Recent Issues in Plan Confirmation

CONCURRENT SESSION

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Abstract

The past year has provided several important developments in the law governing exit from a chapter 11 case, including treatment of claims, plan terms, confirmation requirements, releases, and appeals.

- Section 510(b) of the Bankruptcy Code requires the subordination of certain claims. *In re American Housing Foundation*, 785 F.3d 143 (5th Cir. 2015), as revised (June 8, 2015), arguably expanded the scope of section 510(b)'s subordination beyond what practitioners and investors have envisioned.
- Sections 1126(f) and 1129(a)(8) together provide that an unimpaired class's acceptance is not necessary for plan confirmation. Section 502(b)(2) disallows unmatured interest as of the petition date on an allowed unsecured claim regardless of the debtor's financial condition. Thus, distinguishing between plan impairment and statutory impairment, *In re Energy Future Holdings Corp.*, 540 B.R. 109 (Bankr. D. Del. 2015) (appeals pending), ruled that a solvent debtor's unsecured claim class may be left "unimpaired" under section 1124(1) even though the plan does not provide any distribution for post-petition interest on the class's allowed claims and even though the claims' holders would have a statutory right to interest (i) at least at the federal judgment rate if the claim was impaired or (ii) at the contract rate if the claim was left "unimpaired" under section 1124(2). But section 1124(1) and Third Circuit precedent require some distribution, based on the court's discretion under its equitable powers, for postpetition interest before any distribution to equity holders.
- Sections 503, 506, 507, 726 and 1129, among others, establish priorities for the distribution of estate assets to satisfy claims, reflecting legislative policy that certain

categories of claims, such as administrative, tax, wage or domestic support claims should receive full recovery before distributions on other unsecured claims and that unsecured claims should receive full recovery before equity receives a recovery. While creditors may consent, before or after bankruptcy, to less favorable treatment than statutory priorities, these rules generally ensure that the priorities accorded to non-consenting creditors will be respected. However, recent appellate decisions hold that in appropriate circumstances parties may use "gifting," structured dismissals or other settlement mechanisms to avoid the Code's priorities, even when such settlements favor lower priority creditors or leave out one or more constituencies, if the property being distributed does not belong to the estate or if statutory alternatives such as dismissal or conversion would produce even less attractive results.

- Recent Third Circuit decisions signal some tightening of the circumstances in which appellate courts will dismiss as equitably moot an appeal from a confirmation order. While appellate courts favor merits review and, where possible, finding a way to provide meaningful relief, the equitable mootness doctrine remains an important tool to protect third-parties who rely on the finality of bankruptcy court orders and to prevent recalcitrant creditors from holding up the process.
- Courts of Appeal are split on whether a confirmation order may release a non-debtor or enjoin a third party from asserting a direct claim against the non-debtor without the releasing party's consent. The majority of circuits (Second, Third, Fourth, Sixth, Seventh, and Eleventh Circuits) permit nonconsensual releases and injunctions in limited circumstances. Recent decisions from the Eleventh Circuit (*In re Seaside Eng'g & Surveying, Inc.*, 780 F.3d 1070 (11th Cir. 2015)) and the District of

Delaware (*In re Millennium Lab Holdings, II, LLC*, No. 15-12284 (LSS), ECF Nos. 206, 259 (Bankr. D. Del. 2015, 2016)) expand the circumstances in which releases are permissible to cover, respectively, a bar order in related litigation and a release from creditors who did not benefit directly from the releasees' contribution to the chapter 11 plan.

- A debtor or plan proponent may modify a confirmed plan any time before the plan is substantially consummated if circumstances warrant and the court confirms the plan as modified. 11 U.S.C. § 1127(b). The provision recognizes the fluidity of the reorganization process while also reinforcing the principle of finality in chapter 11 cases. *SCH Corp. v. CFI Class Action Claimants*, 597 Fed. Appx. 143 (3rd Cir. 2015), attempts to define "modification" and to give guidance on which "circumstances warrant" modification in a case where a post-confirmation default resulted in a settlement that revised plan terms.

Statutory Subordination Under Section 510(b) in Light of *In re American Housing Foundation*

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Section 510(b) of the Bankruptcy Code requires the subordination of certain claims.[1] This article provides an overview of the case law interpreting this statute. It then considers section 510(b) in light of the Fifth Circuit's recent decision in *In re American Housing Foundation*, which arguably expanded the scope of 510(b)'s subordination beyond what practitioners and investors have envisioned.[2]

1. Overview of Existing Law

Section 510(b) provides:

> For the purpose of distribution under this title, a claim arising from rescission of a purchase or sale of a security of the debtor or of an affiliate of the debtor, for damages arising from the purchase or sale of such a security, or for reimbursement or contribution allowed under section 502 on account of such a claim, shall be subordinated to all claims or interests that are senior to or equal the claim or interest represented by such security, except that if such security is common stock, such claim has the same priority as common stock.

In short, section 510(b) mandates subordination of any claim: (i) arising from the rescission of a purchase or sale of a security of the debtor or an affiliate; (ii) for damages arising from the purchase or sale of a security of the debtor or an affiliate; or (iii) for reimbursement or contribution on account of a claim allowed under section 502 under either (i) or (ii).

1.1. Meaning of "Rescission"

Section 510(b) provides for the subordination of claims "arising from *rescission* of a purchase or sale of a security of the debtor or of an affiliate of the debtor." There is limited case law interpreting this portion of section 510(b).[3] However, legislative history indicates that this

[1] 11 U.S.C. § 510(b).

[2] 785 F.3d 143 (5th Cir. 2015), as revised (June 8, 2015).

[3] The vast majority of the case law since the enactment of section 510(b) focuses on the "damages arising from the purchase or sale of such a security" portipon of the statute. There is very limited case law addressing the rescission portion of the statute—*i.e.*, "a claim arising from rescission of a purchase or sale of a security of the debtor or of an affiliate of the debtor." What little case law there is, is not helpful in drawing any real takeaways. *(cont'd)*

statute was enacted in large part in response to a law review article written by Professors Slain and Kripke.[4] Slain and Kripke's article focused on the following issue:

> The absolute priority rule mandates the complete subordination of equity claims against a bankrupt to the claims of general creditors. Yet, under present law [before enactment of § 510(b)], a shareholder can escape the effects of the rule if he can prove a right to rescind his purchase. Establishment of such a claim will give him equality with or perhaps priority over general creditors. Although it is arguable that such treatment accords with policies of the securities acts, it takes no account of the rules and policies of bankruptcy distribution.[5]

Accordingly, mandatory subordination of securities rescission claims is warranted because of (1) the dissimilar risk and return expectations of shareholders and creditors and (2) the reliance of creditors on the equity cushion provided by shareholder investment. In light of these policies, Slain and Kripke highlighted the situations in which a shareholder could bypass the absolute priority rule by raising a rescission claim under one or more of several federal and state statutes and common law rules.

The authors explained: "A transaction may violate the Securities Act in two respects: it may be an unregistered nonexempt public offering of securities or it may be effected through the use of a deceptive prospectus. Section 12(1) of the Securities Act allows rescission by the purchaser in the first situation, and section 12(2) allows rescission in the second."[6] Slain and Kripke also highlighted a number of other federal and state securities laws that could be the

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See, e.g., In re Wisconsin Barge Line, Inc., 76 B.R. 142, 143 (Bankr. E.D. Mo. 1987) (facing both claims for rescission of a stock contribution agreement as well as a claim for damages, and choosing to focus on the claim for damages for its analysis only).

[4] See H. Rep. No. 95–595, at 194-96, Bankruptcy Reform Act of 1978 (1977) (citing John J. Slain and Homer Kripke, The Interface Between Securities Regulation and Bankruptcy—Allocating the Risk of Illegal Securities Issuance Between Securityholders and the Issuer's Creditors, 48 N.Y.U. L. Rev. 261 (1973)).

[5] Id. at 298.

[6] Id. at 266 (referring to 15 U.S.C. §§ 77*l*(1) and (2) (1970)).

predicate of a private action in which either rescission or damages would be the remedy for a stockholder, including Rule 10b-5 of the Securities Exchange Act of 1934, antifraud provisions of Section 17(a) of the Securities Act of 1933, and Blue Sky laws.

Note, however, that section 510(b) is not limited to statutory rescission claims. In a recent case, the Fifth Circuit found that section 510(b) could be expanded beyond rescission claims arising from securities fraud to include rescission claims arising from mutual agreement of the parties.[7] The Fifth Circuit began by looking to Black's Law Dictionary's definition of "rescission", which defines the term as a "party's unilateral unmaking of a contract for a legally sufficient reason, such as the other party's material breach or a judgment rescinding the contract; voidance."[8] "Legal rescission" is defined as "[r]escission that is effected by the agreement of the parties."[9]

The Fifth Circuit then noted that "[t]he plain language of § 510(b) does not distinguish between equitable rescission by a court as a remedy for securities fraud and legal rescission by the parties as a remedy for irreconcilable differences."[10] The state court judgment enforcing the parties' settlement agreement—under which an asset contribution and transition agreement was rescinded following the parties' irreconcilable differences—was based on Texas law, so the Fifth Circuit turned to an examination of Texas law on rescission. The Fifth Circuit analogized the

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[7] In re SeaQuest Diving, LP, 579 F.3d 411, 422 (5th Cir. 2009) ("Slain and Kripke's two policy rationales for mandatory subordination apply equally to rescission claims arising from securities fraud and rescission claims arising from the mutual agreement of the parties. In both situations, (1) the investors initially bargained for the risk and return expectations of investors, but later changed their minds due to unforeseen future events; (2) the unsecured creditors presumably relied on the investors' contributions to the 'equity cushion'; and (3) disaffected investors are attempting to share the assets of the bankruptcy estate *pari passu* with unsecured creditors who never bargained for an equity stake in the debtor.") (citation omitted).

[8] Id. at 419 (quoting Black's Law Dictionary 1332 (8th ed. 2004)).

[9] Id. (quoting Black's Law Dictionary 1332 (8th ed. 2004)).

