Medley of Current Chapter 11 Issues: From Overcoming Challenges to Finding an Efficient Exit Strategy

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This article will explore the current Chapter 11 issues from the inception of the case to exit and will discuss current case law and trends, including financing obstacles, the ability of a lender to obtain default interest post-petition, plan support agreements, structured dismissals, cram-down interest rates, non-conventional financing, third-party releases and the erosion of the equitable mootness doctrine on appeal. To help illustrate this discussion, consider the following scenario:

FACTS

ABC Inc. owns and operates a resort hotel in Florida, with significant amenities, including a spa, 4 on-site restaurants, meeting rooms, catering services and golf. The hotel is estimated by the Debtor to have a value of $175M, and estimated by the Bank to have a value of $125M. Bank has a mortgage on the property, and a lien on all assets, including rents and receivables, and controls all of the hotel's cash through a lockbox arrangement, with an account control agreement. Bank is owed $150M. There is a priority tax claim of $3M. There are unsecured claims of $10M, including an $8M judgment that was obtained against the hotel. An Official Committee of Unsecured Creditors was formed.

The hotel has historically generated 60% of its business from groups, which also generate more ancillary revenue from spa, golf and catering. After the financial crisis in 2008, and the lingering "AIG effect", the hotel's financial performance dropped dramatically. Although it improved in recent years, golf has waned in popularity, and the resort continues to lose group business to comparable resorts that are on the Ocean. The Debtor was able to pay operating expenses, but was unable to service the debt. Bank called a default, accelerated the mortgage, assessed default interest of 18% (a significant premium over the 6% non-default rate), and brought a foreclosure action. ABC Inc. filed Chapter 11 to stay the foreclosure and explore strategic opportunities with the resort.

Issue No. 1: At the outset of the case, the Debtor seeks authority to use cash collateral, offering a replacement lien in all post-petition revenues, to the extent of any diminution. The Debtor's budget provides for not only operating expenses to be paid, but current legal fees as well. Bank does not object to reasonable operating expenses being paid, but does object to payment of legal fees. In support of the objection, the Bank argues that it already has a lien on all rents pursuant to Section 552, and that a replacement lien in this circumstance does not provide adequate protection. What result?

Issue No. 2: The parties had a contested valuation hearing and the Debtor prevailed, with a valuation of $175M. Now the Bank claims entitlement to pre-petition and post-petition interest at the default rate of 18%. Is the Bank entitled to the default rate under Section 506(b)?

Issue No. 3: Debtor files a plan that proposes to restructure the Bank's loan, with interest payments at the rate of prime plus 2% over 10 years, with a balloon payment due in year 10. Bank fights the cram down rate, and claims entitlement to a market rate of 10%. What result?

Issue No. 4: Debtor's plan seeks broad third party releases that include releases of the Debtor's officers and directors. Debtor claims that the O&Ds have substantially contributed to the success of the hotel, have not drawn a salary for years, and have worked hard to improve the value of the hotel, in the best interest of all the constituents. Bank objects, and claims that such non-consensual third party releases are not allowed. What result?

Issue No.5: Assume the Bank prevailed at the contested valuation hearing, and the property is determined to have a value $125M. The Debtor acknowledges that it can no longer succeed with the cram down plan it wanted to accomplish. The Bank wants the hotel sold through the Chapter 11, as it believes that is the best way to maximize value. The Committee objects, unless there is some carve-out for unsecureds. The Debtor, Bank and Committee agree to a sale process, which provides for the Bank to gift $2.5M to the unsecureds out of the proceeds of the Bank's collateral. The Debtor, Bank and Committee agree that the case can then be dismissed, with the dismissal order providing for a distribution process, and with agreed upon releases being exchanged between the parties to the settlement. The IRS objects, because it is getting nothing on account of $3M tax claim, and contends that this structured dismissal violates the absolute priority rule. What result?

Issue No. 6: The bankruptcy court approves the sale process and dismissal, and the IRS appeals (without obtaining a stay). The Debtor, Committee and Bank assert that the appeal is equitably moot, because the distributions under the plan have already commenced. What result?

I. Financing Obstacles

As a front end issue (challenge), how does the debtor continue to operate when the cash is subject to a security interest or doesn't belong to the debtor?

A. Security Interest in Rents

In most cases, debtors can provide adequate protection for the use of cash collateral by, *inter alia*, offering a replacement lien in post-petition receivables, which would otherwise be cut off by Section 552(a). However, Section 552(b)(2) provides that "if the debtor and an entity entered into a security agreement before the commencement of the case and if the security interest created by such security agreement extends to property of the debtor acquired before the commencement of the case and to amounts paid as rents of such property or the fees, charges, accounts, or other payments for the use or occupancy of rooms and other public facilities in hotels, motels, or other lodging properties, then such security interest extends to such rents and such fees, charges, accounts, or other payments acquired by the estate after the commencement of the case to the extent provided in such security agreement, except to any extent that the court, after notice and a hearing and based on the equities of the case, orders otherwise."

Thus, in a situation in which the debtor's cash collateral consists solely of "rents" or payments for rooms at a motel, the lender will have an automatic post-petition lien on such rents and fees, pursuant to Section 552(b)(2). If the debtor wants to use such cash without the lender's consent and offer a replacement lien as adequate protection, the lender could object and assert that the replacement lien in this situation is not adequate protection, because the debtor is not providing the lender with anything that it does no already have under Section 552(b)(2). This could create a problem for debtors that do not have anything else to offer as adequate protection.

The case law has recognized that, in cases in which the debtor's cash consists solely of rents or other income described under Section 552(b)(2), simply purporting to offer a secured creditor a replacement lien or cash payments derived from the same rents which the debtor proposes to utilize does not qualify as sufficient "adequate protection" pursuant to sections 361 and 363 of the Code. *See, Putnal v. Suntrust Bank*, 489 B.R. 285, 290 (M.D. Ga. 2013) ("Most courts recognize that a prepetition security interest in rents is a special kind of collateral that, pursuant to 11 U.S.C. § 552(b), continues in full force and effect after the petition is filed. As such, the replacement lien theory's purported protection is seen as 'illusory'…Put another way, a replacement lien simply provides no protection for the very real interest the creditor has in accruing rents. That is why 'virtually every case addressing this issue' has rejected the replacement lien [theory].")(*citing In re Smithville Crossing, LLC*, 2011 Bankr. LEXIS 4605, 2011 WL 5909527 at *10). At the same time, if a hotel or motel owner has revenues from sources other than "rents", such as restaurant revenue or retail revenue, the debtor can argue that income from these sources is not covered by Section 552(b)(2).

II. Lender's Entitlement to Default Interest

Section 506(b) makes clear that an over-secured lender is entitled to "interest on such claim, and any reasonable fees, costs, or charges provided for under the agreement or State statute under which such claim arose." At the same time, Section 506(b) does not specify the rate of interest that applies to such entitlement. As a result, there has historically been considerable divergence in the courts on this issue, with some courts variously determining that the appropriate rate should be: (a) the non-default contract rate, (b) the default rate (sometimes subject to a balancing of the equities analysis), or (c) an equitable rate to be

determined by the court. Recent case law in the Eleventh Circuit, however, makes clear that both in the claim adjudication context, and in the plan reinstatement context, the lender is entitled to the default rate of interest (to the extent the lender is otherwise entitled to the default rate under applicable state law).

In re: Sundale, Ltd, 410 B.R. 101 (S.D. Fla. 2009), cited with approval by the Eleventh Circuit in *In re: Sagamore Partners, Ltd.*, 2015 WL 5091909 (11th Cir. Aug. 31, 2015), stands for the proposition that an over-secured creditor is entitled to default interest post-petition, to the extent provided by applicable state law, and that nothing in the Bankruptcy Code gives the bankruptcy court the power to equitably modify this state law right. Judge Isicoff in *Sundale* considered both Supreme Court and Eleventh Circuit precedent, and concluded that, while there is a "reasonableness" qualifier for "fees, costs, or charges," the entitlement to post-petition interest is "unqualified." *Id.* at 104. The *Sundale* court further noted that Florida law expressly recognizes a lender's right to charge default interest, if the underlying loan documents so provide. Thus, according to *Sundale*, since the allowance of claims generally, and post-petition interest in particular, is governed by applicable state law, and there is no bankruptcy provision that allows the bankruptcy court to override this state law entitlement to the lender on equitable or other grounds, an over-secured lender is entitled to post-petition default interest if such lender is entitled to such default interest under state law.

Likewise, in *In re: Sagamore Partners, Ltd.*, 2015 WL 5091909 (11th Cir. Aug. 31, 2015), the Eleventh Circuit concluded that, in order to cure a reinstate a claim under Section 1123(d), as amended in 1994, the debtor was required to cure the default in accordance with the underlying contract or agreement, as long as such agreement was in compliance with non-bankruptcy law. In *Sagamore*, since the lender's loan documents required it to pay default interest, and those provisions complied with Florida law, the debtor was required to pay default-rate interest to cure its default under the plan, which increased the claim amount by $5.5 million. Prior to 1994, the Code did not define "cure," and some courts held that a debtor's cure of its default returned the parties to the "*status quo ante*," such that the lender's right to default interest was lost. Now, under *Sagamore*, it is clear that a cure and reinstatement requires the debtor to pay interest at the default rate, to the extent the lender is entitled to default interest under the loan documents and applicable state law. The Eleventh Circuit further concluded that the lender was entitled to both default interest and late fees, because those are consistent remedies that are allowed to be pursued concurrently under Florida law. Addressing the equitable mootness issue, the Eleventh Circuit concluded that effective relief was available, because requiring Sagamore to pay default interest was an effective remedy, and the debtor had sufficient funds to pay the default interest.

In contrast, a number of courts in the Fourth Circuit believe that the line is not so clear and have either allowed or disallowed post-petition default interest after consideration of certain equitable factors. *See, In re Parker*, No. 12-03128-8-SWH (Bankr. E.D.N.C. Nov. 19, 2014), *partially rev'd*, No. 5:15-CV-25-F (E.D.N.C. September 17, 2015)(unpublished). In determining whether to enforce a contractual default rate of interest, these courts have traditionally looked at four factors: (1) whether the creditor faces a significant risk that the debt will not be paid; (2) whether the lower non-default rate of interest is the prevailing market rate; (3) whether the difference between the default and non-default rate is reasonable; and (4) whether the purpose of the default rate is to compensate the creditor for losses sustained as a result of the default or whether it is simply a disguised penalty. *In re Deep River Warehouse, Inc*., No. 04-52749, 2005

WL 1513123, at *3 (Bankr. M.D.N.C. June 22, 2005); see also *In re Croatan Surf Club, LLC*, No. 11-00194-8-SWH, 2012 WL 1906386, at *4 (Bankr. E.D.N.C. May 25, 2012); *In re Dixon*, 228 B.R. 166, 174 (W.D. Va. 1998)). Additionally, some courts consider the sophistication of the parties. *Deep River*, 2005 WL 1513123, at *5; *Dixon*, 228 B.R. at 177.

Upon consideration of these factors in *In re Parker*, the bankruptcy court denied post-petition default interest concluding that there was little or no risk of non-payment, the lower non-default rate of interest was not the prevailing market rate, the difference between the default rate of 25% and the non-default rate of 15% was unreasonable and the purpose of the default rate was a disguised penalty.

III. Plan Support Agreements

A plan support agreement ("PSA") is an agreement among the parties for just that: support for the terms of a chapter 11 plan. It can be presented in different contexts and forms, but generally is highlighted when the bankruptcy court is asked to approve the terms of such an agreement. PSA's are not very common, especially outside of New York and Delaware and there is very little published case law on when such an agreement should be approved or rejected. Generally, the arguments against court approval of a PSA include the violation of solicitation rules found in § 1125 of the Bankruptcy Code, the approval of terms that would constitute a *sub rosa* plan and the approval of specific terms that might not be permissible in the plan itself. Two recent decisions from the Southern District of New York shed some light on current issues involving PSA's.

The court in *In re Residential Capital, LLC*, 2013 Bankr. LEXIS 2601 (Bankr. S.D.N.Y. June 27, 2013) considered and approved a PSA. In *Residential Capital*, the PSA was entered into between the debtor, its parent company, the creditors' committee and certain claimants and provided for an agreement that resulted from months of court supervised mediation and would resolve disputes over billions of dollars of claims. *Id*. at *2. The PSA was controversial and 13 parties objected to its approval raising issues specific to the impact of certain terms. The PSA included third party releases which caused objections by the US Trustee as well as creditors. *Id*. at *19. Over these objections, the court approved the PSA using the business judgment rule under § 363. The court ruled that the PSA does not violate § 1125 because even though it obligates parties to vote in favor of the plan, it provides numerous termination events that allow parties to withdraw from their obligations. *Id*. at *69. Previous unreported decisions denying approval of PSA's required specific performance and were deemed to violate § 1125. The court further noted that approval of the PSA did not preclude any challenges to the plan that includes the terms of the PSA and that approval of the PSA did not constitute approval of the third party releases included therein. *Id*. at 72-73. Essentially, non-parties to the PSA preserved their rights to object to the terms of the plan at confirmation.

