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Feature

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Scheme of Arrangement Confirming Nonconsensual Third-Party Releases Approved in Chapter 15s

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Third-party releases are a hot-button issue in the U.S., where the circuit courts are split on whether they have the power to grant such releases, when such a grant is appropriate, whether such releases are ever permissible without consent and, in those circuits that permit them, what constitutes such consent.[2] However, as Hon. **Martin Glenn** of the U.S. Bankruptcy Court for the Southern District of New York points out in his recent decision in the *Avanti* case,[3] such handwringing might not be necessary or even relevant in the chapter 15 context. In *Avanti*, Judge Glenn issued a decision explaining why such releases were permissible in a chapter 15 case involving a U.K. scheme of arrangement.

Despite the fact that no objections to recognition of the U.K. scheme of arrangement or enforcement of the releases had been lodged, the court issued a well-reasoned opinion. Indeed, the *Avanti* opinion clearly articulates the rationale and provides helpful comparisons between third-party releases in chapter 11 and chapter 15 cases.

At the time of its U.K. restructuring, Avanti Communications Group plc was a public, U.K.-based satellite services provider with a significantly overleveraged capital structure. Avanti owed (1) approximately $118 million under its super-senior term loan facility (the "term loan facility"), (2) approximately $323 million under its 10 percent/15 percent senior secured notes due in 2021 (the "2021 notes"), and (3) approximately $557 million under its 12 percent/17.5 percent senior secured notes due in 2023 (the "2023 notes").[4]

After experiencing delays related to the manufacture, procurement and launch of two of its satellites, Avanti entered into restructuring negotiations with its significant creditors that ultimately resulted in an agreement to, among other things, equitize the 2023 notes and amend the 2021 notes. Avanti then commenced a proceeding under Part 26 of the Companies Act 2006 before the High Court of Justice of England and Wales (the "U.K. Court") in which it sought to convene a meeting of the holders of the 2023 notes (the only group of creditors affected) to approve a scheme of arrangement embodying its restructuring. The scheme of arrangement provided for the release of guarantees from affiliates of Avanti in order to prevent any dissenting holders from seeking relief outside the scheme of arrangement. It was overwhelmingly approved by holders of more than 98 percent of the 2023 notes.

The U.K. Court also authorized the appointment of a foreign representative to file a chapter 15 case in the U.S. in order to recognize and enforce the scheme of arrangement and releases. The foreign representative sought (1) recognition of the U.K. proceeding as a "foreign main proceeding" under chapter 15; (2) relief afforded to foreign main proceedings under § 1520 of the Bankruptcy Code; (3) an order recognizing, granting comity to, and giving full force and effect in the U.S. to, among other things, the U.K. proceeding and the scheme of arrangement; and (4) an order enjoining parties from taking any action inconsistent with the scheme of arrangement, including certain releases given in favor of certain of the debtor's direct and indirect subsidiaries (the "subsidiary guarantors") that guaranteed the 2023 notes.[5]

In his decision, Judge Glenn pointed out that the analysis applicable to the approval of third-party releases in chapter 15 cases is different from that in chapter 11 cases. In a chapter 15, the focus is on whether the foreign court had proper authority to grant the releases, and thus whether the chapter 15

1 The views expressed in this article do not reflect the views of Dentons or any of its clients.

2 Courts in the Fifth, Ninth, Tenth and District of Columbia Circuits have held that the Bankruptcy Code only allows the bankruptcy court to grant releases against a debtor and prohibits releases of nondebtors or injunctions protecting such nondebtors unless specific consent is provided. The Second, Fourth, Sixth, Seventh and Eleventh Circuits have held that such third-party releases might be given consensually and, in certain circumstances, nonconsensually. *Id.* at 2-3 and cases cited therein. Courts still struggle with the nature of such consent, as well as the extent to which disclosure of such release provisions in a plan is sufficient. More recently, the U.S. District Court for the District of Delaware held that bankruptcy courts have constitutional authority to provide third-party releases in a reorganization plan, even where such releases are nonconsensual. *Opt-Out Lenders v. Millennium Lab Holdings II LLC (In re Millennium Lab Holdings II LLC)*, Civ. No. 17-1461, No. 15-12284 (LSS) (D. Del. Sept. 21, 2018).

3 *Avanti Commc'ns Grp. PLC*, 582 B.R. 603 (Bankr. S.D.N.Y.).