[10] Id.

case to one in which a plaintiff sought rescission of a real estate contract after learning that the land was encumbered by easements and not suitable for residential use.[11] There, the court ordered the defendants to refund the purchase price and the plaintiffs to return the property to the defendants.[12] In *SeaQuest*, the Fifth Circuit reasoned that the parties had structured the initial deal as an equity investment rather than a loan, and therefore, the rescission of the agreement pursuant to the state court judgment was properly subordinated pursuant to section 510(b).[13]

In short, from the relatively rare case like *SeaQuest*, there is little case law and hence, little apparent controversy regarding subordination of securities rescission claims. Indeed, public debtors routinely confirm reorganization plans that contain classes of subordinated securities claims, yet such cases rarely spawn litigation from class action securities counsel regarding their priority. That is largely because the law is relatively clear: their claims are subordinated.

1.2. Meaning of "An Affiliate of the Debtor"

The Bankruptcy Code definition of "affiliate" also is relatively clear and well understood. It nonetheless warrants quotation in full:

> (A) [an] entity that directly or indirectly owns, controls, or holds with power to vote, 20 percent or more of the outstanding voting securities of the debtor, other than an entity that holds such securities—
>
> > (i) in a fiduciary or agency capacity without sole discretionary power to vote such securities; or
> >
> > (ii) solely to secure a debt, if such entity has not in fact exercised such power to vote;
>
> (B) [a] corporation 20 percent or more of whose outstanding voting securities are directly or indirectly owned, controlled, or held with power to vote, by the debtor,

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[11] Id. at 420 (citing Smith v. Nat'l Resort Communities, Inc., 585 S.W.2d 655, 656 (Tex. 1979)).

[12] Id. (citing Smith, 585 S.W.2d at 659-60).

[13] Id. at 422.

> or by an entity that directly or indirectly owns, controls, or holds with power to vote, 20 percent or more of the outstanding voting securities of the debtor, other than an entity that holds such securities—
>
> > (i) in a fiduciary or agency capacity without sole discretionary power to vote such securities; or
> >
> > (ii) solely to secure a debt, if such entity has not in fact exercised such power to vote;
>
> (C) [a] person whose business is operated under a lease or operating agreement by a debtor, or person substantially all of whose property is operated under an operating agreement with the debtor; or
>
> (D) [an] entity that operates the business or substantially all of the property of the debtor under a lease or operating agreement.[14]

1.3. Meaning of "Damages"

The word "damages" arises in the second alternative as a basis for subordination under section 510(b). It is, therefore, distinct from securities rescission claims. Thus, claims for both rescission and for damages, in each case arising from the purchase or sale of a security, are subject to subordination. However, while rescission claims are relatively straightforward, application of the word "damages" within the context of section 510(b) can be more challenging.

Courts routinely find that a claim is for "damages" when a claim results from torts such as fraud or breach of fiduciary duties related to the purchase or sale of a security.[15] The Delaware bankruptcy court has elaborated: "The term ['damages'] connotes a recovery broader than a simple claim on an unpaid debt. The term 'damages' implies a tortious injury, as for example, one suffered from the fraudulent issue, purchase or sale of securities. It also serves to include

[14] 11 U.S.C. § 101(2).

[15] See, e.g., In re Am. Hous. Found., 785 F.3d 143, 153-54 (5th Cir. 2015), as revised (June 8, 2015).

claims by investors who technically do not have a claim for rescission but who still have a securities fraud claim."[16]

However, as the Fifth Circuit has also noted, "various circuits 'have adopted [a] broad reading of the damages category' contained in Section 510(b), and 'the circuit courts agree that a claim arising from the purchase or sale of a security can include a claim predicated on post-issuance conduct'—i.e., conduct after the issuance of the security—'such as breach of contract.'"[17] For example, the Third Circuit has held that a claim arising from breach of a provision in a stock purchase agreement that required the issuer to use its best efforts to register stock and to ensure that it was freely tradable was subject to mandatory subordination.[18] The Tenth Circuit has held that a claim arising from post-issuance fraud of the debtor, which caused an investor to hold rather than sell his securities, was subject to mandatory subordination.[19] And the Second Circuit has held that a claim arising from breach of a stock exchange provision in a termination agreement also was subject to mandatory subordination.[20]

As can be seen from these examples, damages claims subject to subordination can include claims that are removed from the actual purchase or sale. Moreover, the distinction between a claim for breach of contract, which may be subject to subordination, and a simple

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[16] In re Montgomery Ward Holding Corp., 272 B.R. 836, 842 (Bankr. D. Del. 2001) (citations omitted); see also In re Washington Bancorporation, 1996 WL 148533, at *20 (D.D.C. Mar. 19, 1996) ("Assuming for the purposes of this motion that the commercial paper is a security, section 510(b) does not apply. FDIC-C seeks to recover solely on WBC's debt obligations under the commercial paper, rather than on a tort claim in the sale of the paper. FDIC-C, as assignee of the original commercial paper holders, merely asserts the claim for the debt. … Accordingly, WBC's claim for subordination based upon section 510(b) shall be dismissed."); In re Wyeth Co., 134 B.R. 920, 921-22 (Bankr. W.D. Mo. 1991) (("[A section 510(b)] claim must directly concern the stock transaction and not merely be a claim on a debt.").

[17] In re Am. Hous. Found., 785 F.3d at 154 (quoting In re SeaQuest Diving, LP, 579 F.3d 411, 421 (5th Cir. 2009)).

[18] See In re Telegroup, Inc., 281 F.3d 133, 136, 141-42 (3d Cir. 2002).

[19] In re Geneva Steel Co., 281 F.3d 1173, 1180-81 (10th Cir. 2002).

[20] In re Med Diversified, Inc., 461 F.3d 251, 256 (2d Cir. 2006).

claim on an unpaid debt, which is not subject to subordination, may not always be so clear. This will be seen in the discussion of *American Housing Foundation* below.

1.4. Meaning of "Arising From"

Matters become even more complex with the phrase "arising from". Courts generally acknowledge the ambiguity of the phrase, and therefore have turned to the legislative history as well as the policy considerations articulated in Slain and Kripke's law review article to attempt to distill its meaning. Courts largely follow the "but for" test, articulated by the Third Circuit in *In re Telegroup* described further below.[21] However, there are also limits to the "but for" test, as discussed in the Second Circuit's decision in *In re Med Diversified, Inc.*, also described further below.

In *In re Telegroup*, shareholders filed proofs of claim seeking damages for the debtor's alleged breach of its agreement to use its best efforts to ensure that their stock was registered and freely tradeable. The shareholders argued that section 510(b) should be read narrowly to apply only to claims arising from fraud or other illegality that occurred at the time of the purchase or sale of the stock, *i.e.*, not as was the case in *Telegroup*, where the actionable conduct occurred after the purchase of the stock. The bankruptcy court and district court took a broader view of section 510(b) and subordinated the shareholders' claims, and the shareholders appealed.

The Third Circuit recognized the ambiguity of the phrase "arising from", but went on to note:

> For a claim to "aris[e] from the purchase or sale of ... a security," there must obviously be some nexus or causal relationship between the claim and the sale of the security, but § 510(b)'s language alone provides little guidance in delineating the precise scope of the required nexus. On the one hand, it is reasonable, as a textual matter, to hold that the claims in this case do not "arise from" the purchase

[21] In re Telegroup, Inc., 281 F.3d 133 (3d Cir. 2002).

> or sale of Telegroup's stock, since the claims are predicated on conduct that occurred after the stock was purchased. On the other hand, it is, in our view, more natural, as a textual matter, to read "arising from" as requiring some nexus or causal relationship between the claims and the purchase of the securities, but not as limiting the nexus to claims alleging illegality in the purchase itself. In particular, the text of § 510(b) is reasonably read to encompass the claims in this case, since *the claims would not have arisen but for the purchase of Telegroup's stock* and allege a breach of a provision of the stock purchase agreement.[22]

In reaching its holding, the Third Circuit relied on legislative history and Slain and Kripke's law review article. It noted that "Congress enacted § 510(b) to prevent disappointed shareholders from recovering their investment loss by using fraud and other securities claims to bootstrap their way to parity with general unsecured creditors in a bankruptcy proceeding. Nothing in this rationale would distinguish those shareholder claims predicated on post-issuance conduct from those shareholder claims predicated on conduct that occurred during the issuance itself."[23] The court found that the claimants in essence were equity investors seeking compensation for the decline in value of Telegroup's stock.[24] Therefore, the Third Circuit held that the claims were properly subordinated pursuant to section 510(b).

The Second Circuit acknowledged limits to the "but for" test in *In re Med Diversified*.[25] There, the court considered whether a claim of a former executive of the debtor needed to be subordinated pursuant to section 510(b) where the claim was based on the debtor's failure to exchange stock the former executive held in another company for common stock of the debtor

[22] Id. at 138 (emphasis added).

[23] Id. at 142.

[24] Id. ("Put differently, because claimants retained the right to participate in corporate profits if Telegroup succeeded, we believe that § 510(b) prevents them from using their breach of contract claim to recover the value of their equity investment in parity with general unsecured creditors. Were we to rule in claimants' favor in this case, we would allow stockholders in claimants' position to retain their stock and share in the corporation's profits if the corporation succeeds, and to recover a portion of their investment in parity with creditors if the corporation fails.").

[25] In re Med Diversified, Inc., 461 F.3d 251 (2d Cir. 2006).

pursuant to his termination agreement. The former executive argued that the debtor's promise to purchase the stock he held in another company was equivalent to a promise to make a cash severance payment to him. The court disagreed, finding that the key difference was that the former executive had

> bargained not for cash but to become a stockholder in the debtor. Once he entered a binding agreement obligating him to purchase shares of the debtor in return for his shares [in the other company], and to forego the significant cash compensation to which he otherwise was due upon termination, he became bound by the choice he made to trade the relative safety of cash compensation for the upside potential of shareholder status—the very choice highlighted by Slain and Kripke.[26]

The court therefore held that the claim was properly subordinated because the case did fell within the policy concerns underlying section 510(b) based on the agreement between the parties to turn a debt into an equity interest.