Another key factor in *Residential Capital* court's approval of the PSA was the fact that it was the result of lengthy negotiations between the debtor and several other major constituents. *Id*. at 70. This is in contrast to the PSA that was rejected in the case of *In re Innkeepers USA Trust*, 442 B.R. 227 (Bankr. S.D.N.Y. 2010). In *Innkeepers*, the debtor sought approval to assume a PSA with only one of its creditors who was also an insider. *Id*. at 229. Because the PSA involved an insider, the court indicated the heightened scrutiny/entire fairness standard may apply as opposed to the business judgment rule, but did not opine on this issue ruling instead

that the proposed PSA did not meet either standard. *Id*. at 231. The court rejected the PSA because the court could not find that it was a disinterested transaction, entered into with due care and in good faith. *Id*. The evidence demonstrated that the debtor did not market this plan or even engage in a valuation of the exchanges in the PSA. *Id*. at 232. Of particular importance, in the court's opinion, was the PSA's prohibition against the debtor valuing the assets or engaging with other creditors. The court reasoned that the PSA gave one insider party too much control over the case. *Id*. The court was also highly concerned about a provision that prevented the debtor from taking actions consistent with its fiduciary obligations. *Id*. at 235. Overall, the rejection of the PSA was due to the court's belief that the process that the debtor did not act in good faith in entering into the PSA and in providing transparency to its creditors. *Id*. at 233. "I do not believe the process leading to the PSA reflects the more even-handed approach required in this case." *Id*. at 236.

What is the takeaway from these cases? A PSA is only going to be approved if it is negotiated in good faith, with due care, transparency, and a faithful adherence to the debtor's fiduciary duties. Some of the takeaways are common sense. The more buy-in a debtor has to the PSA, the more likely it is to be approved. The PSA should also reflect a fair deal for the estate. In essence, the PSA should be consistent with the purpose of Chapter 11.

IV. Structured Dismissals in Chapter 11 Cases

A. Overview.

Following the liquidation or sale of substantially all of a debtor's assets under § 363 of the Bankruptcy Code, the Chapter 11 debtor traditionally has considered the following three exit options under the Bankruptcy Code: (i) filing a liquidating Chapter 11 plan; (ii) converting its case to a case under Chapter 7; or (iii) dismissing its Chapter 11 case and returning the parties to their state law rights and remedies. However, each of these options has its own set of attendant issues as outlined below:

1. Liquidating Plan. Filing a liquidating plan requires compliance with 11 U.S.C. §§1123 and 1129 meaning that the "safeguards of disclosure, voting, acceptance, and confirmation" are required. *Comm. Of Equity Sec. Holders v. Lionel Corp. (In re Lionel Corp.)*, 722 F.2d 1063, 1071 (2d Cir. 1983). This process can be time-consuming and expensive, not to mention that the liquidating debtor must have sufficient cash to satisfy administrative expense and priority claims. Further, if a secured creditor has a lien on substantially off of the debtor's assets, the debtor must obtain the secured lender's agreement to fund the costs of both the liquidating plan and the confirmation process.

2. Conversion to Chapter 7. Converting a Chapter 11 case to Chapter 7 pursuant to 11 U.S.C. §1112(b) adds another layer of fees and expenses for the Chapter 7 trustee, the Chapter 7 trustee's counsel, and for the U.S. Trustee/Bankruptcy Administrator to a bankruptcy estate which may be administratively insolvent following the § 363 sale. A more significant concern for the debtor is the loss of control over causes of action or preference

claims not sold to the Chapter 11 buyer. When and where possible, the debtor should retain control over such actions.[1]

3. Dismissal of Chapter 11 Case. The ordinary effect of a dismissal under 11 U.S.C §1112(b) is to restore the parties' property rights and remedies to their position prior to bankruptcy. The result is that any avoided transfers, avoided liens, receivership proceedings are reinstated, property is revested in the debtor, and all state law rights are preserved. When the debtor faces pending or future litigation and has little or no funds to fight, a traditional dismissal under §1112(b) could be harmful.

4. Structured Dismissals. Against this backdrop, many bankruptcy courts have considered and allowed a fourth exit option for the Chapter 11 debtor under certain circumstances - structured dismissals. Structured dismissals involve a traditional dismissal of the Chapter 11 case with some "structured" components such as:

- releases and exculpations;
- procedures for reconciling and paying claims;
- "gifting" of funds from secured lenders to creditors of lower priority;
- provisions for a bankruptcy court's continued retention of jurisdiction over certain post-dismissal matters;
- conditions to effectiveness of the dismissal, and
- provisions that, notwithstanding §349, prior bankruptcy court orders survive dismissal.

As the Third Circuit noted, a structured dismissal is "a disposition that winds up the bankruptcy with certain conditions attached instead of simply dismissing the case and restoring the status quo ante." *Official Comm. of Unsecured Creditors v. CIT Group/Bus. Credit Inc. (In re Jevic Holding Corp.)*, 787 F.3d 173, 177 (3d Cir. 2015), *as amended* (August 18, 2015), *petition for cert .* docketed, No. 15-649 (U.S. Nov. 17, 2015).

B. Statutory Authority

There is currently no express authority in the Bankruptcy Code which permits structured dismissals in Chapter 11 cases.[2] Instead, courts authorizing structured dismissals have cobbled

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[1] A Chapter 7 case involves more oversight of the liquidation process since the Chapter 7 trustee is required to file a final report outlining the assets liquidated, the claims allowed, and the proposed distributions. Also, because the Chapter 7 trustee is a fiduciary, the Chapter 7 trustee can examine and pursue claims and causes of action.

[2] Even as structured dismissals have occurred with increased frequency, commentators have expressed uncertainty whether the Bankruptcy Code permits them. *Jevic Holding*, 787 F.3d at 181, n. 5 (citing Norman L. Pernick & G. David Dean, *Structured Chapter 11 Dismissals: A Viable and Growing Alternative After Asset Sales,* AM. BANKR. INST. J., June 2010, at 1; *see, e.g., Kainos Partners Holding Co., LLC v. Official Comm. of Unsecured Creditors (In re Kainos Partners Holding Co.)*, No. 09-12292 BLS, 2012 WL 6028927 (D. Del. Nov. 30, 2012); *In re World Health Alts.,* 344 B.R. 291, 293–95 (Bankr. D. Del. 2006). *But cf. In re Biolitec, Inc.,* 528 B.R. 261 (Bankr. D. N.J. 2014) (rejecting a proposed structured dismissal as invalid under the Code)*; see also Jevic Holding*, 787 F.3d at 181, n.6 (citing. Brent Weisenberg, *Expediting*

together portions of §§ 349(b), 1112(b), 305(a), and/or 105(a) for the authority to enter such relief.

Under §1112(b), a party in interest may move the bankruptcy court to dismiss a Chapter 11 case "for cause". "For cause" may include, among other things, "substantial or continuing loss to or diminution of the estate and the absence of a reasonable likelihood of rehabilitation" and "inability to effectuate substantial consummation of a confirmed plan." 11 U.S.C. § 1112(b)(4). Dismissal or conversion of a chapter 11 case under § 1112(b) involves a two-step process. First, the court must determine whether "cause" exists for dismissal or conversion. Second, the court must determine whether dismissal or conversion of the case is in the best interests of the creditors and the estate. *See*, *e.g.*, *Rollex Corp. v. Associated Materials, Inc. (In re Superior Siding & Window, Inc.)*, 14 F.3d 240, 242 (4th Cir. 1994).

Section 305 permits a court to dismiss or suspend all proceedings in a case "if the interests of creditors and the debtor would be better served by such dismissal or suspension." 11 U.S.C. § 305(a). Section 305(a)(1) is primarily used to dismiss involuntary cases where creditors involved in an out-of-court restructuring file an involuntary bankruptcy petition to extract more favorable treatment from the debtor. However, this provision has also been applied to dismiss voluntary cases on a more limited basis. Because an order dismissing a case under § 305(a) may be reviewed on appeal only by a district court or a bankruptcy appellate panel, rather than by a court of appeals or the U.S. Supreme Court (*see* 11 U.S.C. § 305(c)), § 305(a) dismissal is an "extraordinary remedy." *See In re Kennedy*, 504 B.R. 815, 828 (Bankr. S.D. Miss. 2014); *see also Gelb v. United States (In re Gelb)*, No. CC-12-1086-PaKiTa, 2013 WL 1296790, *6, n.13 (B.A.P. 9th Cir .Mar. 29, 2013) (dismissal or suspension order under § 305(a) reviewable by bankruptcy appellate panel).

Section 105(a) authorizes a bankruptcy court to enter orders that are necessary or appropriate to carry out the provisions of the Bankruptcy Code. However, it "'does not allow the bankruptcy court to override explicit mandates of other sections of the Bankruptcy Code.'" *Law v. Siegel*, 134 S. Ct. 1188, 1194 (2014) (quoting 2 COLLIER ON BANKRUPTCY ¶ 105.01[2], 105–06 (16th ed. 2013)).

Finally, § 349(b) governs the effect of a dismissal in a Chapter 11 case by returning all parties to the bankruptcy to their respective positions prior to the date of the petition unless the court orders otherwise "for cause." This provision supplements the general provision under §1112(b) for dismissal which returns the parties to the status quo ante. It is the "for cause" provision under § 349(b) which serves as the linchpin for structured dismissals to include other terms and conditions as may be necessary or appropriate in the interests of creditors.

Chapter 11 Liquidating Debtor's Distribution to Creditors, AM. BANKR. INST. J., April 2012, at 36 ("[T]he time is ripe to make crystal clear that these procedures are in fact authorized by the Code."). *But cf.* Nan Roberts Eitel et al., *Structured Dismissals, or Cases Dismissed Outside of Code's Structure?* 30 AM. BANKR. INST. J., Mar. 2011, at 20 (article by United States Trustee staff arguing that structured dismissals are improper under the Code).

C. Prior Court Decisions.

The few reported and unreported decisions on structured dismissals suggest that some courts are willing to order structured dismissals where there is no creditor objection and the structured dismissal is viewed as a more expeditious, cost-effective, and beneficial means of closing a chapter 11 case. *See*, *e.g.*, *In re Buffet Partners, L.P.*, No. 14-30699-HDH-11, 2014 WL 3735804,*4 (Bankr. N.D. Tex. July 28, 2014) (ruling that sections 105(a) and 1112(b) of the Bankruptcy Code provide authority for structured dismissals and approving structured dismissal, "emphasiz[ing] that not one party with an economic stake in the case has objected to the dismissal in this manner"); *In re Felda Plantation, LLC*, No. 9:11-bk-14614-BSS, 2012 WL 1965964 (Bankr. N.D. Fla. May 29, 2012) (granting chapter 11 debtor's motion for structured dismissal in order, provided that, notwithstanding dismissal, all orders entered in bankruptcy survived dismissal, court retained jurisdiction to rule on fee applications, and debtor was obligated to pay U.S. Trustee and professional fees, as well as creditors, as specified); *Omaha Standing Bear Pointe, L.L.C. v. Rew Materials (In re Omaha Standing Bear Pointe, L.L.C.)*, No. BK10-81413-TJM, 2011 WL 69859 (Bankr. D. Neb. Mar. 17, 2011) (noting that chapter 11 debtor's motion for structured dismissal was granted after real property was sold free and clear and proceeds were distributed to secured creditor); *see also In re Fleurantin*, 420 F. App'x. 194, 2011 WL 80633 (3d Cir. Mar. 28, 2011) (ruling that bankruptcy court did not abuse its discretion in approving structured dismissal of individual chapter 7 case, which trustee argued "was in the best interests of the parties, particularly in light of the estate's continued expenditure of legal fees in response to [debtor's] motions and other efforts to obstruct its administration").

However, other courts have rejected structured dismissals either finding that they are not authorized under the Bankruptcy Code or are not warranted under the circumstances of the particular case. *See*, *e.g.*, *In re Biolitec*, 528 B.R. 261 (Bankr. D. N.J., 2014) (rejecting proposed structured dismissal as invalid under Bankruptcy Code)*; In re Strategic Labor, Inc.*, 467 B.R. 11, 13 (Bankr. D. Mass. 2012) (stating that "[t]his matter offers an object lesson in how not to run a Chapter 11 case"; denying debtor's post-asset sale motion for approval of a structured dismissal, where, among other things, debtor intentionally mischaracterized secured claim of Internal Revenue Service and used cash collateral without authority; and instead granting U.S. Trustee's motion to convert to chapter 7).

In most of these cases, the U.S. Trustee has lodged objections to the structured dismissals even if they are consensual. The U.S. Trustee has argued, among other things, that structured dismissals: (i) distribute assets without adhering to statutory priorities; (ii) include improper and overbroad releases and exculpation clauses; (iii) violate the express requirements of section 349(b); (iv) may constitute "*sub rosa*" chapter 11 plans that seek to circumvent plan confirmation requirements and creditor protections; (v) improperly provide for retention of the bankruptcy court's jurisdiction; and (vi) fail to reinstate the remedies of creditors under applicable nonbankruptcy law. *See* Nan Roberts Eitel, et. al., *Structured Dismissals, or Cases Dismissed Outside of Code's Structure?*, 30 AM. BANKR. INST. J., Mar. 2011, at20.

D. Jevic Holding Corp.

The Third Circuit is the first circuit which has addressed the issue of structured dismissals. Not only was the Third Circuit confronted with a structured dismissal that was only partially consented to by the creditors, but the structured dismissal deviated from the

Bankruptcy Code's priority scheme. In a split decision, the court held that Chapter 11 cases can be resolved by a structured dismissal that deviates from the Bankruptcy Code's priority scheme but only in "rare circumstances".[3]

1. Background

In 2006, a subsidiary of Sun Capital Partners purchased Jevic Transportation, Inc., a New Jersey trucking company, in a leveraged buyout financed by a group of lenders led by CIT Group. The leveraged buyout consisted of an $85 million revolving credit facility extended by CIT to Jevic so long as Jevic maintained $5 million in assets and collateral. Jevic continued to struggle and eventually entered into a forbearance agreement with CIT to prevent CIT from foreclosing on its assets, which agreement provided for a $2 million guarantee by Sun Capital. With the company's performance stagnant and the expiration of the forbearance agreement coming up, Jevic filed a Chapter 11 bankruptcy petition in 2008. At the time of its petition, Jevic owed $53 million to CIT and Sun Capital, which both held first-priority liens on substantially all of Jevic's assets. Jevic further owed approximately $20 million to its tax creditors and general unsecured creditors.

