Northeast Bankruptcy Conference and Consumer Forum

Recent Developments

PLENARY SESSION

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2023

Case Law Update

Northeast Bankruptcy Conference & Consumer Forum

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Tyler v. Hennepin Cnty., Minnesota, 143 S. Ct. 1369 (2023)

- **Holding**: Tyler plausibly alleged that Hennepin County violated the taking clause by retaining the excess value of her condo above the amount of her tax debt. The Court did not make a holding with regard to the Eighth Amendment because of its holding regarding the Fifth Amendment.

Tyler - Facts

- Geraldine Tyler owned a condo in Hennepin County, Minnesota and had outstanding property tax debt in the approximate amount of $15,000. Hennepin County seized the condo and sold it for $40,000, keeping the access $25,000 for itself, consistent with the county statute. Tyler filed suit and alleged an unconstitutional taking pursuant to the Takings Clause of the Fifth Amendment and the Excessive Fines Clause of the Eighth Amendment. Hennepin filed a Motion to Dismiss for failure to state a claim, which the District Court granted and the Eighth Circuit affirmed.

Tyler – Discussion

- The Court reviewed Hennepin County's statute that allowed them to keep proceeds after a tax foreclosure sale above and beyond the tax debt in question and held that a state (or county) cannot write a statute that attempts to work around the Takings Clause and violates traditional property interest.
- Hennepin County argued that Tyler did not have standing because there were additional encumbrances on the property that would have needed to be paid. The Court rejected that argument because, in addition to not raising that on appeal, the tax foreclosure extinguishes the other liens on the property and Tyler still had articulated a financial harm because Hennepin County kept $25,000 that belonged to her. Hennepin County also argues that Tyler abandoned the property by not paying her taxes, which the Court rejected.

Tyler - Concurrence

- Justice Gorsuch, joined by Justice Jackson, wrote a concurrence that indicated that the Eighth Circuit analysis of whether the cause of action regarding excessive fines under the Eighth Amendment was flawed and that such economic penalties (i.e. keeping excess proceeds from a sale to deter non-compliance) was a fine.

Tyler – Takeaways

- Fraudulent Transfer?
  - Reasonably equivalent value?
  - BFP v. Resolution Trust Corp., 511 U.S. 531 (1994)
    - Compliant foreclosure sale= Reasonably equivalent value? Does that apply to a town tax foreclosure?
      - "We emphasize that our opinion today covers only mortgage foreclosures of real estate. The considerations bearing upon other foreclosures and forced sales (to satisfy tax liens, for example) may be different."
  - Timing
    - Automatic foreclosure transfer or subsequent sale transfer?
  - State law specific?
    - Is there equity to show value? Was there equity at the time of the automatic foreclosure sale if there were junior liens?

Bartenwerfer v. Buckley, 143 S. Ct. 665 (2023)

- Question: May an individual be subject to liability for the fraud of another that is barred from discharge in bankruptcy under 11 U.S.C. § 523(a)(2)(A), by imputation, without any act, omission, intent or knowledge of her own?

- Holding: 11 U.S.C. § 523(a)(2)(A) precludes a debtor from discharging debt obtained by fraud, regardless of the debtor's own culpability, because the passive voice of § 523(a)(2)(A) turned on how the money was obtained, not who committed fraud to obtain it.

Bartenwerfer – Facts

- Facts:
  - Prior to a bankruptcy filing, the debtor and her then-boyfriend purchased a house in San Francisco in 2005.
  - They decided to remodel the home and sell it for a profit as business partners. The debtor's partner led the house renovation, and the debtor was largely uninvolved with the process. Along came a buyer for the home, and as typical in many residential sales, the debtor and her partner attested that they had disclosed "all material facts relating to the property."
  - After the purchase, the buyer discovered several defects in the property, including a leaky roof, defective windows, a missing fire escape, and permit problems. He sued in California state court, and a jury found in the buyer's favor for breach of contract, negligence, and nondisclosure of material facts, holding the debtor and her partner jointly responsible for over $200,000 in damages.
  - The debtor and her now-husband filed for Chapter 7 bankruptcy.

Bartenwerfer – Procedural History

- The buyer filed an adversary complaint alleging that the $200,000 damages were nondischargeable under 11 U.S.C. § 523(a)(2)(A), which bars the discharge of "any debt . . . for money . . . to the extent obtained by . . . false pretenses, a false representation, or actual fraud."
- The Bankruptcy Court imputed the husband's fraudulent intent to the debtor because they had formed a legal partnership for the renovation.
- On appeal, the Ninth Circuit's BAP disagreed because § 523(a)(2)(A) barred her discharge only if she knew or had reason to know of her husband's fraud.
- On remand, the Bankruptcy Court concluded that the debtor didn't have the requisite knowledge and thus the debt was dischargeable.
- The BAP affirmed, but the Ninth Circuit reversed in part, holding that debtor liable for partner's fraud cannot discharge that debt in bankruptcy, regardless of culpability.

Bartenwerfer – Analysis

- This unanimous decision resolves a circuit split.
- The Bankruptcy Code contains several narrowly construed exceptions to discharge, including Sec. 523(a)(2)(A), which bars "an individual debtor" from "discharg[ing]…any debt…for money, property, services, or credit, to the extent obtained by…false pretenses, a false representation, or actual fraud."
- Whose fraud matters here? Who must possess the requisite intent to commit the nondischargeable fraud?

Bartenwerfer – Analysis

- In a unanimous opinion, Justice Barrett focused on the text of the statute:
  - The "[p]assive voice pulls the actor off the stage." I.e., what matters is "obtained by".
  - Subsections (B) and (C) expressly hinge on debtor's culpability. Thus, the inference in (A) is that the exclusion of debtor culpability was intentional.
- Common law of fraud has long maintained that fraud liability is not limited to the wrongdoer.
- As a result, debtors continue to be liable for debt even if didn't personally perpetrate the fraud, but are vicariously liable and share in the proceeds of the fraud.

Bartenwerfer – Analysis

- The § 523(a)(2)(A) exception turns on *how* the money was obtained, not *who* committed fraud to obtain it.
- Congress was agnostic about who committed the fraud.
- Focus on *Strang v. Bradner*, 1885 Supreme Court case
  - Discharge denied to one partner based on a debt incurred by fraud of another partner
- Congress enacts statutes with awareness of the Supreme Court's relevant decision, so when Congress revised the statute at issue in *Strang*, the implication is that Congress rejected Bartenwerfer's argument that the fraud here must have been the debtor's fraud
- Finally, § 523(a)(2)(A) relies on state law to define the cope of one's liability for the fraud of another, so the real complaint here is with California.

Bartenwerfer – Future implications?

- Look at fraud statutes in your own state
- Concurring opinion by Justice Sotomayor and Justice Jackson.
  - Is *Bartenwerfer* limited to be based on the outcome of a partnership under state law only?
  - Justice Sotomayor only joined Court's opinion with the "understanding" that it concerns fraud only by "agents" and "partners within the scope of the partnership", i.e., this was not a situation where the debtor had no agency or relationship with the fraudster.
- Passive voice in this statute – are there are other areas with passive language where this similar argument can be made?

Lac du Flambeau Band of Lake Superior Chippewa Indians v. Coughlin, 143 S. Ct. 1689 (2023)

- Question: Whether 11 U.S.C. § 106(a), which "abrogate[s]" the "sovereign immunity" of a "governmental unit . . . with respect to" a list of Bankruptcy Code provisions, read together with 11 U.S.C. § 101(27), which defines the term "governmental unit" to include "other foreign or domestic government[s]," clearly abrogates the common-law immunity of an Indian tribe from suit.
- Holding: The Bankruptcy Code unequivocally abrogates the sovereign immunity of all governments, and "all governments" includes federally recognized Indian tribes.

