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Case Summaries for 2019 Caribbean Insolvency Symposium – Judge's Panel

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Merit Mgmt. Group, LP v. FTI Consulting, Inc., 138 S. Ct. 883, 891 (2018)

FACTS

Two companies were in competition to obtain the last harness-racing license in Pennsylvania. By agreement of the companies, one withdrew as a competitor for the license, and agreed to allow the other company to buy its stock for $55 million. The purchasing company – now without competition – was able to obtain the harness-racing license and arranged for a bank's Cayman Island branch to finance the purchase as part of a larger $850 million transaction. The Cayman Islands branch wired the $55 million to another bank in Pennsylvania, which agreed to serve as a third-party escrow agent for the transaction. The shareholders in the selling company also deposited its stock certificates in escrow as well.

Unfortunately, the purchasing company was unable to obtain a sperate license that was necessary for its business. As a result, the purchasing company and its parent (the "Debtor") filed a Chapter 11 Bankruptcy.

The Trustee then sued shareholders of the selling company for constructive fraudulent transfers. The Trustee alleged that the Debtor was insolvent and significantly overpaid for the purchased stock. The shareholders moved for a judgment on the pleadings pursuant to Rule 12(c) of the Federal Rules of Civil Procedure. In their motion, the shareholders alleged that the Trustee's suit was barred by 11 U.S.C. 546(e) because the transfer at issue was a settlement payment made by or to (or for the benefit of) a covered financial institution.

ANALYSIS/DECISION

Section 546(e) of the Code, i.e., the "securities safe harbor," states, in pertinent part, that "the trustee may not avoid a transfer that is a margin payment . . . or settlement payment . . . made by or to (or for the benefit of) a . . . financial institution . . . in connection with a securities contract . . . commodity contract . . . or forward contract, that is made before the commencement of the case, except under section 548(a)(1)(A) of this title." 11 U.S.C.A. § 546(e).

Here, the Court was asked to determine how the "securities safe harbor" operates, when the transfer at issue was executed via multiple transactions, which include participation by financial institutions. Moreover, the Court was:

> [A]sked to determine how the safe harbor operates in the context of a transfer that was executed via one or more transactions, *e.g.,* a transfer from A → D that was executed via B and C as intermediaries, such that the component parts of the transfer include A → B → C → D. If a trustee seeks to avoid the A → D transfer, and the § 546(e) safe harbor is invoked as a defense, the question becomes: When determining whether the § 546(e) securities safe harbor saves the transfer from avoidance, should courts look to the transfer that the trustee seeks to avoid (*i.e.,* A → D) to determine whether that transfer meets the safe-harbor criteria, or should courts look also to any component parts of the overarching transfer (*i.e.,* A → B → C → D)?

Merit Mgmt. Group, LP v. FTI Consulting, Inc., 138 S. Ct. 883, 888 (2018).

The Court's analysis was relatively simple and focused on the plain language of the statute. After analyzing the text and statutory structure of Section 546(e), the Court determined that the relevant transfer for the purposes applying the 546(e) exception is the overarching transfer that the trustee is seeking to avoid. The fact that financial institutions may have been utilized as intermediaries in the component transactions comprising the overarching transfer, does not shield the overarching transfer from avoidance liability. Applying that principle to the case, the Court determined that the overarching transfer at issue, i.e., the transfer from the selling company to the Debtor, fell outside of Section 546(e)'s safer harbor.

Czyzewski v. Jevic Holding Corp., 137 S. Ct. 973 (2017)

FACTS

A private equity firm purchased the Debtor, pre-petition, through a leveraged buyout. Two years after the buyout, the Debtor filed for Chapter 11 Bankruptcy. As of the Petition Date, the Debtor owed $53 million to senior secured creditors (the buyer and lender) and over $20 million to tax and general unsecured creditors.

The circumstances surrounding the Debtor's bankruptcy lead to two lawsuits. The first lawsuit was filed by former employees of the Debtor regarding violations of state and federal Worker Adjustment and Retraining Notification (WARN) Acts laws. This lawsuit resulted in, among other things, a judgment which included an $8.3 million priority wage claim by the employees ("WARN Claimants"), entitled to payment before the general unsecured creditors of the Debtor's estate. The second lawsuit was a fraudulent transfer lawsuit against the buyer and lender.

