debtor's burden of continued oversight, it can cause immense harm to a licensee whose business is dependent upon the license. For these reasons, as Third Circuit Judge Ambro noted in *Exide*, perhaps the fairest approach would be for courts to use their equitable powers to fashion relief that does not over-burden either the debtor or the licensee, based on the circumstances of each case. As always, the downside of admitting equitable relief would be some uncertainty as to whether, and to what extent trademark rights will be terminated through bankruptcy. Clearly, given the stakes at issue, the Supreme Court's decision resolving the circuit split is much anticipated.

Footnotes

* Melissa Martinez is a bankruptcy and restructuring associate at Saul Ewing Arnstein & Lehr LLP in the firm's Philadelphia office.

** Monique Bair DiSabatino is a partner of Saul Ewing Arnstein & Lehr LLP in the Bankruptcy and Restructuring Practice in the firm's Wilmington office.

1 *Mission Prod. Holdings, Inc. v. Tempnology, LLC (In re Tempnology, LLC)*, 879 F.3d 389 (1st Cir. 2018), *cert. granted in part*, *Mission Prod. Holdings, Inc. v. Tempnology, LLC*, No. 17-1657, 2018 WL 2939184 (Oct. 26, 2018).

2 11 U.S.C.A. § 365(a).

3 *See* 11 U.S.C.A. § 365(g) ("[T]he rejection of an executory contract or unexpired lease of the debtor constitutes a breach of such contract or lease … .").

4 *Lubrizol Enters., Inc. v. Richmond Metal Finishers, Inc.*, 756 F.2d 1043 (4th Cir. 1985).

5 11 U.S.C.A. § 365(n).

6 *Sunbeam Prods., Inc. v. Chicago Am. Mfg., LLC*, 686 F.3d 372 (7th Cir. 2012).

7 *Sunbeam*, 686 F.3d at 377 (citing *Thompkins v. Lil' Joe Records, Inc.*, 476 F.3d 1294, 1306 (11th Cir. 2007)); *see also In re Exide Techs.*, 607 F.3d 957, 965, 967 (3d Cir. 2010) (Ambro, J., concurring) (finding that "a trademark licensor's rejection of a trademark agreement under 11 U.S.C. § 365 does not necessarily deprive the trademark licensee of its rights in the licensed mark," and reasoning that the lower courts should have used their equitable powers to give the

debtor a fresh start without stripping the licensee of its "fairly procured trademarks").

8 *In re Tempnology, LLC*, 879 F.3d at 397.

9 The court remarked that "[a]n exclusive right to sell a product is not equivalent to an exclusive right to exploit the product's underlying intellectual property." *In re Tempnology, LLC*, 879 F.3d at 398.

10 *In re Tempnology, LLC*, 879 F.3d at 402.

11 Notably, First Circuit Judge Torruella wrote separately to agree with the majority that § 365(n) did not protect Mission's exclusive distribution rights or its non-exclusive trademark license. However, the Judge disagreed with the majority's "bright-line rule" that the omission of trademarks from the definition of "intellectual property" in the Code leaves the non-rejecting party without *any* remaining rights to use a debtor's trademark. Judge Torruella instead followed the BAP and the Seventh Circuit in finding that Mission's rights to use the Debtor's trademark did not vaporize upon rejection. Rather, he reasoned that the effect of the Debtor's rejection should be guided by the terms of the Agreement and nonbankruptcy law, which could be used to fashion an appropriate equitable remedy.

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KeyCite Red Flag - Severe Negative Treatment
Reversed and Remanded by Mission Product Holdings, Inc. v. Tempnology, LLC, U.S., May 20, 2019

879 F.3d 389
United States Court of Appeals, First Circuit.

IN RE: TEMPNOLOGY, LLC, n/k/a Old Cold LLC, Debtor.
Mission Product Holdings, Inc., Appellant,
v.
Tempnology, LLC, n/k/a Old Cold LLC, Appellee.

No. 16-9016
|
January 12, 2018

Synopsis

Background: Chapter 11 debtor moved for determination of what rights exclusive distributor of its products and licensee of its intellectual property retained as result of election that it made following debtor's rejection of underlying agreement between parties. The United States Bankruptcy Court for the District of New Hampshire, J. Michael Deasy, J., 541 B.R. 1, ruled that distributor/licensee had no remaining distribution rights or rights in debtor's trademarks or logo, and distributor/licensee appealed. The Bankruptcy Appellate Panel of the First Circuit, Hoffman, J., 559 B.R. 809, affirmed in part and reversed in part. Appeal was taken.

Holdings: The Court of Appeals, Kayatta, Circuit Judge, held that:

[1] exclusive right granted to counter-party under its rejected executory contract with debtor to sell certain products manufactured using debtor's patented cooling technology was not equivalent to an exclusive right to exploit the underlying intellectual property, and counter-party, by making statutory election, could not preserve its exclusive right to distribute these products;

[2] products produced using Chapter 11 debtor's patented cooling technology were neither "intellectual property" nor an "embodiment" of such intellectual property;

[3] on issue of first impression, trademarks which exclusive distributor of products produced using debtor's patented cooling technology was allowed to use pursuant to terms of rejected marketing and distribution agreement did not constitute "intellectual property"; and

[4] even assuming that adversary proceeding was required to determine scope of counter-party's continuing rights under its rejected marketing and distribution agreement with debtor, bankruptcy court's failure to require adversary proceeding, instead deciding scope of counter-party's continuing rights in connection with debtor's motion to reject agreement, was mere harmless error.

Bankruptcy court's decision affirmed.

Torruella, Circuit Judge, filed opinion concurring in part and dissenting in part.

West Headnotes (16)

[1] **Bankruptcy**
Assumption, Rejection, or Assignment

Debtor-in-possession, with bankruptcy court's approval, may reject any executory contract that, in debtor's business judgment, is not beneficial to the company. 11 U.S.C.A. § 365(a).

1 Cases that cite this headnote

[2] **Bankruptcy**
Conclusions of law; de novo review
Bankruptcy
Clear error

On appeal from decision of the Bankruptcy Appellate Panel (BAP), the Court of Appeals accords no special deference to determinations made by the BAP, but instead trains the lens of its inquiry directly on bankruptcy court's decision, reviewing bankruptcy court's factual findings for clear error and its conclusions of law de novo. Fed.Rules Bankr.Proc.Rule 8013, 11 U.S.C.A.

1 Cases that cite this headnote

[3] **Bankruptcy**
Executory nature in general

"Executory contracts," as that term is used in the Bankruptcy Code, are contracts on which performance is due to some extent on both sides. 11 U.S.C.A. § 365(a).

1 Cases that cite this headnote

[4] **Bankruptcy**
Assumption, Rejection, or Assignment

Bankruptcy statute governing debtor's executory contracts and unexpired leases permits trustee or debtor-in-possession to assume those contracts that are beneficial and reject those that may hinder debtor's recovery, thereby providing an elixir for use in nursing a business back to good health by allowing the trustee or debtor-in-possession to prescribe it as an emetic to purge the bankruptcy estate of obligations that promise to hinder a reorganization. 11 U.S.C.A. § 365(a).

1 Cases that cite this headnote

[5] **Bankruptcy**
Effect of Acceptance or Rejection

Parenthetical phrase "including a right to enforce any exclusivity provision of such contract," as used in bankruptcy statute allowing the licensee under rejected intellectual property agreement to elect to retain its rights to such intellectual property, could not be interpreted as allowing license to elect to retain its rights under any exclusivity provision in entire contract, whether or not that provision granted exclusive use of a pertinent intellectual property right; Congress did not intend that, as result of licensee's election, its post-rejection rights could extend beyond its bargained-for intellectual property rights. 11 U.S.C.A. § 365(n)(1)(B).

1 Cases that cite this headnote

[6] **Bankruptcy**
Effect of Acceptance or Rejection

Exclusive right granted to counter-party under its rejected executory contract with Chapter 11 debtor to sell certain products manufactured using debtor's patented cooling technology was not equivalent to an exclusive right to exploit the underlying intellectual property, and contract counter-party, by making statutory election following debtor's rejection of this executory contract, could not preserve its exclusive right to distribute these products. 11 U.S.C.A. § 365(n)(1)(B).

Cases that cite this headnote

[7] **Bankruptcy**
Effect of Acceptance or Rejection

Words "any embodiment of such intellectual property," as used in bankruptcy statute allowing the licensee under rejected intellectual property agreement to elect to retain its rights to such intellectual property, including any embodiment of such intellectual property, referred to a tangible or physical object which existed prepetition, and to which licensee had access pursuant to terms of rejected agreement; "embodiment of intellectual property," as used in statute, was something inherently limited in number, such as a prototype or example of product, but did not include all products produced using the intellectual property. 11 U.S.C.A. § 365(n)(1)(B).

1 Cases that cite this headnote

[8] **Statutes**
Terms of art

Statutes
Extrinsic Aids to Construction

When statutory language includes a term of art, resort to sources beyond the statutory text is particularly appropriate to make clear the intended meaning of that term.

Cases that cite this headnote

[9] **Bankruptcy**
Effect of Acceptance or Rejection

Purpose of Congress in specifying that licensee under rejected intellectual property agreement, by electing to retain its rights to such intellectual property, would also preserve its rights in "any embodiment of such intellectual property," was to allow licensee to exploit its right to the underlying intellectual property. 11 U.S.C.A. § 365(n)(1)(B).

1 Cases that cite this headnote

[10] **Bankruptcy**
Effect of Acceptance or Rejection

Products produced using Chapter 11 debtor's patented cooling technology were neither "intellectual property" nor an "embodiment" of such intellectual property, and thus counter-party to rejected marketing and distribution agreement with Chapter 11 debtor, by making statutory election, could not preserve its exclusive to sell such products post-rejection. 11 U.S.C.A. § 365(n)(1)(B).

Cases that cite this headnote

[11] **Bankruptcy**
Presentation of grounds for review

By never raising argument in bankruptcy court as basis for preserving its exclusive product distribution rights following Chapter 11 debtor's rejection of executory marketing and distribution agreement, contract counter-party waived that argument as issue on appeal. 11 U.S.C.A. § 365(n)(1)(B).

Cases that cite this headnote

[12] **Bankruptcy**
Effect of Acceptance or Rejection

Trademarks which exclusive distributor of products produced using Chapter 11 debtor's patented cooling technology was allowed to use pursuant to terms of rejected marketing and distribution agreement did not constitute "intellectual property," within meaning of bankruptcy statute providing that licensee of debtor's intellectual property may elect to continue using such property following debtor's rejection of underlying agreement, and distributor, by making this election, could not preserve its right to continue using debtor's trademarks post-rejection.

1 Cases that cite this headnote

[13] **Bankruptcy**
Effect of Acceptance or Rejection

Rejection of executory contract does not "vaporize" the contract rights thereunder, but rather converts those rights into a prepetition claim for damages. 11 U.S.C.A. § 365(g).

Cases that cite this headnote

[14] **Bankruptcy**
Assumption, Rejection, or Assignment

Principal aim of Congress in providing for rejection of debtor's executory contracts and unexpired leases was to release the debtor's estate from burdensome obligations that can impede a successful reorganization. 11 U.S.C.A. § 365(a).

Cases that cite this headnote

[15] **Trademarks**
Function and purpose of trademarks in general

Trademarks, unlike patents, are public-facing messages to consumers about the relationship between the goods and the trademark owner; they signal uniform quality and also protect a business from competitors who attempt to profit from its developed goodwill.

Cases that cite this headnote

[16] **Bankruptcy**
Harmless error

Even assuming that adversary proceeding was required to determine scope of counter-party's continuing rights under its rejected marketing and distribution agreement with Chapter 11 debtor, as result of its statutory election to retain its rights in debtor's intellectual property, bankruptcy court's failure to require adversary proceeding, instead deciding scope of counter-party's continuing rights in connection with debtor's motion to reject agreement, was mere harmless error, where bankruptcy court permitted debtor and contract counter-party to conduct discovery, and there was no evidence that either party had a need for, or in fact did conduct, discovery, and if they did, counter-party offered no explanation for how this discovery generated any factual dispute that need be resolved by testimonial hearing. 11 U.S.C.A. § 365(n)(1)(B); Fed. R. Bankr. P. 7001, 9014.

Cases that cite this headnote

***392** APPEAL FROM THE BANKRUPTCY APPELLATE PANEL FOR THE FIRST CIRCUIT

Attorneys and Law Firms

Robert J. Keach, with whom Lindsay K.Z. Milne and Bernstein, Shur, Sawyer & Nelson, P.A., Portland, ME, were on brief, for appellant.

Lee A. Harrington, Boston, MA, with whom Daniel W. Sklar and Nixon Peabody LLP, Manchester, NH, were on brief, for appellee.

Before Torruella, Lynch, and Kayatta, Circuit Judges.

Opinion

KAYATTA, Circuit Judge.

Generally speaking, when a company files for protection under Chapter 11 of the Bankruptcy Code, the trustee or the debtor-in-possession may secure court approval to "reject" any executory contract of the debtor, meaning that the other party to the contract is left with a damages claim for breach, but not the ability to compel further performance. 11 U.S.C. §§ 365(a), 1107(a); see NLRB v. Bildisco & Bildisco, 465 U.S. 513, 531–32, 104 S.Ct. 1188, 79 L.Ed.2d 482 (1984); Mason v. Official Comm. of Unsecured Creditors, for FBI Distrib. Corp. & FBC Distrib. Corp. (In re FBI Distrib. Corp.), 330 F.3d 36, 43–44 (1st Cir. 2003). When the rejected contract, however, is one "under which the debtor is a licensor of a right to intellectual property," the licensee may elect to "retain its rights ... to such intellectual property," thereby continuing the debtor's duty to license the intellectual property. 11 U.S.C. § 365(n)(1). In this case, Tempnology, LLC ("Debtor")—a debtor-in-possession seeking to reorganize under Chapter 11—rejected an agreement giving certain marketing and distribution rights to Mission Product Holdings, Inc. The parties agree that Mission can insist that the rejection not apply to nonexclusive patent licenses contained in the rejected agreement. They disagree as to whether the rejection applies to the agreement's grants of a trademark license and of exclusive rights to sell certain of Debtor's goods. In the case of the trademark license, resolving that disagreement poses for this circuit an issue of first impression concerning which other circuits are split. For the following reasons, we agree with the bankruptcy court that the rejection left Mission with only a pre-petition damages claim in lieu of any obligation by Debtor to further perform under either the trademark license or the grant of exclusive distribution rights.

I.

Debtor made specialized products—such as towels, socks, headbands, and other accessories—designed to remain at low temperatures even when used during exercise, which it marketed under the "Coolcore" and "Dr. Cool" brands. A significant intellectual property portfolio supported Debtor's products. This portfolio consisted of two issued patents, four pending patents, research studies, and a multitude of registered and pending trademarks.

On November 21, 2012, Mission and Debtor executed a Co-Marketing and Distribution Agreement, which serves as the focal point of this appeal. The Agreement provided Mission with three relevant categories of rights.

First, Debtor granted Mission distribution rights to certain of its manufactured ***393** products within the United States.[1] These products, called "Cooling Accessories," were defined in the Agreement as "products of the specific types listed on Exhibit A" and "manufactured by or on behalf of [Debtor]." They also included "additional products that are hereafter developed by [Debtor]." Exhibit A broke down the thirteen listed products into two categories: "Exclusive" and "Non-Exclusive" Cooling Accessories. For "Exclusive Cooling Accessories"—comprised of towels, wraps, hoodies, bandanas, multi-chills, and doo rags—Debtor agreed that "it will not license or sell" the products "to anyone other than [Mission] during the Term." Mission's rights with respect to the remaining Cooling Accessories—comprised of socks, headbands, wristbands, sleeves, skullcaps, yoga mats, and baselayers—were nonexclusive because Debtor reserved for itself the "right to sell ... to vertically integrated companies as well as customers that are not Sports Distributors or retailers in the Sporting Channel."

Second, Debtor granted Mission a nonexclusive license to Debtor's intellectual property. This "non-exclusive, irrevocable, royalty-free, fully paid-up, perpetual, worldwide, fully-transferable license" granted Mission the right "to sublicense (through multiple tiers), use, reproduce, modify, and create derivative work based on and otherwise freely exploit" Debtor's products—including Cooling Accessories—and its intellectual property. This irrevocable license, however, expressly excluded any rights to Debtor's trademarks.

Trademarks were the subject of the third bucket of rights. Section 15(d) of the Agreement granted Mission a "nonexclusive, non-transferable, limited license" for the term of the Agreement "to use [Debtor's] trademark and logo (as well as any other Marks licensed hereunder) for the limited purpose of performing its obligations hereunder, exercising its rights and promoting the purposes of this Agreement." This license came with limitations. Mission was forbidden from using the trademarks in a manner that was disparaging, inaccurate, or otherwise inconsistent with the terms of the Agreement. Further, Mission was required to "comply with any written trademark guidelines" and Debtor had "the right to review and approve all uses of its Marks," except for certain pre-approved uses.

The Agreement also included a provision permitting either party to terminate the Agreement without cause. On June 30, 2014, Mission exercised this option, triggering a "Wind-Down Period" of approximately two years. Debtor, in turn, issued a notice of immediate termination for cause on July 22, 2014, claiming that Mission's hiring of Debtor's former president violated the Agreement's restrictive covenants. Pursuant to the Agreement's terms, Mission's challenge to Debtor's immediate termination for cause went before an arbitrator. The arbitrator determined that Debtor had waived any grounds for immediate termination under the restrictive covenant and that the Agreement remained in effect until the expiration of the Wind-Down Period. That ruling meant that Mission was contractually entitled to retain its distribution and trademark rights until July 1, 2016, and its nonexclusive intellectual property rights in perpetuity.

Intervening events, however, put an earlier end to the parties' contractual relationship. Although Debtor posted profits in 2012, its financial outlook dimmed. After ***394** accruing multi-million dollar net operating losses in 2013 and 2014, Debtor filed a voluntary petition for Chapter 11 bankruptcy on September 1, 2015. The following day, Debtor moved to reject seventeen of its contracts, including the Agreement, pursuant to 11 U.S.C. § 365(a).

[1]Section 365(a) permits a debtor-in-possession,[2] with the court's approval, to "reject any executory contract" that, in the debtor's business judgment, is not beneficial to the company. See Agarwal v. Pomona Valley Med. Grp., Inc. (In re Pomona Valley Med. Grp., Inc.), 476 F.3d 665, 669–71 (9th Cir. 2007); see also Bildisco & Bildisco, 465 U.S. at 520, 523, 104 S.Ct. 1188. In its memoranda supporting its motion, Debtor informed the bankruptcy court that it sought to reject the Agreement because it hindered Debtor's ability to derive revenue from other marketing and distribution opportunities. Debtor faulted Mission—and particularly the Agreement's grant of

exclusive distribution rights—for its bankruptcy. It alleged that the Agreement "suffocated the Debtor's ability to market and distribute its products" after Mission failed to fulfill its obligations, "essentially starving the Debtor from any income."

Mission objected to the rejection motion, arguing that 11 U.S.C. § 365(n) allowed Mission to retain both its intellectual property license and its exclusive distribution rights. Section 365(n) provides an exception from section 365(a)'s broad rejection authority by limiting the debtor-in-possession's ability to terminate intellectual property licenses it has granted to other parties.

On September 21, 2015, the bankruptcy court granted Debtor's motion to reject certain executory contracts, except for the Agreement, for which it ordered further hearing. In a subsequent one-sentence order, the bankruptcy court granted the motion to reject the Agreement, "subject to Mission Product Holdings's election to preserve its rights under 11 U.S.C. § 365(n)." Debtor then moved for a determination of the applicability and scope of Mission's rights under section 365(n). In that motion, Debtor conceded that Mission retained its nonexclusive, perpetual license to certain of Debtor's intellectual properties—which did not include its trademarks—but argued that section 365(n) did not cover either Mission's exclusive distribution rights or the trademark license. Mission again objected, arguing that the relief Debtor requested required an adversary proceeding pursuant to Rule 7001(2) of the Federal Rules of Bankruptcy Procedure.

After holding a nontestimonial hearing, the bankruptcy court concluded that Mission's election pursuant to section 365(n) did not preserve either the exclusive distribution rights or the trademark license. The court found that section 365(n) only protected intellectual property rights, and Mission's exclusive distributorship could not fairly be characterized as such. With respect to trademarks, the court reasoned that Congress's decision to leave trademarks off the definitional list of intellectual properties in 11 U.S.C. § 101(35A) left the trademark license unprotected from rejection. Finally, the court rejected Mission's argument that the Bankruptcy Code required an adversary proceeding to determine the issue. The court viewed "the Motion in the context of rejection under ***395** § 365, which is a contested matter under Fed. R. Bankr. P. 9014."

Mission appealed to the Bankruptcy Appellate Panel for the First Circuit ("BAP"). The BAP affirmed the bankruptcy court's order with respect to Mission's exclusive distribution rights, concluding that "Mission's attempt to re-characterize its exclusive product distribution rights under the Agreement as an intellectual property license [is] unsupported by either the letter or the spirit of the Agreement." Like the bankruptcy court, the BAP read section 365(n)'s protection of "exclusivity provision[s]" as encompassing only the exclusivity attributes, such as they might be, of intellectual property rights. The BAP also affirmed the bankruptcy court's determination that the section 365(n) motion did not require Debtor to commence an adversary proceeding under Bankruptcy Rule 7001.

Regarding trademarks, however, the BAP diverged from the bankruptcy court. Although the BAP agreed that section 365(n) failed to protect Mission's rights to Debtor's trademarks, it disagreed as to the effect of that conclusion. Rather than finding that rejection extinguished the non-debtor's rights, the BAP followed the Seventh Circuit's ruling in Sunbeam Products, Inc. v. Chicago American Manufacturing, LLC, 686 F.3d 372 (7th Cir. 2012). The BAP held that, because section 365(g) deems the effect of rejection to be a breach of contract, and a licensor's breach of a trademark agreement outside the bankruptcy context does not necessarily terminate the licensee's rights, rejection under section 365(g) likewise does not necessarily eliminate those rights. Thus, the BAP reversed the bankruptcy court's determination that Mission no longer had protectable rights in Debtor's trademarks and trade names.

This appeal ensued. We affirm the bankruptcy court's determinations. We conclude that section 365(n) does not apply to Mission's right to be the exclusive distributor of Debtor's products, or to its trademark license. Unlike the BAP and the Seventh Circuit, we also hold that Mission's right to use Debtor's trademarks did not otherwise survive rejection of the Agreement.

II.

[2]On appeal from a decision by the BAP, "[w]e accord no special deference to determinations made by the [BAP]," and instead "train the lens of our inquiry directly on the bankruptcy court's decision."[3] Wheeling & Lake Erie Ry. Co. v. Keach (In re Montreal, Maine & Atl. Ry., Ltd.), 799 F.3d 1, 5 (1st Cir. 2015). In doing so, we review the bankruptcy court's factual findings for clear error and its conclusions of law de novo. DeGiacomo v. Traverse (In re Traverse), 753 F.3d 19, 24 (1st Cir. 2014).

III.

[3] [4]We begin with the statutory framework that defines the scope of Debtor's ability, "subject to the court's approval," to "assume or reject any executory contract or unexpired lease of the debtor." 11 U.S.C. § 365(a). Executory contracts, although not defined in the Bankruptcy Code, are generally considered to be contracts "on which performance is due to some extent on both sides." ***396** In re FBI Distrib. Corp., 330 F.3d at 40 n.5 (quoting Bildisco & Bildisco, 465 U.S. at 522 n.6, 104 S.Ct. 1188); see also Parkview Adventist Med. Ctr. v. United States ex rel. Dep't of Health & Human Servs., 842 F.3d 757, 763 n.12 (1st Cir. 2016). Section 365(a) permits the debtor-in-possession to assume those contracts that are beneficial and reject those that may hinder its recovery. In re FBI Distrib. Corp., 330 F.3d at 42. It provides an "elixir for use in nursing a business back to good health" by allowing the trustee or debtor-in-possession to "prescribe it as an emetic to purge the bankruptcy estate of obligations that promise to hinder a reorganization." Thinking Machs. Corp. v. Mellon Fin. Servs. Corp. (In re Thinking Machs. Corp.), 67 F.3d 1021, 1024 (1st Cir. 1995). Section 365(a) thus furthers Chapter 11's "paramount objective" of rehabilitating debtors. In re FBI Distrib. Corp., 330 F.3d at 41. In lieu of the rejected obligation, a debtor is left with a liability for what the Code deems to be a pre-petition breach of the contract. 11 U.S.C. § 365(g) ("[T]he rejection of an executory contract or unexpired lease of the debtor constitutes a breach of such contract or lease ... immediately before the date of the filing of the petition....").

In 1985, the Fourth Circuit was tasked with applying this framework to an intellectual property license granted by a debtor. See Lubrizol Enters., Inc. v. Richmond Metal Finishers, Inc., 756 F.2d 1043 (4th Cir. 1985). The Fourth Circuit held that the term "executory contract" in section 365(a) encompassed intellectual property licenses, id. at 1045, and that under section 365(g) the effect of rejection was to terminate an intellectual property license, id. at 1048. The court based its reasoning on what it saw as the animating principles behind section 365(g), thus distinguishing "statutory breach" from common law breach:

> Even though § 365(g) treats rejection as breach, the legislative history of § 365(g) makes clear that the purpose of the provision is to provide only a damages remedy for the non-bankrupt party.... [T]he statutory "breach" contemplated by § 365(g) controls, and provides only a money damages remedy for the non-bankrupt party. ... Allowing specific performance would obviously undercut the core purpose of rejection under § 365(a).

Id.

Three years later, Congress responded. Rather than amending either section 365(a) or section 365(g), Congress enacted a brand new section 365(n). See S. Rep. No. 100-505, at 8 (1988). Section 365(n)(l) gives to a licensee of intellectual property rights a choice between treating the license as terminated and asserting a claim for pre-petition damages—a remedy the licensee held already under section 365(g)—or retaining its intellectual property rights under the license. It states, in full:

> If the trustee rejects an executory contract under which the debtor is a licensor of a right to intellectual property, the licensee under such contract may elect—
>
> (A) to treat such contract as terminated by such rejection if such rejection by the trustee amounts to such a breach as would entitle the licensee to treat such contract as terminated by virtue of its own terms, applicable nonbankruptcy law, or an agreement made by the licensee with another entity; or
>
> (B) to retain its rights (including a right to enforce any exclusivity provision of such contract, but excluding any other right under applicable nonbankruptcy law to specific performance of such contract) under such ***397** contract and under any agreement supplementary to such contract, to such intellectual property (including any embodiment of such intellectual property to the extent protected by applicable nonbankruptcy law), as such rights existed immediately before the case commenced, for—
>
> (i) the duration of such contract; and
>
> (ii) any period for which such contract may be extended by the licensee as of right under

applicable nonbankruptcy law.

11 U.S.C. § 365(n)(1).

Congress also amended the definition of intellectual property, thus defining the scope of the new section 365(n)(1). Under 11 U.S.C. § 101(35A),

> The term "intellectual property" means—
>
> (A) trade secret;
>
> (B) invention, process, design, or plant protected under title 35;
>
> (C) patent application;
>
> (D) plant variety;
>
> (E) work of authorship protected under title 17; or
>
> (F) mask work protected under chapter 9 of title 17;
>
> to the extent protected by applicable nonbankruptcy law.

IV.

With the foregoing framework in mind, we turn now to Mission's arguments on appeal. We consider first its contention that its exclusive distribution rights remained unaffected by Debtor's rejection of the Agreement. We then address Mission's contention that its trademark license also remained in effect during the two-year Wind-Down Period. What is at issue for these parties, practically speaking, is whether to classify as prepetition or post-petition liability any damages caused by Debtor's failure to honor its executory obligations during the two-year Wind-Down Period.

A.

[5]Section 365(n)(1)(B) allows Mission "to retain its rights (including a right to enforce any exclusivity provision of such contract ...) under such contract and under any agreement supplementary to such contract, to such intellectual property (including any embodiment of such intellectual property to the extent protected by applicable nonbankruptcy law)." Mission would have us read the words "any exclusivity provision of such contract" in the foregoing parenthetical as meaning any "exclusivity provision" in the entire contract (or any supplementary agreement), whether or not the provision grants exclusive use of a pertinent intellectual property right.

We disagree. We start in section 365(a) with the universe of all executory contracts that a debtor may seek to reject; section 365(n)(1) then focuses on a subset of that universe ("executory contract[s] under which the debtor is a licensor of a right to intellectual property"); subsection (n)(1)(B) then says what happens to intellectual property rights granted under such contracts (the licensee may "retain its rights"); and the parenthetical merely makes clear that those rights "to such intellectual property" include any exclusivity attributes of those rights. In this manner, subsection (n)(1)(B) protects, for example, an exclusive license to use a patent, but does not protect an exclusive right to sell a product merely because that right appears in a contract that also contains a license to use intellectual property.

Our reading aligns with the legislative record. In enacting section 365(n), Congress ***398** made clear that it was responding to a "particular problem arising out of recent court decisions." S. Rep. No. 100-505, at 5. The limited "purpose of the bill is to amend Section 365 of the Bankruptcy Code to make clear that the rights of an intellectual property licensee to use the licensed property cannot be unilaterally cut off." Id. at 1. The amendment is "not in any way intended to address broader matters under Section 365." Id. at 5. Congress, it seems, was focused on a narrow issue, and only intended its amendment to address that issue. It did not intend the scope of its amendment to extend beyond the licensee's bargained-for intellectual property rights post-rejection, as Mission's position would necessarily require. Further supporting our reading of the statutory text, Congress's description of the protected exclusivity rights in both relevant congressional reports is limited to license rights, and does not mention or imply the protection of exclusive rights other than those to intellectual property. The House Report, describing the House's version of the bill,[4] states that, "[u]nder the legislation, any right in the license agreement giving the licensee an exclusive license will still be enforceable by the licensee, but other rights of the licensee cannot be specifically enforced." H.R. Rep. No. 100-1012, at 6 (1988). Similarly, the Senate Report says that "if the contract granted exclusive use to the licensee, such exclusivity would be preserved to the license." S. Rep. No. 100-505, at 9.

[6]Mission's fallback position is to argue that, in this instance, its exclusive distribution right is, de facto, a provision that renders its right to use Debtor's intellectual property exclusive. The unstated premise is that because Mission has an exclusive right to sell certain of Debtor's products made using Debtor's intellectual property, no one else can use the intellectual property. Hence, Mission reasons, the exclusive distribution right is an "exclusivity provision" of the intellectual property right.

The most obvious defect in this argument is its premise. The Agreement and record are clear that Debtor can use its intellectual property to make and sell products other than those for which the Agreement grants Mission exclusive distribution rights. The only thing that is exclusive is the right to sell certain products, not the right to practice, for example, the patent that is used to make those products. An exclusive right to sell a product is not equivalent to an exclusive right to exploit the product's underlying intellectual property.

But, argues Mission, because of its exclusive distribution rights, no one can use the Debtor's patent to make at least some products if those products are to be sold in Mission's territory. Perhaps. But this is simply a restriction on the right to sell certain products that, like many products, happen to be made using a patent. And the exclusivity Mission seeks to maintain would apply fully even if there were no patent license at all. Given that the right to sell a product is clearly not included within the statute's definition of intellectual property, we are not going to treat it as such merely because of a coincidental practical effect it may have in limiting the scope of the manner in which a patent might be exploited, especially where the Agreement itself expressly makes clear that any patent license is nonexclusive. To hold otherwise would be to find buried in a parenthetical to a statutory subsection an implied exception to rejection that would, ***399** in practical terms, likely cover as much commercial territory as do some of the rights expressly defined as protected. See Whitman v. Am. Trucking Ass'n, 531 U.S. 457, 468, 121 S.Ct. 903, 149 L.Ed.2d 1 (2001) ("Congress ... does not, one might say, hide elephants in mouseholes."). The fact that Mission can cite no circuit court precedent for its effort to paint its exclusive distribution right as a de facto exclusive intellectual property right further buttresses our conclusion.[5]

Mission also argues that its nonexclusive license of intellectual property "lacks meaningful value" unless it retains an exclusive right to sell certain of Debtor's products. Why this is so is not apparent given that section 365(n) protects the nonexclusive license, hence Mission retained the right to use the intellectual property. The Agreement itself spells out myriad ways that Mission could exploit its nonexclusive intellectual property rights that were presumably unaffected by rejection of its exclusive distribution right: Mission could still "sublicense (through multiple tiers), use, reproduce, modify, and create derivative work based on" Debtor's intellectual property. And if those rights lacked meaningful value, that hardly becomes a reason for turning rights that are not intellectual property rights into intellectual property rights. Rather, it simply suggests that most of the contract's value was apparently in the exclusive distribution agreement.

[7]Nor does the reference in section 365(n)(1)(B) to "any embodiment of such intellectual property" help Mission. Embodiment is a term of art associated with intellectual property. The Senate Report includes a letter informing the Judiciary Committee of the Department of Commerce's view of the bill, which states that "[a]lthough 'embodiment' is not defined, we assume the term arises from the copyright law." S. Rep. No. 100-505, at 12. Black's Law Dictionary tags the term as belonging to patent law, and offers three alternate definitions: (1) "[t]he tangible manifestation of an invention"; (2) "[t]he method for using this tangible form"; or (3) "[t]he part of a patent application or patent that describes a concrete manifestation of the invention." *Embodiment*, Black's Law Dictionary (10th ed. 2014). Black's Law Dictionary further notes that while intellectual property "is a mental construct" without "physical structure," an embodiment "is a specific physical form of the invention" and thus "[e]ach embodiment exists in the real world." Id. (quoting Morgan D. Rosenberg, The Essentials of Patent Claim Drafting xvii (2012)).

[8]Where the statutory language includes a term of art, resort to sources beyond the text is particularly appropriate to make clear the intended meaning of that term. See Molzof v. United States, 502 U.S. 301, 307, 112 S.Ct. 711, 116 L.Ed.2d 731 (1992). Both the Senate Report and the Department of Commerce letter offer additional insight into the meaning of "embodiment" and its application to a licensee's rights. The Senate Report provides three examples of protected rights, and concludes with two traits that all protected rights must contain:

> [T]he parties might have agreed that the licensor would prepare a prototype incorporating the licensed intellectual property. If such a prototype was prepared prior to the filing of the petition for

> relief, but had not been delivered to ***400** the licensee at that time, then the licensee can compel the delivery of the prototype in accordance with the terms of the rejected license. Other examples of embodiments include genetic material needed to produce certain biotechnological products and computer program source codes. There are many other possible examples of embodiments, but critical to any right of the licensee to obtain such embodiments under this bill is the prepetition agreement of the parties that the licensee have access to such material and the physical existence of such material on the day of the bankruptcy filing.

S. Rep. No. 100-505, at 9-10 (emphasis added). The Department of Commerce letter states:

> Where the licensed intellectual property is not a work of authorship, we assume the term "embodiment" would be interpreted in a similar sense of enablement in a manner reasonable in the circumstances and would not necessarily include all physical manifestations of the intellectual property. For example, an embodiment of a licensed process might be interpreted to include technical data sufficient to enable the licensee to operate the process, but not a manufacturing facility using (or embodying) the process; and an embodiment of a licensed invention might be interpreted to include a sample of the invention, but not all inventory.

S. Rep. No. 100-505, at 12 (emphasis added).

[9]A few common themes appear in these explanations. First, the pre-petition agreement must give the licensee access to the embodiment of intellectual property. Second, an embodiment of intellectual property is a tangible or physical object that exists pre-petition. Third, an embodiment of intellectual property is something inherently limited in number—it is a prototype or example of a product, but does not include all products produced using the intellectual property. Finally, we can infer that the purpose of this provision is to allow the licensee to exploit its right to the underlying intellectual property.

[10]Here, we have no object to which Mission requires access in order to exploit an intellectual property right. Rather, we have a prosaic, nonexclusive right to use a patented process, and an unremarkable and entirely independent right to be the exclusive distributor of some but not all goods made with that process. There is simply no "embodiment" at issue in the relevant statutory sense.

Nor does this case, as Mission contends, bear on the enforceability of all negative covenants independent of an intellectual property license. If a party possesses an intellectual property license, perhaps the Code may protect from rejection certain negative covenants—such as confidentiality—that do not materially restrict the debtor's reorganization, are tied closely to the intellectual property license, and are necessary to implement its terms. See Biosafe Int'l, Inc. v. Controlled Shredders, Inc. (In re Szombathy), Nos. 94 B 15536, 95 A 01035, 1996 WL 417121, at *11 (Bankr. N.D. Ill. July 9, 1996) rev'd in part sub nom. Szombathy v. Controlled Shredders, Inc., Nos. 94 B 15536, 95 A 01035, 1997 WL 189314 (N.D. Ill. Apr. 14, 1997). But we are not presented with that situation here.

[11]Finally, we observe that Mission salts its brief with several undeveloped suggestions that rejection under section 365(a), even if allowed, might not extinguish a right to demand specific performance of the negative covenant implicit in the exclusive distribution rights. Mission attempts to support these suggestions by ***401** citing In re Szombathy, 1996 WL 417121, and by emphasizing that case's reliance on a quote from the Department of Commerce's letter to the Senate Judiciary Committee. Neither source seems to come close to carrying the meaning claimed by Mission. In any event, even as Mission tendered an analogous argument in connection with its trademark license (which we address, below), it never raised any such argument in the bankruptcy court as a basis for preserving its exclusive distribution rights. Hence, the argument is waived in this civil action. See Argentaria v. Wiscovitch-Rentas (In re Net-Velázquez), 625 F.3d 34, 40 (1st Cir. 2010) ("The proposition is well established that, 'absent the most extraordinary circumstances, legal theories not raised

squarely in the lower court cannot be broached for the first time on appeal.' " (quoting Teamsters, Chauffeurs, Warehousemen & Helpers Union, Local No. 59 v. Superline Transp. Co., 953 F.2d 17, 21 (1st Cir. 1992))).

B.

[12]We next consider whether Mission retained its rights to use Debtor's trademarks post-rejection. In defining the intellectual property eligible for the protection of section 365(n), Congress expressly listed six kinds of intellectual property. 11 U.S.C. § 101(35A). Trademark licenses (hardly something one would forget about) are not listed, even though relatively obscure property such as "mask work protected under chapter 9 of title 17" is included. Id. Nor does the statute contain any catchall or residual clause from which one might infer the inclusion of properties beyond those expressly listed.

One might reasonably conclude that Congress's decision not to include trademark licenses within the protective ambit of section 365(n) must mean that such licenses are not exempt from section 365(a) rejection. On the other hand, the conclusion that an agreement finds no haven from rejection in section 365(n) does not entirely exhaust the possible arguments for finding that a right under that agreement might otherwise survive rejection. For example, we have held that a counterparty's right to compel the return of its own property survives rejection of a contract under which the debtor has possession of that property. See Abboud v. The Ground Round, Inc. (In re The Ground Round, Inc.), 482 F.3d 15, 19 (1st Cir. 2007). This case, though, does not present us with a request by a party following rejection to recover its own property temporarily in the hands of the debtor. Rather, it presents a demand by a party to continue using the debtor's property.

Regarding trademarks specifically, the Senate Report states that Congress "postpone[d]" action on trademark licenses "to allow the development of equitable treatment of this situation by bankruptcy courts." S. Rep. No. 100-505, at 5. The only circuit to address this issue squarely has resisted the temptation to find in this ambiguous comment outside the statutory text a toehold for unfettered "equitable" dispensations from section 365(a) rejection when it would otherwise apply. See Sunbeam, 686 F.3d at 375 ("What the Bankruptcy Code provides, a judge cannot override by declaring that enforcement would be 'inequitable.' "). We agree. See Law v. Siegel, — U.S. —, 134 S.Ct. 1188, 1194-95, 188 L.Ed.2d 146 (2014) ("We have long held that 'whatever equitable powers remain in the bankruptcy courts must and can only be exercised within the confines of' the Bankruptcy Code." (quoting Norwest Bank Worthington v. Ahlers, 485 U.S. 197, 206, 108 S.Ct. 963, 99 L.Ed.2d 169 (1988))).

***402** There is, though, an alternative argument for finding that a right to use a debtor's trademark continues post-rejection. That argument rests not on equitable dispensation from rejection, but instead on an exploration of exactly what rejection means. The argument, as accepted by the Seventh Circuit in Sunbeam, runs thus: Under section 365(g), section 365(a) rejection constitutes a breach of contract that "frees the estate from the obligation to perform." Sunbeam, 686 F.3d at 377 (quoting Thompkins v. Lil' Joe Records, Inc., 476 F.3d 1294, 1306 (11th Cir. 2007)). "But nothing about this process implies that any rights of the other contracting party have been vaporized." Id. Therefore, reasoned the Seventh Circuit, while rejection converts a debtor's duty to perform into a liability for pre-petition damages, it leaves in place the counterparty's right to continue using a trademark licensed to it under the rejected agreement. In so reasoning, the Seventh Circuit found itself unpersuaded by the contrary approach taken by the Fourth Circuit in Lubrizol. Sunbeam, 686 F.3d at 378; see also In re Exide Techs., 607 F.3d 957, 964–68 (3d Cir. 2010) (Ambro, J., concurring).

[13] [14]Of course, to be precise, rejection as Congress viewed it does not "vaporize" a right. Rather, rejection converts the right into a pre-petition claim for damages. Putting that point of vocabulary to one side, and leaving open the possibility that courts may find some unwritten limitations on the full effects of section 365(a) rejection, we find trademark rights to provide a poor candidate for such dispensation. Congress's principal aim in providing for rejection was to "release the debtor's estate from burdensome obligations that can impede a successful reorganization." Bildisco & Bildisco, 465 U.S. at 528, 104 S.Ct. 1188. Sunbeam therefore largely rests on the unstated premise that it is possible to free a debtor from any continuing performance obligations under a trademark license even while preserving the licensee's right to use the trademark. See Sunbeam, 686 F.3d at 377. Judge Ambro's concurrence in In re Exide Technologies shares that premise. See 607 F.3d at 967 (Ambro, J., concurring) (assuming that the bankruptcy court could allow the licensee to retain trademark rights even while giving the debtor "a fresh start").

[15]Careful examination undercuts that premise because

the effective licensing of a trademark requires that the trademark owner—here Debtor, followed by any purchaser of its assets—monitor and exercise control over the quality of the goods sold to the public under cover of the trademark. See 3 J. Thomas McCarthy, McCarthy on Trademarks & Unfair Competition § 18:48 (5th ed. 2017) ("Thus, not only does the trademark owner have the right to control quality, when it licenses, it has the duty to control quality."). Trademarks, unlike patents, are public-facing messages to consumers about the relationship between the goods and the trademark owner. They signal uniform quality and also protect a business from competitors who attempt to profit from its developed goodwill. See Societe Des Produits Nestle, S.A. v. Casa Helvetia, Inc., 982 F.2d 633, 636 (1st Cir. 1992). The licensor's monitoring and control thus serve to ensure that the public is not deceived as to the nature or quality of the goods sold. Presumably, for this reason, the Agreement expressly reserves to Debtor the ability to exercise this control: The Agreement provides that Debtor "shall have the right to review and approve all uses of its Marks," except for certain pre-approved uses. Importantly, failure to monitor and exercise this control results in a so-called "naked license," jeopardizing the continued validity of the owner's own trademark rights. ***403** McCarthy, supra, § 18:48; see also Eva's Bridal Ltd. v. Halanick Enters., Inc., 639 F.3d 788, 790 (7th Cir. 2011) ("[A] naked license abandons a mark."); Restatement (Third) of Unfair Competition § 33 ("The owner of a trademark, trade name, collective mark, or certification mark may license another to use the designation. ... Failure of the licensor to exercise reasonable control over the use of the designation by the licensee can result in abandonment....").

The Seventh Circuit's approach, therefore, would allow Mission to retain the use of Debtor's trademarks in a manner that would force Debtor to choose between performing executory obligations arising from the continuance of the license or risking the permanent loss of its trademarks, thereby diminishing their value to Debtor, whether realized directly or through an asset sale. Such a restriction on Debtor's ability to free itself from its executory obligations, even if limited to trademark licenses alone, would depart from the manner in which section 365(a) otherwise operates. And the logic behind that approach (no rights of the counterparty should be "vaporized" in favor of a damages claim) would seem to invite further leakage. If trademark rights categorically survive rejection, then why not exclusive distribution rights as well? Or a right to receive advance notice before termination of performance? And so on.

Although claiming to follow Sunbeam, our dissenting colleague seems to reject its categorical approach in favor of what Sunbeam itself rejected—an "equitable remedy" that would consider in some unspecified manner the "terms of the Agreement, and non-bankruptcy law." See Sunbeam, 686 F.3d at 375-76. In so doing, our colleague gives great weight to a few lines in the Senate Report, treating them variously as "guidance," as a statement of Congress's "intent," and even as a mandate that "instruct[s]" the courts. In short, the dissent's interpretative approach seems to accord a line in the Senate Report the force of a line in the statute itself. Moreover, it does so by taking a line out of the Senate Report addressing section 365(n), which itself has no relevant ambiguity, and then uses that line to inform the dissent's interpretation of the previously enacted section 365(a). And while it is true that the Senate Report references equitable consideration, the dissent also seems to overlook the fact that when Congress otherwise intended to grant bankruptcy courts the ability to "equitably" craft exceptions to the Code's rules, it did so in the statute itself. See, e.g., 11 U.S.C. § 365(d)(5) (requiring the trustee to perform the obligations of the debtor until an unexpired lease is assumed or rejected "unless the court, after notice and a hearing and based on the equities of the case, orders otherwise"); id. § 552(b)(1) (stating that a security agreement may extend to proceeds or profits acquired after the commencement of the case "to the extent provided by such security agreement and by applicable nonbankruptcy law, except to any extent that the court, after notice and a hearing and based on the equities of the case, orders otherwise"); see also id. § 502(j) ("A reconsidered claim may be allowed or disallowed according to the equities of the case."); id. § 557(d)(2)(D) (allowing the expedited disposition of grain by, inter alia, "such other methods as is equitable in the case"); id. § 723(d) ("[T]he court, after notice and a hearing, shall determine an equitable distribution of the surplus so recovered...."); id. § 1113(c) (listing whether "the balance of the equities clearly favors rejection of such agreement" as a factor for a court to consider in determining whether to approve an application for rejection of a collective bargaining agreement); id. § 1114(g) (requiring a court to modify the payment of retirement benefits ***404** if the court finds that "such modification is necessary to permit the reorganization of the debtor and assures that all creditors, the debtor, and all of the affected parties are treated fairly and equitably, and is clearly favored by the balance of the equities").