Native American tribes are not immune to the automatic stay and are obligated to submit to the bankruptcy process in the same way that states and the federal government do.

Lac du Flambeau – Facts

- Facts:
  - The debtor borrowed $1,100 from a payday lender, Lendgreen, before filing for bankruptcy. Lendgreen was owned by a federally recognized tribe, Lac du Flambeau Band of Lake Superior Chippewa Indians ("the Band"). When the debtor filed a chapter 13 petition, the debt was scheduled as an unsecured, nonpriority claim. It had grown to almost $1,600.
  - Despite the automatic stay, Lendgreen continued to attempt to collect the debt and called the debtor, demanding payment.
  - The debtor was driven to despair and even attempted suicide, allegedly due to the collection attempts.

Lac du Flambeau – Procedural History

- The debtor sought an injunction to halt the collections attempts and to enforce the automatic stay and recover damages for willful violations of the automatic stay. The Bankruptcy Court dismissed the suit because the Bankruptcy Code did not clearly express Congress's intent to abrogate tribal sovereign immunity.
- In a divided opinion, the First Circuit reversed, concluding that the Bankruptcy Code "unequivocally strips tribes of their immunity." *In re Coughlin*, 33 F. 4th 600, 603-604 (2022).

Lac du Flambeau – Analysis

- A statute "abrogates" sovereign immunity only if Congress uses language that is "unmistakably clear".
  - Although it's a "demanding standard," it is not a "magic-words requirement."
- In the Bankruptcy Code, § 106(a) expressly abrogates the sovereign immunity of "governmental units" for enumerated purposes, including the automatic stay.
- Definition of "governmental unit" under § 101(27):
  - "United States; State; Commonwealth; District; Territory; municipality; foreign state; department, agency, or instrumentality of the United States . . . , a State, a Commonwealth, a District, a Territory, a municipality, or a foreign state; or other foreign or domestic government."

Lac du Flambeau – Analysis

- Where do federally recognized tribes fit into that definition?
- Justice Jackson writes that the definition of "governmental unit" "exudes comprehensiveness from beginning to end."
- Under the § 101(27) definition of governmental unit, there is a long list of subdivisions and components of every government, then concludes with a broad catchall phrase of "other foreign or domestic government[s]".
- The pairing of two extremes equals all-inclusiveness:
  - Rain or shine; near and far
  - Car manufacturers, "foreign or domestic"
  - Defend the Constitution against all enemies, "foreign or domestic"

Lac du Flambeau – Analysis

- Thus, every government must be foreign or domestic. The question is where on the spectrum does it fall.
- Exceptions to the automatic stay in § 106(a) apply to all governmental units, e.g., police and regulatory authority, special powers to taxing authorities, and collection of fines.
- Congress did not cherry-pick certain governments from the abrogation in § 106(a).
- Therefore, a tribe is "foreign or domestic government", and its sovereign immunity is abrogated.

Lac du Flambeau – Analysis

- Justice Gorsuch, not surprisingly, dissented, positing that tribes are neither a foreign government nor a domestic government; rather, tribes have a unique status in the law.
- Accordingly, there is no clear statement of Congressional intent to abrogate tribes' sovereign immunity.

Lac du Flambeau – Future implications?

- Is this case unique to Native American tribes? The Supreme Court does not explicitly say so in the decision.
- Perhaps there are implications on state sovereign immunity given the broad and sweeping language used by the Court. For example, prior to this decision, a state agency could require that a sale of a nursing home comply with certain provisions and dictate the allocation of sale proceeds behind a shield of sovereign immunity, all without appearing in bankruptcy court.

MOAC Mall Holdings LLC v. Transform Holdco LLC, 143 S. Ct. 927 (2023)

- Question: Does the language in 363(m) restrict a court's ability to adjudicate an appeal of an "authorization under subsection (b) or (c)" of Section 363 if the sale and lease is 1) not stayed and 2) there is a good faith purchaser?

- Holding: 11 U.S.C. § 363(m) is not Jurisdictional

The Supreme Court held that it will not treat a provision as jurisdictional unless congress "clearly states" as much. There is no "magic language" per se, but it does need to be clear in the statute that there was congressional intent.

11 U.S.C. § 363(m)

- **(m)** The reversal or modification on appeal of an authorization under subsection (b) or (c) of this section of a sale or lease of property does not affect the validity of a sale or lease under such authorization to an entity that purchased or leased such property in good faith, whether or not such entity knew of the pendency of the appeal, unless such authorization and such sale or lease were stayed pending appeal.

MOAC – Facts & Procedural History

- Facts:
  - Petitioner MOAC Mall Holdings, LLC ("MOAC") was the landlord of a Sears store in the Mall of America. As part of Sears bankruptcy and as a debtor in possession, Sears transferred its right to assign its lease to Respondent, Transform Holdco LLC ("Transform") which allowed Transform to designate who it could assign the lease to.
  - Transform assigned the lease to its subsidiary and MOAC objected based on a lack of adequate assurance of future performance and the sale was approved over MOAC's objection. The transfer was approved under an "Assignment Order."
  - MOAC appealed the Order allowing the assignment of the lease and moved for stay pending appeal, which request was denied. The court reasoned that the Assignment Order did not qualify as "an appeal of an authorization" as described in 363(m) and "emphasized that Transform has explicitly represented that it would not invoke 363(m)."
  - The lease was assigned during the pendency of the appeal.

MOAC – Procedural History

- On appeal, the District Court initially vacated the Assignment Order and Transform sought a rehearing for the first time arguing that 363(m) deprived the District Court of Jurisdiction. The District Court agreed and held due to 2nd Circuit precedent, it was bound to treat 363(m) as jurisdictional and therefore not subject to waiver or judicial estoppel.
  - Note: the District Court was "appalled" by Transform waiting to invoke 363(m).
- The Second Circuit affirmed and held that Section 363(m) is jurisdictional and that an appellate court lacked the authority to adjudicate the merits of an appeal challenging a sale order unless there was a lack of good faith or the Order had been stayed pending appeal. MOAC appealed.

MOAC – Arguments by Transform

1. 363(m) is jurisdictional.

2. The appeal is moot because the lease has already been transferred.

MOAC – Jurisdictional Analysis

- Statutory Analysis:
  - Nothing in Section 363(m) that addresses the court's authority
  - Contains no "clear tie" and is separate from any of the Code's jurisdictional provisions
  - That 363(m) issues "directions" does not make it jurisdictional
  - That 363(m) is read as part of a "covered authorization" of the sale
- In Rem Argument - Transform argued Court lacked a basis to exercise in rem jurisdiction over the transfer to a good faith purchaser because it is no longer part of the estate
  - Nothing in 363(m) limits the court's "adjudicatory capacity"
  - Can't argue Court has jurisdiction over the sale, but doesn't have jurisdiction after the sale

MOAC – Equitable Mootness

- Equitable Mootness – A judicially created doctrine where the Court renders the appeal moot because any remedy would be inequitable.

- Respondent argued that since the assignment of the lease had not been stayed pending appeal, there remained "no legal vehicle" for the Court to fashion a remedy – i.e. the lease was transferred and no longer property of the estate and thus the Court could not undo the transfer.

MOAC – Equitable Mootness

- The Court appears to have indicated its disapproval of mootness arguments (citing it's prior decision in Chafin v. Chafin, 568 U.S. 165 (2013)) and seemed uninterested in what the remedy may be as long as there was some interest that the party had in the outcome.
    - "Our cases disfavor these kinds of mootness arguments"

So… What does this mean?