4 Under an intercreditor agreement, the term loan facility ranked above the 2021 and 2023 notes. *Id.* at 5.

5 While the *Avanti* decision is most notable for its analysis of third-party releases arising under chapter 15, the bankruptcy court also dealt with the preliminary issue regarding eligibility to file under § 109 of the Bankruptcy Code. While noting that the applicability of § 109 to a chapter 15 case results from the controversial ruling in *Drawbridge Special Opportunities Fund LP v. Barnet (In re Barnet)*, 737 F.3d 238 247 (2d Cir. 2013), the court concluded that the retainer paid to the New York law firm representing the foreign representative, as well as the fact that the indenture relating to one of Avanti's debt issuances was governed by New York law, each constituted property in the U.S. for purposes of § 109. *Id.* at 9. The decision reflects the case law trend that a retainer held by a U.S. law firm or contract rights under a New York law-governed indenture are sufficient to satisfy the "property in the [U.S.]" eligibility requirement under § 109(a). Revisions to chapter 15 that have been proposed to the U.S. Congress by the National Bankruptcy Conference on Aug. 20, 2018, include a proposal to render § 109(a) not applicable to a case under chapter 15 on the basis that *Barnet* was wrongly decided and that the same *Barnet* decision invited Congress to revisit the drafting of § 109(a).

court should recognize and enforce the foreign court's grant based on principles of comity.[6] Judge Glenn focused his attention on two provisions of chapter 15: Section 1521(a), which authorizes the court to grant "any appropriate relief" to a foreign representative "where necessary to effectuate the purposes of [chapter 15] and to protect the assets of the debtor or the interests of the creditors,"[7] and § 1507(a) and (b), which allows the court to "provide additional assistance to a foreign representative" if, "consistent with principles of comity," such assistance will, among other things, ensure the "just treatment of all holders of claims," "protection of claim holders in the [U.S.] against prejudice" and "distribution of proceeds of the debtor's property substantially in accordance with the order prescribed by this title."[8]

Focusing in particular on the "principles of comity and cooperation with foreign courts" language of § 1507, Judge Glenn noted that "third-party nondebtor releases are common in schemes sanctioned under [U.K.] law, particularly for releases of affiliate Guarantees."[9] He then looked at the extent to which creditors in the U.K. had been given a full and fair opportunity to vote on — and be heard in connection with — the restructuring. He noted that the scheme of arrangement had received 98 percent approval by the one class being affected, and creditors therein had been afforded a right to be heard consistent with U.S. due-process standards. Accordingly, Judge Glenn granted the request for recognition and enforcement of the scheme of arrangement and related sanctions order.

The court distinguished the *Vitro* decision,[10] where the Fifth Circuit affirmed the bankruptcy court's decision in a chapter 15 case not to grant comity to and enforce an order of a Mexican court approving a restructuring that involved the releases of guarantees provided by U.S.-based nondebtor affiliates of the Mexican debtor. As noted by Judge Glenn, in the *Vitro* case, there were very troubling facts and circumstances that led the Fifth Circuit, in an exercise of discretion to refuse to recognize and enforce the Mexican restructuring plan. Most significantly, approval of the hotly contested plan from the one voting class of creditors was only achieved through the counting of votes from "insiders" (*i.e.*, 50 percent of all voting claims were held by intercompany debtholders), and the threshold for approval in Mexico was (at the time) lower (50 percent — a bare majority).[11] In contrast, the court noted that a U.K. scheme of arrangement requires a majority of creditors representing not less than 75 percent in value in each creditor class, and the *Avanti* scheme of arrangement had near-unanimous noninsider support.[12]

Avanti follows in the steps of two earlier chapter 15 decisions by Judge Glenn. In *Sino-Forest*,[13] he granted the recognition and enforcement of third-party releases approved in the debtor's Canadian insolvency proceeding in conjunction with the settlement of securities class-action litigation. In that case, Judge Glenn reiterated the principle that he had previously articulated in his opinion in *Metcalfe*, namely that under chapter 15's comity standard, the court's task is not "to make an independent determination about the propriety of individual acts of a foreign court" but to determine whether the foreign procedures "meet our fundamental standards of fairness."[14]

Sino-Forest dealt with a scenario similar to the one in *Vitro* (and *Avanti*) — the implementation of third-party releases approved by a foreign court — but it was particularly interesting as it was the first chapter 15 ruling to address such a request since *Vitro*. Armed with his deep familiarity with the *Metcalfe* facts, Judge Glenn used the same factors that the *Vitro* court had used to distinguish *Metcalfe*, including the near-unanimous support for the plan, the absence of insider votes, the Canadian court's evaluation of the sensitivities involved with the approval of third-party releases, and the lack of objections to the requested relief, but it reached a conclusion opposite to the one reached in *Vitro*. In this respect, the *Avanti* rationale reflects the deliberate, consistent and analytical approach taken by the U.S. Bankruptcy Court for the Southern District of New York in connection with chapter 15 recognition and the enforcement of third-party releases that have been sanctioned in foreign proceedings.

The granting of the relief requested in *Avanti* — recognition of the scheme of arrangement and enforcement of the releases — seems to have been an easy call. The facts of *Avanti* (98 percent approval, no objecting creditors and draconian results if not approved) favored the relief. Judge Glenn noted that third-party releases under U.K. schemes of arrangement are relatively common, particularly releases of affiliate guarantees of the debt being adjusted by the scheme of arrangement.[15] Accordingly, the court concluded that schemes of arrangement sanctioned under U.K. law that provide for third-party releases should be recognized and enforced under chapter 15 of the Bankruptcy Code.[16] Since the case was brought in the Second Circuit, where third-party releases are not prohibited, the granting of the relief was also not contrary to public policy and thus consistent with principles of comity.