Although the court ultimately found that the claim should be subordinated, the court "acknowledge[d] the outer boundaries of the statute's text and purpose. 'Nothing in our rationale would require the subordination of a claim simply because the identity of the claimant happens to be a shareholder [or one who completed a bargain to become a shareholder], where the claim lacks any causal relationship to the purchase or sale of stock and when subordinating the claim[] would not further the policies underlying section 510(b) ….'"[27] While the court's statements purport to establish the "outer boundaries" of section 510(b), the court's statements respectfully do not say much—suggesting that the outer boundaries of the necessary causal connection may be very far out indeed.

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[26] Id. at 256.

[27] Id. at 259 (quoting In re Telegroup, 281 F.3d at 144 n.2).

1.5. Meaning of "Reimbursement or Contribution Allowed Under Section 502 on Account of Such Claim"

In 1984, section 510(b) was amended to include the phrase "claim for reimbursement or contribution allowed under section 502 on account of such a claim." Prior to this amendment, the Ninth Circuit had held that indemnity claims for litigation costs were not within the scope of section 510(b).[28] Although there is no legislative history accompanying this amendment, courts have interpreted this provision as extending subordination to indemnification claims, including claims for the recovery of attorneys' fees.[29]

The upshot of this portion of section 510(b) is that officers, directors and underwriters named as defendants in securities actions involving debtors are on their own, as a practical matter, in funding their defense unless they have an insurance carrier that steps into the breach. But even the existence of D&O insurance may not afford cover given the inherent ambiguity over whether insurance proceeds are part of a debtor's bankruptcy estate. A charter's indemnification provision therefore may be of very little value in any case where they are not assured of assumption relatively early in the case.

[28] In re Christian Life Center, 821 F.2d 1370, 1376 (9th Cir. 1987) ("The officers' indemnity claims are for litigation costs, not for reimbursement of liability owed to the holders of the securities. The argument that the security holder may circuitously elevate his claim to a general unsecured claim through indemnity is relevant only to indemnity of liability. The security holder recovers nothing from the officers when the latter are merely indemnified for defense costs. Thus section 510(b)—at least prior to the 1984 amendment—does not require subordination of indemnity claims for defense costs.").

[29] See, e.g., In re De Laurentiis Entm't Grp., Inc., 124 B.R. 305, 310 (C.D. Cal. 1991) (finding "that Section 510(b) governs PaineWebber's claim for litigation expenses. In construing the provisions of Section 510(b), the Court concludes that PaineWebber's claim for litigation expenses incurred in defending an action brought by securities holders in connection with the public offerings of stock is subordinated to the claims of the general unsecured creditors."); In re Touch Am. Holdings, Inc., 381 B.R. 95, 106 (Bankr. D. Del. 2008) (holding that officers' and directors' indemnification claims for liability and costs associated with ERISA litigation should be subordinated under section 510(b) where the "gist of the ERISA Litigation is to recover damages based upon the lost value of the stock, which are claims derived from the employees' purchase and ownership of the stock").

1.6. Subordination to What?

Section 510(b) states that a claim "shall be subordinated to all claims or interests that are senior to or equal the claim or interest represented by such security, except that if such security is common stock, such claim has the same priority as common stock." If a claim is based on the purchase of common stock, the analysis is straightforward. Pursuant to the plain language of the statute, the common stock claim is subordinated to the level of common stock. This furthers the purpose of section 510(b) to prevent "disappointed equity investors from recovering a portion of their investment in parity with bona fide creditors in a bankruptcy proceeding."[30] However, situations involving securities other than common stock may not be as clear.

1.6.1. Non-Common Stock Equity Interests

For example, in *USA Commercial Mortgage Co.*, a claim asserting damages for fraud and breach of contract arising from the purchase of the debtor's LLC membership interests was subordinated.[31] In determining to what level the LLC membership interests should be subordinated, the court noted that the plain language of section 510(b) and the history of the section support the conclusion that the claim should be subordinated *below* all LLC membership interests, *i.e.*, below equity.[32] The court acknowledged that the effect of its ruling may be

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[30] In re Telegroup Inc., 281 F.3d 133, 135 (3d Cir. 2002).

[31] 377 B.R. 608 (B.A.P. 9th Cir. 2007).

[32] Id. at 618-19 ("Based on the principle of *expressio unius est exclusio alterius* (the express mention of one thing excludes all others), it can be inferred that Congress did not intend for § 510(b) to subordinate claims based on securities other than common stock (i.e., limited partnership interests) to a level on par with those securities. While Congress likely did not specifically have LLC membership interests in mind when enacting either the Bankruptcy Reform Act of 1978 or the Bankruptcy Amendments and Federal Judgeship Act of 1984, this does not change the fact that, under the plain meaning of § 510(b), Appellants' claims would be subordinated below the priority of the Diversified membership interests, not given an equal priority with them.") (footnote and citations omitted).

functionally equivalent to disallowance (*i.e.*, no distribution on the claims).[33] Some commentators have referred to this form of subordination as "super-subordination" and have advocated for a change in the statute that would subordinate claims based on equity interests in the debtor to a level *pari passu* with equity in the debtor, whether those interests are common stock, preferred stock, a membership interest, a limited partnership interest, or any other type of interest in an entity, particularly in light of the fact that alternatives to the traditional corporate business structure are increasingly more common.[34]

Without such a change, consider the following hypothetical.[35] Limited Liability Co is sued by a holder of certain LLC membership interests on account of such interests. The LLC membership interest holder obtains a judgment against Limited Liability Co, and Limited Liability Co files for bankruptcy. Aside from the judgment, Limited Liability Co has very limited outstanding debts and a healthy amount of assets on hand. Based on the court's reasoning in *USA Commercial Mortgage Co.*,[36] the judgment creditor's claim would be subordinated to all other equity interests. Therefore, Limited Liability Co could distribute substantially all of its assets to equityholders, leaving little or nothing for the judgment creditor to recover. The legislative history unfortunately did not contemplate such a scenario. Accordingly, as some commentators have suggested, it may be necessary to amend section 510(b) to bring this Code provision in line with the fact that more and more companies are structured as limited liability companies or limited partnerships.

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[33] Id. at 620.

[34] See Millet, Craig H. et al., Super-Subordination, a Super Problem: A Call to Amend § 510(b), ABI Journal (June 2015).

[35] A variation on this hypothetical was raised by Millet and his co-authors. See id.

[36] 377 B.R. 608 (B.A.P. 9th Cir. 2007).

1.6.2. Securities of an Affiliate of the Debtor

The Second Circuit recently considered which level to subordinate section 510(b) claims on account of securities of an affiliate.[37] The case involved debt securities and debt claims rather than equity claims. Lehman Brothers Inc. ("LBI") was the lead underwriter for unsecured notes issued by its parent company, Lehman Brothers Holdings Inc. ("Lehman Holdings"). Following the bankruptcy of both Lehman Holdings and LBI, the "Junior Underwriters"—comprised of various non-Lehman financial institutions—were held to account for the noteholders' losses. A Master Agreement Among Underwriters (the "Agreement") governed the relationship between LBI and the Junior Underwriters.

One provision of the Agreement created a right of contribution among co-underwriters for losses or liabilities resulting from securities fraud claims arising out of the offerings. Investors in Lehman Holdings notes filed securities fraud lawsuits against the Junior Underwriters, alleging material misstatements and omissions in the offering documents. The Junior Underwriters asserted claims for contribution or reimbursement against the liquidation estate of LBI as lead underwriter of those notes. The SIPA Trustee sought to subordinate the Junior Underwriters' claims to the claims of general unsecured creditors of LBI pursuant to section 510(b).

Both the bankruptcy court and district court agreed that the Junior Underwriters' claims should be subordinated to the claims of LBI's general unsecured creditors, but the courts offered different rationales for reaching this result. The bankruptcy court's analysis hinged on the *type of the claims at issue*—claims for contribution and reimbursement. In particular, the court focused on the level of priority that such claims would have against a debtor in the absence of section

[37] In re Lehman Bros. Inc., 808 F.3d 942 (2d Cir. 2015).

510(b) and ultimately concluded that the Junior Underwriters' claim should be subordinated to the claims of general unsecured creditors. Rather than focus on the type of claim at issue, the district court construed section 510(b) to mandate that the *type of security* dictate the appropriate level of subordination, "whether or not the security represents an actual claim in the debtor's case."[38] The district court explained the distinction:

> Thus, while I reach the same result as the Bankruptcy Court, I do so not by looking at the type of claim asserted, but rather by looking at the type of claim represented by the security. Regardless of the approach, I agree with the Bankruptcy Court and other courts that arising-from claims in the affiliate context must at the very least be subordinated to general unsecured claims to effectuate the purpose of the statute.

The court found that because the securities involved were bonds, and because the bonds were unsecured debt instruments, "the most natural way to read section 510(b) is that the claim 'represented by' such unsecured debt instruments is an unsecured claim. Accordingly, [the district court concluded that the Junior Underwriters' claims are] properly subordinated to claims of unsecured creditors."[39]

In short, the reasoning of the courts was different, albeit slightly, but the result was the same. On appeal, the Second Circuit adopted the district court's construction of section 510(b)—which, as noted, tied the appropriate level of subordination to the priority level of the underlying

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[38] In re Lehman Bros. Inc., 519 B.R. 434, 452 (S.D.N.Y. 2014) (internal citations omitted).