Even if we did sit in the chancellor's chair in applying section 365(a), we would likely hesitate to adopt our colleague's approach. Under such a case-specific, equitable approach, one might in theory preclude rejection only where the burden of quality assurance on the debtor will be minimal. The problem, though, is that in the bankruptcy context especially, where the licensor and licensee are at odds over continuing to deal with each other, the burden will likely often be greater than normal. Here, for example, the adversarial relationship between Debtor and Mission may portend less eager compliance. More importantly, in all cases there will be some burden, and it will usually not be possible to know at the time of the bankruptcy proceeding how great the burden will prove to be, as it will depend very much on the subsequent actions of the licensee. Conversely, the burden imposed on the counterparty of having its trademark right converted to a prepetition damages claim at a time when the relationship signaled by the trademark is itself ending will in most instances be less than the burden of having patent rights so converted. The counterparty may still make and sell its products—or any products—just so long as it avoids use of the trademark precisely when the message conveyed by the trademark may no longer be accurate. We therefore find unappealing the prospect of saddling bankruptcy proceedings with the added cost and delay of attempting to draw fact-sensitive and unreliable distinctions between greater and lesser burdens of this type. See RadLAX Gateway Hotel, LLC v. Amalgamated Bank, 566 U.S. 639, 649, 132 S.Ct. 2065, 182 L.Ed.2d 967 (2012) ("[I]t is our obligation to interpret the Code clearly and predictably using well established principles of statutory construction."). There is, too, the public's interest in not being misled as to the origin and quality of goods that consumers buy.

In sum, the approach taken by Sunbeam entirely ignores the residual enforcement burden it would impose on the debtor just as the Code otherwise allows the debtor to free itself from executory burdens. The approach also rests on a logic that invites further degradation of the debtor's fresh start options. Our colleague's alternative, "equitable" approach seems similarly flawed, and has the added drawback of imposing increased uncertainty and costs on the parties in bankruptcy proceedings. For these reasons, we favor the categorical approach of leaving trademark licenses unprotected from court-approved rejection, unless and until Congress should decide otherwise. See James M. Wilton & Andrew G. Devore, Trademark Licensing in the Shadow of Bankruptcy, 68 Bus. Law. 739, 771-76 (2013).

C.

[16]Mission's final argument is that the bankruptcy court erred by not holding an adversary proceeding under Bankruptcy Rule 7001. Mission contends that because the rule governing adversary proceedings includes within its ambit determinations of an "interest in property," the bankruptcy court was required to hold such a hearing to determine the scope of Mission's rights. The bankruptcy court instead treated the issue as a contested matter under Rule 9014. We need not address this argument directly, because we find that even if an adversary proceeding was required, any error was harmless.

***405** Mission contends that it was prejudiced because it was not given a fair opportunity to develop an evidentiary record. But the issues at stake can be resolved—and are resolved, in our de novo review—without reliance on any disputed facts outside the four corners of the Agreement. The logical leap Mission asks us to make—that extrinsic evidence would be both appropriate and lead to a different result—is unsupported by any possible extrinsic evidence to which Mission points. Further, the bankruptcy court permitted Mission and Debtor to conduct discovery following its September 21, 2015 order. There is no evidence, however, that either party had a need for or in fact did conduct discovery, and if they did, Mission offers no explanation for how this discovery generated any factual dispute that need be resolved in a testimonial hearing. Requiring Debtor to commence an adversary proceeding would only have delayed the resolution of critical issues without changing the bankruptcy court's ultimate determination.

V.

For the foregoing reasons, the bankruptcy court's decision is affirmed.

TORRUELLA, Circuit Judge (Concurring in part, dissenting in part).

I agree with the majority that 11 U.S.C. § 365(n) does not protect Mission's exclusive distribution rights or its nonexclusive trademark license. The plain language of this subsection identifies "intellectual property," which, for purposes of chapter 11, does not encompass trademarks. See 11 U.S.C. § 101(35A). However, I disagree with the majority's bright-line rule that the omission of trademarks from the protections of section 365(n) leaves a non-rejecting party without any remaining rights to use a debtor's trademark and logo. As Judge Easterbrook wrote, "an omission is just an omission," and simply implies that section 365(n) does not determine how trademark licenses should be treated—one way or the other. Sunbeam, 686 F.3d at 375. I would follow the Seventh Circuit and the BAP in finding that Mission's rights to use Debtor's trademark did not vaporize as a result of Debtor's rejection of the executory contract.

The majority focuses on the Bankruptcy Code's protection of debtors' ability to reorganize and to escape "burdensome obligations." But, as the majority acknowledges, in some situations, the Bankruptcy Code also provides protections to non-debtor parties of an executory contract, allowing the courts to determine an equitable remedy pursuant to the terms of a rejected contract. See Ohio v. Kovacs, 469 U.S. 274, 280, 105 S.Ct. 705, 83 L.Ed.2d 649 (1985); see also In re Nickels Midway Pier, LLC, 255 Fed.Appx. 633, 637-38 (3d Cir. 2007); Abboud, 482 F.3d at 19. Thus, to determine the effect of a section 365(a) rejection on a trademark license, we look to the plain text of section 365 as a whole, which dictates the parameters of such a rejection of an executory contract.

A plain language review reveals section 365's silence as to the treatment of a trademark license post-rejection. Where a statute is silent, we look to the legislative history for assistance. DiGiovanni v. Traylor Bros., Inc., 75 F.3d 748, 755 (1st Cir. 1996) (citing Cabral v. I.N.S., 15 F.3d 193, 194 (1st Cir. 1994)). Resultantly, our examination leads us back to Congress's intent when it enacted section 365(n). The Senate Committee report makes clear that Congress enacted section 365(n) as a direct response to the Fourth Circuit's decision in Lubrizol, 756 F.2d 1043, where the court found that rejection of a contract for an intellectual property license deprived the licensee of all rights previously granted under that license. See ***406** S. Rep. No. 100-505, at 2-3. In so doing, Congress intended to "correct[ ] the perception of some courts that Section 365 was ever intended to be a mechanism for stripping innocent licensee [sic] of rights central to the operations of their ongoing business." Id., at 4.

Specific to trademark licenses, the Senate Committee report explains that the purposeful omission of trademarks was not designed to leave trademark licensees unprotected, but rather was "designed to allow more time for study, not to approve Lubrizol." Sunbeam, 686 F.3d at 375. The relevant portion of the Senate report reads:

> [T]he bill does not address the rejection of executory trademark[s],.... While such rejection is of concern because of the interpretation of [§] 365 by the Lubrizol court and others, ... such contracts raise issues beyond the scope of this legislation. In particular, trademark ... relationships depend to a large extent on control of the quality of the products or services sold by the licensee. Since these matters could not be addressed without more extensive study, it was determined to postpone congressional action in this area and to allow the development of equitable treatment of this situation by bankruptcy courts.

S. Rep. No. 100-505, at 5. This legislative history expresses congressional concern about the application of Lubrizol's holding to trademarks licenses until further studies are done, and, rather than continue to apply Lubrizol's holding, encourages "equitable treatment" by the courts to resolve disputes arising in the meantime. Id. Why would Congress have provided this guidance if it meant for Lubrizol—the very case Congress rejected—to apply to trademark licenses? Congress has yet to advise the courts about the results of any further studies; as such, the majority's judicially created bright-line rule contravenes congressional intent.

The majority's view infers that the omission of trademarks from section 101(35A)'s definition of "intellectual property," and therefore the protections of section 365(n), implies that section 365 categorically affords no protections to licensees of trademarks. Yet, Congress's own interpretation of section 365(n) informs us that the bill does not "address or intend any inference to be drawn concerning the treatment of executory contracts which are unrelated to intellectual property." Id. "In light of these direct congressional statements of intent, it is simply more freight than negative inference will bear to read rejection of a trademark license to effect the same result as termination of that license." In re Exide Techs., 607 F.3d at 967 (Ambro, J., concurring) (citation and internal quotation marks omitted).

Instead, like the BAP below, I find it appropriate to view a debtor's section 365(a) rejection through the broader lens of section 365, as the Seventh Circuit did in Sunbeam. Section 365(g) states that "the rejection of an executory contract or unexpired lease of the debtor constitutes a breach of such contract or lease." 11 U.S.C. § 365(g). Similar to other contractual breaches outside of the bankruptcy context, a rejection pursuant to section 365(a) does not automatically terminate a non-rejecting party's rights under a contract. Sunbeam, 686 F.3d at 377. Admittedly, "[w]hat the Bankruptcy Code provides, a judge cannot override by declaring that enforcement would be inequitable." Id. at 375 (internal quotation marks omitted). Given the Bankruptcy Code's silence as to the post-rejection rights that a trademark licensee does or does not retain, and in accordance with principles governing breaches of contract, we must resolve the dispute by looking to the terms of the ***407** contract to which these sophisticated parties agreed, and other applicable non-bankruptcy law. While the majority mistakenly insists that that this approach rejects the one followed in Sunbeam, it is precisely what the Seventh Circuit called for in finding that rejection does not abrogate a contract. Id. at 377. The majority takes issue with this consideration in what it terms as "some unspecified manner," but ignores that "the development of equitable treatment" is precisely what Congress has instructed the courts to do. See S. Rep. No. 100-505, at 6. Instead, the majority's view that a section 365(a) rejection eliminates a licensee's rights to the bargained-for use of a debtor's trademark effectively treats a debtor's rejection as a contract cancellation, rather than a contractual breach, putting the court at odds with legislative intent. It also "makes bankruptcy more a sword than a shield, putting debtor-licensors in a catbird seat they often do not deserve." In re Exide Techs., 607 F.3d at 967-68 (Ambro, J., concurring).

I respect my colleagues' concern that following the Seventh Circuit's holding that a section 365(a) rejection does not categorically eviscerate the trademark rights that a debtor-licensor bargained away may "require[ ] that the trademark owner—here Debtor—monitor and exercise control over the quality of the goods sold to the public" post-rejection. However, licensees have trademark quality assurance obligations under the terms of their individual contracts which can be enforced through further legal action and the equitable remedy of specific performance. In the current case, Mission's obligations are laid out in Section 15(d) of the Agreement, which states that, inter alia, Mission shall not use the trademarks in a disparaging or inaccurate manner, shall comply with written trademark guidelines, and shall not create a unitary composite mark. The majority speculates that the remaining burden on the debtor will be too great in the bankruptcy context, and therefore, if it "were in the chancellor's chair," it would not follow this approach. However, we need not enter such a debate as it is not the role of the courts to legislate, as the majority's approach effectively does, through the creation of bright-line rules in the face of congressional intent. Congress contemplated the majority's concern when it enacted section 365(n), recognizing "that there may be circumstances in which the future affirmative performance obligations under a license cannot be performed in a manner that benefits the estate." S. Rep. No. 100-505, at 4-5. The legislative history indicates that treatment of trademark licenses is one such circumstance.

Accordingly, the BAP was correct to follow the Seventh Circuit's lead in finding that, even though 11 U.S.C. § 365(n) does not provide Mission protection of its license to use Debtor's trademarks, Debtor's rejection of the executory contract does not rescind the Agreement and eviscerate any of Mission's remaining trademark rights. Instead, as Congress has instructed the bankruptcy courts to do, the effect of Debtor's rejection on Mission's trademark license should be guided by the terms of the Agreement, and non-bankruptcy law, to determine the appropriate equitable remedy of the functional breach of contract. I respectfully dissent.

All Citations

879 F.3d 389, 65 Bankr.Ct.Dec. 23, Bankr. L. Rep. P 83,196

Footnotes

1 In addition to the United States, the exclusive geographic territory also included "other countries and territories that [Mission] acquires exclusive distribution rights to pursuant to its first rights of refusal and notice."

2 Although this provision of the statute only refers to the powers of a trustee, per 11 U.S.C. § 1107(a), a Chapter 11 "debtor in possession shall have all the rights ... and powers, and shall perform all the functions and duties, ... of a trustee serving in a case under this chapter." See also In re FBI Distrib. Corp., 330 F.3d at 42 n.8 (citing this provision).

3 We do nevertheless pay great attention to the considered opinion of the three experienced bankruptcy judges who sit on the BAP. Among other things, our consideration of such an opinion reduces the likelihood that our court of general appellate jurisdiction is blindsided by the effect that a decision might have on matters or issues of bankruptcy law and practice that are beyond the ken of the parties in a particular proceeding.

4 Congress ultimately adopted the Senate version, although the language of this section of the House bill is identical to its Senate counterpart.

5 Mission cites Encino Bus. Mgmt., Inc. v. Prize Frize, Inc. (In re Prize Frize, Inc.), 32 F.3d 426 (9th Cir. 1994), but the contract in that case granted an "exclusive license to utilize the proprietary rights." Id. at 427. This case is clearly distinguishable, as Mission was granted no such right.

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KeyCite Red Flag - Severe Negative Treatment
Superseded by Statute as Stated in Mission Product Holdings, Inc. v. Tempnology, LLC, U.S., May 20, 2019

756 F.2d 1043
United States Court of Appeals,
Fourth Circuit.

LUBRIZOL ENTERPRISES, INC., Appellee,
v.
RICHMOND METAL FINISHERS, INC., Appellant.
In re RICHMOND METAL FINISHERS, INC., Debtor.

No. 84–1539.
|
Argued Dec. 3, 1984.
|
Decided March 15, 1985.

Synopsis

In Chapter 11 case, debtor moved to reject technology license agreement which debtor claimed was an executory contract. The Bankruptcy Court, 34 B.R. 521, granted motion, and creditor moved for stay pending appeal. The Bankruptcy Court for the Eastern District of Virginia, 36 B.R. 270, denied motion, and creditor appealed. The United States District Court for the Eastern District of Virginia, at Richmond, D. Dortch Warriner, J., 38 B.R. 341, reversed and remanded. Debtor appealed. The Court of Appeals, James Dickson Phillips, Circuit Judge, held that: (1) for purposes of bankruptcy provision relating to rejection of executory contracts, agreement between debtor and another corporation granting nonexclusive license to utilize metal coating process technology was executory as to each of the parties; (2) in finding that debtor's contingent obligations under the agreement were not sufficiently onerous that relief from them would be beneficial, District Court improperly substituted its business judgment for that of the debtor; and (3) District Court misapprehended controlling law in thinking that even by rejecting the agreement the debtor could not deprive nonbankrupt party of all rights to the technology process; in fact, the rejection would leave nonbankrupt party with only a money damages remedy, but no further rights under the agreement to continued use of the process.

Reversed and remanded.

West Headnotes (8)

[1] **Bankruptcy**
Executory Nature in General

Under bankruptcy provision relating to rejection of executory contracts by debtor, a contract is "executory" if performance is due to some extent on both sides. Bankr.Code, 11 U.S.C.A. § 365(a).

56 Cases that cite this headnote

[2] **Bankruptcy**
Executory Nature in General

Contingency of an obligation does not prevent its being executory under bankruptcy provision relating to rejection of executory contracts. Bankr.Code, 11 U.S.C.A. § 365(a).

25 Cases that cite this headnote

[3] **Bankruptcy**
Executory Nature in General

For purposes of bankruptcy provision relating to rejection of executory contracts, contract is not executory as to a party simply because the party is obligated to make payments of money to the other. Bankr.Code, 11 U.S.C.A. § 365(a).

26 Cases that cite this headnote

[4] **Bankruptcy**
Executory Nature in General

For purposes of bankruptcy provision relating to rejection of executory contracts, contract between debtor and another corporation granting nonexclusive license to utilize metal coating process technology was executory as to each of the parties, since debtor had continuing duties of, inter alia, notifying corporation of further licensing of the process and defending infringement suits, and corporation had continuing duties to account and pay royalties for life of the agreement. Bankr.Code, 11 U.S.C.A. § 365(a).

32 Cases that cite this headnote

[5] **Bankruptcy**
"Business Judgment" Test in General

In context of bankruptcy provision relating to rejection of executory contracts, courts addressing question of whether rejection would be advantageous to debtor must start with proposition that debtor's decision is to be accorded the deference mandated by the sound business-judgment rule as generally applied by courts to discretionary action or decisions of corporate directors. Bankr.Code, 11 U.S.C.A. § 365(a).

67 Cases that cite this headnote

[6] **Bankruptcy**
Particular Cases and Issues

Bankruptcy court's factual adjudication whether decision of debtor that rejection of executory contract will be advantageous is so manifestly unreasonable that it could not be based on sound business judgment, but only on bad faith, whim or caprice, is reviewable under "clearly erroneous" standard. Bankr.Code, 11 U.S.C.A. § 365(a).

49 Cases that cite this headnote

[7] **Bankruptcy**
Proceedings

In finding that, for purposes of determining propriety of bankruptcy debtor's rejection of executory contract, debtor's contingent obligations under the contract were not sufficiently onerous that relief from them would be beneficial, district court improperly substituted its business judgment for that of the debtor. Bankr.Code, 11 U.S.C.A. §§ 365, 365(a).

21 Cases that cite this headnote

[8] **Bankruptcy**
Grounds for and Objections to Assumption, Rejection, or Assignment

In denying bankruptcy debtor's right to reject executory contract, district court misapprehended controlling law in thinking that even by rejecting the agreement the debtor could not deprive nonbankrupt party of all rights to technology process which was subject of the licensing agreement; in fact, the rejection would leave nonbankrupt party with only a money damages remedy, but no further right under the agreement to continued use of the process. Bankr.Code, 11 U.S.C.A. § 365(a, g).

51 Cases that cite this headnote

Attorneys and Law Firms

***1044** James R. Sheeran, Richmond, Va., for appellant.

Marilyn Shea-Stonum (Jeanne M. Rickett, Jones, Day, Reavis & Pogue, Washington, D.C., Benjamin C. Ackerly, Dennis T. Lewandowski, Richmond, Va., Hunton & Williams, Washington, D.C., on brief), for appellee.

Before PHILLIPS and WILKINSON, Circuit Judges, and BUTZNER, Senior Circuit Judge.

Opinion

JAMES DICKSON PHILLIPS, Circuit Judge:

The question is whether Richmond Metal Finishers (RMF), a bankrupt debtor in possession, should have been allowed to reject as executory a technology licensing agreement with Lubrizol Enterprises (Lubrizol) as licensee. The bankruptcy court approved rejection pursuant to 11 U.S.C. § 365(a), 34 B.R. 521 stay denied 36 B.R. 270; but the district court reversed on the basis that within contemplation of § 365(a), the contract was not executory and, alternatively, that rejection could not reasonably be expected substantially to benefit the bankrupt debtor. 38 B.R. 341. We reverse and remand for entry of judgment in conformity with that entered by the bankruptcy court.

***1045** I

In July of 1982, RMF entered into the contract with Lubrizol that granted Lubrizol a nonexclusive license to utilize a metal coating process technology owned by RMF. RMF owed the following duties to Lubrizol under the agreement: (1) to notify Lubrizol of any patent infringement suit and to defend in such suit; (2) to notify Lubrizol of any other use or licensing of the process, and to reduce royalty payments if a lower royalty rate agreement was reached with another licensee; and (3) to indemnify Lubrizol for losses arising out of any misrepresentation or breach of warranty by RMF. Lubrizol owed RMF reciprocal duties of accounting for and paying royalties for use of the process and of cancelling certain existing indebtedness. The contract provided that Lubrizol would defer use of the process until May 1, 1983, and in fact, Lubrizol has never used the RMF technology.

RMF filed a petition for bankruptcy pursuant to Chapter 11 of the Bankruptcy Code on August 16, 1983. As part of its plan to emerge from bankruptcy, RMF sought, pursuant to § 365(a), to reject the contract with Lubrizol in order to facilitate sale or licensing of the technology unhindered by restrictive provisions in the Lubrizol agreement. On RMF's motion for approval of the rejection, the bankruptcy court properly interpreted § 365 as requiring it to undertake a two-step inquiry to determine the propriety of rejection: first, whether the contract is executory; next, if so, whether its rejection would be advantageous to the bankrupt.

Making that inquiry, the bankruptcy court determined that both tests were satisfied and approved the rejection. But, as indicated, the district court then reversed that determination on the basis that neither test was satisfied and disallowed the rejection. This appeal followed.

II

[1] We conclude initially that, as the bankruptcy court ruled, the technology licensing agreement in this case was an executory contract, within contemplation of 11 U.S.C. § 365(a). Under that provision a contract is executory if performance is due to some extent on both sides. *NLRB v. Bildisco and Bildisco,* 465 U.S. 513, ——, 104 S.Ct. 1188, 1194 n. 6, 79 L.Ed.2d 482 (1984). This court has recently adopted Professor Countryman's more specific test for determining whether a contract is "executory" in the required sense. By that test, a contract is executory if the " 'obligations of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete the performance would constitute a material breach excusing the performance of the other.' " *Gloria Manufacturing Corp. v. International Ladies' Garment Workers' Union,* 734 F.2d 1020, 1022 (4th Cir.1984) (quoting Countryman, *Executory Contracts in Bankruptcy: Part I,* 57 Minn.L.Rev. 439, 460 (1973). This issue is one of law that may be freely reviewed by successive courts.

Applying that test here, we conclude that the licensing agreement was at the critical time executory. RMF owed Lubrizol the continuing duties of notifying Lubrizol of further licensing of the process and of reducing Lubrizol's royalty rate to meet any more favorable rates granted to subsequent licensees. By their terms, RMF's obligations to give notice and to restrict its right to license its process at royalty rates it desired without lowering Lubrizol's royalty rate extended over the life of the agreement, and remained unperformed. Moreover, RMF owed Lubrizol additional contingent duties of notifying it of suits, defending suits and indemnifying it for certain losses.

The unperformed, continuing core obligations of notice and forbearance in licensing made the contract executory as to RMF. In *Fenix Cattle Co. v. Silver (In re Select-A-Seat Corp.),* 625 F.2d 290, 292 (9th Cir.1980), the court found that an obligation of a debtor to refrain from selling software packages under an exclusive licensing agreement made a contract executory as to the debtor notwithstanding the continuing ***1046** obligation was only one of forbearance. Although the license to Lubrizol was not exclusive, RMF owed the same type of unperformed continuing duty of forbearance arising out of the most favored licensee clause running in favor of Lubrizol. Breach of that duty would clearly constitute a material breach of the agreement.

[2] Moreover, the contract was further executory as to RMF because of the contingent duties that RMF owed of giving notice of and defending infringement suits and of indemnifying Lubrizol for certain losses arising out of the use of the technology. Contingency of an obligation does not prevent its being executory under § 365. *See In re Smith Jones, Inc.,* 26 B.R. 289, 292 (Bankr.D.Minn.1982) (warranty obligations executory as to promisor); *In re O.P.M. Leasing Services, Inc.,* 23 B.R. 104, 117 (Bankr.S.D.N.Y.1982) (obligation to defend infringement suits makes contract executory as to promisor). Until the time has expired during which an event triggering a contingent duty may occur, the contingent obligation represents a continuing duty to stand ready to perform if the contingency occurs. A breach of that duty once it was triggered by the contingency (or presumably, by anticipatory repudiation) would have been material.

Because a contract is not executory within the meaning of § 365(a) unless it is executory as to both parties, it is also necessary to determine whether the licensing agreement was executory as to Lubrizol. *See Bildisco,* 465 U.S. at ——, 104 S.Ct. at 1194 n. 6. We conclude that it was.

[3] Lubrizol owed RMF the unperformed and continuing duty of accounting for and paying royalties for the life of the agreement. It is true that a contract is not executory as to a party simply because the party is obligated to make payments of money to the other party. *See Smith Jones,* 26 B.R. at 292; H.Rep. No. 95–595, 95th Cong., 2d Sess. 347, *reprinted in* 1978 U.S.Code Cong. & Ad.News 5787, 5963, 6303–04. Therefore, if Lubrizol had owed RMF nothing more than a duty to make fixed payments or cancel specified indebtedness under the agreement, the agreement would not be executory as to Lubrizol. However, the promise to account for and pay royalties required that Lubrizol deliver written quarterly sales reports and keep books of account subject to inspection by an independent Certified Public Accountant. This promise goes beyond a mere debt, or promise to pay money, and was at the critical time executory. *See Fenix Cattle,* 625 F.2d at 292. Additionally, subject to certain exceptions, Lubrizol was obligated to keep all license technology in confidence for a number of years.

[4] Since the licensing agreement is executory as to each party, it is executory within the meaning of § 365(a), and the district court erred as a matter of law in reaching a contrary conclusion.*

III

[5] There remains the question whether rejection of the executory contract would be advantageous to the bankrupt. *See Borman's, Inc. v. Allied Supermarkets, Inc.,* 706 F.2d 187, 189 (6th Cir.1983). Courts addressing that question must start with the proposition that the bankrupt's decision upon it is to be accorded the deference mandated by the sound business judgment rule as generally applied by courts to discretionary actions or decisions of corporate directors. *See Bildisco,* 465 U.S. at ——, 104 S.Ct. at 1195 (noting that the business judgment rule is the "traditional" test); *Group of Institutional Investors v. Chicago, Milwaukee, St. Paul & Pacific Railroad,* 318 U.S. 523, 550, 63 S.Ct. 727, 742, 87 L.Ed. 959 (1943) (applying business ***1047** judgment rule to bankrupt's decision whether to affirm or reject lease); *Control Data Corp. v. Zelman (In re Minges),* 602 F.2d 38, 43 (2d Cir.1979) (applying *Institutional Investors* outside of railroad reorganizations); *Carey v. Mobil Oil Corp. (In re Tilco, Inc.),* 558 F.2d 1369, 1372–73 (10th Cir.1977) (applying *Institutional Investors* to rejection of gas contracts).

As generally formulated and applied in corporate litigation the rule is that courts should defer to—should not interfere with—decisions of corporate directors upon matters entrusted to their business judgment except upon a finding of bad faith or gross abuse of their "business discretion." *See, e.g., Lewis v. Anderson,* 615 F.2d 778, 782 (9th Cir.1979); *Polin v. Conductron Corp.,* 552 F.2d 797, 809 (8th Cir.1977). Transposed to the bankruptcy context, the rule as applied to a bankrupt's decision to reject an executory contract because of perceived business advantage requires that the decision be accepted by courts unless it is shown that the bankrupt's decision was one taken in bad faith or in gross abuse of the bankrupt's retained business discretion.

[6] In bankruptcy litigation the issue is of course first presented for judicial determination when a debtor, having decided that rejection will be beneficial within contemplation of § 365(a), moves for approval of the rejection. The issue thereby presented for first instance judicial determination by the bankruptcy court is whether the decision of the debtor that rejection will be advantageous is so manifestly unreasonable that it could

not be based on sound business judgment, but only on bad faith, or whim or caprice. That issue is one of fact to be decided as such by the bankruptcy court by the normal processes of fact adjudication. And the resulting fact determination by the bankruptcy court is perforce then reviewable up the line under the clearly erroneous standard. *See Minges,* 602 F.2d at 43; *see generally* 1 *Collier on Bankruptcy* ¶ 3.03(8)(b) (L. King 15th ed. 1984).

Here, the bankruptcy judge had before him evidence not rebutted by Lubrizol that the metal coating process subject to the licensing agreement is RMF's principal asset and that sale or licensing of the technology represented the primary potential source of funds by which RMF might emerge from bankruptcy. The testimony of RMF's president, also factually uncontested by Lubrizol, indicated that sale or further licensing of the technology would be facilitated by stripping Lubrizol of its rights in the process and that, correspondingly, continued obligation to Lubrizol under the agreement would hinder RMF's capability to sell or license the technology on more advantageous terms to other potential licensees. On the basis of this evidence the bankruptcy court determined that the debtor's decision to reject was based upon sound business judgment and approved it.

On appeal the district court simply found to the contrary that the debtor's decision to reject did not represent a sound business judgment. The district court's determination rested essentially on two grounds: that RMF's purely contingent obligations under the agreement were not sufficiently onerous that relief from them would constitute a substantial benefit to RMF; and that because rejection could not deprive Lubrizol of all its rights to the technology, rejection could not reasonably be found beneficial. We conclude that in both of these respects the district court's factual findings, at odds with those of the bankruptcy court, were clearly erroneous and cannot stand.

A

[7] In finding that the debtor's contingent obligations were not sufficiently onerous that relief from them would be beneficial, the district court could only have been substituting its business judgment for that of the debtor. There is nothing in the record from which it could be concluded that the debtor's decision on that point could not have been reached by the exercise of sound (though possibly faulty) business judgment in the normal process of evaluating alternative courses of action. If ***1048** that could not be concluded, then the business judgment rule required that the debtor's factual evaluation be accepted by the court, as it had been by the bankruptcy court. *See Schein v. Caesar's World, Inc.,* 491 F.2d 17, 20 (5th Cir.1974).

B

[8] On the second point, we can only conclude that the district court was under a misapprehension of controlling law in thinking that by rejecting the agreement the debtor could not deprive Lubrizol of all rights to the process. Under 11 U.S.C. § 365(g), Lubrizol would be entitled to treat rejection as a breach and seek a money damages remedy; however, it could not seek to retain its contract rights in the technology by specific performance even if that remedy would ordinarily be available upon breach of this type of contract. *See In re Waldron,* 36 B.R. 633, 642 n. 4 (Bankr.S.D.Fla.1984). Even though § 365(g) treats rejection as a breach, the legislative history of § 365(g) makes clear that the purpose of the provision is to provide only a damages remedy for the non-bankrupt party. H.Rep. No. 95–595, 95th Cong., 2d Sess. 349, *reprinted in* 1978 U.S.Code Cong. & Ad.News 5963, 6305. For the same reason, Lubrizol cannot rely on provisions within its agreement with RMF for continued use of the technology by Lubrizol upon breach by RMF. Here again, the statutory "breach" contemplated by § 365(g) controls, and provides only a money damages remedy for the non-bankrupt party. Allowing specific performance would obviously undercut the core purpose of rejection under § 365(a), and that consequence cannot therefore be read into congressional intent.

IV

Lubrizol strongly urges upon us policy concerns in support of the district court's refusal to defer to the debtor's decision to reject or, preliminarily, to treat the contract as executory for § 365(a) purposes. We understand the concerns, but think they cannot control decision here.

It cannot be gainsaid that allowing rejection of such contracts as executory imposes serious burdens upon contracting parties such as Lubrizol. Nor can it be doubted that allowing rejection in this and comparable cases could have a general chilling effect upon the willingness of such parties to contract at all with businesses in possible financial difficulty. But under bankruptcy law such equitable considerations may not be indulged by courts in respect of the type of contract here in issue. Congress has plainly provided for the rejection of executory contracts, notwithstanding the obvious adverse consequences for contracting parties thereby made inevitable. Awareness by Congress of those consequences is indeed specifically reflected in the special treatment accorded to union members under collective bargaining contracts, *see Bildisco,* 465 U.S. at ——, 104 S.Ct. at 1193–96, and to lessees of real property, *see* 11 U.S.C. § 365(h). But no comparable special treatment is provided for technology licensees such as Lubrizol. They share the general hazards created by § 365 for all business entities dealing with potential bankrupts in the respects at issue here.

The judgment of the district court is reversed and the case is remanded for entry of judgment in conformity with that entered by the bankruptcy court.

REVERSED AND REMANDED.

All Citations

756 F.2d 1043, 226 U.S.P.Q. 961, 12 Collier Bankr.Cas.2d 310, 12 Bankr.Ct.Dec. 1281, Bankr. L. Rep. P 70,311

Footnotes

* We disagree with the district court's characterization of the transaction as effectively a completed sale of property. If an analogy is to be made, licensing agreements are more similar to leases than to sales of property because of the limited nature of the interest conveyed. Congress expressly made leases subject to rejection under § 365 in order to "preclude any uncertainty as to whether a lease is an executory contract" under § 365. 2 *Collier on Bankruptcy* ¶ 365.02 (L. King 15th ed. 1984).

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Disagreed With by In re Tempnology, LLC, 1st Cir., January 12, 2018

686 F.3d 372
United States Court of Appeals,
Seventh Circuit.

SUNBEAM PRODUCTS, INC., doing business as Jarden Consumer Solutions, Plaintiff–Appellant,
v.
CHICAGO AMERICAN MANUFACTURING, LLC, Defendant–Appellee.

No. 11–3920.
|
Argued May 22, 2012.
|
Decided July 9, 2012.

Synopsis

Background: Chapter 7 trustee and purchaser of debtor's patents and trademarks brought adversary proceeding against company to which debtor had outsourced production of its fans, alleging patent and trademark infringement, and dispute arose as to whether company was acting within scope of intellectual-property license granted by debtor prepetition and whether that license had terminated upon trustee's rejection of underlying contract. The United States Bankruptcy Court for the Northern District of Illinois, Pamela S. Hollis, J., 459 B.R. 306, entered judgment for company. Plaintiffs appealed.

[Holding:] The Court of Appeals, Easterbrook, Chief Judge, in a matter of first impression, held that trustee's rejection of contract did not abrogate company's license to sell fans branded with debtor's trademark.

Affirmed.

West Headnotes (12)

[1] **Bankruptcy**
Effect of Acceptance or Rejection
Trademarks
Duration of consent; post-termination use

Chapter 7 trustee's rejection of debtor's contract with company to which debtor had outsourced production of its fans did not abrogate company's license under the contract to sell fans branded with debtor's trademark, and thus company did not infringe trademarks, which had been bought by third party, by continuing to make and sell debtor-branded fans; trustee's rejection of contract constituted a breach, not a rescission, and left company's rights under contract in place. 11 U.S.C.A. § 365(a, g).

6 Cases that cite this headnote

[2] **Bankruptcy**
Construction and Operation
Bankruptcy
Effect of Acceptance or Rejection

"Intellectual property" under the Bankruptcy Code includes patents, copyrights, and trade secrets, but not trademarks, and thus trademarks are unaffected by the provision of the Bankruptcy Code permitting the debtor's intellectual-property licensees to continue using the debtor's intellectual property after rejection of the license, provided the licensees meet certain conditions. 11 U.S.C.A. §§ 101(35A), 365(n).

1 Cases that cite this headnote

[3] **Bankruptcy**
Equitable powers and principles

What the Bankruptcy Code provides, a court cannot override by declaring that enforcement would be inequitable.

9 Cases that cite this headnote

[4] **Bankruptcy**
Equitable powers and principles
Bankruptcy
Effect of Acceptance or Rejection

After the trustee's rejection of an intellectual-property licensee granted by the debtor, the licensee's rights depend on what the Bankruptcy Code provides rather than on notions of equity. 11 U.S.C.A. § 365(a).

9 Cases that cite this headnote

[5] **Copyrights and Intellectual Property**
Contracts

Outside of bankruptcy, a licensor's breach does not terminate a licensee's right to use intellectual property.

3 Cases that cite this headnote

[6] **Bankruptcy**
Effect of Acceptance or Rejection

Bankruptcy Code, by classifying debtor's rejection of an executory contract as breach establishes that in bankruptcy, as outside of it, the other party's rights remain in place. 11 U.S.C.A. § 365(g).

7 Cases that cite this headnote

[7] **Bankruptcy**
Effect of Acceptance or Rejection

After rejecting a contract, a debtor is not subject to an order of specific performance. 11 U.S.C.A. § 365(a, g).

3 Cases that cite this headnote

[8] **Bankruptcy**
Rejection of executory contract or lease
Bankruptcy
Effect of Acceptance or Rejection

After rejecting a contract, the debtor's unfulfilled obligations are converted to damages; when the debtor does not assume the contract before rejecting it, these damages are treated as a prepetition obligation, which may be written down in common with other debts of the same class. 11 U.S.C.A. § 365(a, g).

2 Cases that cite this headnote

[9] **Bankruptcy**
Rejection of executory contract or lease
Bankruptcy
Effect of Acceptance or Rejection

A lessee that enters bankruptcy may reject the lease and pay damages for abandoning the premises, but rejection does not abrogate the lease, which would absolve the lessee of the need to pay damages. 11 U.S.C.A. § 365(a, g).

Cases that cite this headnote

[10] **Bankruptcy**
Effect of Acceptance or Rejection

A lessor that enters bankruptcy may not, by rejecting the lease, end the tenant's right to possession and thus re-acquire premises that might be rented out for a higher price. 11 U.S.C.A. § 365(a, g).

1 Cases that cite this headnote

[11] **Bankruptcy**
Rejection of executory contract or lease
Bankruptcy

Effect of Acceptance or Rejection

A bankrupt lessor, by rejecting the lease, might substitute damages for an obligation to make repairs, but not rescind the lease altogether. 11 U.S.C.A. § 365(a, g).

Cases that cite this headnote

[12] **Bankruptcy**
Effect of Acceptance or Rejection

Rejection of debtor's executory contract is not the functional equivalent of a rescission, rendering void the contract and requiring that the parties be put back in the positions they occupied before the contract was formed; rather, rejection merely frees the estate from the obligation to perform and has absolutely no effect upon the contract's continued existence. 11 U.S.C.A. § 365(a, g).

4 Cases that cite this headnote

Attorneys and Law Firms

***374** Scott R. Clar, Attorney, Crane, Heyman, Simon, Welch & Clar, Chicago, IL, for Debtor.

Joseph D. Frank (argued), Attorney, Frank/Gecker LLP, Chicago, IL, for Appellant.

William John Barrett (argued), Attorney, Barack, Ferrazzano, Kirschbaum & Nagelberg LLP, Chicago, IL, Richard M. Hoffman, Attorney, Northbrook, IL, for Appellee.

Scott R. Clar, Attorney, Crane, Heyman, Simon, Welch & Clar, Chicago, IL, for Trustee.

Before EASTERBROOK, Chief Judge, and WILLIAMS and TINDER, Circuit Judges.

Opinion

EASTERBROOK, Chief Judge.

Lakewood Engineering & Manufacturing Co. made and sold a variety of consumer products, which were covered by its patents and trademarks. In 2008, losing money on every box fan, Lakewood contracted their manufacture to Chicago American Manufacturing (CAM). The contract authorized CAM to practice Lakewood's patents and put its trademarks on the completed fans. Lakewood was to take orders from retailers such as Sears, Walmart, and Ace Hardware; CAM would ship directly to these customers on Lakewood's instructions. Because Lakewood was in financial distress, CAM was reluctant to invest the money necessary to gear up for production—and to make about 1.2 million fans that Lakewood estimated it would require during the 2009 cooling season—without assured payment. Lakewood provided that assurance by authorizing CAM to sell the 2009 run of box fans for its own account if Lakewood did not purchase them.

In February 2009, three months into the contract, several of Lakewood's creditors filed an involuntary bankruptcy petition against it. The court appointed a trustee, who decided to sell Lakewood's business. Sunbeam Products, doing business as Jarden Consumer Solutions, bought the assets, including Lakewood's patents and trademarks. Jarden did not want the Lakewood-branded fans CAM had in inventory, nor did it want CAM to sell those fans in competition with Jarden's products. Lakewood's trustee rejected the executory portion of the CAM contract under 11 U.S.C. § 365(a). When CAM continued to make and sell Lakewood-branded fans, Jarden filed this adversary action. It will receive 75% of any recovery and the trustee ***375** the other 25% for the benefit of Lakewood's creditors.

[1] The bankruptcy judge held a trial. After determining that the Lakewood–CAM contract is ambiguous, the judge relied on extrinsic evidence to conclude that CAM was entitled to make as many fans as Lakewood estimated it would need for the entire 2009 selling season and sell them bearing Lakewood's marks. *In re Lakewood Engineering & Manufacturing Co.*, 459 B.R. 306, 333–38 (Bankr.N.D.Ill.2011). Jarden contends in this court—following certification by the district court of a direct appeal under 28 U.S.C. § 158(d)(2)(A)—that CAM had to stop making and selling fans once Lakewood stopped having requirements for them. The bankruptcy court did not err in reading the contract as it did, but the effect of the trustee's rejection remains to be determined.

[2] *Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc.*, 756 F.2d 1043 (4th Cir.1985), holds that, when an intellectual-property license is rejected in bankruptcy, the

licensee loses the ability to use any licensed copyrights, trademarks, and patents. Three years after *Lubrizol,* Congress added § 365(n) to the Bankruptcy Code. It allows licensees to continue using the intellectual property after rejection, provided they meet certain conditions. The bankruptcy judge held that § 365(n) allowed CAM to practice Lakewood's patents when making box fans for the 2009 season. That ruling is no longer contested. But "intellectual property" is a defined term in the Bankruptcy Code: 11 U.S.C. § 101(35A) provides that "intellectual property" includes patents, copyrights, and trade secrets. It does not mention trademarks. Some bankruptcy judges have inferred from the omission that Congress codified *Lubrizol* with respect to trademarks, but an omission is just an omission. The limited definition in § 101(35A) means that § 365(n) does not affect trademarks one way or the other. According to the Senate committee report on the bill that included § 365(n), the omission was designed to allow more time for study, not to approve *Lubrizol.* See S.Rep. No. 100–505, 100th Cong., 2d Sess. 5 (1988), 1988 U.S.C.C.A.N. 3200. See also *In re Exide Technologies,* 607 F.3d 957, 966–67 (3d Cir.2010) (Ambro, J., concurring) (concluding that § 365(n) neither codifies nor disapproves *Lubrizol* as applied to trademarks). The subject seems to have fallen off the legislative agenda, but this does not change the effect of what Congress did in 1988.

The bankruptcy judge in this case agreed with Judge Ambro that § 365(n) and § 101(35A) leave open the question whether rejection of an intellectual-property license ends the licensee's right to use trademarks. Without deciding whether a contract's rejection under § 365(a) ends the licensee's right to use the trademarks, the judge stated that she would allow CAM, which invested substantial resources in making Lakewood-branded box fans, to continue using the Lakewood marks "on equitable grounds". 459 B.R. at 345; see also *id.* at 343–46. This led to the entry of judgment in CAM's favor, and Jarden has appealed.

[3] [4] What the Bankruptcy Code provides, a judge cannot override by declaring that enforcement would be "inequitable." See, e.g., *Toibb v. Radloff,* 501 U.S. 157, 162, 111 S.Ct. 2197, 115 L.Ed.2d 145 (1991); *In re Kmart Corp.,* 359 F.3d 866, 871 (7th Cir.2004); *In re Sinclair,* 870 F.2d 1340 (7th Cir.1989). There are hundreds of bankruptcy judges, who have many different ideas about what is equitable in any given situation. Some may think that equity favors licensees' reliance interests; others may believe that equity ***376** favors the creditors, who can realize more of their claims if the debtor can terminate IP licenses. Rights depend, however, on what the Code provides rather than on notions of equity. Recently the Supreme Court emphasized that arguments based on views about the purposes behind the Code, and wise public policy, cannot be used to supersede the Code's provisions. It remarked: "The Bankruptcy Code standardizes an expansive (and sometimes unruly) area of law, and it is our obligation to interpret the Code clearly and predictably using well established principles of statutory construction." *RadLAX Gateway Hotel, LLC v. Amalgamated Bank,* ––– U.S. ––––, 132 S.Ct. 2065, 2073, 182 L.Ed.2d 967 (2012).

Although the bankruptcy judge's ground of decision is untenable, that does not necessarily require reversal. We need to determine whether *Lubrizol* correctly understood § 365(g), which specifies the consequences of a rejection under § 365(a). No other court of appeals has agreed with *Lubrizol*—or for that matter disagreed with it. *Exide,* the only other appellate case in which the subject came up, was resolved on the ground that the contract was not executory and therefore could not be rejected. (*Lubrizol* has been cited in other appellate opinions, none of which concerns the effect of rejection on intellectual-property licenses.) Judge Ambro, who filed a concurring opinion in *Exide,* concluded that, had the contract been eligible for rejection under § 365(a), the licensee could have continued using the trademarks. 607 F.3d at 964–68. Like Judge Ambro, we too think *Lubrizol* mistaken.

Here is the full text of § 365(g):

> Except as provided in subsections (h)(2) and (i)(2) of this section, the rejection of an executory contract or unexpired lease of the debtor constitutes a breach of such contract or lease—
>
> (1) if such contract or lease has not been assumed under this section or under a plan confirmed under chapter 9, 11, 12, or 13 of this title, immediately before the date of the filing of the petition; or
>
> (2) if such contract or lease has been assumed under this section or under a plan confirmed under chapter 9, 11, 12, or 13 of this title—
>
> (A) if before such rejection the case has not been converted under section 1112, 1208, or 1307 of this title, at the time of such rejection; or
>
> (B) if before such rejection the case has been converted under section 1112, 1208, or 1307 of this title—
>
> (i) immediately before the date of such conversion, if such contract or lease was assumed before such conversion; or

(ii) at the time of such rejection, if such contract or lease was assumed after such conversion.

Most of these words don't affect our situation. Subsections (h)(2) and (i)(2) are irrelevant, and paragraph (1) tells us that the rejection takes effect immediately before the petition's filing. For our purpose, therefore, all that matters is the opening proposition: that rejection "constitutes a breach of such contract".

[5] Outside of bankruptcy, a licensor's breach does not terminate a licensee's right to use intellectual property. Lakewood had two principal obligations under its contract with CAM: to provide CAM with motors and cord sets (CAM was to build the rest of the fan) and to pay for the completed fans that CAM drop-shipped to retailers. Suppose that, before the bankruptcy began, Lakewood had broken its promise by failing to provide the motors. ***377** CAM might have elected to treat that breach as ending its own obligations, see Uniform Commercial Code § 2–711(1), but it also could have covered in the market by purchasing motors and billed Lakewood for the extra cost. UCC § 2–712. CAM had bargained for the security of being able to sell Lakewood-branded fans for its own account if Lakewood defaulted; outside of bankruptcy, Lakewood could not have ended CAM's right to sell the box fans by failing to perform its own duties, any more than a borrower could end the lender's right to collect just by declaring that the debt will not be paid.

[6] [7] [8] [9] [10] [11] What § 365(g) does by classifying rejection as breach is establish that in bankruptcy, as outside of it, the other party's rights remain in place. After rejecting a contract, a debtor is not subject to an order of specific performance. See *NLRB v. Bildisco & Bildisco,* 465 U.S. 513, 531, 104 S.Ct. 1188, 79 L.Ed.2d 482 (1984); *Midway Motor Lodge of Elk Grove v. Innkeepers' Telemanagement & Equipment Corp.,* 54 F.3d 406, 407 (7th Cir.1995). The debtor's unfulfilled obligations are converted to damages; when a debtor does not assume the contract before rejecting it, these damages are treated as a pre-petition obligation, which may be written down in common with other debts of the same class. But nothing about this process implies that any rights of the other contracting party have been vaporized. Consider how rejection works for leases. A lessee that enters bankruptcy may reject the lease and pay damages for abandoning the premises, but rejection does not abrogate the lease (which would absolve the debtor of the need to pay damages). Similarly a lessor that enters bankruptcy could not, by rejecting the lease, end the tenant's right to possession and thus re-acquire premises that might be rented out for a higher price. The bankrupt lessor might substitute damages for an obligation to make repairs, but not rescind the lease altogether.

[12] Bankruptcy law does provide means for eliminating rights under some contracts. For example, contracts that entitle creditors to preferential transfers (that is, to payments exceeding the value of goods and services provided to the debtor) can be avoided under 11 U.S.C. § 547, and recent payments can be recouped. A trustee has several avoiding powers. See 11 U.S.C. §§ 544–51. But Lakewood's trustee has never contended that Lakewood's contract with CAM is subject to rescission. The trustee used § 365(a) rather than any of the avoiding powers—and rejection is not "the functional equivalent of a rescission, rendering void the contract and requiring that the parties be put back in the positions they occupied before the contract was formed." *Thompkins v. Lil' Joe Records, Inc.,* 476 F.3d 1294, 1306 (11th Cir.2007). It "merely frees the estate from the obligation to perform" and "has absolutely no effect upon the contract's continued existence". *Ibid.* (internal citations omitted).