Conclusion

In cross-border insolvency practice, it is always interesting to see how — even after chapter 15 recognition of a foreign proceeding is granted — bankruptcy courts resolve the inherent tensions between different rules and legal systems.

While the approval of a noncontroversial restructuring scheme of arrangement that includes third-party releases from a jurisdiction in which such releases are commonplace, seems consistent with chapter 15 jurisprudence, it will be interesting to see whether other courts in circuits that take a dim view of third-party releases in chapter 11 plans would favor — in a chapter 15 context — the same approach taken in *Avanti*, emphasizing the comity mandate as set forth in chapter 15. It will be equally interesting to see

6 *Id.* at 3.
7 *Id.* (Ex. 10). *See also* 11 U.S.C. § 1521(a).
8 *Id. See also* 11 U.S.C. § 1507(a) and (b).
9 *Id.* at 3.
10 *In re Vitro S.A.B. de C.V.*, 701 F.3d 1031 (5th Cir. 2012).
11 *Id.* at 12. Insider votes are not counted under the Bankruptcy Code. 11 U.S.C. § 1129(a)(10).
12 *Id.*
13 *In re Sino-Forest Corp.*, No. 13-10361 (Bankr. S.D.N.Y. Nov. 25, 2013).
14 *In re Metcalfe & Mansfield Alternative Invest.*, 421 B.R. 685 (Bankr. S.D.N.Y. 2010), distinguishing *In re Vitro S.A.B. de C.V.*, 701 F3d 1031 (5th Cir. 2010). Notably, a portion of the *Sino-Forest* opinion was devoted to distinguishing the *Vitro* decision, and the *Sino-Forest* court declined to apply *Vitro*'s three-step framework for determining the appropriateness of post-recognition relief, focusing instead on the propriety of the relief as "additional assistance" and comity under § 1507.
15 *Avanti* at 12.
16 *Id.* at 13.

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Confirming Nonconsensual Third-Party Releases Approved in Chapter 15s

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how courts deal with future cases from other jurisdictions with facts that are not so tidy, especially those where third-party releases are rare. Nevertheless, by making extensive use of the principles of comity that permeate chapter 15, *Avanti* potentially opens a strategic option for foreign companies that (1) need or desire third-party releases and (2) are considering whether filing a plenary proceeding outside the U.S. with an ancillary chapter 15 case — instead of a plenary chapter 11 case — might offer a higher probability of a successful restructuring. abi

Turnaround Topics

By John Yozzo and Samuel Star

For Better or Worse, Prepackaged and Pre-Negotiated Filings Now Account for Most Reorganizations

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There's not much that's distinctly new or novel about prepackaged, pre-negotiated and pre-arranged bankruptcy filings (collectively referred to herein as "pre-filings" by the authors) in recent years, except their growing numbers — and that is a story in itself. Today, pre-filings account for a majority of cases that emerge from chapter 11 via a confirmed reorganization plan.

Prepacks have been around for a long time. Business usage of the term "prepackaged bankruptcy" can be traced back nearly 30 years. There are articles and academic literature that refer to prepacks dating back to the early 1990s, notably "Business and Law: Prepackaging a Bankruptcy"[1] and "The Economics of Prepackaged Bankruptcy."[2] The "Business and Law" article references Crystal Oil Co., which filed a chapter 11 petition along with a solicited reorganization plan in October 1986 and emerged 91 days later, as one of the first recognized instances of a large prepack filing. Prepackaged filings increased in frequency in the early-to-mid 1990s in the wake of the original leveraged buyout (LBO) bust, but then faded as corporate capital structures became increasingly complex, only to make a comeback since the end of the 2009 recession, as concentrated debt holdings by large distressed-investor groups have made prepacks and other pre-filings a bit easier to negotiate and implement.

Prepacks often are viewed as being akin to out-of-court debt exchanges while also availing a debtor of the remedies of chapter 11, either to bind holdout creditors and/or to take advantage of specific provisions of the Bankruptcy Code, such as the rejection of executory contracts. Required-consent thresholds and the specific negative-covenant language contained in the legal documentation of a debtor's bonds and loans, along with the particular composition and concentration of debt-holders, will largely determine whether an out-of-court debt exchange or prepackaged filing is the more feasible route. When key creditor holdouts have a blocking position that precludes a prepackaging filing around a proposed plan that otherwise has substantial creditor support, then a pre-negotiated filing is the likely result.

A pre-negotiated filing is generally understood to be a case in which the debtor has had substantial negotiations with select creditor groups prior to a filing and has reached a consensus on key restructuring provisions with some *bloc* of creditors, which are documented either in a term sheet or a plan support agreement (PSA), also known as a restructuring support agreement (RSA). Large creditors might sign binding lockup agreements in support of an RSA, but there is no reorganization plan submitted with the chapter 11 filing, nor has there been a formal solicitation of creditors prior to filing.

The RSA often serves as the basis for key provisions of an eventual reorganization plan. A pre-negotiated filing is far from a "done deal," having yet to obtain the requisite creditor support for a plan. Post-filing negotiations pertaining to an RSA or its implementation can still become contentious, especially in large and complex cases, as occurred in the case of *Caesars Entertainment Operating Co.* or the protracted (and recently resolved) dispute between Claire's Stores and a large holder of its second-lien notes. However, pre-negotiated filings usually facilitate a path forward and pave the way for a reorganization plan that typically gets confirmed and implemented more quickly than a freefall filing.