The parties reached a settlement agreement that provided the following: (a) the fraudulent transfer lawsuit would be dismissed with prejudice; (b) the lender would deposit $2 million into an account earmarked to pay legal fees and expenses in connection with the fraudulent transfer lawsuit; (c) the buyer would assign its lien on the debtor's assets to a trust, which would pay taxes and administrative expenses, and distribute the remaining funds, on a pro rata basis, to the low-priority general unsecured creditors, *but nothing to the WARN Claimants*; and (d) the Debtor's bankruptcy case would be dismissed.

Although the Court found that the "structured dismissal" violated the Code's ordinary priority rules, it approved the settlement because of the "dire circumstances" present in the case, and the fact that there was no realistic prospect of a distribution to anyone other than the secured creditors.

ANALYSIS/DECISION

After determining that the WARN Claimants had standing, the Court "turn[ed] to the basic question presented: Can a bankruptcy court approve a structured dismissal that provides for distributions that do not follow ordinary priority rules without the affected creditors' consent?"

The Court's analysis emphasized that the priority system is fundamental to the proper operation of the Bankruptcy Code. And while the Code does not specifically prohibit structured dismissals, the Court noted that it "would expect to see some affirmative indication of intent if Congress actually meant to make structured dismissals a backdoor means to achieve the exact kind of nonconsensual priority-violating final distributions that the Code prohibits in Chapter 7 liquidations and Chapter 11 plans."

Although the Court recognized that Section 349(b) allows a bankruptcy court to enter various orders in connection with the dismissal of a case, "[n]othing else in the Code authorizes a court ordering a dismissal to make general end-of-case distributions of estate assets to creditors of the kind that normally take place in a Chapter 7 liquidation or Chapter 11 plan—let alone final distributions that do not help to restore the *status quo ante* or protect reliance interests acquired in the bankruptcy, and that would be flatly impermissible in a Chapter 7 liquidation or a Chapter 11 plan because they violate priority without the impaired creditors' consent." Nor could the Court find any bankruptcy-related justification for allowing a violation of the ordinary priority rules.

The Court also found that, notwithstanding prior Third Circuit rulings, Congress did not authorize a "rare case" exception that would allow a court to "alter the balance struck by statute."

Therefore, the approval of the structured dismissal was reversed and remanded.

In re Nuverra Envtl. Sols., Inc., 590 B.R. 75 (D. Del. 2018)

FACTS

Prior to the Petition Date, the Debtors began negotiations with certain creditors to prepare a prepackaged plan of reorganization (the "Plan"). To that effect, the Debtors began soliciting prepetition votes on the Plan. As of the date of their Chapter 11 filing, the Debtors had $500 million in secured debt and an uncontroverted value of $302.5 million. The Plan eliminated approximately $500 million of funded debt through the conversion to equity of certain notes and other secured debt. Additionally, senior creditors funded "gifted" distributions to holders of "out-of-the-money" general unsecured claims under the Plan.

With respect to these "gifted" distributions, the Plan treated unsecured creditors in different ways based upon, among other things, their respective legal rights and importance to the ongoing operation of the Debtors' businesses. For example, creditors holding claims derived from the purchase of certain notes (the "Note Creditors") received a combination of stock and cash by virtue of the gifted distributions from senior creditors, with an aggregate recovery valued at approximately 4-6%. In contrast, trade and certain other creditors related to the Debtors' business and operations (the "Trade Creditors") were reinstated under the Plan and therefore, were entitled to receive a 100% recovery by virtue of the gifted distributions. The Note Creditors voted to reject the plan, and one particular member of the class (the Appellant in this case) also objected to confirmation. The Appellant argued that: (a) it would receive a distribution of less value than certain of the Debtors' other unsecured creditors who also held unsecured claims; and (b) the classification scheme contemplated in the Plan was improper. The Bankruptcy Court overruled the objection, confirmed the plan, and held that any request to stay the confirmation order beyond the 10-day period included therein was not warranted.

The Appellant filed a notice of appeal, emergency motion to stay the confirmation order pending appeal, and motion for expedited consideration. The Court denied the stay motion, and the Debtors filed a motion to dismiss.