Scholars uniformly criticize *Lubrizol,* concluding that it confuses rejection with the use of an avoiding power. See, e.g., Douglas G. Baird, *Elements of Bankruptcy* 130–40 & n.10 (4th ed.2006); Michael T. Andrew, *Executory Contracts in Bankruptcy: Understanding "Rejection",* 59 U. Colo. L.Rev. 845, 916–19 (1988); Jay Lawrence Westbrook, *The Commission's Recommendations Concerning the Treatment of Bankruptcy Contracts,* 5 Am. Bankr.Inst. L.Rev. 463, 470–72 (1997). *Lubrizol* itself devoted scant attention to the question whether rejection cancels a contract, worrying instead about the right way to identify executory contracts to which the rejection power applies.

***378** *Lubrizol* does not persuade us. This opinion, which creates a conflict among the circuits, was circulated to all active judges under Circuit Rule 40(e). No judge favored a hearing *en banc.* Because the trustee's rejection of Lakewood's contract with CAM did not abrogate CAM's contractual rights, this adversary proceeding properly ended with a judgment in CAM's favor.

AFFIRMED.

All Citations

686 F.3d 372, 67 Collier Bankr.Cas.2d 1808, 56 Bankr.Ct.Dec. 189, Bankr. L. Rep. P 82,303, 103 U.S.P.Q.2d 1421

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3. THE HONORABLE MADELINE WANSLEE

Topic: Default Interest Rates - When are they recoverable and what is the standard for evaluating them: *In re New Investments, Inc.,* 840 F.3d 1137 (2016).

840 F.3d 1137
United States Court of Appeals, Ninth Circuit.

IN RE NEW INVESTMENTS, INC, Debtor.
Pacifica L 51 LLC, Creditor–Appellant,
v.
New Investments Inc., Debtor–Appellee.

No. 13-36194
|
Argued and Submitted May 3, 2016—Seattle, Washington
|
Filed November 4, 2016

Synopsis
Background: Deed of trust lender objected to confirmation of debtor's proposed Chapter 11 plan, which purported to cure debtor's default on deed of trust loan by making plan payments that included interest only at lower, pre-default interest rate. The United States Bankruptcy Court for the Western District of Washington, Marc Barreca, J., overruled lender's objection and entered order confirming plan, and lender appealed.

[Holding:] The Court of Appeals, Murguia, Circuit Judge, held that, while debtor, by curing default on deed of trust loan, was entitled to return to pre-default conditions, debtor could cure its default only in accordance with terms of deed of trust loan agreement, which required payment of post-default interest at higher default rate in order to effect cure.

Reversed and remanded.

Berzon, Circuit Judge, filed dissenting opinion.

West Headnotes (11)

[1] **Bankruptcy**
Curing defaults

Provision of Chapter 11 indicating that plan of reorganization must provide adequate means for its implementation, including the "curing or waiving of any default," means that plan may include a provision authorizing debtor to remedy any breach of loan agreement and to return to pre-default conditions. 11 U.S.C.A. § 1123(a)(5)(G).

2 Cases that cite this headnote

[2] **Bankruptcy**
Conclusions of law; de novo review

On appeal, the Court of Appeals reviews bankruptcy court's interpretation of bankruptcy statutes de novo.

Cases that cite this headnote

[3] **Statutes**
Language

When construing statute, court begins with language of statute.

Cases that cite this headnote

[4] **Statutes**
In general; factors considered
Statutes
Plain, literal, or clear meaning; ambiguity

If statutory text is ambiguous, court may employ other tools, such as legislative history, to ascertain the meaning of ambiguous terms.

Cases that cite this headnote

[5] **Statutes**
Burden of proof

Party contending that legislative act changed settled law has burden of showing that the legislature intended such a change.

Cases that cite this headnote

[6] **Bankruptcy**
Curing defaults

While Chapter 11 debtor, by curing default on deed of trust loan, was entitled to return to pre-default conditions, debtor could cure its default only in accordance with terms of deed of trust loan agreement and governing Washington law, a law which, because loan agreement required payment of post-default interest at higher default rate, mandated payment of interest by debtor at higher default rate in order to effect such a cure; merely by proposing to cure default in Chapter 11 plan, debtor did not become entitled to effect this cure, contrary to terms of loan agreement, by payments that included interest component calculated at pre-default rate. 11 U.S.C.A. § 1123(d); Wash. Rev. Code Ann. § 61.24.090(1)(a).

4 Cases that cite this headnote

[7] **Statutes**
Operation and Effect

Fact that Congress had a particular purpose in mind when enacting statute does not limit the effect of statute's text.

Cases that cite this headnote

[8] **Statutes**
Relation to plain, literal, or clear meaning; ambiguity

Fact that Congress may not have foreseen all of the consequences of statutory enactment is not a sufficient reason for refusing to give effect to statute's plain meaning.

Cases that cite this headnote

[9] **Bankruptcy**
Curing defaults

While Chapter 11 debtor, by curing default on mortgage loan by means of plan payments, can avoid acceleration or foreclosure, two of the more common consequences of default, debtor does not effectuate a cure merely by paying past due installments of principal at the pre-default interest rate; rather, debtor's "cure" obligations may also include late charges, attorneys' and trustee's fees, and publication and court costs. 11 U.S.C.A. § 1123(d).

3 Cases that cite this headnote

[10] **Bankruptcy**
Protection Against Discrimination or Collection Efforts in General; "Fresh Start."

Principal purpose of the Bankruptcy Code is to grant a fresh start to the honest but unfortunate debtor. 11 U.S.C.A. § 101 et seq.

Cases that cite this headnote

[11] **Bankruptcy**
In general; nature and purpose

Bankruptcy Code is not a purely remedial statute, and Chapter 11 strikes a balance between debtor's interest in reorganizing and restructuring its debts and creditors' interest in maximizing value of bankruptcy estate. 11 U.S.C.A. §§ 101 et seq., 1101 et seq.

Cases that cite this headnote

Attorneys and Law Firms

***1138** Dillon E. Jackson (argued) and Terrance J. Keenan, Foster Pepper PLLC, Seattle, Washington; Stuart P. Kastner, Stuart P. Kastner PLLC, Seattle, Washington; for Creditor–Appellant.

Lawrence K. Engel (argued), Bellevue, Washington, for Debtor–Appellee.

Appeal from the United States Bankruptcy Court for the Western District of Washington, Marc Barreca, Bankruptcy Judge, Presiding. D.C. No. 13–10948–MLB

Before: Susan P. Graber, Marsha S. Berzon, and Mary H. Murguia, Circuit Judges.

Dissent by Judge Berzon

OPINION

MURGUIA, Circuit Judge:

In loan agreements—and any subsequent bankruptcy proceedings—a borrower "defaults" on a loan when he fails to fulfill a material obligation under the terms of the loan agreement, such as making a payment by a particular date. A default can trigger certain consequences, such as foreclosure on any property securing the loan, late fees and penalties, or "acceleration," which occurs when the entire unpaid amount of the loan becomes immediately due and payable. But the borrower can also "cure" the default, most often by paying the arrearages and bringing the loan current. A cure generally allows the borrower to avoid the consequences of default, restores the loan to its original terms, and allows the borrower to keep the property.

[1]The Bankruptcy Code incorporates the concept of cure. Chapter 11 provides that a debtor's plan of reorganization must "provide adequate means for the plan's implementation," including the "curing or waiving of any default." ***1139** 11 U.S.C. § 1123(a)(5)(G). This statute means that a plan of reorganization may include a provision authorizing the debtor to remedy any breach of a loan agreement with a creditor and return to pre-default conditions. *Great W. Bank & Tr. v. Entz–White Lumber & Supply, Inc. (In re Entz–White Lumber &Supply, Inc.)*, 850 F.2d 1338, 1340 (9th Cir. 1988).

We held in *Entz–White* that a debtor who cures a default "is entitled to avoid all consequences of the default—including higher post-default interest rates." *Id.* at 1342. In other words, if a loan agreement provided for a higher, post-default interest rate on arrearages in the event of default, a debtor who "cures" is entitled to repay the arrearages at the lower, pre-default interest rate. We concluded that "the power to cure under the Bankruptcy Code authorizes a plan to nullify all consequences of default, including avoidance of default penalties such as higher interest," even when the terms of the loan agreement called for a higher interest rate upon default. *Id.*

The case before us requires us to decide whether *Entz–White* 's rule that a debtor may nullify a loan agreement's requirement of post-default interest remains good law in light of 11 U.S.C. § 1123(d), a provision that Congress enacted after *Entz–White*. Section 1123(d) provides that, if a plan proposes to cure a default, "the amount necessary to cure the default shall be determined in accordance with the underlying agreement and applicable nonbankruptcy law." 11 U.S.C. § 1123(d). We hold that *Entz–White* 's rule of allowing a curing debtor to avoid a contractual post-default interest rate in a loan agreement is no longer valid in light of § 1123(d).

I.

New Investments, Inc. ("New Investments") borrowed $3,045,760.51 from Pacifica L 51, LLC's ("Pacifica") predecessor in interest to purchase a hotel property in Kirkland, Washington. The note, which was secured by a deed of trust, provided for an interest rate of 8 percent. The note also specifically provided that in the event of default, the interest rate would increase by 5 percent.

New Investments defaulted on the note in 2009. When Pacifica commenced non-judicial foreclosure proceedings, New Investments filed for Chapter 11 bankruptcy. New Investments's plan of reorganization proposed to cure the default by selling the property to a third party and using the proceeds of the sale to pay the outstanding amount of the loan at the pre-default interest rate. Pacifica objected to the plan on the ground that, under the terms of the note, it was entitled to be paid at the higher, *post-default* interest rate.

The bankruptcy court confirmed New Investments's plan over Pacifica's objection and authorized the sale of the hotel for $6,890,000. Of the sale proceeds, $2,830,877.28 would be paid to Pacifica, reflecting the *pre-default* interest rate and extinguishing any other late penalties. Anticipating an appeal, the bankruptcy court ordered that $100,000 of the proceeds be reserved for Pacifica's attorney's fees on appeal and that $670,000 be set aside as a disputed claim reserve for Pacifica. Pacifica timely appeals from the confirmation order.

II.

[2] [3] [4] [5]We have jurisdiction under 28 U.S.C. § 158(d), and we review the bankruptcy court's interpretation of bankruptcy statutes de novo. *Boyajian v. New Falls Corp. (In re Boyajian)*, 564 F.3d 1088, 1090 (9th Cir. 2009). "When construing the meaning of a statute, we begin with the language of that statute." *Benko v. Quality Loan Serv. Corp.*, 789 F.3d 1111, 1118 (9th Cir. 2015). "If the statutory text is ambiguous, ***1140** we employ other tools, such as legislative history, to construe the meaning of ambiguous terms." *Id.* "A party contending that legislative action changed settled law has the burden of showing that the legislature intended such a change." *Green v. Bock Laundry Mach. Co.*, 490 U.S. 504, 521, 109 S.Ct. 1981, 104 L.Ed.2d 557 (1989).

III.

[6]Chapter 11 of the Bankruptcy Code provides that a plan of reorganization must, among other things, "provide adequate means for the plan's implementation," including the "curing or waiving of any default." 11 U.S.C. § 1123(a)(5)(G). In *Entz–White*, we observed that the Bankruptcy Code did not define "cure." 850 F.2d at 1340. We borrowed the Second Circuit's definition: "A default is an event in the debtor-creditor relationship which triggers certain consequences. Curing a default commonly means taking care of the triggering event and returning to pre-default conditions. The consequences are thus nullified. This is the concept of 'cure' used throughout the Bankruptcy Code." *Id.* (alteration omitted) (quoting *Di Pierro v. Taddeo (In re Taddeo)*, 685 F.2d 24, 26–27 (2d Cir. 1982)). We held that "the power to cure under the Bankruptcy Code authorizes a plan to nullify all consequences of default, including avoidance of default penalties such as higher interest." *Id.* at 1342. As a result, a debtor whose plan proposed to cure a default would allow him to avoid having to pay a higher, post-default interest rate called for in the loan agreement.

Entz–White was decided in 1988. In 1994, Congress amended § 1123 to add subsection (d). Pub. L. No. 103–394, Title II, § 305, Oct. 22, 1994, 108 Stat. 4106. Subsection (d) provides:

> Notwithstanding subsection (a) of this section and sections 506(b), 1129(a)(7), and 1129(b) of this title, if it is proposed in a plan to cure a default the amount necessary to cure the default shall be determined in accordance with the underlying agreement and applicable nonbankruptcy law.

11 U.S.C. § 1123(d).

Subsection § 1123(d) renders void *Entz–White* 's rule that a debtor who proposes to cure a default may avoid a higher, post-default interest rate in a loan agreement. Subsection (d) governs here because New Investments's plan proposes to cure a default. The underlying agreement—here, the promissory note—requires the payment of a higher interest rate upon default. And "applicable nonbankruptcy law"—here, Washington state law—allows for a higher interest rate upon default when provided for in the loan agreement.[1] *See* Wash. Rev. Code Ann. § 61.24.090(1)(a) (providing that a borrower may cure a monetary default by paying the trustee "[t]he entire amount then due under the terms of the deed of trust and the obligation secured thereby, other than such portion of the principal as would not then be due had no default occurred"). In other words, under § 1123(d), "the amount necessary to cure [New Investments's] default" is governed by the deed of trust and Washington law, which respectively require and permit repayment at a higher, post-default interest rate.

***1141** The plain language of § 1123(d) compels the holding that a debtor cannot nullify a preexisting obligation in a loan agreement to pay post-default interest solely by proposing a cure. But even if we were to read ambiguity into the statute, the legislative history would not help New Investments. The House Report for the bill that became § 1123(d) states that Congress was primarily concerned with overruling the Supreme Court's decision in *Rake v. Wade*, 508 U.S. 464, 113 S.Ct. 2187, 124 L.Ed.2d 424 (1993). H.R. Rep. No. 103–835, at *55 (1994). *Rake* had held that a Chapter 13 debtor who proposed to cure a default was required to pay interest on his arrearages to a secured creditor even if the underlying loan agreement did not provide for such interest. 508 U.S. at 472, 113 S.Ct. 2187. Congress viewed this as an untoward result that allowed for "interest on interest payments" and provided an unbargained-for windfall to creditors. H.R. Rep. No. 103–835, at *55. The House Report states that § 1123(d) would "limit the secured creditor to the benefit of the initial bargain with no court contrived windfall." *Id.* It further stated that it was "the Committee's intention that a cure pursuant to a plan should operate to put the debtor in the same position as if the default had never occurred." *Id.*

[7] [8]The fact that Congress had a particular purpose in mind when enacting a statute does not limit the effect of the statute's text, a principle *Entz–White* itself recognized. *See* 850 F.2d at 1341 (noting that a Senate Report for the bill that became 11 U.S.C. § 1124 showed "only that the drafters in the Senate were concerned primarily with defaults resulting in acceleration; it does not show that they meant to confine the section to that situation"). Rather, "[t]he fact that Congress may not have foreseen all of the consequences of a statutory enactment is not a sufficient reason for refusing to give effect to its plain meaning." *Union Bank v. Wolas*, 502 U.S. 151, 158, 112 S.Ct. 527, 116 L.Ed.2d 514 (1991). By its terms, § 1123(d) tells us to look to the promissory note and Washington law to determine what amount New Investments must pay to cure its default. Here, that analysis requires the payment of post-default interest.

This result is further consistent with the intent of § 1123(d) because it holds the parties to the benefit of their bargain. Moreover, the House Report's statement "that a cure pursuant to a plan should operate to put the debtor in the same position as if the default had never occurred" is consistent with the concept of cure generally, which § 1123(d) has not altered or attempted to define. *See Taddeo*, 685 F.2d at 26–27 ("Curing a default commonly means taking care of the triggering event and returning to pre-default conditions. The consequences are thus nullified.").

[9]What § 1123(d) affects is *how* a debtor returns to pre-default conditions, which can include returning to a lower, pre-default interest rate. In the traditional case, a borrower who has defaulted on a loan obligation can cure the default by paying arrearages. *See* Restatement (Third) of Property (Mortgages) § 8.1(b) & cmt. c (1997); Wash. Rev. Code Ann. § 61.24.090(a)(1). This procedure allows the borrower to avoid acceleration or foreclosure, which are some of the more common consequences of default. *See* Restatement (Third) of Property (Mortgages) § 8.1(a); Wash. Rev. Code Ann. § 61.24.090(a). However, the borrower does not effectuate a cure merely by paying past due installments of principal at the pre-default interest rate. Rather, the borrower's cure obligations may also include "late charges, attorneys' and trustee's fees, and publication and court costs." Restatement (Third) of ***1142** Property (Mortgages) § 8.1 cmt. c; *see also* Wash. Rev. Code Ann. § 61.24.090(1)(b). It is only once these penalties are paid that the debtor can return to pre-default conditions as to the remainder of the loan obligation.

The common law treatment of cure is consistent with the Bankruptcy Code's protections for creditors who would have been entitled to receive accelerated payment on a defaulted loan. For a debtor to render such a creditor "unimpaired" and unable to object to the debtor's plan, *Platinum Capital, Inc. v. Sylmar Plaza, L.P. (In re Sylmar Plaza, L.P.)*, 314 F.3d 1070, 1075 (9th Cir. 2002); 11 U.S.C. § 1126(f), the debtor must cure the default but may not "otherwise alter the legal, equitable, or contractual rights" of the creditor, 11 U.S.C. § 1124(2)(E). Here, one of those rights is post-default interest, and New Investments's cure may not alter that right.

Consistent with § 1124(2), the debtor can return to pre-default conditions, which can include a lower, pre-default interest rate, only by fulfilling the obligations of the underlying loan agreement and applicable state law. 11 U.S.C. § 1123(d). By its terms, § 1123(d) requires that we look to the "underlying agreement," not only to the "pre-default interest provisions" of the underlying agreement. To read any such limitation into § 1123(d) would be "to add specific language that Congress did not include in a carefully considered statute." *Illinois v. Abbott & Assocs., Inc.*, 460 U.S. 557, 572, 103 S.Ct. 1356, 75 L.Ed.2d 281, (1983); *see also United States v. Plaza Health Labs., Inc.*, 3 F.3d 643, 649 (2d Cir. 1993) ("[W]e cannot add to the statute what congress did not provide."). Here, the note provided that upon default, the interest rate on the loan would increase by 5 percent. Unfortunately for New Investments, the increased interest rate applies to the entirety of the note and not just to arrearages.

[10] [11]We are mindful that "[t]he principal purpose of the Bankruptcy Code is to grant a fresh start to the honest but unfortunate debtor." *Marrama v. Citizens Bank of Mass.*, 549 U.S. 365, 367, 127 S.Ct. 1105, 166 L.Ed.2d 956 (2007) (internal quotation marks omitted). And Congress wanted to protect debtors against unbargained-for interest requirements in enacting § 1123(d). But the Bankruptcy

Code is not a purely remedial statute. *Fla. Dep't of Revenue v. Piccadilly Cafeterias, Inc.*, 554 U.S. 33, 51, 128 S.Ct. 2326, 171 L.Ed.2d 203 (2008). "Rather, Chapter 11 strikes a balance between a debtor's interest in reorganizing and restructuring its debts and the creditors' interest in maximizing the value of the bankruptcy estate." *Id.* If the loan agreement did not require a higher, post-default interest rate, New Investments would not have to pay it. However, today's result holds New Investments to *its* bargain by adhering to the terms of its loan agreement with Pacifica, as required by § 1123(d).

Both the text and the legislative history of § 1123(d) make clear that the provision was intended to limit parties to the benefit of their bargain when a debtor seeks to effectuate a cure and return to pre-default conditions. The parties bargained for a higher interest rate on the note in the event of default, and Pacifica is entitled to the benefit of that bargain under the terms of § 1123(d).

IV.

We conclude that Pacifica is entitled to receive payment of the loan at the post-default interest rate. We therefore reverse the decision of the bankruptcy court and remand for further proceedings.

REVERSED and REMANDED.

***1143** BERZON, Circuit Judge, dissenting:

Neither 11 U.S.C. § 1123(d) nor any other provision of the Bankruptcy Code provides a definition of "cure" contrary to the one this Court announced in *Great Western Bank & Trust v. Entz–White Lumber & Supply, Inc.* (*In re Entz–White Lumber &Supply, Inc.*), 850 F.2d 1338, 1340 (9th Cir. 1988). We are therefore bound by this Court's precedent, according to which New Investments may, in curing its default, pay the pre-default interest rate contained in the promissory note.

Instead of abiding by our longstanding case law, the majority concludes that Congress displaced *Entz–White* when it passed § 1123(d). Because neither the text of the statute nor the legislative history of § 1123(d) support the majority's departure, I dissent.

I.

Chapter 11 requires that a debtor's plan of reorganization "provide adequate means for the plan's implementation, such as ... curing or waiving of any default." 11 U.S.C. § 1123(a)(5). In the absence of any statutory definition, this Court held in *Entz–White* that "[c]uring a default" means "returning to pre-default conditions," such that any consequences of the default are "nullified." 850 F.2d at 1340 (quoting *Di Pierro v. Taddeo* (*In re Taddeo*), 685 F.2d 24, 26–27 (2d Cir. 1982)). Because curing a default returns the debtor to the status quo ante, we concluded, "the power to cure under the Bankruptcy Code authorizes a plan to nullify all consequences of default, including avoidance of default penalties such as higher interest." *Id.* at 1342.

After this Court decided *Entz–White*, Congress enacted 11 U.S.C. § 1123(d). Section 1123(d), part of the 1994 amendments to the Bankruptcy Code, provides:

> Notwithstanding subsection (a) of this section and sections 506(b), 1129(a)(7), and 1129(b) of this title, if it is proposed in a plan to cure a default the amount necessary to cure the default shall be determined in accordance with the underlying agreement and applicable nonbankruptcy law.

Pacifica maintains—and the majority agrees—that this provision overruled *Entz–White* 's holding that a debtor who cures a default, thus "nullify[ing] all consequences of" that default, may repay arrearages at the pre-default interest rate. *See* 850 F.3d at 1342.

Pacifica bears the burden of showing that Congress, in passing § 1123(d), intended to change settled law. *Tome v. United States*, 513 U.S. 150, 163, 115 S.Ct. 696, 130 L.Ed.2d 574 (1995) (quoting *Green v. Bock Laundry Mach. Co.*, 490 U.S. 504, 521, 109 S.Ct. 1981, 104 L.Ed.2d 557 (1989)). In determining whether Pacifica has met this burden, we "will not read the Bankruptcy Code to erode past bankruptcy practice absent a clear indication that Congress intended such a departure." *Hamilton v. Lanning*, 560 U.S. 505, 517, 130 S.Ct. 2464, 177 L.Ed.2d 23 (2010) (citations and internal quotation marks omitted).

Pacifica has not carried this burden, as both the statutory text and the legislative history of § 1123(d) support the continuing viability of *Entz–White* 's holding. The majority opinion errs in concluding otherwise, and, in doing so, wrongly imposes a severe penalty on debtors in New Investments' situation.

II.

The Bankruptcy Reform Act of 1994, among other things, added nearly identical language regarding how one cures a default to Chapters 11, 12, and 13 of the Bankruptcy Code. Pub. L. No. 103–394, § 305, 108 Stat. 4106 (1994). Like the subsection here at issue, 11 U.S.C. §§ 1222(d) ***1144** and 1322(e) provide that, notwithstanding other provisions of the Bankruptcy Code not relevant here, "if it is proposed in a plan to cure a default, the amount necessary to cure the default, shall be determined in accordance with the underlying agreement and applicable nonbankruptcy law."

Nowhere did the 1994 amendments define "cure a default" or suggest that this Circuit's then-operative definition of "cure" was incorrect. Rather, § 1123(d) indicates which materials the parties may consult in determining *how* to cure a default. Accordingly, as a result of the 1994 amendments, the *terms* of a cure are circumscribed by the underlying agreement and applicable nonbankruptcy law.

Neither § 1123(d) nor any other provision of the Bankruptcy Code explains *where* in the underlying agreement to look for the provisions that apply in the event of a cure. If, as *Entz–White* held, "[c]uring a default" means "returning to pre-default conditions," 850 F.2d at 1340, the provisions of the agreement setting out the pre-default interest rate provide the relevant information. If "curing a default" means paying a penalty triggered by the default, the provisions of the agreement addressing higher post-default interest rates establish the relevant requirements. But in *Entz–White*, we decisively rejected this alternative definition of "cure." *Id.* at 1342. We called the creditor's argument in favor of this reading "spurious," as it "amount[ed] to saying, once more, that the higher rate of interest is not a consequence of default that can be cured." *Id.*

In short, the text of § 1123(d) makes clear that New Investments' cure will be based on the terms of the promissory note, but offers no guidance on which of the note's provisions governs here. *Entz–White* provides that guidance, by specifying that a "cure" permits the debtor to "avoid all consequences of the default." *Id.* Applying that understanding, it is the pre-default interest provisions of the underlying agreement that govern. The majority's conclusion that § 1123(d) overruled *Entz–White* has no basis in the text of the statute.

III.

The legislative history of § 1123(d) confirms that Congress did not mean to disturb this Court's holding in *Entz–White.* In adding § 1123(d), Congress focused on addressing an entirely separate matter—the Supreme Court's holding in *Rake v. Wade*, 508 U.S. 464, 113 S.Ct. 2187, 124 L.Ed.2d 424 (1993). H.R. Rep. No. 103–835, at 55 (1994); *see also* S. Rep. No. 103–168, at 53 (1993) (discussing the parallel provision included in the Senate bill).

In *Rake*, the Supreme Court held that an oversecured creditor was entitled to pre- and post-confirmation interest on mortgage arrearages paid to cure a default under a Chapter 13 plan. 508 U.S. at 471–75, 113 S.Ct. 2187. This reading of the relevant provisions of the Bankruptcy Code, §§ 506(b), 1322(b), and 1325(a)(5), permitted secured creditors to collect interest on top of the interest payments paid by debtors under their mortgages. *Id.* at 470–75, 113 S.Ct. 2187.

Congress overtly rejected this result in enacting § 1123(d). H.R. Rep. No. 103–835, at 55. The amendments to § 1123 were contained in § 305 of the Bankruptcy Reform Act of 1994, which is entitled "Interest on Interest." Pub. L. No. 103–394, § 305, 108 Stat. 4106, 4134 (1994). The relevant House Report states that the amendments "will have the effect of overruling the decision of the Supreme Court in *Rake v. Wade*," because *Rake* "had the effect of providing a windfall to secured creditors" by giving them "interest on interest payments, and interest on the late charges and other fees, even where applicable ***1145** laws prohibit[ ] such interest and even when it was something that was not contemplated by either party in the original transaction." H.R. Rep. No. 103–835, at 55.

Far from repudiating *Entz–White* 's holding, the House Report reiterated *Entz–White* 's interpretation of "cure," stating, "[i]t is the Committee's intention that a cure pursuant to a plan should operate to put the debtor in the same position as if the default had never occurred." *Id.* The legislative history thus indicates, at the very least, that the new provision was not meant *sub silentio* to enact a definition of "cure" conflicting with that adopted in *Entz–White*. It also suggests that the relevant provisions of the "underlying agreement" for a "cure" are those that would have applied "if the default had never occurred." *See id.*

In sum, the pertinent 1994 amendments eliminated the possibility of a "court contrived windfall" for secured creditors. *Id.* Pacifica's challenge to the Bankruptcy Court's confirmation order does not implicate the concern that animated Congress. Like the text of the statute, the legislative history in no way suggests that *Entz–White* 's definition of "cure" is incorrect or was overruled.

Here, the underlying agreement provides both pre- and post-default interest rates. As the statute requires, we look to that agreement in determining which rates may apply. And in selecting which provision of the contract governs, we rely on our precedent and use the pre-default rate. New Investments therefore could cure the default by paying interest on the debt at the pre-default rate.

IV.

Notwithstanding its recitation of the relevant text and legislative history, the majority somehow concludes that *Entz–White* is no longer controlling. Relying on an incorrect interpretation of § 1123(d), the majority's opinion mistakenly upsets this Circuit's binding precedent.

A three judge panel of this Court is "bound by decisions of prior panels unless an en banc decision, Supreme Court decision or subsequent legislation undermines those decisions." *Gen. Const. Co. v. Castro*, 401 F.3d 963, 975 (9th Cir. 2005) (quoting *Benny v. U.S. Parole Comm'n*, 295 F.3d 977, 983 (9th Cir. 2002)). No act of Congress or intervening higher authority justifies the panel's departure from our precedent here.

As discussed, Congress has not defined "cure the default" in the years since we decided *Entz–White*. There is thus no "clear indication that Congress intended ... a departure," *Hamilton*, 560 U.S. at 517, 130 S.Ct. 2464, from this Court's past practice. The interpretation of the statute best supported by the legislative record favors continuity. No intervening case law from the Supreme Court or the Ninth Circuit calls *Entz–White* into doubt. On the contrary, this Court has continued to rely on *Entz–White*'s holding. *See Platinum Capital, Inc. v. Sylmar Plaza, L.P.* (*In re Sylmar Plaza, L.P.*), 314 F.3d 1070, 1075 (9th Cir. 2002) (concluding *Entz–White* precluded a creditor's argument "that a plan intended to nullify the consequences of a default (thereby avoiding the higher post-default interest rate) does not meet the purposes of the Bankruptcy Code"); *cf. Gen. Elec. Capital Corp. v. Future Media Prods. Inc.*, 547 F.3d 956, 960–61 (9th Cir. 2008) (treating *Entz–White* as good law, but concluding it did not apply to a claim paid in full as a result of asset sales outside of a Chapter 11 plan).

Stare decisis thus requires us to apply *Entz–White* and hold that New Investments "is entitled to avoid all consequences of the default—including higher ***1146** post-default interest rates." 850 F.2d at 1342. I would affirm the Bankruptcy Court order confirming New Investments' plan of reorganization, which reflects the pre-default interest rate included in the promissory note.

All Citations

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Footnotes

1 We reject New Investments's argument that Washington's deed of trust law cannot constitute "applicable nonbankruptcy law" under § 1123(d) because the Bankruptcy Code's automatic stay would prevent foreclosure under Washington law. *See* 11 U.S.C. § 362(a); Wash. Rev. Code Ann. § 61.24.040. This reading would render the phrase "applicable nonbankruptcy law" meaningless because the automatic stay would always trump state law foreclosure provisions, contrary to the statutory text and intent.

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Feature

By David M. Neff

Default Interest Claims Make Gains

David M. Neff
Perkins Coie LLP
Chicago

David Neff is a partner in Perkins Coie LLP's Bankruptcy and Restructuring Group in Chicago. His practice includes financial restructuring, bankruptcy and commercial litigation.

Once a loan goes into default, loan documents typically increase the interest rate that the borrower must pay. This default interest can substantially add to what the debtor must account for under its bankruptcy plan. As a result, debtors often challenge default interest claims. When a lender is seeking default interest for a pre-petition period, courts typically look to whether the amount constitutes permissible liquidated damages or an unenforceable penalty under applicable state law.

When the lender is seeking default interest for a post-petition period, courts start their analysis by referencing § 506(b) of the Bankruptcy Code, which allows a secured creditor to receive post-petition interest on its claim to the extent its collateral is worth more than its debt. If the lender is oversecured, courts have taken various approaches in determining whether to allow default interest. Some, especially courts of appeals, have presumed the validity of default-interest provisions, especially if junior creditors will not be harmed by its payment.[1] Others have employed the state law analysis of whether the default interest constitutes permissible liquidated damages, analyzing whether such damages could have been determined with relative certainty at the time of contract formation and the default interest rate was a reasonable estimate of damages the lender might suffer.[2]

Yet even if the default interest is deemed permissible liquidated damages, many courts also consider equitable factors, such as whether junior creditors would be impacted by the allowance of default interest, whether the amount is so large that it "shocks the conscience of the court," and whether the default interest rate is customary in the industry.[3] Still other courts depart from this analysis and instead hold that a default-interest provision is not a liquidated-damages clause, but rather an additional "charge" under § 506(b) that is assessed after a breach and is examined only for reasonableness.[4]

Thus, whether default interest arises pre-petition or post-petition, courts are likely to consider state law, often as it relates to liquidated damages. However, *In re Altadena Lincoln Crossing LLC*[5] throws into question whether the liquidated-damages approach is appropriate and provides persuasive analysis for lenders seeking default interest even in a jurisdiction that employs a liquidated-damages analysis.

Facts of *Altadena Lincoln Crossing*

Altadena obtained two loans from East West Bank (EWB) to construct a mixed-use project. The loan-negotiation process took months, with many drafts exchanged by both parties' counsel. No one could recall any discussions regarding the 5 percent default interest rate that EWB had included in the documents.[6] As Altadena's expert would later testify, parties rarely negotiate default interest rates at the time a loan is originated.[7] There was no evidence that the choice of 5 percent was an attempt by EWB to quantify, estimate, approximate or compensate for any damages as a result of a default.[8] Rather, it was the typical default interest rate that EWB used for construction loans, which the parties agreed was a common default rate for such loans.[9]

When Altadena failed to repay the larger loan at the original maturity date, it entered into a number of modification agreements with EWB, increasing the principal loan amount and extending the maturity date.[10] The parties later entered into a series of short-term forbearance agreements that mostly served to extend the maturity date further.[11] Altadena complained about the accruing default interest; however, the forbearance agreements reaffirmed the default interest rate, released any claims against EWB related to the loan, and contained a provision forgiving all accrued default interest if Altadena paid the outstanding loan balance by the new maturity date.[12]

continued on page 64

1 *See Gen. Elec. Capital Corp. v. Future Media Prods.*, 547 F.3d 956 (9th Cir. 2008); *In re Terry Ltd. P'ship*, 27 F.3d 241 (7th Cir. 1994); *Bradford v. Crozier (In re Laymon)*, 958 F.2d 72 (5th Cir. 1992); *Equitable Life Assurance Soc'y v. Sublett (In re Sublett)*, 895 F.2d 1381 (11th Cir. 1990); *In re LHD Realty Corp.*, 726 F.2d 327 (7th Cir. 1984); *Mack Fin. Corp. v. Ireson*, 789 F.2d 1083 (4th Cir. 1986); *Ruskin v. Griffiths*, 269 F.2d 827 (2d Cir. 1959).

2 *See In re Boulders on the River*, 169 B.R. 969 (Bankr. D. Ore. 1994); *In re Timberline Prop. Dev. Inc.*, 136 B.R. 382 (Bankr. D.N.J. 1992); *In re Hollstrom*, 133 B.R. 535 (Bankr. D. Colo. 1991); *In re White*, 88 B.R. 498 (Bankr. D. Mass. 1988).

3 *See Prudential Ins. Co. of Am. v. SW Boston Hotel Venture LLC (In re SW Boston Hotel Venture LLC)*, 479 B.R. 210 (B.A.P. 1st Cir. 2012); *In re Gen. Growth Props. Inc.*, 451 B.R. 323 (Bankr. S.D.N.Y. 2011); *In re Jack Kline Co.*, 440 B.R. 712 (Bankr. S.D. Tex. 2010); *In re Yazoo Pipeline Co. LP*, 2009 WL 2857863 (Bankr. S.D. Tex. 2009); *In re Urban Communicators PCS Ltd. P'ship*, 379 B.R. 232 (Bankr. S.D.N.Y. 2008); *In re Route One West Windsor Ltd. P'ship*, 225 B.R. 76 (Bankr. D.N.J. 1998); *In re Liberty Warehouse Assocs. Ltd. P'ship*, 220 B.R. 546 (Bankr. S.D.N.Y. 1998); *In re Ace-Texas Inc.*, 217 B.R. 719 (Bankr. D. Del. 1998); *In re Vest Assocs.*, 217 B.R. 696 (Bankr. S.D.N.Y. 1998); *In re Johnson*, 184 B.R. 570 (Bankr. D. Minn. 1995); *Conn. Gen. Life Ins. Co. v. Schaumburg Hotel Owner Ltd. P'ship (In re Schaumburg Hotel Owner Ltd. P'ship)*, 97 B.R. 943 (Bankr. N.D. Ill. 1989); *In re Consol. Operating Partners LP*, 91 B.R. 113 (Bankr. D. Colo. 1988); *In re W.S. Sheppley & Co.*, 62 B.R. 271 (Bankr. N.D. Iowa 1986).

4 *See In re AE Hotel Venture*, 321 B.R. 209 (Bankr. N.D. Ill. 2005); *Fischer Enters. Inc. v. Geremia (In re Kalian)*, 178 B.R. 308 (Bankr. D.R.I. 1995).

5 *E. W. Bank v. Altadena Lincoln Crossing LLC (In re Altadena Lincoln Crossing LLC)*, Case No. 2:18-cv-8738, 2019 WL 1057044 (C.D. Cal. March 6, 2019).

6 *In re Altadena Lincoln Crossing LLC*, 2018 WL 3244502, at *1 (Bankr. C.D. Cal. 2018).

7 *Id.* at *2.

8 *Id.*

9 *Id.*

10 *Id.* at *3.

11 *Id.*

12 *Id.*

Default Interest Claims Make Gains

from page 12

The loan documents required Altadena to pay all of EWB's out-of-pocket costs in connection with a default, including attorneys' fees and expenses, late charges, post-judgment collection services, title reports (including foreclosure reports), appraisal fees, title insurance and fees due to a foreclosure trustee.[13] The loan agreement also included a late fee on any late or missed payments, intended to serve as compensation for additional administrative tasks related to servicing and processing late payments.[14] The bankruptcy court would later find these fees enforceable and that "the default interest rate was not intended to compensate EWB for any of these types of expenses."[15]

The Debtor Met Its Burden of Proof

The bankruptcy court held that under Ninth Circuit precedent, default interest should be allowed unless it would not be enforceable under applicable nonbankruptcy law.[16] It then noted that § 1671(b) of the California Civil Code allows liquidated damages unless the party seeking to challenge them proves that they were unreasonable under the circumstances at the time the agreement to pay them was made.[17] In that regard, California statutory law is similar to the nonstatutory law in most other states.

The bankruptcy court found that Altadena met its burden of proof by establishing that "there was no endeavor at all by either of the parties at the time they entered into the loans, let alone a reasonable endeavor, to estimate any losses that might be suffered by EWB in the event of a default."[18] Alternatively, the court found that Altadena met its burden of proof by simply providing the details of the lending agreement.[19] Considering the principal amount along with the default interest rate of 5 percent, the court found the magnitude of default interest (which had grown to be $10 million since the loan had matured in 2009) to be "grossly disproportionate to any administrative costs or other actual damages not already being passed along to the Debtor under separate provisions of the loan agreement that EWB could reasonably have anticipated at the time the loan was made."[20] In so ruling, the bankruptcy court rejected EWB's arguments that (1) the court should have considered the increased risk of loss resulting from a borrower's default, or any perceived diminution in the value of its loan; (2) default interest compensates the lender for the increased costs of managing a defaulted loan; (3) Altadena should be barred from challenging the default-interest provisions because the forbearance agreements reaffirmed that it owed the 5 percent rate; and (4) the court should have considered that the 5 percent default interest rate is what other lenders typically charge.[21]

The District Court Reverses

The district court noted that the bankruptcy court's findings of fact were undisputed,[22] but reached the opposite legal conclusion on *de novo* review of the applicability of the California liquidated-damages statute, as well as the result if that statute controlled. In first considering the applicability of § 1671(b), the district court held that it did not apply to a fully matured loan, such as existed in Altadena, because an increased interest rate payable upon a loan maturity default is not a liquidated damage, but rather an agreement to pay a higher interest rate upon the occurrence of a contingency (*i.e.*, nonpayment of the loan balance at maturity).[23] The district court distinguished a bankruptcy court decision from several years earlier, *In re 8110 Aero Drive Holdings LLC*,[24] in which the bankruptcy court found that a default-interest provision that applied to the entire loan balance after a default but prior to maturity of the loan — rather than just the portion in default — constituted a liquidated-damages clause.[25] As a result — since Altadena's loan had matured and its entire amount was in default, and EWB only charged the default rate of interest on the amount of the loan that was in default — the district court found that there was no liquidated-damages clause and that § 1671(b) did not apply.[26]

Next, the district court considered whether the default interest would be allowed, even if it constituted liquidated damages and § 1671(b) applied. The district court noted that liquidated damages are unenforceable if they bear no reasonable relationship to the harm the parties could have anticipated at the time they entered into the contract.[27] To make that determination, the district court rejected the bankruptcy court's conclusion that the parties actually had to have tried to estimate such harm.[28] Instead, the district court required only that the liquidated-damages provision "be reasonable in light of the potential harm that could result from a breach, as that harm could be anticipated at the time of contract formation."[29] Consequently, the district court focused on the "substantive reasonableness of the liquidated-damages provision rather than on the process of contract formation that gave rise to the provision."[30]

To determine whether the default-interest provision bore a reasonable relationship to the possible harm that EWB might suffer upon default, the district court found that a default adversely affects the value of a loan.[31] It agreed with EWB's expert that lenders commonly insist on an increased interest rate to recoup the diminution in value of a loan when it goes into default and that the 5 percent interest rate was actually less

13 *Id.* at *4.
14 *Id.*
15 *Id.*
16 *Id.* at *6 (citing *Gen. Elec. Capital Corp. v. Future Media Prods. Inc.*, 547 F.3d 956, 961 (9th Cir. 2008)).
17 *Id.* at *6.
18 *Id.* at *8.
19 *Id.*
20 *Id.*
21 *Id.* at *7-11.

22 *E. W. Bank v. Altadena Lincoln Crossing LLC (In re Altadena Lincoln Crossing LLC)*, 2019 WL 1057044 (C.D. Cal. March 3, 2019).
23 *Id.* at *4-5.
24 Case No. 16-03135-MM, 2017 WL 2712961 (Bankr. S.D. Cal. May 8, 2017).
25 *Id.* at *11.
26 *Altadena Lincoln Crossing*, 2019 WL 1057044, at *5-6.
27 *Id.* at *6.
28 *Id.*
29 *Id.* (citations omitted).
30 *Id.* The court noted that it remains relevant whether the parties had equal bargaining power and were both represented by lawyers in negotiating the underlying contract. *Id.* at n.8.
31 *Id.* at *7.

than the rate necessary to compensate EWB for the decline in the value of its loan to Altadena.[32] By so holding, the district court explicitly rejected the bankruptcy court's ruling that only a lender's out-of-pocket damages could be considered in determining whether the default interest rate was reasonable.[33]

Conclusion

The district court's opinion in *Altadena* represents a seismic shift for lenders in the allowance of default interest where California law applies and is instructive for cases in other jurisdictions, as many courts undertake a liquidated-damages analysis in determining whether to allow default interest. Had the bankruptcy court's ruling in *Altadena* been affirmed, default interest would almost never be allowed because a lender can rarely show that it had negotiated the default-interest provision or took steps at the time of the contract formation to estimate its potential losses upon a later default by its borrower. In addition, because loan agreements typically allow the lender to recoup most of its out-of-pocket costs upon default, the lender would be unlikely to obtain any additional amounts under the bankruptcy's court's ruling. The district court's opinion resets the state of the law to honor the parties' agreement that a customary default interest rate will be owed upon default, at least where it is assessed against the entire loan balance after maturity of the loan by its terms or through acceleration. This result seems most in accord with the parties' intentions, commercial expectations and guidance from the courts of appeals. abi

32 *Id.*
33 *Id.* The district court also rejected the bankruptcy court's conclusion that the attributes of a loan are established when it is made and thus a defaulted loan is no riskier than a nondefaulted loan. The district court found that defaulted loans are more likely to go into foreclosure, making the loan less valuable to a potential buyer and consequently of lower value to the lender. *Id.* at n.9.

4. THE HONORABLE BRUCE HARWOOD

Topic: Consent: Is failure to object sufficient?

KeyCite Yellow Flag - Negative Treatment
Distinguished by In re FKF 3, LLC, S.D.N.Y., November 6, 2013

484 B.R. 598
United States Bankruptcy Court,
S.D. New York.

In re OLDCO M CORPORATION, (f/k/a Metaldyne Corporation), et al., Debtor.
Executive Sounding Board Associates Inc., as Trustee for the Oldco M Distribution Trust, Plaintiff,
v.
Advanced Machine & Engineering Co., Defendant.

Bankruptcy No. 09–13412 (MG).
|
Adversary No. 11–01939 (MG).
|
Dec. 20, 2012.

Synopsis

Background: Trustee appointed under liquidating Chapter 11 plan brought adversary proceeding for avoidance of preferential transfer, and moved for entry of default judgment in its favor when defendant failed to respond.

Holdings: The Bankruptcy Court, Martin Glenn, J., held that:

[1] bankruptcy judge, even as non-Article-III judge, had constitutional authority to enter final default judgment when defendant failed to respond to complaint, and

[2] preference defendant's inaction, in utterly failing to respond to trustee's complaint despite fact that summons notified it that failure to respond might result in default judgment against it, constituted its implied consent to entry of default judgment by bankruptcy judge.

Motion granted.

West Headnotes (12)

[1] **Constitutional Law**
Delegation of Powers by Judiciary

There are two components inherent in constitutional right to Article III judge: (1) an individual constitutional right of litigants to insist upon Article III decisionmaker; and (2) a structural constitutional right, stemming from separation of powers doctrine.

Cases that cite this headnote

[2] **Constitutional Law**
Waiver in general

Structural constitutional right to Article III judge cannot be lost through waiver or by express or implied consent of parties.

Cases that cite this headnote

[3] **Constitutional Law**
Establishment, Organization, and Jurisdiction of Courts

Touchstone for non-waivable structural right to Article III judge is that Congress may not withdraw from Article III judicial cognizance any matter which, from its nature, is subject of suit at common law, in equity, or in admiralty.

Cases that cite this headnote

[4] **Bankruptcy**
Counterclaims
Bankruptcy
State law claims
Bankruptcy
Claims or proceedings against estate or debtor; relief from stay
Bankruptcy
Consent to or Waiver of Objections to

Jurisdiction or Venue

Stern's prohibition against bankruptcy court's entry of final judgment on state law counterclaims that will not necessarily be resolved by process of ruling on proof of claim is concerned only with individual constitutional right of litigants to insist on Article III decisionmaker, a right which can be lost through waiver or consent.

Cases that cite this headnote

[5] **Bankruptcy**
Consent to or Waiver of Objections to Jurisdiction or Venue

Defendant in case or proceeding referred to bankruptcy court may consent, either expressly or impliedly, to final determination by non-Article III tribunal, even though defendant would otherwise have right to have dispute adjudicated by Article III tribunal.

1 Cases that cite this headnote

[6] **Bankruptcy**
Consent to or Waiver of Objections to Jurisdiction or Venue

While consent should not be lightly inferred, implied consent is proper basis for upholding exercise of authority by bankruptcy judge to enter final order or judgment.