What has changed about prepacks and pre-negotiated plans in recent years are their sheer numbers, which have increased appreciably. Is this a favorable development for debtors, creditors and the reorganization process? The answer is neither obvious nor definitive. Pre-filings tend to produce a more-streamlined chapter 11 reorganization process, fewer unpredictable outcomes, shorter case lengths, and fewer case-related expenses for the debtor than a conventional filing. These features generally are viewed favorably by bank lenders, trade creditors and the distressed-investing community.

However, there are drawbacks emanating from a reorganization process that is done as a pre-filing. A primary criticism leveled at pre-filings is that they are often shortsighted in their ambition and scope, and accomplish little more than financial reengineering without adequately addressing operating deficiencies and implementing substantive remedies, thereby leaving a reorganized company less

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1 *The New York Times* (1990).
2 *Journal of Applied Corporate Finance* (1991).

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leveraged but likely "unfixed" and still susceptible to subsequent failure. However, it would be premature to evaluate the legitimacy of these concerns given the relative recency of the pre-filing surge.

Pre-Filings by the Numbers

In order to assess the impact of pre-filings on case lengths, the authors analyzed large (those with liabilities greater than $50 million at the time of filing) chapter 11 cases that emerged from bankruptcy via a confirmed reorganization plan from January 2010 through June 2018. There were 434 relevant filings that emerged during this nearly eight-year period. Filings that were resolved via a sale of the debtor or substantially all its assets were excluded. The analysis supports the general observation that pre-filings have increased in recent years, and also identifies several factors that have contributed to their growing share of reorganizations.

Pre-Filings Have Accounted for a Larger Share of Reorganized Companies Since 2015

- *Forty-four percent* of cases that emerged from chapter 11 in 2010-18 (191 of 434) were pre-filings (that is, either prepackaged or prearranged/pre-negotiated), accounting for nearly one-half (47 percent) of all pre-filings over this period.
- However, 65 percent of cases that emerged after 2015 (71 of 109) were pre-filings, compared to 37 percent (120 of 325) from 2010-15 (as shown in Exhibit 1).

Pre-Filings and Private-Equity Ownership

- Reorganizations of companies owned by private-equity (PE) sponsors were much more likely to be pre-filing cases than non-PE owned companies, owing to the pressing need to quickly de-lever businesses, many of which were still operationally profitable at filing. As the share of chapter 11 filings attributable to companies owned by PE sponsors increases, which it has in recent years, the proportion of pre-filings likewise has increased.
  - – Companies owned by PE sponsors accounted for 27 percent of reorganized companies, yet accounted for 38 percent of all pre-filings.
  - – In all, 63 percent of filing companies owned by PE sponsors were pre-filing cases (73 of 116), compared to 37 percent for non-PE owned companies (118 of 318).

Pre-Filings and Debtor Size

- Reorganizations of larger companies were much more likely to be pre-filing cases than those of smaller companies.
  - – Companies with liabilities at filing in excess of $1 billion accounted for 29 percent of reorganized companies, yet accounted for *38 percent* of all pre-filings.
  - – In all, 58 percent of companies with liabilities at filing in excess of $1 billion were pre-filing cases (72 of 124), compared to 38 percent for companies with liabilities at filing of less than $1 billion (119 of 310).

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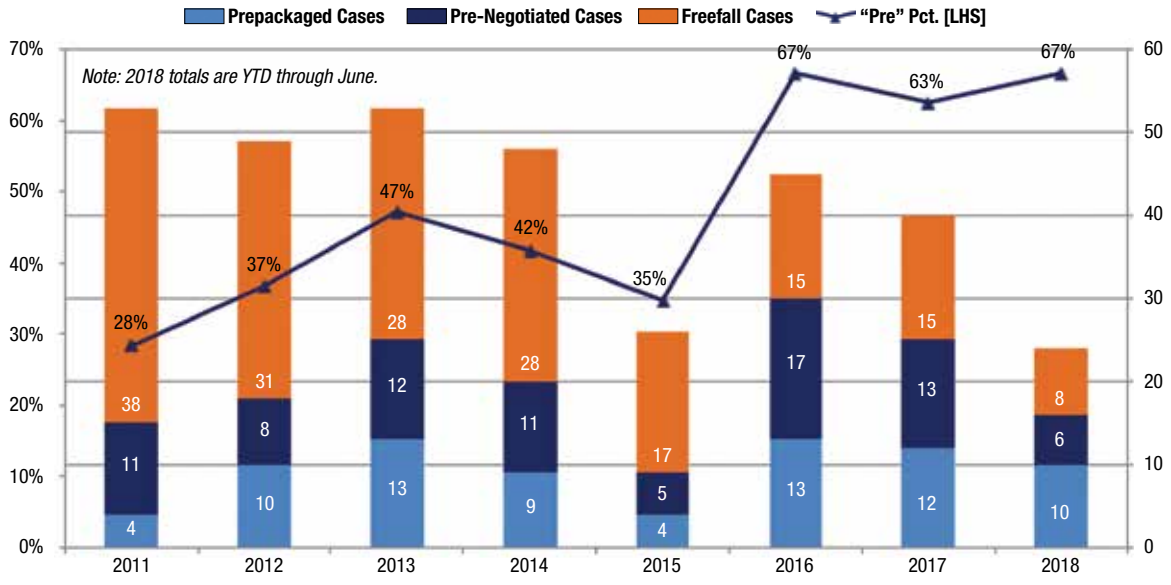
Exhibit 1: Emerging Chapter 11 Cases via a POR



Sources: The Deal Pipeline and FTI Consulting, Inc.