During the bankruptcy case, two lawsuits were filed. The first lawsuit was a class action filed by a group of terminated truck drivers against Jevic and Sun Capital, alleging that Jevic and Sun Capital violated both state and federal Worker Adjustment and Retraining Notification (WARN) Acts. The drivers argued that Jevic and Sun Capital were required to provide the drivers with 60-day written notice under the WARN Acts prior to terminating their employment. The bankruptcy court later held that Sun Capital was not an "employer" as contemplated by the WARN Acts and therefore was not liable. The bankruptcy further held later that Jevic had not violated the federal WARN Act provisions. However, the bankruptcy court ruled that Jevic had violated the state WARN Act provisions for not providing timely notice and therefore was subject to claims by the terminated truck drivers which the drivers estimated to be in the sum of $12.4 million. The drivers contended that $8.3 million of the $12.4 million claim was likely to be classified as employee wage claims that would be granted special priority under §507(a)(4).

The second lawsuit was filed by the committee of unsecured creditors alleging fraudulent conveyance and preference actions on behalf of the bankruptcy estate against Sun Capital and CIT. After the bankruptcy court dismissed a portion of the committee's claims, Sun Capital, CIT, the committee, and the drivers met to settle the remaining fraudulent conveyance claims. At the time of these negotiations, Jevic's only remaining assets consisted of $1.7 million in cash which was subject to Sun Capital's first-priority lien and the fraudulent conveyance action against Sun Capital and CIT. Sun Capital, CIT, and the committee eventually reached a settlement agreement whereby (i) CIT agreed to pay $2 million into an account for the debtor's and committee's legal fees and other administrative expenses, (ii) Sun Capital agreed to assign its lien on the $1.7 million in cash to a trust to pay tax and administrative claims first before distributing the balance to general unsecured claims on a pro rata basis, (iii) Sun Capital, CIT and the committee agreed that they exchange mutual releases, (iv) the committee would dismiss with prejudice its fraudulent conveyance action; and (v) Jevic's Chapter 11 case would be

[3] Petition for *en banc* hearing denied on August 18, 2015. Petition for Certiorari to the U.S. Supreme Court docketed November 17, 2015.

dismissed. *Jevic*, 787 F.3 at 177. Nowhere in the settlement was there any provision or consideration for the terminated truck drivers; nor did the settlement propose to distribute the remaining assets of Jevic's bankruptcy estate consistent with the absolute priority rule.

The terminated truck drivers and the United States Trustee each objected to the settlement. The drivers argued that the distribution violated the absolute priority rule and that the committee breached its fiduciary duty to the drivers by entering into a settlement that did not include the drivers. The United States Trustee likewise argued that the distribution violated the absolute priority rule and additionally argued that there was no explicit authority under the Bankruptcy Code which permitted a bankruptcy court to enter a structured dismissal.

The bankruptcy court overruled all of the objections and approved the settlement. In doing so, the bankruptcy court found that there was "no realistic prospect" of a meaningful distribution to anyone other than the secured creditors unless the settlement was approved. *Id*. at 178. The bankruptcy court also found that the proposed settlement was fair and equitable using the multifactor test found in *Martin v. Martin (In re Martin)*, 91 F.3d 389 (3d Cir. 1996),[4] for evaluating settlements under Federal Rule of Bankruptcy Procedure 9019. *Id*. at 179. Although the bankruptcy court seemed troubled that the drivers were not included in the settlement distribution, the bankruptcy court concluded that the omission of the drivers from the settlement distribution was not prejudicial to them because their claims against the Jevic estate were "effectively worthless" as the estate lacked any unencumbered funds." *Id*. at 178. Faced with either "a meaningful return or zero", the bankruptcy court concluded that "[t]he paramount interest of the creditors mandates approval of the settlement notwithstanding its failure to comply with the Bankruptcy Code's priority scheme. *Id*.

On appeal, the district court affirmed holding, in the alternative, that the appeal was equitably moot as the settlement had been substantially consummated. [5]

2. Third Circuit's Opinion

In affirming, the Third Circuit upheld the settlement and confirmed the Bankruptcy Court's authority to order a structured dismissal, albeit in "rare circumstances." The Third Circuit agreed with the Bankruptcy Court that the structured dismissal was "the least bad alternative"

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[4] The Court must "assess and balance the value of the claim that is being compromised against the value to the estate of the acceptance of the compromise proposal." *In re Martin,* 91 F.3d at 393. The Third Circuit "recognize[s] four criteria that a bankruptcy court should consider in striking this balance": { "pageset": "Sfa (1) the probability of success in the litigation; (2) the likely difficulties in collection;(3) the complexity of the litigation involved, and the expense, inconvenience and delay necessarily attending it; and (4) the paramount interest of the creditors. *Id.*

[5] When the drivers appealed to the United States District Court for the District of Delaware. they filed a motion in the Bankruptcy Court to stay its order pending appeal. The Bankruptcy Court denied the stay request, and the drivers did not renew their request for a stay before the District Court. The parties began implementing the settlement months later, distributing over one thousand checks to priority tax creditors and general unsecured creditors.

because there was "no prospect" of a plan being confirmed and conversion to Chapter 7 would have resulted in the secured creditors taking their collateral "in short order." *Id.* at 185.

Writing for the majority, Judge Hardiman first turned to the question of whether the Bankruptcy Code provides for structured dismissals in Chapter 11 cases.[6] Judge Hardiman concluded that structured dismissals are "simply dismissals that are preceded by other orders of the bankruptcy court . . . that remain in effect after dismissal." *Id.* at 181. Noting that the Bankruptcy Code does not expressly authorize structured dismissals, Judge Hardiman observed that:

> And though Section 349 of the Code contemplates that dismissal will typically reinstate the pre-petition state of affairs by revesting property in the debtor and vacating orders and judgments of the bankruptcy court, it also explicitly authorizes the bankruptcy court to alter the effect of dismissal "for cause—in other words, the Code does not strictly require dismissal of a Chapter 11 case to be a hard reset." 11 U.S.C. § 349(b); H.R. Rep. No. 595 at 338 ("The court is permitted to order a different result for cause."); see also *Matter of Sadler*, 935 F.2d 918, 921 (7th Cir. 1991) ("'Cause' under §349(b) means an acceptable reason.")

Id.

Judge Hardiman then addressed the drivers' argument that structured dismissals were nothing more than an end run around the procedures that govern plan confirmation and conversion to Chapter 7. Judge Hardiman rejected as overbroad the drivers' argument that the position of the settlement proponents overestimated the breadth of bankruptcy courts' settlement-approval power under Rule 9019, "'render[ing] plan confirmation superfluous' and paving the way for illegitimate *sub rosa* plans engineered by creditors with overwhelming bargaining power." *Id*. Here, the bankruptcy court found there was no evidence that a plan of reorganization could be confirmed or that a conversion to Chapter 7 would net any benefit to unsecured creditors. As a result, Judge Hardiman concluded that, "absent a showing that the structured dismissal has been contrived to evade the procedural protections and safeguards of the plan confirmation or conversion process, a bankruptcy court has discretion to order such a disposition." *Id.* at 182. Notably, Judge Hardiman expressly stated that this "appeal does not require us to decide whether structured dismissals are permissible when a confirmable plan is in the offing or conversion to a Chapter 7 might be worthwhile." *Id.* at 181.

Judge Hardiman then turned to the question of whether a structured dismissal must follow the absolute priority rule. The Judge Hardiman observed "that bankruptcy courts may approve settlements that deviate from the priority scheme of § 507 of the Bankruptcy Code only

[6] On appeal to the Third Circuit, instead of challenging the Bankruptcy Court's discretionary judgments as to the propriety of a settlement and dismissal, the drivers and the United States Trustee argued that the Bankruptcy Court did not have the discretion it purported to exercise. Specifically, they claimed that bankruptcy courts have no legal authority to approve structured dismissals, at least to the extent they deviate from the priority system of the Bankruptcy Code in distributing estate assets. *Id.* at 180.

if they have 'specific and credible grounds to justify [the] deviation.'" *Id.* at 184 (quoting *Iridium Operating LLC v. Official Comm. Of Unsecured Creditors and JPMoran Chase Bank, N.A. (In re Iridium Operating LLC)*, 478 F.3d 452, 466 (2d Cir. 2007).

The drivers argued that the absolute priority rule under §507 applies to all distributions of the bankruptcy estate under Chapter 11 regardless of whether it is pursuant to a plan of reorganization or a settlement. Finding some merit to this argument, the Third Circuit agreed that both settlements and plans of reorganization must be "fair and equitable" and that "fair and equitable" in a plan of reorganization context must comply with the absolute priority rule. However, the Third Circuit pointed out that "[w]hen Congress codified the absolute priority rule . . . , it did so in the specific context of plan confirmation, see § 1129(b)(2)(B)(ii), and neither Congress nor the Supreme Court has ever said that the rule applies to settlements in bankruptcy." *Id.* at 183.

Judge Hardiman then turned to two sister circuits that had previously considered whether a structured dismissal "may ever skip a class of objecting creditors in favor of more junior creditors." *Id.at 182*.

In *U.S. v. AWECO, Inc. (In re AWECO Inc.)*, 725 F.2d 293, 295 (5th Cir. 1984), the Fifth Circuit rejected a settlement that would have transferred litigation proceeds to an unsecured creditor without paying senior creditors in full. *Id*. The Fifth Circuit concluded that the "fair and equitable" standard applies to settlements, and "fair and equitable" means compliant with the priority system. *Id*.

Criticizing the Fifth's Circuit's approach as "too rigid," the Second Circuit chose to adopt the more flexible approach in *Iridium Operating LLC v. Official Comm. Of Unsecured Creditors and JPMoran Chase Bank, N.A. (In re Iridium Operating LLC)* 478 F.3d 452 (2007). There, the court held that the absolute priority rule "is not necessarily implicated" when "a settlement is presented for court approval apart from a reorganization plan[.]" *Id* at 459, 465-66. "[W]hether a particular settlement's distribution scheme complies with the Code's priority scheme must be the most important factor for the bankruptcy court to consider when determining whether a settlement is 'fair and equitable' under Rule 9019," but a noncompliant settlement could be approved when "the remaining factors weigh heavily in favor of approving a settlement[.]" *Id.* at 464.

Judge Hardiman agreed with the Second Circuit's approach. "Given the 'dynamic status of some pre-plan bankruptcy settlements,' it would make sense for the Bankruptcy Code and the Federal Rules of Bankruptcy Procedure to leave bankruptcy courts more flexibility in approving settlements than in confirming plans of reorganization." *Jevic Holding*, 787 F.3d at 183 (quoting *Iridium*, 478 F.3d at 464). However, the court echoing the concerns of the Second Circuit cautioned that under most circumstances, compliance with the Bankruptcy Code's priority scheme will usually be dispositive of whether a settlement is "fair and equitable." "Settlements that skip objecting creditors in distributing estate assets raise justifiable concerns about collusion among debtors, creditors, and their attorneys and other professionals." *Id.; see Iridium*, 478 F.3d at 464.

Judge Hardiman summarized by saying "we believe the Code permits a structured dismissal, even one that deviates from the § 507 priorities, when a bankruptcy judge makes sound findings of fact that the traditional routes out of Chapter 11 are unavailable and the settlement is the best feasible way of serving the interests of the estate and its creditors." *Jevic Holding*, 787 F.3d at 185–86.

3. Judge Scirica's Dissent

Judge Scirica agreed with the majority that structured dismissals are authorized by the Bankruptcy Code and, in some extraordinary instances, may deviate from the absolute priority rule.[7] However, Judge Scirica felt that the facts in *Jevic Holding* did not warrant a departure from the absolute priority rule. According to Judge Scirica, the parties to the settlement could have simply followed the absolute priority rule and that Sun Capital was diverting funds from the drivers to avoid funding litigation against itself. As such, he concluded that the settlement was at odds with one of the Bankruptcy Code's core goals, to maximize the value to the estate. Instead, Judge Scirica believed, the settlement only enriched certain creditors and not the bankruptcy estate as a whole.

Judge Scirica focused primarily on distinguishing *Iridium* from the case at bar. In *Iridium*, the unsecured creditors' committee brought suit against a group of secured lenders. According to Judge Hardiman, the proposed settlement deviated from the absolute priority rule in two instances. First, the proposed settlement contemplated splitting the estate's cash between the secured lenders and a litigation trust set up to fund a different estate action against a certain priority administrative creditor. Second, the settlement provided that any remaining funds left in the litigation trust would go to the unsecured creditors and skip that certain administrative creditor. The Second Circuit held that this violation of the absolute priority rule was permissible in the first instance, but the court remanded the case back to the lower court for a determination on the second instance, stating that the record does not explain why the remaining balance of the litigation trust should not be distributed according to the absolute priority rule.

Judge Scirica ultimately concluded that he would have remanded the case back to the bankruptcy court, not to unwind the settlement, but for a determination of the state WARN Act damages and wage priority claims, a disgorgement of the proceeds necessary make a pro rata distribution on such state WARN Act and wage priority claims, and a distribution of the disgorged proceeds in accordance with the absolute priority rule.