1. Even if the sale (or lease) is not stayed pending the appeal, the appeal can be heard
2. Even if there is no proof of bad faith, the appeal can be heard
3. Will this affect Chapter 11 Plans post- substantial consummation?
4. Will this affect DIP lenders and applicable Orders (364(e) is similar to 363(m))

MOAC - Practical Takeaways

- Make a clear record of good faith for your purchaser/lessee
- Make a clear record of good faith for DIP lenders

In re Purdue Pharma L.P., No. 22-110-bk (L) (2d Cir. May 30, 2023).

- **Questions Presented**: (1) Whether the bankruptcy court had the authority to approve the nonconsensual release of direct third-party claims against the Sacklers, a non-debtor, through the Plan; and (2) whether the text of the Bankruptcy Code, factual record, and equitable considerations support the bankruptcy court's approval of the Plan.

- **Holdings**: (1) The bankruptcy court has both the jurisdiction and statutory authority to approve nonconsensual release of third-party direct claims against non-debtors; and (2) the bankruptcy court's approval of the Plan is affirmed.

Background

- In 1995, Purdue developed OxyContin, a powerful painkiller, which the company advertised as nonaddictive. Years later, following an aggressive marketing campaign and continued assurances from Purdue, it was determined that the company had indeed misled doctors and patients regarding the high risks associated with its drug. This discovery triggered a proliferation of lawsuits brought by parties adversely affected by OxyContin, including individuals, state governments, and federal agencies.
- In 2004, Purdue's Board of Directors voted to indemnify Purdue's directors and officers—many of whom were Sacklers—against claims related to their service to the company. The indemnity agreement, while expansive, contained an exception exposing those protected by the agreement to liability where it was determined that they had acted in bad faith.
- Fearing that they would eventually be targeted, the Sacklers began taking steps to protect their assets. From 2008 to 2016, Purdue distributed more than $10 billion to Sackler family trusts and holding companies, reducing the company's total assets by 75%.
- On September 15, 2019, Purdue filed for bankruptcy with a debtor's estate worth approximately $1.8 billion. Days later, it sought an injunction halting all lawsuits against it, which the bankruptcy court granted a month later. At that time, there were over 3,000 actions pending against Purdue and the Sacklers worth an estimated $40 trillion.

Procedural History

- After a multi-phased mediation, the agreement eventually reached among Purdue, the Sacklers, and several creditors included a contribution by the Sacklers of $4.325 billion over approximately nine years and several highly expansive nonconsensual releases permanently enjoining certain third-party claims against the Sacklers.
- A vote on the proposed plan was held in the summer of 2021, and 95% of the 120,000 votes cast in the U.S. and Canada were in favor of the plan.
- On September 17, 2021, the bankruptcy court confirmed a slightly modified version of the plan, which required that the shareholder releases apply only "where . . . a debtor's conduct or the claims asserted against it [are] a legal cause or a legally relevant factor to the cause of action against the shareholder released party . . . ."

Procedural History (cont.)

- Several objecting parties, including eight states, the District of Columbia, and the U.S. Trustee, appealed the plan to the District Court. On December 16, 2021, the District Court vacated the bankruptcy court's decision to confirm the plan on the basis that the relevant sections of the Bankruptcy Code "do not confer on any court the power to approve the release of non-derivative third-party claims against non-debtors." The District Court further asserted that the Second Circuit's corresponding case law is "unsettled, except in asbestos cases."
- Following the District Court's rejection of the plan, a group comprised of Purdue, the Sacklers, and numerous creditors appealed the ruling to the Second Circuit. On March 3, 2022, while the appeal was pending, the eight states that had objected to the settlement, along with the District of Columbia, reached a new agreement with Purdue and the Sacklers. Under that agreement, the Sacklers would contribute an additional $1.175–$1.675 billion, bringing the family's total contributions to the plan up to at least $5.5 billion; in return, the eight states and the District of Columbia agreed to withdraw their opposition to the plan. As a result of the modified agreement, the remaining objectors include only the U.S. Trustee, various Canadian municipalities and indigenous nations, and several pro se individuals.

13 Months Later ….

Second Circuit Decision

- Subject Matter Jurisdiction: A bankruptcy court's subject-matter jurisdiction under the Code is broad. It extends to all civil actions so long as "the action's outcome might have any conceivable effect on the bankrupt estate." *Parmalat Cap. Fin. Ltd. v. Bank of Am. Corp.*, 639 F.3d 572, 579 (2d Cir. 2011) (internal quotation marks omitted); see also 28 U.S.C. §§ 157(a), 1334. However, that jurisdictional reach is not endless: a bankruptcy court may only "enjoin third-party non-debtor claims that directly affect the *res* of the bankruptcy estate." *Johns-Manville Corp. v. Chubb Indemnity Ins. Co.* ("Manville III"), 517 F.3d 52, 66 (2d Cir. 2008).

- Subject Matter Jurisdiction (cont.): Agreeing with both the bankruptcy court and the District Court, the Second Circuit concluded that "it is conceivable, indeed likely, that the resolution of the released claims would directly impact the *res*."

- The court pointed out that (1) direct claims against the Sacklers brought by third-parties may preclude derivative claims brought by the estate; and (2) due to the indemnity agreement between Purdue and the Sacklers, Purdue may have to indemnify the Sacklers against certain direct third-party claims.

Bankruptcy Code Authority

- The court identified §§ 105(a) and 1123(b)(6) of the Bankruptcy Code as providing the statutory basis for the bankruptcy court's approval of the releases. Section 105(a) states that a bankruptcy court "may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title."

- Section 1123(b)(6) states that "a plan may . . . include any other appropriate provision not inconsistent with the applicable provisions of [the Bankruptcy Code]." The court explained that § 1123(b)(6) "act[s] in tandem with § 105(a)" to "grant[] bankruptcy courts a 'residual authority' consistent with 'the traditional understanding that bankruptcy courts, as courts of equity, have broad authority to modify creditor-debtor relationships.'"

Key Supporting Cases

- In *United States v. Energy Resources Co., Inc.*, the Supreme Court held that this provision—acting in tandem with § 105(a)—grants bankruptcy courts a "residual authority" consistent with "the traditional understanding that bankruptcy courts, as courts of equity, have broad authority to modify creditor-debtor relationships."
- *Airadigm Commc'ns, Inc. v. FCC (In re Airadigm Commc'ns, Inc.)*, 519 F.3d 640, 657 (7th Cir. 2008).
- *Class Five Nev. Claimants (00-2516) v. Dow Corning Corp. (In re Dow Corning Corp.)*, 280 F.3d 648, 656-58 (6th Cir. 2002).
- Although our case law has never expressly cited § 1123(b)(6) to support the imposition of third-party releases, we now explicitly agree with these Circuits and conclude that § 1123(b)(6), with § 105(a), permit bankruptcy courts' imposition of third-party releases.

Second Circuit Case Law

- Despite the district court's pronouncement to the contrary, *Purdue II*, 635 B.R. at 89, this Court's precedents permit the imposition of nonconsensual third-party releases.
- In response to the contention that there is no supporting Second Circuit case law, the Second Circuit responds:

  That reading is incorrect in the face of our case law, most explicitly Drexel, where we concluded: "In bankruptcy cases, a court may enjoin a creditor from suing a third party, provided the injunction plays an important part in the debtor's reorganization plan." In re Drexel Burnham Lambert Group, Inc. ("Drexel"), 960 F.2d 285, 293 (2d Cir. 1992). Our opinions in Manville I and Metromedia further confirm that such releases are neither discharges nor allowable only in the context of asbestos cases.

The Seven Factor Test

1. Whether there is an identity of interests between the debtors and released third parties, including indemnification relationships, “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. Whether claims against the debtor and non-debtor are factually and legally intertwined, including whether the debtors and the released parties share common defenses, insurance coverage, or levels of culpability.
3. Whether the scope of the releases is appropriate.
4. Whether the releases are essential to the reorganization, in that the debtor needs the claims to be settled in order for the res to be allocated, rather than because the released party is somehow manipulating the process to its own advantage.
5. Whether the non-debtor contributed substantial assets to the reorganization.
6. Whether the impacted class of creditors “overwhelmingly” voted in support of the plan with the releases.
7. Whether the plan provides for the fair payment of enjoined claims.