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Pre-Filings and Industry Sector

• Reorganizations in certain industry sectors, primarily energy and media, were more likely to be pre-filing cases. This makes sense, as companies that are asset-rich or whose enterprise value is derived largely from asset values are often better candidates for pre-filings than those that are asset-light and in need of extensive operational restructuring.

– The energy sector accounted for a disproportionate share of pre-filings. In all, 56 percent of energy sector companies that reorganized were pre-filings (45 of 80), compared to 44 percent across all industry sectors. Most of these occurred after the onset of the energy bust in late 2014.

– The media sector also accounted for a disproportionately large share of pre-filings. In all, 62 percent of media sector companies that reorganized were pre-filings (21 of 34), compared to 44 percent across all industry sectors. Media companies tend to be more levered than other industry sectors, so the prevalence of pre-filings in this sector is not surprising.

Pre-Filings by Venue

• Reorganizations outside the court venues of the District of Delaware, Southern District of New York and Southern District of Texas were much less likely to be pre-filings.

– Filings in Delaware accounted for 42 percent of all filings, but accounted for 54 percent of all pre-filings. In all, 57 percent of cases filed in Delaware were pre-filings (104 of 182), versus 44 percent across all venues.

– Filings in the Southern District of New York accounted for 17 percent of all filings, but accounted for 20 percent of all pre-filings. In all, 52 percent of cases filed in this district were pre-filings (38 of 73), versus 44 percent across all venues.

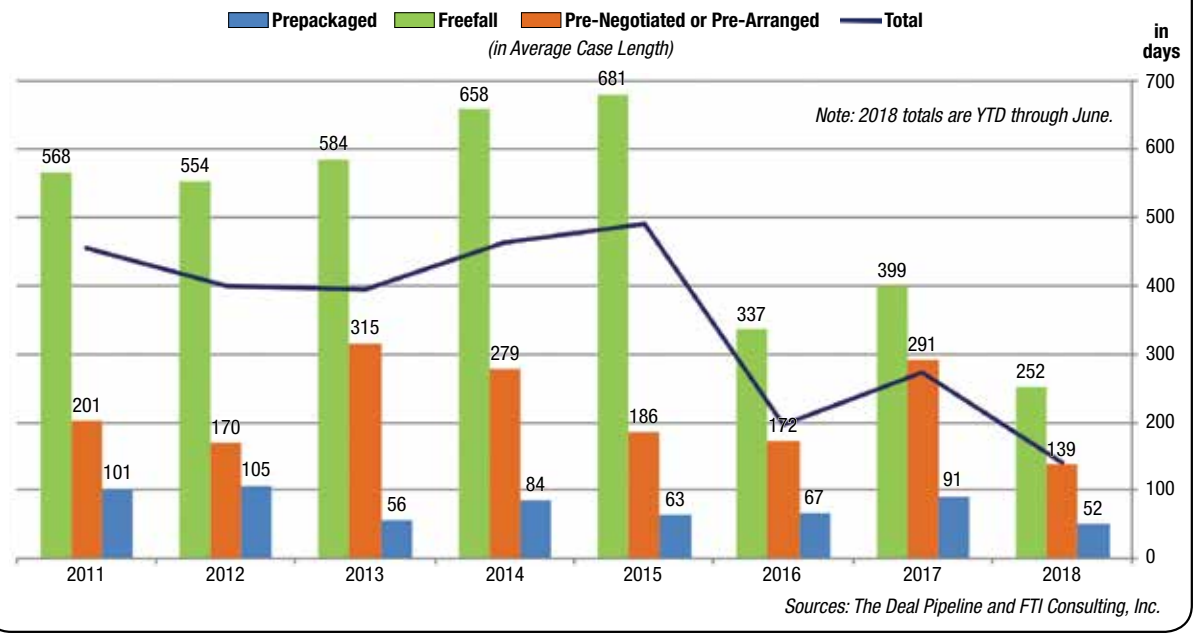
– Filings in the Southern District of Texas accounted for 6 percent of all filings, but accounted for 9 percent of all pre-filings. In all, 69 percent of cases filed here were pre-filings (18 of 26), which is likely attributable to the high percentage of filings by energy companies in that venue.

– Filings in all other venues accounted for 35 percent of all filings, but accounted for just 16 percent of all pre-filings. In all, only 20 percent of cases filed in all other venues were pre-filings (31 of 153), versus 44 percent across all venues.