E. Other Cases

Since *Jevic Holding* was published, there have been two cases which have allowed and approved structured dismissals.

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[7] Judge Scirica points out that this is not a case where equitable mootness applies. *Jevic Holding*, 787 F.3d. at 186. According to Judge Scirica, this doctrine applies only where there is a confirmed plan of reorganization. *See (Samson Energy Res. Co. v. Semcrude, L.P. (In re Semcrude, L.P.)*, 728 F.3d 314 (3d Cir.2013).

In re Naartjie Custom Kids, Inc., 534 B.R. 416, 423 (Bankr. D. Utah 2015), the debtor sought to have the bankruptcy court approve a structured dismissal order under §§ 305(a), 349(b), and 105(a), and Rule 1017(a) after it determined quickly that it could not reorganize but needed to liquidate its assets. The debtor claimed that a structured dismissal was appropriate because there were no causes of action to prosecute, there were no pending adversary proceedings, the claims reconciliation process would be completed before the case was dismissed, proper notice was given, and no party with an economic stake had objected to the structured dismissal.

Agreeing that a bankruptcy court has the authority to alter the effects of dismissals under §349(b), the bankruptcy court decided that if cause is shown that a structured dismissal will better serve the interests of the creditors and the debtor, then the bankruptcy court may alter the effect of dismissal. In dicta, the bankruptcy court stated that if there was an objection to the structured dismissal, then the outcome of the court's decision might have been different.

In *Petersberg Regency, LLC*, 540 B.R. 508 (Bankr. D. N.J. 2015), the debtor's sole asset consisted of a nonoperating hotel formerly located in Virginia which was irretrievably damaged by a hurricane in 2003. *Id*. at 512. The creditors filed motions that provided for the distribution of the debtor's only significant asset, the insurance proceeds generated by the storm damage, and dismissal of the case under a consensual settlement among those creditors. *Id*. The debtor and its principals objected contending that the settlement was not in the best interest of creditors and that the debtor should be allowed to proceed with a liquidating plan. *Id*. at 512-513. Rejecting this argument, the bankruptcy court concluded that the proposed settlement was "fair and equitable" and "in the best interest of the estate" under the *Martin* factors. *Id*. at 535. Further, the court determined that it had authority under §349 of the Bankruptcy Code to approve a structured dismissal. *Id*. at 531. The bankruptcy court noted that unlike *Jevic Holding,* all creditors, except the insiders whose claims likely would be subordinated, will receive a distribution and the "class-skipping" issue which figured in *Jevi*c Holdingwas not present in this case. *Id* at 532.

F. Conclusion

When no party with an economic interest objects and/or the structured dismissal adheres to the absolute priority rule, courts seem more likely to approve a structured dismissal. But where there are objections by creditors with an economic interest and/ or the structured dismissal provides for "class-skipping" distributions, the proponent of the structured dismissal will face a high hurdle to show that there are no other alternatives and that the structured dismissal is in the best interest of creditors.

V. "Cramdown" Interest Rates

In order to "cramdown" a dissenting class of creditors, plan treatment, among other things, must be fair and equitable. Section 1129(b)(2) of the Bankruptcy Code defines the meaning of "fair and equitable" as it pertains to certain classes of claims. Section 1129(b)(2)(A) provides three express alternatives in order that a plan may be found to be fair and equitable with respect to a class of secured creditors: (i) the claimant retains its liens and receives deferred cash payments totaling its allowed claim; (ii) the claimant's collateral be sold with liens

attaching to the proceeds of sale; or (iii) the claimant receives the indubitable equivalent of its secured claim.[8]

In accordance with Section 1129(b)(2)(A)(i)(II), deferred cash payments due a creditor must equal "a value, as of the effective date of the plan, of at least the value of the creditor's interest in the estates interest in" the collateral. This provision requires that the plan pay the "present value" of the secured claim. The Court in *In re Fisher*, 29 B.R. 542, 543 (Bankr. D. Kan. 1983), defined present value in the following manner:

> [present value is not] a legal concept, but rather it is a term of art in the financial community. It simply means that a dollar received today is worth more than a dollar to be received in the future. To compensate the creditor for not receiving its money today, the debtor is charged an additional amount of money. The charge is based on a rate of interest called a "discount rate." The discount rate is used to calculate how much the creditor should be paid so it will have the same amount of money in the future as it would have had if it did not have to wait to be paid.

While section 1129(b)(2)(i)(II) requires that the plan pay the "present value" of the secured claim, it does not specify how bankruptcy courts are to calculate the appropriate cramdown interest rate. In addition, the Bankruptcy Code sets no limits on how long a plan may defer such payments, thus leaving the issue to the courts to determine on a case-by-case basis.[9]

A. Till v. SCS Credit Corp., 541 U.S. 465 (2004)

In *Till v. SCS Credit Corp.,* 541 U.S. 465 (2004) ("Till"*)*, the Supreme Court addressed cramdown interests rates in the context of a Chapter 13 plan and evaluated four approaches to calculating cramdown interest rates (i) coerced loan, (ii) presumptive contract rate, (iii) formula rate, and (iv) cost of funds. *Till,* 541 U.S. at 473-480. A plurality[10] of the Court rejected three of

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[8] 11 U.S.C. §1129(B)(2)(a)(i)-(iii).

[9] In cases involving real property collateral, courts often (but not invariably) find plans proposing long amortizations, including those with balloon payments, to be fair and equitable under section 1129(b)(2)(A)(i). Such findings largely turn on a court's determination that the real property collateral securing the creditor's claim is unlikely to depreciate during the cramdown term. *See, e.g.*,*In re Briscoe Enters., Ltd., II*, 994 F.2d 1160, 1170 (5th Cir. 1993); *In re James Wilson Assocs.*, 965 F.2d 160, 165, 172-73 (7th Cir. 1992) (plan found to be fair and equitable, despite seven year term and twenty-five year amortization, where value of real property collateral exceeded the creditor's lien, providing "a considerable cushion" against default); *In re Boulders on the River, Inc.*, 164 B.R. 99, 101 (B.A.P. 9th Cir. 1994) (affirming plan proposing twenty-five year amortization with seventh year balloon payment); *In re Patrician St. Joseph Partners, Ltd. P'ship*, 169 B.R. 669, 673 (D. Ariz. 1994) (ten year term at 8%, based on twenty-five year amortization); *In re Arden Properties, Inc.*, 248 B.R. 164, 166, 173 (Bankr. D. Ariz. 2000) (fifteen year term based on thirty year amortization). But see *In re Manion*, 127 B.R. 887, 889 (Bankr. N.D. Fla. 1991) (finding conversion of five year balloon into twenty-year note unreasonable where, among other things, plan did not provide reserves for upkeep of group home securing loan).

[10] The plurality opinion, written by Justice Stevens, was joined by Justices Souter, Ginsberg, and Breyer. Justice Thomas, concurring in the judgment, wrote a separate concurring opinion. *Id*. at 485. The

the approaches[11] and found that the "formula rate best comports with the purposes of the Bankruptcy Code." *Id*. According to the Court, the formula rate, which begins with the prime rate and adjusts it upward based on certain risk factors, "entails a straightforward, familiar, and objective inquiry, and minimizes the need for potentially costly additional evidentiary proceedings." *Id.* at 479.

The Supreme Court provided guidance for the trial courts noting that in applying the formula approach they should:

> Begin[s] by looking to the national prime rate, reported daily in the press, which reflects the financial market's estimate of the amount a commercial bank should charge a creditworthy commercial borrower to compensate for the opportunity costs of the loan, the risk of inflation, and the relatively slight risk of default. Because bankrupt debtors typically pose a greater risk of nonpayment than solvent commercial borrowers, the approach then requires a bankruptcy court to adjust the prime rate accordingly.

Id. at 478-79.

Although *Till* involved a chapter 13 case, the Court suggested in a footnote that the "formula rate" approach should apply to chapter 11 cases. *Id*. at 474 n.10. The Court further commented that "[w]e think it likely that Congress intended bankruptcy judges and trustees to follow essentially the same approach when choosing an appropriate interest rate under any of these provisions." *Id.*

The Court acknowledged in a footnote, however, that:

> [T]here is no readily apparent Chapter 13 'cram down market rate of interest…Interestingly, the same is not true in the Chapter 11 context, as numerous lenders advertise financing for Chapter 11 debtors in possession. Thus, when picking a cram down rate in a Chapter 11 case, it might make sense to ask what rate an efficient market would produce. In the Chapter 13 context, by contrast, the absence of any such market obligates courts to look to first principles and ask only what rate will fairly compensate a creditor for its exposure.

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dissenting opinion, written by Justice Scalia and joined by Chief Justice Rehnquist and Justices O'Connor and Kennedy, favored the presumptive contract rate approach. *Id*. at 492.

[11] "These considerations lead us to reject the coerced loan, presumptive contract rate, and cost of funds approaches. Each of these approaches is complicated, imposes significant evidentiary costs, and aims to make each individual creditor whole rather than to ensure the debtor's payments have the required present value. For example, the coerced loan approach requires bankruptcy courts to consider evidence about the market for comparable loans to similar (though nonbankrupt) debtors – an inquiry far removed from such courts' usual task of evaluating debtors' financial circumstances and the feasibility of their debt adjustment plans. In addition, the approach overcompensates creditors because the market lending rate must be high enough to cover factors, like lenders' transaction costs and overall profits, that are no longer relevant in the context of court-administered and court-supervised cram down loans." *Id*. at 477.

Id.

Based on such dicta, *Till*'s application in chapter 11 cases remains open to varying interpretation. Where no efficient market exists, however, the Supreme Court appears to indicate that the formula method applied in *Till* is appropriate. The majority of bankruptcy courts have applied *Till* in Chapter 11, some using it as persuasive guidance, others first making a threshold determination of whether an efficient market exists, and yet other courts strictly following the formula approach in Chapter 11, notwithstanding footnote 14 in *Till*. Those courts that continue to apply a market rate generally consider threshold evidence of whether an "efficient market" exists for a loan of the sort sought by the debtor in the plan, and apply a market rate only after finding that an efficient market exists, which has been most common in commercial real estate and hotel/resort cases. It should be noted, however, that it is the creditor's burden to demonstrate that a higher rate than that proposed by a debtor is appropriate. *See Till*, 541 U.S. at 484 (the formula approach places the evidentiary burden on the more knowledgeable party, the lender, thereby facilitating more accurate calculation of the appropriate interest rate).

There are two circuit court opinions that consider the application of *Till* in Chapter 11, one from the Sixth Circuit, and one from the Fifth Circuit, neither of which concluded that *Till* was necessarily applicable in Chapter 11. In *Bank of Montreal v. Official Committee of Unsecured Creditors, (In re American Homepatient, Inc.)*, 420 F.3d 559 (6th Cir. 2005), the Sixth Circuit concluded that Till was "not directly on all fours," as a result of footnote 14, and applied the coerced loan approach, unless no efficient market existed. The Fifth Circuit, in *In re: Texas Grand Prairie Hotel Realty, LLC*, 2013 U.S. App. LEXIS 4514, at *33 (5th Cir. March 1, 2013), held that there is no specific methodology to calculate a cramdown interest rate in Chapter 11, while at the same time recognizing that bankruptcy courts may view *Till* as persuasive guidance. The Fifth Circuit concluded, however, that *Till* is not controlling in the Chapter 11 context. Nevertheless, both the debtor and lender in *Texas Grand Prairie* applied the Till prime plus approach, and the Fifth Circuit found no clear error in the bankruptcy court's conclusion that the debtor's approach was an appropriate application of the prime plus method, while the lender's "blended rate" approach did not constitute an "efficient market" for purposes of calculating a cramdown rate. The Fifth Circuit recognized, however, that *Till* may permit an "efficient market approach."

One prominent bankruptcy court decision that received considerable attention on this issue was Judge Drain's bench ruling in the *Momentive Performance Materials* case on August 26, 2014, which was affirmed on appeal by the Southern District of New York, on May 4, 2015. In *Momentive*, Judge Drain concluded that the *Till* formula approach strictly applies in Chapter 11, without the court needing to make any threshold decision as to whether an "efficient market" exists. In adopting the formula approach, Judge Drain concluded that a cramdown rate should not contain any profit or cost element, as both are inconsistent with determining present value for Section 1129(b) purposes. Judge Drain concluded that market testimony is only relevant when determining the proper risk premium that should apply, but should not be considered as a basis to apply a market rate, as that is not what the Code requires. In short, the lender is entitled to be compensated at a risk-free rate, adjusted by a risk premium that takes into account the circumstances of the debtor and the collateral. But the lender would not be put in the same position as it would be if it was be repaid on the loan and re-loaned the proceeds in a new transaction.

In Florida, Judge Williamson's decision in *In re J.C. Householder Land Trust #1*, 501 B.R. 441 (Bankr. M.D. Fla. 2013), provides helpful guidance. In *Householder*, Judge Williamson cited to the Fifth Circuit's decision in *Texas Grand Prairie*, which recognized that most bankruptcy courts only applied the Till formula approach after concluding that no efficient market exists. Thus, "the threshold issue for determining the appropriate cramdown interest rate is whether an efficient market exists." *Id.* at 454. The Householder court went on to describe the evidentiary burden that a lender would have in establishing that an efficient market exists, with expert testimony that meets the *Daubert* and Rule 702 standard, most importantly that the opinion be supported by sufficient facts or data. Thus, it was necessary for the expert to identify actual loans that had made in similar "real-life examples," not just testimony about conversations with lenders as to what rate they would offer in a hypothetical situation. Because the lender's evidence did not establish that an efficient market existed, the *Householder* court applied the *Till* formula approach.