On appeal, the Appellant raised the following issues: (a) whether the Bankruptcy Court erred by finding that the "gift" under the Plan made by secured creditors to unsecured creditors, providing varying levels of claim recovery, did not constitute unfair discrimination; and (b) whether the Bankruptcy Court erred by concluding that the Plan properly classified the Note Creditors' claims (the "Note Claims") separately from other general unsecured claims. As its requested relief, the Appellant requested payment of 100% of its claim, plus interest, so it would receive the same treatment as the Trade Creditors. Aside from responding to the appellate issues, the Debtors asserted that the appeal was equitably moot as the Plan had been substantially consummated.

ANALYSIS/DECISION

The Court first addressed the equitable mootness claim. In analyzing equitable mootness, courts in the Third Circuit must determine: (1) whether a confirmed plan has been substantially consummated; and (2) if so, whether granting the relief requested in the appeal will (a) fatally scramble the plan and/or (b) significantly harm third parties who have justifiably relied on plan confirmation. Because the Appellant conceded that the Plan was substantially consummated, the Court turned to the second prong of the analysis to determine whether granting the requested relief would require undoing the plan as opposed to modifying it in a manner that would not cause its cause its collapse.

The Court noted that the first item to review in the analysis is the specific relief requested. Here, the Appellant requested a 100% distribution. But providing the Appellants with a greater recovery than the other members of its class would violate 1123(a)(4) of the Code. Furthermore, even if the Court could authorize a larger individual recovery to the Appellant without violating the Bankruptcy Code, the Court was unsure how it could fund such a recovery. Moreover, the gifted distributions were funded by the collective, agreed concessions of various senior lenders. The Court held that it could not order those creditors to supplement a gift that they made voluntarily. Therefore, the Court found that "there [wa]s no practical relief that could be granted to Appellant that would not violate express provisions of the Bankruptcy Code, fatally scramble the Plan, and significantly harm third parties who have justifiably relied on plan confirmation."

Alternatively, the Court also found that the Plan was properly confirmed. Because unfair discrimination is not defined in the Bankruptcy Code, the Court applied the *Markell* test set forth by Bruce A. Markell in "A New Perspective on Unfair Discrimination in Chapter 11," 72 Am. Bankr. L. J. 227, 249 (1998). Under the *Markell* test, a rebuttable presumption of unfair discrimination arises when there is: "(1) a dissenting class; (2) another class of the same priority; and (3) a difference in the plan's treatment of the two classes that results in either (a) a materially lower percentage recovery for the dissenting class (measured in terms of the net present value of all payments), or (b) regardless of percentage recovery, an allocation under the plan of materially greater risk to the dissenting class in connection with its proposed distribution."

The Court noted that unsecured creditors would not be entitled to any distribution under the Bankruptcy Code's priority scheme, and the higher distribution Trade Creditors did not diminish the distribution to Note Creditors. Moreover, if the Trade Creditors did not receive their increased distributions, the surplus distribution would revert to secured creditors, not Trade Creditors. In other words, because the Appellant and its class were not entitled to a distribution in the first place, providing a greater distribution to a different class of unsecured creditors did not alter the distribution to which the Appellant was entitled.

The Court also found that the "gifting" scheme did not violate the absolute priority rule in Section 1129. Unlike the other cases examined by the Court, there was no "vertical class skipping" which gave property to *junior* claimants over the objection of a more *senior* class that was impaired. In other words, the gift at issue did not impermissibly provide for a distribution to a class *junior* to the Note Creditors.

With respect to classification, the Court found that there is significant flexibility in classifying claims and interests into different classes. These classifications are permissible as long as there exists a rational legal or factual basis for separate classification, and all claims or interests within a particular class are substantially similar. Here, the Note Creditors derived their claims from a single debt instrument, while the Trade Creditors' all had claims that arose in connection with the Debtors' business operations. Therefore, the Court found that the Plan permissibly classified the Note Creditors' claims separately from the Trade Creditors' claims.