6 Cases that cite this headnote

[7] **Bankruptcy**
Particular proceedings or issues
Bankruptcy
Bankruptcy judges

Bankruptcy judge, even as a non-Article-III judge, has constitutional authority to enter final default judgment when defendant fails to respond to complaint.

8 Cases that cite this headnote

[8] **Constitutional Law**
Establishment, Organization, and Jurisdiction of Courts

Structural right to Article III judge guarantees that Congress may not remove from Article III judicial cognizance cases that were triable in courts of law, equity or admiralty at time of adoption of the Constitution.

Cases that cite this headnote

[9] **Bankruptcy**
Consent to or Waiver of Objections to Jurisdiction or Venue
Bankruptcy
Default

Preference defendant's inaction, in utterly failing to respond to trustee's complaint despite fact that summons notified it that failure to respond might result in default judgment against it, not only served as admission of material allegations of complaint, except as to amount of damages, but also constituted its implied consent to entry of default judgment by bankruptcy judge. 11 U.S.C.A. § 547(b).

8 Cases that cite this headnote

[10] **Bankruptcy**
Default

When plaintiff in bankruptcy proceeding seeks only a sum certain or a sum that can be made certain by computation, Clerk of bankruptcy court may enter final default judgment upon the opposing party's default without any action by bankruptcy judge.

2 Cases that cite this headnote

[11] **Bankruptcy**
Judgment or order; relief
Interest
Particular cases and issues

Award of prejudgment interest in preference avoidance proceeding is discretionary, so that only bankruptcy judge, and not clerk of court acting alone, may include prejudgment interest in default judgment upon the opposing party's default.

Cases that cite this headnote

[12] **Interest**
Particular cases and issues

In proceeding in which defendant fails to appear, bankruptcy judge may include prejudgment interest in final default judgment, if appropriate, based on facts and circumstances of case.

Cases that cite this headnote

Attorneys and Law Firms

***600** Duane Morris LLP, By: Lawrence J. Kotler, Esq., Philadelphia, PA, Counsel for Movant, Executive Sounding Board Associates Inc., as Trustee for the Oldco M Distribution Trust.

MEMORANDUM OPINION AND ORDER

GRANTING TRUSTEE'S MOTION FOR DEFAULT JUDGMENT

MARTIN GLENN, Bankruptcy Judge.

This case raises the narrow but important and recurring issue whether a bankruptcy court may enter a final default judgment in an adversary proceeding in which the sole defendant failed to respond to the summons and complaint. The Court concludes that it may order entry of a final default judgment because the properly served defendant's failure to respond to the summons and complaint provides consent to the entry of the default judgment.

I. BACKGROUND

The adversary complaint in this case was filed by Executive Sounding Board Associates Inc. (the "Trustee"), the liquidating trustee of the Oldco M Distribution Trust (the "Trust"), which was established pursuant to the *Second Amended Joint Plan of Liquidation of Debtors and Debtors in Possession* (the "Plan") filed on May 11, 2011. (09–13412, ECF Doc. # 1180.) The complaint alleges claims under sections 547 and 550 of the Bankruptcy Code. No response to the complaint was ever filed. The bankruptcy court Clerk's certificate of default, required under FED.R.CIV.P. 55(a) made applicable to this proceeding by FED. R. BANKR.P. 7055, has already been entered in this case. The plaintiff has filed a motion for the entry of a default judgment in the amount of $7,311.64, plus costs. The motion is supported by an affidavit establishing that the complaint seeks only recovery of a "sum certain," that the defendant failed to respond to the complaint, and that the defendant is neither a minor nor an incompetent person.

This case is one of many similar cases filed by the Trustee after all avoidance claims were assigned to the Trust under the confirmed Plan.[1] Proof of service of the summons and complaint on the defendant was filed on June 21, 2011. (ECF Doc. # 3.) On August 12, 2011, the Trustee filed proof of service of a second summons and complaint on the defendant. (ECF Doc. # 5.) No response to the complaint was filed.

1 This Opinion controls the outcome of all of the other adversary proceedings commenced by the Trustee as to which no response to the summons and complaint was filed by the defendant. Separate judgments will be entered in each of the cases.

On November 11, 2011, the Trustee filed an application for entry of a certificate of default by the Clerk of the bankruptcy court. (ECF Doc. # 6.) The Clerk issued the certificate of default on November 18, 2011, and proof of service of the certificate of default on the defendant was filed that same day. (ECF Doc. # 8.) The defendant still did not respond or seek to vacate the certificate of default.

On May 10, 2012, the Trustee filed a motion, supported by the declaration of Lawrence J. Kotler, Esq., counsel for the Trustee, for entry of judgment in the amount of $7,561.64 (the amount of the preference plus costs). (ECF Doc. # 9.) Proof of service of the motion and supporting declaration on the defendant was filed on June 1, 2012. (ECF Doc. # 12.) No response was filed.

***601** Despite having received notice on four separate occasions, the defendant never submitted a response to any of the pleadings filed in this case. When the motion for entry of a default judgment came on for hearing on July 16, 2012, no one appeared for the defendant. Because of issues raised after the Supreme Court's decision in *Stern v. Marshall,* ––– U.S. ––––, 131 S.Ct. 2594, 180 L.Ed.2d 475 (2011), regarding the authority of a bankruptcy judge to enter default judgments in preference avoidance actions, the Court directed plaintiff's counsel to file a brief addressing whether the Court can enter the requested judgment. That brief was filed and served on the defendant. (ECF Doc. # 14.) No response was filed.

II. DISCUSSION

Bankruptcy courts in the Second Circuit have historically been able to order the entry of a default judgment in an adversary proceeding when the defendant failed to respond to the complaint. This practice was premised on the theory that by failing to respond to the summons and complaint, a party implicitly consents to final judgment by an Article I court even where that party would otherwise have been constitutionally entitled to final adjudication by an Article III court. The official form of summons used by the bankruptcy court that must be served with every adversary complaint provides that a response to the complaint must be filed within 30 days after the date of the issuance of the summons. The summons also provides, in bold and all capital letters, as follows:

> **IF YOU FAIL TO RESPOND TO THIS SUMMONS, YOUR FAILURE WILL BE DEEMED TO BE YOUR CONSENT TO ENTRY OF A JUDGMENT BY THE BANKRUPTCY COURT AND JUDGMENT BY DEFAULT MAY BE TAKEN AGAINST YOU FOR THE RELIEF DEMANDED IN THE COMPLAINT.**

See Summons and Notice of Pre–Trial Conference in Adversary Proceeding (*available at* www.nysb.uscourts.gov, Forms).[2] It is hard to conceive of clearer language warning of the consequences of failing to respond to the adversary complaint.

2 This form is one of the official bankruptcy forms containing the identical language regarding consent. *See* Forms B 250A, 250B and 250C (*available at* http://www.uscourts.gov/FormsAndFees/Forms/BankruptcyForms. aspx).

Following the Supreme Court's decision in *Stern,* courts outside of this District have split on whether a bankruptcy court may order the entry of a default judgment where the underlying claims could not be finally adjudicated by a non-Article III court without consent. None of those cases, however, considered the consent language contained in the summons that failure to respond to the summons and complaint provides consent to entry of a default judgment. The Court concludes that, by applying the correct analysis to the entry of a default judgment, *Stern* does not limit the bankruptcy court's authority to enter a default judgment when the defendant has failed to respond to the summons and complaint.[3] The same answer ***602** applies whether the claims in the complaint are characterized as "related-to," core, or core but requiring an Article III judge to enter a final order or judgment if the defendant appears, defends and does not consent to a bankruptcy judge entering a final order or judgment.[4]

3 This case does *not* raise the issue whether a bankruptcy judge may order the entry of a final default judgment after a hearing to determine the amount of damages under FED.R.CIV.P. 55(b)(2). But if a defendant loses the right to an Article III judge by failing to respond to the complaint, it is not clear why that right would be resurrected by thereafter appearing and opposing an award of damages. For example, once the Seventh Amendment right to a jury trial is lost by failing to timely demand a jury, the right is not resurrected when

a party otherwise entitled to a jury changes its mind. *See, e.g.,* 9 CHARLES ALAN WRIGHT & ARTHUR J. MILLER, FEDERAL PRACTICE AND PROCEDURE § 2321, at 267 (3d ed. 2008) ("It is well settled by a considerable array of cases that waiver by failure to make a timely demand is complete even though it was inadvertent and unintended and regardless of the explanation or excuse."). Additionally, the Court does not decide whether or when a bankruptcy judge may order entry of a final default judgment other than as a result of a defendant's failure to respond to the adversary complaint.

4 For that reason it is unnecessary to decide whether a bankruptcy court may enter a final order or judgment on preference avoidance and recovery claims under sections 547 and 550 of the Bankruptcy Code where the defendant has not filed a proof of claim, defends the action and refuses to consent to adjudication by a bankruptcy judge. Case law is divided on this question.

For cases upholding the authority of bankruptcy judges to enter final judgments on preference avoidance claims, *see, e.g., Post–Confirmation Comm. v. Tomball Forest, Ltd. (In re Bison Bldg. Holdings, Inc.),* 473 B.R. 168, 171 (Bankr.S.D.Tex.2012) (Isgur, J.) ("This Court may not issue a final order or judgment in matters that are within the exclusive authority of Article III courts. The Court may, however, exercise authority over essential bankruptcy matters under the 'public rights exception.' Actions to recover preferential transfers under § 547 fall within the Bankruptcy Court's constitutional authority.") (citations omitted); *Burtch v. Seaport Capital, LLC (In re Direct Response Media, Inc.),* 466 B.R. 626, 644 (Bankr.D.Del.2012) (Gross, J.) ("This Court disagrees that the *Stern* decision stands for the ... proposition that a non-Article III court does not have authority to enter a final judgment on a preference ... claim brought by the Debtor to augment the estate, or any other core claim (as defined in 28 U.S.C. § 157(b)(2)) that is not a state law counterclaim.... By extension, the Court concludes that *Stern* does not remove the bankruptcy courts' authority to enter final judgments on other core matters, including the authority to finally adjudicate preference ... actions like those at issue before this Court."); *West v. Freedom Med., Inc. (In re Apex Long Term Acute Care–Katy, L.P.),* 465 B.R. 452, 463 (Bankr.S.D.Tex.2011) (Isgur, J.) ("The Court concludes that preference actions both stem from the bankruptcy itself and are decided primarily pursuant to *in rem* jurisdiction. The cause of action for preferential transfers is established by the Bankruptcy Code. The provision for recovering preferences is integrally bound up in the overall scheme for ensuring equitable distribution among creditors. Preferential transfers are payments for legitimate debts. Preferences are avoidable precisely because they enable some creditors to receive more than their fair distribution under the Bankruptcy Code. The entire purpose of the cause of action, then, is to enforce the Bankruptcy Code's equality of distribution. In this respect, preferential transfer actions are fundamentally different from fraudulent transfer actions, although the two causes of action superficially resemble.").

For cases rejecting the authority of bankruptcy judges to enter final judgments on preference avoidance claims, *see, e.g., Penson Fin. Servs. Inc. v. O'Connell (In re Arbco Capital Mgmt., LLP),* 479 B.R. 254, 264–66 (S.D.N.Y.2012) (Oetken, J.) ("Most recently the Supreme Court concluded that the public rights exception is limited to 'cases in which the claim at issue derives from a federal regulatory scheme, or in which resolution of the claim by an expert government agency is deemed essential to a limited regulatory objective within the agency's authority.' ... The Court ... concludes that claims for avoidance of preferential transfers, where the creditor has filed no proof of claim, are not subject to the public right [s] exception.... While the Supreme Court has not expressly held that actions to avoid preferential transfers are matters of private right, the Supreme Court has examined the authority of the bankruptcy court to adjudicate preferential transfer claims in the Seventh Amendment context and determined that preference defendants are entitled to a trial by jury.... *Stern's dicta* similarly support the conclusion that where a creditor has not submitted a proof of claim, preference actions may be finally adjudicated only by an Article III court.... Accordingly, this Court concludes that preferential transfer claims, where, as here, the preference defendant has filed no proof of claim against the bankruptcy estate, are matters of private right.") (citations omitted); *Tabor v. Kelly (In re Davis),* 2011 WL 5429095, at *12 (Bankr.W.D.Tenn. Oct. 5, 2011) (Latta, J.) ("Using this test, when a creditor who has not filed a proof of claim is sued by the bankruptcy trustee to recover a preferential transfer, it is a matter of private right, which, as we have seen, requires the exercise of the judicial power of the United States, a power that cannot be exercised by a non-Article III judge.").

*603 A. Overview of Relevant Statutory Provisions and Supreme Court Precedent

Article III, Section 1 of the United States Constitution provides as follows:

> The judicial power of the United States shall be vested in one Supreme Court, and in such inferior courts as the Congress may from time to time ordain and establish. The judges, both of the supreme and inferior courts, shall hold their offices during good behaviour, and shall, at stated times, receive for their services, a compensation, which shall not be diminished during their continuance in office.

U.S. Const. art. III, § 1.

Pursuant to Article III, Congress may not "withdraw from [Article III] judicial cognizance any matter which, from its nature, is the subject of a suit at the common law, or in equity, or admiralty." *Murray's Lessee v. Hoboken Land & Improvement Co.,* 59 U.S. 272, 18 How. 272, 15 L.Ed. 372 (1856). In *Northern Pipeline Construction Co. v. Marathon Pipe Line Co.,* 458 U.S. 50, 102 S.Ct. 2858, 73 L.Ed.2d 598 (1982), the Supreme Court struck down as unconstitutional the 1978 Bankruptcy Act's provisions vesting final adjudicative authority in the bankruptcy court—an Article I court—over certain state—law claims asserted by the debtor against a third party. The Supreme Court held that Article III required final adjudicative authority over matters within the competence of the Article III judiciary to be vested in an Article III court, and not removed to tribunals where judges lack the Article III protections of life tenure and non-diminution of salary. *Id.* at 80–81, 102 S.Ct. 2858. The Court recognized "a category of cases involving *'public* rights' that Congress could constitutionally assign to 'legislative' courts [*i.e.,* Article I bankruptcy courts] for resolution,"[5] but also held that Article III prohibits bankruptcy courts from entering final judgments on matters of purely *private* rights. *Id.* at 81, 102 S.Ct. 2858 (emphasis added).

5 *Stern v. Marshall,* — U.S. ——, 131 S.Ct. 2594, 2610, 180 L.Ed.2d 475 (2011). Public rights are, essentially, (1) rights created by federal law, to which the political branches are free to attach conditions; (2) claims tied up inextricably with such rights; or (3) "matters that historically could have been determined exclusively by the Executive and Legislative Branches." *See id.,* 131 S.Ct. at 2611–613 (internal quotation marks and citation omitted). In *Granfinanciera, S.A. v. Nordberg,* 492 U.S. 33, 109 S.Ct. 2782, 106 L.Ed.2d 26 (1989), in the context of determining whether a defendant was entitled to a Seventh Amendment right to a jury, the Court held that the public-rights doctrine does not allow a bankruptcy court to decide a fraudulent-conveyance claim against a non-creditor. It reasoned that fraudulent conveyance claims are more akin to suits at common law that resemble state-law contract claims than "creditors' hierarchically ordered claims to a pro rata share of the bankruptcy res." *Id.* at 56, 109 S.Ct. 2782. However, in *Katchen v. Landy,* 382 U.S. 323, 86 S.Ct. 467, 15 L.Ed.2d 391 (1966), and *Langenkamp v. Culp,* 498 U.S. 42, 111 S.Ct. 330, 112 L.Ed.2d 343 (1990), the Supreme Court held that bankruptcy courts have the authority to decide preference actions against creditors who filed a proof of claim in the bankruptcy, as the determination of this issue is "part and parcel" of the claims-allowance process.

In response to *Northern Pipeline,* Congress enacted the Bankruptcy Amendments and Federal Judgeship Act of 1984 (the "1984 Act"), which allows district ***604** courts to refer all cases and proceedings arising under, arising in or related to a case under title 11 to bankruptcy judges.[6] 28 U.S.C. § 157(a). Importantly, the 1984 Act also divided bankruptcy matters into "core" and "non-core." *See* 28 U.S.C. § 157(b)(1), (c)(1). Section 157 provides a non-exhaustive list of examples of core matters, including avoidance actions and counterclaims by the estate against persons filing claims against the estate. *Id.* § 157(b)(2)(C), (F) and (H).

6 In this District, all chapter 11 cases and related proceedings are automatically referred to bankruptcy judges via a standing order of reference. *See* Amended Standing Order of Reference M–431, dated January 31, 2012 (Preska, C.J.).

The statute provides that bankruptcy courts may hear core matters and non-core matters that are "otherwise related" to a case under title 11, but they only have statutory authority to enter final judgments in core proceedings. For non-core matters, absent consent of the parties, bankruptcy courts may only submit proposed findings of fact and conclusions of law to the district court; the district court then has the authority to enter a final judgment after reviewing *de novo* any matters to which a party objects. 28 U.S.C. § 157(c)(1). However, as discussed below, parties may *consent* to a bankruptcy court's final adjudication of non-core matters pursuant to section 157(c)(2). 28 U.S.C. § 157(c)(2).[7]

7 Under section 157(d), a "district court may withdraw ... any case or proceeding referred [to the bankruptcy court] on its own motion or on a timely motion of any party, for cause shown," 28 U.S.C. § 157(d), referred to

as "withdrawing the reference." In the Second Circuit, courts evaluate whether "cause" is shown by looking to, among other things, the following factors: "whether the claim or proceeding is core or non-core ... considerations of efficiency, prevention of forum shopping, and uniformity in the administration of bankruptcy law." *In re Orion Pictures Corp.,* 4 F.3d 1095, 1101 (2d Cir.1993). Post-*Stern,* district courts in this district have also considered whether the bankruptcy court has the constitutional authority to enter a final judgment. *See, e.g., Lehman Bros. Holdings Inc. v. JPMorgan Chase Bank, N.A. (In re Lehman Bros. Holdings Inc.),* 480 B.R. 179, 188 (S.D.N.Y.2012) (Sullivan, J.) ("To determine whether a party has shown 'cause' for permissive withdrawal ... the Second Circuit, prior to *Stern,* directed that the district court weigh several factors [(the 'Orion factors')], including: (1) whether the claim [or proceeding] is core or non-core, (2) what is the most efficient use of judicial resources, (3) what is the delay and what are the costs to the parties, (4) what will promote uniformity of bankruptcy administration, (5) what will prevent forum shopping, and (6) other related factors.... Chief among these factors pre-*Stern* was the first factor—whether the claim or proceeding is core or non-core. However, post-*Stern,* this factor no longer occupies the same position of prominence among the *Orion* factors.... Thus, in evaluating a motion to withdraw post-*Stern,* the principal question is no longer whether the claim in question is 'core' or 'non-core' pursuant to the Bankruptcy Code but whether the bankruptcy court has *constitutional authority* to enter final judgment on the claims at issue.") (internal quotation marks and citations omitted) (emphasis added).

[1] [2] Questions concerning whether parties may consent to entry of a final order or judgment by an Article I bankruptcy judge arise primarily from several decisions of the Supreme Court, beginning with *Murray's Lessee,* 59 U.S. 272, 18 How. 272, 15 L.Ed. 372 (1856), and carrying forward to modern times with *Commodity Futures Trading Comm'n v. Schor,* 478 U.S. 833, 106 S.Ct. 3245, 92 L.Ed.2d 675 (1986) and, most recently, *Stern.* In *Schor,* the Supreme Court found two components inherent in the constitutional right to an Article III judge: (1) the individual constitutional right of litigants to insist on an Article III decision-maker; and (2) the structural constitutional right, stemming from the separation of ***605** powers doctrine which requires an Article III decision-maker. *See Schor,* 478 U.S. at 848–49, 106 S.Ct. 3245. The Supreme Court has recognized that the individual constitutional right to an Article III decision-maker may be lost through waiver or express or implied consent. *Id.* at 848, 106 S.Ct. 3245 ("[A]s a personal right, Article III's guarantee of an impartial and independent federal adjudication is subject to waiver."). The structural right, however, which is derived from the core separation of powers principle, assures that the executive and legislative branches will not encroach on the powers of the Article III judiciary. As a result, the structural Article III protection cannot be lost through waiver or express or implied consent by the parties. In other words, "[w]hen these Article III limitations are at issue, notions of consent and waiver cannot be dispositive because the limitations serve institutional interests that the parties cannot be expected to protect." *Id.* at 851, 106 S.Ct. 3245.

[3] [4] The right to an Article III judge does not always invoke both the individual and structural components of the right. The touchstone for the non-waivable structural right is that Congress may not "withdraw from [Article III] judicial cognizance any matter which, from its nature, is the subject of a suit at the common law, or in equity, or admiralty." *Murray's Lessee,* 59 U.S. at 284; *Schor,* 478 U.S. at 854, 106 S.Ct. 3245 ("The risk that Congress may improperly have encroached on the federal judiciary is obviously magnified when Congress 'withdraw[s] from judicial cognizance any matter which, from its nature, is the subject of a suit at the common law, or in equity, or admiralty' and which therefore has traditionally been tried in Article III courts, and allocates the decision of those matters to a non-Article III forum of its own creation. *Murray's Lessee v. Hoboken Land Improvement Co.,* 18 How. 272, 284, 15 L.Ed. 372 (1856). Accordingly, where private, common law rights are at stake, our examination of the congressional attempt to control the manner in which those rights are adjudicated has been searching."); *Stern,* 131 S.Ct. at 2609 ("Article III could neither serve its purpose in the system of checks and balances nor preserve the integrity of judicial decisionmaking if the other branches of the Federal Government could confer the Government's 'judicial Power' on entities outside Article III. That is why we have long recognized that, in general, Congress may not 'withdraw from judicial cognizance any matter which, from its nature, is the subject of a suit at the common law, or in equity, or admiralty.' ") (citation omitted). In *Stern,* the Court set forth limitations on a bankruptcy judge's authority to enter a final judgment in certain matters; Congress did not remove from Article III judicial cognizance any cases in bankruptcy court for which the right to an Article III decision-maker exists. As a result, only the individual right is at issue and it can be lost through waiver or consent.

As discussed below, the Supreme Court and several circuit courts (including the Second Circuit) have found that in matters referred to the bankruptcy courts, the right to an Article III court invokes only the waivable individual right and does not implicate separation-of-powers concerns. In *Stern* itself, the Court acknowledged that the parties may consent to entry of a final order or judgment by a bankruptcy judge in non-core matters. *See Stern,* 131 S.Ct. at 2606, 2609.

B. Under Second Circuit Law, a Defendant May Impliedly Consent to Final Adjudication by a Non–Article III Tribunal Where It Would Otherwise Be Constitutionally Entitled to an Article III Tribunal

[5] Second Circuit precedent provides that a defendant in a case or proceeding ***606** referred to the bankruptcy court may consent, either expressly or impliedly, to a final determination by a non-Article III tribunal, even though the defendant would otherwise have the right to have the dispute adjudicated by an Article III tribunal.[8]

[8] Two recent decisions from other Circuits also bear on these issues and are discussed later in this Opinion. *See Exec. Benefits Ins. Agency v. Arkison (In re Bellingham Ins. Agency, Inc.),* 702 F.3d 553 (9th Cir.2012) (hereinafter, "*Bellingham* "); *Waldman v. Stone,* 698 F.3d 910 (6th Cir.2012) (hereinafter, "*Waldman* "). Neither *Bellingham* nor *Waldman* is controlling here because there is binding Second Circuit precedent.

In *Men's Sportswear, Inc. v. Sasson Jeans, Inc. (In re Men's Sportswear, Inc.),* 834 F.2d 1134 (2d Cir.1987), the district court affirmed a default judgment in the amount of $1.1 million entered by the bankruptcy court after the court struck the defendant's answer as a result of the defendant's misconduct. On appeal to the Second Circuit, the defendant argued that the bankruptcy court lacked the authority to enter the default judgment, arguing that only an Article III judge could do so. The Second Circuit rejected that argument. The defendant also asserted that the claim on which judgment was entered was a "non-core" claim and accordingly should not have been adjudicated by an Article I bankruptcy judge. *Id.* at 1137.

The Second Circuit concluded that it made no difference whether the claim was core or non-core. Rather, the court found it dispositive that the defendant had impliedly consented to the bankruptcy judge entering a final judgment:

> [W]e need not resolve [the issue whether the claim was core or non-core], for even if the instant action was not a "core" proceeding, 28 U.S.C. § 157(c)(2) empowers the bankruptcy court to enter final judgment in a "non-core" but "related" matter, providing both parties consent to the court's jurisdiction. We conclude that Sasson's failure to object to Judge Lifland's assumption of "core jurisdiction" at any point in these extensive proceedings before the bankruptcy court and the further failure to object to any part of the appeal process in the district court constitutes consent to the final adjudication of this controversy before the bankruptcy court.
>
> We are cognizant that a court should not lightly infer from a litigant's conduct consent to have private state-created rights adjudicated by a non-Article III bankruptcy judge. Indeed, to do so would violate the spirit of *Northern Pipeline Constr. Co. v. Marathon Pipe Line Co.,* 458 U.S. 50, 102 S.Ct. 2858, 73 L.Ed.2d 598 (1982), which emphasizes that the power to adjudicate private rights, such as the right to recover contract damages, cannot be lodged in a court lacking "the essential attributes of the judicial power."

Id. at 1137–38. While *Men's Sportswear* was decided long before *Stern,* the Second Circuit identified the existence of a constitutional right to an Article III tribunal, based on the *Northern Pipeline* decision, but nonetheless concluded that implied consent can supply a proper basis for the bankruptcy court to enter a final order or judgment.

Recent post-*Stern* decisions of district courts within this Circuit have recognized the continued vitality of the holding in *Men's Sportswear* that implied consent is a proper basis for upholding the exercise of authority of a bankruptcy judge to enter a final order or judgment. In *Coudert Brothers LLP v. Baker & McKenzie LLP (In re Coudert Brothers LLP),* 2011 WL 5593147 (S.D.N.Y. Sept. 23, 2011) (McMahon, J.), the court addressed at length the ***607** role of express and implied consent to adjudication by an Article I bankruptcy judge after *Stern.* While concluding that the defendant had not consented to adjudication by the bankruptcy court based on the facts in that case, the district court recognized that implied consent is a sufficient basis for concluding that the bankruptcy court may enter a final order of judgment:

> Prior to *Stern,* courts in this Circuit routinely found that parties could and did consent implicitly to the exercise of final jurisdiction by the Bankruptcy Court even with respect to non-core matters. *See, e.g., In re Men's Sportswear, Inc.,* 834 F.2d 1134, 1137–138 (2d Cir.1987); *In re Millenium Seacarriers. Inc.,* 419 F.3d 83, 98 (2d Cir.2005); *In re Tyson,* 433 B.R. 68, 77 (S.D.N.Y.2010); *cf. Roell v. Withrow,* 538 U.S. 580,

123 S.Ct. 1696, 155 L.Ed.2d 775 (2003). *Stern* confirmed that consent can be a sufficient basis for Article I final adjudication, making clear that its Article III holding did not go to the Bankruptcy Court's subject matter jurisdiction: "Section 157 allocates the authority to enter final judgment between the Bankruptcy Court and the district court. *See* § 157(b)(1), (c)(1). That allocation does not implicate questions of subject matter jurisdiction. *See* § 157(c)(2) (parties may consent to entry of final judgment by Bankruptcy Judge in non-core case)." *Stern,* 131 S.Ct. at 2608.

2011 WL 5593147, at *10.

In *Development Specialists, Inc. v. Akin Gump Strauss Hauer & Feld LLP,* 462 B.R. 457 (S.D.N.Y.2011) (McMahon, J.), the debtor asserted claims against the defendants to recover fees and fraudulent conveyances. *Id.* at 461. After the bankruptcy court denied the defendants' motions to dismiss, the district court granted the defendants' motion to withdraw the reference with respect to their claims. The court found that the claims in the case did not involve public rights and would not necessarily be resolved by the claims allowance process, and, absent consent, the claims could not be finally adjudicated by an Article I court. In considering whether the defendants had consented to the bankruptcy court's adjudication of the claims, the court explained:

> [T]he 1984 Bankruptcy Act vested final adjudicative power over "core" matters in Bankruptcy Court, and allowed it to make recommendations only in "non-core" matters. *See* 28 U.S.C. § 157. However, § 157 also provides that a Bankruptcy Judge may finally adjudicate a non-core matter if the parties consent to such adjudication.... *Such consent could either be express or implied.* However, where a jury right is asserted, any consent to final adjudication in Bankruptcy Court must be express. *See* 28 U.S.C. § 157(e).

Id. 469–70 (citations omitted and emphasis added). The *Development Specialists* court found that the defendants did not consent to the bankruptcy court's adjudication of the claims, because (1) merely pleading in its answer that a bankruptcy court has *jurisdiction* to consider the claims does not constitute consent to the bankruptcy court's *authority* to finally adjudicate such claims; (2) requesting the bankruptcy court dismiss the case and enter "judgment" does not constitute consent, particularly where the motions were submitted before *Stern* was decided and the defendants therefore did not realize that the court could not finally determine the claims without their consent; and (3) appealing the bankruptcy court's ruling does not constitute consent because it is not a "knowing and voluntary" relinquishment of rights to an Article III decision-maker. *Id.* at 471–72. While finding that the circumstances in the case before it did not satisfy the requirements for express or ***608** implied consent, the court in *Development Specialists* recognized that the principle of *Men's Sportswear* remains good law in this Circuit. *Id.* at 470.

Two recent district court decisions in the Southern District of New York, denying motions to withdraw the reference, notwithstanding the bankruptcy court's inability, absent consent, to issue a final judgment on the claims, have also cited *Men's Sportswear* with approval. *See Weisfelner v. Blavatnik (In re Lyondell Chem. Co.),* 467 B.R. 712, 722 (S.D.N.Y.2012) (Cote, J.); *Messer v. Bentley Manhattan Inc. (In re Madison Bentley Assocs., LLC),* 474 B.R. 430, 436 (S.D.N.Y.2012) (Scheindlin, J.). In both cases, the courts found that the moving parties had not consented to the bankruptcy court's adjudication of the matters.

In *Weisfelner,* the court held that the defendants' participation in proceedings before the bankruptcy court without objection for over a year, and the bankruptcy court's order confirming the plan and allowing the court to "hear and determine" claims, did not amount to the defendants' consent to the court's ability to enter final judgment on their core fraudulent transfer claims. 467 B.R. at 722. First, the court explained that *implied* consent appeared to be insufficient under FED.R.CIV.P. 12(b), made applicable by Bankruptcy Rule 7012(b), because Rule 7012(b) requires the "express consent of the parties" for a bankruptcy court to issue a final judgment in non-core matters. *Id.* ("There is no implied consent where, as here, defendants seek withdrawal at the close of discovery before any trial activities or judgment, and where new precedent renders unclear the authority of the bankruptcy to enter final judgment on certain claims."). Significantly, Rule 7012(b) presupposes that a party responded to a complaint; this makes the rule inapplicable to default judgment determinations, where no response has been filed.[9] In addition, the court drew a distinction between subject matter jurisdiction and the court's authority to enter final judgments, finding that, while the plan's language authorizing the court to "hear and determine" claims conferred jurisdiction upon the court, it did not confer authority for the court to enter final judgments.[10] *Id.*

9 The Ninth Circuit's recent decision in *Bellingham* rejected the argument that the requirement for *express* consent contained in Rule 7012 prevents a judicial determination that the facts and circumstances of the case support a finding of implied consent to entry of a final judgment by a bankruptcy judge. *See Bellingham,* 702 F.3d at 569 ("[T]he text of 157(c) only requires consent simpliciter. *See* 28 U.S.C. 157(c)(2) (requiring 'the consent of all the parties to the proceeding'). By contrast, 157(e) permits bankruptcy judges to conduct jury trials 'with the *express* consent of all the parties' (emphasis added). The adjectival distinction suggests that Congress intended to allow parties to consent by their actions to the authority of bankruptcy courts to enter dispositive orders on any bankruptcy-related claim. Accordingly, in cases like this one—in which the defendant was aware of its right to seek withdrawal of the reference but opted instead to litigate before the bankruptcy court—consent is established."). A proposed amendment to Rule 7012 removes the requirement that consent be express; the Committee Note explains that "[t]he amended rule also removes the provision requiring express consent before the entry of final orders and judgments in non-core proceedings." *See http://www.uscourts.gov/RulesAndPolicies/rules/proposed-amendments. aspx,* at 42 of 238.

10 The *Weisfelner* court rejected the notion that there was a statutory "gap" with respect to the type of claims implicated in *Stern*-core claims which a bankruptcy court may not finally adjudicate. Recognizing the Supreme Court's explicit statement that its holding was "narrow," the court explained that "[d]isallowing bankruptcy courts from issuing findings of fact and conclusions of law on core Article III claims would significantly change the division of labor between bankruptcy courts and district courts.... When Congress enacted the 1984 Act, it delegated bankruptcy courts greater authority over core claims than non-core claims. Post *Stern,* this statutory structure should be upheld as much as possible." *Id.* at 724. *See also Bellingham,* 702 F.3d at 565 ("Nowhere does the statute explicitly authorize bankruptcy judges to submit proposed findings of fact and conclusions of law in a core proceeding; § 157(c)(1) is expressly limited to 'non-core' proceedings. Is the power 'to hear and determine' capacious enough to include the power to submit proposed findings in a core proceeding? Or are bankruptcy courts impotent to address fraudulent conveyance proceedings, because they fall in the interstices of § 157? We have noted that Congress enumerated the examples of core proceedings in § 157(b)(2) with a view toward expanding the bankruptcy court's jurisdiction to its constitutional limit. With respect to any bankruptcy-related claim, then, the bankruptcy courts must be vested with as much adjudicatory power as the Constitution will bear. In light of this statutory objective, the power to 'hear and determine' a proceeding surely encompasses the power to hear the proceeding and submit proposed findings of fact and conclusions of law to the district court. Section 157(b)(1) empowers bankruptcy courts to 'hear and determine' fraudulent conveyance claims in a manner consistent with the strictures of Article III—and that includes the more modest power to submit findings of fact and recommendations of law to the district courts.") (internal quotation marks and citations omitted).

In *Messer,* the complaint asserted fraudulent conveyance and alter ego claims. ***609** The district court found that the defendants had not consented to the court's adjudication of their claims by failing to timely file a motion to withdraw the reference. 474 B.R. at 436–37. The court noted that, pursuant to 28 U.S.C. § 157(c)(2), a bankruptcy court may make a final determination of non-core claims with the parties' consent. *Id.* It explained that "[t]his exception endures under *Stern:* '[e]ven when private rights are at issue, non-Article III adjudication may be appropriate when both parties consent.' " 474 B.R. at 436 (quoting *Stern,* 131 S.Ct. at 2628). In reaching its decision, the *Messer* court cautioned other courts that, in cases where private, state-law rights are to be determined by a non-Article III judge, consent should not be lightly inferred; indeed, "a waiver of important rights should only be found where it is fully knowing." *Id.* at 437 (quoting *Dev. Specialists,* 462 B.R. at 472).

[6] While these recent decisions recognize that implied consent should not be easily found, nothing in *Coudert Brothers, Development Specialists, Weisfelner,* or *Messer* suggests that consent cannot or should not be found where a defendant has been properly served with a summons that expressly warns that failure to respond to the complaint will be deemed consent to entry of a default judgment by the bankruptcy court. While cautioning against too easily finding consent, each of these cases nevertheless acknowledges that implied consent is a proper basis for upholding the exercise of authority of a bankruptcy judge to enter a final order or judgment.

As explained below, nothing in *Stern* undercuts the rationale in *Men's Sportswear.* Because *Men's Sportswear* remains the law of this Circuit, this Court is bound to follow its reasoning unless and until the Second

Circuit or the Supreme Court say otherwise. The issue then is whether defendant's failure to respond to the summons and complaint provides express or implied consent to entry of a final default judgment by an Article I bankruptcy judge. In light of the explicit language contained in the summons, this is frankly an easy decision.

C. A Defendant's Failure to Respond to the Summons and Complaint Constitutes Implied Consent, Providing This Court With the Authority to Enter a Final Default Judgment

When a defendant fails to respond to a properly served complaint in an adversary ***610** proceeding, the plaintiff may move for entry of a default judgment on the claim. The procedure for seeking a default judgment is set forth in FED. R. BANKR.P. 7055, which incorporates FED.R.CIV.P. 55. Pursuant to Rule 7055(a), the bankruptcy court Clerk "must enter [a] party's default" when "a party against whom a judgment for affirmative relief is sought has failed to plead or otherwise defend, and the failure is shown by affidavit or otherwise." FED.R.CIV.P. 55(a). If the claim is for a sum certain or a sum that can be made certain by computation, the Clerk *must* enter judgment against the defaulting party in the amount of the claim. FED.R.CIV.P. 55(b). Rather than asking the Clerk to enter the judgment in this case, the plaintiff's motion asks the bankruptcy judge to order the entry of the judgment.

1. The Impact of Stern v. Marshall

The Supreme Court's decision in *Stern v. Marshall,* ––– U.S. ––––, 131 S.Ct. 2594, 180 L.Ed.2d 475, has impacted the bankruptcy court's ability to issue final judgments in core proceedings by holding that a bankruptcy court lacks constitutional authority to make final determinations on certain types of core matters. *Stern* concerned the estate of Vickie Lynn Marshall (a/k/a Anna Nicole Smith). One of Vickie's creditors, Pierce Marshall, filed a proof of claim in the bankruptcy and a defamation claim against Vickie. Vickie counterclaimed, alleging that Pierce had tortiously interfered with her receipt of an inter-vivos gift from her late husband, Pierce's father. Vickie's counterclaim arose under state law. Despite finding that Vickie's counterclaim was "core" under section 157(b)(2)(c), the 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 2610.

The Court reached its conclusion, in part, by relying on the distinction between public and private rights set forth in *Northern Pipeline.* The Court held that the state-law counterclaim at issue was a purely private right and the bankruptcy court, as an Article I court, lacked the constitutional authority to enter a final judgment on the claim, notwithstanding its "core" status. Essentially, Congress in adopting the 1984 Act improperly granted bankruptcy courts the authority to finally determine claims that fell outside the public rights exception and therefore granted bankruptcy judges authority that exceeded the permissible limits of Article III. The Court also based its opinion on other factors, including the fact that the defendant, Pierce, did not consent to adjudication by a non-Article III tribunal.

The Court addressed the issue of consent twice in its opinion. First, the Court considered whether Pierce consented to the bankruptcy court's final determination of his defamation claim against Vickie. It found that Pierce had, in fact, consented by repeatedly advising the court that he was happy to litigate his claim in the bankruptcy court. The Court specifically acknowledged that, pursuant to 28 U.S.C. § 157(c)(2), a party can consent to a bankruptcy court's authority to finally adjudicate a non-core claim. *Id.* at 2606. In reaching its conclusion, the Court reiterated the holding in *Schor* that the individual constitutional right to an Article III decision-maker may be waived, whereas the structural, separation-of-powers constitutional right may not. It emphasized that Pierce could not later complain about the bankruptcy court's decision on the defamation claim because Pierce was unhappy with the result. *Id.* at 2608 ("Given Pierce's course of conduct before the Bankruptcy Court, we conclude that he consented to that court's resolution of his ***611** defamation claim (and forfeited any argument to the contrary). We have recognized the value of waiver and forfeiture rules in complex cases, and this case is no exception. In such cases, as here, the consequences of a litigant ... sandbagging the court—remaining silent about his objection and belatedly raising the error only if the case does not conclude in his favor—can be particularly severe. If Pierce believed that the Bankruptcy Court lacked the authority to decide his claim for defamation, then he should have said so—and said so promptly. Instead, Pierce repeatedly stated to the Bankruptcy Court that he was happy to litigate there. We will not consider his claim to the contrary, now that he is sad.") (internal quotation marks and citations omitted).

Second, the Court found that Pierce did not consent to the bankruptcy court's determination of Vickie's counterclaim against Pierce by filing a proof of claim in the bankruptcy case. *Id.* at 2615 n. 8. Because a creditor in bankruptcy must file a proof of claim to recover against the estate, merely filing a proof of claim cannot be considered consent to a bankruptcy court's decision of matters unrelated to that claim or the bankruptcy. For this reason, the Court noted that the notion of jurisdictional "consent" does not apply in bankruptcy proceedings as it might in other contexts. *Id.* Notably, however, the Court did not rule out the efficacy of express or implied consent to a non-Article III decision-maker.

2. Confusion in the Courts Following Stern

In the wake of the Supreme Court's decision in *Stern,* bankruptcy courts outside of this District have split on the issue whether bankruptcy judges have the authority to enter default judgments based on a defendant's failure to respond to an adversary complaint. Some courts have entered default judgments in preference actions, reasoning that preference avoidance and recovery actions under sections 547 and 550 of the Bankruptcy Code are not affected by the *Stern* decision. *See Hagan v. Classic Prods. Corp.* (*In re Wilderness Crossings, LLC*), 2011 WL 5417098 (Bankr.W.D.Mich. Nov. 8, 2011); *White v. Pugh (In re Butler Innovative Solutions),* 2011 WL 4628746 (Bankr.D.D.C. Oct. 4, 2011); *see also Apex,* 465 B.R. at 463 (preference recovery involves equality of distribution, an essential attribute of bankruptcy proceedings, rather than simply augmentation of the estate).

Other courts have taken what is arguably the safest path by submitting proposed findings of fact and conclusions of law to the district court for entry of a final judgment, thus avoiding the question whether a bankruptcy judge has the authority to enter the final order. *See, e.g., Best Western Int'l Inc. v. Richland Hotel Corp.,* 2012 WL 608016 (D.Ariz. Jan. 18, 2012); *Mich. State Univ. Fed. Credit Union v. Ueberroth (In re Ueberroth),* 2011 Bankr.LEXIS 5136 (Bankr.W.D.Mich. Dec. 19, 2011); *Hagan v. e–Limidebt, Inc. (In re Gifford*), 2011 U.S. Dist. LEXIS 104488 (W.D.Mich. Sept. 15, 2011); *Reed v. Johnson (In re Johnson),* 2011 Bankr.LEXIS 3542 (Bankr.W.D.Mich. Aug. 22, 2011).

Judge Hughes in the Eastern District of Michigan has written at length on the topic of bankruptcy judge authority to enter default judgments, ultimately concluding that bankruptcy judges lack the authority to enter final default judgments for claims that would be covered by the *Stern* decision. *See Moyer v. Koloseik (In re Sutton),* 470 B.R. 462 (Bankr.W.D.Mich.2012); *Meoli v. Huntington Nat'l Bank (In re Teleservices Grp., Inc.),* 456 B.R. 318 (Bankr.W.D.Mich.2011). However, Judge Dales, his colleague in the same district, ***612** has disagreed. *See In re Wilderness Crossings,* 2011 WL 5417098.

[7] The focus in most of these cases has centered on whether the default at issue involves claims as to which the bankruptcy court may enter final orders or judgments if the cases are actually litigated to conclusion. This Court sees the issue differently—namely, does the failure to respond to a properly served adversary complaint constitute implied consent to the entry of a final judgment by a bankruptcy judge? The Court concludes that it does, meaning a bankruptcy judge has the constitutional authority to enter a final default judgment when the defendant fails to respond to the complaint.

Only one decision at the Circuit court level since *Stern* may be read to *preclude* the use of consent to authorize an Article I judge to enter a final order or judgment. *See Waldman v. Stone,* 698 F.3d 910. In *Waldman,* a chapter 11 debtor-in-possession, Ron Stone, brought an adversary proceeding in bankruptcy court against his principal creditor, Randall Waldman. Before *Stern* was decided, the bankruptcy court found that Waldman had obtained nearly all of Stone's business assets through fraudulent means. As relief, the bankruptcy court entered a final judgment discharging Stone's debt to Waldman and awarding Stone more than $3 million in compensatory and punitive damages. *Id.* at 914. The district court affirmed the bankruptcy court and *Stern* was decided while Waldman's appeal to the Sixth Circuit was pending. After requesting additional briefs addressing the issues raised by *Stern,* the Sixth Circuit affirmed the bankruptcy court's discharge of Stone's debt, but it held that the bankruptcy court lacked constitutional authority to enter a final judgment awarding Stone compensatory and punitive damages.

Waldman challenged the bankruptcy court's ability to enter a judgment on several grounds, the most relevant being that the bankruptcy court lacked constitutional authority to enter a final judgment on Stone's claims based on Article III of the Constitution.[11] The Sixth Circuit held that Waldman's failure to raise the argument below (before *Stern* was decided) did not constitute implied consent. *Id.* at 917–18. Citing *Schor,* the court found that Waldman's objection implicated the structural right to an Article III judge, in addition to his personal right, because "Article III envisions—indeed it mandates—that the judicial Power will be vested" in Article III judges, and if "Congress can shift the judicial Power to [non-Article III judges], the Judicial Branch is weaker and less independent than it is supposed to be." *Id.* According to the court, while personal rights may be waived, structural rights cannot, and therefore Waldman did not forfeit his ability to object to the bankruptcy court's final determination of the matter by not raising the issue below. *Id.* at 918–19.

11 Waldman also argued that the judgment was beyond the statutory authority of the bankruptcy court because the claims were non-core claims under section 157, meaning the bankruptcy court lacked power to enter final judgment on them. *Id.* at 916–17. The court held that Waldman forfeited this objection because his own pleadings expressly stated that all of Stone's claims in the case were core. *Id.*

The simplest answer for present purposes is that the *Waldman* decision is inconsistent with the Second Circuit's decision in *Men's Sportswear,* which is the controlling precedent for this court.[12] As ***613** further explained below, *Waldman* is also inconsistent with the recent decision by the Ninth Circuit in *Bellingham,* 702 F.3d 553, which concluded that implied consent is effective to permit a bankruptcy judge to enter a final order or judgment on a fraudulent conveyance claim even though the bankruptcy court could not do so absent consent.

12 *Waldman* never directly discusses the issue of consent (never mentioning "consent") and it does not address the portions of *Stern* that support consent, and specifically section 157(c)(2). Furthermore, in support of the discussion about the structural component of Article III, *Waldman* emphasizes only the importance of the structural component of Article III (*see Waldman,* 698 F.3d at 917–18), but it fails to address the critical issue, derived from *Murray's Lessee, Schor* and *Stern,* that the structural component of Article III prevents *Congress* from removing cases from Article III judicial cognizance, something that has not occurred here.

With respect to the merits of the objection, the *Waldman* court framed the issue whether a bankruptcy court may issue a final judgment as turning on whether Stone's claims were private rights, which are reserved for Article III courts, or public rights, which may be determined by bankruptcy court judges. *Waldman,* 698 F.3d at 918–19. The *Waldman* court held that the bankruptcy court was constitutionally permitted to enter final judgment on Stone's disallowance claims against Waldman because those claims arose under section 502(b) of the Bankruptcy Code and were "part and parcel" of the claims-allowance process in bankruptcy. *Id.* 919–21. Conversely, Stone's affirmative claims arose exclusively under state law and fit into the new category created by *Stern* of "core" claims that could not be finally adjudicated by a bankruptcy court. Accordingly, the *Waldman* court found that the bankruptcy court's entry of a final judgment with respect to those claims violated Article III.[13] *Id.* at 921–22.