B. Methods of Determining Appropriate Cramdown Interest Rate.

Since no *per se* rule for chapter 11 cramdown interest rates exists, various methods have been applied, including the Formula Method, the Prevailing/Efficient Market Approach, and the Tranche Method.[12]

1. The (*Till*) Formula Method

The Formula Method calculates the prevailing market rate for a loan of equal term, with due consideration of the quality of the security and the risk of subsequent default. In applying the Formula Method, most courts start with a base of either the prime rate, the T-bill rate or LIBOR, and then add basis points in accordance with various risk factors involved. *Till*, 541 U.S. 465 (2004) (adopting a "formula approach" in Chapter 13 case, and using the prime rate as the base rate); *United States v. Neil Pharmacal Co.*, 789 F.2d 1283, 1285 (8th Cir. 1986); *Hardzog v. Federal Land Bank of Wichita*, 901 F.2d 858, 860 (10th Cir. 1990); *In re Fowler*, 903 F.2d 694, 698 (9th Cir. 1990); *In re Villa Diablo Associates*, 156 B.R. 650 (Bankr. N.D. Cal. 1993) (stating that the formula approach seeks a market rate and that there is no authority for the proposition that the formula approach should result in a rate more favorable to the debtor than that resulting from an examination of the marketplace).

Consequently, as the base rate is finite, the bankruptcy court need only find the appropriate risk components, since the risk factors vary with each case. *In re Way Apartments D.T.*, 201 B.R. 444, 454-55 (Bankr. N.D. Tex. 1996); *In re Camino Real Landscape Maintenance Contractors*, 818 F.2d 1503, 1507-08 (9th Cir. 1987). In determining the appropriate risk component, however, courts typically look at the following factors as the basis for adding points:

- type of property
- operating history
- quality and location of property
- status of the market and market factors
- risk of default

[12] Some courts have adopted variations of these methods and a minority of courts have also applied the contract rate.

- size and term of the loan
- circumstances of the estate
- feasibility of the reorganization plan

See Till, 541 U.S. at 479[13]; *United States v. Doud*, 869 F.2d 1144, 1145 (8th Cir. 1989); *In re Villa Diablo Associates*, 156 B.R. 650 (Bankr. N.D. Cal. 1993); *In re Computer Optics Inc.*, 126 B.R. 664, 672 (Bankr. D.N.H. 1991); *In re E.I. Parks I Ltd. Partnership*, 122 B.R. 549, 555 (Bankr. W.D. Ark. 1990).

Post-*Till*, many non-chapter 13 cases have adopted *Till*'s formula rate approach. *See, e.g.*, *In re Red Mountain Machinery Company*, 2011 WL 1428266 (Bankr. D. Ariz. Apr. 4, 2011) (applying *Till* formula approach to determine cramdown interest rate); *In re Mendoza*, 2010 WL 1610120 (Bankr. N.D. Cal. 2010) (applying *Till* formula approach, bankruptcy court started with the prime rate of 3.25% and added a risk premium of 1.15% for total interest rate of 4.4%); *In re Princeton Office Park, L.P.*, 423 B.R. 795, 808 (Bankr. D.N.J. 2010) (holding that the cramdown interest rate to be used for the creditor should be determined under *Till*'s formula rate approach); *In re Hand*, 2009 WL 1306919, at *16-17 (Bankr. D. Mont. 2009) (relying on both *Till* and Ninth Circuit precedent in using formula rate approach; denying plan confirmation because debtor and secured creditor both failed to provide sufficient evidentiary basis for proposed interest rates); *In re Deep River Warehouse, Inc.*, 2005 WL 2319201 (Bankr. M.D.N.C. 2005) (Bankruptcy Court announced its intent to apply the formula approach, went through the motions of applying the formula, and then concluded the opinion by stating that its resultant interest rate represented the "market interest rate."). Many other Courts have adopted the *Till* formula rate approach, or some modified version thereof, but only where there was a finding that no efficient market existed or where there was insufficient evidence to support an efficient/accurate market rate. *See infra,* The Prevailing/Efficient Market Method.

Some courts have acknowledged but not applied *Till* in chapter 11 cases, while others have ignored it altogether. *See, e.g.*, *Good v. RMR Investments, Inc.*, 428 B.R. 249, 255 (E.D. Tex. 2010) (finding *Till* not to be binding in chapter 11 cases and upholding the bankruptcy court's use of contractual default rate of interest); *In re North Valley Mall, LLC*, 2010 WL 2632017 (Bankr. C.D. Cal. 2010) (using a "blended rate" approach that it believed was more fitting for real estate loans); *In re DBSD North America, Inc.*, 419 B.R. 170 (Bankr. S.D.N.Y. 2009) (acknowledging that *Till* is arguably relevant, the bankruptcy court preferred relying on the market interest rate for loans with similar terms and the prepetition contract rate); *In re Valencia Flour Mill, Ltd.*, 348 B.R. 573, 577-78 (Bankr. D.N.M. 2006) (making no mention of *Till*, court applied coerced loan rate approach based on pre-*Till* Tenth Circuit precedent); *In re Associated Wood Prods., Inc.,* 323 B.R. 479, 482 (Bankr. D. Minn. 2005) (making no mention of *Till*; denying confirmation).

These factors vary with each case, as do the facts of each case. Consequently, and because the *Till* case was decided in the context of a Chapter 13 case, there is no blanket rule and existing Formula Method precedent is merely persuasive authority, though it has certainly become prevalent among bankruptcy cases. The lack of a blanket rule has led many courts to

[13] The Court in *Till* noted that the specific risk premium to be added to the prime rate must be arrived at by considering "the circumstances of the estate, the nature of the security, and the duration and feasibility of the reorganization plan." *Till*, 541 U.S. at 479.

use the Prevailing Market Method, which does not necessarily consider the varying factors of each case.

2. The Prevailing/Efficient Market Approach (a/k/a Hybrid Approach)

The prevailing/efficient market approach does not necessarily conflict with the Supreme Court's plurality in *Till*, but rather seeks to determine whether an efficient market exists in accordance with the Supreme Court's footnote 14. If the Court determines that an efficient market exists, then it will apply the efficient market rate of interest derived from expert testimony. Courts generally consider the expert assessment, typically of a mortgage banker or other financial expert, of the interest rate market to determine the current market rate for similar loans. If, however, the Court is not satisfied that an efficient market exists, the Court will apply the *Till* formula rate approach. *See In re Winn Dixie Stores, Inc.*, 356 B.R. 239 (Bankr. M.D. Fla. 2006) (Funk, J.) (finding an efficient market and noting that "the appropriate interest rate…is the prevailing market rate for a loan of a term equal to the payout period, taking into account the quality of the security and the risk of default"); *Bank of Montreal v. Official Committee of Unsecured Creditors, (In re American Homepatient, Inc.)*, 420 F.3d 559 (6th Cir. 2005) (stating that when "no efficient market exists for a Chapter 11 debtor, then the bankruptcy court should employ the formula approach endorsed by the *Till* plurality"); *GECC v. Brice Road Developments, LLC*, 392 B.R. 274 (B.A.P. 6th Cir. 2008) (based on the available market for first-lien financing, bankruptcy court determined that a 6% cram down interest rate was appropriate); *In re South Canaan Cellular Investments, Inc.*, 427 B.R. 44, 77-78 (Bankr. E.D. Penn. 2010) (bankruptcy court found that the creditor had not met its burden of persuasion with respect to whether an efficient market existed. The court applied *Till* approach and found that a risk premium of 2.75% was appropriate for a total interest rate of 6%); *In re Griswold Building*, LLC, 420 B.R. 666, 692-96 (Bankr. E.D. Mich. 2009) (based upon expert testimony, the court found "that there was no credit market for commercial real estate loans secured by office buildings located in the central business district of downtown Detroit that [it] could turn to for guidance." As result, the court employed the formula approach and found that a risk premium of 5% was appropriate for a total interest rate of 8.25%.); *In re American Trailer & Storage, Inc.*, 419 B.R. 412 (Bankr. W.D. Mo. 2009) (Court adopted a nuanced version of *Till* in the Chapter 11 context, which involved first considering the existence of an efficient market and then resorting to the formula approach, where no efficient market existed.); *In re G-I Holdings, Inc.*, 420 B.R. 216, 267 (D.N.J. 2009) (applying *Till*'s formula approach after finding no evidence that an efficient market existed); *In re Sylvan I-30 Enterprises*, 2006 WL 2539718 (Bankr. N.D. Tex. Sept. 1, 2006) (because there was no evidence that the risk of non-payment or non-performance was any greater then it was when the loan was made, an efficient market would likely produce the variable rate in the Agreement and related loan documents, which provide present value for the creditor); *In re Northwest Timberline Enters., Inc.*, 348 B.R. 412, 434 (Bankr. N.D. Tex. 2006) (using *Till*'s formula rate approach to add 5.75% risk adjustment after finding that no efficient market existed); *In re Cantwell*, 336 B.R. 688, 693 (Bankr. D.N.J. 2006) (using the *Till* formula rate approach to add 1% risk adjustment to the prime rate after finding no evidence of an efficient market); *In re Prussia Assocs.*, 322 B.R. 572, 590-91 (Bankr. E.D. Pa. 2005) (applying *Till*'s formula rate approach after finding expert testimony insufficient to determine whether an efficient market rate existed).

Insufficient expert evidence may result in the court failing to find that an "efficient market" exists and instead applying the Till's formula rate approach. *See Prussia Assocs.*, 322

B.R. at 590 (applying Till approach after finding that "each [expert] opinion seemed based . . . simply on anecdotal stories about other transactions in which the experts were involved, that were not particularly comparable, or on their visceral instincts about the state of the marketplace" and that "the details which underlay their opinions were insufficiently shared with the Court to an extent which would permit it to make a meaningful comparison with the facts of this case").

Some courts have noted that debtors' circumstances are generally not as advantageous as average borrowers and that no efficient market can exist for such "forced loans." *Hardzog v. Federal Land Bank of Wichita*, 901 F.2d 858, 860 (10th Cir. 1990); *In re Fowler*, 903 F.2d 694, 697-98 (9th Cir. 1990); *United States v. Neil Pharmacal Co.*, 789 F.2d 1283, 1287-88 (8th Cir. 1986); *In re Oaks Partners, Ltd.*, 135 B.R. 440, 444-45 (Bankr. N.D. Ga. 1991); *In re Computer Optics, Inc.*, 126 B.R. 664, 672 (Bankr. D.N.H. 1991). Other courts, however, reject the notion that the lack of a market for "forced loans" makes a determination of the cramdown interest rate impossible. *See, e.g.*, *In re Birdneck Apartments Associates II L.P.*, 156 B.R. 499, 508-09 (Bankr. E.D. Va. 1993); *In re Eastland Partners Ltd. Partnership*, 149 B.R. 105, 106 (Bankr. E.D. Mich. 1992).

3. The Coerced Loan Approach

"Under the coerced loan approach, the court treats any deferred payment of an obligation under a plan as a coerced loan, and the rate of return that would be charged or obtained by the creditor making a loan to a third party with similar terms, duration, collateral, and risk." *In re American Trailer & Storage, Inc.*, 419 B.R. 412, 433 (Bankr. W.D. Mo. 2009).

In *Till*, the plurality rejected this approach:

> For example, the coerced loan approach requires bankruptcy courts to consider evidence about the market for comparable loans to similar (though nonbankrupt) debtors-an inquiry far removed from such courts' usual task of evaluating debtors' financial circumstances and the feasibility of their debt adjustment plans. In addition, the approach overcompensates creditors because the market lending rate must be high enough to cover factors, like lenders' transaction costs and overall profits, that are no longer relevant in the context of court-administered and court-supervised cramdown loans.

Till, 541 U.S. at 477. A modified version of this standard was the one applied by the Tenth Circuit prior to *Till*. *See, e.g.*, *Hardzog v. The Federal Land Bank of Wichita (In re Hardzog)*, 901 F.2d 858, 860 (10th Cir. 1990) (Chapter 12) ("in absence of special circumstances, such as the market rate being higher than the contract rate, Bankruptcy Courts should use the current market rate of interest used for similar loans in the region"); *Wade v. Bradford*, 39 F.3d 1126, 1130 (10th Cir. 1994); *In re Stratford Associates*, 145 B.R. 689, 1703 (Bankr. D. Kan. 1992) ("the 'market rate' refers to the market rate of interest in similar workout situations").

4. The Presumptive Contract Approach

"The presumptive contract approach uses the negotiated contract rate between the parties, subject to adjustments based on the particular facts of the case." *See American Trailer*, 419 B.R. at 433 n. 66. This standard was adopted by the Seventh Circuit in *Till*, before the decision was overruled by the Supreme Court. *See, e.g.*, *In re Till*, 301 F.3d 583, 592 (7th Cir. 2002) (Chapter 13). Pre-*Till*, several courts had endorsed the contract rate approach. *See, e.g.*, *In re Smith*, 192 B.R. 563 (Bankr. W.D. Okla. 1996) (Bankr. W.D. Okla. 1996) (Chapter 13) (using the contract rate as proxy for market rate absent stipulation or evidence to contrary); *In re Oglesby*, 221 B.R. 515 (Bankr. D. Colo. 1998) (Chapter 13).

5. The Tranche Method ("Band of Investment" or "Blended Rate")

The Tranche Method was developed because there was no true market for 100% loan-to-value (LTV) loans, because of the subjective approach of the Formula Method's risk factors, and because of the appeal of blending the Formula and Prevailing Market Rate Methods. In determining the appropriate cramdown interest rate, the Tranche Method creates a theoretical loan market when none exists. While appealing, few Courts have adopted this approach since the Supreme Court's plurality in *Till*.