In re Tempnology, LLC, 879 F.3d 389 (1st Cir. 2018), *cert. granted in part sub nom. Mission Prod. Holdings, Inc. v. Tempnology, LLC*, 139 S. Ct. 397 (2018)

FACTS

The Debtor made specialized products designed to remain at low temperatures when used during exercise. Prior to the Petition Date, the Debtor and Mission Products Holdings ("Mission") entered into a Co-Marketing and Distribution Agreement (the "Agreement") which provided Mission with, among other things, three relevant categories of rights: (a) distribution rights to certain of its manufactured products; (b) a non-exclusive license to the Debtor's intellectual property; and (c) a non-exclusive, non-transferable, limited license for the use of the Debtor's trademark. The

Agreement also contained a provision permitting either party to terminate the agreement without cause, which would trigger a two-year "wind-down" period.

The Debtor exercised the termination provision but attempted to immediately terminate the Agreement, alleging that Mission violated the Agreement's restrictive covenants. At arbitration, the arbitrator found that the Debtor waived any grounds for immediate termination. The Debtor subsequently filed for Chapter 11 Bankruptcy and moved to reject the Agreement. The Debtor and Mission agreed that Mission could insist that the rejection not apply to nonexclusive patent licenses contained in the Agreement. The Debtor and Mission, however, disagreed on whether the rejection applied to the Agreement's grants of a trademark license and of exclusive rights to sell certain of Debtor's goods. Moreover, Mission argued that Section 365(n) allowed it to retain both its intellectual property license and its exclusive distribution rights.

The Bankruptcy Court granted Debtor's rejection motion, subject to Mission'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). Mission again objected, arguing that the relief requested required an adversary proceeding pursuant to Rule 7001(2) of the Federal Rules of Bankruptcy Procedure.

After holding a non-evidentiary 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. Several appeals ensued.

ANALYSIS/DECISION

In analyzing the decisions of the lower courts, the Court first turned to the plain language of the statute. Section 365(a) permits the debtor-in-possession to assume or reject contracts. With respect to the rejection of intellectual property rights, Section 365(n)(1) states that:

> 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.

Under 11 U.S.C. § 101(35A), the term "intellectual property" is defined as: (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. The term "trademark," however, is not specifically mentioned in Section 101(35)A) as a recognized type of intellectual property.

After analyzing the language in the statute, the Court first turned to the exclusivity agreement. The Court found that Section 365(n) did not apply to the exclusivity provisions in the Agreement at issue. While Section 365 (n)(1)(B) may protect an exclusive license to use a recognized form of intellectual property under the Code, it does not also protect the exclusive right to *sell a product* just because that right appears in a contract that also contains a license to use intellectual property. As noted by the Court, Congress made clear that 365(n) was narrowly intended to ensure that the rights of an intellectual property licensee to use the licensed property are not unilaterally cut off. Given that the right to sell a product is not included within the Code's definition of intellectual property, the Court refused to treat it as such.

With respect to the trademarks, the Court recognized that Congress expressly listed six kinds of intellectual property in the Code. Trademark licenses – which are common and "not easily forgotten" – appear to have been purposefully excluded by Congress. The Court determined that Congress' decision to exclude trademark licenses from the scope and language of section 365(n) was presumably purposeful.

The Court also noted that that trademarks are different from the other, listed, intellectual property categories because the licensing of trademarks requires the trademark owner to monitor and exercise control of the quality of goods sold to the public in the subject trademark. The failure to monitor and exercise this control over a trademark can result in a "naked license," which can jeopardize the continued validity of the owner's trademark rights. Thus, if Mission were allowed to retain and use the Debtor's trademarks, it:

> "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."

Accordingly, the Court held that, unless Congress decides otherwise, trademark licenses are unprotected from court-approved rejection.

The Court also held that the Bankruptcy Court's decision to rule without the initiation of an adversary proceeding was, at most, harmless error.

***In re Fundamental Long Term Care, Inc.*, 873 F.3d 1325 (11th Cir. 2017), *cert. denied sub nom. Estate of Jackson v. Schron*, 139 S. Ct. 210 (2018)**

FACTS

The Estates of several, deceased, nursing home patients brought a series of wrongful death lawsuits against a network of nursing homes. The suits resulted in $1 billion of uncontested, "empty chair" judgments against the network. To evade the enforcement of the judgments and other liabilities, the nursing home network, under the direction of a lawyer and investment banker, engaged in a series of transactions involving the creation of new entities, and the transfer of assets and stock. One entity was created to purchase the assets of the network and another company was created to purchase the stock. The result of the transactions was that one entity owned all of the network's assets, but none of its liabilities; a classic "bust-out" scheme.