Purdue Pharma – What's Next?

- In his concurring opinion, Judge Richard Wesley lamented that "the majority's answer pins [the Second] Circuit firmly on one side of a weighty issue that, for too long, has split the courts of appeals. . . . Absent direction from Congress . . . or the High Court, the answer is a function of geography."
- On July 7, the Department of Justice filed a motion to stay the issuance of the mandate, announcing that the government will be filing a petition for *certiorari*.
- But for now … know your geography and see you back here next summer.

***Bartenwerfer v. Buckley*, 143. S. Ct. 665 (2023)**

Holding: Justice Barrett wrote a unanimous opinion holding that a partner that was herself innocent of fraud cannot discharge debt resulting from the fraud of her partner. 11 U.S.C. § 523(a)(2)(A) precluded a debtor from discharging debt obtained by fraud, regardless of the debtor's own culpability, because the passive voice of § 523(a)(2)(A) turned on how the money was obtained, not who committed fraud to obtain it.

Facts: Prior to a bankruptcy filing, the debtor and her then-boyfriend purchased a house in San Francisco in 2005. They decided to remodel the home and sell it for a profit as business partners. The debtor's partner led the house renovation, and the debtor was largely uninvolved with the process. Along came a buyer for the home, and as typical in many residential sales, the debtor and her partner attested that they had disclosed "all material facts relating to the property." After the purchase, the buyer discovered several defects in the property, including a leaky roof, defective windows, a missing fire escape, and permit problems. He sued in California state court, and a jury found in the buyer's favor for breach of contract, negligence, and nondisclosure of material facts, holding the debtor and her partner jointly responsible for over $200,000 in damages.

The debtor and her now-husband filed for Chapter 7 bankruptcy. Not surprisingly, the buyer fled an adversary complaint alleging that the damages under the state court judgment were nondischargeable under 11 U.S.C. § 523(a)(2)(A), which bars the discharge of "any debt . . . for money . . . to the extent obtained by . . . false pretenses, a false representation, or actual fraud."

The Bankruptcy Court imputed the debtor's husband's fraudulent intent to the debtor because they had formed a legal partnership to for the renovation. On appeal, the Ninth Circuit's Bankruptcy Appellate Panel did not agree as to the debtor's fraudulent intent because they read § 523(a)(2)(A) as barring her discharge only if she knew or had reason to know of her husband's fraud. On remand, with that reading in mind, the Bankruptcy Court concluded that the debtor did not have the requisite knowledge of the fraud and thus could discharge her debt.

The Bankruptcy Appellate Panel affirmed, but the Ninth Circuit reversed in part, holding that under the Supreme Court's decision in *Stang v. Bradner*, 114 U.S. 555 (1885), a debtor who is liable for her partner's fraud cannot discharge that debt in bankruptcy, regardless of culpability.

Reasoning: Justice Barrett starts with an analysis of the text of the statute, holding that the "very terms" of § 523(a)(2)(A) resulted in nondischargeabilty for the debtor's debt in this case. The statute's use of the "[p]assive voice pulls the actor off the stage." There is no active actor engaging in the fraud in the text of the statute, and Justice Barrett did not agree that subsections (B) and (C), which required active behavior by a debtor, informed subsection (C). Instead, the "more likely inference is that (A) excludes debtor culpability from consideration given that (B) and (C) expressly hinge on it."

The decision goes on to review the common law of fraud, citing to numerous older cases for the proposition that fraud liability is *not* limited to the wrongdoer, such as when a principal is liable for the fraud of their agents (*McCord v. Western Union Telegraph Co.*, 39 Minn. 181, 185, 39 N.

W. 315, 317, 39 N.W. 318 (1888); *Tome v. Parkersburg Branch R. Co.*, 39 Md. 36, 70-71 (1873); *White v. Sawyer*, 82 Mass. 586, 589, 16 Gray 586 (1860)), or individuals liable for the fraud of their partners (*Tucker v. Cole*, 54 Wis. 539, 540-541, 11 N. W. 703, 703-704 (1882); *Alexander v. State*, 56 Ga. 478, 491-493 (1876); *Chester* v. *Dickerson*, 54 N. Y. 1, 11 (1873)).

The precedent relied upon in *Stang* provided another key for the Court's opinion. In the late 19th century, the discharge exception for fraud provided that "no debt created by the fraud or embezzlement *of the bankrupt* . . . shall be discharged under this act." In *Stang*, the Court held that the fraud of one partner was the fraud of all. Thirteen years after *Stand*, Congress deleted "of the bankrupt". Because the Court generally assumes that when Congress enacts a statute, it is aware of the Court's relevant precedents, with this deletion, Congress must have been embracing the holding of *Stang*, which Justice Barrett did, too.

Moreover, § 523(a)(2)(A) relies on state law to define the scope of one's liability for the fraud of another. Justice Barrett declared that the complaint the debtor had here – that the "fresh start" policy of modern bankruptcy law could not possibly align with this interpretation of the statute – should be addressed with the State of California instead.

Concurring Opinion by Justice Sotomayor and Justice Jackson:

The concurring opinion tried to limit the reach of the holding to be based on the outcome of a partnership under state law only. Justice Sotomayor stated that she joined the Court's opinion with the "understanding" that it concerns fraud only by "agents" and "partners within the scope of the partnership", i.e., this was *not* a situation where the debtor had no agency or relationship with the fraudster.

Future Implications

It remains to be seen how Justice Sotomayor's concurring opinion will impact if bankruptcy courts will determine that an innocent debtor's debt is nondischargeable only if there was an agency or partnership in play.

***Lac du Flambeau Band of Lake Superior Chippewa Indians v. Coughlin*, 22-227 (Sup. Ct. June 15, 2023)**

Holding: Native American tribes do not have sovereign immunity from damages claims for violations of the automatic stay of the Bankruptcy Code. The Bankruptcy Code unambiguously abrogates the sovereign immunity of all governments, and "all governments" includes federally recognized Indian tribes.

This was an 8-1 decision written by Justice Kentaji Brown Jackson.

Facts: The debtor borrowed $1,100 from a payday lender, Lendgreen, before filing for bankruptcy. Lendgreen was owned by a federally recognized tribe, Lac du Flambeau Band of Lake Superior Chippewa Indians ("the Band"). When the debtor filed a chapter 13 petition, the debt was scheduled as an unsecured, nonpriority claim. It had grown to almost $1,600.

Despite the automatic stay, Lendgreen continued to attempt to collect the debt and called the debtor, demanding payment. After the bankruptcy filing, the debtor attempted suicide and blamed his action on the never-ending calls for the debt collector. The debtor sought an injunction to halt the collections attempts and to enforce the automatic stay and recover damages for willful violations of the automatic stay. The Bankruptcy Court dismissed the suit because the Bankruptcy Code did not clearly express Congress's intent to abrogate tribal sovereign immunity.

The First Circuit reversed, concluding that the Bankruptcy Code "unequivocally strips tribes of their immunity." *In re Coughlin*, 33 F. 4th 600, 603-604 (2022).

Reasoning: The Court's decision is not surprising, given the tenor of the questioning at oral argument on this case. Justice Jackson reiterates the rule that a congressional statute "abrogates" sovereign immunity only if Congress uses language that is "unmistakably clear." She focused on two provisions of the Bankruptcy Code in her decision.

First, 11 U.S.C. § 106(a) expressly abrogates the sovereign immunity of "*governmental unit[s]*" for enumerated purposes, which includes the § 363 automatic stay.