To create this market, the Tranche Method uses a weighted average of interest rates from three different levels, or tranches, of financing, which theoretically gives an accurate interest rate. *See*, e.g., *In re Crosscreek Apartments Ltd.*, 213 B.R. 521, 543-44 (Bankr. E.D. Tenn. 1997); *In re Cellular Information Systems Inc.*, 171 B.R. 926, 943-44 (Bankr. S.D.N.Y. 1994); *In re SM 104 Ltd.*, 160 B.R. 202 (Bankr. S.D. Fla. 1993) (Ginsberg, J.) (using ten year treasury rate as "base rate," but also applying tranche method to determine appropriate interest rate). But *see Bank of Montreal v. Official Committee of Unsecured Creditors, (In re American Homepatient, Inc.)*, 420 F.3d 559 (6th Cir. 2005) (rejecting the "tiered financing approach" as being beyond what is contemplated in Section 1129, and providing a more favorable interest rate to creditors); *In re Red Mountain Machinery Company*, 2011 WL 1428266 (Bankr. D. Ariz. Apr. 4, 2011) (rejecting the investment band method in favor of *Till* formula approach).

The First Tranche is derived from the market rate for adjustable rate loans from lenders who make first loans of up to 70-75 percent LTV. Typically, pension funds, banks and insurance companies provide First Tranche financing.

The Second Tranche is derived from the yields that investors seek for loans that provide junior debt financing of up to 85 percent LTV of the underlying collateral. Typically, private finance companies, who seek to secure an overall internal rate of return between 15-30 percent, provide Second Tranche financing.

The Third Tranche is derived from the yields that investors seek in the most "junior tranche," which includes the remainder of the loan up to 100 percent LTV. The Third Tranche is a highly leveraged position most often characterized as equity, whose investors are typically entrepreneurial investors seeking the smallest amount of risk with a high overall internal rate of return of between 18-40 percent.

The appropriate interest rate for the proposed plan is then calculated by averaging the three interest rates. *See, e.g., In re Bloomingdale Partners*, 155 B.R. 961, 984-85 (Bankr. N.D. Ill.

1993); *In re SM 104 Ltd.*, 160 B.R. 202 (Bankr. S.D. Fla. 1993) (applying the "band of investment technique" used in *Bloomingdale Partners*). Therefore, the Tranche Method proves useful in calculating the allegedly appropriate market rate of interest where financing vehicles on comparable loan collateral are readily available in relation to each Tranche.

Despite the appeal of these calculations, though, expert testimony remains pertinent to determine each Tranche's interest rate. Further, although the Tranche Method attempts to determine the market rate for a non-existent market, certain courts remain unimpressed and deem the Tranche Method as another "forced loan."

VI. Unconventional Financing.

Alternative sources of financing are available to Chapter 11 debtors when conventional bank financing is not available. While there are many different and creative sources of such financing, following is a summary of some of these financing mechanisms, and the benefits, dangers and drawbacks of each.

A. Factoring[14]

Factoring of accounts receivables is one way for a business to generate immediate working capital. *See,* Dan Barufaldi, www.investopedia.com*/ articles/pf/* 09/ seven-ways-borrow money.asp. The debtor enters into a factoring agreement to sells its "eligible" accounts receivable to a factor. The factor will usually advance 75-80% of the receivables' value retaining approximately 20-25% in a "reserve" account maintained by the factor. *Id.* Uncollected receivables are set off against the funds in the reserve account. The amount of the reserve can vary depending on the quality of the receivables and the historical average of the customer payers. If the payer is historically late, the amount of the required reserve likely will be increased.

The factor handles the transactions, administers the accounts, conducts credit assessments and handles collections. *Id*. For these services and the funds advance, the factoring costs to the debtor may exceed 20% of the face value of the receivables. *Id.*

Once the accounts are paid, the debtor receives the difference between the face value and the reserve. *Id*. The factor usually gets a 2-3% fee for the first 30 days, with late charges ranging from 0.067-0.125% per day thereafter. *Id*.

The benefits of factoring include quick access to cash (usually within 3-10 days). *Id.* However, if the debtor is operating on thin margins, then the factoring of its accounts receivables may exacerbate the debtor's cash flow crunch. Factoring also involves the lack of control over (i) customer payments which normally are paid to a lockbox maintained by the factor, and (ii) the determination as to which accounts receivables are eligible for factoring. *Id.* Reputable factors exist in the market place for furniture and other industries but the borrower should exercise due diligence before selecting a factor and should review and understand the factoring agreement before entering into a factoring arrangement.

[14] *See*, Dan Barufaldi, www.investopedia.com*/ articles/pf/* 09/ seven-ways-borrow money.asp

At issue in most bankruptcy proceedings is whether the factoring agreement constitutes a "true sale" or is the nature of a securitized loan. If the agreement is in the nature of a securitized loan, the courts will look to see whether the factoring company properly perfected its security interest.[15] Article 9 of the U.C.C. covers security interests, and section 9–102(2) states that the article applies to a number of contract-created security interests, including the factor's lien.

It is important to note, that the mere existence of recourse in a factoring agreement is not itself dispositive of the proper characterization of a transaction. See, *Major's Furniture*, 602 F.2d at 544 ("[T]he presence of recourse in a sale agreement without more will not automatically convert a sale into a security interest"); Official Comment 3 to U.C.C. Section 9-608 ("The parties are always free to agree that … an obligor is liable for a deficiency, even if the transaction is a sale of receivables"). Several courts have held that a transaction was a sale notwithstanding significant or even complete recourse. Other courts have reasoned that if the nature and level of recourse reveals that all or virtually all risk of loss was retained by the transferor, the transfer should properly be characterized as a loan. See, *Major's Furniture*, 602 F.2d at 538 (accounts sold with "full recourse", with a reserve from the purchase price held back against future non-paying accounts, and with a requirement that seller repurchase accounts delinquent after 60 days, held to be disguised loans); *In re The Woodson Co*., 813 F.2d at 266 (seller's purchase of insurance policy to insure buyers of participations in mortgages against loss one important factor in court's holding of disguised loan); *Blackford v. Commercial Credit Cor*p., 263 F.2d 97 (5th Cir. 1959) (sale at 15 percent initial discount, with 15 percent less finance charge to be paid to seller as accounts collected, coupled with seller's warranty of collectability, held a disguised loan); *Milana v. Credit Discount Co*., 163 P.2d at 869 (purported absolute assignment held secured loan where purchase price reserve held back until all accounts were paid, seller warranted solvency of account debtors until accounts paid, and seller guaranteed payment of accounts).

Major's Furniture represents the most frequently cited case by courts for its analysis of the nature and level of recourse and its holding that a transfer structured as a sale should be recharacterized as a loan where the transferee assumes almost none of the risks associated with ownership. Major's Furniture involved a purported sale by Major's to Castle of accounts

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[15] As stated by the Third Circuit Court of Appeals in reviewing prior cases:

> [D]espite the express language of the Purchase Agreements, the respective courts examined the parties' practices, objectives, business activities and relationships and determined whether the transaction was a sale or a secured loan only after analysis of the evidence as to the true nature of the transaction.

Major's Furniture Mart, Inc. v. Castle Credit Corp., Inc., 602 F.2d 538 (3d Cir. 1979); see also, *In re Evergreen Valley Resort, Inc*., 23 B.R. 659, 661 (Bankr. D. Me. 1982); *In re Carolina Utilities Supply Co*., Inc., 118 B.R. 412 (Bankr. D. S.C. 1990).

receivable in which Major's effectively retained all risk associated with the collectibility of the assigned accounts. The Third Circuit Court of Appeals adopted the findings and conclusions of the lower court and held that, notwithstanding the "sale" language contained in the Purchase Agreement, the transfer was merely a loan secured by a pledge because "none of the risks present in a true sale is present here": It appears that Castle required Major's to retain all conceivable risks of uncollectibility of these accounts. It required … that Major's warrant that the accounts were fully enforceable legally and were "fully and timely collectible." It also imposed an obligation to indemnify Castle out of a reserve account for losses resulting from a customer's failure to pay, or for any breach of warranty, and an obligation to repurchase any account after the customer was in default for more than 60 days … Guaranties of quality alone, or even guarantees of collectibility alone, might be consistent with a true sale, but Castle attempted to shift all risks to Major's, and incur none of the risks or obligations of ownership.

Major's Furniture, 602 F.2d. at 545; see also, *Blackford v. Commercial Credit Corp*., 263 F.2d at 106 (transfer of accounts held a loan where transferor warranted that each account would be paid timely, agreed to pay any amounts not timely paid and provided similar protections "essentially guaranteeing [the transferees] that they will suffer no loss on the transaction"); *Fox v. Peck Iron & Metal Co*., 25 B.R. at 690 ("Peck never assumed the normal risks of ownership, such as the risk that the value of the property might decline"); *Abeloff v. Ohio Finance Co*., 313 Mich. 568, 21 N.W.2d 856 (1946); *Union Planters Nat. Bank of Memphis v. U.S*., 426 F.2d 115 (6th Cir. 1970).

B. Hedge-Fund Lenders[16]

Hedge fund lenders typically loan money to high risk businesses, such as asset- or technology-concept backed companies. *Id.* The decision to lend is made after some due diligence, but with greater flexibility than that experienced with conventional lenders. *Id.*

The benefit of hedge fund loans is that access to funds is usually quick. *Id.* However, the dangers can include high borrowing costs and prepayment penalties. *Id*. Non-disclosure agreements should be signed at the outset as some hedge funds have been known to fund risky loans to exploit the internal information gained in the process, which can benefit their other trading. *Id.*

C. Convertible Debt Instruments.[17]

Convertible debt instruments are asset-backed loans that require the business owner to give up some future equity in the business if the lender wishes to convert the debt to an equity position in the company. *Id.* One of the benefits is that the lender incurs less risk in making this type of loan and therefore is more likely to make the loan even with some risk in the situation. *Id*. It is also less risky for the lender than a straight equity investment if the lender wants to be paid back with some return on its investment and does not want to acquire an ownership stake

[16] *See also*, Bo J. Howell, *Hedge Funds: A New Dimension in Chapter 11 Bankruptcy Proceedings*, 7 DePaul Bus. and Com. L. J., 35 (2008)

[17] *See also*, Tim J. Durken, *False Alarm? Convertible Bonds Unlikely to be Reduced By the Value of Their Conversion Rights in Bankruptcy*, www. Jagersmith.com/ downloads/pdf/Bankruptcy-Risk-Convertible-Bond-Debt- Unlikely-Disallowed-by-Value-of-Conversion-Rights.pdf

in the company. *Id.* For instance, if the company's bottom line growth is not performing as anticipated, the lender may simply want to be repaid its debt. *Id.*

The dangers and drawbacks to the borrower under this scenario is the potential loss of future equity if the company does well. *Id*. Conversely, if the company is performing below budget, the owner may be required to pay back unconverted debt. *Id.*

D. Venture Capital Backed Company Loans

For eligible companies, this bank-based lending source has significant benefits. *Id.* Companies with previous backing from venture capital companies that have established relationships with certain banks can obtain access to this bank lending source based on the bank's reliance on the earlier due diligence done by the previous venture capital firms. *Id.*

The benefits of these loans is that borrowers can access bank lenders previously unavailable to the company, the borrower can obtain quicker access to the funds due to the pre-screening by the venture capital firm, and the borrowers can obtain access to bank financing with a higher risk threshold than a stand-alone bank loan. *Id.*

This bank lending comes with a high interest rate and probable future stock warrant coverage requirements, which allows the lender to purchase shares in the borrowing company at a future date at a specified fixed price or a price under current market price at the time of purchase. *Id.* As a result, this type of lending is available only to a small percentage of borrowers.

E. Hard Money Lenders

Hard money loans are traditionally used for troubled or opportunistic commercial real estate and businesses who do not qualify for conventional bank financing. Often the borrower cannot obtain typical mortgage financing because they do not have acceptable credit or other information typically required by a conforming lender.

Hard money loans are typically short-term capital (or bridge loans) that provide funding based on the value of the real estate acting as collateral. Hard money lenders focus on the value of the collateral property rather than on a borrower's ability to repay the debt based on the borrower's personal income or assets as is common with conventional lenders. Because such loans are not based on traditional credit guidelines which protect banks from high default rates, hard money loans tend to be more expensive. Only state usury laws control the interest rate which hard money lenders can charge.

F. New Debt Securities.

Where prospects for refinancing are virtually nonexistent, use of new debt securities can be a useful tool for financing in a Chapter 11 case. Essentially, the debtor offers the secured lender(s) new debt securities with new maturity dates, interest rates and financial covenants pursuant to a Chapter 11 plan. Such a plan can be approved so long as the debtor provides the same collateral package to the secured lender(s) and otherwise provides the "indubitable equivalent" of the lender(s)' claims. So long as the standards for confirmation of a plan are

otherwise met, trade creditors and equity holders would not necessarily be impaired in this context.

G. Rights Offerings.

Rights offerings have become more common in the last decade as a source of exit financing. *See e.g. Rights Offerings as a Means of Financing Exits from Chapter 11*, 18 Am. Bankr. Inst. L.Rev. 615 (2010). Use of rights offerings allows a reorganized company to continue its strategic acquisitions where the financing environment might otherwise delay or frustrate the pursuit of such goals.