When the Estates learned of the bust-out transactions, they initiated: (a) proceedings supplementary against various entities and individuals alleged to have received fraudulent transfers; and (b) involuntary Chapter 7 proceedings against the Debtor, who was one of the successor entities created in connection with the bust-out scheme. A target of the litigation was

Rubin Schron ("Schron"); a wealthy real estate investor who was allegedly involved in some way in the bust-out scheme. Notably, though, the pleadings did not allege that Mr. Schron owned any of the successor entities, or that he was directly involved in designing the transactions comprising the bust-out scheme.

The Estates subsequently commenced an adversary proceeding in Bankruptcy Court. The Complaint was amended twice to add numerous counts, parties and legal theories, ultimately aimed at unwinding the bust-out scheme and recovering the assets of the original judgment debtor. The claims against Schron were dismissed because, among other things, the Complaint did not allege that Schron committed any act individually, or that there was a basis for derivative liability. The Court supplemented its dismissal by also entering a final judgment in favor of Schron. The final judgment stated that it was "entered in favor of Schron on all claims that were or could have been asserted by Plaintiffs against him in the amended complaint and the second amended complaint."

After a 12-day bench trial on the remaining counts, the Court ordered the parties to mediation. Mediation was successful and ultimately resulted in five settlement agreements which generated $23.7 million. Because Schron had been dismissed from the litigation, he was not a party to any of the settlement agreements. The Estates, however, had repeatedly represented that they intended to bring future action against Schron. Accordingly, Schron opposed the various settlements unless they were accompanied by a permanent injunction preventing the Estates from reviving or bringing any new state-court judgment-enforcement actions against him.

In this regard, the Bankruptcy Court issued a permanent injunction (the "Injunction") prohibiting the Plaintiffs from pursuing claims against Schron arising out of the nucleus of facts set forth in the Complaint. The Injunction was essential to and a condition of the Court's approval of the settlements. The Bankruptcy Court determined that a settlement of the surviving claims could not be "fair and equitable" unless it also finally resolved the claims against Schron.

The Estates appealed Schron's dismissal from the case and the Injunction. The District Court affirmed both orders of the Bankruptcy Court. The Estates appealed the affirmance, asserting that: (a) that the Bankruptcy Court lacked jurisdiction to enjoin state-law claims; (b) even if the Bankruptcy Court had jurisdiction, it violated the All Writs Act and the Anti-Injunction Act; (c) the Estates' sufficiently alleged their causes of action; and (d) even if the Estates did not sufficiently allege their causes of action, they should be granted to leave to amend their Complaint.

ANALYSIS/DECISION

The Court first addressed the issue of jurisdiction. The Court found that a bankruptcy court has the authority to enjoin a civil action "if the outcome could alter the Debtor's rights, liabilities, options, or freedom of action or in any way impacts upon the handling and administration of the bankrupt estate." In the instant case, the Court found that any judgments against third parties would impact the size and administration of the bankruptcy estate, as well as the debtor's potential claims with respect to the bust-out scheme. Accordingly, the Court found that the Bankruptcy Court possessed subject-matter jurisdiction under § 1334(b) to enjoin claims against Schron arising from the bust-out scheme.

The Court then addressed whether the Bankruptcy Court had authority to enjoin pending and future state-court proceedings under the particular circumstances of the case. The Bankruptcy Court justified the Injunction under the All Writs Act, 28 U.S.C. § 1651, which states that federal courts "may issue all writs necessary or appropriate in aid of their respective jurisdictions and agreeable to the usages and principles of law." The All Writs Act, however, is limited by the Anti-Injunction Act, 28 U.S.C. § 2283, which provides that a Court of the United States may not grant an injunction to stay proceedings in a State court except: (1) as expressly authorized by Act of Congress; (2) where necessary in aid of its jurisdiction; or (3) to protect or effectuate its judgments. The Eleventh Circuit agreed with the Bankruptcy Court's conclusion that the Injunction was "necessary in aid of its jurisdiction" and necessary "to protect or effectuate its judgments" under the second and third Anti-Injunction Act exceptions.