[39] In re Lehman Bros. Inc., 503 B.R. 778, 787 (Bankr. S.D.N.Y.) ("The 'claims …represented by such security" are the claims of the Co–Underwriters for reimbursement and contribution (and not for recovery on account of LBHI securities themselves). The resulting claim would be a general unsecured claim against LBI were it not for the subordination mandate of section 510(b)").

security[40]—and affirmed the district court's decision to subordinate the Junior Underwriters' claims to LBI's general unsecured creditors.[41] The Second Circuit explained:

> [I]n the affiliate securities context, "the claim or interest represented by such security" means a claim or interest of the same type as the affiliate security. Claims arising from securities of a debtor's affiliate should be subordinated in the debtor's bankruptcy proceeding to all claims or interests senior or equal to claims in the bankruptcy proceeding that are of the same type as the underlying securities (generally, secured debt, unsecured debt, common stock, etc.; and in some circumstances potentially a narrower sub-category).[42]

The court noted that existing case law on the subject was inconsistent and outcome-driven,[43] providing "little guidance in determining the appropriate level of subordination."[44] The court also did not elaborate on the distinction, or how application of the two analyses may lead to different results. In so holding, the Second Circuit acknowledged that "[w]hen a bankruptcy court subordinates claims arising out of securities that were issued by the debtor's affiliate, it

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[40]*Id.* at 944.

Id. at 946.

[41] LBI had a single class of general unsecured creditors, which under the liquidation would "consume" the estate. Id. at 951 n.12.

[42] Id. At 946.

[43] To illustrate the divergent approaches courts have adopted in analyzing the proper treatment of claims governed by section 510(b), compare In re Am. Hous. Found., 785 F.3d at 153 (determining the appropriate level of subordination for a claim arising from affiliate-issued securities by examining the underlying security; finding that section 510 "makes clear that claims arising from equity investments in a debtor's affiliate should be treated the same as equity investments in the debtor itself—i.e., both are subordinated to the claims of general creditors") with In re VF Brands, Inc., 275 B.R. 725, 727 (Bankr. D. Del. 2002) (determining the appropriate level of subordination for claim arising from affiliate-issued securities by examining the priority level of the claim against the debtor and concluding that a fraud claim is akin to a general unsecured claim). See also In re Wisconsin Barge Line, Inc., 76 B.R. 142, 143 (Bankr. E.D. Mo. 1987) (holding that claims against a parent corporation arising from purchase of equity in the subsidiary corporation were subject to subordination to the claims of general unsecured creditors but offering no rationale to justify the level of subordination).

[44] Id. at 950 n.10 (citing In re Am. Hous. Found., 785 F.3d 143; In re VF Brands, Inc., 275 B.R. 725 (Bankr. D. Del. 2002); In re Lernout & Hauspie Speech Prods., N.V., 264 B.R. 336 (Bankr. D. Del. 2001); In re Basin Res. Corp., 190 B.R. 824 (Bankr. N.D. Tex. 1996); In re Wis. Barge Line, 76 B.R. 142 (Bankr. E.D. Mo. 1987)).

may become somewhat messy to superimpose the capital structure of the affiliate onto that of the debtor ….”[45]

Notwithstanding these challenges, the Court concluded that the bankruptcy court, as a court of equity "regularly making these types of determinations," was well positioned to ascertain the correct level to which the claims should be subordinated.[46] Moreover, the Court stated that a bankruptcy court was free to add tiers or group claims together into narrower subcategories as necessary when granular distinctions within the affiliate's capital structure may not be mirrored in the debtor's estate's waterfall.[47]

2. Fifth Circuit Decision in In re American Housing Foundation

The Fifth Circuit's recent decision in *In re American Housing Foundation* touched on certain of the foregoing topics and has arguably broadened the scope of section 510(b).[48] American Housing Foundation ("AHF") developed low-incoming housing projects. AHF created various single-purpose limited partnerships ("LPs") to fund these projects. Either AHF or one of its wholly-owned subsidiaries served as the general partner of the LPs. Private investors would

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[45] Id. at 950-51.

[46] Id. at 951.

[47] Id. at 951 ("The bankruptcy court will be guided by the instruction that claims arising from securities of a debtor's affiliate are to be subordinated to all claims or interests senior or equal to claims in the bankruptcy proceeding that are of the same type as the underlying securities (generally, secured debt, unsecured debt, common stock, etc.). The bankruptcy court is well-suited to engage in that kind of classification and discrimination. A court of equity may also determine whether it makes sense to group claims for subordination into narrower sub-categories. When granular distinctions of priority among the affiliate's securities are not mirrored in the debtor's estate, a bankruptcy court may have to add tiers to the waterfall or, in a different case, may have to group multiple levels of priority. Similar choices are made in Chapter 11 reorganizations, in which bankruptcy judges determine whether securities are 'substantially similar' to other securities such that they should be classified together. See 11 U.S.C. § 1122 (providing that a debtor's reorganization plan 'may place a claim or an interest in a particular class only if such claim or interest is substantially similar to the other claims or interests of such class').").

[48] See id.

buy into the LPs and serve as limited partners. AHF guaranteed repayment of those investments.[49]

Robert Templeton invested in various LPs, ultimately investing over $5 million. As described above, AHF or a wholly owned AHF subsidiary served as the general partner and guaranteed Templeton's investment. Templeton served as a limited partner, taking most of the equity in LPs along with the other limited partners. In the subsequent bankruptcy of AHF, Templeton filed proofs of claim for (i) an "unliquidated unsecured claim" asserting fraud and breach of fiduciary duties on account of AHF's former president's actions, as well as (ii) a "liquidated unsecured claim" seeking reimbursement of his investments.

As an initial matter, the bankruptcy court took issue with the structure of the guarantees, noting that the deals frustrated any type of legal analysis. It summarized the deals as follows:

> In each deal, Templeton was a major investor. For the same investment dollars, Templeton received a guaranty from AHF, which, according to Templeton, was a guaranty of repayment of the amount of the investment. Templeton contends that the guaranties are, in effect, unconditional promises to repay by AHF the amount of the investments. But a guaranty is part of a three-party transaction and is a promise to answer for the repayment of a debt. How does a guaranty bootstrap the Templeton investments into something more? Templeton's construction makes the guaranties promissory notes. By the very structure of each of the Templeton deals, AHF received nothing in return for its guaranty. In each instance, AHF is, per the deal, nothing more than a fractional interest holder in the limited partnership into which Templeton's investment dollars were to flow. The structure defies an interpretation that AHF received any consideration for its absolute, unconditional promise to repay Templeton's investment.[50]

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[49] Id. at 145.

[50] In re Am. Hous. Found., 2013 WL 1316723, at *11 (Bankr. N.D. Tex. Mar. 30, 2013) aff'd sub nom. In re Am. Hous. Found., Inc., 2014 WL 1599929 (N.D. Tex. Apr. 11, 2014) aff'd in part, rev'd in part and remanded sub nom. In re Am. Hous. Found., 785 F.3d 143 (5th Cir. 2015), as revised (June 8, 2015).

Indeed, the court determined that the guarantees "do not actually provide that AHF guaranteed the amount of Templeton's investments."[51] The bankruptcy court, noting that it had the power to recharacterize debt as equity, recharacterized the guarantees as equity. The court explained that if the interest sold was an "equity security interest …. the claim falls within the requirements of § 510(b) and must be given the same priority as common equity interests."[52] As such, the court then subordinated Templeton's recharacterized claims (i.e., to equity interests) to those of the general unsecured creditors.

On appeal, the Fifth Circuit court began by considering generally the applicability of section 510(b) in the context of securities issued by an affiliate of the debtor. The court explained:

> The most important policy rationale behind Section 510(b) is that claims seeking to recover a portion of claimants' equity investments should be subordinated. Moreover, Section 510(b) applies whether the securities were issued by the debtor *or by an affiliate of the debtor*. Accordingly, this provision makes clear that claims arising from equity investments in a debtor's affiliate should be treated the same as equity investments in the debtor itself—i.e., both are subordinated to the claims of general creditors.[53]

Next, the court engaged in a step-by-step analysis of section 510(b) as applied to Templeton's claims. The court easily concluded that Templeton's "unliquidated claims"—i.e., those for fraud, breach of fiduciary duties, and money-had-and-received," constituted claims for "damages"[54] that should be subordinated It considered the question of whether Templeton's "liquidated claims" (seeking reimbursement under AFH's guaranties) constituted claims for

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[51] Id.

[52] Id. at *18..

[53] Id. at 153 (emphasis in original) (brackets, internal quotations, and citations omitted).

[54] Id. at 153.

damages to be a more difficult question.[55] The court began by noting that various bankruptcy courts, as noted above, have reasoned that the concept of damages "has the connotation of some recovery *other than* the simple recovery of an unpaid debt due upon an instrument."[56] The court went on to note:

> Yet the situation is different where, as here, the unpaid debt is itself an equity investment. Templeton is not merely seeking recovery under independent promissory notes, but rather under guaranties which the bankruptcy court found to be "intimately intertwined" with the LP agreements. Although Templeton is suing for breach of the guaranties of his LP interests (rather than suing directly for repayment of his equity investments in the LPs), this is exactly the elevation of form over substance that Section 510(b) seeks to avoid—by subordinating claims that functionally seek to recover a portion of claimants' equity investments.[57]

The court therefore concluded that the liquidated claims under the guarantees constituted claims for "damages" under section 510(b), citing to a number of other circuits that found that a claim arising from the purchase or sale of a security can include a claim predicated on post-issuance conduct, including breach of contract claims, which Templeton conceded.[58]

Next, the court determined that the LP interests constituted "securities" given that an "interest of a limited partner in a limited partnership" is expressly included in section 101(49)(A)'s definition of "security."[59] The court also found that the LP interests were securities "of an affiliate" of AHF because the LPs were "operated under … operating agreement[s] by a

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[55] Id. at 154.

[56] Id. at 154 (citing In re Blondheim Real Estate, Inc., 91 B.R. 639, 640 (Bankr. D.N.H. 1988) (holding that claim for recovery on debtor's promissory note should not be subordinated under 510(b)); In re Wyeth Co., 134 B.R. 920, 921–22 (Bankr. W.D. Mo 1991) (reasoning that "the use of the term 'damages' implies more than a simple debt" and holding that debt on promissory notes should not be subordinated)).

[57] Id. (citations omitted).