Second, 11 U.S.C. § 101(27) defines "governmental unit" as "United States; State; Commonwealth; District; Territory; municipality; foreign state; department, agency, or instrumentality of the United States . . . , a State, a Commonwealth, a District, a Territory, a municipality, or a foreign state; or other foreign or domestic government."

Thus, the real question was whether a federally recognized tribe falls within the definition of "governmental unit." Justice Jackson rebutted each of the tribe's arguments, such as the fact that every other case finding a waiver involved a statute that specifically mentioned tribes, something Justice Gorsuch also argues in his dissent.

Justice Jackson states that "every government must be foreign or domestic to some degree; the question is just where on the spectrum it falls." "[W]e find that, by coupling foreign and domestic together, and placing the pair at the end of an extensive list, Congress unmistakably

intended to cover all governments in §101(27)'s definition, whatever their location, nature, or type." Moreover, Congress did not "cherry-pick" certain governments from the abrogation in § 106(a). Thus, a tribe is a "foreign or domestic government". Thus, Congress intended to abrogate tribe's sovereign immunity in § 106(a), too.

As Justice Jackson decidedly stated, "[T]he Bankruptcy Code unequivocally abrogates the sovereign immunity of any and every government that possesses the power to assert such immunity. Federally recognized tribes undeniably fit that description; therefore, the Code's abrogation provision plainly applies to them as well."

Concurring Opinion by Justice Thomas:

Justice Thomas concurred in the judgment but stated that tribal immunity is a common law doctrine. As such, because no federal law provides tribes sovereign immunity in federal courts, there can be no sovereign immunity in the bankruptcy context.

Dissent by Justice Gorsuch:

Justice Gorsuch dissented on the premise that tribes have enjoyed "a unique status in our law", meaning that they were neither foreign nor domestic. Tribes are mentioned specifically in the statute every time the Court had previously found a waiver of sovereign immunity. Because the Bankruptcy Code does not refer to "tribes" explicitly, Justice Gorsuch argued that there is no waiver of sovereign immunity.

Future Implications

This decision may seem limited to the sovereign immunity claims of federally recognized tribes, but are there implications on state sovereign immunity as a result of this decision?

PURDUE PHARMA AND THE SECOND CIRCUIT'S APPROVAL OF NONCONSENSUAL THIRD-PARTY RELEASES: PRESSURE MOUNTS FOR SUPREME COURT REVIEW

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On May 30, 2023, the Second Circuit issued the much-anticipated decision in *In re Purdue Pharma L.P.* reversing the District Court's (SDNY) decision and upholding the Bankruptcy Court's approval of nonconsensual third-party releases in the Chapter 11 plan of Purdue Pharma.[1] In reaching its ruling, the Second Circuit responded to the District Court's challenge that prior decisions on the subject were "inconclusive" or "lack[ed] clarity."[2] The Second Circuit's opinion deliberately analyzed jurisdictional and statutory authority, reviewed Second Circuit case law and then laid out seven factors for the bankruptcy courts below to consider when opining on the propriety of nonconsensual third-party releases. It remains to be seen what impact this decision may have outside the Second Circuit and, if given the opportunity, whether the Supreme Court will weigh in to resolve the current circuit split on the issue.

Background

I. Facts

In re Purdue Pharma L.P. centers on the bankruptcy plan precipitating from a barrage of lawsuits targeting the case's namesake pharmaceutical company and first family—the Sacklers—who are widely held responsible for the American opioid epidemic. In 1995, Purdue developed

[1] *In re Purdue Pharma L.P.*, No. 22-110-bk (L) (2d Cir. May 30, 2023).
[2] *Id*. at 35

OxyContin, a powerful painkiller, which the company advertised as nonaddictive. Years later, following an aggressive marketing campaign and continued assurances from Purdue, it was determined that the company had indeed misled doctors and patients regarding the high risks associated with its drug. This discovery triggered a proliferation of lawsuits brought by parties adversely affected by OxyContin, including individuals, state governments, and federal agencies.

In 2004, Purdue's Board of Directors voted to indemnify Purdue's directors and officers—many of whom were Sacklers—against claims related to their service to the company. The indemnity agreement, while expansive, contained an exception exposing those protected by the agreement to liability where it was determined that they had acted in bad faith.

Fearing that they would eventually be targeted, the Sacklers began taking steps to protect their assets. From 2008 to 2016, Purdue distributed more than $10 billion to Sackler family trusts and holding companies, reducing the company's total assets by 75%. On September 15, 2019, Purdue filed for bankruptcy with a debtor's estate worth approximately $1.8 billion. Days later, it sought an injunction halting all lawsuits against it, which the bankruptcy court granted a month later. At that time, there were over 3,000 actions pending against Purdue and the Sacklers worth an estimated $40 trillion.

II. Procedure

Following the discovery process, a multi-phased mediation was held to reach a plan of reorganization and avoid liquidation of the debtor's estate. The agreement eventually reached among Purdue, the Sacklers, and several creditors included a contribution by the Sacklers of $4.325 billion over approximately nine years and several highly expansive nonconsensual releases permanently enjoining certain third-party claims against the Sacklers. A vote on the proposed plan was held in the summer of 2021, and 95% of the 120,000 votes cast in the U.S.

and Canada were in favor of the plan. On September 17, 2021, the bankruptcy court confirmed a slightly modified version of the plan, which required that the shareholder releases apply only "where . . . a debtor's conduct or the claims asserted against it [are] a legal cause or a legally relevant factor to the cause of action against the shareholder released party . . . ."[3]

Several objecting parties, including eight states, the District of Columbia, and the U.S. Trustee, appealed the plan to the District Court. On December 16, 2021, the District Court vacated the bankruptcy court's decision to confirm the plan on the basis that the relevant sections of the Bankruptcy Code "do not confer on any court the power to approve the release of non-derivative third-party claims against non-debtors."[4] The District Court further asserted that the Second Circuit's corresponding case law is "unsettled, except in asbestos cases."[5]

Following the District Court's rejection of the plan, a group comprised of Purdue, the Sacklers, and numerous creditors appealed the ruling to the Second Circuit. On March 3, 2022, while the appeal was pending, the eight states that had objected to the settlement, along with the District of Columbia, reached a new agreement with Purdue and the Sacklers. Under that agreement, the Sacklers would contribute an additional $1.175–$1.675 billion, bringing the family's total contributions to the plan up to at least $5.5 billion; in return, the eight states and the District of Columbia agreed to withdraw their opposition to the plan. As a result of the modified agreement, the remaining objectors include only the U.S. Trustee, various Canadian municipalities and indigenous nations, and several *pro se* individuals.

[3] *Id.* at 23 (citing Deferred Joint App'x at 1330-31).
[4] *In re Purdue Pharma, L.P.*, 635 B.R. 26, 90 (S.D.N.Y. 2021)
[5] *Id.* at 104.

The Decision

On appeal, the Second Circuit was presented with the following questions: "(1) whether the bankruptcy court had the authority to approve the nonconsensual release of direct third-party claims against the Sacklers, a non-debtor, through the Plan; and (2) whether the text of the Bankruptcy Code, factual record, and equitable considerations support the bankruptcy court's approval of the Plan."[6] In answering both of these questions in the affirmative, the Second Circuit discussed the bankruptcy court's subject matter jurisdiction, the Bankruptcy Code's authority, and the factors the court deemed relevant to releasing direct third-party claims against non-debtors.