With respect to the dismissed claims, the Injunction was necessary to "protect the integrity or enforceability of its existing orders, i.e. the Court's order dismissing the Bankruptcy Estates' claims against Schron, as well as the settlement agreement between the Probate Estates, the Trustee, and the remaining defendants. With respect to the potential claims, i.e., those not yet asserted against Schron in the Complaint, the Court found that the injunction was necessary in aid of the Court's jurisdiction. Moreover, courts have found that "state *in personam* proceedings that threaten to make complex multidistrict litigation unmanageable" may be enjoined in aid of the court's jurisdiction. Although the Court noted that this case was not multidistrict in nature, it was sufficiently complex to justify the injunction.

The Court then turned to the allegations in the Complaint and the Estates' argument that the Bankruptcy Court had not properly analyzed the allegations. The Court first noted that the Complaint failed to allege that Schron took any affirmative act with respect to the bust-out scheme. And while the lawyer and investment banker may have sometimes acted as an agent/fiduciary of Schron, the Complaint did not allege that they acted in this capacity with respect to the bust-out scheme. In fact, the Complaint incorporated several factual allegations from a separate lawsuit where Schron alleged that the lawyer and investment banker had executed the bust-out scheme without Schron's knowledge or involvement, for their own benefit, and in breach of duties they owed to him. Thus, the Court found that the Complaint failed to properly state a claim against Schron under any sort of agency theory.

The Complaint also alleged liability under a sperate transaction; an agreement wherein Schron and other defendants paid the receiver of the judgment debtor $700,000, for all claims that the estate had against any third parties. Although the Complaint alleged that these claims were worth over $2 billion, the Complaint failed to allege sufficient facts to support this figure.

The Estates also argued that their abuse-of-process counts against Schron were improperly dismissed. However, the Court found that the Estates failed to properly allege, as required, that the defense of the original judgment debtor was not primarily designed for the simple goal of defending it.

Last, the Estates challenged the dismissal of their claims with prejudice. The Court found that in light of the Estates' "inability or unwillingness to remedy the deficiencies in their pleadings, the bankruptcy court exercised proper discretion in dismissing the Second Amended Complaint with prejudice."

In re Taylor, Bean & Whitaker Mortgage Corp., 3:09-BK-07047-JAF, 2018 WL 5784699 (Bankr. M.D. Fla. Nov. 1, 2018)

FACTS

Taylor, Bean & Whitaker Mortgage, Corp. ("TBW" or the "Debtor") filed for Chapter 11 Bankruptcy after being raided by the FBI. The Bankruptcy Court confirmed a liquidating Chapter 11 Plan and appointed a plan trustee. The Trustee filed several adversary proceedings, including one against the Debtor's payroll provider, ADP, Inc. n/k/a ADP, LLC ("ADP"). ADP provided payroll services for the Debtor from 2006 to 2009. The Trustee sought to recover $34 million paid to ADP in connection with its payroll servicing, alleging that ADP was an "initial transferee" under Section 550 of the Bankruptcy Code.

In response, ADP alleged that it was a "mere conduit," shielded from initial transferee liability under applicable Eleventh Circuit case law. The Trustee and ADP both filed three, separate, partial summary judgment motions on the issue of the mere conduit defense.

ANALYSIS/DECISION

The Court was asked to determine "whether ADP, a payroll processing company, was a mere conduit when it processed the Transfers pursuant to TBW's instructions, notwithstanding the fact that the Transfers may have been part of a 'great big fraud.'" The mere conduit defense required ADP to prove that it: (a) did not have control over the funds received from TBW; and (b) acted in good faith and as an innocent participant in the fraudulent transfers.

As noted by the Court, the lack of control by a bank over a deposit account is the quintessential example of a mere conduit. Here, ADP asserted that its business model was akin to that of a bank. So, while ADP had possession of the funds, "TBW's Payroll and HR Departments directed and controlled the money transferred to ADP for the payment of employee wages, taxes and garnishments. And much like a bank, ADP was contractually obligated to honor those instructions."