[58] Id. (citing In re SeaQuest Diving, LP, 579 F.3d 411, 422 (5th Cir. 2009); In re Betacom of Phoenix, Inc., 240 F.3d 823, 831–32 (9th Cir. 2001), In re Telegroup, Inc., 281 F.3d at 141–42, In re Geneva Steel Co., 281 F.3d 1173, 1180–81 (10th Cir. 2002), and In re Med Diversified, Inc., 461 F.3d 251, 256 (2d Cir. 2006)).

[59] 11 U.S.C. § 101(49)(A)(xiii).

debtor."[60] Finally, the court concluded that Templeton's claims "arise from" the purchase of those securities, because there was "some nexus or causal relationship between the claim and the sale."[61] In particular, the court found that the unliquidated tort claims stemmed directly from the LP investments, and therefore a nexus existed. The guaranty claims also had a nexus given that the bankruptcy court found that the guarantees were "intimately intertwined" with the LP agreements.

Based on these findings, the court held that section 510(b) mandated subordination of Templeton's guarantee claims to those of general unsecured creditors.

3. Impact of American Housing Foundation on Statutory Subordination

Some have read *American Housing Foundation* as potentially significantly expanding the scope of mandatory abstention, especially because of the Fifth Circuit's conclusion that claims under a guarantee constitute breach of contract claims that can be subordinated. While that may be true, the facts of *American Housing Foundation* are somewhat unique, involving equity interests in fraudulent limited partnerships that were purportedly guaranteed by an affiliate.

[60] 11 U.S.C. § 101(2)(C). The Fifth Circuit's decision is also noteworthy for its finding with respect to "affiliates." The Fifth Circuit noted that there were two plausible readings of section 101(2)(C)—whether "by a debtor" is meant to modify "operated" or "operating agreement." See 11 U.S.C. § 101(2)(C) ("The term 'affiliate' means—(C) person whose business is operated under [an] operating agreement by a debtor…"). The LPs were undisputedly "operated" by the debtor. However, the court also found that the LP agreements were "operating agreements" by the debtor even when the debtor was not a party to such agreements. The court relied upon the fact that the debtor, through its former president, had complete control over the LPs which were in fact parties to the agreements. The court recognized that this finding was in tension with decisions reached by several bankruptcy courts. 785 F.3d at 157 (citing In re Wash. Mut., Inc., 462 B.R. 137, 146 (Bankr. D. Del. 2011) (holding that "because the agreement in question is between two non-debtors, it cannot provide a basis for subordination under section 101(2)(C)," and rejecting the argument that "mere 'control' of an entity is sufficient to ignore its legal separateness"); In re SemCrude, L.P., 436 B.R. 317, 321 (Bankr. D. Del. 2010) ("[E]ven if the Debtors could show that the partnership agreement is a lease or operating agreement, the agreement is between two non-debtors."); In re Sporting Club at Ill. Ctr., 132 B.R. 792, 797 (Bankr. N.D. Ga. 1991) (determining that entity was not an affiliate of debtor for purposes of venue statute where the debtors were not "parties to any lease or operating agreement"); In re Maruki USA Co., 97 B.R. 166, 169 (Bankr. S.D.N.Y. 1988) (rejecting, for purposes of venue statute, argument that entity was affiliate of debtor where debtor owned 100% of stock of entity's general partner)).

[61] 785 F.3d at 155 (quoting In re SeaQuest Diving LP, 579 F.3d at 421).

Affiliates often guarantee one another's debt, but not their equity. Indeed, the bankruptcy court in *American Housing Foundation* found the notion of a guarantee of equity to be strange. Moreover, the documentation evidencing the investments and guarantees in *American Housing Foundation* were poorly done and, in cases, unclear. That added to the confused nature of the guarantees.

So perhaps *American Housing Foundation* is *sui generis*; a narrow ruling limited to its odd facts. One way to consider the potential ramifications of *American Housing Foundation* is through a hypothetical involving a guarantee of debt, not equity. For example, assume that Parent Co has issued unsecured debt securities that have been guaranteed by Sub Co. Both file bankruptcy, and the noteholders assert guarantee claims against Sub Co. Does section 510(b) apply to subordinate the noteholders' guarantee claims and, if so, to which claims should they be subordinated? The notes unquestionably are securities, and Parent Co and Sub Co unquestionably are affiliates. So at least some of the elements of section 510(b) are satisfied. As noted above, however, many courts have held that a simple claim for nonpayment of a debt security does not give rise to the sort of "damages" contemplated by section 510(b). Accordingly, it would appear that, without more, the guarantee claims should not be subject to subordination.

Or should they? As the Fifth Circuit noted, many courts have held that breach of contract claims arising out of a securities transaction fall within the scope of section 510(b). And the Fifth Circuit held that the guarantees in *American Housing Foundation* were "intimately intertwined" with the securities issued by the limited partnerships. Sub Co's guarantee of Parent Co's debt securities likely was "intimately intertwined" with the debt securities; indeed, the obligations undoubtedly were issued at the same time, part and parcel of the same transaction. But is this enough for the transaction to fall within the scope of section 510(b)? Perhaps not. The securities in *American Housing Foundation* involved equity. Accordingly, the Fifth Circuit focused on the policies against elevating equity claims to debt claims, a focus that is inapplicable in the context of Sub Co's debt guarantee. This key distinguishing feature should take Sub Co's guarantee out of the scope of section 510(b).

Assume, however, that at the time Parent Co issued its debt securities, it was a publicly-reporting company. Assume further that 18 months after issuance of the debt securities, it announced a need to significantly restate its financial statements, including those that had been issued prior to the time of issuance of its debt securities. This announcement leads to a breach of several covenants and representations and warranties under the indenture governing the debt securities. Holders of the notes direct the trustee to issue a letter to Parent Co and Sub Co declaring a default and alleging damages. Parent Co and Sub Co then file bankruptcy. Are the noteholders' claims against Sub Co on account of the guarantee claim "damages" as contemplated by section 510(b)? Does it matter if the noteholders assert they were defrauded and demand rescission?

In theory, these new facts might make the claim against Sub Co under the guarantee subject to subordination. Such a finding could be supported by the Tenth Circuit's decision in In re Geneva Steel Co., where the court subordinated a bondholder's claim that was based on fraudulent inducement to the claims of both bondholders and "general goods and services creditors."[62] But this result begs the question why debt securities should be subject to mandatory

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[62] 281 F.3d 1173, 1180 (10th Cir. 2010) ("[w]e find the risk allocation argument persuasive in this case. Allen's claim, at its essence, accuses [the debtor] of manipulating information concerning his investment. He acquired and held that investment with the belief that its value would increase, though he no doubt recognized that for any number of reasons it might not; indeed, he recognized that it might even lose value. In contrast, a mere creditor of [the debtor] could expect nothing more than to recoup the value of goods or services supplied to the company. Yet *(cont'd)*

subordination. The noteholders of Parent Co did not assume the risks of equity owners; they are not seeking to elevate claims of low priority (equity) to claims of higher priority (debt). They made valid loans. To subordinate the guarantee claims almost seems a penalty.

Indeed, what damages are there beyond the unpaid principal amount of the notes? Shareholders may have quantifiable damage claims when a restatement is announced due to changes in the stock price. But the same cannot necessarily be said of debt securities; the holders of the debt cannot recover more than the unpaid principal and interest. This likely explains why the focus of section 510(b) is on equity securities and efforts by holders of equity to elevate their status to that of debt claim holders. The statute allocates risk in bankruptcy in a manner that reflects the relative risks undertaken by stockholders and creditors. That fundamental purpose does not come into play with debt securities.

Nonetheless, assume that a court finds grounds to subordinate the note holders' guarantee claims against Sub Co. What are they subordinated to? The *Lehman* decisions summarized above suggest different methodological analyses, but the results were the same. Here, the securities constitute unsecured debt, as does the guarantee claim. Accordingly, the guarantee claims should be subordinated to other unsecured creditors of Sub Co. But what if Sub Co has sufficient value to honor the guarantees, at least in part? The noteholders, whose guarantee claims are structurally senior to Parent Co's other creditors, can retain that value ahead of such other creditors. Does section 510(b) contemplate *structural* subordination in such a scenario? The *Lehman* decisions vest bankruptcy courts with fairly broad discretion in subordinating claims. Structural

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now, having watched his investment gamble turn sour, Allen would shift his losses to those same creditors. We think this effort clashes with the legislative policies that section 510(b) purports to advance."

subordination has been urged in other cases,[63] though not to a ruling. Regardless, it seems doubtful that structural subordination could be ordered absent facts sufficient to warrant substantive consolidation.

4. Conclusion

The foregoing hypothetical suggests challenges in subordinating debt securities and related guarantee claims in relatively common transaction structures. Accordingly, the seemingly broad statements in *American Housing Foundation* may be limited to its facts, involving puzzling guarantees of equity investments. So strange were they that the lower courts recharacterized the guarantees as equity. While the Fifth Circuit sidestepped this analysis, it did note that not to mandatorily subordinate the claims would be to elevate the forms of the claims over their substance because they were, in essence, equity.

[63] In re Arcapita Bank B.S.C., Case No. 12-11076 (SHL) (Bankr. S.D.N.Y.).

"Unimpairment" and Payment of Post-Petition Interest on Unsecured Claims

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According to an October 30, 2015 ruling of the bankruptcy court in the Energy Future Holdings Corp., et al. ("EFH")[1] bankruptcy proceedings, an unsecured claim against a solvent debtor may be rendered "unimpaired" under Section 1124(1) of the Bankruptcy Code notwithstanding the fact that the plan will not pay post-petition interest at the contract rate on the creditor's allowed claim. In fact, according to the EFH court, the question whether any post-petition interest should be awarded under Section 1124(1) will be up to the sole discretion of the court even though the same creditor would have a statutory right to interest (i) at least at the federal judgment rate if the claim was impaired under the plan, or (ii) at the contract rate if the claim was rendered "unimpaired" under Section 1124(2) of the Bankruptcy Code.