I. Subject Matter Jurisdiction

The court prefaced its discussion of subject matter jurisdiction by identifying what gives the bankruptcy court its ability to release claims at all: its power of discharge under 11 U.S.C. § 524(a). It explained that "a bankruptcy discharge releases a debtor from personal liability with respect to any debt by enjoining creditors from attempting to collect on that debt, so long as the debtor discloses all its financial information and puts those assets towards its estate."[7] The court then drew the distinction between the power of discharge and the releases at issue in the appeal. The court determined that "[w]hile the Bankruptcy Code forbids a *discharge* of a non-debtor's claim under 11 U.S.C. § 524(e), the releases … do not constitute a discharge of debt for the Sacklers because the releases neither offer umbrella protection against liability nor extinguish all claims."[8]

[6] *In re Purdue Pharma L.P.*, No. 22-110-bk (L), at 42 (2d Cir. May 30, 2023).
[7] *Id.* at 45.
[8] *Id*. at 46.

In analyzing the subject matter jurisdiction of the bankruptcy court, the Second Circuit focused on the impact the proposed releases would have on the *res* of the bankruptcy estate. Agreeing with both the bankruptcy court and the District Court, the Second Circuit concluded that "it is conceivable, indeed likely, that the resolution of the released claims would directly impact the *res*."[9] The court pointed out that (1) direct claims against the Sacklers brought by third-parties may preclude derivative claims brought by the estate; and (2) due to the indemnity agreement between Purdue and the Sacklers, Purdue may have to indemnify the Sacklers against certain direct third-party claims.

II. Bankruptcy Code Authority

The court identified §§ 105(a) and 1123(b)(6) of the Bankruptcy Code as providing the statutory basis for the bankruptcy court's approval of the releases. Section 105(a) states that a bankruptcy court "may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title."[10] Section 1123(b)(6) states that "a plan may . . . include any other appropriate provision not inconsistent with the applicable provisions of [the Bankruptcy Code]."[11] The court explained that § 1123(b)(6) "act[s] in tandem with § 105(a)" to "grant[] bankruptcy courts a 'residual authority' consistent with 'the traditional understanding that bankruptcy courts, as courts of equity, have broad authority to modify creditor-debtor relationships.'"[12]

In response to the District Court's endorsement of the appellees' view that nonconsensual releases of third-party claims against non-debtors cannot be permitted absent express

[9] *Id.* at 48.
[10] 11 U.S.C. § 105(a).
[11] 11 U.S.C. § 1123(b)(6).
[12] *In re Purdue Pharma L.P.*, No. 22-110-bk (L), at 52 (quoting *United States v. Energy Resources Co., Inc.*, 495 U.S. 545, 549 (1990)).

authorization by the Bankruptcy Code, the Second Circuit pointed out that in *Energy Resources* the Supreme Court permitted the approval of certain reorganization plan provisions absent the Bankruptcy Code's express authorization of those provisions. The Second Circuit also rejected the appellee's view "that *Energy Resources* only speaks to the ability of bankruptcy courts to modify 'creditor-debtor' relationships."[13] Here, the court expressly endorsed the views of the Sixth and Seventh Circuits, which have held that bankruptcy courts have the authority under § 1123(b)(6) to permit third-party releases. The circuits that have held to the contrary, including the Fifth, Ninth, and Tenth Circuits, rely on § 524(e), which states that the "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."[14] This language, according the Second Circuit, does not explicitly bar third-party releases and, as such, should not be construed as doing so.

The court also found support for its holding in Second Circuit case law. For example, in *In re Drexel Burnham Lambert Group, Inc.*, the Second Circuit concluded that bankruptcy courts "may enjoin a creditor from suing a third party, provided the injunction plays an important part in the debtor's reorganization plan."[15] Notably, this conclusion had not persuaded the District Court, which maintained that *Drexel* "did not identify any source of [the power to enjoin a creditor from suing a third party] in the Bankruptcy Code," and its mention of that power "became far less persuasive" following the passage of §§ 524(g) and 524(h), which, among other things, amended the Code to expressly authorize such injunctions in asbestos cases.[16] The Second Circuit emphatically rejected the District Court's view that the Bankruptcy Code's

[13] Trustee Br. at 54.
[14] 11 U.S.C. § 524(e).
[15] 960 F.2d 285, 293 (2d Cir. 1992).
[16] *In re Purdue Pharma, L.P.*, 635 B.R. at 97.

express authorization of third-party releases in asbestos cases precludes such releases outside the asbestos context.

III. The Seven Factors

Following its holding that the bankruptcy court had both the jurisdiction and statutory authority to impose nonconsensual releases of third-party direct claims against non-debtors, the Second Circuit identified seven factors relevant to the approval of such releases:

1. **Whether there is an identity of interests between the debtors and released third parties, including indemnification relationships, "such that a suit against the non-debtor is, in essence, a suit against the debtor or will deplete the assets of the estate."[17]**

2. **Whether claims against the debtor and non-debtor are factually and legally intertwined, including whether the debtors and the released parties share common defenses, insurance coverage, or levels of culpability.**

3. **Whether the scope of the releases is appropriate.**

4. **Whether the releases are essential to the reorganization, in that the debtor needs the claims to be settled in order for the *res* to be allocated, rather than because the released party is somehow manipulating the process to its own advantage.**

5. **Whether the non-debtor contributed substantial assets to the reorganization.**

6. **Whether the impacted class of creditors "overwhelmingly" voted in support of the plan with the releases.[18]**

7. **Whether the plan provides for the fair payment of enjoined claims.**

The court, however, stipulated that (1) "[a]lthough consideration of each factor is required, it is not necessarily sufficient—there may even be cases in which all factors are present, but the inclusion of third-party releases in a plan of reorganization should not be approved"; (2) "the bankruptcy court is required to support each of these factors with specific and detailed findings";

[17] *Class Five Nev. Claimants v. Dow Corning Corp. (In re Dow Corning Corp.)*, 280 F.3d 648, 656–58 (6th Cir. 2002).
[18] *In re Master Mortgage Inv. Fund*, 168 B.R. 930, 935 (Bankr. W.D. Mo. 1994).

and (3) "a provision imposing [nonconsensual releases of third-party direct claims against non-debtors] . . . must be imposed against a backdrop of equity."[19] The court nevertheless found that the "detailed findings" of the bankruptcy court in this case "support approval of the Plan under each of the seven factors."[20]

Looking Ahead

Unless a rehearing en banc is scheduled by the Second Circuit or a petition for a rehearing is filed,[21] the parties wishing to appeal the Second Circuit's decision will have until August 28 to file a petition for a writ of certiorari. To date, no rehearing has been ordered by the Second Circuit, and there is no indication yet whether a cert petition will be filed.[22] It is also unclear whether—assuming a cert petition *is* filed—the Supreme Court will elect to hear the case and cure the circuit split. However, there is certainly an interest among the circuit courts in it doing so. In his concurring opinion, Judge Richard Wesley lamented that "the majority's answer pins [the Second] Circuit firmly on one side of a weighty issue that, for too long, has split the courts of appeals. . . . Absent direction from Congress . . . or the High Court, the answer is a function of geography."[23]

Should the Supreme Court elect to hear this case, it will be faced with a decision between the pro-release majority view held by the Second, Fourth, Sixth, Seventh, and Eleventh Circuits, and minority view held by the Fifth, Ninth, and Tenth Circuits. A Supreme Court decision would correct the law in those Circuits whose stance it rejects and clarify the law in those in which the

[19] *In re Purdue Pharma L.P.*, No. 22-110-bk (L), at 67.
[20] *Id.* at 75.
[21] Under FRAP 35, a rehearing en banc could be ordered by a majority of the circuit judges or by petition of a party within the time prescribed for filing a petition of rehearing under FRAP 40. According to Supreme Court rules (Rule 13), the time for filing a petition for a writ of certiorari runs from the date of the denial of rehearing or, if rehearing is granted, the subsequent entry of judgment.
[22] The Second Circuit docket does reveal that certain pro se parties have filed petitions for rehearing as of June 13, 2023. These requests may alter the Supreme Court deadline for filing a petition for certiorari.
[23] *Id.* at 13–14 of concurrence.

issue is unsettled. The First Circuit falls into the latter category. There, "bankruptcy courts that have considered . . . third-party release provisions have generally determined that, in the context of chapter 11 plans of reorganization, such courts have subject matter jurisdiction to enter such orders, but that such jurisdiction should be exercised with restraint and in extraordinary circumstances."[24] Should *In re Purdue Pharma L.P.* not reach the Supreme Court, the issue of third-party releases will no doubt remain a contested issue in bankruptcy courts across the country for years to come.