Impact of Pre-Filings on Case Lengths and Outcomes

Most restructuring professionals recognize that the duration of a typical chapter 11 case from filing to emergence has become shorter in recent years. A primary driver behind these shorter case lengths is the prevalence of pre-filings. Consequently, the average duration of chapter 11 reorganizations fell by nearly one-half in 2016-18 compared to 2010-15, to 212 days from 401 days. Exhibit 2 shows a breakdown by category. The average case length of pre-filings did not change materially over this multi-year period; there were just a lot more of them in 2016-18. Prepackaged filings were con-

Exhibit 2: Emerging Chapter 11 Cases (Average Case Length)



Sources: The Deal Pipeline and FTI Consulting, Inc.

sistently within a range of 50-100 days from filing to emergence, averaging nearly 80 days, while pre-negotiated filings took about 216 days, on average, to emerge.

However, it was not just the increasing frequency of pre-filings that drove down average case length; the duration of freefall cases contracted sharply, to 344 days in 2016-18 from 545 days in 2010-15. This recent contraction might have been influenced by small sample size and case-specific randomness, as there were only a total of 38 freefall cases that emerged in 2016-18, compared to an average of 28 per year from 2011-15.

The impact of shorter case lengths on debtors' reorganization outcomes is not as easy to discern, and there are varying opinions on the issue. A prevailing belief is that a pre-filing is a "cheaper" alternative for a debtor than a conventional filing because it saves the estate substantial sums in professionals' fees. Related expenses can be a spurious argument, as many of the costs pertaining to negotiations with creditors around an RSA or plan are incurred prior to a filing rather than avoided, as are some other bankruptcy-associated expenses that once were primarily incurred post-filing. Moreover, a pre-packaged filing that is consummated in 80 days is certainly going to incur fewer reorganization-related expenses than a freefall filing that takes a year or more to emerge, but these undertakings are likely to be dissimilar in work scope. Can a 90-day prepack filing accomplish in scope and substance what a 250-day conventional filing could have, all other things being equal? It is not likely, but it is possible, depending on the man-hours and resources devoted to the effort.

The common criticism that a pre-filing is a less-rigorous reorganization that does not give the debtor sufficient time to plan and implement needed operating changes can be a misleading argument, as substantive business reforms can still be accomplished in an abbreviated time frame. For example, the authors' firm recently advised Southeastern Grocers LLC, which filed for bankruptcy in late March with a prepackaged reorganization plan. It emerged from chapter 11 in 65 days with a plan that equitized more than $500 million of debt (40 percent of its pre-petition debt), secured exit financing, closed 94 stores (and related lease rejections), planned remodels for nearly 100 stores and completed several M&A transactions in this short period of time. It was an impressive accomplishment by the debtor in only two months. Many of these actions were anticipated and planned out prior to filing.

Lastly, the concept of reorganization (either a pre-filing or conventional filing) as a comprehensive process to rehabilitate broken or uncompetitive businesses has often been an unrealistic ambition in many cases since the Great Recession. This is largely attributable to aggressive event milestones and liquidity constraints often imposed by debtor-in-possession (DIP) lenders, which no longer afford debtors the luxury of a lengthy reorganization.

Such lender constraints are not arbitrary; they often reflect a debtor's lack of unencumbered assets at the time of filing, as leveraged borrowers increasingly have relied on first-lien secured debt in recent years compared to the pre-recession period. This reality has limited financing options available to debtors during the pendency of a case. In instances where distressed investors will become majority owners of a debtor, they are also likely to favor an expedited reorganization process. Such time urgency is an aspect of most large cases today, whether or not the filing was a conventional one.

> **[P]re-filings should be judged by their future failure rates compared to their similarly situated peers, out-of-court workouts and other debtors that have reorganized around conventional chapter 11 filings.**

It Is Too Soon to Evaluate the Lasting Efficacy of Pre-Filings

The prevalence of prepackaged bankruptcies and other pre-filings with negotiated RSAs/PSAs that become the basis of a reorganization plan is a trend that is not likely to abate anytime soon, and will continue to impact case lengths and the scope of work in reorganizations. Whether these reorganization efforts ultimately "fix" a debtor and provide more than a salve of debt relief remains to be seen, as a large majority of these cases have emerged only within the last couple of years, which is typically too soon for re-failure to occur.

The ultimate effectiveness of pre-filings should be judged by their future failure rates compared to their similarly situated peers, out-of-court workouts and other debtors that have reorganized around conventional chapter 11 filings. Within the next few years, sufficient time will have passed to better assess these outcomes and judge their success in a more statistically rigorous way. The authors would expect that bankruptcy academicians will study these outcomes, as has been done for distressed-debt exchanges and "chapter 22" filers. Until then, expect a few premature victory laps by some debtors who will be back in a courthouse sooner than they expected. abi

Editor's Note: *For more on this topic, purchase* A Practitioner's Guide to Pre-Packaged Bankruptcy: A Primer*, available in the ABI Store (store.abi.org). Members must log in first to obtain reduced pricing.*

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Rochelle's DAILY WIRE

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Stern Held Inapplicable to Orders Denying Summary Judgment

> Delaware district judge explains why Stern doesn't confer the equivalent of an appeal from an interlocutory order.