The decision arose out of an EFH debtor's objection to a proof of claim filed by an indenture trustee in respect of approximately $1.4 billion of PIK notes issued by an intermediate holding company. As of the petition date, $1.65 billion was outstanding in respect of the PIK notes, and because the issuer was solvent, the indenture trustee also sought payment of additional amounts, including post-petition interest at the contract rate, as part of the noteholders' allowed claim.[2]

The bankruptcy court agreed with the debtor that the allowed amount of the noteholder's claim was to be determined without reference to the debtor's financial condition, ruling that Section 502(b)(2) of the Bankruptcy Code flatly prohibited the allowance of unmatured interest

[1] *Energy Future Holdings Corp.*, 540 B.R. 109 (Bankr. Del. 2015). Appeals pending (although cases administratively closed).

[2] The indenture trustee also sought payment of additional amounts, including prepayment penalties, make-whole premiums, call premiums, and pre- and post-petition fees, costs and expenses as part of the noteholders' allowed claim. On the same day that the bankruptcy court issued its ruling on the noteholders' entitlement to post-petition interest, the court also issued a companion opinion denying the noteholders' make-whole premium claim. *Energy Future Holdings Corp.*, 540 B.R. 96 (Bankr. Del. 2015).

as part of an allowed unsecured claim under all circumstances.[3] The court went on to explain however, that while the debtor's financial condition had no bearing on the amount of an unsecured creditor's allowed claim, the issue was relevant to a determination whether a creditor was entitled to receive post-petition interest **on** its allowed claim as a condition to confirmation of a plan of reorganization.

1. Confirming a Plan

The goal of a chapter 11 reorganization is to adjust debts and/or reduce operating expenses in an effort to return a debtor to financial health. In order to do this, the bankruptcy court must first confirm a plan of reorganization addressing the proposed treatment of the claims and interests of the debtor. A plan will organize the claims against, and interests in, a debtor into various classes.[4] Each claim or interest within a given class must be substantially similar to the other claims or interests in such class.[5] The members of each class of claims or interests that will be impaired and receive or retain a distribution under the plan will be provided an opportunity to vote to accept or reject the plan.[6] Members of any class that will not receive or retain any property under a plan will be deemed to have rejected the plan.[7] Members of any class that is not impaired under a plan are conclusively presumed to have accepted the plan.[8]

[3] The court ruled that the noteholders' allowed claim was limited to the $1.65 billion of principal and accrued fees and interest due under the applicable indenture as of the petition date.

[4] 11 U.S.C. §1123(a)(1).

[5] 11 U.S.C. §1122(a).

[6] 11 U.S.C. §1126.

[7] 11 U.S.C. §1126(g).

[8] 11 U.S.C. §1126(f).

The Bankruptcy Code provides that an impaired class of claims has accepted a plan if the holders of two-thirds in amount and a majority in number of the voting creditors in such class have accepted the plan.[9] So long as certain other conditions are met, a plan may be confirmed if each class has either accepted the plan or is not impaired under the plan.[10] Even if one or more classes of claims have rejected the plan, the plan may still be confirmed if, among other things, (i) each holder of a claim or interest that has not accepted the plan will receive or retain property under the plan that is at least as valuable as the property that the holder would receive if the debtor were liquidated under chapter 7 of the Bankruptcy Code,[11] (ii) "the plan does not discriminate unfairly, and is fair and equitable, with respect to each class of claims or interests that is impaired under, and has not accepted the plan,"[12] and (iii) at least one impaired class has accepted the plan (without counting the votes of insiders in such class).[13]

The requirement that each holder of a claim or interest that has not accepted the plan will receive or retain property under the plan that is at least as valuable as the property that the holder would receive if the debtor were liquidated under chapter 7 of the Bankruptcy Code is embodied in Section 1129(a)(7)(A)(ii) of the Bankruptcy Code and is referred to as the "best interest of creditors" test. It applies to any class of impaired claims or interests in which at least one creditor or interest holder has rejected the plan, regardless whether the class as a whole has accepted or rejected the plan.

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[9] 11 U.S.C. §1126(c). A class of interests has accepted the plan if holders of at least two-thirds of the voting interest in such class vote to accept the plan. 11 U.S.C. §1126(d).

[10] 11 U.S.C. §1129(a)(8).

[11] 11 U.S.C. §1129(a)(7).

[12] 11 U.S.C. §1129(b)(1).

[13] 11 U.S.C. §1129(a)(10).

The requirement that the plan must not discriminate unfairly, and must be "fair and equitable," with respect to each class of claims or interests that is impaired under and has not accepted the plan, is embodied in Section 1129(b)(1) and is referred to as the "fair and equitable" test. This test applies only to a class of claims or interests that has rejected a plan.

The requirement that at least one impaired class has accepted that plan (without counting the votes of insiders in such impaired class) is embodied in Section 1129(a)(10) of the Bankruptcy Code. This rule is intended to insure that, notwithstanding compliance with the best interest of creditors test and the fair and equitable test, no plan will be confirmed where every impaired class of claims has voted to reject the plan. While courts will generally provide a plan proponent with latitude to classify substantially similar claims into two or more separate classes where a valid business justification for separate classification exists,[14] a plan proponent may not separately classify substantially similar claims into two or more separate classes where the purpose is to gerrymander votes to facilitate confirmation of a plan.[15] In those rare cases where the debtor is solvent, a plan proponent may disenfranchise a class of disgruntled unsecured noteholders by rendering the class unimpaired under Section 1124(1) of the Bankruptcy Code

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[14] Examples of valid business justifications are to provide different forms of consideration to each class, *see In re Greate Bay Hotel & Casino, Inc*., 251 B.R. 213 (Bankr. D. N.J. 2000) (cash for general unsecured claims; financial instruments for bondholders), or in recognition of the unique attributes of various claims, *see Teamsters Nat'l Freight Indus. Negotiating Comm. v. U.S. Truck Co., Inc. (In re U.S. Truck Co., Inc.)*, 800 F.2d 581 (6th Cir. 1986) (separately classifying employee/labor claims from other unsecured claims).

[15] *In re Village Green I, GP*, 811 F.3d 816 (6th Cir. 2016)(finding that a plan was not proposed in good faith where debtor sought to artificially impair claims of former lawyer and accountant in order to gerrymander impaired accepting class); *In re Boston Post Road Ltd. P'ship*, 21 F.3d 477 (2d Cir. 1994), *cert. denied*, 513 U.S. 1109 (1995) (prohibiting a debtor from separately classifying the unsecured deficiency claim of the FDIC from the unsecured claims of trade creditors where the purpose of the separate classification was to enable the debtor to gerrymander an impaired accepting class of creditors); *Phoenix Mutual Life Ins. Co. v. Greystone III Joint Venture (In re Greystone III Joint Venture)*, 995 F.2d 1274 (5th Cir. 1992), *cert. denied*, 506 U.S. 821 (1992) (emphasizing a "clear rule" that a debtor cannot separately classify similar claims to gerrymander an affirmative vote where there are no "good business reasons"); *In re Sentry Operating Co. of Texas, Inc.*, 264 B.R. 850 (Bankr. S.D. Tex. 2001) (separate classification impermissible because the purpose of gerrymandering was being materially served).

(and conclusively presumed to have accepted the plan pursuant to Section 1126(f) of the Bankruptcy Code). According to the EFH court, in such case, the debtor's shareholders may be able to retain their ownership stake in the debtor without paying post-petition interest to the "unimpaired" noteholders at the contractual rate, or perhaps without paying any interest at all.

2. Post-Petition Interest on Unsecured Claims

There are four instances where an unsecured creditor may be entitled to receive post-petition interest on its allowed claim as a condition to confirmation of a plan: (i) under the "best interest test" when a debtor is solvent and a class of claims has accepted a plan but at least one creditor in the class has rejected the plan; (ii) under the "fair and equitable" test when a debtor is solvent and an impaired class has rejected the plan; (iii) when a class of claims has been rendered "unimpaired" under Section 1124(1) of the Bankruptcy Code; and (iv) when a class of claims has been rendered "unimpaired" under Section 1124(2) of the Bankruptcy Code.

2.1. Best Interest Test

The "best interest" test of Section 1129(a)(7)(A)(ii) of the Bankruptcy Code provides that any impaired creditor that rejects a plan must receive under the plan at least as much as such creditor would receive if the debtor were liquidated under chapter 7.[16] Section 726(a) of the Bankruptcy Code provides a waterfall of distribution priorities in a chapter 7 liquidation. Each higher priority claim in the waterfall must be paid in full before any value can be distributed to a lower priority claim. Payment of the allowed amount of general unsecured claims (other than non-compensatory penalty claims), proof of which have been timely filed, is the second level of priority in a chapter 7 liquidation. Only after the allowed amount of such claims have been paid

[16] Because Section 1123(a)(4) of the Bankruptcy Code provides that all creditors in a given class must receive the same treatment, the "best interest" test will apply to all creditors in an impaired class (including those creditors that have accepted the plan) so long as one or more creditors in the class have rejected the plan, and regardless whether the impaired class as a whole has accepted or rejected the plan.

in full may distributions be made in respect to claims that are junior in priority in the waterfall. The fifth level of priority under Section 726(a) is the payment of interest at the legal rate on allowed unsecured claims. If any value remains after payment of interest at the legal rate on the first four levels of claims under the Section 726 waterfall, such value will be returned to the debtor.