13 The court remanded the case to the bankruptcy court to recast its judgment as proposed findings of fact and conclusions of law. Interestingly, the Sixth Circuit noted that, in contrast to the parties' assertions in their pleadings, Stone's affirmative claims were non-core, and therefore the bankruptcy court could issue proposed findings of fact and conclusions of law. *Id.* at 922. The court did not decide whether a statutory "gap" would have prevented the bankruptcy court from issuing the proposed report had the claims been core. As previously noted, the Ninth Circuit in *Bellingham* and district courts in this District have specifically rejected the argument that any statutory "gap" would prevent a bankruptcy court from issuing proposed findings of fact and conclusions of law for core claims that may not be finally adjudicated by an Article I court. *See supra* note 10.

In a recently issued decision, the Ninth Circuit took the opposite view and held that implied consent is sufficient to provide a bankruptcy judge with constitutional authority to enter a final order or judgment. While concluding that a defendant in a fraudulent conveyance action is entitled to an Article III decision-maker, the court held that the defendant in that case could—and did—impliedly consent to final adjudication by a non-Article III tribunal. *See Bellingham,* 702 F.3d at 566–70. The bankruptcy court had granted summary judgment to the plaintiff on a fraudulent conveyance claim. *Id.* at 556. The Ninth Circuit affirmed the bankruptcy court's final judgment in the action. While the court concluded that the defendant was constitutionally entitled to final determination by an Article III judge, the defendant consented to the bankruptcy court's adjudication of the issue by failing to object to the bankruptcy court's authority to finally decide the case. *Id.* The defendant raised the objection for the first time in a motion to dismiss submitted to the Ninth Circuit. *Id.* at 557.

The court explained:

> Following the genesis of the modern bankruptcy system, the Supreme Court ***614** clarified that "Article III, § 1's guarantee of an independent and impartial adjudication by the federal judiciary of matters within the judicial power of the United States ... serves to protect primarily personal, rather than structural, interests." *Stern* further made clear that § 157 "does not implicate questions of subject matter jurisdiction." Accordingly, "as a personal right, Article III's guarantee of an impartial and independent federal adjudication is subject to waiver." And in fact, § 157(c)(2) expressly provides that bankruptcy courts may enter final judgments in non-core proceedings "with the consent of all the parties to the proceeding." 28 U.S.C. § 157(c)(2).
>
> If consent permits a non-Article III judge to decide finally a non-core proceeding, then it surely permits the same judge to decide a core proceeding in which he would, absent consent, be disentitled to enter final judgment. The only question, then, is whether EBIA did in fact consent to the bankruptcy court's jurisdiction.

Id. at 567 (citations omitted). Because the defendant failed to timely object to the bankruptcy court's final judgment, it consented to such final determination by a non-Article III judge. *Id.* at 569–70 (notwithstanding the provision in Rule 7012 that requires express consent, "a litigant's actions may suffice to establish consent").

3. Stern *Does Not Impact Whether a Bankruptcy Court May Issue a Default Judgment*

Bellingham, rather than *Waldman,* accurately reflects the law in the Second Circuit. Since 1938, the Federal Rules of Civil Procedure have provided authority for the Clerk of the court to enter a default judgment in a case in which a defendant has failed to appear and the plaintiff seeks only a sum certain or that can be made certain through calculation. Nothing in *Stern* suggests that the procedure set forth in Rule 55 authorizing the Clerk to enter a default judgment is constitutionally suspect. Moreover, nothing in *Stern* suggests that consent of the parties is not effective in permitting a bankruptcy judge to enter a final order or judgment. Cases decided before and after *Stern* recognize that implied consent by conduct may permit a non-Article III judge to enter final orders or judgments in matters in which the parties would otherwise have the right to an Article III judge.

[8] Reading *Murray's Lessee, Schor* and *Stern* together, the structural right to an Article III judge guarantees that *Congress* may not remove from Article III judicial cognizance cases that were triable in courts of law, equity or admiralty at the time of the adoption of the Constitution. With the gloss that *Stern* placed on a bankruptcy court's authority to enter final orders or judgments (i.e., requiring that proposed findings of fact and conclusions of law be submitted to the district court with respect to certain matters), Congress has not removed from judicial cognizance any class of cases referred to the bankruptcy courts. If a defendant appears, defends, and refuses to consent to an Article I bankruptcy judge's entry of a final judgment or order in "related-to" or core matters covered by the *Stern* decision and its progeny, the bankruptcy judge may not do so. But only the individual waivable constitutional right is implicated.

[9] [10] [11] [12] Where a summons and complaint have been properly served and the defendant has failed to respond, the Court concludes that the defendant's actions, or lack thereof, (1) serve as an admission of the material allegations of the complaint except as to the amount of damages, *see* FED.R.CIV.P. 8(b)(6), and (2) constitute implied consent to the entry of a default judgment by a bankruptcy judge. The ***615** answer is the same whether the claims asserted in the adversary complaint are core, non-core, or core but for which only an Article III judge may enter a final order or judgment consistent with the U.S. Constitution absent consent. Additionally, where the plaintiff seeks only "a sum certain or a sum that can be made certain by computation," the Clerk of the bankruptcy court may enter the final default judgment without any action by a judge.[14]

14 In this case no hearing was required to determine the amount of damages since only a judgment for a sum certain was requested. The plaintiff did not request an award of prejudgment interest; but in many cases motions for entry of default judgments in preference avoidance actions include requests for prejudgment interest. An award of prejudgment interest in preference avoidance actions is discretionary so only a judge acting under Rule 55(b)(2) and not the Clerk acting alone under Rule 55(b)(1) may include prejudgment interest in a judgment. *See* 10A CHARLES ALAN WRIGHT, ARTHUR J. MILLER & MARY K. KANE, FEDERAL PRACTICE AND PROCEDURE § 2683 n. 1 (3d ed. 1998) ("Had the request for a judgment by default included an amount of prejudgment interest, it would have been necessary for plaintiff to address its

request to the court, as allowance of prejudgment interest in the absence of a statutory provision is in the discretion of the court.") (citation omitted); *McHale v. Boulder Capital LLC (In re The 1031 Tax Group, LLC),* 439 B.R. 84, 87 (Bankr.S.D.N.Y.2010) ("Although there is no specific reference to prejudgment interest in the Bankruptcy Code, courts have typically relied on the word 'value' in section 550(a) as authorizing an award of interest. Courts in the Second Circuit and in this district have recognized that the award of prejudgment interest is discretionary, and absent a sound reason to deny prejudgment interest, such interest should be awarded.") (internal citations and footnote omitted). In a case in which the defendant fails to appear, the Court concludes that a bankruptcy judge may include prejudgment interest in a final default judgment, if appropriate, based on the facts and circumstances of the case. *Boulder Capital,* 439 B.R. at 87.

III. CONCLUSION

The defendant in this case was properly served with the summons and complaint. Having clearly been told the consequences of failing to timely respond to the complaint, and thereafter failing to do so, the defendant evinced clear and knowing, albeit implied, consent to this Court's entry of a default judgment. For the foregoing reasons, the motion of the Trustee for entry of a default judgment in this adversary proceeding is **GRANTED.**

IT IS SO ORDERED.

All Citations

484 B.R. 598, 57 Bankr.Ct.Dec. 92

End of Document

282 B.R. 765
United States Bankruptcy Court,
S.D. New York.

In re TELIGENT, INC., et al., Debtors.

No. 01–12974(SMB).
|
Sept. 13, 2002.

Synopsis

Chapter 11 debtors sought order confirming their proposed Chapter 11 plan. The Bankruptcy Court, Stuart M. Bernstein, Chief Judge, held that: (1) term "agree," as used in provision of the Bankruptcy Code requiring administrative and priority creditors to be paid in full unless they agree to different treatment of their claims, does not require that creditors' consent be express; and (2) administrative claimants that did not respond to solicitation by debtors in administratively insolvent case to agree to accept part payment on their claims would be deemed, by their silence, to have consented to treatment proposed by debtors.

So ordered.

West Headnotes (4)

[1] **Bankruptcy**
Provisions for satisfaction of claims; relation to recovery in liquidation

Term "agree," as used in provision of the Bankruptcy Code requiring administrative and priority creditors to be paid in full unless they agree to different treatment of their claims, does not require that creditors' consent be express, but should be interpreted to include implied consent. Bankr.Code, 11 U.S.C.A. § 1129(a)(9).

6 Cases that cite this headnote

[2] **Bankruptcy**
Provisions for satisfaction of claims; relation to recovery in liquidation

Administrative claimants that did not respond to solicitation by debtors in administratively insolvent Chapter 11 case to agree to accept part payment on their claims would be deemed, by their silence, to have consented to treatment proposed by debtors, where solicitation advised claimants that any failure to respond would be treated as consent, and where those claimants who did not respond, when subsequently contacted by debtors, did not object to treatment proposed, but complained only of not wanting any more to do with case. Bankr.Code, 11 U.S.C.A. § 1129(a)(9).

1 Cases that cite this headnote

[3] **Statutes**
Plain language; plain, ordinary, common, or literal meaning

Courts should properly assume, absent sufficient indication to contrary, that Congress intends the words in its enactments to carry their ordinary, contemporary, common meaning.

1 Cases that cite this headnote

[4] **Contracts**
Acceptance of Offer and Communication Thereof

As general rule, offeror cannot treat silence or inaction as acceptance; however, there are exceptions to this rule, such as where offeree has duty to speak, or where offeror has stated his intention or given offeree reason to understand that he will do so, and where offeree in remaining silent and inactive intends to accept. Restatement (Second) of Contracts § 69(1).

Cases that cite this headnote

Attorneys and Law Firms

***766** Kirkland & Ellis, Matthew N. Kleiman, Esq., Anup Sathy, Esq., Scott R. Zemick, Esq. of Counsel, Chicago, IL, for Debtors.

Simpson Thacher & Bartlett, Steve Fuhrman, Esq., Robert Trust, Esq., of Counsel, New York City, for JPMorgan Chase Bank, as Agent.

MEMORANDUM DECISION REGARDING IMPLIED CONSENT TO DIFFERENT TREATMENT UNDER 11 U.S.C. § 1129(a)(9)

STUART M. BERNSTEIN, Chief Judge.

The debtors in these chapter 11 cases sought an order confirming their joint chapter 11 plan (the "Plan"). The Court conducted the confirmation hearing on September 5, 2002, received documentary evidence in addition to testimonial evidence through proffers, and based upon the evidence, confirmed the Plan.

Ordinarily, this would end the matter. The confirmation, however, depended upon the determination that certain holders of general administrative and priority claims had agreed, through acquiescence, to different and less favorable treatment than the specific treatment set out in § 1129(a)(9). Because this issue is likely to recur, I write separately to explain my reasoning.

BACKGROUND

At all relevant times, Teligent, Inc. was the ultimate parent corporation to twenty domestic subsidiaries, all debtors and debtors in possession before this Court, as well as to many non-debtor foreign subsidiaries. Prior to the May 21, 2001 petition date (the "Petition Date"), the debtors were primarily engaged in the business of ***767** providing telecommunication services to wholesale and retail customers.

The debtors financed their operations prior to bankruptcy through bank loans and public debt. As of the Petition Date, they owed approximately $800 million to their pre-petition bank lenders (the "Lenders"), and at the time of the confirmation hearing, still owed approximately $740 million. The pre-petition debt was secured by all or substantially all of debtors' assets. In addition, the debtors owed approximately $740 million to their public noteholders.

Most pertinent to the issue presented, the debtors also accrued a substantial amount of unpaid administrative debt during the chapter 11 cases. On or about June 13, 2001, the Court signed an order authorizing the debtors to use the Lenders' cash collateral. The order provided that all amounts advanced to the debtors would be treated as loans (the "Postpetition Loans"). The Postpetition Loans were entitled to priority in payment over all other administrative claims, and were secured, *inter alia,* by the estates' chapter 5 avoidance claims. As of the date of the confirmation hearing, the debtors owed $72 million to the Lenders on account of the Postpetition Loans. The debtors owed another approximate $70 million in additional administrative debt incurred during the chapter 11 cases, exclusive of professional fees which were funded by the Lenders through a carve out.

After operating in chapter 11 for a period of time, the debtors decided to liquidate. Their efforts proved to be disappointing. The debtors raised around $65 million through the sale of their "enterprise" companies, and used the proceeds to reduce the secured pre-petition debt. The debtors could not, however, sell their core assets. They eventually terminated their retail operations, and only their wholesale operations remain. Between the Petition Date and the confirmation hearing, their work staff shrunk from nearly 1500 employees to only 59.

As matters stood, the estates were administratively insolvent. The assets were insufficient to satisfy the Lenders' superpriority claims, and nothing was available for distribution to any other creditor, including the administrative and priority creditors. The debtors could not, therefore, satisfy § 1129(a)(9) which required, at a minimum, that the debtors "cash out" the administrative creditors on the effective date except to the extent that a particular administrative creditor agreed to different treatment.[1]

[1] Section 1129(a)(9) requires that

> Except to the extent that the holder of a particular claim has agreed to a different treatment of such claim, the plan provides that—
> (A) with respect to a claim of a kind specified in

section 507(a)(1) or 507(a)(2) of this title, on the effective date of the plan, the holder of such claim will receive on account of such claim cash equal to the allowed amount of such claim;
(B) with respect to a class of claims of a kind specified in section 507(a)(3), 507(a)(4), 507(a)(5), 507(a)(6), or 507(a)(7) of this title, each holder of a claim of such class will receive—
(i) if such class has accepted the plan, deferred cash payments of a value, as of the effective date of the plan, equal to the allowed amount of such claim; or
(ii) if such class has not accepted the plan, cash on the effective date of the plan equal to the allowed amount of such claim; and
(C) with respect to a claim of a kind specified in section 507(a)(8) of this title, the holder of such claim will receive on account of such claim deferred cash payments, over a period not exceeding six years after the date of assessment of such claim, of a value, as of the effective date of the plan, equal to the allowed amount of such claim.

***768 The Plan**

Faced with the inevitable failure of the reorganization, the debtors, the Lenders and the Official Committee of Unsecured Creditors (the "Committee") sought a way to salvage it. Any plan would require a significant amount of negotiation and compromise. The Lenders would have to fund it because they were the only party with money. However, in light of the amount of administrative and priority debt, no realistic amount of funding would be enough to pay all of the administrative and priority debt in full. Thus, every administrative and priority creditor would have to agree to accept substantially less. Given the number of creditors, obtaining their consent would be time consuming and expensive, with no guarantee of success.

The "easy" part involved the matters that the debtors, Lenders and the Committee could control. Under the plan that was negotiated, the debtors would emerge from chapter 11 as Reorganized Teligent. Reorganized Teligent would continue to operate the debtors' remaining wholesale business, and employ 50 people. The Lenders would receive 100% of the equity in Reorganized Teligent in exchange for the Postpetition Loans and secured claims.

The money needed for distributions and other purposes would come from the Lenders. The Plan set up a Claim Fund of $4 million to pay the administrative and priority creditors. The Claim Fund was subject to adjustments, and by the time of the confirmation hearing, only $3.25 million was available for distribution. The Plan established classes for Administrative Convenience Claims and Priority Convenience Claims (collectively, the "Convenience Class") that included administrative and priority claims of $3,000.00 or less, as well as anyone with a larger administrative or priority claim who agreed to reduce his claim and opt into the Convenience Class. Each holder of a Convenience Class claim would receive full payment on the Effective Date. The Plan distributed the balance of the Claim Fund on a *pro rata* basis to the remaining administrative, non-tax priority and tax priority debt. All three groups received the same treatment under the Plan, and they will be referred to collectively as the Administrative Creditors for the balance of this opinion.

Despite the debtors' administrative insolvency, the Plan also provided a potential distribution to the unsecured creditors. The Lenders agreed to assign their collateral—the chapter avoidance claims—to the Unsecured Claims Estate Representative. The Plan also assigned $300,000.00 to the Unsecured Claims Estate Representative to fund the investigation and prosecution of those claims.

The "hard" part involved obtaining the consent of the Administrative Creditors to different and less favorable treatment offered under the Plan. There were 2006 administrative and priority creditors. Approximately 75% held Convenience Class claims, and did not have to be solicited. The remaining 454 Administrative Creditors had to agree to accept the different treatment. Because so little was available for distribution, almost any one of the 454 could prevent confirmation merely by insisting on his right to full payment.

The Consent Form

Pursuant to the Disclosure Statement, the debtors prepared a consent form (the "Consent Form") approved by the Court, and sent one to each Administrative Creditor. The Consent Form explained that the Bankruptcy Code required payment in full of administrative and priority claims for a plan to be approved unless the holder of an administrative or priority claim agreed to a different treatment of his claim. The Consent Forms further explained that there were insufficient funds to pay the ***769** administrative and priority claims in full. Rather, the Administrative

Creditors would receive between 5% and 12% if the Plan was confirmed. Unless the Administrative Creditors agreed to accept the different treatment proposed under the Plan, the debtors would have to withdraw the Plan and dismiss their cases, or convert them to chapter 7. Either way, the Administrative Creditors would probably not receive a distribution.

The Consent Form asked the Administrative Creditor to make an election from among three choices: (1) agree to accept the treatment under the Plan, *i.e.,* the *pro rata* share of the Claim Fund, (2) opt into the Convenience Class and accept the lesser of $3,000.00 or the allowed amount of the claim, or (3) decline to accept the treatment provided under the Plan. All the Administrative Creditor had to do was check the box next to his choice. The debtors urged each Administrative Creditor to accept the different treatment, and return the completed Consent Form. The Consent Form included a conspicuous notice that the debtors planned to ask the Court to rule that any Administrative Creditor who failed to return a Consent Form should be deemed to have agreed to accept the treatment under the Plan.

The debtors also simplified the procedure for communicating the election. The Consent Form indicated that it could be returned to the debtors either by: (a) mailing it in the self-addressed stamped envelope that had been provided; (b) faxing it to a toll free number listed on the Consent Form; or (c) e-mailing the election information to an e-mail address also provided on the Consent Form.

The Solicitation Process

The debtors caused the Consent Forms to be mailed on July 15, 2002 to all known Administrative Creditors. They had already notified the Administrative Creditors of the impending delivery of an important package requiring a time sensitive response, and followed up within a week after the Consent Forms were mailed. The Consent Forms indicated in bold, capital letters immediately above the election boxes that the deadline to return the Consent Forms to the debtors was 5:00 P.M., Prevailing Eastern Time, on August 7, 2002.

The debtors coordinated and maintained a Call Center that was staffed with seventeen customer service representatives and claim managers to answer any questions from administrative and priority creditors relating to the treatment of their claims under the Plan or the Consent Forms. The Consent Form listed a toll-free phone number that connected callers to a customer service center staffed between 7:30 a.m.—7:00 p.m., Monday through Friday. Calls received after 7:00 p.m. were directed to a stand-alone voice mailbox. Messages received in the voice mailbox were returned promptly the following morning. The debtors also initiated a targeted call campaign one week after the Consent Forms were mailed to "get out the vote." They contacted each Administrative Creditor to answer any questions, and urged him to return the Consent Form.

From July 16 through August 7 (the "Call Campaign Period"), the debtors' call center staff tracked all communications with the Administrative Creditors. Any communication with a creditor was treated as a single contact, regardless of whether the contact was the result of an incoming call to the Call Center or an outgoing call initiated by the Call Center staff. During the Call Campaign Period, the Call Center staff had an aggregate of 1214 contacts with creditors to discuss the Consent Forms and the treatment of administrative and priority claims under the Plan.

***770 Results of Consent Form Solicitation**

As stated, the debtors sent out Consent Forms to the 454 Administrative Creditors. Eighty-five returned the form indicating that they agreed to accept the treatment under the Plan. Another 205 Administrative Creditors opted into the Convenience Class, effectively consenting to the alternative treatment offered under the Plan. Forty-nine Administrative Creditors settled their claims with the debtors pursuant to separate stipulations or agreements, and finally, eight Administrative Creditors returned the Consent Form electing not to agree with the treatment provided under the Plan. These objecting creditors subsequently changed their election to accept the treatment under the Plan. The face amount of the claims held by the Administrative Creditors who returned the Consent Form, including those that opted into the Convenience Class, aggregated nearly $48 million.

The remaining 107 Administrative Creditors did not return the Consent Forms. They represented an aggregate claim face value of approximately $4,529,270.00. The debtors made two attempts to contact 106 of these 107 creditors to answer questions and urge them to complete and return the Consent Form.[2] According to the proffer at the hearing, the debtors left voice mail messages with all 107, and eventually spoke to all but ten or eleven. In response to the inquiry regarding why they had not returned the Consent Form, between 60% and 70% stated, in substance, that they saw no reason to do so. They interpreted the Consent Form to say that if they did not return it, they would receive the same treatment as they would if they agreed to accept the treatment under the Plan. The remaining Administrative Creditors complained of "Teligentitis," and wanted nothing further to do with the cases. *None of the 107 Administrative Creditors contacted during the follow-up advised the debtors that they objected to the different treatment proposed under the Plan.*

2 The debtors contacted the Wisconsin Department of Revenue, a priority creditor, only once. The creditor advised the debtors during the first (and only) contact that it would not return the Consent Form.

As of the confirmation hearing, the Convenience Class creditors were entitled to receive $2.25 million of the $3.25 million in the Claim Fund. This left $1 million. The debtors estimated that the claims of the 107 non-responding Administrative Creditors, after reconciliation, would exceed $2.1 million. If the debtors had to pay 100% of the allowed amount of these claims, they would not have been able to confirm the Plan.

DISCUSSION

[1] [2] Section 1129(a)(9) of the Bankruptcy Code is a "default" provision. It requires administrative and priority creditors to be paid in full unless they agree to a different treatment of their claims. The issue presented in this case was whether it is appropriate to infer that agreement from the silent minority—the 107 creditors who did not bother to return the Consent Form or object either to the Consent Form procedures or the debtors' stated intention to ask the Court to treat their silence as consent.

The inquiry necessarily begins with the Bankruptcy Code. Section 1129(a)(9) says only that holders of administrative or priority claims must "agree" to different treatment, but it does not say how. While several courts have concluded that the virtually identical provisions of 11 U.S.C. § 1322(a)(2) governing chapter 13 plans ***771** require an *express* consent,[3] *e.g., In re Northrup,* 141 B.R. 171, 173 (N.D.Iowa 1991); *In re Randolph,* 273 B.R. 914, 918 (Bankr.M.D.Fla.2002); *see In re Escobedo,* 169 B.R. 178, 179 (Bankr.N.D.Ind.1993) (priority claimants must "affirmatively agree" to different treatment), others have concluded that the creditor's agreement may, in appropriate circumstances, be implied from his conduct. *See, e.g., In re Trans World Airlines, Inc.,* Case no. 01–0056, *Transcript of Confirmation Hearing* at 12–13 (Bankr.D. Del. June 14, 2002)(construing § 1129(a)(9)); *In re Faccipone,* No. 92–01225, 1992 WL 722289, at *2 (Bankr.N.D.N.Y. Oct.7, 1992).

3 Section 1322 states that

(a) The plan shall—

....

(2) provide for the full payment, in deferred cash payments, of all claims entitled to priority under section 507 of this title, unless the holder of a particular claim agrees to a different treatment of such claim....

[3] The latter view rests on firmer ground. While § 1129(a)(9) requires agreement, it does not state that the agreement must be express.[4] Courts should, therefore, "properly assume, absent sufficient indication to the contrary, that Congress intends the words in its enactments to carry 'their ordinary, contemporary, common meaning' ". *Pioneer Inv. Servs. Co. v. Brunswick Assocs. Ltd. Partnership, et al.,* 507 U.S. 380, 388, 113 S.Ct. 1489, 123 L.Ed.2d 74 (1993) (quoting *Perrin v. United States,* 444 U.S. 37, 42, 100 S.Ct. 311, 62 L.Ed.2d 199 (1979)).

4 In contrast, a class of claims "accepts" a plan only if the requisite majority of creditors within the class "accepts" it, 11 U.S.C. § 1126(c), and the Bankruptcy Rules clearly require an affirmative act to "accept." *See* Fed. R. Bankr.P. 3018(c).

The ordinary and common meaning of "agree" is "to grant consent; assent; to concede or grant," WEBSTER'S II NEW COLLEGE DICTIONARY 23 (1999); *see also* AMERICAN HERITAGE DICTIONARY OF THE ENGLISH LANGUAGE 36 (1996) ("to grant consent; accede"). "Consent" may be stated expressly, or implied from one's conduct without any direct expression. *See* BLACK'S LAW DICTIONARY 300 (7th ed.1999). Congress's use of the word "agree" in section 1129(a)(9) of the Bankruptcy Code should be interpreted to include implied consent.

[4] This conclusion is also consistent with general principles of contract law. As a rule, an offeror cannot treat silence or inaction as an acceptance. RESTATEMENT (SECOND) OF CONTRACTS § 69(1), at 164 (1981). Thus, he cannot ordinarily force the other party into a contract by saying "if I do not hear from you

by next Tuesday, I shall assume you accept." JOHN D. CALAMARI & JOSEPH M. PERILLO THE LAW OF CONTRACTS § 2–18, at 83 (3d ed.1987). Nevertheless, there are exceptions to this rule, and two apply in this case. First, an offeree will be deemed to accept the offer through silence when he has a duty to speak. *Id.* Second, the offeree's silence may constitute acceptance where the offeror has stated his intention or given the offeree reason to understand that he will do so, "and the offeree in remaining silent and inactive intends to accept the offer." RESTATEMENT (SECOND) OF CONTRACTS § 69(1), at 164.

The first situation is a variation of the more general principle of estoppel through silence. An offeree's silence will be deemed to be an acceptance when he has a duty to speak. *See, e.g., Hughes v. John Hancock Mut. Life Ins. Co.,* 163 Misc. 31, 297 N.Y.S. 116, 120 (N.Y.Mun.Ct.1937). The duty to speak need not be purely legal, but may be based on principles of ***772** ethics and good faith. *Columbia Broad. Sys. v. Stokely–Van Camp, Inc.,* 522 F.2d 369, 378 (2d Cir.1975)(discussing New York law of estoppel); *In re Ellison Assocs.,* 63 B.R. 756, 765 (S.D.N.Y.1983)(discussing estoppel by silence). Bankruptcies, in this regard, give rise to unique moral and ethical concerns because each creditor's action may affect the rights of every party in interest.

In bankruptcy, everyone's fate—the debtors, its employees and its creditors—is often intertwined and dependent on the success of a plan. While certain parties have the right to be paid in full, it is sometimes impossible to do so. The debtor has the right to ask each administrative and priority creditor to accept less, and such a creditor, who may hold the future of the case in his hands, should be under an obligation to speak up. This does not mean that he must accept the debtor's offer to take less, but only that he must respond to it. Otherwise, his silence could defeat the plan even though that was not his intention. Simply put, one's general right to remain silent in the face of an offer should be subject to question and reconsideration where passivity will threaten the fundamental goals of bankruptcy—rehabilitation, saving jobs and equality of distribution. *See NLRB v. Bildisco & Bildisco,* 465 U.S. 513, 528, 104 S.Ct. 1188, 79 L.Ed.2d 482 (1984) ("The fundamental purpose of reorganization is to prevent the debtor from going into liquidation, with an attendant loss of jobs and possible misuse of economic resources."); *In re Ionosphere Clubs, Inc.,* 98 B.R. 174, 176 (Bankr.S.D.N.Y.1989) (acknowledging that "[t]he paramount policy and goal of Chapter 11, to which all other bankruptcy policies are subordinated, is the rehabilitation of the debtor").

The present situation presented a ready example of this principle. These cases were administratively insolvent. The Disclosure Statement and Consent Form advised the Administrative Creditors that the confirmation of the Plan hinged on their agreement to accept the treatment under the Plan, a prediction borne out by the actual events. Further, given the small amount available for distribution, almost any one of the 107 Administrative Creditors solicited by the debtors could prevent confirmation by refusing the different treatment and demanding payment in full.

Thus, the fate of the case and every party with a stake in the outcome depended on their assent, and they knew it. The same documents also advised them that the debtors intended to ask the Court to treat the failure to respond as an agreement to accept the different treatment. Given the circumstances, each Administrative Creditor who did not consent should have, in good conscience, communicated that fact to the debtors.

Equally important, the debtors provided a quick, easy and inexpensive way for each Administrative Creditor to make his election. He had only to check a box on the Consent Form, and mail it in a pre-addressed, stamped envelope, fax it to a toll free number, or e-mail the information to the address provided by the debtors. If the Administrative Creditor failed to respond for any reason, he received two telephonic contacts from the debtors reminding him to return the Consent Form. He did not have to hire an attorney or file a formal objection, and in light of the procedures established by the debtors, there was no danger that he would be lulled into silence.

Finally, if silence were not treated as consent, serious and possibly unintended consequences would follow. The Plan would be rendered unconfirmable. There was no other plan, and the case would have gone into a straight, chapter 7 liquidation. ***773** In that event, the debtors could not reorganize around their existing business, the fifty people they intended to employ would not have jobs, the Lenders would get all of the assets, and no other creditor would receive a distribution. In short, it was reasonable and appropriate under the circumstances to require the Administrative Creditors to speak up, failing which they should be deemed to have accepted the debtors' offer of different treatment under the Plan.

Even in the absence of a duty to speak, the record made at the confirmation hearing supported the finding that the nonresponding creditors intended to accept the different treatment through their silence. The debtors told them that with the Court's permission, they intended to treat a non-response as a consent to different treatment. In that event, the failure to return the Consent Form would put the Administrative Creditor in the same position as if he had expressly agreed to accept the different treatment. Thus, an Administrative Creditor might have reason to believe that he could accept the different treatment simply by ignoring the Consent Form.

The evidence demonstrated that most Administrative Creditors did not return the Consent Forms for precisely this reason. Approximately two-thirds of the non-responding Administrative Creditors advised the debtors, during the telephone follow-up, that they saw no purpose in returning the Consent Form because as they understood the documents, the result was the same whether they affirmatively accepted the proposed treatment or ignored the offer.

The balance said they were sick of Teligent, and wanted nothing further to do with the cases. Nevertheless, none expressed an objection to the proposed treatment, and their apathy did not imply any. The documents they were sent advised them that absent their consent, the Plan could not be confirmed, and they would not receive a distribution. In the absence of any evidence that they disagreed with the proposed treatment, I do not presume that their failure to return the Consent Form indicated an intent to forego a distribution and cause the case to crater.

In conclusion, under the circumstances of this case, the failure to return the Consent Form implied agreement to the proposed treatment under the Plan within the meaning of 11 U.S.C. § 1129(a)(9). The foregoing shall constitute the Court's findings of fact and conclusions of law on this issue. *See* Fed.R.Civ.P. 52(a).

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Fresno Division.

In re REAL WILSON ENTERPRISES, INC.,
Debtor.

No. 11–15697–B–11.
|
Sept. 23, 2013.

Attorneys and Law Firms

Hilton A. Ryder, Esq., of McCormick, Barstow, Sheppard, Wayte & Carruth, LLP, appeared on behalf of the debtor, Real Wilson Enterprises, Inc.

Michael S. Abril, Esq., and Keri L. Bland, Esq., of Kuhs & Parker, appeared on behalf of the secured creditor, Citizens Business Bank.

MEMORANDUM DECISION REGARDING MOTION TO CONFIRM THIRD AMENDED PLAN

W. RICHARD LEE, Bankruptcy Judge.

***1** This disposition is not appropriate for publication. Although it may be cited for whatever persuasive value it may have, *see* Fed. R.App. P. 32.1, it has no precedential value, *see* 9th Cir. B.A.P.R. 8013–1.

Before the court is a motion by the debtor Real Wilson Enterprises, Inc. (the "Debtor" or "Real Wilson") to confirm its third amended chapter 11 plan (the "Plan"). Secured creditor Citizens Business Bank (the "Bank") vigorously opposes confirmation. Although the court is not yet ready to conclude that Real Wilson is unable to reorganize and pay its debts through a chapter 11 plan, that reorganization will not be through this Plan. The Debtor has not sustained its burden of proof on a number of issues necessary to confirm a chapter 11 plan, including the fundamental requirement that a plan must be accepted by at least one impaired class of creditors. Accordingly, the motion to confirm the Debtor's Plan will be denied.

This Memorandum Decision contains the court's findings of fact and conclusions of law required by Federal Rule of Civil Procedure 52(a), made applicable to this contested matter by Federal Rules of Bankruptcy Procedure 7052 and 9014(c).[1] The court has jurisdiction over this matter under 28 U.S.C. § 1334, 11 U.S.C. § 1129, and General Order Nos. 182 and 330 of the U.S. District Court for the Eastern District of California. This is a core proceeding as defined in 28 U.S.C. § 157(b)(2)(L).

1 Unless otherwise indicated, all chapter, section, and rule references are to the Bankruptcy Code, 11 U.S.C. §§ 101–1532, and to the Federal Rules of Bankruptcy Procedure, Rules 1001–9036, as enacted and promulgated *after* October 17, 2005, the effective date of the Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA) of 2005, Pub.L. No. 109–8, 119 Stat. 23.

Background and Findings of Fact.

Only a brief background is necessary to tee up this ruling. Real Wilson is a corporation. It owns and operates a gas station and mini-mart business in Bakersfield, California (the "Mini–Mart"). The Bank holds a claim that is secured by virtually all of the Debtor's real and personal property assets. The Debtor's schedules declare assets of approximately $1.1 million and a secured debt to the Bank of more than $1.19 million.[2] The schedules also disclose a priority debt owed to the California State Board of Equalization ("SBOE") of more than $233,000. Not disclosed on the schedules is the fact that the Debtor also owes property taxes to the Kern County Treasurer–Tax Collector ("KCTC") of more than $84,000.[3]

2 The Bank filed proof of its secured claim in the amount of $1,180,100.94. During most of this bankruptcy case, the Debtor has been making monthly "adequate protection" payments to the Bank in the amount of $9,716.84. It is not clear how much will be owed to the Bank after application of these payments and adjudication of its attorney's fees.

3 KCTC filed a proof of claim showing prepetition property taxes and penalties due for the tax years 2008 and 2009 in the amount of $47,271.98, for tax year

2010 in the amount of $19,489.40, and for tax year 2011 in the amount of $17,972.86. With the accrual of interest at the statutory rate of 18% per annum, KCTC's tax claim has increased substantially since commencement of this case. For purposes of this contested matter, the Debtor and the Bank stipulated that KCTC's claim, as of September 1, 2013, would be $111,356.04. *See* Stipulation Concerning Tax Claims at 2, ECF No. 470.

Real Wilson is owned by Randeep Dhillon ("Dhillon") who holds 100% of the stock in the corporation. Dhillon also owns numerous other entities, some of which, together with Dhillon personally, have also been before this court in unsuccessful chapter 11 proceedings filed in 2011 at or about the same time as this case.

In April 2011, the Bank filed a civil action against Real Wilson and Dhillon seeking the appointment of a receiver and judicial foreclosure of its lien against the Debtor's assets.[4] Indeed, a receiver was appointed by the state court on May 13, 2011. This bankruptcy was then filed on May 17, 2011, to prevent the receiver from retaining possession of the Mini–Mart. On May 31, 2011, this court entered orders compelling the receiver to turn over the Mini–Mart to the Debtor and denying the Bank's request to excuse the receiver from the turnover requirement.

4 The April 2011 litigation was actually the Bank's second judicial foreclosure action against the Debtor. The first was filed in August 2010. It was soon settled, the defaults were cured, and the action was dismissed in October 2010. The Debtor failed to make timely payments to the Bank and again defaulted beginning in November 2010. *See* Declaration of Eric D. Shumate in Support of Citizens Business Bank's Motion for Order Excusing Compliance with Certain Requirements of 11 U.S.C. § 543, ECF No. 32.

***2** For months thereafter, this case suffered one frustrating delay after another. Initially, the Debtor blamed the delay on the fact that Dhillon was in his own personal bankruptcy and was unable to focus his attention on administration of this case. Further delay resulted from the Debtor's inability (or unwillingness) to diligently respond to and complete SBOE's audit of its tax liability. The Debtor filed its first plan and disclosure statement on January 19, 2012, but was unable to move toward confirmation because of the unresolved issues with SBOE. The Plan that is presently before the court was filed on January 17, 2013.[5]

5 The first amended plan and disclosure statement were filed on May 1, 2012. Approval of the disclosure statement was again denied. The second amended disclosure statement was filed, with a second amended plan, on October 26, 2012. Before it could be approved, on January 17, 2013, the Debtor filed its third amended disclosure statement together with this Plan. The third amended disclosure statement was approved on March 8, 2013.

The Plan places the Bank's secured claim into Classes 2A and 3A, bifurcating the claim into two separate claims and classes based on the kind of collateral (i.e., real or personal property) but then consolidates their treatment under Class 2A. Under the Plan, the Bank's secured claim will be treated as fully secured, be amortized over a period of 20 years, bear interest at the rate of 5% per annum, and become all due in seven years. The Plan provides for KCTC's secured property tax claim in Class 2B, which proposes to amortize the entire claim over a period of 60 months after confirmation with interest at the statutory rate of 18% per annum.

Issues Presented.

The Bank objects to confirmation on several grounds, but it does not object to the proposed treatment of its claim.[6] Nevertheless, the Bank argues that the Plan does not satisfy other elements for confirmation prescribed in § 1129. For the reasons set forth below, the court agrees with the Bank that the Plan, in its current form, is unconfirmable. In so ruling though, the court will not attempt to address all of the issues raised by the Bank because resolution of each issue is not necessary to the court's ruling and some of those issues, such as the lack of evidence to support the proposed interest rate payable on the Bank's claim, are better left for resolution if and when the Debtor attempts to confirm another plan. Instead, the court will address only those issues that require some legal analysis and resolution to guide the parties if the Debtor proposes another plan.

6 The Bank does object indirectly to the interest rate payable on its claim. At the confirmation hearing, the Bank argued for the first time that the Debtor had not offered any evidence to show that the 5% interest rate satisfies the cramdown requirement of § 1129(b)(2)(A). The Bank offered the testimony of an expert witness to address what the interest rate should be. The court sustained the Debtor's objection to the testimony because (1) the Bank had not raised the objection

before the hearing, and (2) the Bank had not previously disclosed its intention to present an expert for examination by the Debtor.

As a result of this contest, the Debtor is now on notice as to the issues it will need to address in a subsequent plan. The Debtor has already "burned its bridge" with the Bank and demonstrated an inability (or unwillingness) to honor its agreements with the Bank. *See supra* note 4. Based on this prepetition history between the parties and the record in this case, it is clear that confirmation of any plan will require a "cram down" over the Bank's objection and that any ruling in favor of the Debtor will be vigorously appealed. The court trusts that the next plan will be crafted with the appropriate changes and presented with additional evidence to preemptively address the Bank's certain objection.

Analysis and Conclusions of Law.

Burden of Proof. The Debtor, as the plan proponent, has the burden to prove, by a preponderance of the evidence, that its Plan satisfies the applicable confirmation requirements of § 1129. *See Liberty Nat'l Enters. v. Ambanc La Mesa Ltd. P'ship (In re Ambanc La Mesa Ltd. P'ship),* 115 F.3d 650, 653 (9th Cir.1997). Even in the absence of an objection, the court has an independent duty to make sure that the Debtor has offered sufficient evidence to sustain a finding that each requirement under § 1129 has been satisfied. *See Everett v. Perez (In re Perez),* 30 F.3d 1209, 1213 (9th Cir.1994).

3** ***Acceptance by an Impaired Class: § 1129(a)(10). The Bank's most compelling objection goes to the fact that the Plan was not accepted by at least one impaired, noninsider class. Unless a proposed plan leaves all classes of claims unimpaired, the Bankruptcy Code conditions a debtor's ability to confirm a chapter 11 plan on the requirement that "at least one class of claims that is impaired under the plan has accepted the plan, determined without including any acceptance of the plan by an insider." § 1129(a)(10). A class of creditors accepts a plan if, of the creditors who vote in that class, "at least two-thirds in amount and more than one-half in number of the allowed claims of such class" accept the plan. § 1126(c). Here, the creditors in four impaired classes voted on the Plan by returning ballots; the Debtor argues that one of those classes, Class 5B, has accepted the Plan.[7] However, the Bank contends that the Class 5B votes cannot be counted.

7 According to the Plan, Classes 2A, 2B, 3A, 5A, and 5B are impaired. The Bank, the sole creditor in Classes 2A and 3A, voted to reject the Plan. None of the creditors in Classes 2B and 5A returned a ballot. When no creditors within a class vote to accept a plan, that class is deemed to have rejected the plan. *See Bell Road Inv. Co. v. M. Long Arabians (In re M. Long Arabians),* 103 B.R. 211, 21516 (9th Cir.BAP1989) (rejecting *In re Ruti–Sweetwater, Inc.,* 836 F.2d 1263 (10th Cir.1988)). Thus, four of the five classes have rejected the Plan.

Class 5B is comprised of three creditors: JAL Enterprises, Inc., Kulsharan Kaur, and Jasvant Singh Gill. The Debtor concedes that JAL Enterprises, Inc. is an insider, so its acceptance must be disregarded. *See* § 1129(a)(10). Similarly, based on the testimony given during the confirmation hearing, it appears that Kulsharan Kaur is also an insider whose vote cannot be considered. This leaves only Jasvant Singh Gill, whose affirmative vote would arguably make Class 5B an accepting, impaired class.[8] Nevertheless, as the Bank points out, the court must address a more foundational question of whether the creditors in Class 5B were even entitled to vote in the first place. The relevant statutory provision here states,

8 The court is not finding here that Jasvant Singh Gill is not an insider. It is clear from the evidence that the debt to Jasvant Singh Gill was arranged through some personal relationship with Dhillon. The exact nature of that relationship, however, has not been explored.

> Notwithstanding any other provision of this section, a class is deemed not to have accepted a plan if such plan provides that the claims or interests of such class **do not entitle the holders of such claims or interests to receive or retain any property under the plan** on account of such claims or interests.
>
> § 1126(g) (emphasis added). "The legislative history pertinent to this Code section indicates that it is not even necessary to solicit votes from a class whose members are to receive or retain nothing" since they are deemed to have already rejected the plan. *In re Waterways Barge P'ship,* 104 B.R. 776, 783 (Bankr.N.D.Miss .1989).

Here, the treatment of Class 5B is stated in the Plan as follows: "Class 5B consisting of the unsecured claims of Jal Enterprises, Inc. [sic], Kulsharan Kaur and Jasvant Singh [sic] shall be subordinated to payment of [Class 5A] and shall receive no distribution under the Plan." Based on the clear and unambiguous language of the Plan—that these creditors "shall receive no distribution under the Plan"—it appears that the holders of Class 5B claims are not entitled to "receive or retain any property under the plan." Therefore, even if none of the Class 5B creditors were insiders, the court still cannot count their accepting votes as the entire class is conclusively deemed to have rejected the Plan. *See In re Egan,* 142 B.R. 730, 732 (Bankr.E.D.Pa.1992) (disregarding acceptance vote from a class that would receive nothing under plan); *In re Waterways Barge P'ship,* 104 B.R. at 783 (similar).

***4** In response, the Debtor argues that the Class 5B creditors are not waiving their claims, that instead they will retain their claims and be paid in some manner outside of Real Wilson's bankruptcy through an agreement with Dhillon. However, § 1126(g) looks to the four corners of the Plan, not to the parties' secret agreement with regard to future payment from a third party. By its plain language, Class 5B creditors will not receive or retain any property under the Plan. Thus, none of the impaired classes have accepted the Plan, and the Debtor has not satisfied this confirmation requirement under § 1129(a)(10).

Treatment of the Secured Property Tax Claim: § 1129(a)(9). The Bank also objects to the Plan's treatment of Class 2B, containing the fully secured properly tax claim held by KCTC. KCTC did not object to, or vote to reject, the Plan, which proposes to amortize its claim over a period of 60 months *after confirmation.* The Bank contends that KCTC's entire claim must be paid within 60 months *after commencement of the case,* which, due to the age of the case (now approaching 2.5 years) and the decreasing amount of the time left in that 60–month window, would substantially increase the amount of the monthly payments to KCTC.

The Bank's argument is based on § 1129(a)(9)(D), which governs the treatment of secured tax claims and provides, in pertinent part, the following:

> (9) Except to the extent that the holder of a particular claim **has agreed to a different treatment** of such claim, the plan provides that—
>
> > ...
> >
> > (D) **with respect to a secured claim which would otherwise meet the description of an unsecured claim of a governmental unit under section 507(a)(8), but for the secured status of that claim,** the holder of that claim will receive on account of that claim, cash payments, in the same manner and over the same period, as prescribed in subparagraph (C).

§ 1129(a)(9)(D) (emphasis added). Subparagraph (D) must be read in conjunction with subparagraph (C), which governs the treatment of unsecured, priority tax claims and states,

> (C) with respect to a claim of a kind specified in section 507(a)(8) of this title, the holder of such claim will receive on account of such claim regular installment payments in cash—
>
> > (i) of a total value, as of the effective date of the plan, equal to the allowed amount of such claim;
> >
> > (ii) **over a period ending not later than 5 years after the date of the order for relief under section 301....**

§ 1129(a)(9)(C) (emphasis added). Subparagraphs (C) and (D) both incorporate by reference § 507(a)(8). This provision gives priority status to certain unsecured tax claims, including one for "a property tax incurred before the commencement of the case and last payable without penalty after one year before [the commencement of the case]." § 507(a)(8)(B). Although it does not appear to be the case, the Debtor and the Bank have assumed that KCTC's entire claim is for such property taxes.[9]

9 Although the Bank's § 1129(a)(9)(D) argument is well taken, neither the Bank, nor the Debtor, has properly analyzed the applicable statutes. KCTC's proof of claim indicates that its claim includes the property taxes owed in the years 2008 through 2011. The portion of the KCTC's claim representing the 2008 and 2009 taxes, indeed more than one half of its claim, does not appear to be for taxes "last payable without penalty after one year before [the commencement date]," meaning that the § 1129(a)(9)(C) and (D) analysis should not even apply to that portion. Thus, this discussion is intended to only address that portion of KCTC's claim that "would otherwise meet the description of an unsecured claim of a governmental unit under section 507(a)(8)," rather than KCTC's entire claim. The court sees no reason why the remainder of KCTC's claim could not be bifurcated and treated as an ordinary secured claim.