[24] *In re Grove Instruments, Inc.*, 573 B.R. 307, 314 (Bankr. D. Mass. 2017).

Feature

By Shane G. Ramsey and John T. Baxter

Should Solvent Debtors Pay Post-Petition Interest at the Contract Rate? Recent Decisions Say "Yes"

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Two recent decisions from the Fifth and Ninth Circuit Courts of Appeals have addressed a question that does not arise often: In a solvent-debtor chapter 11 case, is the debtor required to pay post-petition interest (or "pendency interest") to unsecured creditors to render such claims unimpaired? If so, what is the applicable rate of interest to use? In addition, a subsequent decision from the Second Circuit, while not ultimately reaching the issue, favorably cited the recent Fifth and Ninth Circuit decisions.

Solvent-Debtor Exception

The default rule in bankruptcy law is that interest ceases to accrue on a claim once a debtor has filed for bankruptcy.[1] This rule is one of necessity; in most chapter 11 cases, the debtor cannot pay all of its creditors, therefore payment of post-petition interest would diminish the value of the estate and result in disparate treatment of creditors.[2]

Accordingly, 18th century English courts developed the solvent-debtor exception, which required bankrupts to pay interest that accrued during bankruptcy before retaining value from an estate.[3] In turn, American courts imported this doctrine and applied it under the Bankruptcy Act of 1898.[4]

The solvent-debtor exception was not codified, instead existing as a common law exception to the Bankruptcy Act's prohibition on the collection of post-petition interest as part of a creditor's claim.[5] Courts interpreted the exception as flowing from the purpose of bankruptcy law to ensure an equitable distribution of assets.[6] Under this exception, creditors of a solvent debtor were entitled to be made whole, including receiving post-petition interest, before surplus value was returned to the bankrupt.[7]

History of Post-Petition Interest in Solvent-Debtor Cases Under the Bankruptcy Code

Most modern case law recognizes that unsecured creditors of solvent debtors are entitled to post-petition interest on their claims if they are to be deemed unimpaired.[8] In solvent-debtor cases where interest on an unsecured claim is required, the applicable language is less clear on what rate of interest should apply. Section 726(a)(5) of the Bankruptcy Code refers to interest at "the legal rate," which, unfortunately, is not particularly helpful. Courts that have addressed this issue have concluded that the "legal rate" of interest means either the contract rate[9] or federal statutory rate[10] set forth in 28 U.S.C. § 1961.[11]

However, some cases have held that creditors of solvent debtors are not entitled to post-petition interest at any rate at all, on the grounds that the solvent-debtor exception did not survive the Code's enactment. These cases, however, are in the minority.

Ninth Circuit's Decision in *PG&E*

In *In re PG&E Corp.*,[12] the Ninth Circuit ruled that a solvent debtor's chapter 11 plan must pay pendency interest to unsecured creditors to render their claims unimpaired. In so doing, the court opined: "[P]ursuant to the solvent-debtor exception, unsecured creditors

1 *See Sexton v. Dreyfus*, 219 U.S. 339, 344, 31 S. Ct. 256, 55 L. Ed. 244 (1911); 11 U.S.C. § 502(b)(2).
2 *See Vanston Bondholders Protective Comm. v. Green*, 329 U.S. 156, 163-64, 67 S. Ct. 237, 91 L. Ed. 162 (1946). But such concerns do not exist when a bankrupt has sufficient funds to pay all outstanding debts. *See Johnson v. Norris*, 190 F. 459, 462 (5th Cir. 1911) (emphasizing that default rule halting accrual of interest during bankruptcy "was not intended to be applied to a solvent estate").
3 *See, e.g., Bromley v. Goodere*, (1743) 26 Eng. Rep. 49, 51-52; 1 Atkyns 75, 79-81.
4 *See, e.g., City of New York v. Saper*, 336 U.S. 328, 330 n.7, 69 S. Ct. 554, 93 L. Ed. 710 (1949) (recognizing solvent-debtor exception).
5 *See* Bankruptcy Act of 1898, ch. 541, § 63, 30 Stat. 544, 562-63 (repealed) (stating that allowed claim excludes "costs incurred and interests accrued after the filing of the petition").
6 *See Johnson*, 190 F. 459, 466; *Debentureholders Protective Comm. of Cont'l Inv. Corp. v. Cont'l Inv. Corp.*, 679 F.2d 264, 269 (1st Cir. 1982) (calling exception "fair and equitable"). The common law absolute-priority rule requires that a creditor be "made whole" before junior interests take from the bankruptcy estate.
7 *See In re Chicago, Milwaukee, St. Paul & Pac. R.R. Co.*, 791 F.2d 524, 529 (7th Cir. 1986).
8 *See In re New Valley Corp.*, 168 B.R. 73, 81 (Bankr. D.N.J. 1994) (holding that "a solvent debtor is not required to pay post-petition interest on claims of unsecured creditors who are unimpaired"); Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, § 213(d), 108 Stat. 4106, 4125-26 (overruling *New Valley* by repealing 11 U.S.C. § 1124(3) (1988) and, in effect, requiring payment of post-petition interest for unsecured creditors to be unimpaired).
9 *See, e.g., Gencarelli v. UPS Cap. Bus. Credit*, 501 F.3d 1, 7 (1st Cir. 2007) ("This is a solvent-debtor case and, as such, the equities strongly favor holding the debtor to his contractual obligations."); *In re Dow Corning Corp.*, 456 F.3d 668, 680 (6th Cir. 2006) ("[T]here is a presumption that default interest should be paid to unsecured claimholders in a solvent-debtor case."); *Dvorkin Holdings LLC*, 547 B.R. 880, 893-94 (N.D. Ill. 2016) (rejecting argument that federal judgment rate applied and awarding interest at contract rate).
10 The Federal Judgment Rate is calculated "from the date of the entry of the judgment, at a rate equal to the weekly average one-year constant maturity Treasury yield, as published by the Board of Governors of the Federal Reserve System, for the calendar week preceding the date of the judgment." *See* 28 U.S.C. § 1961.
11 *See, e.g., In re Cardelucci*, 285 F.3d 1231, 1234 (9th Cir. 2002) (holding that creditor was entitled to interest on its allowed unsecured claim at federal judgment rate rather than contract rate); *In re RGN-Grp. Holdings LLC*, 2022 WL 494154, *6 (Bankr. D. Del. Feb. 17, 2022) (holding that creditor was entitled to interest on its allowed unsecured claim at federal judgment rate rather than contract rate).
12 46 F.4th 1047 (9th Cir. 2022), *reh'g denied*, No. 21-16043 (9th Cir. Oct. 5, 2022), *stayed pending petition for cert.*, No. 21-16043 (9th Cir. Oct. 27, 2022).

possess an 'equitable right' to post-petition interest [under § 1124(1) of the Bankruptcy Code] when a debtor is solvent."

Regarding the applicable rate of interest, the Ninth Circuit, in reversing the lower court, held that there is a presumption that the pendency interest to be paid to unsecured creditors should be based on the contractual or default rate, not the federal judgment rate, absent contrary and compelling equitable considerations.

In reaching its holding, the Ninth Circuit first addressed whether its prior decision in *In re Cardelucci*[13] was controlling in the case before it. Both the bankruptcy and district courts below held that *Cardelucci* established a broad rule that all unsecured claims in a solvent-debtor bankruptcy are entitled only to post-petition interest at the federal judgment rate, regardless of impairment status.