A fraudulent transfer defendant attempted (unsuccessfully) to convince District Judge Leonard P. Stark of Delaware that *Stern v. Marshall*, 131 S. Ct. 2594 (2011), in practice and effect confers an automatic appeal from a bankruptcy court's interlocutory order denying a motion for summary judgment.

Without prejudice, the district court had previously denied a motion to withdraw the reference. In typical fashion, the order provided for the bankruptcy court to "manage the discovery process and any motion practice." The order allowed a renewed motion to withdraw the reference once the bankruptcy court had identified disputed issues of fact for submission to a jury.

Later, the defendant filed a motion in bankruptcy court for summary judgment, seeking dismissal of one count in a multi-count complaint because there allegedly were no facts to support a fraudulent transfer claim. The bankruptcy court's order denying summary judgment said it was a core proceeding.

Although the procedural posture was complicated, the defendant came to Judge Stark contending that denial of summary judgment was not core. More significantly, the defendant argued that the bankruptcy court should have entered proposed findings and conclusions for Judge Stark to review *de novo*.

Judge Stark didn't buy the idea. If the defendant's theory were correct, there would be the equivalent of an automatic appeal to district court anytime a bankruptcy court were to deny a motion to dismiss or a motion for summary judgment on a non-core claim.

The bankruptcy court's order said it was core under 28 U.S.C. § 157(b)(2), which contains a nonexclusive list of core matters, including proceedings to recover fraudulent transfers. 28 U.S.C. § 157(b)(2)(H).

The statement of "core" status was of no moment, Judge Stark said, because the order made no determination as to how the claim would be treated and did not purport to impair the defendant's rights under *Stern*. Furthermore, Judge Stark said the defendant conceded that the "core" label was nominally correct, given 28 U.S.C. § 157(b)(2)(H).

On an issue of greater significance regarding the right to *de novo* review, Judge Stark distinguished *Stern*, which entailed a final, binding judgment. In comparison, the bankruptcy court's order was nonfinal.

Judge Stark followed a 2012 Montana district court opinion rejecting the idea that a defendant is entitled to *de novo* review from denial of summary judgment in an order that is not a final and binding judgment. He also cited bankruptcy court decisions finding *Stern* inapplicable to an order denying a motion to dismiss or to a motion for partial summary judgment.

Opinion Link

View Opinion

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Case Details

Judge Name Leonard P. Stark

Case Citation	American Media Inc. v. Anderson Management Services Inc. (In re Anderson News LLC), 15-m-199 (D. Del. May 23, 2018)
Case Name	In re Anderson News LLC
Court	3rd Circuit Delaware
Bankruptcy Tags	Bankruptcy Litigation Practice and Procedure Venue/Jurisdiction

Bill Rochelle
EDITOR-AT-LARGE, ABI
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An insightful writer known for his authoritative take on legal developments affecting bankruptcy practice, Bill Rochelle published for Bloomberg every day from 2007 through 2015.

Prior to his second career in journalism, he practiced bankruptcy law for 35 years, including 17 years as a partner in the New York office of Fulbright & Jaworski LLP.

By The Numbers

Total cases in system	1142
Business Cases	443
Consumer Cases	496
Circuit Splits Cases	47
Supreme Court Cases	71
Total Judges	624

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March 15, 2019

Reading Stern Narrowly, Delaware Judge to Issue Final Order in Fraudulent Transfer Suit

> Judge Sontchi declines to rule that 28 U.S.C. § 157 is unconstitutional by denominating fraudulent transfer suits as 'core' proceedings.

Narrowly interpreting Supreme Court authority, Chief Bankruptcy Judge Christopher S. Sontchi of Delaware disagreed with the Ninth Circuit and several district courts by holding that the bankruptcy court has constitutional authority to enter a final judgment in a fraudulent transfer suit against a defendant who neither filed a claim nor consented to final adjudication in bankruptcy court.

Judge Sontchi concluded that the Supreme Court has not explicitly ruled that Sections 157(b)(1) and (b)(2)(H) are unconstitutional when applied to fraudulent transfer suits against defendants who have not filed proofs of claim. Absent high court authority, he declined to find the statute to be unconstitutional.

When thinking about Judge Sontchi's opinion, consider this question: Did he ignore an obvious implication of *Stern v. Marshall*, 564 U.S. 462 (2011)?

The Suit by the Creditors' Trust

The Paragon Offshore PLC chapter 11 plan created a trust to pursue claims on behalf of creditors. The trust filed suit after confirmation to recover allegedly fraudulent transfers that occurred before Paragon's chapter 11 filing.

The defendants filed a motion asking Judge Sontchi to declare that he could only enter proposed findings of fact and conclusions of law. Judge Sontchi denied the motion in a scholarly March 11 opinion that surveys the ups and downs (mostly downs) of bankruptcy courts' powers following *Northern Pipeline Construction Co. v. Marathon Pipe Line Co.*, 458 U.S. 50 (1982) (plurality opinion).