***5** It is clear that the proposed treatment of KCTC's claim does not comply with § 1129(a)(9)(D), which requires that KCTC receive "cash payments, in the same manner and over the same period, as prescribed in subparagraph (C) [of § 1129(a)(9)]." Turning to subparagraph (C), that means, *inter alia,* that KCTC's claim must be paid in regular installments "over a period ending not later than 5 years after the date of the order for relief." § 1129(a)(9)(C)(ii). Since the Debtor filed a voluntary petition, the date of the order for relief in this case was

May 17, 2011. *See* § 301(b). That then means that any tax claims governed by subparagraphs (C) and (D) must be paid by May 17, 2016, five years after the order for relief. Yet, under the Plan, the payments on account of KCTC's claim would have continued well beyond this statutory deadline, until some point in 2018. Thus, the treatment of Class 2B does not satisfy § 1129(a)(9)(D).

In response, the Debtor raises a novel issue of law, arguing that § 1129(a)(9)(D) is not even applicable to KCTC's particular secured tax claim. Subparagraph (D) of § 1129(a)(9) is a relatively recent addition to the Bankruptcy Code, introduced in 2005 as part of BAPCPA. *See* Pub.L. No. 109–8, § 710(3), 119 Stat. at 127. As a result, there is limited case law interpreting this provision.[10] However, the application of § 1129(a)(9)(D) is explained simply in the *Collier* treatise:

10 The most discussed issue surrounding secured tax claims and § 1129(a)(9)(D) concerns the interplay between the claims' impairment, classification, and their holders' ability to vote. *Compare In re Mangia Pizza Invs., LP,* 480 B.R. 669, 677–79 (Bankr.W.D.Tex.2012) (reasoning that secured tax creditor who accepted treatment worse than what § 1129(a)(9)(D) required should not be given ability to vote), *with In re Greenwood Point, LP,* 445 B.R. 885, 90607 (Bankr.S.D.Ind.2011) (concluding that secured tax creditor who received treatment in accordance with § 1129(a)(9)(D) is nevertheless an impaired claim entitled to vote). None of the case law appears to be helpful to the issue faced here.

> Section 1129(a)(9)(D), added by the 2005 Act, requires plan proponents to treat secured tax claims in the same manner as unsecured tax claims, if, but for the security, the tax claim would qualify for treatment as a priority unsecured tax claim within the meaning of section 1129(a)(9)(C). 7 Collier on Bankruptcy ¶ 1129.02[9][d], at 1129–50 (Alan N. Resnick & Henry J. Sommer eds., 16th rev. ed.2013).

The question raised by the Debtor's response is what kind of claims fall within the scope of § 1129(a)(9)(D)? Subparagraph (D)'s language indicates that it only applies to a "secured claim which would otherwise meet the description of an unsecured claim of a governmental unit under section 507(a)(8), but for the secured status of that claim." The Debtor argues essentially that the reference to § 507(a)(8) establishes a predicate—that the tax claim had to first be an unsecured claim covered by § 507(a)(8)—in order for the mandatory treatment under subparagraphs (C) and (D) to apply. Since priority tax claims under § 507(a)(8) are expressly limited to "allowed *unsecured* claims of governmental units," and given that KCTC's tax claim could never be unsecured by operation of California law,[11] the Debtor contends that KCTC's tax claim could never qualify as a priority tax claim under § 507(a)(8) and that § 1129(a)(9)(D) would not apply as a result. It argues that § 1129(a)(9)(D) applies only to those tax claims that were unsecured at the commencement of the bankruptcy case and somehow became secured during the case. However, this interpretation of the statute is without any support and conflicts with the plain language of the statute itself.

11 This proposition posited by the Debtor may not be entirely accurate. According to the Debtor's Disclosure Statement, KCTC's claim is made up of both real property taxes and personal property taxes, but these taxes are secured only by the Debtor's real property. The real property taxes are indeed automatically secured by a lien against real property. *See* Cal. Rev. & Tax.Code § 2187 ("Every tax, penalty, or interest ... on real property is a lien against the property assessed."). However, that is not necessarily the case for personal property taxes. First, the "[California] Revenue and Taxation Code does not ... provide that a tax on personal property constitutes an automatic lien on the property assessed." *Purcell v. Khan (In re Purcell),* 362 B.R. 465, 470 (Bankr.E.D.Cal.2007) (citing *T.M. Cobb Co. v. Cnty. of Los Angeles,* 16 Cal.3d 606, 618 (1976)). Second, personal property taxes may be, but are not automatically, secured by real properly. *See* Cal. Rev. & Tax Code §§ 2189, 2189.3; *Bd. of Supervisors of San Die go Cnty. v. Lonergan,* 27 Cal.3d 855, 859 & n. 3 (1980).

***6** The first clause of subparagraph (D) suggests that a secured tax claim only needs to "meet the description of"—or *resemble*—an unsecured, priority tax claim *but for the claim's secured status.* It does not actually have to be an unsecured tax claim. If Congress had wanted to impose the condition advanced by the Debtor, subparagraph (D) would have to read, "with respect to a secured claim which would otherwise *be* an unsecured claim of a governmental unit under section 507(a)(8)." Instead, Congress used the more-convoluted phrase "meet the description of." By using "meet the description of," rather than "be," Congress intended that a secured tax claim only resemble a claim described in § 507(a)(8), without actually qualifying as one, before being afforded the preferred treatment under § 1129(a)(9)(C) and (D).

The second clause "but for the secured status of that claim" further negates the Debtor's interpretation of subparagraph (D). This "but for" language mandates that the claim's secured status must be disregarded when deciding if the claim would otherwise fall under §

507(a)(8). In practice, this means that to determine whether § 1129(a)(9)(D) applies to a particular claim, all one must do is omit the term "unsecured" from § 507(a)(8) and then look to see if the claim otherwise satisfies the characteristics described in § 507(a)(8). Based on this analytical approach, it is clear that Congress intended to treat certain secured tax claims the same as similar unsecured tax claims in a chapter 11 plan, i.e., those secured tax claims which, *but for their secured status,* meet the description of priority tax claims in § 507(a)(8).

Lastly, the Debtor's interpretation of § 1129(a)(9)(D) necessarily singles out a particular subset of tax claims for inferior treatment, when Congress has not offered a record of such an intention. Its interpretation is inconsistent with the notion that Congress amended § 1129(a)(9) to improve the treatment of tax claims in general (at least those kinds of taxes given priority) in chapter 11 cases, regardless of their secured or unsecured status. In fact, the title for this statutory amendment was "Periodic Payment of **Taxes** in Chapter 11 Cases," without any mention of the kinds of taxes affected by the amendment. *See* H.R.Rep. No. 109–31, pt. 1, at 102 (2005) (emphasis added), *reprinted in* 2005 U.S.C.C.A.N. 88, 166. There is simply no support in the statute's language or the legislative history[12] that Congress did not want to equate the preferential treatment to secured tax claims with that of the otherwise unsecured tax claims.

12 Nothing else in the legislative history is otherwise helpful in this particular instance. *See* H.R.Rep. No. 109–31, pt. 1, at 102, *reprinted in* 2005 U.S.C.C.A.N. 88, 166 ("In addition, [section 710 of BAPCPA] requires the same payment treatment to be accorded to a secured claim that would otherwise meet the description of an unsecured claim under section 507(a)(8).").

The court agrees with the Bank that § 1129(a)(9)(D) applies to at least a portion of KCTC's claim and that the Plan's treatment of that claim does not meet the statutory requirements. However, the Debtor has responded to the Bank's objection on two other grounds, which the court will consider briefly in anticipation that they may arise in a future confirmation hearing.

***7** *Standing to Object.* The Debtor argues that the Bank does not have standing to object to the Plan's treatment of KCTC's claim. Section 1128(b) of the Code generally provides that "[a] party in interest may object to confirmation of a plan," and the Bank, as a secured creditor, constitutes a party in interest in this case. *See* § 1109(b) (setting forth a non-exhaustive list of who may constitute a "party in interest" entitled to appear and be heard in chapter 11 cases). Nevertheless, that statutory provision is tempered by the well-established rule that a party in interest only has standing to object to provisions of a plan that directly affect its interest. *See Platinum Capital, Inc. v. Sylmar Plaza, L.P. (In re Sylmar Plaza, L.P.),* 314 F.3d 1070, 1075 (9th Cir.2002) (unimpaired creditor had no standing to raise unfair-discrimination objection); *Mut. Life Ins. Co. of N.Y. v. Patrician St. Joseph Partners Ltd. P'ship (In re Patrician St. Joseph Partners Ltd. P'ship),* 169 B.R. 669, 680, 682 (D.Ariz.1994) (oversecured creditor had no standing to raise best-interest-of-creditors and absolute-priority-rule objections); *In re Quigley Co.,* 391 B.R. 695, 703 (Bankr.S.D.N.Y.2008) (collecting cases). Courts have concluded, for example, that creditors, who do not hold claims affected by § 1129(a)(9) (i.e., administrative expense claims, priority tax claims), have no standing to argue that a plan does not treat those claims in accordance with § 1129(a)(9). *See, e.g., In re Seasons Partners, LLC,* 439 B.R. 505, 514 (Bankr.D.Ariz.2010) (secured creditor had no standing to object to treatment of priority tax claims); *In re Applied Safety, Inc.,* 200 B.R. 576, 587 (Bankr.E.D.Pa.1996) (general creditor had no standing to object to treatment of administrative expense claims); *In re Adamson Co.,* 42 B.R. 169, 172 (Bankr.E.D.Va.1984) (secured creditor had no standing to object to treatment of priority claims).

Arguably, the Bank may be affected by how the Plan will treat KCTC's secured tax claim, which could establish its standing. Both creditors hold claims secured by some of the same collateral (i.e., the real property), and KCTC's tax lien has priority over the Bank's consensual lien. *See* Cal. Rev. & Tax.Code § 2192.1. However, any difference between how the Plan proposes to pay KCTC's claim and how the Bank believes the claim should be paid (i.e., in accordance with § 1129(a)(9)(D)) would have only a tangential and nominal effect on the Bank's interests. Because the Plan's treatment of KCTC's claim does not "directly implicate [the Bank's] own rights and interests," the Bank does not have standing to object to that provision. *In re Quigley,* 391 B.R. at 705.

Nevertheless, as previously mentioned, the court acknowledges that it still has an independent duty to ensure that a plan satisfies all of the requirements for confirmation under § 1129. *See In re Ambanc La Mesa Ltd. P'ship,* 115 F.3d at 653; *see also U.S. Aid Funds, Inc. v. Espinosa,* 559 U.S. 260, 277 & nn. 1415 (2010) (chapter 13 context) (stating that the Code "*requires* bankruptcy courts to address and correct a defect in a debtor's proposed plan even if no creditor raises the issue" (emphasis in original)). Even if the Bank lacks standing to object on § 1129(a)(9) grounds, the court must determine on its own whether the Plan satisfies the requirements of § 1129(a)(9)(D). *See Official Comm. of Unsecured Creditors v. W. Farm Credit Bank (In re Michelson),* 141 B.R. 715, 720–21 (Bankr.E.D.Cal.1992) ("The court's role in the confirmation process is more active than its role in garden-variety litigation."). Therefore, the court finds that, absent KCTC's "agreement" to the Plan, the Plan does not comply with § 1129(a)(9)(D) and cannot be confirmed in its present form.

***8** *KCTC's "Agreement" to the Plan.* Finally, the court must consider whether KCTC has "agreed" to the treatment of its claim by not objecting to confirmation. The application of subparagraph (D) of § 1129(a)(9), discussed above, is qualified with the clause, "Except to the extent that the holder of a particular claim has agreed to a different treatment of such claim." § 1129(a)(9). When an affected creditor has "agreed" to the proposed treatment under a plan, that treatment can deviate from what is otherwise required by the statute.

Here, KCTC did not submit a ballot to accept the Plan. It was therefore deemed to have rejected the Plan. *See In re M. Long Arabians,* 103 B.R. at 21516 (finding that bankruptcy court erred in "assum[ing] that a failure to vote constituted an acceptance of the plan"). However, whether KCTC has "*accepted* " the Plan and whether it has "*agreed* " to certain treatment under the Plan are two distinct issues, which must be separately analyzed. *See Sosa v. Alvarez–Machain,* 542 U.S. 692, 711 n. 9 (2004) (reciting the "usual rule that when the legislature uses certain language in one part of the statute and different language in another, the court assumes different meanings were intended" (internal quotation marks omitted)).

At issue here is the meaning of the term "agreed": Whether this requires that a creditor expressly or affirmatively consent to its treatment, or whether consent may be implied from its conduct, or lack thereof (i.e., from its silence). On this issue, courts are divided.[13] *Compare In re Jankins,* 184 B.R. 488, 492 n. 8 (Bankr.E.D.Va.1995) ("This Court, however, construes the term 'has agreed' in Section 1129(a)(9) as requiring the affected creditor's affirmative concurrence and not mere failure to object."), *and In re Digital Impact, Inc.,* 223 B.R. 1, 7 & n. 1 (Bankr.N.D.Okla.1998) (similar), *with In re Teligent, Inc.,* 282 B.R. 765, 770–72 (Bankr.S.D.N.Y.2002) ("Congress's use of the word 'agree' in section 1129(a)(9) of the Bankruptcy Code should be interpreted to include implied consent.").

13 Similar language appears in one of the confirmation requirements for a chapter 13 plan as well. *See* § 1322(a)(2) (requiring full payment of priority claims "unless the holder of a particular claim agrees to a different treatment of such claim"). Although courts are also split on this issue in the chapter 13 context, the majority of the published decisions appear to adopt the interpretation that requires affirmative consent from the affected creditor. *Compare In re Hutc hens,* 480 B.R. 374, 382 (Bankr.M.D .Fla.2012) ("Merely failing to object to a proposed Chapter 13 plan, which does not provide for full payment of a priority claim, does not constitute express affirmation."), *Fort v. Fla. Dep't of Revenue (In re Fort),* 412 B.R. 840, 859 (Bankr.W.D.Va.2009) (similar), *In re Glazier,* Case No. 06–20116–D–13L, 2008 WL 2148555, at *4 (Bankr.E.D.Cal. May 20, 2008) (similar), *In re Randolph,* 273 B.R. 914, 918–19 (Bankr.M.D.Fla.2002) (similar), *and In re Northrup,* 141 B.R. 171, 173 (Bankr.N.D.Iowa 1991) (similar), *with In re Hebert,* 61 B.R. 44, 4647 (Bankr.W.D.La.1986) (concluding that tax creditor's "failure to object to its treatment under the plan in this case constitutes 'agreement' to such treatment under Section 1322(a)(2)").
In one opinion, the Bankruptcy Appellate Panel for the Ninth Circuit mentioned briefly in a footnote that a debtor's attorney, who held an administrative expense claim entitled to priority, affirmatively consented to different treatment under § 1322(a)(2) by drafting and filing the debtor's chapter 13 plan. *See Wolff v. Johnson (In re Johnson),* 344 B.R. 104, 107 n. 6 (9th Cir.BAP2006). That case does not offer much guidance here since the attorney's conduct would evidence consent under either interpretation of the term "agreement."

In this court's view, those courts requiring affirmative consent have the better interpretation of "agreed." The court finds it difficult to apply the "implied consent" interpretation particularly in this case because it bluntly contradicts the fact that KCTC, by failing to cast a ballot, is deemed to have rejected the Plan. In principle, one cannot conclusively reject an idea and implicitly agree to it at the same time. While KCTC does not necessarily have to cast a ballot accepting the Plan, the record must show that KCTC has affirmatively agreed to the Plan's treatment of its claim.[14] That can be done by a written notice, stipulation, or addendum to the Plan itself. On the record before the court, KCTC has not "agreed" to have its claim paid in a manner that does not comply with § 1129(a)(9)(D).

14 The same "has agreed" exception found in the preface to § 1129(a)(9) also applies to the holders of administrative claims who must be paid in full, in cash on the effective date of the Plan. § 1129(a)(9)(A).

> Holders of administrative claims do not even get to vote for or against the plan.

Feasibility: § 1129. The last issue which the court will address is the question of "feasibility;" the Bank contends that the Debtor has not shown the ability to make the necessary Plan payments. The feasibility issue arises under § 1129(a)(11), which requires the court to find that "[c]onfirmation of the plan is not likely to be followed by the liquidation, or the need for further financial reorganization of the debtor or any successor of the debtor under the plan, unless such liquidation or reorganization is proposed in the plan." "The purpose of section 1129(a)(11) is to prevent confirmation of visionary schemes which promise creditors and equity security holders more under a proposed plan than the debtor can possibly attain after confirmation." *Pizza of Haw., Inc. v. Shakey's, Inc. (In re Pizza of Haw., Inc.),* 761 F.2d 1374, 1382 (9th Cir.1985) (quotation marks omitted). To be specific, § 1129(a)(11) does not require the Debtor to prove where every penny will come from; it only requires a showing that future liquidation or reorganization "is not likely." In that regard, the Debtor's track record over the course of this bankruptcy, including the monthly payments of adequate protection to the Bank, lends significant support to a finding that the present Plan, as drafted, could be fiscally successful.

***9** However, the Bank's feasibility objection goes not to the question of what the Plan payments are as proposed, but rather what the Plan payments should be. In other words, the Bank argues that if the Debtor proposes a new plan that complies with § 1129, then the Debtor would be unable to perform under such plan given the need to substantially increase plan payments to certain creditors. The court has already determined that payments to KCTC on a portion of its secured tax claim will have to be increased to comply with § 1129(a)(9)(D). And if the Bank ultimately prevails on its challenge to the interest rate payable on its claim, then a substantially higher plan payment for Class 2A will be required as well. Yet, until those issues are resolved in a subsequent plan, the court cannot rule on the Bank's feasibility objection.

If and when that issue comes back before the court, the Debtor will have to make a clear and persuasive showing of its ability to produce the revenue necessary to fund the increased plan payments. The Debtor will also have to do a better job of reconciling the cash reported in its monthly operating reports against the balances shown in its monthly bank statements.[15]

15 The Bank presented an analysis of the substantial discrepancy between the cash flow reported in the monthly operating reports and the cash balances reflected in the bank statements. In summary, the bank statements do not show the increasing cash reported in the monthly operating reports. According to the bank statements, the Debtor appears to be "breaking even" each month, which raises doubts about its ability to fund the Plan. When asked to explain where the money is going, the Debtor revealed for the first time that a substantial amount of cash is being kept in a back room safe. This safe and the cash therein has never been reported in the monthly operating reports.

Conclusion.

Based on the foregoing, the Debtor's third amended Plan does not satisfy the requirements of § 1129(a) and cannot be confirmed. Accordingly, the Debtor's motion to confirm the Plan will be denied.

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5. THE HONORABLE DANIEL COLLINS

Topic: Marijuana Businesses in Bankruptcy: What relief is available?

I. BACKGROUND: FEDERAL AND STATE LAWS

The Supremacy Clause of the U.S. Constitution states that federal law "shall be the supreme law of the land; and the judges in every state shall be bound thereby, anything in the Constitution or laws of any State to the contrary notwithstanding."[1]

A. Federal Controlled Substances Act ("CSA"):

- Under the CSA, it is unlawful for an individual to knowingly or intentionally "manufacture, distribute, or dispense, or possess with intent to manufacture, distribute, or dispense a controlled substance." [2]
- It is also unlawful under the CSA to

  (1) knowingly open, lease, rent, use, or maintain any place, whether permanently or temporarily, for the purpose of manufacturing, distributing, or using any controlled substance; (2) manage or control any place, whether permanently or temporarily, either as an owner, lessee, agent, employee, occupant, or mortgagee, and knowingly and intentionally rent, lease, profit from, or make available for use, with or without compensation, the place for the purpose of unlawfully manufacturing, storing, distributing, or using a controlled substance." [3]
- Marijuana is a Schedule I drug. [4]
- A Schedule I drug is a "drug or other substance [that] has a high potential for abuse," has "no currently accepted medical use treatment in the United States" and "[t]here is a lack of accepted safety for use of the drug or other substance under medical supervision." [5]

B. States that Permit the Use, Sale, and Distribution of Medical Marijuana

- So far, 33 states have legalized the use, sale, and distribution of medical marijuana, which directly conflicts with the federal CSA. Presented below are laws from five of those states.
- Arizona:
  - Arizona Medical Marijuana Act.[6]
    - Allows a patient with an Arizona registry ID card to use cannabis for medical purposes
  - *State v. Jones*, a recent Arizona Supreme Court case, expanded the interpretation of A.R.S. § 36-2801(8) and held that hashish and marijuana are not two distinct forms of cannabis.[7] "[T]he definition of marijuana in § 36-2801(8) includes resin, and by extension of hashish, and that § 36-2811(B)(1) immunizes the use of such marijuana consistent with AMMA."[8]
  - Arizona licensed 31 new dispensaries in 2016.[9]
- California:
  - Medicinal and Adult-Use Cannabis Regulation and Safety Act.[10]
- Colorado:

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[1] U.S. Const., Art. VI, cl. 2.
[2] 21 U.S.C. § 841(a)(1).
[3] 21 U.S.C. § 856 (a).
[4] 21 U.S.C. § 812, Sched. 1(c)(10).
[5] 21 U.S.C. § 812(b)(1)(A)-(C).
[6] 36 Ariz. Rev. Stat. §§ 36-2801—36-2819.
[7] *State v. Jones*, 440 P.3d 1139, 1142 (Ariz. 2019).
[8] *Id.* at 1144.
[9] *Arizona Medical Marijuana Laws & Regulations*, Americans For Safe Access, https://www.safeaccessnow.org/arizona_medical_marijuana_laws.
[10] Cal. Prof. Code §§ 26000-26001.

- Medical use of marijuana for persons suffering from debilitating medical conditions.[11]
- Uniform Controlled Substances Act of2013: Offenses relating to marijuana and marijuana concentrate—definitions.[12]
- Medical marijuana program.[13]

- Michigan: Michigan Medical Marijuana Act.[14]
- Washington: Washington State Medical Use of Cannabis Act.[15]

C. The Conflict:

Even though legalization of recreational and medical marijuana use is changing at the state level, there is an inevitable conflict between state laws and the federal CSA. This conflict is apparent in the context of bankruptcy. Entities in the cannabis industry face challenges when seeking bankruptcy relief; their actions may be legal under state law, but not under federal law. Because U.S. Bankruptcy Courts are courts of federal jurisdiction[16] the challenge arises when debtors (and sometimes creditors) seek relief in bankruptcy court. Their actions, deemed legal under state law, are considered criminal conduct under federal law. The following cases provide a glimpse of bankruptcy courts' approaches to this issue.

II. BANKRUPTCY CASELAW

In re Arenas and *In re Rent-Rite Super Kegs W. Ltd.*, are two cases whose decisions turn on (1) whether there is cause for dismissal or conversion of the case and (2) whether the dismissal or conversion of the case is in the best interest of the creditors.

A. Cause for dismissal is prejudicial delay

- *In re Arenas*, 535 B.R. 845 (B.A.P. 10th Cir. 2015).
  - Facts: Debtors (husband and wife) owned building with two units. In one unit, debtors grew and sold marijuana, while the other unit was leased to third parties who used the space to dispense medical marijuana. Debtors filed a Chapter 7 then wanted to convert to Chapter 13. The U.S. Trustee sought dismissal of the bankruptcy case. The bankruptcy court held that debtors' conduct violated the CSA and denied the motion to convert to Chapter 13. Debtors were also denied relief in Chapter 7 because "engaging in criminal conduct demonstrated lack of good faith that would bar confirmation of their Chapter 13 plan."[17]
  - Issue: "Can a debtor obtain relief in the federal bankruptcy court?"[18]
  - Rule: "The court may dismiss a case under this chapter only after notice and a hearing and only for cause, including—(1) unreasonable delay by the debtor that is prejudicial to creditors."[19] "Cause" includes a nonexhaustive list of examples.[20]

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[11] C.R.S.A. Const. Art. XVIII, § 14.
[12] Colo. Rev. Stat. Ann. § 18-18-406—18-18-406.6.
[13] Colo. Rev. Stat. Ann. §25-1.5-106.
[14] Mich. Comp. Laws Ann. §§ 333.26423-333.26430.
[15] Wash. Rev. Code Ann. §§ 69.51a.005-69.51a.903.
[16] U.S. Const., Art. I, § 8, cl. 4.
[17] *In re Arenas*, 535 B.R. at 847.
[18] *Id.*
[19] 11 U.S.C. § 707(a)(1).

[20] 11 U.S.C. § 1307(c)(1)-(11).

- Held: Affirmed the bankruptcy court, because debtors violated the CSA.
- Reasoning: "[W]hile the debtors have not engaged in intrinsically evil conduct, the debtors cannot obtain bankruptcy relief because their marijuana business activities are federal crimes."[21] The Bankruptcy Court did not abuse its discretion in denying motion to convert to Chapter 13. Thus, there was cause to denythe motion to convert to Chapter 13. The court reasoned that debtors' marijuana business activities violated the federal CSA. [22]
  1. The court found the debtors' "monthly income from sources other than marijuana was not enough to fund their plan . . . the debtors could only fund their plan with income from marijuana activity, because their other sources of income would not be enough."[23]
  2. Additionally, the Trustee would have violated federal law by administering the assets linked to contraband.[24] If the Trustee did not administer the assets, there would have been prejudicial delay: "If the Trustee abandoned the Assets, the debtors would retain their business after exposing the Trustee to grave risk, provide the creditors with little or no recovery, and receive a discharge, protected all the while from their creditors' collection efforts by the automatic stay and then the discharge injunction."[25]
  3. Further, the court found lack of good faith on the part of the debtors, despite having good intentions, because "[i]f the debtors are incapable of proposing a confirmable plan, it is objectively unreasonable for them to seek Chapter 13 relief whether their intentions are kindly or not."[26]

B. Cause for dismissal is gross mismanagement and unclean hands.

- *In re Rent-Rite Super Kegs W. Ltd.*, 484 B.R. 799 (Bankr. D. Colo. 2012).
  - Facts: Around 25% of debtor's income came from leasing warehouse space to tenants who cultivated marijuana. Creditor (VFC Partners 14 LLC) moved to dismiss Chapter 11.
  - Issue: "[W]hether the case must be dismissed under the clean hands doctrine."[27]
  - Rule: Two Step Process:
    1. Step 1: Whether there is "cause" for dismissal or conversion of the Chapter 11 case:
       1. 11 U.S.C. § 1112(b)(4)(A)-(P) provides a non-exhaustive list of potential causes to dismiss or convert the case. One example is gross mismanagement: "Where a court finds 'gross mismanagement of the estate' by a debtor, that finding compels a conclusion that 'cause' exists for dismissal or conversion of the chapter 11 case."[28]

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[21] *In re Arenas*, 535 B.R. at 849-850.
[22] *Id.* at 846.
[23] *Id.* at 852.
[24] *Id.*
[25] *Id.* at 853.
[26] *Id.* at 852-53.
[27] *In re Rent-Rite Super Kegs W. Ltd.*, 484 B.R. 799, 802 (2012).
[28] *Id.* at 809; 11 U.S.C. § 1112(b)(4)(B).

- Unclean hands[29] may be one cause for dismissal or conversion. A plan may be confirmed only if "[t]the plan has been proposed in good faith and not by any means forbidden by law."[30]

2. Step 2: Whether dismissal or conversion of said case is in the best interest of creditors and the estate:
    2. To determine this step, the court would usually look to assets available for distribution and balance the creditors' reasonable expectation of a distribution in a Chapter 7 case against the inevitable race to the courthouse by individual creditors to obtain judgements and chase assets to execute on.

- Held: Court found cause to dismiss or convert the case to Chapter 7.
- Reasoning: Debtor acknowledged its conduct "expose[d] the Debtor to criminal liability and thus expose[d] its primary asset to forfeiture. It acknowledge[d] that its criminal behavior has continued post-petition."[31]

Forfeiture under the CSA
The creditor's collateral was at risk of forfeiture, because "[a]ny person convicted of a violation of [the federal CSA] punishable by imprisonment for more than one year shall forfeit to the United States, irrespective of any provision of State law –

(1) Any property constituting, or derived from, any proceeds the person obtained, directly or indirectly, as the result of such violation;

(2) Any of the persons' property used, or intended to be used, in any manner or part, to commit, or to facilitate the commission of, such violation."[32]

- Debtor engaged in unlawful activity, because while the activity was legal under Colorado law, it violated the federal CSA.[33]
    i. Step 1 "Cause": Court found "gross mismanagement" of estate. The debtor engaged in criminal conduct post-petition. "It is that post-petition presence of activity on the Debtor's property—pursuant to leases that it knowingly entered into—that violates the CSA; exposes the Debtor to criminal liability; and exposes both the Debtor and its mortgage creditor to forfeiture of the Warehouse that constitutes gross mismanagement of the estate and requires the Court to either convert this case to a case under chapter 7 or to dismiss it."[34]
        - Unclean hands:[35] "Whether it is characterized, strictly speaking as an application of the clean hands doctrine or simply as part of the Court's totality of the circumstances "cause" analysis, the Debtor's continued criminal activity satisfies the requirement of "cause" under §1112(b) and requires dismissal or conversion of this chapter 11 bankruptcy case."[36]
    ii. Step 2 "Best Interests to Creditors": The court left this open and also considered consequences of the debtor's criminal conduct. There was no motion filed in this case for abandonment or stay relief regarding the

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[29] *See infra* p. 5 Section D.
[30] 11 U.S.C. § 1129(a)(3).
[31] *Id.* at 809.
[32] 21 U.S.C. § 853(a).
[33] *In re Rent-Rite Super Kegs W. Ltd.*, 484 B.R. at 811.
[34] *Id.* at 809.
[35] *See infra* p. 5 Section D.
[36] *Id.*

warehouse. Thus, "immediately upon conversion, the chapter 7 estate would contain a major asset that is the location of ongoing criminal activity and is subject to forfeiture under the CSA. The trustee who is appointed in the case would have responsibility for a site where continuing criminal conduct is taking place."[37] The record did not permit the court to decide whether dismissal or conversion was in the best interests of creditors, but there was cause to dismiss or convert the case.

C. Whether reorganization plan was proposed "by any means forbidden by law."

Unlike the decision *In re Rent-Rite Super Kegs W. Ltd.*, the decision in *Garvin v. Cook Invs.* turns on the court's interpretation of whether the plan was "*proposed* in good faith and not by any means forbidden by law" (emphasis added). The Ninth Circuit affirmed the bankruptcy court's confirmation of a plan of reorganization even though at least part of the plan would be funded by debtor's marijuana-related business.

- *Garvin v. Cook Invs. NW, SPNY, LLC*, 922 F.3d 1031 (9th Cir. 2019).
    - Facts: Debtor, owner of five real estate holding companies, filed for Chapter 11 relief. The bankruptcy court confirmed the Chapter 11 reorganization plan over the U.S. Trustee's argument that the plan was not confirmable because Green Haven, a tenant of one property, grew marijuana on the property in violation of the CSA.[38]
    - Issue: Whether 11 U.S.C. § 1129(a)(3) prevents the court from confirming a plan "that is proposed in an unlawful manner as opposed to a plan with substantive provisions that depend on illegality."[39]
    - Rule: For a Chapter 11 reorganization plan to be confirmed, it is necessary that "the plan has been proposed in good faith and not by any means forbidden by law."[40]
    - Held: Ninth Circuit affirmed confirmation of the reorganization plan.
    - Reasoning: In interpreting 11 U.S.C. § 1129(a)(3), the court said the district court looked to proposal of a plan, not the terms of the plan (or substance of the plan). The court applied the plain meaning of the statute and found that the plan was not "proposed by any means forbidden by law."
    - Note: The US Trustee had argued early in the case that having a tenant in the marijuana business was gross mismanagement under § 1112(b). The bankruptcy judge denied the motion to dismiss but gave leave to renew at confirmation; the US Trustee did not renew the motion to dismiss at confirmation. The Ninth Circuit (and the district court) held that the US Trustee had waived this argument by failing to renew its motion to dismiss at plan confirmation. If the court had considered gross mismanagement issues under §1112(b) (i.e., if the US Trustee had renewed its motion to dismiss at plan confirmation), it's possible that the case would have come out differently.

D. Cause for dismissal was unclean hands.

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[37] *Id.* at 810.
[38] *Garvin*, 922 F.3d at 1033.
[39] *Id.* at 1035.
[40] 11 U.S.C. § 1129(a)(3).

The following cases discuss unclean hands as "cause" for dismissal or conversion. Under the Unclean Hands Doctrine, "[O]ne who does not come into equity with clean hands, and keep them clean, must be denied all relief, whatever may have been the merits of his claim."[41]

- *In re Basrah Custom Design, Inc.*, 2019 WL 2202742 (Bankr. E.D. Mich. May 21, 2019).
    - Facts: Debtor, a Michigan corporation that manufactured and installed custom cabinets, filed Chapter 11 bankruptcy. Debtor used and occupied two conjoined buildings owned by the president and only shareholder of the debtor. The November lease named Debtor as landlord and a medical marijuana dispensary as tenant. The lease stated that "Premises will be used for licensed medical marijuana dispensary and for no other purpose whatsoever." The U.S. Trustee sought dismissal of the case. The Trustee claimed debtor had unclean hands, because the motive of the president of the debtor was to profit from the marijuana business, rather than "disentangle [itself] from any marijuana-based business."[42] In contrast, the debtor argued that it in fact wanted to disentangle itself from marijuana activity.[43]
    - Issue: Whether debtor's entanglement with a medical marijuana dispensary business, legal under Michigan law, requires dismissal of the federal bankruptcy case.
    - Rule: 11 U.S.C. § 1112(b)(1): "[O]n request of a party in interest, and after notice and a hearing, the court shall convert a case under this chapter to a case under chapter 7 or dismiss a case under this chapter, whichever is in the best interests of creditors and the estate, for cause . . . ."
    - Held: Yes, dismissal was required.
    - Reasoning: The court found the debtor had unclean hands because the president's motive was to make more money off of the marijuana business by either (1) leasing the property to another marijuana business for higher rent or (2) using the property himself to operate a marijuana business.[44] The court therefore found the president of the debtor corporation did not seek to disentangle himself from illegal activity but sought instead to continue the illegal operations in violation of the federal CSA in order to profit from it.[45]
    - Dismissal, as opposed to conversion, was in the best interest of the creditors and the estate:
        - "First, a conversion to Chapter 7 would mean a liquidation of the Debtor, and the termination of the Debtor's business of manufacturing and installing custom cabinets."[46] The debtor does not want the assets liquidated, as it was apparent the president wanted to continue the marijuana business activity.[47] Also, no "creditor of the Debtor advocated for the conversion and liquidation of the Debtor in Chapter 7. There is no reason to think that a liquidation of the Debtor in Chapter 7 is in the best interests of the creditors or the estate."[48]
        - "Second . . . this Court sees "no practical alternative to dismissal" in this case."[49] The court was not willing to grant stay relief requested by the

[41] *In re Medpoint Mgmt., LLC*, 528 B.R. 178 (Bankr. D. Ariz. 2015) (citing *Hall v. Wright*, 240 F.2d 787, 794-95 (9th Cir. 1957)).
[42] *In re Basrah Custom Design, Inc.*, 2019 WL 2202742 at 11.
[43] *Id.*
[44] *Id.*
[45] *Id.*
[46] *Id.* at 12.
[47] *Id.*
[48] *Id.*
[49] *Id.*

tenant, because the tenant also has unclean hands. If the court granted the stay, it would essentially aid the tenant's illegal operations.[50]

- *Northbay Wellness Group, Inc. v. Beyries*, 789 F.3d 956 (9th Cir. 2015).
  - Facts: Beyries, who was both an attorney and Chapter 7 debtor, stole $25,000 from his creditor/client, Northbay Wellness Group, a medical marijuana dispensary in California. The debtor filed for bankruptcy and the creditor brought an adversary proceeding to determine the debt was nondischargeable. The bankruptcy court dismissed the creditor's complaint because their marijuana sales prevented the court from granting relief.[51]
  - Issue: Whether the bankruptcy court "abused its discretion by applying the doctrine of unclean hands to bar [creditor] Northbay's request for a judgment of nondischargeability."[52]
  - Rule: "A plaintiff with unclean hands cannot obtain a judgment of nondischargeability."[53] The doctrine of unclean hands "requires that the plaintiff 'shall have acted fairly and without fraud or deceit to the controversy in issue.'"[54] Determining whether unclean hands precludes relief requires "weigh[ing] the substance of the right asserted by [the] plaintiff against the transgression which, it is contended, serves to foreclose that right."[55]
  - Held: Yes, the bankruptcy court abused its discretion. Reversed.
  - Reasoning: The court noted the debtor "was on Northbay's board of directors and partnered in Northbay's business, so he was as responsible as Northbay for its illegal marijuana sales. That illegal activity must be attributed to both parties in the weighing of wrongdoing, so it does not tip the balance in either direction."[56] Not only did the debtor violate the CSA, but the debtor also stole $25,000 from the creditor, his client. The court found that the debtor's "wrongdoing outweighed Northbay's, both as to harm caused to each other and as to harm caused to the public."[57] Absolving the debtor of responsibility would be tantamount to permitting a lawyer to steal from his client and contrary to the public interest.[58]

As discussed in brief above, unclean hands may be cause for dismissal or conversion of a bankruptcy case. However, in the following Arizona case, the involuntary debtor involved in the marijuana industry was the one arguing it has "unclean hands" as a defense.

- *In re Medpoint Mgmt., LLC*, 528 B.R. 178 (Bankr. D. Ariz. 2015).
  - Facts: The involuntary debtor is an LLC involved in marijuana-related business activity.[59] The debtor moved to dismiss the involuntary Chapter 7 petition filed against it, arguing that the bankruptcy trustee would violate federal law by

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[50] *Id.* at 13.
[51] *Northbay Wellness Group, Inc.*, 789 F.3d at 959.
[52] *Id.*
[53] *Id.* (citing *In re Uwimana*, 274 F.3d 806 (4th Cir. 2001)).
[54] *Id.* (citing *Ellenburg v. Brockway, Inc.*, 763 F.2d 1091, 1097 (9th Cir. 1985)).
[55] *Id.* at 960 (citing *Republic Molding Corp. v. B.W. Photo Utils.*, 319 F.2d 347 (9th Cir. 1963).
[56] *Id.*
[57] *Id.*
[58] *Id.* at 961.

[59] *In re Medpoint Mgmt., LLC*, 528 B.R. at 180.

administering assets of the debtor.[60] The debtors argued that creditors had unclean hands because they too were involved with marijuana-related activity. Lastly, the debtor noted the conflict between state and federal law, making the bankruptcy court "the most inefficient and troublesome forum."[61] The creditors argued that the Consolidated and Further Continuing Appropriations Act ("Cromnibus Act") safeguarded marijuana businesses in Arizona from federal prosecution.[62] The U.S. Trustee posed concerns regarding her administration of illegal assets.[63]

- Issues:
  1. Whether there is cause to dismiss the petition;
  2. Whether petitioning creditors can or should be entitled to an order of the court entering an order of relief; and
  3. Whether petitioning creditors acted in bad faith in filing the petition.[64]
- Rule:
  1. "The Court may dismiss a chapter 7 case for cause after notice and a hearing."[65]
  2. "Under the 'clean hands' doctrine, one who does not come into equity with clean hands, and keep them clean, must be denied all relief, whatever may have been the merits of the claim."[66]
- Held: There was cause to dismiss the petition. Creditors' request for relief was denied in favor of Debtor. The court granted Debtor's motion to dismiss.
- Reasoning:
  1. Yes, there was cause to dismiss under 11 U.S.C. § 707(a). The court looked to *In re Arenas* to find that the chapter 7 trustee would be violating the CSA by liquidating the assets linked to illegal activity. The court also relied on *In re Rent-Rite Super Kegs W. Ltd.* Further, "The Court finds that the prospects of a possible forfeiture or seizure of Medpoint's assets poses an unacceptable risk to a chapter 7 estate and to a chapter 7 trustee."[67] However, the court did not make a finding regarding the forfeitability of the assets.[68] Additionally, despite the creditors' argument, the court noted the Cromnibus Act would not bar the Department of Justice from prosecuting marijuana businesses under the CSA, and the funding provided to the Department of Justice to prevent enforcement was only through September 30, 2015.[69]
  2. "Petitioning Creditors' hands are unclean and they cannot now seek relief from this Court." The court noted that the creditors knew or should have known that they were getting themselves into "marijuana-related business affairs."[70] "Petitioning Creditors nonetheless decided to contract with Medpoint to pursue potentially lucrative investments or lending profits, and/or consulting fees, none of which could be realized but for Medpoint's marijuana-related business affairs."[71]

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[60] *Id.* at 181-182.
[61] *Id.* (citing Motion at 13:11).
[62] *Id.* at 183.
[63] *Id.* at 184.
[64] *Id.*
[65] *Id.* at 184.
[66] *Id.* at 186 (citing *Hall v. Wright*, 240 F.2d 787, 794-95 (9th Cir. 1957).
[67] *Id.* at 185.
[68] *Id.* at 185 n. 11.
[69] *Id.* at 185-86.
[70] *Id.* at 187.
[71] *Id.*

3. The court found no bad faith on the part of the creditors.

- *In re Johnson,* 532 B.R. 53 (Bankr. W.D. Mich. 2015).
  - Facts: Debtor was a caregiver who also had a marijuana business and also grew marijuana in the basement of his residence. (The court inferred that the debtor's truck was used to transport marijuana to the patients or the dispensary). The bankruptcy estate included the debtor's residence, truck, and horticultural items (fertilizer, growing lights). Approximately half of debtor's income came from his marijuana-related business activity.[72] Debtor testified his payments to the Chapter 13 trustee derived from his Social Security income ($1,203) not from his marijuana business.[73] The U.S. Trustee moved to dismiss, arguing that debtor's involvement in marijuana activity violated the CSA.[74]
  - Issue: Whether debtor's business, legitimate under state law but criminal under federal CSA, precludes the court from granting him the relief available under the U.S. Bankruptcy Code.
  - Rule: "There is no constitutional right to obtain a discharge of one's debts in bankruptcy."[75]
  - Held: Yes, the debtor's medical marijuana business precluded the court from granting him relief under the U.S. Bankruptcy Code, unless the debtor abandoned and destroyed the contraband (marijuana and marijuana products) in his bankruptcy estate.
  - Reasoning: While debtor claimed he had segregated his income and attempted to sanitize his plan payments, "money is fungible and the arrangement would [have] invariably taint[ed] the court and the Standing Trustee," since they would be supporting the debtor's criminal conduct.[76] "Debtor's financial life is inextricably bound up with his federal criminal activity through the Chapter 13 plan, even if he segregates proceeds of that activity. The two aspects of the Debtor's life cannot be hermetically sealed from each other, and the pervasive benefits of bankruptcy will invariably advance both." [77]
    - The court gave the debtor the option either to continue with his marijuana business or seek relief under the Bankruptcy Code. "In the court's view, the Debtor cannot conduct an enterprise that admittedly violates federal criminal law while enjoying the federal benefits the Bankruptcy Code afford him."[78] If the debtor sought relief, the court required he cease growing, selling, and distributing marijuana immediately as well as cease using the property from bankruptcy estate to continue the criminal activity.[79] However, if the debtor wanted to continue his marijuana business, he would need to file a motion to dismiss under § 1307(b).[80]
    - US Trustee's motion to dismiss was denied without prejudice.

[72] *In re Johnson,* 532 B.R. at 55.
[73] *Id.* at 55-56.
[74] *Id.* at 54.
[75] *Id.* 59 (citing *United States v. Kras*, 409 U.S. 434 (1973)).
[76] *Id.* 56-57.
[77] *Id.* at 57.
[78] *Id.* at 59.
[79] *Id.*
[80] *Id.*

Summary of US Trustee's Position in Bankruptcy Cases[81]

- The bankruptcy system cannot be used as an instrument in the ongoing commission of a crime
- Bankruptcy trustees and other estate fiduciaries should not be required to administer assets if doing so would cause them to violate federal criminal law
- The CSA does not distinguish between the seller or grower of marijuana and more "downstream" participants; all are violating federal criminal law
- Although bankruptcy may be used to administer the illicit proceeds of criminal activities (e.g., Enron), those cases deal with the aftermath of fraud; the parties are not currently involved in a fraudulent or criminal scheme

III. SOLUTIONS

There are ways debtors may avoid these challenges when seeking bankruptcy relief.

(1) Sanitizing plan payments/Segregating income:

Debtors may be able to use non-marijuana-related income to fund a reorganization plan by segregating their marijuana-related income from other sources of income. However, this option requires sufficient funds that are not tainted with marijuana activity. For example, debtors in *In re Arenas* would not have had enough money, even if their case had been converted to a Chapter 13, to fund a reorganization plan with funds that came from a source other than marijuana activity.

However, it is unlikely that this will help the debtor avoid violating the federal law. In fact, some courts do not allow debtors to sanitize their plan payments. For example, the court in *In re Johnson* explained that sanitizing the plan payments would not have been enough because "money is fungible and the arrangement would invariably taint the court and the standing trustee, because the trustee would be supporting the debtor's criminal conduct.[82] Further, the benefits of obtaining bankruptcy relief would have advanced "[t]he two aspects of the Debtor's life."[83]

(2) Abandonment and destruction of contraband:

Debtors may abandon and subsequently destroy marijuana and marijuana products included in the bankruptcy estate before or after filing for bankruptcy.[84]

[81] Clifford J. White III, *Why Marijuana Assets May Not Be Administered in Bankruptcy*, 36-DEC Am. Bankr. Inst. J. 34 (2017).

[82] *In re Johnson,* 532 B.R. at 56-7.

[83] *Id.* at 57.

[84] Matthew W. Hoelscher, *Legalization and Reorganization: Marijuana in Chapter 13*, NACTT Quarterly, 2018; *In re Johnson,* 532 B.R. 53 (Bankr. W.D. Mich. 2015).

(3) Receiverships:

Debtors should consider "state court insolvency proceedings, such as receiverships and assignments for the benefit of creditors."[85] "[A] receivership occurs when a court orders an asset, typically real estate or a business enterprise, to be placed in the custody of a receiver appointed by the court, for the benefit of creditors . . . . [T]he receiver generally takes control of the property, collects any income from the property, and liquidates the property for the benefit of its creditors, must like a trustee in bankruptcy would."[86] Further, "receiverships remain open for business for marijuana-related businesses."[87]

(4) Termination and Eviction Clauses:

If the debtor is a landlord whose tenants grow, dispense, or distribute cannabis, the debtor can negotiate termination and eviction clauses with their tenants to state that in the event of the landlord's bankruptcy, the landlord may evict the tenant before filing.[88]

(5) Legislative Proposals:

The Strengthening the Tenth Amendment Through Entrusting States (STATES) Act, S. 3032

- Introduced by Senators Elizabeth Warren (D-Mass) and Cory Gardner (R-Colo) on June 7, 2018
- Would amend the CSA so that, as long as states (and federally recognized tribes) comply with certain protections, its provisions no longer apply to any person acting in compliance with State (or tribal) laws relating to the manufacture, production, possession, distribution, dispensation, administration, or delivery of marijuana
- Would amend the CSA's definition of "marihuana" to exclude industrial hemp
- General idea is to recognize state laws legalizing cannabis

The SAFE Banking Act, HR 1595

- Would provide a safe harbor for financial institutions to work with cannabis businesses that operate in compliance with state laws
- Would prevent federal banking regulators from punishing banks for working with cannabis-related businesses that are obeying state laws or halting their services, taking action on loans made to those businesses, or limiting a depository institution's access to the Deposit Insurance Fund
- Would protect ancillary businesses that work with the cannabis industry from being charged with money laundering and other financial crimes
- Would require the Financial Industry Examination Council to develop guidance to help credit unions and banks understand how to lawfully serve cannabis businesses
- Bill was approved by the House Financial Services Committee in late March 2019, along with an amendment from Rep. Steve Stivers (R-Ohio) that would extend the same treatment to insurers[89]

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68 G. David Dean and Katherine M. Devanney, "Marijuana's Journal from Greenhouse to Courthouse: Can Cannabis Debtors Seek Bankruptcy Protection?" ABI Journal. May 30, 2019.