A public company can "raise" equity pursuant to a Chapter 11 plan by offering pre-petition creditors and, less frequently, equity security holders the right to purchase equity in the post-emergence company usually at a discount. Offering solicitations are typically made in connection with a plan or following confirmation of a plan but prior to consummation of the plan. While 11 U.S.C. §1145 exempts these offerings from securities laws, the amount of capital that can be raised is limited to the value of the security being exchanged. A key component of rights offerings are backstop purchasers who commit to purchase any securities that are not taken up by the rights class through the exercise of rights. *Id.* Backstop purchasers may be new investors, but are frequently a group of pre-petition creditors seeking to support or propose a plan of reorganization. *Id.* Because of the amount of money invested by these backstop purchasers, the provisions of § 1145 may be unavailable and registration of the offering would thus be required under section 4(2) of the Securities Act, 15 U.S.C. §77(d)(2)(2006) .

VII. THIRD-PARTY RELEASES

A. Introduction

It should be no surprise that third party releases are a controversial and typically hotly contested issue in bankruptcy. The Bankruptcy Code itself appears to disavow such releases. Under 11 U.S.C. § 524(e) "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." And yet, some courts still allow such releases citing the need for flexibility and the court's power under § 105 to "issue any order, process or judgment that necessary or appropriate to carry out the provisions of this title." The dispute over third party releases continues today. Most of the time this dispute centers on the scope of releases provided in a chapter 11 plan. Other times, the dispute arises because the parties to settlement ask the court to approve a bar order under Fed. R. Bankr. P. 9011. The language is different and the factors don't specifically coincide, but the question is the same. Under what context can a bankruptcy court order that creditors are enjoined from bringing claims against a non-debtor third party?

B. Background

Historically, the circuit courts have been split on whether third party releases are permitted under the Bankruptcy Code. The Ninth and Tenth Circuits have historically rejected third party releases. *See Resorts Int'l v. Lowenschuss (In re Lowenschuss)*, 67 F.3d 1394 (9th Cir. 1995); *In re Western Real Estate Fund, Inc.*, 922 F.2d 592 (10th Cir. 1990), *opinion modified*, *Abel*

v. West, 932 F.2d 898 (10th Cir. 1991). In a somewhat recent decision, the Fifth Circuit made it clear that third party releases are likewise not welcome in that jurisdiction. In *In re Vitro SAB De CV*, 701 F.3d 1031, 1061 (5th Cir. 2012), the court reviewed its prior decisions and held that its precedent "seem broadly to foreclose non-consensual non-debtor releases and permanent injunctions." (internal quotation marks omitted). These circuit courts generally conclude that such releases are not permitted under § 524(e). However, this is the minority position. Decisions from the Second, Third, Fourth, Sixth and Seventh circuits appear to permit a third party release under certain limited circumstances. *See In re Metromedia Fiber Network, Inc*., 416 F.3d 136 (2nd Cir. 2005); *In re Dow Corning Corp.*, 280 F.3d 648 (6th Cir. 2002); *In re A.H. Robins Co., Inc.*, 880 F.2d 694 (4th Cir. 1989); *Matter of Specialty Equip. Companies, Inc*. 3 F.3d 1043 (7th Cir. 1993).

C. The State of Third Party Releases

1. In the Eleventh Circuit

Until recently, courts in the Eleventh Circuit were not clear on whether the Eleventh Circuit Court of Appeals had taken a position in the dispute over third party releases. In the recent decision of *SE Prop. Holdings, LLC v. Seaside Eng'g & Surveying (In re Seaside Eng'g & Surveying*, 780 F.3d 1070 (11th Cir. 2015)) the court made it clear that third party releases are permitted, even if only permitted in certain limited, unusual cases. In fact, the Eleventh Circuit held that its prior decision of *In re Munford*, 97 F.3d 449 (11th Cir. 1996), where it approved a release of third parties in a bar order as part of a settlement, was precedent establishing the ability to provide such third party releases.[18] While recognizing the availability of third party releases, the Eleventh Circuit made it clear this was the exception rather than the rule.

> We also agree, however, with the majority view that such bar orders ought not be issued lightly, and should be reserved for those unusual cases in which such an order is necessary for the success of the reorganization, and only in situations in which such an order is fair and equitable under all the facts and circumstances. The inquiry is fact intensive in the extreme.

Seaside, 780 F.3d at 1079. In undertaking this fact intensive analysis, the Eleventh Circuit has joined in adopting the following seven factor test, that was established in *Dow Corning*, 280 F.3d at 658 and adopted in other circuits including in *Behrmann v. National Heritage Foundation*, 663 F.3d 704, 712 (4th Cir. 2011):

(1) There is an identity of interests 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 the assets of the estate;
(2) The non-debtor has contributed substantial assets to the reorganization;
(3) The injunction is essential to reorganization, namely, the reorganization hinges on the debtor being free from indirect suits against parties who would have indemnity or contribution claims against the debtor;
(4) The impacted class, or classes, has overwhelmingly voted to accept the plan;

[18] The Eleventh Circuit uses the phrases third party releases and bar orders interchangeably.

(5) The plan provides a mechanism to pay for all, or substantially all, of the class or classes affected by the injunction;
(6) The plan provides an opportunity for those claimants who choose not to settle to recover in full; and
(7) The bankruptcy court made a record of specific factual findings that support its conclusions.

780 F.3d at 1079.

While the list uses the term "and," the *Seaside* decision makes it clear that the court has discretion to determine which factors will be relevant in each case and that this is a non-exclusive list. *Id*.[19]

Even though the Eleventh Circuit seems to have cleared up any confusion over the availability of third party releases, recent decisions of the bankruptcy courts in this circuit demonstrate that the burden is a high one indeed. In fact, the trend in published opinions seems to be a very strict application of the law leading to a denial of third party releases in the majority of cases. *See, e.g., In re Fundamental Long Term Care, Inc.*, 515 B.R. 352, 359 (Bankr. M.D. Fla. 2014) (court denied bar order where the enjoined parties did not receive any benefit)[20]; *In re GunnAllen Fin., Inc*., 443 B.R. 908, (Bankr. M.D. Fla. 2011) (court denied bar order when individuals being released did not contribute anything to the settlement); *In re HWA Properties*, 544 B.R. 231 (Bankr. M.D. Fla. 2016) (court declined third party releases in plan of reorganization applying the seven factor test). In the case of *In re Storage Masters JYP, LLC*, 2012 Bankr. LEXIS 6284 (Bankr. M.D. Fla. July 24, 2012), the bankruptcy court denied the request to release the principal's guaranty to the bank even though he was contributing of $600,000 to the estate. The court opined that because the debtor did not provide any evidence of the principal's financial ability to pay or on the value of the guaranty obligation, it could not determine if the principal's contribution was substantial. *Id*. at *26. The court held that "[r]eleasing every insider of a single-asset debtor who contributes cash to keep his investment would gut the provisions of § 524(e); courts must limit the use of non-debtor releases to unusual circumstances." *Id*. at *27. Admittedly, some of these cases were decided before the *Seaside* opinion, but the courts still applied the same legal analysis.

D. Other Circuits

In other circuits, the trend is likewise a strict look at third party releases. In the Fourth Circuit, the courts emphasize that plan releases should be granted "cautiously and infrequently" and "only under unusual circumstances." *In re Neogenix Oncology, Inc.*, 508 B.R. 345, 357 (Bankr. D. MD 2014) quotations omitted. *See also, In re 710 Long Ridge Rd. Operating Co., II, LLC*, 2014 Bankr. LEXIS 863, *55 (Bankr. D.N.J. March 5, 2014) (court approved third party

[19] In *In re Cello Energy, LLC*, 2012 Bankr. LEXIS 1533 (Bankr. S.D. Ala. April 10, 2012) the court denied the request for third party releases as part of a plan because the debtor could not meet all seven factors; however, this decision was entered before *Seaside* which is now controlling law in the Eleventh Circuit).

[20] The court would later actually approve the same bar order in a later decision after the parties modified the terms of the compromise and in conjunction with entering an injunction that enjoined the litigation of certain claims. *See Estate of Jackson v. GE Capital Corp. (In re Fundamental Long Term Care, Inc.)*, 527 B.R. 497 (Bankr. M.D. Fla. 2015).

releases that it found were fair and absolutely necessary in order to effect reorganization, but rejected releases of manager, directors, officers and employees because they did not provide any critical financial contribution to the plan that was necessary for confirmation); *In re Charles St. African Methodist Episcopal Church of Boston*, 499 B.R. 66, 103 (Bankr. E.D. Mass. 2013) (court rejected third party release that "is not essential to the debt repayment objections of the Plan, that foes not have the assent of the affected creditor, and that does not treat that creditor so well that the release of of virtually no concern."). In the *Neogenix Oncology* case, the court initially rejected the third party releases, ruling, in part, that a third party release cannot be essential to reorganization in a liquidating plan. 508 B.R. at 359. However, on a second try, the same court later approve the third party releases. *See In re Neogenix Oncology, Inc.*, 2015 Bankr. LEXIS 3343 (Bankr. D. MD Sept. 30, 2015). On the second try, the debtor provided for an opt-out in the solicitation package. With creditors having the ability to opt out of the release and additional evidence on the lack of value in the claims being released, the court then approved the releases using the same seven factor analysis that earlier required rejection. Interestingly, the court, in a detailed analysis, rejected the argument that the lack of any response by creditors to the opt-out provision in the solicitation package constituted implied consent for the releases. *Id*. at *15.

E. Conclusion

Whether the court calls it a bar order or third party release, the Eleventh Circuit courts along with others still allow for releases of third parties, but only in unusual circumstances and only when such orders are fair and equitable to the parties being enjoined.

VIII. EQUITABLE MOOTNESS

A. Introduction and Background

Equitable mootness is a doctrine that permits the appellate court to dismiss an appeal based on its lack of power to rescind the transaction. The Supreme Court tells us that an appeal is moot in the constitutional sense only if events have taken place during the pendency of the appeal that make it "impossible for the court to grant 'any effectual relief whatever.'" *Church of Scientology v. United States*, 506 U.S. 9, 12, 113 S. Ct. 447, 449, 121 L. Ed. 2d 313 (1992) (quoting *Mills v. Green*, 159 U.S. 651, 653, 40 L. Ed. 293, 16 S. Ct. 132 (1895)). Even though a court may not be able to return the parties to the *status quo ante*, if it can fashion *some* form of meaningful relief, the appeal is not constitutionally moot. *Id.* at 12.

Equitable mootness, on the other hand, is a broader interpretation of mootness that is widely recognized and accepted in bankruptcy and recognized in every circuit that hears bankruptcy appeals. *See*, *e.g.*, *Manges v. Seattle-First Nat'l Bank (In re Manges)*, 29 F.3d 1034, 1038-39 (5th Cir. 1994), *cert. denied*, 130 L. Ed. 2d 1071, 115 S. Ct. 1105 (1995); *In re Specialty Equip. Cos.*, 3 F.3d 1043, 1048 (7th Cir. 1993); *Rochman v. Northeast Utils. Serv. Group (In re Public Serv. Co.)*, 963 F.2d 469, 471-72 (1st Cir.), *cert. denied*, 506 U.S. 908, 121 L. Ed. 2d 226, 113 S. Ct. 304 (1992); *First Union Real Estate Equity & Mortgage Invs. v. Club Assocs. (In re Club Assocs.)*, 956 F.2d 1065, 1069 (11th Cir. 1992); *Central States, Southeast and Southwest Areas Pension Fund v. Central Transp., Inc.*, 841 F.2d 92, 95-96 (4th Cir. 1988); *In re AOV Indus.*, 253 U.S. App. D.C. 186, 792 F.2d 1140, 1147 (D.C. Cir. 1986); *Trone v. Roberts Farms, Inc. (In re Roberts Farms, Inc.)*, 652 F.2d 793, 796-97 (9th Cir. 1981).

Under the equitable mootness doctrine, courts have held that "an appeal should . . . be dismissed as moot when, even though effective relief could conceivably be fashioned, implementation of that relief would be inequitable." *Official Comm. of Unsecured Creditors of LTV Aerospace & Defense Co. v. Official Comm. of Unsecured Creditors of LTV Steel Co. (In re Chateaugay Corp.*), 988 F.2d 322, 325 (2d Cir. 1993). As Judge Easterbrook wrote, "there is a big difference between *inability* to alter the outcome (real mootness) and *unwillingness* to alter the outcome ('equitable mootness')." *In re UNR Indus.*, 20 F.3d 766, 769 (7th Cir.), *cert. denied*, 130 L. Ed. 2d 416, 115 S. Ct. 509 (1994). Equitable mootness seeks to "strike the proper balance between the equitable considerations of finality and good faith reliance on a judgment and the competing interests that underlie the rights of a party to seek review of a bankruptcy court order adversely affecting him." *In re Lett*, 632 F.3d 1216, 1226 (11th Cir.2011).

Equitable mootness was originally implemented by courts in response to appeals of plan confirmation. Key to the analysis is whether a plan has been substantially consummated. "[T]he court must determine whether the reorganization plan has been so substantially consummated that effective relief is no longer available." *First Union Real Estate Equity & Mortg. Invs. V. Club Assocs.* (*In re Club Assocs*.), 956 F.2d 1065, 1069 (11th Cir. 1992). While substantial consummation of the plan does not end the inquiry in any jurisdiction, it is one of the foremost factors in determining equitable mootness. Overall, the majority of courts utilize a small list of factors in deciding whether an appeal is equitably moot. Those factors generally include:

1. Whether a stay pending appeal was obtained, and if not was it even sought;
2. Whether the plan has been substantially consummated;
3. What kind of relief does the appellant seek;
4. What impact would the relief have on third parties not before the court; and
5. Can the court fashion effective and equitable relief without affecting the re-emergence of the debtor as a revitalized entity.