Judge Sontchi laid out the statutory framework, beginning with 28 U.S.C. § 157(b)(1), where Congress gave bankruptcy courts power to "hear and determine . . . all core proceedings." Section 157(b)(2)(H) lists fraudulent transfer suits among "core proceedings." Thus, the statute permits bankruptcy courts to enter final judgments in fraudulent transfer suits.

By contending that he could not issue a final judgment in a fraudulent transfer suit, Judge Sontchi said that the defendants were asking him to rule that parts of 28 U.S.C. § 157 are unconstitutional.

Granfinanciera and *Stern*

Judge Sontchi parsed the Supreme Court's bankruptcy decisions to identify what the justices held and how they limited their opinions. After *Marathon Pipe Line*, he examined *Granfinanciera S.A. v. Nordberg*, 492 U.S. 33 (1989), which, he said, was closely related but not binding, even though the facts were "closely analogous." Like the case at bar, *Granfinanciera* involved a fraudulent transfer suit against a defendant who had not filed a claim. The high court ruled that the defendant was entitled to a jury trial.

Judge Sontchi said that *Granfinanciera* at bottom was a Seventh Amendment case involving the right to a jury trial, not an Article III case regarding the constitutional limitations on the powers of bankruptcy judges. He said that *Granfinanciera* "alone" did not compel him to rule that Section 157(b)(2) violates Article III of the Constitution.

Judge Sontchi said that *Granfinanciera* "intentionally and explicitly refrained from extending its opinion to the constitutionality of the entry of final orders by bankruptcy courts pursuant to [Section 157] — the very issue before this Court today."

Next, Judge Sontchi turned to *Stern*. Like *Granfinanciera*, he said that *Stern* "does not bind lower courts on issues that were not directly before it."

While "its rhetoric may have been at points, sweeping," Judge Sontchi said that *Stern*'s "ultimate holding was not." Rather, he alluded to how the Chief Justice said that *Stern* should little affect the distribution of work between district and bankruptcy judges.

Stern, Judge Sontchi said, "included a crystal-clear statement that 'Congress, in one isolated respect, exceeded' its Article III power when passing the 1984 Amendments — and that 'isolated' issue is not the issue before this Court today."

Nodding to the Ninth Circuit and other courts that have ruled otherwise, Judge Sontchi said, "Perhaps *Stern* provides compelling evidences of how the Supreme Court *would* rule on this issue if it were to address it directly, but it does not decide it." [Emphasis in original.]

Since neither *Stern* nor *Granfinanciera* were controlling, Judge Sontchi said that the defendants "are not asking this Court to apply controlling precedent to the matter at hand. Instead, Movants are asking this court to *extend* the holdings of those cases, in order to find that 28 U.S.C. § 157(a) is unconstitutional to the extent it directs bankruptcy judges to enter final orders in fraudulent transfer claims against parties who have not filed claims against the bankruptcy estate. The Court decline to make that leap." [Emphasis in original.]

Judge Sontchi made two other notable rulings. First, he held that a claim for unjust enrichment is noncore even when the claim is based on the same facts as a fraudulent transfer claim that is core. He also held that the defendants had not waived their objections to the final adjudicatory power of the bankruptcy court by participating in the formulation of the plan.

Observations

Stern found a constitutional infirmity insofar as Section 157 lodged final adjudicatory authority in the bankruptcy court over a counterclaim based on a tortious interference claim under state law. *Stern* did not deal with a fraudulent transfer counterclaim.

So, the question is: Given the 5/4 ruling in *Stern* that Section 157(b)(2)(C) was unconstitutionally applied to the facts of the case before the Supreme court, does it follow ineluctably that Section 157(b)(2)(H) is also unconstitutional when the defendant has not filed a claim or consented to final adjudication in bankruptcy court?

In this writer's view, *Stern* does imply that Section 157(b)(2)(H) is also unconstitutional on the facts of a case like that before Judge Sontchi. However, keep in mind that *Stern* was a 5/4 decision. Also recall that none of the opinions in *Marathon Pipe Line* commanded a majority of the justices.

It is therefore not a foregone conclusion that the Supreme Court will assuredly rule that Section 157(b)(2)(H) is unconstitutional when and if the question is squarely presented. It is possible that the high court will draw a line and say that the Court has gone far enough in eroding the powers of bankruptcy judges. However, don't hold your breath.

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Case Details

Judge Name	Christopher S. Sontchi
Case Citation	Paragon Litigation Trust v. Noble Corp. PLC (In re Paragon Offshore PLC), 17-51882 (Bankr. D. Del. March 11, 2019)
Case Name	In re Paragon Offshore PLC
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An insightful writer known for his authoritative take on legal developments affecting bankruptcy practice, Bill Rochelle published for Bloomberg every day from 2007 through 2015.

Prior to his second career in journalism, he practiced bankruptcy law for 35 years, including 17 years as a partner in the New York office of Fulbright & Jaworski LLP.

By The Numbers

Total cases in system	1142
Business Cases	443
Consumer Cases	496
Circuit Splits Cases	47
Supreme Court Cases	71
Total Judges	624