[86] Daniel A. White, *Excusal and Absention: Receiverhip Issues in Bankruptcy*, 28 No. 2 J. Bankr. L. & Prac. NL Art. 3.

[87] *Id.*

[88] Matthew W. Hoelscher, *Legalization and Reorganization: Marijuana in Chapter 13*, NACTT Quarterly, 2018.

[89] Victoria Guida, *House Panel Approves Landmark Bill to Let Banks Serve Pot Businesses*, Politico, Mar. 28, 2019, https://www.politico.com/story/2019/03/28/marijuana-bill-house-financial-services-1303494.

IV. BANKING AND MARIJUANA-RELATED ENTITIES

Marijuana-related entities are challenged not only when it comes to their fight in the bankruptcy court, but also in their growing need to store their cash profits. Banks refuse to allow these entities to open bank accounts let alone apply and receive loans. Because the marijuana industry deals largely with cash, problems quickly arise from the safety of employees and company profits to inefficient and costly tax payments. The following discusses these risks and challenges in greater detail and ways entities, such as private banks, are helping to mitigate them.

- Ray Stern, *Banking on Pot: Arizona's Banks and Medical-Marijuana Dispensaries Seek an Unprosecutable Relationship*, Phoenix New Times (Dec. 29, 2014), https://www.phoenixnewtimes.com/news/banking-on-pot-arizonas-banks-and-medical-marijuana-dispensaries-seek-an-unprosecutable-relationship-6666923.
    - GreenStar Payment Solutions of Denver is a firm that provides debit card services to recreational and medical marijuana dispensaries in Arizona, Colorado, among other states.

- Robb Mandelbaum, *Where Pot Entrepreneurs Go When the Banks Just Say No*, N.Y. Times, (Jan. 4, 2018), https://www.nytimes.com/2018/01/04/magazine/where-pot-entrpreneurs-go-when-the-banks-just-say-no.html.
    - Issue: Individuals and companies in the marijuana industry have nowhere to store their cash earnings. Because possession, use, sales, and distribution of marijuana is illegal under the federal CSA, banks refuse to provide checking accounts for those in the marijuana industry. The industry predominantly deals with cash, which is accompanied by problems such as risk of violent crime against employees.
    - Private banks are beginning to allow marijuana-related businesses to open checking accounts.
    - In particular, Safe Harbor Private Banking, a division of Partner Colorado, a credit union in Arvada, Colorado, does not lend money, "because the federal authorities could seize whatever collateral backs a loan."
    - Safe Harbor's manager and chief executive of Partner Colorado, Sundie Seefried, says her chances of prosecution are less than 20%.
        - How it works:
            - Safe Harbor is "the nosiest banker" because it "delve[s] deeply into nearly every aspect of their clients' finances and operations."
            - An hour-long interview to get to know its clients
            - Document collection: clients must list the owners, investors, vendors, customers, financial statements, tax forms, organizing documents, state licenses, leases, handbooks, etc.
            - Frequent inspection of premises (ex: every three months) by Safe Harbor bankers to ensure Colorado's laws are followed.
            - Bankers track every transaction to ensure nothing goes into the illicit market
            - If unusual deposit, for example from a new source, "the banker holds the money until the client can account for it."
            - Safe Harbor will close any accounts that do not comply (with the then applicable Cole memo) "to weed out less-committed clients."

        - Administrative fees:
            - The first year, every $100,000 deposit to Safe Harbor, client pays $450 fee, and $300 each subsequent year.
            - Around 75% of the marijuana-connected clients pay less than $1,000 per account.

- John Chiang, *Banking Access Strategies for Cannabis-Related Businesses: A Report From the State Treasurer's Cannabis Banking Working Group*, California State Treasurer (Nov. 7, 2017).
    - Because the cannabis industry deals largely with cash, it is risky and expensive to collect taxes and fees from marijuana-related businesses for state and local governments.
        - Ways to circumvent these risks:
            - Armored Couriers: Have businesses in the cannabis industry contract to have an armored courier pick up and transport their cash for secured counting and then transportation to a Federal Reserve facility. This option mitigates the risks to banks by increasing safety and taxpayer compliance.
            - Smart safes and kiosks on cannabis business premises: After the kiosks are fed with cash, the armored courier would stop and collect the money. These kiosks can also be used as vending machine for cannabis products as well as "programmed to send excise tax and fee information to government agencies."
            - Money Services Businesses: use the cash to purchase money orders or electronically make money transfers to government agencies.
            - Third Party Payment Services: permit cannabis businesses to open an account with them
    - Three reasons to permit cannabis businesses access to banking services:
        - Because cannabis industry deals with huge amounts of cash, the businesses and employees become targets of violent crime.
        - The cash-only tax and fee payments impose unnecessary expenses and safety risks.
        - Providing the cannabis industry with access will remove it from the illicit market and establish it as part of the state's economy through regulation and taxes.

- Vince Sliwoski, *No Bankruptcy, No Problem? Receivership and Cannabis*. Canna Law Blog (Sept. 19, 2017), https://www.cannalawblog.com/no-bankruptcy-no-problem-receivership-and-cannabis/.
    - Parties in bankruptcy that are connected to marijuana can either "(1) liquidate without court supervision, or (2) explore state court receivership."
        - (1) liquidating without the supervision of the court does not protect "pot business creditors."
        - (2) State court receivership allows protection, but it is complex.
    - States, such as Washington and Oregon, "seek to bridge the bankruptcy gap by allowing creditors to seize and sell cannabis."

  - Creditors receive high interest rates for loans to marijuana companies and marijuana companies have a hard time getting loans from banks, because they "lack lienable collateral." These businesses' net worth is largely connected to cannabis.
  - In Washington, a third party may liquidate cannabis whether thecannabis was first proposed as loan collateral.

- Jeff Daniels, *California Senate passes legislation to create state-chartered cannabis banks*, CNBC (May 21, 2019), https://www.cnbc.com/2019/05/21/california-senate-passes-bill-to-create-state-chartered-cannabis-banks.html.
  - Senate Bill 5.1 passed "Under the state legislation . . . private banks or credit unions can apply for a limited purpose state charter so they can provide depository services to licensed cannabis businesses." Senate Bill 5.1 "still requires approval of the Assembly and California Gov. Gavin Newsom to become law."
  - "The Democratic lawmaker's bill would set up special checks by pot businesses as a way to pay state and local taxes, fees and rent."
  - Nonetheless, these businesses will not be able to get a loan.

- Nick Kovacevich, *California's Cannabis Banking Moves Forward*, Forbes (June 11, 2019), https://www.forbes.com/sites/nickkovacevich/2019/06/11/californias-banking-moves-forward/#7a52c891fbba.
  - From the bill, the Cannabis Limited Charter Banking and Credit Union Law"would authorize the limited charter bank or credit union to issue special-purpose checks to cannabis businesses in order to pay government fees, taxes, rent and vendor invoices."

- Jeffrey Gramlich and Kimberly Houser, *Marijuana Business and Sec. 280E: Potential Pitfalls for Clients and Advisers*, The Tax Adviser, (June 30, 2015), https://www.thetaxadviser.com/issues/2015/jul/houser-jul15.html.
  - Under 26 U.S.C. § 280E, entities in business with controlled substances, namely Schedule I and II of the federal CSA, are generally prohibited from deducting their expenses.
  - However, the Supreme Court case *James v. United States* held that illegal income that came from embezzlement was taxable.[90] The Court further noted that businesses that deal with illegal activity may deduct business expenses. Exceptions to this rule includes marijuana: marijuana businesses are prohibited from deducting business expenses.
  - Nonetheless, § 280E does not apply if marijuana-related activity is not the primary good of the business.[91]
  - There is risk to professionals such as attorneys and accountants whose clients work in the marijuana industry. While marijuana use, sale, and growth is legal at the state level, because it is still illegal at the federal level, professionals such as attorneys and

[90] *James v. United* States, 366 U.S. 213 (1961)
[91] See *Californians Helping to Alleviate Medical Problems, Inc. v. Comm'r of Internal Revenue*, 128 T.C. 173 (2007) (holding that medical marijuana dispensary's deductions were permitted because business provided not only medical marijuana but mainly provided other caregiving services such as counseling, hygiene products, support groups, and computer access).

accountants must take caution if they knowingly aid and abet marijuana business clients.

- Brad Auerbach, *How Cannabis Entrepreneurs Feel About Sessions' Reversal of the Cole Memo*, Forbes (Mar. 3, 2018), https://www.forbes.com/sites/bradauerbach/2018/03/03/how-cannabis-entrepreneurs-feel-about-sessions-reversal-of-the-cole-memo-#3d12204dc4ae.
    - The Cole Memo, drafted by Deputy Attorney General under the Obama administration James Cole, was recently rescinded by Attorney General Jeff Sessions of the Trump administration in early 2018. With chances of federal prosecution on the horizon, the marijuana industry will suffer from even more challenges now that investors and banks will be hesitant to do business with them.
    - Nathaniel Gurien, CEO of FinCann, says that there is an "expected renewal of the Rohrbacher-Blumenauer budget amendment (which prohibits use of federal funds for DOJ enforcement of federal marijuana laws against state-sanctioned medical marijuana licensees)." At this point, entrepreneurs in the cannabis industry are expecting a "chilling effect" when it comes to investment and banking.
    - Erik Knutson, CEO of Keep Brands says that "cash transactions will once again be the norm" and this will lead to an increase in violent crime.
    - Arnaud Dumas de Rauly, Chief Strategy Officer for The Bline Group, said that the upside to all of this is "current businesses will be forced to be more rigorous with their operations, cash-flow, and compliance strategies."

<u>General addition</u> to give a sense of the scope/size of the industry: As of November 2018, there were approximately 28,000 marijuana/cannabis businesses in operation, employing about 150,000 people in the United States. These businesses manage and control approximately $9 billion in cash revenues.[92]

[92] James P. Crumlish, *The Growth, Development, and Difficulties of the Current Marijuana Business*, NACVA/CTI QuickRead, Dec. 5, 2018, http://quickreadbuzz.com/2018/12/05/the-growth-development-and-difficulties/?utm_campaign=website&utm_source=nacva&utm_medium=email
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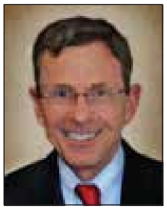
On Our Watch

By Clifford J. White iii and John Sheahan

Why Marijuana Assets May Not Be Administered in Bankruptcy



Clifford J. White III
Executive Office for U.S. Trustees
Washington, D.C.

John Sheahan
Executive Office for U.S. Trustees
Washington, D.C.

Clifford White is the director of the Executive Office for U.S. Trustees. He served as an ex officio member of the ABI Commission to Study the Reform of Chapter 11 and currently serves in the same capacity on the ABI Commission on Consumer Bankruptcy. John Sheahan is a trial attorney in the Office of the General Counsel. Both are based in Washington, D.C.

Marijuana continues to be regulated by Congress as a dangerous drug, and as the U.S. Supreme Court has recognized, the federal prohibition of marijuana takes precedence over state laws to the contrary.[1] The primacy of federal law over state law is hardly a novel proposition and has been the rule since the ratification of the Constitution. Thus, whenever a marijuana business files for bankruptcy relief, a threshold question is whether the debtor can be granted relief consistent with the Bankruptcy Code and other federal law. If the answer to that question is "no," the U.S. Trustee Program (USTP), in its role as the watchdog of the bankruptcy system, will move to dismiss.

Illegal enterprises simply do not come through the doors of the bankruptcy courthouse seeking help to further their criminal activities. To obtain bankruptcy relief, some may try to hide the nature of their business or income, but bankruptcy courts require full financial disclosure and are not a hospitable forum for continuing a fraudulent or criminal scheme.

Marijuana businesses are a unique and unprecedented exception to this rule because they often involve companies that openly propose to continue their illegal activity during and after the bankruptcy case. Those cases present a challenge to the bankruptcy system because they generally involve assets that are illegal even to possess. In contrast to other types of cases involving illegal businesses, in which the criminal activity has already been terminated and the principal concern of the bankruptcy court is to resolve competing claims by victims for compensation, a marijuana bankruptcy case might involve a company that is not only continuing in its business, but even seeking the affirmative assistance of the bankruptcy court in order to reorganize its balance sheet and thereby facilitate its violations of the law going forward.

The USTP's response to marijuana-related bankruptcy filings is guided by two straightforward and uncontroversial principles. First, the bankruptcy system may not be used as an instrument in the ongoing commission of a crime, and reorganization plans that permit or require continued illegal activity may not be confirmed. Second, bankruptcy trustees and other estate fiduciaries should not be required to administer assets if doing so would cause them to violate federal criminal law.

The USTP's policy of seeking dismissal of marijuana bankruptcy cases that cannot lawfully be administered is not a new one; rather, it is a policy that has been applied consistently over two presidential administrations and under three attorneys general. Nor are these concerns unique to marijuana. These same principles would also guide the USTP's response in a case involving any other type of ongoing criminal conduct or administration of illegal property.

> **[T]he USTP will continue to enforce the legislative judgment of Congress by preventing the bankruptcy system from being used for purposes that Congress has determined are illegal.**

Although a recent *ABI Journal* article[2] takes the USTP to task for its marijuana-enforcement efforts, it is noteworthy that the author fully agrees with the USTP's position as to the first of the two aforementioned principles and appears to agree to a significant extent with the second principle. As the author concedes, "it hardly needs explanation that a bankruptcy court should not supervise an ongoing criminal enterprise regardless of its status under state law."[3] As to the second principle, "[i]t would obviously violate federal law for the trustee to sell marijuana."[4]

Given these concessions, the author's disagreement with the USTP's position would appear to be limited to a fairly narrow range of cases: those where the administration of the estate would not require the trustee to sell marijuana (but would require the trustee to administer other marijuana-derived property), and those where the debtor is a "downstream" participant in a marijuana business, such as a lessor of a building used for a marijuana dispensary.[5]

Yet under the CSA, there is no distinction between the seller or the grower of marijuana and the

1 Controlled Substances Act, 21 U.S.C. § 801, *et seq.* (the "CSA"); *Gonzales v. Raich*, 545 U.S. 1, 12 (2005).

2 Steven J. Boyajian, "Just Say No to Drugs? Creditors Not Getting a Fair Shake When Marijuana-Related Cases Are Dismissed," XXXVI *ABI Journal* 9, 24-25, 74-75, September 2017, *available at* abi.org/abi-journal.

3 *Id.* at 25.

4 *Id.*

5 *Id.* at 74.

supposedly more "downstream" participants whom the article proposes to protect: All are in violation of federal criminal law. In particular, § 856 of the CSA specifically prohibits knowingly renting, managing or using property "for the purpose of manufacturing, distributing, or using any controlled substance;" § 863 of the CSA makes it a crime to sell or offer for sale any drug paraphernalia, which is defined to include, among other things, "equipment, product, or material of any kind which is primarily intended or designed for use" in manufacturing a controlled substance; and § 855 provides for a fine against a person "who derives profits or proceeds from an offense [of the CSA]."[6] Thus, not only would a trustee who offers marijuana for sale violate the law, so too would a trustee who liquidated the fertilizer or equipment used to grow marijuana, who collected rent from a marijuana business tenant or who sought to collect the profits of a marijuana investment.

Although cases involving illicit proceeds of Ponzi schemes and other criminal activities — seen in such notorious cases as *Enron*, *Dreier LLP* and *Madoff* — are administered in bankruptcy, they deal with the aftermath of fraud, usually after individual wrongdoers have been removed from the business. Such cases are wholly inapposite analogies to a marijuana case, where the illegal activity is still continuing through the bankruptcy administration process and where bankruptcy relief might allow the company to expand its violations of law in the future. Nor do any of those cases involve proposed chapter 11 and 13 plans where the feasibility of the plan itself is directly premised on the continued receipt of profits from an illegal enterprise. And none of them requires the courts or trustees to deal with property of the kind described in the CSA, for which mere possession is a federal crime.

6 Controlled Substances Act, 21 U.S.C. § 801, *et seq*.

Similarly, although the author cites two decades-old decisions in support of his claim that "courts have not always shied away from handling marijuana-related bankruptcies,"[7] it is noteworthy that neither of those decisions involved active marijuana operations or would have required a bankruptcy trustee to administer any illegal marijuana assets.[8] Both *Chapman* and *Kurth Ranch* involved bankruptcy cases that were filed *after* law enforcement had arrested and seized the assets of marijuana growers. The legal issues raised by the current wave of marijuana filings were simply not present in those cases: Neither case involved an ongoing violation of law, and in neither case were there any marijuana assets to be administered, because all illegal assets had been seized and disposed of pre-petition.

Finally, the article suggests that the "ongoing conflict over marijuana policy" is one that should take place outside the bankruptcy system. The USTP agrees. However, that does not mean that the USTP or the courts should turn a blind eye to bankruptcy filings by marijuana businesses. Rather than make its own marijuana policy, the USTP will continue to enforce the legislative judgment of Congress by preventing the bankruptcy system from being used for purposes that Congress has determined are illegal. abi

7 *Id.* at 25.
8 *See Dep't of Revenue v. Kurth Ranch*, 511 U.S. 767 (1994); *In re Chapman*, 264 B.R. 565 (B.A.P. 9th Cir. 2001).

2018 WL 989263
Only the Westlaw citation is currently available.
NOT FOR PUBLICATION
United States Bankruptcy Appellate Panel of the Ninth Circuit.

IN RE: Patricia G. OLSON, Debtor.
Patricia G. Olson, Appellant,
v.
William Albert Van Meter, Chapter 13 Trustee; Cody Bass; City of South Lake Tahoe; United States of America; U.S. Bank, N.A., Appellees.

BAP No. NV–17–1168–LTiF
|
Bk. No. 3:17–bk–50081–BTB
|
Argued and Submitted on December 1, 2017
| FILED—
February 5, 2018

Appeal from the United States Bankruptcy Court for the District of Nevada, Honorable Bruce T. Beesley, Bankruptcy Judge, Presiding

Attorneys and Law Firms

Anne J. Williams of the Law Offices of J. Craig Demetras argued for Appellant Patricia G. Olson;

Seth Joseph Adams of Woodburn & Wedge argued for Appellee Cody Bass.

Before: LAFFERTY, TIGHE,[*] and FARIS, Bankruptcy Judges.

Concurrence by Judge Tighe

MEMORANDUM[**]

Memorandum by Judge Lafferty

***1** The Debtor is 92 years old, legally blind, and resides in an assisted living facility. She sought chapter 13[1] relief to stop foreclosure of her commercial real property. One of the tenants at that property operated a marijuana dispensary on the premises and continued to pay rent to Debtor postpetition. Debtor's plan called for her to sell the commercial real property to pay off all creditors. At the hearing on the motion to sell and reject the lease with the tenant, the bankruptcy court dismissed the case sua sponte on the ground that Debtor's postpetition acceptance of rents from the dispensary business was an ongoing criminal violation that disqualified her from bankruptcy relief.

Because the bankruptcy court did not make adequate findings for us to discern the standard under which it concluded that dismissal was mandatory, we VACATE and REMAND.

FACTS[2]

Prepetition, Debtor Patricia G. Olson was the general partner of Olson Bijou Center, L.P., a California limited partnership ("OBC"). OBC owned real property on Lake Tahoe Boulevard in South Lake Tahoe, California, known as the Olson Bijou Shopping Center (the "Shopping Center Property").

Beginning in January 2013, Appellee Cody Bass began leasing space in the Shopping Center Property from OBC; although the record includes only an unsigned copy of the lease, the signature block on the lease indicates that it was to be signed by Debtor's son, Patrick Olson, as manager of OBC.[3] The lease expressly authorized Mr. Bass to operate a "dispensary."[4] Pursuant to that authority, Mr. Bass operated at the leased premises Tahoe Wellness Cooperative ("TWC"), a marijuana dispensary authorized under California law. Both the operation of the dispensary business and the leasing of the premises for such a business, however, potentially violated the federal Controlled Substances Act, 21 U.S.C. §§ 801–904 ("CSA"). The CSA classifies marijuana as a controlled substance, 21 U.S.C. § 812, and makes it unlawful to

> (1) knowingly open, lease, rent, use, or maintain any place, whether permanently or temporarily, for the purpose of manufacturing, distributing, or using any controlled substance;
>
> (2) manage or control any place, whether permanently or temporarily, either as an owner, lessee, agent, employee, occupant, or mortgagee, and knowingly and intentionally rent, lease, profit from, or make available for use, with or without compensation, the place for the purpose of unlawful manufacturing, storing,

distributing, or using a controlled substance.

***2** 21 U.S.C. § 856(a).

In early 2016, Mr. Bass and OBC entered into a letter of intent for Mr. Bass to purchase the Shopping Center Property for $4.2 million; Mr. Bass made a $25,000 payment to Debtor's attorney pursuant to the letter of intent. Shortly thereafter, Mr. Bass, OBC, and Debtor entered into an option agreement, which expired on March 3, 2016. Mr. Bass tendered an additional $50,000 to be applied to the purchase price if the option were exercised. According to Mr. Bass' declaration in support of his opposition to the motion to sell, he gave notice on April 1, 2016, that he was exercising the option agreement. He asserted that this notice was timely based on a First Amendment to Option Agreement attached to his declaration, which extended the deadline for exercising the option to April 4, 2016 and appears to be signed by Debtor. But in Debtor's second declaration in support of pending motions, she stated that Mr. Bass came to her assisted living facility on March 3, 2016, the day the option agreement expired, and asked her to sign papers, but she did not understand what she may have signed, and she believed Mr. Bass misled her into "signing something."[5]

OBC and Debtor did not perform under the option agreement, and, in May 2016, Mr. Bass sued OBC, Debtor, and Mr. Olson in El Dorado County Superior Court for damages and specific performance.

The Shopping Center Property was encumbered by a deed of trust in favor of U.S. Bank, N.A. In August 2016 U.S. Bank recorded a notice of default, and in December 2016 it recorded a notice of sale. The foreclosure sale was set for February 1, 2017.

On January 30, 2017, Debtor filed a chapter 13 petition, which stayed both the foreclosure and the Bass litigation. That same day, she filed a quitclaim deed transferring OBC's interest in the Shopping Center Property to herself individually. Mr. Bass continued to pay rent postpetition to Debtor or her counsel.

***3** About a month after the bankruptcy filing, the bankruptcy court approved a stipulation between Debtor and U.S. Bank for the use of cash collateral for Debtor's ordinary operating expenses and maintenance of the Shopping Center Property as well as assisted living expenses and health insurance, through April 2017. In exchange, Debtor granted U.S. Bank a postpetition replacement lien on all rents generated from the Shopping Center Property and agreed to make adequate protection payments of $4,000 per month. According to the stipulation, at that time expected rental income was $16,220 per month, including TWC's monthly rental payment of $10,200. In early May 2017, the court approved another cash collateral stipulation extending the agreement to use cash collateral through July 31, 2017 and modifying the budget to exclude the rent from TWC. There is no evidence in the record to indicate whether the postpetition rents paid by Mr. Bass were used to make payments pursuant to the initial cash collateral stipulation; other than Debtor's counsel's oral representation that the May 2017 rent payment was being held in a safe in his office, the record does not show what happened to those funds at all.

Debtor's proposed chapter 13 plan called for monthly payments of $150 for 12 months and $2,100 for 48 months. The plan also provided that Debtor would sell the Shopping Center Property within six months of plan confirmation and use the net proceeds to pay all administrative, priority, and unsecured claims.

In April 2017, Debtor filed a motion to sell free and clear under § 363(f) the Shopping Center Property and the adjacent property, which she also owned, for $3 million. Among the conditions of the sale of the Shopping Center Property were (i) court approval of the rejection or termination of Mr. Bass' lease and the commencement of eviction proceedings by Debtor; and (ii) court-ordered rejection, termination, or voiding of the option agreement with Mr. Bass. Debtor also filed a motion to reject the lease and the option agreement with Mr. Bass.[6] In her declaration in support of the motion to reject, Debtor stated that she had entered into the lease with Mr. Bass in January 2013 and that Mr. Bass "currently operates a medical marijuana dispensary at 3443 Lake Tahoe Blvd[.]" In a subsequent declaration filed May 11, 2017, Debtor further testified:

> 1. am 92–years [sic] old and legally blind. I live in an assisted living facility in Sparks, Nevada.
>
> ....
>
> 9. t times prior to the filing of this case, my son, Patrick Olson, acted and served as my attorney-in-fact. In doing so, Patrick managed most of my financial affairs, which included the management of 949 Bal Bijou Road and 3443 Lake Tahoe Blvd. Patrick's duties included obtaining leases for the properties, collecting rents and paying all expenses, such as the secured mortgage payment to U.S. Bank, real property taxes and insurance premiums.
>
> 10. n 2012, Patrick Olson, through Olson Bijou Center L.P., leased space at 3443 Lake Tahoe Blvd. to Cody

Bass.

....

15. wish to end any involvement with Mr. Bass and his illegal business. I do not want to use money from Mr. Bass to fund my Chapter 13 Plan. I don't want to sell my property to Mr. Bass and do not want to finance his purchase of 3343 Lake Tahoe Blvd. I wish only to terminate any dealings with Mr. Bass and to sell my property and pay my creditors in full.

Mr. Bass opposed both motions. In his declaration in support of his opposition to the motion to sell, Mr. Bass confirmed that he had been operating a marijuana dispensary on the premises pursuant to the terms of his lease with OBC and that he had paid rent to the Debtor postpetition.

Shortly thereafter, the chapter 13 trustee filed a motion to dismiss for failure to make plan payments and for failure to file an amended plan. Mr. Bass also filed a motion to dismiss the case on grounds that Debtor's acceptance of rents from his marijuana dispensary violated the CSA. Neither of those motions were heard because they were mooted by the bankruptcy court's sua sponte dismissal of Debtor's case.

***4** At the initial hearing on the motion to sell and motion to reject, the bankruptcy court questioned whether it could authorize the sale, given that the Debtor had been accepting rents from leasing a marijuana dispensary; the parties argued the issue, and the court continued the matter for a few days to study the relevant authorities. At the continued hearing, the court heard additional argument but concluded, based on its interpretation of relevant case law, that because Debtor had continued to receive rent postpetition, the case had to be dismissed:

> I think it's a crime for Ms. Olson to be accepting rents from an illegal operation, so I am dismissing this case .... My finding is this debtor is leasing property for an unlawful purpose under federal law, although lawful under state law ... and has continued to accept rents during the course of her bankruptcy.

Hr'g Tr. (May 22, 2017) at 6:4–5; 22–25. In response to a request for clarification from Debtor's counsel, the court explained:

> [I]f the debtor has committed a crime during the course of the bankruptcy and continued for several months to commit a crime during the course of the bankruptcy, I think that is a basis for not providing relief to the debtor. Had the debtor, prior to filing bankruptcy or not during the bankruptcy had not committed the crime of taking money from a marijuana operation, I would feel differently. But that's not what happened here. Because you don't, in my opinion, get to go through five or six months of a bankruptcy knowingly receiving illegal proceeds and then say, oh, I'm not going to take those anymore, I want to sell the property now, so I get to play here. I don't think that's correct.

Id. at 7:17–8:3. The bankruptcy court entered its sua sponte order dismissing the case on May 31, 2017; the court also granted a stay pending appeal. Debtor timely appealed.

JURISDICTION

The bankruptcy court had jurisdiction pursuant to 28 U.S.C. §§ 1334 and 157(b)(2)(A). We have jurisdiction under 28 U.S.C. § 158.

ISSUE

Whether the bankruptcy court abused its discretion in dismissing Debtor's chapter 13 case.

STANDARD OF REVIEW

We review a bankruptcy court's dismissal of a chapter 13 case for abuse of discretion. Ellsworth v. Lifescape Med. Assoc., P.C. (In re Ellsworth), 455 B.R. 904, 914 (9th Cir. BAP 2011). A bankruptcy court abuses its discretion if it applies the wrong legal standard, misapplies the correct legal standard, or if its factual findings are clearly erroneous. TrafficSchool.com, Inc. v. Edriver Inc., 653 F.3d 820, 832 (9th Cir. 2011).

DISCUSSION

Ordinarily, a bankruptcy court grants or denies relief based on a specific provision in the Code. Here, the bankruptcy court did not specify what Code section or other authority it relied upon in dismissing Debtor's case. The court concluded, apparently based on case law from other jurisdictions, that Debtor's postpetition receipt of rental payments from a tenant that operated a marijuana dispensary on property she owned was (i) a violation of the CSA that (ii) constituted grounds for dismissal of the case. The legal basis for dismissal could have been bad faith under § 1307(c), but the bankruptcy court made no bad faith finding and did not engage in the totality of the circumstances analysis required for dismissal under that Code section.

Alternatively, the bankruptcy court may have been acting pursuant to its inherent power to "issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title." § 105(a). But, if acting pursuant to its inherent powers, the court could act only "within the confines of the Bankruptcy Code." Law v. Seigel, 134 S.Ct. 1188, 1194–95 (2014) (citations omitted). And where a statute adequately addresses the conduct at issue, the court's inherent powers should be invoked only when that statute does not fully address the situation at hand. See Chambers v. NASCO, Inc., 501 U.S. 32, 50 (1991) ("[I]f in the informed discretion of the court, neither the statute nor the Rules are up to the task, the court may safely rely on its inherent power [in imposing a sanction for bad faith litigation conduct].").

***5** But the bankruptcy court did not articulate the legal basis for its ruling or make findings to support its conclusions that the CSA was being violated and that that violation was grounds for dismissal. When a court imposes the harsh penalty of dismissal in circumstances such as those presented here, it is imperative that it state with clarity and precision its factual and legal bases for doing so.

The standard for dismissal of a chapter 13 case is set forth in § 1307(c). That section provides that on request of a party in interest and after notice and a hearing, the bankruptcy court may convert a chapter 13 case to chapter 7, or may dismiss a case, whichever is in the best interests of creditors and the estate, for "cause." § 1307(c).[7] Section 1307(c) sets forth a non-exclusive list of factors that constitute "cause" for conversion or dismissal.[8] In dealing with questions of conversion and dismissal, the bankruptcy court engages in a two-step process: "First, it must be determined that there is 'cause' to act. Second, once a determination of 'cause' has been made, a choice must be made between conversion and dismissal based on the 'best interests of the creditors and the estate.' Nelson v. Meyer (In re Nelson), 343 B.R. 671, 675 (9th Cir. BAP 2006).

Although not listed, bad faith is cause for dismissal. Leavitt v. Soto (In re Leavitt), 171 F.3d 1219, 1224 (9th Cir. 1999). In determining bad faith, the bankruptcy court is to apply a totality of the circumstances analysis, considering (1) whether the debtor misrepresented facts in her petition or plan, unfairly manipulated the Bankruptcy Code, or otherwise filed her chapter 13 petition or plan in an inequitable manner; (2) the debtor's history of filings and dismissals; (3) whether the debtor only intended to defeat state court litigation; and (4) whether egregious behavior is present. Id.

On appeal, Debtor assumes the bankruptcy court dismissed her case on grounds of bad faith by arguing that the bankruptcy court abused its discretion in not considering the totality of the circumstances, especially the fact that Debtor was using the bankruptcy to sever her ties with Mr. Bass' business. But the bankruptcy court did not invoke § 1307(c), nor did it explicitly find bad faith.

The bankruptcy court stated that it had "looked at the cases," but did not articulate any rules drawn from those cases that applied to the facts before it. The case law addressing facts such as those presented here is sparse, and there is no controlling authority in the Ninth Circuit.

***6** Some courts have held that, to the extent estate assets are used for or generated by the operation of a federally prohibited marijuana business, a trustee or debtor in possession may not administer those assets without violating federal law. Arenas v. U.S. Tr. (In re Arenas), 535 B.R. 845, 852 (10th Cir. BAP 2015); In re Medpoint Mgmt., LLC, 528 B.R. 178, 184–85 (Bankr. D. Ariz. 2015), vacated in part, Medpoint Mgmt., LLC v. Jensen (In re Medpoint Mgmt., LLC), BAP No. AZ–15–1130–KuJaJu, 2016 WL 3251581 (9th Cir. BAP Jun. 3, 2016); In re Johnson, 532 B.R. 53, 56–57 (Bankr. W.D. Mich. 2015);[9] In re Rent–Rite Super Kegs W., Ltd., 484 B.R. 799, 810 (Bankr. D. Colo. 2012). The bankruptcy court here made no finding, however, that the trustee would be administering the proceeds of an illegal business, and there is no evidence in the record that the rents were to be used to fund the plan.

Some courts have held that a bankruptcy filing or a plan of reorganization proposed by a debtor who is involved in an illegal enterprise is not in good faith, even where the debtor does not have a subjective bad motive, is in legitimate need of bankruptcy relief, and there is otherwise no indicia of an attempt to abuse the bankruptcy process. In re Arenas, 535 B.R. at 852–53; In re Rent–Rite Super Kegs W., Ltd., 484 B.R. at 809. Related to the good faith analysis, some courts have concluded that a debtor engaged in an illegal business who seeks bankruptcy relief comes into court with unclean hands and is not eligible for relief. In re Rent–Rite Super Kegs W., Ltd., 484 B.R. at 807; cf. In re Medpoint Mgmt., LLC, 528 B.R. at 186–87 (petitioning creditors who knew the putative debtor was engaged in a federally prohibited medical marijuana business had unclean hands and could not seek relief from the bankruptcy court).

The bankruptcy court here made no finding of bad faith or unclean hands. Further, it concluded that it was a crime for Debtor to be accepting rents from Mr. Bass' business without making any findings showing that all the elements of a CSA violation had been established (such as the requirement that the conduct be "knowing").

The foregoing cases suggest possible reasons for the court's decision, but without specific findings and conclusions, we cannot determine whether or how the court found those cases applicable to the facts of this case, nor can we adequately evaluate the propriety of the bankruptcy court's ruling.

Accordingly, on remand, the bankruptcy court should articulate the findings that led it to determine that Debtor was violating the CSA and what legal standard it relied upon in dismissing the case.

CONCLUSION

For the reasons set forth above, we VACATE and REMAND.

TIGHE, Bankruptcy Judge, CONCURRING.

I concur in the memorandum and write separately to emphasize (1) the importance of evaluating whether the Debtor is actually violating the Controlled Substances Act and (2) the need for the bankruptcy court to explain its conclusion that dismissal was mandatory under these circumstances. With over twenty-five states allowing the medical or recreational use of marijuana, courts increasingly need to address the needs of litigants who are in compliance with state law while not excusing activity that violates federal law. A finding explaining how a debtor violates federal law or otherwise provides cause for dismissal is important to avoid incorrectly deeming a debtor a criminal and denying both debtor and creditors the benefit of the bankruptcy laws.

***7** As the memorandum details, there are a number of situations where the federal prohibition on marijuana distribution prevented debtors from reorganizing or liquidating under federal bankruptcy laws. Typically, these were cases where the debtor sought to continue to distribute marijuana postpetition or where a trustee would be asked to accept proceeds of a drug-related business, situations where federal law would clearly be violated. See, e.g., In re Arenas, 535 B.R. 845 (debtors themselves grew and sold marijuana); In re Rent–Rite Super Kegs W., Ltd., 484 B.R. 799 (debtor's ongoing postpetition leases with marijuana-growing tenant exposed debtor to criminal liability and primary asset to forfeiture).

This Debtor's plan did not necessarily require the rental income from the dispensary to fund the proposed payments. It provided for minimal plan payments until a sale motion could be filed and the Debtor's real property sold. The sale of Debtor's real property would have been simply a liquidation of legal estate assets. In fact, but for the marijuana-related proceeds, the sale of real property to fund a plan is a common scenario because of the ability in bankruptcy to sell property subject to a bona fide dispute free and clear of a lien. See § 363(f)(4).

If, on remand, the basis for dismissal is the court's concern that Debtor committed a crime by receiving postpetition rent derived from a marijuana business, an explicit finding of the facts required for criminal liability is needed. Section 856(a)(2) of Title 21 prohibits a person with a premises from knowingly and intentionally allowing its use for the purpose of distributing drugs. United States v. Tamez, 941 F.2d 770, 774 (9th Cir. 1991). A violation of section 856(a) also requires a showing that a primary or principal use of the premises is for drug distribution or manufacture. See United States v. Mancuso, 718 F.3d 780, 794–96 (9th Cir. 2013). Any prosecution of this crime would require a showing that Debtor knew that Mr. Bass leased the property to operate a marijuana dispensary, and that she intended to allow that use.

The Debtor's personal knowledge is an especially critical inquiry for an elderly, blind woman residing in assisted living with an attorney-in-fact in charge of the lease. Although Debtor stated in her second declaration in support of the motion to reject the lease that Bass was operating a medical marijuana dispensary, the record does not indicate when Debtor became aware of this. She stated in that declaration that she did not want to be involved in leasing to a marijuana business.

Any prosecution of 21 U.S.C. § 856(a)(2) would need to prove beyond a reasonable doubt that Debtor herself "knowingly and intentionally" leased the property where the marijuana is distributed. See Elonis v. United States, 135 S.Ct. 2001, 2009 (2015) (general rule is that a guilty mind is a necessary element in the proof of every crime); Morissette v. United States, 342 U.S. 246, 252 (1952) ("wrongdoing must be conscious to be criminal"). Debtor's son's knowledge in acting for her cannot be imputed to Debtor for purposes of showing criminal knowledge and intent. Nor can Mr. Bass' intent and knowledge be imputed to the Debtor.

Bankruptcy courts have historically played a role in providing for orderly liquidation of assets, equal payment to creditors, and resolution of disputes that otherwise would take many years to resolve. Although debtors connected to marijuana distribution cannot expect to violate federal law in their bankruptcy case, the presence of marijuana near the case should not cause mandatory dismissal.[1] I believe this focus on specific federal violations along with the further analysis required by the lead memorandum properly address the challenge of a marijuana related case.

All Citations

Slip Copy, 2018 WL 989263

Footnotes

* Hon. Maureen A. Tighe, U.S. Bankruptcy Judge for the Central District of California, sitting by designation.

** This disposition is not appropriate for publication. Although it may be cited for whatever persuasive value it may have (see Fed. R. App. P. 32.1), it has no precedential value. See 9th Cir. BAP Rule 8024–1.

1 Unless specified otherwise, all chapter and section references are to the Bankruptcy Code, 11 U.S.C. §§ 101–1532.

2 The parties did not include all relevant documents in their excerpts of record. We have thus exercised our discretion to review relevant imaged documents from the bankruptcy court's electronic docket. See O'Rourke v. Seaboard Sur. Co. (In re E.R. Fegert, Inc.), 887 F.2d 955, 957–58 (9th Cir. 1989); Atwood v. Chase Manhattan Mortg. Co. (In re Atwood), 293 B.R. 227, 233 n.9 (9th Cir. BAP 2003).

3 In Debtor's declaration in support of the motion to reject lease, she stated that she believed the lease "agreements" were taken from her residence by government law enforcement authorities in May 2015. In Debtor's second declaration in support of the motions to sell and to reject, she stated, "[t]here is no signed lease agreement between Mr. Bass and me."

4 The lease also required Mr. Bass to "comply with all statutes, codes, ordinances, orders, rules and regulations of any Federal, California, municipal or other governmental or quasi-governmental entity ...."

5 We include these "facts" merely to provide some context for the proceedings before the bankruptcy court, and for no other purpose. And we should be particularly circumspect in this instance, in which we remand after determining that the bankruptcy court neither articulated the legal basis for its decision sua sponte to dismiss this case, nor identified with precision the facts which it must have determined, or upon which it might have relied, under any cognizable theory, in dismissing the case. Accordingly, we neither make any determination concerning what appear to be disputed facts, nor "weigh" any such facts, nor determine credibility, nor even, indeed, opine regarding what facts might be

relevant under the as-yet-undetermined legal standard to be applied by the bankruptcy court on remand.

6 The City of South Lake Tahoe (the "City") filed a joinder in the motion to reject on the ground that Mr. Bass' permit to operate the dispensary had expired and had not been renewed because the Debtor had not provided her written consent.

7 Although that statute requires a request by a party in interest or the United States trustee, the bankruptcy court may dismiss or convert a case sua sponte under § 105(a). Tennant v. Rojas (In re Tennant), 318 B.R. 860, 868–70 (9th Cir. BAP 2004). Additionally, despite § 1307's requirement of notice and a hearing, due process is satisfied if the impacted party has had an opportunity to be heard. See id. at 870 (noting that the concept of notice and a hearing is flexible and depends on what is appropriate in the circumstances). Debtor does not argue that her due process rights were violated, nor does she dispute that the court had the authority to sua sponte dismiss the case.

8 Those enumerated factors include: unreasonable delay by the debtor that is prejudicial to creditors; failure to commence making timely payments; denial of confirmation of a plan; and material default by the debtor with respect to a term of a confirmed plan.

9 In In re Johnson, the bankruptcy court acknowledged the problems created when a debtor who operates a marijuana business that is legal under state law seeks bankruptcy relief, noting that continued operation of the marijuana business would result in the court and the trustee tacitly supporting the debtor's criminal enterprise. 532 B.R. at 56–57. Nevertheless, the court ruled that it would permit the debtor to remain in chapter 13 on the condition that he stop engaging in the marijuana business. Id. at 58. The bankruptcy court here explicitly disagreed with this approach.

1 Cf. Northbay Wellness Grp., Inc. v. Beyries, 789 F.3d 956, 960–61 (9th Cir. 2015) (bankruptcy court abused its discretion by failing to conduct the balancing test required by doctrine of unclean hands, and instead determining that unclean hands applied solely because the creditor had engaged in marijuana distribution).

End of Document

KeyCite Red Flag - Severe Negative Treatment
Vacated in Part by In re Medpoint Management, LLC, 9th Cir.BAP (Ariz.), June 3, 2016

528 B.R. 178
United States Bankruptcy Court, D. Arizona.

IN RE MEDPOINT MANAGEMENT, LLC, an Arizona limited liability company, Purported Debtor.

Case No: 2:14–bk–15234–DPC
|
Signed April 6, 2015

Synopsis
Background: Putative debtor, a limited liability company (LLC) involved in medical marijuana business, moved to dismiss the involuntary Chapter 7 petition filed against it and for award of damages against petitioning creditors based on their alleged bad faith.

Holdings: The Bankruptcy Court, Daniel P. Collins, Chief Judge, held that:

[1] on novel issue in the district, "cause" existed to dismiss involuntary Chapter 7 petition filed against bankrupt LLC whose only assets were marijuana-related assets;

[2] creditors were barred by "unclean hands" doctrine from seeking relief in federal bankruptcy court by filing involuntary Chapter 7 petition against LLC that they knew from start of debtor-creditor relationship was in medical marijuana business; but

[3] petitioning creditors did not act in bad faith in filing an involuntary Chapter 7 petition against a debtor on account of debts relating to state-licensed medical marijuana operations.

Motion granted in part and denied in part.

West Headnotes (9)

[1] **Bankruptcy**
Involuntary Cases

"Cause" existed to dismiss involuntary Chapter 7 petition filed against bankrupt limited liability company (LLC) whose only assets were marijuana-related assets, such as name and trademark that LLC licensed to another entity for use in sale of medical marijuana products, given that all of the LLC's assets were potentially subject to forfeiture under federal law, and that Chapter 7 trustee, if one were appointed, would necessarily have to violate federal narcotics law in carrying out his or her duties under the Bankruptcy Code. 11 U.S.C.A. § 707(a).

4 Cases that cite this headnote

[2] **Bankruptcy**
Power and Authority

Bankruptcy court is court of equity.

1 Cases that cite this headnote

[3] **Equity**
Conduct with respect to different transactions

Conduct supporting "unclean hands" defense must be immediately related to the cause in controversy.

Cases that cite this headnote

[4] **Equity**
He Who Comes into Equity Must Come with Clean Hands

Under "unclean hands" doctrine, federal court should not, in an ordinary case, lend its judicial power to plaintiff who seeks to invoke that power for purpose of consummating a transaction in clear violation of the law.

Cases that cite this headnote

[5] **Equity**
He Who Comes into Equity Must Come with Clean Hands

Under "unclean hands" doctrine, one who does not come into equity with clean hands, and keep them clean, must be denied all relief, whatever may have been the merits of his claim.

Cases that cite this headnote

[6] **Equity**
Nature of unconscionable conduct

Having voluntarily chosen to enter into consulting relationships with limited liability company (LLC) that they knew was in medical marijuana business, or to build cultivation facility on LLC's behalf, despite the problems posed by illegality of the LLC's operations under federal law, in order to earn lucrative consulting and other fees, creditors were barred by "unclean hands" doctrine from later seeking relief in federal bankruptcy court by filing involuntary Chapter 7 petition against LLC when LLC failed to pay creditors for their services.

2 Cases that cite this headnote

[7] **Bankruptcy**
Frivolity or bad faith; sanctions

Court determines whether involuntary bankruptcy petition was filed in bad faith, so as to support award of compensatory or punitive damages against petitioning creditors, by considering the totality of the circumstances and evaluating the facts against what reasonable person would have done or believed. 11 U.S.C.A. § 303(i)(2).

Cases that cite this headnote

[8] **Bankruptcy**
Frivolity or bad faith; sanctions

Petitioning creditors did not act in bad faith in filing an involuntary Chapter 7 petition against a debtor on account of debts relating to state-licensed medical marijuana operations; viability of such a petition was novel question under law of the judicial district, and petitioning creditors' conduct was not such as to support award of damages against them. 11 U.S.C.A. § 303(i)(2).

1 Cases that cite this headnote

[9] **Bankruptcy**
Frivolity or bad faith; sanctions

Not every failed reason for filing an involuntary bankruptcy petition amounts to bad faith. 11 U.S.C.A. § 303(i)(2).