The Bankruptcy Code does not define the phrase "interest at the legal rate" for purposes of determining the appropriate rate of interest to be applied to the first four levels of priority in the Section 726(a) waterfall. In the EFH case, Judge Sontchi adopted the findings of Judge Walrath in *In re Washington Mutual, Inc.*, 400 B.R. 200, 243 (Bankr. Del. 2011), and Judge Spector in *In re Dow Corning Corporation*, 237 B.R. 380 (Bankr. E.D. Mich. 1999) ("*Dow I*") and concluded that the term "interest at the legal rate" referred to the Federal Judgment Rate. Therefore, the EFH court concluded that in order for a solvent debtor's plan to be confirmed where one or more creditors in an impaired class votes to reject the plan, the plan must provide all creditors in the class with a distribution of a value that is at least equivalent to the allowed amount of their claims together with post-petition interest at the Federal Judgment Rate.[17]

2.2. Fair and Equitable Test

Section 1129(b)(1) of the Bankruptcy Code provides certain parameters under which a plan proponent may confirm a plan that has been rejected by one or more classes of claim or interests. This section provides that a plan may be "crammed down" on an impaired class that

[17] The EFH court did not address the question of the appropriate date for determining the Federal Judgment Rate, but the *Washington Mutual* court concluded that the appropriate date for determination was the petition date. *Washington Mutual*, 400 B.R. at 246. This determination was based upon a finding that the reference to payment of the "legal rate ***from the date of the filing of the petition***" in Section 726(a)(5) suggested that the petition date was the appropriate date for determining the Federal Judgment Rate to be applied. However, one could reasonably argue that the reference to the petition date in Section 726(a)(5) is intended to describe only the time period covered and provides no guidance as to the appropriate date for determining the applicable rate to apply during the time period.

has rejected the plan if all conditions to confirmation have been met other than the acceptance of the plan by each impaired class, and so long as the plan does not "discriminate unfairly and is fair and equitable" with respect to each rejecting class. The phrase "fair and equitable" is not defined in the Bankruptcy Code, but in the case of a class of unsecured claims that has rejected the plan, the phrase requires that the plan at least provide (i) that each holder in such class receive or retain property of a value equal to the allowed amount of such claim, or (ii) that no holder in any junior class will receive or retain any property in respect of such junior claim or interest. At first blush clause (i) would seem to indicate that where an impaired class has rejected a plan, the creditors in such class need only receive payment of their allowed claim as a condition to the receipt or retention of value by a junior class. However, because the "best interest" test applies to any class in which at least one creditor has rejected the plan, it is axiomatic that creditors in a rejecting class of claims against a solvent debtor are entitled to receive post-petition interest on their allowed claims at least at the Federal Judgment Rate as required by Section 726(a)(5) of the Bankruptcy Code.

Moreover, the EFH court concluded, like the Sixth Circuit in *In re Dow Corning Corp.*, 456 F.3d 668 (6th Cir. 2006) ("*Dow III*"), that the "fair and equitable" requirement of Section 1129(b)(2) authorizes bankruptcy courts to require a debtor to pay post-petition interest at a rate greater than the Federal Judgment Rate if the equities of the case so require. However, the EFH court departed from the Sixth Circuit's determination that the fair and equitable standard created a presumption that post-petition interest should be paid at the contract rate where a class of impaired unsecured claims has rejected a plan of a solvent debtor.[18]

[18] *Energy Future Holdings Corp*., 549 B.R. at 117 (citing *Dow III*, 456 F.3d at 679 ("[w]hen a debtor is solvent, the presumption is that a bankruptcy court's role is merely to enforce the contractual rights of the parties, and the role that equitable principals play in the allocation of competing interest is significantly reduced.")).

It is interesting to consider that in Judge Sontchi's view, the fact that the debtor's equity interests were held by an insolvent intermediate holding company rather than by the ultimate equity holders of EFH militated against the granting of interest at the contract rate to the rejecting class of unsecured noteholders. Judge Sontchi pointed out that the bankruptcy court in *In re Dow Corning Corp.*, 244 B.R. 678 (Bankr. E.D. Mich. 1999) ("*Dow II*") had noted that bankruptcy courts may use their discretion when deciding whether to award post-petition interest when "such payments may mean a *pro tanto* reduction in the payment of principal owed to lower-priority creditors."[19] It is not entirely clear, however, that the *Dow II* court would have approved of this principal extending beyond junior creditors of the applicable debtor to structurally subordinated creditors whose claims were against the equity owner of the applicable debtor merely because the equity holder was not the ultimate owner the debtor-enterprise and because the equity owner happened to be subject to an administratively consolidated proceeding with the applicable debtor.

2.3. Unimpairment

The EFH court next noted that notwithstanding compliance with the "fair and equitable" requirements of Section 1129(b)(2)(B)(i) of the Bankruptcy Code with respect to an objecting class of unsecured claims, a debtor might yet be unable to confirm a plan where the objecting class of unsecured claims was the only impaired class under the plan. This is because the Bankruptcy Code provides that if one or more classes of claims is impaired under a plan, at least one class of impaired claims must have accepted the plan (without counting the votes of any insiders in such class)[20]. The court suggested that in situations where a solvent debtor has been

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[19] *Id.* (citing *Dow II*, 244 B.R. at 691).

[20] 11 U.S.C. § 1129(a)(10).

frustrated in its attempts to confirm a plan due to the rejection of the plan by the sole class of impaired creditors, the debtor might still be able to confirm the plan by disenfranchising the intransigent class of creditors by rendering the class technically unimpaired pursuant to Section 1124 of the Bankruptcy Code.

Section 1124 of the Bankruptcy Code describes two alternatives for rendering a class of claims unimpaired and conclusively presumed to have accepted a plan pursuant to Section 1126(f) of the Bankruptcy Code. Under Section 1124(1), a class of claims will be deemed unimpaired if the plan does not alter the legal, equitable and contractual rights of each claim in the class. Under Section 1124(2), a debtor may render a class of claims unimpaired by curing all monetary defaults, compensating the creditors for any pecuniary loss resulting from incurable defaults, and reinstating the applicable claims in the class according to their contractual terms.

The EFH court noted that "impairment" was "a term of art" under the Bankruptcy Code that determines a creditor's standing to vote on a plan and ability to raise various arguments during the confirmation phase of a bankruptcy proceeding.[21] Section 1124(1) of the Bankruptcy Code provides that a class of claims will be impaired under a plan unless the **plan leaves unaltered** "the legal, equitable, and contractual rights" of the holders of each claim in the class. If **the plan** does not alter the "legal, equitable and contractual rights" of the creditors in a given class, each holder of a claim in the class will be conclusively presumed to have accepted the plan. In parsing the language of the Section 1124(1), the EFH court drew heavily on *In re PPI Enterprises (U.S.), Inc.,* 324 F.3d 197, 202-203 (3d Cir. 2003), which distinguished between the impairment of a claim under a plan (which renders a class impaired and entitled to vote on the plan) and the statutory impairment of a claim by virtue of a provision of the Bankruptcy Code or

[21] *Id*. at 119.

other applicable law (which does not render the claim impaired for purposes of Section 1124(1) of the Bankruptcy Code).

At issue in *PPI* was the treatment that was required to be provided in respect of a landlord's rejection damage claim in order to render the claim unimpaired for purposes of Section 1124(1) of the Bankruptcy Code. The *PPI* plan separately classified a landlord's rejection damage claim and proposed to pay the landlord's allowed claim in full subject to the cap on rejection damages specified in Section 502(b)(6) of the Bankruptcy Code. The court ruled that the landlord's claim was "unimpaired" for purposes of Section 1124(1) of the Bankruptcy Code because the claim had been modified by the statutory provisions of the Bankruptcy Code and not by the contractual provisions of the plan.[22]

Judge Sontchi concluded that the same analysis applied to the statutory impairment of the landlord's claim in the *PPI* case should extend to the statutory prohibition against the unsecured noteholders' claim for post-petition interest under Section 502(b)(2) of the Bankruptcy Code. Thus, the EFH court ruled that the denial of a financial creditor's claim for contractual interest during the post-petition period did not render the creditor's claim "impaired" for purposes of Section 1124(1) of the Bankruptcy Code because the impairment resulted from the application of bankruptcy code and not by virtue of the provisions of the plan.

In determining that a debtor did not have a legal obligation to pay post-petition interest (regardless of the debtor's financial condition) in order to render an unsecured claim unimpaired for purposes of Section 1124(1) of the Bankruptcy Code, Judge Sontchi noted the seemingly

[22] The *PPI* court had adopted the analysis used in *In re American Solar King Corp.,* 90 B.R. 808 (Bankr. W.D. Tex. 1988), which held that a claim that was subordinated pursuant to Section 510(b) of the Bankruptcy Code was impaired by virtue of the statute and not by the debtor's plan, and thus the claim was "unimpaired" for purposes of Section 1124 of the Bankruptcy Code and the holder of the claim was not entitled to vote on the plan.

incongruous fact that the same debtor would have had the legal obligation to at least pay post-petition interest at the legal rate on the same claim had the debtor been solvent and the claim classified as impaired under the plan. The court also acknowledged that the Bankruptcy Code had been amended in 1994 to remove Section 1124(3), which had specifically provided that a debtor could render an unsecured class of claims unimpaired by paying the allowed claims in such class in full. Rather than viewing the removal of Section 1124(3) of the Bankruptcy Code as evidence of Congress' intention to require a debtor to pay post-petition interest at the rate specified in the applicable agreement in order to render a claim unimpaired, the court concluded that the removal of Section 1124(3) merely served to enable the bankruptcy courts to exercise their discretion to award interest on an unimpaired claim as a matter of equity (i.e. to insure that the plan does not alter the creditor's "legal, *equitable*, and contractual rights"). Thus, while impaired creditors of a solvent debtor in a class that has not unanimously voted to accept a plan have a legal entitlement to receive post-petition interest at least at the Federal Judgment Rate,[23] where such claims are classified as unimpaired, the question whether creditors will be entitled to receive post-petition interest will be left entirely to the discretion of the court.

According to the EFH court, in order for a plan proponent to insure that its plan provides appropriate treatment to non-voting creditors in unimpaired classes of unsecured claims, the plan need only provide for payment of the "allowed amount of the claims, plus post-petition interest at an appropriate rate if the court, in its discretion, determines to award interest on such allowed amount under its equitable power."

[23] As noted, the "best interest" test of Section 1129(a)(7) is applicable to any class of impaired claims where at least one creditor has rejected the plan (regardless of whether the class as a whole has accepted or rejected the plan) and requires, through reference to Section 726(a)(5) of the Bankruptcy Code, that creditors receive interest at the legal rate on their allowed claims where the debtor is solvent.