See In re Mortgages Ltd., 771 F.3d 1211, 1217 (9th Cir. 2014); *In re Chateaugay Corp.*, 10 F.3d 944, 952 (2d Cir. 1993); *In re Am. HomePatient, Inc.*, 420 F.3d 559, 563 (6th Cir. 2005); *In re Club Assocs*., 956 F.2d at 1069 n. 11.

B. Recent Developments

While originally created for use on a limited basis and in complex plans of reorganization, in some jurisdictions the doctrine has been expanded. For instance, in *Davis v. Shepard (In re Strickland & Davis Int'l, Inc.)*, 612 Fed. Apps. 971 (11th Cir. 2015), the Eleventh Circuit applied equitable mootness to an appeal of approval of a trustee's final report in a chapter 7 case. The court based its decision on the fact that the trustee had distributed the estate's assets over two years earlier and a creditor had completed state law foreclosure proceedings on the debtor's property. *Id*. at 978. The court noted that it has "repeatedly held that where a debtor fails to obtain a stay pending appeal of an adverse bankruptcy court order and the creditor subsequently conducts a foreclosure sale, the court of appeals is powerless to grant relief, and the appeal must be dismissed as moot." *Id*. at 979, *quoting In re Kahihikolo*, 897 F.2d 1540, 1542 (11th Cir. 1987). Additionally, in *JMC Memphis, LLC v. Kapila*, 2015 U.S. Dist. LEXIS 131124 (S.D. Fla. September 29, 2015) (district court held that equitable mootness required dismissal of appeal on a compromise order on a settlement that had already been fully

consummated and funds had been distributed to third parties. The court also based its decision on the failure of the appellant to seek a stay pending appeal.

Even in the context of appeals as to plan confirmation, there has over the years been a loosening of the requirements and readiness of courts to declare an appeal equitably moot. Judge Krause of the Third Circuit recently issued a concurring opinion in the case of *One2One Communs., LLC v. Quad/Graphics, Inc*., 805 F.3d 428, 438 (3rd Cir. 2015) to decry the expansion of equitable mootness and ask the court to eliminate the doctrine altogether. In *One2One Communs*., the court declined to dismiss the appeal as equitably moot holding that it was not the type of complex bankruptcy to which the doctrine applies. *Id*. at 435. The case involved only one secured creditor, seventeen unsecured creditors and only a $200,000 investment in the reorganized debtor. *Id*. "The record illustrates that this case did not involve a sufficiently complex bankruptcy reorganization such that dismissal on the basis of equitable mootness would be appropriate." *Id*. at 436. Judge Krause in his concurring opinion reasoned that there is no constitutional or statutory anchor for declaring an appeal equitably moot. Consider also that the Supreme Court's recent decisions in *Stern* and then *Wellness International* limited the bankruptcy court's authority to rule on certain claims, and only preserved this authority with consent and the existence of a right to appeal to an Article III court. *Id*. at 445. According to Judge Krause, because equitable mootness weakens this supervisory authority it "threatens a far greater impermissible intrusion on the province of the judiciary." *Id*.

Consistent with Judge Krause's criticism, there appears in some jurisdictions, a growing reluctance to simply declare an appeal to be equitably moot. In two recent decisions from the Ninth Circuit, the court declined to determine the appeals were equitably moot. *In First Southern Nat'l Bank v. Sunnyslope Hous. Ltd. P'Ship (In re Sunnyslope Hous. Ltd. P'Ship)*, 2016 U.S. App. LEXIS 6429, *19 (9th Cir. April 8, 2016) the court reasoned that it could fashion effective and equitable relief because the transactions at issue were not very complex and the only party that would be negatively impacted was not the type of innocent third party that doctrine was designed to protect. The court noted that the party to be impacted was the investor who went into the transaction fully aware of the appellant's objection and the appeal. *Id*. at 20. Similarly, in *Grasslawn Lodging, LLC v. Transwest Resort Props*., 801 F.3d 1161, 1173 (9th Cir. 2015), the court ruled that even though the plan had been substantially consummated, the appeal was not equitably moot because the court could fashion "an equitable remedy for each objection that would not bear unduly on innocent third parties." *See also Rogers v. Gladstone (In re Bardos)*, 2016 Bankr. LEXIS 918, *18 (9th Cir. BAP March 23, 2016) (where court ruled appeal of order allowing sale of estate assets was not equitably moot even though the liquidating agent had already spent some portion of the sale proceeds considering that the buyer is the party who insisted on closing even though an appeal was pending).

Other circuit courts have been lately been reluctant to dismiss appeals as equitably moot. In *Ahuja v. Lightsquared, Inc.*, 2016 U.S. App. LEXIS 5508 (2d Cir. March 22, 2016), the Second Circuit ruled that even though the plan was substantially consummated, the appeal was not equitably moot. In the Second Circuit, an appeal is presumed equitably moot if the plan has been substantially consummated. *Id*. at *3. However, this presumption can be overcome if all of the factors (five in this circuit) are met. *Id*. The court reasoned that the appeal was not equitably moot because the court could order at least some effective relief in the form of monetary damages with "knocking the props out from under the completed transaction or effective [the debtor's] emergence as a revitalized corporate entity." *Id*. at *6. In evaluating

equitable mootness with respect to a compromise order, the Eleventh Circuit recently held in *Ulrich v. Welt (In re Nica Holdings, Inc.)*, 810 F.3d 781, 788 (11th Cir. 2015) that the there was no substantial consummation of the transactions because the sale proceeds were sitting in the estate and had not been disbursed. The court would go on to opine that even if there was a distribution, these were not the kind of complicated transactions involving innocent third parties that could not be undone. *Id*.; *See also In re VOIP, Inc.*, 461 B.R. 899, 903 (S.D. Fla. 2011) (court ruled appeal of compromise order was not equitably moot when it involved the transfer of money, no evidence suggested the money had been spent or that a third party had justifiably relied on the settlement); *Desert First Prot. V. Fountainbleau Las Vegas Holdings, LLC (In re Fountainbleau Las Vegas Holdings, LLC)*, 434 B.R. 716, 746 (S.D. Fla. 2010) (where the court ruled the appeal of a cash collateral order was not equitably moot).

Compare these cases to recent decisions from the Third and Sixth Circuits that lead some to declare the equitable mootness doctrine alive and well. In *In re Schwartz*, 2016 U.S. App. LEXIS 1490 (6th Cir. Jan. 26, 2016) the court ruled that an appeal was equitably moot when the plan had been substantially consummated three years earlier. The court also noted that failure to seek a stay was not fatal to an appellant's ability to proceed with the appeal. *Id*. at *4. The third circuit's recent opinion in *Tribune Media Co. v. Aurelius Capital Mgmt., L.P.*, 799 F.3d 272 (3rd Cir. 2015), *cert. denied Aurelius Capital Mgmt., L.P. v. Tribune Media Co*., 2016 U.S. LEXIS 1866 (U.S. March 21, 2016), provides an excellent demonstration of equitable mootness and its limitations. In *Tribune Media*, the court likewise ruled an appeal by Aurelius, a creditor opposing the plan, was equitably moot. *Id*. at 280. A critical issue in the estate was the causes of action arising out of a pre-petition leveraged buyout that saddled the debtor with an extra $8 billion of debt. Kenneth Klee was appointed as examiner and helped value the various causes of action in order to aide in settling the same. *Id*. at 275. The parties submitted competing plans of reorganization. While the plans had other terms, the main discrepancy in the plans was in the treatment of the LBO claims. Aurelius' plan proposed the continued litigation of the LBO claims while the debtor's plan proposed a settlement whereby the estate would receive $369 million as part of the compromise. *Id*. at 276. The court confirmed the debtor's plan over the Aurelius objection. Aurelius appealed and sought a stay pending appeal, but refused to post the $1.5 billion bond required by the court as a condition. Aurelius was likewise unsuccessful in expediting consideration of the appeal. *Id*.

The parties agreed that the plan was substantially consummated, but Aurelius argued that the court could still undue the settlement and reinstate the LBO causes of action without scrambling the plan or causing harm to third parties. *Id*. at 280. With substantial consummation established, the court then turned to consider the second part of the inquiry – "whether granting the relief requested in the appeal will (a) fatally scramble the plan and/or (b) significantly harm third parties who have justifiably relief on plan confirmation." *Id*. at 282. The court found that even though it could undue the settlement, to do so would undermine the settlement, the transactions that relied on the settlement and as a result, recall the entire plan. *Id*. at 281. The court also opined that the third parties in the form of the new equity investors would be harmed. Undoing the settlement would diminish the value of their investment which was made in reliance on it. *Id*. Aurelius did not present the court with any relief that would not undermine the confirmed plan and cause harm to third parties. The court reasoned that such a

result would be inequitable requiring a finding that the appeal was equitably moot.[21] *Id*; *see also Musilino v. Ala. Marble Co*. *(In re Ala. Marble Co.)*, 534 B.R. 820 (N.D. Ala. 2015), aff'd 628 Fed. Appx. 746 (11th Cir. 2016) (court ruled appeal of settlement was equitably moot when settlement had been fully consummated and the appellant did not seek a stay pending appeal).

Contrast this with the Third Circuit's ruling, in the same opinion, that the appeal by the bond trustees was not equitably moot. *Id*. at 282. The bond trustees argued that they were the beneficiaries of a subordination agreement that allowed them to recover ahead of another class of claimants under the plan. *Id*. The court held that this issue was not equitably moot because the court could fashion relief without undoing the plan. The court reasoned that this was a dispute between two classes of creditors over a pot of money. *Id*. at 283. Should the court rule in the trustees' favor, it could simply order a disgorgement from the other class of creditors. *Id*. at 282-283. Alternatively, the other class of creditors could be excluded from the future stream of income from the litigation trust until the trustees are paid in full. Overall, the remedies available would not impact the reorganization and emergence of the debtor and any reliance by the impacted class of creditors was not justifiable. *Id*. at 283. The court therefore held that the district court abused its discretion in ruling that the trustees' appeal was equitably moot. *Id*. at 284.

C. Chapter 9 Cases

There is some dispute over whether the doctrine of equitable mootness is applicable in an appeal of confirmation in a Chapter 9 bankruptcy. The court in *Bennett v. Jefferson County*, 518 B.R. 613, 637 (N.D. Ala. 2014) the court ruled that equitable mootness is not applicable in Chapter 9. In Jefferson County, the appeal centered around the plan provision issuance of new sewer warrants and empowering the bankruptcy court with authority to set sewer rates. *Id*. The court reasoned that equitable mootness did not apply because the concerns in Chapter 9 differ substantially from those in Chapter 11. The prudential concerns in Chapter 11 are "preserving going concerns and maximizing property available to satisfy creditors," while the policy underlying Chapter 9 however "is not future profit, but rather continued provision of public services." *Id*. at 636 (internal quotation marks omitted). The County argued the need for finality, but the court ruled this was outweighed by the need for review. "[O]ne of the costs of finality is to allow a non-article III court to decide important constitutional questions that place substantial future financial obligations on the citizens of Jefferson County without representations." *Id*. at 637. Other courts examining this issue have disagreed. In *Franklin High Yield Tax-Free Income Fund v. City of Stockton (In re City of Stockton)*, 542 B.R. 261 (9th Cir. BAP 2015) the court ruled that equitable mootness applied in Chapter 9 reasoning that the residents of the City depend on it for future services and have a "legitimate concern for finality that is served by the appropriate application of equitable mootness." *Id*. at 274. The court went on to note that the constitutional concerns that were raised in *Jefferson County* are not present in this case. *Id*. The court then ruled that the appeal was equitably moot because the plan had been

[21] The court addressed the argument that dismissing an appeal as equitably moot is itself inequitable because it removes a party's right to appeal. While noting that the court's goal is to find a workable outcome for a diverse universe of interests, the court specifically held that the result in this case was equitable because the appellant assumed the risk of equitable mootness when it refused to post the bond set by the bankruptcy court for a stay pending appeal and failed to even challenge the amount of the bond. *Tribune Media*, 799 F.2d at 281.

JUDICIAL ESTOPPEL THROUGHOUT THE CIRCUITS

"The doctrine of judicial estoppel prevents a party from asserting a claim in a legal proceeding that is inconsistent with a claim taken by that party in a previous proceeding," *New Hampshire v. Maine*, 532 U.S. 742, 121 S. Ct. 1808 (2001) citing 18 Moore's Federal Practice § 134.30, p. 134-62 (3d ed. 2000).

I. Determining whether the application of judicial estoppel is proper

A. SCOTUS

"The circumstances under which judicial estoppel may appropriately be invoked are probably not reducible to any general formulation of principle," *New Hampshire v. Maine*, 532 U.S. 742, 121 S. Ct. 1808 (2001).

In the *New Hampshire* decision, the Court outlined numerous factors for determining whether to apply the doctrine to a particular case[1]:

1. A party's later position must be "clearly inconsistent" with its earlier position;
2. whether the party has succeeded in persuading a court to accept that party's earlier position, so that judicial acceptance of an inconsistent position in a later proceeding would create "the perception that either the first or the second court was misled; and
3. whether the party seeking to assert an inconsistent position would derive an unfair advantage or impose an unfair detriment on the opposing party if not estopped.

The Court would state later in its decision that "it may be appropriate to resist application of judicial estoppel when a party's prior position was based on *inadvertence or mistake*."[2]

B. Eleventh Circuit

The Eleventh Circuit has incorporated the standards outlined in the *New Hampshire* decision into two factors for establishing the bar of judicial estoppel.

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[1] *Id.* at 750-751.
[2] *Id. at 753.*