In response, the Trustee asserted that ADP was unlike a bank because: (a) banks are extensively regulated; and (b) banks have an obligation to return their customer's money. While the Court agreed that these were important distinctions, the Court did not believe that they justified the disqualification of ADP as a mere conduit.

First, while ADP is not regulated the same way as a bank, its contractual obligations are analogous to a bank's obligations when it accepts money into a deposit account. The Court also noted that, as in *Pony Express,* 440 F.3d 1296 (11th Cir. 2006), the mere conduit test "takes on special significance where the recipients of avoidable transfers are agents or fiduciaries of the debtor-transferor ... who are duty-bound to take only limited actions with respect to the funds received." Here, ADP had a limited power of attorney for payroll tax services and to that extent, had some attributes of a fiduciary. In light of the above, the Court found that ADP did not control the transfers at issue and it would be inequitable to find ADP liable for fraudulent transfers in relation to funds that were ultimately passed along to employees, taxing authorities and garnishors of the Debtor. Thus, the Court granted partial summary judgment in favor of ADP on the control element of its mere conduit defense.

The Court then turned to the good faith element of the mere conduit defense. This element required ADP to prove that it was an innocent participant in the fraudulent transfers. As a preliminary matter, the Court found that ADP did not have actual knowledge of the Debtor's condition or its principal's fraudulent conduct until after the FBI raided the Debtor's offices. And while the Trustee identified alleged "red flags" that should have put ADP on notice, the Court found them to be "red herrings." Moreover, "ADP was hired to process the payroll data TBW input into PayForce and provide related customer support. ADP does not advise clients on how to operate their businesses – just payroll processing. It is up to the client to decide what companies they open, who to pay, and how to pay those individuals. ADP has no legal or contractual obligation to review, evaluate, or audit its clients' transactional data, nor should it."

Even if ADP had become suspicious of the Debtor's potential fraudulent activity, the Court found that it was unclear what they could or should have done with the knowledge. Moreover, "[i]t is a tough case to argue that the company handling the automated payroll should have acted where the TBW's Board of Directors and auditors failed to do so." Accordingly, the Court entered partial summary judgment in favor of ADP on the issue of its good faith for purposes of its mere conduit defense.

In re Millennium Lab Holdings II, LLC, 575 B.R. 252 (Bankr. D. Del. 2017), *aff'd*, 591 B.R. 559 (D. Del. 2018)

FACTS

The Debtors filed voluntary Chapter 11 petitions, together with prepackaged plans of reorganization (the "Plan") and a disclosure statement. The Plan provided for the global resolution of claims related to the Debtors' 1.825 billion senior secured credit facility, the proceeds of which funded a $1.3 million dividend to equity holders, paid off certain debts and provided for working capital. Voya – the objecting creditor in this case – funded $106.3 million of the loan. Under the terms of the Plan, each lender, including Voya, would receive, in exchange for an allowed claim under Section 502, its pro rata share of: (a) a new $600 million term loan; (b) 100% of the beneficial ownership interests of the reorganized Debtors; and (c) any recoveries from a trust created to pursue the Debtors' retained causes of action.

Voya objected to the Plan, only on the basis that it included releases of claims that creditors, including Voya, could assert against Non-Debtor Equity Holders, as well as the accompanying bar order and injunction. Voya contended, among other things that: (a) the Court did not have subject matter jurisdiction to grant non-consensual third parties releases; (b) third party releases are impermissible; and (c) the plan must permit parties to opt out of the releases. Additionally, the day before the confirmation hearing, Voya filed a complaint in District Court against certain Non-Debtor Equity Holders, for RICO and common law fraud.

The Bankruptcy Court issued a bench ruling confirming the plan. As part of the bench ruling, the Court agreed that the parties could submit further briefing on the bar order provision and continued the hearing. Prior to the continued hearing, however, the Debtors filed a letter on the docket confirming that, with the consent of Voya and other interested parties, the bar order was removed from the Plan. The letter also stated, among other things, that Voya had no further objections to the Plan that had not been ruled upon. The Court then entered an order confirming the Plan.