The Ninth Circuit in *PG&E* rejected this holding, reasoning that "*Cardelucci* merely held that the phrase 'interest at the legal rate' in § 726(a)(5) refers to the federal judgment rate as defined by 28 U.S.C. § 1961(a)." Section 726(a)(5) "only applies to impaired chapter 11 claims via the best-interests test. *Cardelucci* therefore does not tell us what rate of post-petition interest must be paid on plaintiffs' unimpaired claims."[14] The Ninth Circuit continued, "*Cardelucci* provides no textual basis for applying § 726(a)(5) to unimpaired claims, nor could it."[15] As a result, the Ninth Circuit declined to read *Cardelucci* as establishing the broad rule advocated for by PG&E. According to the court, "*Cardelucci* merely held that the phrase 'interest at the legal rate' in § 726(a)(5) refers to the federal judgment rate. But this holding does not answer what rate of interest is required where § 726(a)(5) does not apply — including for unimpaired claims."[16]

The court concluded by holding "that the equitable solvent-debtor exception — and its core principle that creditors should be made whole when the bankruptcy estate is sufficient — persists under the Code. Accordingly, under the Code, unsecured creditors of a solvent debtor retain an equitable right to post-petition interest pursuant to their contracts, subject to any other equities in a given case. A failure to compensate creditors according to this equitable right as part of a bankruptcy plan results in impairment."[17]

Fifth Circuit's Decision in *Ultra Petroleum*

A little over a month later, the Fifth Circuit issued a ruling in *Ultra Petroleum Corp. v. Ad Hoc Comm. of OpCo Unsecured Creditors (In re Ultra Petroleum Corp.)*[18] addressing the same issue. Just as the Ninth Circuit did in *PG&E*, the Fifth Circuit concluded that in a solvent-debtor case, "[c]reditors are entitled to what they bargained for," meaning that creditors in that case with claims based on contracts were entitled to pendency interest at the default contract rate.

In so doing, the court considered the interplay between §§ 1129(a)(7) and 726(a)(5) of the Bankruptcy Code. Section 1129(a)(7) provides that a bankruptcy court can "cram down" a plan on impaired creditors, over their objection, if they "will receive or retain under the plan ... not less than the amount that [they] would so receive or retain if the debtor were liquidated under chapter 7." In turn, § 726(a) governs what the creditors would get if the debtor were liquidated in a chapter 7 case. Section 726(a) provides a waterfall for the distribution of a debtor's assets in a chapter 7 liquidation. Before a solvent debtor's equityholders get any of the estate's leftovers, § 726(a)(5) says that creditors are to be paid interest on their claims "at the legal rate" from the petition date.

In *Ultra Petroleum*, the debtor relied on the phrase "legal rate" to support its argument that the "legal rate" must be the federal judgment rate. In support of its arguments, the debtors relied on the Ninth Circuit's decision in *Cardelucci*. The Fifth Circuit, like the Ninth Circuit in *PG&E*, rejected the application of *Cardelucci*, noting that the reference to "the legal rate" was not dispositive because, according to the court, the textual reference to "the legal rate" merely "sets a floor — not a ceiling — for what an impaired (and by implication, unimpaired) creditor is to receive in a cram-down scenario."[19] Thus, "even if 'the legal rate' is the Federal Judgment Rate, the Code does not preclude unimpaired creditors from receiving default-rate post-petition interest in excess of the Federal Judgment Rate in solvent-debtor Chapter 11 cases."[20]

These two decisions are a departure from numerous lower court decisions forming the majority rule that the federal judgment rate is the applicable rate of interest in solvent-debtor cases.[21] With these recent decisions from the Fifth and Ninth Circuits, all five of the circuit courts of appeals to have addressed the issue agree that the contract rate is the applicable rate of interest in solvent-debtor cases.[22]

Second Circuit's Decision in *LATAM*

In *In re LATAM Airlines Grp. SA*,[23] the U.S. Court of Appeals for the Second Circuit favorably discussed portions of *Ultra Petroleum* and *PG&E*, stating, "We find these authorities persuasive. We therefore join the Third, Fifth, and Ninth Circuits and hold that a claim is impaired under Section 1124(1) only when the plan of reorganization, rather than the Code, alters the creditor's legal, equitable, or contractual rights."[24] Ultimately, however, the court did not address the extent to which the solvent-debtor exception survived the Bankruptcy Code's enactment, because the court deferred to and affirmed the bankruptcy court's determination that the debtor was insolvent.

13 285 F.3d 1231 (9th Cir. 2002).
14 *PG&E Corp.*, 46 F.4th at 1056.
15 *Id.* (internal citations omitted).
16 *Id.* at 1056-57 (internal citations omitted).
17 *Id.* at 1061.
18 51 F.4th 138 (5th Cir. 2022), *reh'g denied*, No. 21-20008 (5th Cir. Nov. 15, 2022).
19 *Id.* at 158.
20 *Id.* at 158-59.
21 *See, e.g., In re RGN-Grp. Holdings LLC*, 2022 WL 494154, *6 (Bankr. D. Del. Feb. 17, 2022) (holding that creditor was entitled to interest on its allowed unsecured claim at federal judgment rate rather than contract rate); *In re Cuker Interactive LLC*, 622 B.R. 67, 69 (Bankr. S.D. Cal. 2020) (holding that because construing solvent debtor-exception to require payment of contract-rate interest might be problematic in cases with significant number of creditors where several interest rates might apply, leading to an administrative morass and different treatment of creditors in same class, pendency interest must be paid at federal judgment rate); *In re Mullins*, 633 B.R. 1, 16 (Bankr. D. Mass. 2021) (to satisfy best-interests test, which incorporates § 726(a)(5)'s dictate that interest be paid at "the legal rate" in case involving sufficient assets, pendency interest must be paid at federal judgment rate).
22 *See, e.g., Gencarelli v. UPS Cap. Bus. Credit*, 501 F.3d 1, 7 (1st Cir. 2007) ("This is a solvent debtor case and, as such, the equities strongly favor holding the debtor to his contractual obligations."); *In re Dow Corning Corp.*, 456 F.3d 668, 680 (6th Cir. 2006) ("[T]here is a presumption that default interest should be paid to unsecured claimholders in a solvent debtor case."); *In re PPI Enters. (U.S.) Inc.*, 324 F.3d 197, 207 (3d Cir. 2003) (holding that failure to pay post-petition interest on claim "could not qualify for nonimpairment under § 1124(1) because the failure to pay post-petition interest does not leave unaltered the contractual or legal rights of the claim").
23 2022 WL 17660057 (2d Cir. Dec. 14, 2022).
24 *Id.* at *5.

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Takeaways

As a result of these three decisions, lower courts throughout the nation may soon start departing from the majority rule and adopting the reasoning of these circuit courts of appeals. While there may be some baseline appeal to the current majority approach in that it keeps the meaning of "the legal rate" consistent across sections of the Bankruptcy Code, the current trend toward the contractual rate is the more reasoned viewpoint. The purpose of the solvent-debtor exception is to ensure that all creditors are treated fairly where there are sufficient assets to fully fund all claims. By potentially reducing undersecured creditors' interest rate accrual by reverting to the federal rate, these creditors would be in a worse position than they were prior to the bankruptcy — a statement that cannot be said of the debtor's other creditors, whose claims would remain the same.

Accordingly, creditors' and debtors' attorneys alike need to be aware of this current trend when confronting a solvent-debtor case. The ease of imposing the federal interest rate is being eschewed in favor of the fairer contractual rate. While this unquestionably benefits secured creditors, there is no real detriment to debtors, as they are merely held to the obligations that they contractually agreed to prior to the bankruptcy case. abi

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