Cases that cite this headnote

Attorneys and Law Firms

***180** Jonathan B. Frutkin, Carolyn R. Tatkin, The Frutkin Law Firm, PLC, Scottsdale, AZ, for Purported Debtor.

ORDER GRANTING MEDPOINT MANAGEMENT'S MOTION TO DISMISS

DANIEL P. COLLINS, CHIEF UNITED STATES BANKRUPTCY JUDGE

Mike Danzer, 7511 IRA Investments, LLC, Jason Jensen, and Robert Brown (collectively "Petitioning Creditors") filed an involuntary chapter 7 petition ("Petition") against Medpoint Management, LLC ("Medpoint") on October 7, 2014 (DE 1).[1] Medpoint filed a Motion to Dismiss or for Abstention ("Motion") on December 31, 2014, and requested a hearing on damages (DE 34). Petitioning Creditors responded on January 14, 2015 (DE 37) ("Response"), and Medpoint replied ("Reply") (DE 42). The Court heard oral argument on the Motion on January 29, 2015 (DE 45). At the hearing, the Court requested additional briefing on the potential forfeitability of Medpoint's assets under the Controlled Substance Act ("CSA").[2] Petitioning Creditors filed their Supplemental Opposition ("Opposition") (DE 48), and Medpoint filed its Legal Memorandum ("Memorandum") (DE 47) on February 17, 2015. The parties filed simultaneous responses on February 24, 2015. The Court heard oral argument on the supplemental pleadings on March 4, 2015 (DE 52), after which it took the Motion under advisement. The Court now grants the Motion in part and dismisses the Petition.[3]

Background

1. ANW's Relationship with Medpoint

Arizona Nature's Wellness ("ANW") is an Arizona nonprofit entity which holds an Arizona Department of Health Services-issued Dispensary Certificate ("Certificate"). The Certificate allows ANW to operate the "Bloom"-branded medical marijuana dispensary ("Dispensary") under the Arizona Medical Marijuana Act ("AMMA"), codified in A.R.S. §§ 36–2801–2819. AMMA requires that all state-registered dispensaries "be operated on a not-for-profit basis," and that dispensaries' bylaws "contain such provisions relative to the disposition of revenues and receipts to establish and maintain [their] nonprofit character." A.R.S. § 36–2806(A). This requirement has resulted in a proliferation of dispensary-management entities which serve as repositories of dispensary revenues, while dispensaries maintain their nonprofit nature.

Medpoint is (or was) such an entity. Medpoint is an Arizona limited liability company with two members, Ask Nice Twice, LLC ("ANT"), and Here Is Now, LLC ("HIN"). ANT is the manager of Medpoint. Yuri Downing ("Downing") is the 100% owner of both ANT and HIN, and is Medpoint's statutory agent.

Medpoint formerly managed ANW's marijuana business, business relationships ***181** and cultivation operations. Medpoint first came into contact with ANW when Medpoint purchased a 100% membership interest in Tier Management, LLC ("Tier") from Petitioning Creditor Mike Danzer ("Danzer") on January 3, 2013 ("Danzer Sale Agreement"). *See* Motion at Ex. G: Danzer Sale Agreement (DE 34–7). Medpoint acquired Danzer's Tier interest because on January 2, 2013, Tier had entered into a Cultivation and Dispensary Services Agreement with ANW ("Tier Service Agreement"). *See* Motion at Ex. A: Tier Service Agreement (DE 34–1). Medpoint purchased the Tier interest in order to acquire the Tier Service Agreement. *See* Response at Ex. A: Downing Depo., at 27:25–29:17 (DE 37). ANW needed a management entity to partner with because, for example, ANW had no employees.[4]

Under the terms of the Danzer Sale Agreement, Tier, now controlled by Medpoint, continued servicing ANW under the terms of the Tier Service Agreement. *See* Motion at Ex. G: Danzer Sale Agreement, at ¶¶ 2.1.13, 2.1.15 (DE 34–7). Medpoint, through Tier, continued servicing ANW under the Tier Service Agreement until December 11, 2013, when Medpoint signed a separate Cultivation and Dispensary Services Agreement ("Medpoint Service Agreement") with ANW. The Medpoint Service Agreement superseded the Tier Service Agreement. *See* Opposition at Ex. A: Medpoint Service Agreement, at ¶ 29 (DE 48). ANW terminated the Medpoint Service Agreement on May 27, 2014, alleging dissatisfaction with Medpoint's performance under the Medpoint Service Agreement. This is somewhat puzzling, because ANW was a captive entity under the terms of the Medpoint Service Agreement, which Agreement allowed Medpoint to appoint ANW's board. Reply at 3:16–20 (DE 42).[5] Medpoint is not currently performing any management services for ANW or any other entity. Motion at ¶ 15 (DE 34). ANW now contracts for dispensary and cultivation management services with Bloom Master Fund I, LLC ("BMF").[6] Response at Ex. A: Downing Depo., at 57:22–25 (DE 37).[7]

2. Medpoint's Current Assets and Ties to Other Entities

Medpoint owns the "Bloom" name and trademark ("IP") under which ANW sells its marijuana products. *See*

Motion at Ex. B: Trade Name Registration (DE 34–2). Medpoint currently licenses the IP to Bloom IP Industries, LLC ("Bloom Industries") for $8,000 per month. *See* Motion at Ex. J: IP Licensing Agreement (DE 34–10).[8] This is Medpoint's only current source of revenue.

In addition to the IP and the revenue it generates, Medpoint's other assets include: (1) its 100% membership interest in Tier; and (2) its causes of action relating to ***182** ANW's alleged wrongful termination of the Medpoint Service Agreement.[9]

3. Petitioning Creditors' Claims against Medpoint

The Petitioning Creditors consist of Danzer, 7511 IRA Investments, LLC ("7511"), Jason Jensen ("Jensen"), and Robert Brown ("Brown").

Danzer's claims against Medpoint arose from the Danzer Sale Agreement, by which Medpoint bought Danzer's 100% interest in Tier. Under the terms of the Danzer Sale Agreement, Medpoint paid Danzer $150,000 down, and signed a promissory note for two more payments of $150,000 each. *See* Motion at Ex. G: Danzer Sale Agreement (DE 34–7). Medpoint defaulted on the Danzer Sale Agreement. *See* Response at Ex. A: Downing Depo., at 45:25–46:2 (DE 37). Danzer also entered into a Consulting Agreement with Medpoint on January 3, 2013, whereby he would provide services relating to managing construction of a marijuana cultivation facility. *See* Motion at Ex. F: Danzer Consulting Agreement (DE 34–6). Medpoint never paid Danzer any of the $5,000 monthly fees due under the Consulting Agreement. Response at Ex. A: Downing Depo., at 47:9–48:6 (DE 37).

Jensen also signed a Consulting Agreement with Medpoint on January 3, 2013, whereby he would provide project management services relating to the grow house construction. *See* Motion at Ex. E: Jensen Consulting Agreement (DE 34–5). Medpoint never paid Jensen's monthly fees under the Consulting Agreement. Response at Ex. A: Downing Depo., at 50:20–51:3 (DE 37). The Consulting Agreement attached to the Motion does not reference medical marijuana, but the Court does not doubt that Jensen was aware of the nature of Medpoint's business.

On August 27, 2013, Robert Brown loaned Medpoint $100,000 ("Brown Loan"). *See* Motion at Ex. D: Brown Loan (DE 34–4). Medpoint has not repaid the Brown Loan. Response at Ex. A: Downing Depo., at 55:18–20 (DE 37). The first recital of the Brown Loan acknowledges that Medpoint is in the medical marijuana business.

On September 9, 2013, 7511 loaned Medpoint $400,000 ("7511 Loan"). *See* Motion at Ex. C: 7511 Loan (DE 34–3). Medpoint defaulted on the 7511 Loan. 7511 claims Medpoint owes it $400,000. The first recital of the 7511 Loan acknowledges that Medpoint is in the medical marijuana business.

Issue

The issue before this Court is whether it can or should enter an involuntary order for relief against Medpoint despite the fact that Medpoint's current and former business affairs are illegal under applicable federal criminal statutes. This question appears to be a matter of first impression in the District of Arizona. The Court finds that cause exists under section 707(a) to dismiss the Petition.[10]

Medpoint's Arguments

Medpoint argues that a bankruptcy trustee cannot lawfully administer a bankruptcy ***183** estate's marijuana-related assets without violating the CSA. *In re Arenas,* 514 B.R. 887, 891–892 (Bankr.D.Colo.2014) ("For the Trustee to take possession and control of the Debtors' Property and marijuana inventory would directly involve him in the commission of federal crimes."). In *Arenas,* the court held that the inevitable illegality of the trustee's administration of illegal estate assets constituted cause to dismiss under section 707(a). *Id.* Alternatively, Medpoint cites *Northbay* for the proposition that the Court must dismiss this case because Petitioning Creditors' hands are unclean due to their involvement in a medical marijuana enterprise. *Northbay Wellness Grp. v. Beyries,* 2012 WL 4120409, at *4 (N.D.Cal. Sept. 18, 2012) (affirming that unclean hands doctrine prevented bankruptcy court from granting relief to plaintiff medical marijuana business seeking a nondischargability determination, because it was engaged in activity which was illegal under federal law).

Lastly, Medpoint argues that the Court could alternatively suspend all proceedings under section 305(a). Medpoint argues that the conflict between state and federal law makes the bankruptcy court "the most inefficient and troublesome" forum. Motion at 13:11. Medpoint notes that Petitioning Creditors' claims are grounded in state law. *Id.* at 13:18.

Petitioning Creditors' Arguments

Petitioning Creditors deny that Medpoint is currently engaged in any illegal activity and deny that either the IP or the IP licensing revenues are forfeitable under the CSA. Petitioning Creditors distinguish Medpoint from the marijuana-related parties in the cases Medpoint cites, noting that those cases involved operating dispensaries or growers. Response at 4–6. Petitioning Creditors deny they have unclean hands, arguing that nothing in the record or Motion indicates that their claims "are in any way related to the actual proceeds of the sale of marijuana or ongoing illegal activity." *Id.* at 6:19–20. Petitioning Creditors deny that Medpoint used their funds to purchase marijuana or any other illegal substance. *Id.* at 6:23–24. Petitioning Creditors observe that Medpoint "applied for and received a Federal Tax ID number," and that Medpoint banked at Wells Fargo, an FDIC-insured bank. *Id.* at 7:8–11. As to Medpoint's section 305(a) argument, Petitioning Creditors urge that suspending all proceedings would not be in the best interests of creditors, citing the BAP's decision of *In re Eastman,* 188 B.R. 621, 624–625 (9th Cir. BAP 1995) (under section 305(a), "the test is whether both the debtor and the creditors would be 'better served' by a dismissal.").

Lastly, Petitioning Creditors argue that even though medical marijuana may be technically illegal, with the passage of the Consolidated and Further Continuing Appropriations Act ("Cromnibus Act"), there can be no federal enforcement actions against Arizona medical marijuana businesses. The Cromnibus Act is significant because it provides funding for the entire federal government through September 30, 2015. Section 538 of the Cromnibus Act states: "None of the funds made available in this Act to the Department of Justice may be used, with respect to the state[ ] of ... Arizona ... to prevent [Arizona] from implementing [its] own [law] that authorize[s] the use, distribution, possession, or cultivation of medical marijuana." Cromnibus Act, Pub.L. 113–235, § 538 (2014).

The United States' Trustee's Position

At the January 29 hearing on the Motion, counsel for the United States Trustee ("UST") expressed concern and skepticism regarding a trustee's ability to administer a bankruptcy estate for Medpoint. ECRO audio file of Jan. 29, 2014 hearing (DE 46). Posing a hypothetical to the Court, she ***184** asked: "So, you're going to ask a trustee to look at a management contract for illegal activities, essentially. So what is that trustee going to do?" Counsel for the UST was not convinced that Medpoint had any legal, non-marijuana assets that a trustee could lawfully administer. Id. Medpoint affirms that all of its assets are marijuana-related. Memorandum at 4–6 (DE 47).

Analysis

The Court analyzes three general arguments in reaching its decision on the Motion: (1) whether there is cause to dismiss the Petition; (2) whether Petitioning Creditors have unclean hands, and if they do, whether this Court can or should enter an order for relief; and (3) whether Petitioning Creditors acted in bad faith in filing the Petition.

1. Cause to Dismiss under Section 707(a)

[1]Under section 707(a), the Court may dismiss a chapter 7 case for cause after notice and a hearing. In *Arenas,* the bankruptcy court found cause to dismiss the debtor's case because the debtor's assets included marijuana and marijuana-related assets. *In re Arenas,* 514 B.R. 887, 892 (Bankr.D.Colo.2014) ("The impossibility of lawfully administering the Debtors' bankruptcy estate under chapter 7 constitutes cause for dismissal of the Debtors' case under 11 U.S.C. § 707(a)."). The *Arenas* court held that "Debtors' chapter 7 trustee ... [could not] take control of the Debtors' Property without himself violating § 856(a)(2) of the CSA," nor "liquidate the inventory of marijuana plants Mr. Arenas possessed on the Petition Date" without violating § 841(a) of the CSA. *Id.* at 891. Because the trustee was unable to perform his duties, the court found the bankruptcy case was futile.

In *Vel Rey,* the chapter 7 trustee wanted to operate the debtor's property to increase its sale value. *In re Vel Rey Properties, Inc.,* 174 B.R. 859 (Bankr.D.D.C.1994). The trustee asked the bankruptcy court for immunity from liability for any noncompliance with D.C.'s housing regulations while he readied the property for sale. *Id.* at 863. The court denied the trustee's request, noting that if either the trustee or the United States Trustee refused to serve for "concern[ ] about personal liability ... the court could simply dismiss the case for cause under § 707." *Id.* at 866 (citing *Ohio v. Commercial Oil Serv. Corp., Inc.,* 58 B.R. 311 (Bankr.N.D.Ohio 1986)).

In another District of Colorado bankruptcy case, the debtor-in-possession was a landlord who received approximately 25% of its revenue from a marijuana entity. *In re Rent–Rite Super Kegs W. Ltd.,* 484 B.R. 799, 802–803 (Bankr.D.Colo.2012). The bankruptcy court found that renting to the marijuana entity exposed debtor to criminal liability and forfeiture of the real property. *Id.* at 809. Because of the risks associated with the marijuana tenant, the bankruptcy court held that the debtor's continuing lease with the marijuana entity constituted "gross mismanagement of the estate" and was cause to dismiss under section 1112(b)(4)(B). *Id.* The Court is strongly persuaded by the reasoning in this line of cases.

The Court is also persuaded by the UST's argument that the appointment of a chapter 7 trustee would place that trustee in an untenable position. A trustee would have good reason to worry about his/her risk exposure relating to the administration of a marijuana-related entity's estate:

> Where the Bankruptcy Code has conferred special powers upon the trustee and where there was no common-law limitation on that power, Congress has ***185** expressly provided that the efforts of the trustee to marshal and distribute the assets of the estate must yield to governmental interest in public health and safety.

Midlantic Nat'l Bank v. New Jersey Dept. of Envtl. Prot., 474 U.S. 494, 502, 106 S.Ct. 755, 760, 88 L.Ed.2d 859 (1986) (citing *Ohio v. Kovacs,* 469 U.S. 274, 105 S.Ct. 705, 766–767, 83 L.Ed.2d 649 (1985)). The first section of the CSA shows that Congress enacted it in its "governmental interest in public health and safety." In that section, Congress finds and declares: "The illegal importation, manufacture, distribution, and possession and improper use of controlled substances have a substantial and detrimental effect *on the health and general welfare of the American people."* CSA, 21 U.S.C. § 801(2) (emphasis added). Marijuana is a schedule-I controlled substance under the CSA. *See* CSA, 21 U.S.C. § 802(6) (defining a controlled substance to include any drug or substance "included in schedule I ... of this part B of this subchapter."); CSA, 21 U.S.C. § 812(c), Schedule I at (c)(17). A bankruptcy trustee would need to yield to the government's interests in protecting the public's health, as expressed by the CSA.

The Court observes, without deciding, that it is quite possible that Medpoint's IP and the IP licensing revenues could be seized or forfeited, and that Medpoint could be or could have been guilty of facilitation of a crime under the CSA. *See* Deputy A.G. James M. Cole, U.S. DOJ, Memorandum at 2 (June 29, 2011) ("Persons who are in the business of cultivating, selling or distributing marijuana, and those who knowingly facilitate such activities, are in violation of the Controlled Substances Act, regardless of state law."). Both ANW and Medpoint could be or could have been guilty of violating the CSA under an accomplice theory of liability. *See* 18 U.S.C. § 2(a) (establishing aiding and abetting liability for crimes against the U.S.).

The Court finds that the prospects of a possible forfeiture or seizure of Medpoint's assets poses an unacceptable risk to a chapter 7 estate and to a chapter 7 trustee.[11] Other courts have dismissed cases for similar concerns regarding a trustee's potential risk exposure. *See In re Charles George Land Reclamation Trust,* 30 B.R. 918, 924 (Bankr.D.Mass.1983) (dismissing a chapter 7 case for cause because neither a trustee nor the United States Trustee would take the case, due to the "potentially unlimited and untested liability standards of both the State and Federal Superfund statutes.").

Petitioning Creditors' argue that the Cromnibus Act essentially eliminates the risk of federal enforcement actions against medical marijuana operations. This argument also fails to sway the Court. That the Cromnibus Act prohibits the Department of Justice ("DOJ") from using that funding for enforcement against medical marijuana operations does not foreclose the possibility of enforcement. For example, in 2012, the DOJ's Asset Forfeiture Program "recorded total net forfeiture deposits ***186** of $4.2 billion" via coordinated actions involving the FBI, ATF, DEA, and other law enforcement agencies. Dept. of Justice, Asset Forfeiture Program FY 2014 Performance Budget at 1. The Court cites this as an example of a possible non-Cromnibus Act source of funding for enforcement actions against medical marijuana businesses. The Attorney General can spend money from the DOJ's Asset Forfeiture Fund "to seize ... property ... pursuant to any law enforced or administered by the Department of Justice, or [for] any other necessary expense incident to the seizure ... of such property ..." 28 U.S.C. § 524(c)(1)(A). The Court takes this to mean that DOJ can use existing forfeiture proceeds to prosecute claims against Medpoint under the CSA (and seek forfeiture of Medpoint's assets) even though this year's budget allotment could not be used for such prosecution. The Court also notes that the Cromnibus Act only applies to funding through September 30, 2015. The next spending bill approved by Congress might not prohibit the DOJ from using its general funds to enforce the CSA against Arizona's medical marijuana businesses.

The Court will not enter an order for relief which would then result in the appointed chapter 7 trustee necessarily violating federal law (the CSA) in carrying out his or her duties under the Code. The dual risks of forfeiture of Medpoint's assets and a trustee's inevitable violation of the CSA in administration of a Medpoint chapter 7 estate constitute cause for this Court to dismiss Petitioning Creditors' involuntary Petition under section 707(a). The Court grants Medpoint's Motion.

2. Unclean Hands Doctrine

[2] [3] [4] [5]The bankruptcy court is a court of equity. *Young v. United States,* 535 U.S. 43, 50, 122 S.Ct. 1036, 1041, 152 L.Ed.2d 79 (2002). "The 'unclean hands' defense applies to conduct immediately related to the cause in controversy." *In re Everett,* 364 B.R. 711, 723 (Bankr.D.Ariz.2007) (citation omitted). "[B]ecause of the clean hands doctrine a federal court should not, in an ordinary case, lend its judicial power to a plaintiff who seeks to invoke that power for the purpose of consummating a transaction in clear violation of law." *See Johnson v. Yellow Cab Transit Co.,* 321 U.S. 383, 387, 64 S.Ct. 622, 624, 88 L.Ed. 814 (1944). "Under the 'clean hands' doctrine, one who does not come into equity with clean hands, and keep them clean, must be denied all relief, whatever may have been the merits of his claim." *Hall v. Wright,* 240 F.2d 787, 794–95 (9th Cir.1957).

[6]When Medpoint entered into the various agreements with Petitioning Creditors, it was very much in the business of managing and operating a medical marijuana business. Medpoint drained off ANW's cash so that ANW, a not-for-profit entity, would not hold an inordinate amount of cash. In effect, the profitability of ANW's business was usurped by Medpoint via the Medpoint Service Agreement and IP License Agreement. Medpoint's former wholly-owned subsidiary, Infinite Bloom, LLC, employed over 70 people to run and manage ANW's sales and cultivation.[12] Medpoint also hired consultants to help with the construction of a cultivation facility, and branded the cannabis products with the Bloom trademark. Medpoint still licenses that IP to BMF (via Bloom Industries) for ANW's use. Medpoint's IP surely provides value to BMF in the sale of ANW's marijuana products.

Petitioning Creditors knew or should have known that Medpoint's activities ***187** were illegal under federal law. Medpoint did not dupe them into entering the medical marijuana business. Danzer, Brown, and 7511 signed various loan or other documents which expressly stated that Medpoint was in the medical marijuana business and that, under federal law, the production, marketing and sale of marijuana was and remains illegal. *See, e.g.,* Motion at Ex. C: 7511 Loan at 1 (DE 34–3) ("Marijuana is designated as a Class One Controlled Substance by the U.S. Federal Government and pursuant to Federal Law is not approved for sale or distribution in the State of Arizona...."). Jensen signed his Consulting Agreement with Medpoint to help it construct a medical marijuana cultivation facility. All the Petitioning Creditors knew or should have known there were serious possible criminal ramifications to Medpoint's business relationships with ANW and with marijuana products. Petitioning Creditors nonetheless decided to contract with Medpoint to pursue potentially lucrative investments or lending profits, and/or consulting fees, none of which could be realized but for Medpoint's marijuana-related business affairs. The unclean hands defense arises from and applies to Petitioning Creditors' medical marijuana-related claims against Medpoint. Petitioning Creditors' hands are unclean and they cannot now seek relief from this Court.[13]

3. No Bad Faith

Under sub-sections 303(i)(1) and (2), the Court may award Medpoint a judgment for its fees and/or costs associated with the successful Motion, or for proximate actual, and/or punitive damages resulting from a bad faith involuntary petition.

[7]The Court makes bad faith determinations by factual findings, judging the facts against what a reasonable person would have done or believed. *See In re Wavelength,* 61 B.R. 614, 620 (9th Cir. BAP 1986). In doing so, the Court considers the totality of the circumstances. *Higgins v. Vortex Fishing Systems, Inc.,* 379 F.3d 701, 705 (9th Cir.2004). In support of its request for a damages hearing, Medpoint alleges that Petitioning Creditors filed the Petition "for the purpose of seizing control of the medical marijuana license to permit continuing operations of a business that operates in clear violation of federal law." Motion at 11:22–24 (DE 34). Medpoint attaches a draft of a letter containing a

settlement offer from Petitioning Creditors' counsel to ANW's board members. Motion at Ex. K: Pre–Litigation Demand (DE 34–11) ("Demand Letter"). The Demand Letter is unsigned, and Petitioning Creditors deny that they ever actually sent it.

[8]Putting aside the question of the Demand Letter's admissibility under Federal Rule of Evidence 408, the Court finds that the Demand Letter is evidence of Petitioning Creditors' unclean hands but not of their bad faith. The Demand Letter is evidence that Petitioning Creditors were involved in the medical marijuana business. The Court declines to find that Petitioning Creditors acted in bad faith by preparing the Demand Letter.

[9]The viability of an involuntary chapter 7 petition filed against a debtor on account of debts relating to state-licensed ***188** medical marijuana operations is a novel question of law in this District. The Court does not find that Petitioning Creditors' acted unreasonably in filing the Petition. The record shows that Medpoint is not and cannot meet its ongoing financial obligations to numerous creditors, in amount and number sufficient to justify an involuntary petition under section 303(b). The record before this Court does not contain facts to support a finding of Petitioning Creditors' bad faith. As the Ninth Circuit BAP has noted, "[n]ot every failed reason for filing an involuntary petition amounts to 'bad faith.' " *In re Macke Int'l Trade, Inc.,* 370 B.R. 236, 257 (9th Cir. BAP 2007). Petitioning Creditors' unclean hands do not equate to a finding of their bad faith in this instance. Finding no bad faith, there is no need for a hearing on damages proximately caused by a filing that is not in bad faith.

Conclusion

Despite this Court's refusal to grant Petitioning Creditors' requested relief, they still have other options for pursuing recourse against Medpoint. They may well have state-law causes of action against Medpoint which might be enforced in state court. For example, at his deposition, Downing seemingly admitted that Medpoint defaulted on or breached various loan agreements and consulting agreements. The record also contains facts which might support fraudulent transfer claims against Medpoint and/or BMF under Arizona fraudulent transfer laws. Granting Medpoint's Motion will not give it a windfall, because Petitioning Creditors still have the opportunity to pursue their claims to hold Medpoint accountable in state court.

Arizona law is in conflict with the CSA. Arizona has chosen not to enforce the CSA against businesses such as Medpoint. However, as a federal court, this Court must adhere to federal law. Neither the alleged lack of enforcement funding nor the apparent lack of political will to enforce the CSA alters the fact that a person engaged in marijuana related business activities in Arizona is in violation of federal law. Petitioning Creditors may themselves have also violated the CSA and attempted to profit from those violations. At a minimum, they come to this Court with unclean hands. The Court has neither the authority nor the will to enter an order for relief or endanger a trustee who might be assigned to administer drug tainted assets for the benefit of creditors who assumed the risk of doing business with an enterprise engaged in violations of federal law.

Accordingly,

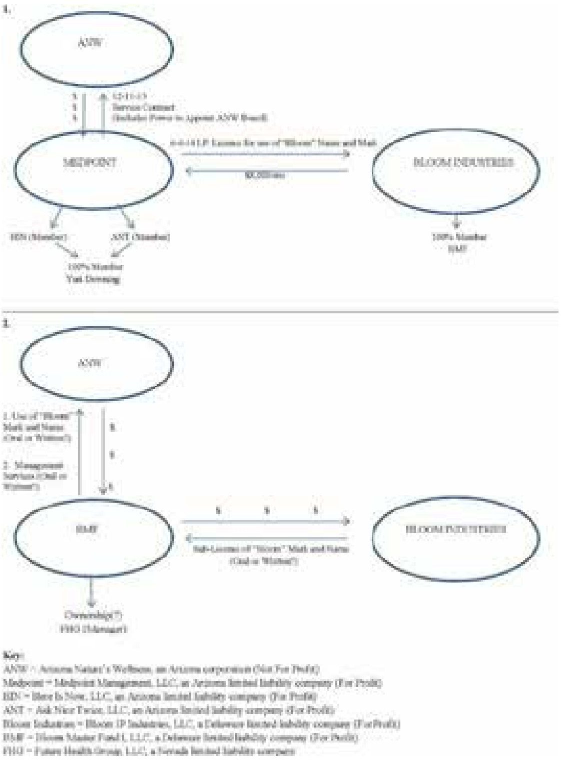
IT IS ORDERED that Medpoint's Motion is granted, and the Petition is dismissed.

IT IS FURTHER ORDERED that Medpoint's request for a hearing on damages is denied, as the Court will not grant Medpoint fees, costs, or damages.

Attachment

MEDPOINT

***189**



All Citations

528 B.R. 178, 73 Collier Bankr.Cas.2d 781, 60 Bankr.Ct.Dec. 248

Footnotes

1 The Court has jurisdiction over this matter under 11 U.S.C. §§ 157 and 1334.

2 The CSA is codified in 21 U.S.C. § 801, et seq.

3 The Court denies Medpoint's request to set a hearing on damages.

4 *See* note 8, *infra*.

5 The Court did not find such a provision in either the Medpoint Service Agreement or the Tier Service Agreement.

6 The record contains no hard facts regarding the agreement between ANW and BMF. No written contract between BMF and ANW (if any exists) is attached to any of the pleadings. Downing is a current employee and former member of BMF.

7 The Court attaches a diagram showing the various entities' relationships before and after ANW terminated the Medpoint Service Agreement.

8 Bloom Industries is a wholly-owned subsidiary of BMF, ANW's current management entity.

9 Infinite Bloom, LLC was previously a wholly-owned Medpoint subsidiary. Medpoint sold Infinite Bloom to BMF for $11,100 on June 2, 2014. *See* Opposition at Ex. B: Asset Sale Agreement (DE 48). Infinite Bloom employed the 74 employees who performed Medpoint's management services for ANW. Medpoint sold Infinite Bloom to BMF "so that [BMF] wouldn't have to switch all the employee contracts and everything else.... " Response at Ex. A: Downing Depo.,

at 113:2–5 (DE 37).

10 All section numbers refer to Title 11 of the United States Code unless stated otherwise.

11 The Court declines to make a finding on the issue of whether Medpoint's assets (the IP, its licensing revenues, its interest in Tier, and claims against ANW and others) are or are not forfeitable/seizable under the CSA and/or other federal law. However, such an issue could very well be central to a bankruptcy court's decision in future cases in states which allow the production and sale of "medical marijuana." The same is true for the issue of the enforceability and seizability/forfeitability of contracts and negotiable instruments. *See* 21 U.S.C. § 881(a)(6) (providing that "negotiable instruments" used to facilitate any violation of the CSA are subject to forfeiture and that "no property right shall exist in them.").

12 *See* note 8, *supra.*

13 *Northbay,* an unpublished opinion, reached a similar conclusion regarding a marijuana entity in California, stating that: "While the sale of marijuana may be legal under certain circumstances in California, it is unquestionably illegal under federal law. Appellants' hands were unclean, as a matter of federal law." *Northbay Wellness Grp., Inc. v. Beyries,* No. C 11–06255 JSW, 2012 WL 4120409, at *4 (N.D.Cal. Sept. 18, 2012). California also allows the production and sale of medical marijuana.

End of Document

6. THE HONORABLE DAVID T. THUMA

Topic: Third Party Releases in Chapter 11 Plans: When are they allowed?

THIRD PARTY RELEASES IN PLANS OF REORGANIZATION

Hon. David T. Thuma[1]
United States Bankruptcy Judge
District of New Mexico

These materials discuss whether a bankruptcy court may approve a plan of reorganization that releases claims held by nondebtors against third parties and, if so, when it is appropriate to do so.

A. Applicable Bankruptcy Code Sections.

§ 105(a). The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title.

§ 524(e). Except as provided in subsection (a)(3)[2] of this section, discharge of a debt of the debtor does not affect the liability of any other entity on, or the property of any other entity for, such debt.

§ 1123(b). Subject to subsection (a) of this section, a plan may
. . .
(3) provide for
(A) the settlement or adjustment of any claim or interest belonging to the debtor or to the estate;
. . .
(6) include any other appropriate provision not inconsistent with the applicable provisions of this title.

B. Debtor Releases.

Not all releases in plans of reorganization are controversial. Plans often release claims debtors hold against creditors. For example: "On confirmation, all claims of the debtor against XYZ corporation are released." § 1123(b)(3)(A) expressly allows these types of releases. *See, e.g., In re Arden*, 176 F.3d 1226, 1228 (9th Cir. 1999) (citing the section).

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[1] With thanks to Kurt Widenhouse, law clerk, for his editing and cite-checking assistance.
[2] § 524(a)(3) protects after-acquired community property of the discharged spouse from the other spouse's creditors.

C. Exculpation Releases.

Releases that exculpate the debtor in possession, officers, directors, and professionals from claims arising during the bankruptcy case are also common and generally approved. An example is:

> None of the Debtors, the Reorganized Debtors, . . . the Creditor Representative, the Committee or any of their respective members, officers, directors, employees, advisors, professionals or agents shall have or incur any liability to any holder of a Claim or Equity Interest for any act or omission in connection with, related to, or arising out of, the Chapter 11 Cases, the pursuit of confirmation of the Plan, the consummation of the Plan or the Administration of the Plan or the property to be distributed under the Plan, except for willful misconduct or gross negligence . . . .

In re PWS Holding Corp., 228 F.3d 224, 246 (3d Cir. 2000). Exculpation releases are a species of third-party release, as they release claims that third parties may have against non-debtors such as professionals and officers. These releases generally have been upheld. The rationale is that the Bankruptcy Code provides limited immunity against negligence claims for estate fiduciaries, so exculpation clauses essentially restate the law. For that reason, acceptable exculpation releases clauses must "carve out" claims based on willful misconduct or gross negligence, for which estate fiduciaries are not immune. *See, e.g., PWS Holding*, 228 F.3d at 246 (exculpation clause is appropriate because it affects no change in liability); *In re Midway Gold US, Inc.*, 575 B.R. 475, 512-13 (Bankr. D. Colo. 2017) (clause restates the fiduciary standard); *In re South Edge LLC*, 478 B.R. 403, 415 (D. Nev. 2012) (to the same effect); *In re Alpha Natural Resources, Inc.*, 556 B.R. 249, 260 (Bankr. E.D. Va. 2016) (exculpation provisions are not unusual and generally are permissible if properly limited); *In re Enron Corp.*, 326 B.R. 497, 503-04 (S.D.N.Y. 2005); *In re Washington Mutual*, 442 B.R. 314, 350-51 (Bankr. D. Del. 2011).

D. Third Party Releases.

The most problematic release is the third party release, often combined with a "channeling injunction." For example:

> Channeling Injunction. In consideration of the undertakings . . . hereunder and other consideration . . . . :
>
> (a) Any and all Channeled Claims are channeled into the Trust and shall be treated, administered, determined, and resolved under the procedures and protocols and in the amounts as established under the Plan . . . . as the sole and exclusive remedy for all holders of Channeled Claims; and
>
> (b) All Entities who . . . hold or assert . . . any Channeled Claim are hereby permanently stayed, enjoined, barred and restrained from taking any action, directly or indirectly, for the purposes of asserting, enforcing, or attempting to assert or enforce any Channeled Claim against any of the Protected Parties . . . .
>
> The provisions of this Section will further operate, as between all Protected Parties, as a mutual release of all Claims relating to the Debtors, the Claims against the Debtor and the Insurance Policies, which any Protected Party may have against another Protected Party except as may specifically be reserved or set forth in a Participating Party Agreement, an Insurance Settlement Agreement or the Plan. The foregoing channeling provisions are an integral part of the Plan and are essential to its implementation.[3]

1. Potential Problems With Third Party Releases. Courts have identified two main issues that must be resolved when ruling on challenged third party releases. First, do the releases run afoul of § 524(e)? Second, if not, does the bankruptcy court have the jurisdiction and authority to approve the releases?

[3] From the First Amended and Restated Plan of Reorganization confirmed in the Roman Catholic Church of the Diocese of Gallup, case No. 13-13676, United States Bankruptcy Court, District of New Mexico.

2. Circuits That Do Not Allow Third Party Releases.

a. Ninth Circuit. The Ninth Circuit has held that third party releases/channeling injunctions are contrary to § 524(e) and cannot be permitted. The first case to address the issue was *Underhill v. Royal*, 769 F.2d 1426 (9th Cir. 1985), which held:

> the bankruptcy court has no power to discharge the liabilities of a nondebtor pursuant to the consent of creditors as part of a reorganization plan. The broad language of § 524(e), limiting the scope of a discharge so that it "does not affect the liability of any other entity," encompasses this result.

769 F.2d at 1432. Next came *American Hardwood, Inc. v. Deutsche Credit Corp.*, 885 F.2d 621 (9th Cir. 1989), which quoted and followed *Underhill*. Most recently, in *Resorts International v. Lawenschuss (In re Lowenschuss)*, 67 F.3d 1394 (9th Cir. 1995), the Ninth Circuit held:

> The bankruptcy court lacks the power to confirm plans of reorganization which do not comply with applicable provisions of the Bankruptcy Code. 11 U.S.C. § 1129(a)(1). Pursuant to 11 U.S.C. § 524(a), a discharge under Chapter 11 releases the debtor from personal liability for any debts. Section 524 does not, however, provide for the release of *third parties* from liability; to the contrary, § 524(e) specifically states that "discharge of a debt of the debtor does not affect the liability of any other entity on, or the property of any other entity for, such debt." 11 U.S.C. § 524(e).
>
> This court has repeatedly held, without exception, that § 524(e) precludes bankruptcy courts from discharging the liabilities of non-debtors. [citations omitted].

See also Deocampo v. Potts, 836 F.3d 1134, 1143 (9th Cir. 2016) (citing *Lowenschuss* approvingly in dicta); *In re Maxitile, Inc.* 237 Fed. App'x 274 (9th Cir. 2007) (unpublished) (following the case law discussed above).

b. D.C., Fifth, and Tenth Circuits. These three circuits have sided with the Ninth and prohibited third party releases. Their rationale is the same, i.e., third party releases cannot be reconciled with § 524(e). *See In re AOV Industries, Inc.*, 792 F.2d 1140, 1152 (D.C. Cir. 1986); *Bank of N.Y. Trust Co. Official Unsecured Creditors' Committee (In re Pacific Lumber)*, 584 F.3d 229, 251-52 (5th Cir. 2009); and *In re Western Real Estate Fund*, 922 F.2d 592, 600-02 (10th Cir. 1990).

3. Circuits That Allow Third Party Releases. The First (bankruptcy court only), Second, Third, Fourth, Sixth, Seventh, Eighth (bankruptcy court only), and Eleventh circuits have ruled that third party releases can be approved in limited circumstances as part of plan confirmation. *See In re Charles St. African Methodist Episcopal Church of* Boston, 499 B.R. 66, 98-103 (Bankr. D. Mass. 2013); *In re Metromedia Fiber Network Inc.*, 416 F.3d 136, 141-43 (2d Cir. 2005); *In re Lower Bucks Hospital*, 571 Fed. App'x 139, 144 (3d Cir. 2014); *Nat'l Heritage Foundation, Inc. v. Highbourne Foundation*, 760 F.3d 344, 347-50 (4th Cir. 2014); *Class Five Claimants v. Dow Corning Corp. (In re Dow Corning Corp.)*, 280 F.3d 648, 657-58 (6th Cir. 2002); *Airadigm Communications, Inc. v. FCC (In re Airadigm Communications Inc.)*, 519 F.3d 640, 655-57 (7th Cir. 2008); *In re Master Mortgage, Investment Fund Inc.,* 168 B.R. 930, 935 (Bankr. W.D. Mo. 1994); *SE Prop. Holdings LLC v. Seaside Engineering & Surveying Inc. (In re Seaside Engineering & Surveying Inc.)*, 780 F.3d 1070, 1077-78 (11th Cir. 2015).

4. How the Courts Deal With § 524(e). Courts allowing third party releases have concluded that § 524(e) does not apply to the issue. For example, the Seventh Circuit held in *Airadigm Communication*:

> Section 524(e) provides that the "discharge of a debt of the debtor does not affect the liability of another entity on, or the property of any other entity for, such debt." 11 U.S.C. § 524(e). The natural reading of this provision does not foreclose a third-party release from a creditor's claims. *Specialty Equipment,* 3 F.3d at 1047. Section 524(e) is a saving clause; it limits the operation of other parts of the bankruptcy code and preserves rights that might otherwise be construed as lost after the reorganization. *Id.; see also In re Hunter,* 970 F.2d 299, 311 (7th Cir. 1992). Thus, for example, because of § 524, a creditor can still seek to collect a debt from a co-debtor who did not participate in the reorganization-even if that debt was discharged as to the debtor in the plan. *Compare* 11 U.S.C. § 524(a)(2) *with* 11 U.S.C. § 524(e). Or a third party could proceed against the debtor's insurer or guarantor for liabilities incurred by the debtor even if the debtor cannot be held

> liable. *See In re Shondel,* 950 F.2d 1301, 1306-07 (7th Cir. 1991); *see also In re Hendrix,* 986 F.2d 195, 197 (7th Cir. 1993).
>
> In any event, § 524(e) does not purport to limit the bankruptcy court's powers to release a non-debtor from a creditor's claims. If Congress meant to include such a limit, it would have used the mandatory terms "shall" or "will" rather than the definitional term "does." And it would have omitted the prepositional phrase "on, or ... for, such debt," ensuring that the "discharge of a debt of the debtor *shall* not affect the liability of another entity"-whether related to a debt or not. *See* 11 U.S.C. § 34 (repealed Oct. 1, 1979) ("The liability of a person who is a co-debtor with, or guarantor or in any manner a surety for, a bankrupt shall not be altered by the discharge of such bankrupt.") (prior version of § 524(e)). Also, where Congress has limited the powers of the bankruptcy court, it has done so clearly-for example, by expressly limiting the court's power, *see* 11 U.S.C. § 105(b) ("[A] court may not appoint a receiver in a case under this title"), or by creating requirements for plan confirmation, *see, e.g.,* 11 U.S.C. § 1129(a) ("The court shall confirm a plan only if the following requirements are met...."). As a result, for the reasons set out in *Specialty Equipment,* § 524(e) does not bar a non-consensual third-party release from liability.

519 F.3d at 657.

The discussion in *In re Archdiocese of St Paul and Minneapolis*, 578 B.R. 823 (Bankr. D. Minn. 2017), also is instructive:

> . . . . can a creditor, as part of a chapter 11 plan, be forced to give up its claim against a non-debtor? If so, under what circumstances?
> . . . . a confirmed plan with such a provision does not violate the Bankruptcy Code as some courts have suggested. Clearly, § 524(a) creates an injunction only as to debts owed by the debtor and § 524(e) makes it clearer that the "discharge of the debt of the debtor does not affect the liability of any other entity, or the property of any other entity for, such debts." From that, it is clear that the debts, if any, of the Catholic entities to the sexual abuse victim would not be discharged by §§ 1141 or 524. But neither of those sections or any other sections prohibit such a provision in a plan nor make a plan containing such provision, per se, unconfirmable. I agree with the Sixth Circuit when it said:
>
>> The Bankruptcy Codes does not explicitly prohibit or authorize a bankruptcy court to enjoin a non-consenting creditor's claims against a non-debtor to facilitate a reorganization plan. *In re Continental Airlines,* 203 F.3d 203, 211 (3d. Cir. 2000). However, bankruptcy courts, "as courts of equity, have broad authority to modify creditor-debtor relationships." *United States v. Energy Resources Co.,* 495 U.S. 545, 549, 110 S.Ct. 2139, 109 L.Ed.2d 580

> > (1990). For example, section 105(a) of the Bankruptcy Code grants a bankruptcy court the broad authority to issue "any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title." 11 U.S.C. § 105(a). This section grants the bankruptcy court the power to take appropriate equitable measures needed to implement other sections of the Code. *See In re Granger Garage, Inc.,* 921 F.2d 74, 77 (6th Cir. 1990).
>
> *In re Dow Corning Corp.*, *supra*, at 656. I conclude, therefore, that such provisions are permissible and that plans containing third party releases can be confirmed under appropriate circumstances.

578 B.R. at 833.

5. Jurisdiction and Constitutional Authority. A second issue is whether bankruptcy courts have the jurisdiction and authority to approve the third-party releases. Two recent cases have discussed the question and have held that they do.

The first is *In re Millennium Lab Holdings II, LLC*, a Delaware bankruptcy case. Ruling from the bench, the bankruptcy court confirmed a plan of reorganization that contained third party releases. On appeal, the district court remanded the case so the bankruptcy court could address the appellant's argument that releasing the third party claims was beyond the bankruptcy's court's constitutional authority outlined in *Stern v. Marshall*, 564 U.S. 462 (2011). *In re Millennium Lab Holdings II, LLC*, 242 F. Supp. 3d 322 (D. Del. 2017).

On remand, the bankruptcy court analyzed the subject matter jurisdiction and constitutional authority issues in detail. First, the court held that it had "core" subject matter jurisdiction to consider confirmation of the debtor's plan under 28 U.S.C. § 157(b)(2)(L) ("Core proceedings include . . . confirmations of plans"). Thus, any problem with approving third party release did not include lack of subject matter jurisdiction.

Next, the bankruptcy court addressed whether it had the constitutional authority to confirm a plan of reorganization with a third-party release. The court ruled that it did. It held that *Stern* did not require a different result because *Stern* only addressed state law counterclaims owned by the estate, not plan confirmation. In its ruling, the court held that it was not necessary to have authority to determine the released claims, so long as it had authority to confirm the plan. *In re Millennium Lab Holdings II, LLC*, 575 B.R. 252, 271(Bankr. D. Del. 2017). The bankruptcy court's ruling on the jurisdiction and constitutional authority issues was affirmed on appeal. *In re Millennium Lab Holdings II, LLC*, 591 B.R. 559 (D. Del. 2018).

The other recent case is *In re Kirwan Offices S.A.R.I.*, 592 B.R. 489 (S.D.N.Y. 2018). Addressing issues very similar to *Millennium Lab*, the district court reached the same conclusions on the bankruptcy court's jurisdiction 592 B.R. at 503-509, and the bankruptcy court's constitutional authority, 592 B.R. at 509-512.

6. <u>When Third Party Releases are Appropriate</u>. In the circuits that allow bankruptcy courts to confirm plans with third party releases, the question remains when they should do so. The usual response is to say that it is rarely appropriate, and then analyze a number of factors relevant to the decision. *In re Master Mortgage Inv. Fund, Inc.*, 168 B.R. 930 (Bankr. W.D. Mo. 1994), for example, lists five factors:

> (1) There is an identity of interest between the debtor and the third party, usually an indemnity relationship, such that a suit against the non-debtor is, in essence, a suit against the debtor or will deplete assets of the estate.
> (2) The non-debtor has contributed substantial assets to the reorganization.
> (3) The injunction is essential to reorganization. Without the it, there is little likelihood of success.
> (4) A substantial majority of the creditors agree to such injunction, specifically, the impacted class, or classes, has "overwhelmingly" voted to accept the proposed plan treatment.
> (5) The plan provides a mechanism for the payment of all, or substantially all, of the claims of the class or classes affected by the injunction.

168 B.R. at 935 (footnotes omitted); *see also Millennium Lab*, 591 B.R. at 566; *Kirwan Offices*, 592 B.R. at 511, citing *In re Metromedia Fiber Network, Inc.*, 416 F.3d 136, 141 (2d Cir. 2005)

(third party releases should be approved only in "rare cases"); *In re Charter Communications*, 419 B.R. 221, 258 (Bankr. S.D.N.Y. 2009) ("unusual circumstances" meant that the third party releases were permissible); *In re SunEdison, Inc.*, 576 B.R. 453, 461-62 (Bankr. S.D.N.Y. 2017) (third party releases appropriate only in "rare and unusual circumstances"); *In re SL Liquidating, Inc.*, 428 B.R. 799, 801 (Bankr. S.D. Ohio 2010) (third party releases are a "drastic measure to be used cautiously" and are "only appropriate in 'unusual circumstances'"), citing *In re Dow Corning Corp.*, 280 F.3d 648, 658 (6th Cir. 2002).

7. Consent. Of course, the analysis is much easier if the third parties consent to the release. *See, e.g., In re Zenith Elecs. Corp.*, 241 B.R. 92 (Bankr. D. Del. 1999); *In re Genco Shipping & Trading Limited*, 513 B.R. 233 (Bankr. S.D.N.Y. 2014) (U.S. Trustee objected to third party releases to the extent the claim holders did not consent).

The issue of implied consent is an important one. *Compare In re Indianapolis Downs, LLC,* 486 B.R. 286, 305 (Bankr. D. Del. 2013) (court found that creditors were deemed to have consented to a third party release by their failure to opt out or vote), with *In re SunEdison, Inc.,* 576 B.R. 453 (Bankr. S.D.N.Y. 2017) (creditor consent cannot be inferred from failure to act because they had no duty to speak).