That same day, Voya filed a Notice of Appeal, together with an emergency motion requesting certification of a direct appeal to the Third Circuit and a motion for stay pending appeal. Voya asserted that a direct appeal would enable the Third Circuit to clarify: (a) whether nonconsensual releases of non-debtors' direct claims against other non-debtors are permissible; and (b) if so, under what circumstances. Voya then filed a Statement of Issues on Appeal which questioned, among other things, and for the first time, whether the Bankruptcy Court had constitutional authority to enter a final order confirming the plan.

The District Court remanded the bankruptcy case for further proceedings to, among other things, consider whether the Bankruptcy Court had constitutional adjudicatory authority to approve the nonconsensual release of Voya's common law fraud and RICO claims against the Non–Debtor Equity Holders.

ANALYSIS/DECISION

As a preliminary matter, the Court noted that the confirmation of reorganization plans is one of the core proceedings specifically listed in 28 U.S.C. §157(b)(2). Thus, there is no doubt that a Bankruptcy Court has subject matter jurisdiction to enter a final order confirming a chapter 11 plan.

The Court then conducted a lengthy analysis of the various cases discussing Bankruptcy Court jurisdiction over certain claims. Specifically, the Court analyzed the history of the decisional case law leading up to *Stern*. The Court then analyzed the various interpretations of *Stern* including: (a) the "narrow interpretation," which stands for the proposition that a bankruptcy judge lacks 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; and (b) the "broad interpretation," which stands for the proposition that a bankruptcy judge cannot enter a final judgment on all state law claims, common law causes of action or all causes of action under state law. The Court determined that under either interpretation, *Stern* is limited to state law claims or counterclaims brought by a debtor-in-possession or trustee.

In the instant case, the operative proceeding was the confirmation of a plan. Confirmation, however, is not a claim, counterclaim or an action. Nor is confirmation a matter of state law. Accordingly, the Court determined that *Stern* was not applicable and the Court, as a constitutional matter, was permitted to enter a final order on confirmation. Even using the broadest interpretation of *Stern*, the confirmation of a plan is a core proceeding that is unique to bankruptcy cases. And there is no doubt that a bankruptcy court has constitutional authority to confirm a bankruptcy plan that only exists in the context of a bankruptcy case.

Voya also argued that it was unconstitutional for a bankruptcy judge to enter a final order in any context, if it affects a lawsuit filed by a creditor against a third party. The Court disagreed, finding that *Stern* does not prevent a bankruptcy judge from entering final orders in statutorily core proceedings that might collaterally impact state law claims – even if the impact effectively precludes adjudication of the merits of the state law claims. While the Court acknowledged that bankruptcy judges cannot enter final orders on certain state common law claims between private parties without their mutual assent, the Third Circuit had already found that: (a) Congress could assign cases involving "public rights" to non-Article III courts; and (b) claims arising under federal bankruptcy laws are public rights, which essentially means that the confirmation of a Chapter 11 plan is a public right.

Voya further argued that the entry of the confirmation order was essentially an "adjudication" of its RICO Lawsuit, which *Stern* prohibits. And, because the RICO Lawsuit was non-core in nature, the Court was prohibited from entering a confirmation order that approved third party releases regarding the non-core RICO Lawsuit. But as noted by the Court, this reasoning improperly "examine[d] the legal consequence of the confirmation order to find fault with the entry of the order, rather than examining the propriety of issuing the confirmation order in the first instance." Even assuming that that the Court did not have constitutional authority to enter a final order confirming the Plan, the Court held that Voya forfeited the right to contest the Court's authority by not raising the argument in its prior court papers or at the prior hearings. Voya also implicitly consented to the Court's authority, thereby waiving the right to contest it. Moreover, Voya did not make a constitutional adjudicatory authority argument or request that the Court enter proposed findings of fact and conclusions of law at the confirmation hearing.

Last, even if Voya was entitled to a hearing on the merits of its RICO Claim, Voya waived its right to such a hearing by asserting that the merits of its RICO Claim were not at issue. If Voya's position was that the confirmation order was an actual adjudication of the RICO Claims, Voya had an obligation to submit evidence on the merits of its claims at the confirmation hearing.