The EFH ruling on the treatment of unimpaired claims raises some interesting questions. For example, the ruling does not address why it is equitable to deny a creditor post-petition interest at its contractual rate under section 1124(1), where the same creditor would be entitled to receive a post-petition interest cure at the applicable contract rate if the debtor chose to reinstate the claim under Section 1124(2) of the Bankruptcy Code.[24] Further, because a debtor need not be solvent in order to utilize Section 1124 of the Bankruptcy Code to render a claim unimpaired, the case raises the question whether courts should routinely decline to award post-petition interest in respect of an unimpaired unsecured claim where the debtor is insolvent and such award would naturally result in a *pro tanto* reduction in the payment of other claims. Conversely, the case does not address why in the case of a solvent debtor a court should not regularly award interest at the contract rate to a creditor that has been disenfranchised by a debtor seeking to avoid the statutory prescriptions of Section 1129(a)(10) of the Bankruptcy Code by rendering the creditor "unimpaired" pursuant to Section 1124(1) of the Bankruptcy Code in an effort to confirm a plan and enhance the recovery of existing equity.

3. Conclusion

The EFH court ruled that Section 502(b)(2) of the Bankruptcy Code serves to exclude post-petition interest from being a component of an allowed unsecured claim under all circumstances. However, the court went on to explain that there are four situations under which an unsecured creditor may be entitled to receive post-petition interest ***on*** its allowed unsecured claim as a condition to confirmation of a plan of reorganization. The four instances where an unsecured creditor may be entitled to interest on its allowed claim under a plan are (i) under Section 1129(a)(7) of the Bankruptcy Code where the debtor is solvent and each holder in an

[24] *In re Moody Nat. SHS Houston H, LLC*, 426 B.R. 667 (Bankr. S.D. Tex. 2010).

accepting class of unsecured claims has not voted in favor of the plan (in which case each holder of a claim in the class will be entitled to receive post-petition interest at the "legal rate" on its allowed claim); (ii) under Section 1129(b)(2)(B)(i) where the debtor is solvent and the applicable class of unsecured claims has rejected the plan (in which case each holder of a claim in the class will be entitled to receive post-petition interest at least at the "legal rate" on its allowed claim (and may receive a higher rate if the court is persuaded that the equities so require)); (iii) where the class has been disenfranchised and rendered unimpaired under Section 1124(1) regardless of whether the debtor is solvent (in which case each holder of a claim in the class will be entitled to receive post-petition interest on its allowed claim only if the court is persuaded that the equities of the case so require); and (iv) where the class has been disenfranchised and rendered unimpaired under Section 1124(2) regardless of whether the debtor is solvent (in which case each holder of a claim in the class will be entitled to receive post-petition interest on its allowed claim at the applicable contract rate specified in the agreement).

As previously noted, in the view of the EFH court there appears to be no circumstance (other than a reinstatement of an unsecured claim pursuant to Section 1124(2) of the Bankruptcy Code) under which an unsecured creditor has a legal right, or even the benefit of a presumption of an entitlement, to payment of post-petition interest at the applicable contract rate. Holders in impaired classes in which as least one creditor has rejected the plan will be entitled to receive post-petition interest at the Federal Judgment Rate where the applicable debtor is solvent, and may, at the court's discretion, be entitled to receive post-petition interest at a greater rate if their class has rejected the plan. At the same time, creditors who have been disenfranchised through the rendering of their claims as unimpaired in accordance with Section 1124(1) of the Bankruptcy Code will be entitled to receive post-petition interest on their allowed claims only if and to the extent that the court determines that the equities support an award of post-petition interest.

While the EFH decision provides a sound analysis on the issue of an unsecured creditor's entitlement to post-petition interest, one may take issue with the court's reluctance to grant a presumption that interest be awarded at the contract rate where an impaired class has rejected a plan posed by a solvent debtor (even in instances where the debtor's equity is held by a co-debtor) and particularly in instances where the creditors have been disenfranchised (and have thus been denied the protections of Section 1129(a)(10) of the Bankruptcy Code) and rendered unimpaired under Section 1124(1) of the Bankruptcy Code.

Avoiding Bankruptcy Priority Rules at Trial and on Appeal: Cramdown, Gifting, Structured Dismissals and Equitable Mootness

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The Bankruptcy Code incorporates a series of interconnected provisions that establish priorities and govern the order in which assets of an estate are distributed to satisfy claims in cases under the Code. These provisions, including sections 503, 506, 507, 726 and 1129, reflect public policy and legislative determinations that certain categories of claims, such as administrative, tax, wage or domestic support claims should be given priority and paid in full before payments are made to other unsecured claims, and that unsecured claims should be paid in full (including penalties and interest) before equity receives a recovery. While the Bankruptcy Code permits creditors to consent to different, non-priority treatment for their claims and likewise will enforce pre-petition subordination agreements that may differ from statutory payment priorities, these rules and particularly the absolute priority rule that is incorporated into the requirements for confirming a plan over the objection of a dissenting class pursuant to section 1129(b), generally ensure that the priorities accorded to non-consenting classes/creditors will be respected as part of the regular claims distribution process.

What happens, then, when assets or the value thereof are distributed outside the regular procedures outlined in the Bankruptcy Code? Recent circuit level cases have considered ways in which parties have sought to avoid the Bankruptcy Code's priorities, including the absolute priority rule and the cram-down requirements through gifting, structured dismissals or other settlement mechanisms, and then sought to protect those results by arguing that any appeal should be dismissed as equitably moot. These cases indicate that in appropriate circumstances, courts will permit parties in interest to use settlements to work around the Bankruptcy Code's priority scheme, even when such settlements favor lower priority creditors or leave out one or more constituencies, if there is an argument that the property being distributed does not belong to the estate and/or the alternatives provided under the Bankruptcy Code—dismissal or conversion—would produce even less attractive results.

That being said, recent Third Circuit cases may signal some tightening of the circumstances in which appellate courts in that circuit will dismiss as equitably moot appeals from bankruptcy court confirmation orders, although it remains unclear whether that court will ever permit that doctrine to apply outside the context of an appeal from a confirmation order. And, while it is clear that appellate courts favor merits review and, where possible, finding a way to provide meaningful relief rather than simply claiming, *ipse dixit*, that all the King's horses and all the King's men couldn't put Humpty together again, the doctrine of equitable mootness remains an important tool to protect third-parties who rely on the finality of bankruptcy court orders and prevent recalcitrant creditors from using their position to hold up the process.

1. Cramdown, Gifting and the Absolute Priority Rule

Cramdown is the Bankruptcy Code's mechanism, under section 1129(b), to confirm a chapter 11 plan notwithstanding that one class of impaired creditors votes against confirmation. To confirm a plan using the section 1129(b) cramdown procedures, a debtor must demonstrate that the plan is "fair and equitable" with respect to each class that is impaired under and has not accepted the plan. To be fair and equitable with respect to an unsecured class, the plan must provide that each creditor in that class receive or retain property equal to the allowed amount of its claim or that holders of claims or interests junior to the dissenting class not receive any recovery on account of such junior claims or interests. *See* 11 U.S.C. § 1129(b)(2)(B).

The absolute priority rule arises out of the "fixed principle for reorganizations: that all creditors were entitled to be paid before the stockholders could retain [shares] for any purpose whatever. [Thus a] plan of reorganization …would not be fair and equitable which admitted the stockholders to participation unless at very least the stockholders made a fresh contribution in money or in money's worth in return for a participation reasonably equivalent to their contribution." *In re DBSD N. Am., Inc.*, 634 F.3d 79, 94 (2d Cir. 2011) (internal citation omitted) (*quoting e.g., Northern Pacific Ry. Co. v. Boyd*, 228 U.S. 482, 507-08 (1913); *Marine Harbor Props., Inc., v. Mfrs. Trust Co*., 317 U.S. 78, 85 (1942).

Gifting is a mechanism by which a more senior creditor agrees to give up a portion of its own recovery to other, usually junior, classes of creditors or equity holders in order to resolve pending or threatened litigation and thereby smooth the way for consummation of a proposed transaction or plan. In the typical gifting scenario, the "gift" skips over one or more priority classes and is paid to a junior class of creditors or even to equity. In *In re SPM Mfg. Corp*., 984 F.2d 1305, 1312-14 (1st Cir. 1993), the First Circuit approved a settlement between the debtor's senior secured and unsecured creditors which, post conversion from chapter 11 to chapter 7, allocated a portion of the proceeds from the liquidation of the secured creditor's collateral to unsecured creditors, skipping over the debtor's intermediate priority creditors. The *SPM* model subsequently was expanded and used by parties to confirm chapter 11 plans that provided for "gifts" carved out of a senior class's estate distribution to a junior class, notwithstanding the absolute priority rule. *See, e.g., In re MCorp Fin., Inc*., 160 B.R. 941, 960 (S.D. Tex. 1993); *In re Genesis Health Ventures, Inc*., 266 B.R. 591, 611-12 (Bankr. D. Del. 2001); *In re Worldcom, Inc*., 2003 WL 23861928, at *60 (Bankr. S.D.N.Y. Oct. 31. 2003).

More recently, the Third Circuit's decision in *In re Armstrong World Indus., Inc.*, 432 F.3d 507, 516-18 (3d Cir. 2005), followed by the Second Circuit's holding in *Dish Network Corp. v. DBSD N. Am., Inc. ,* 634 F.3d 79, 99-100 (2d Cir. 2011), have made it clear that "gifts" may not be used to avoid the absolute priority rule in the context of a chapter 11 plan of reorganization or liquidation, at least with respect to property of the estate. Indeed, in each of those cases, the circuit courts specifically rejected attempts by senior creditors to "gift" a portion of their distribution of estate property to junior creditors/equity pursuant to a chapter 11 plan while skipping over impaired, dissenting intermediate classes. The courts distinguished *SPM*, among other things, on the ground that SPM was a chapter 7 case, so the absolute priority rule did not apply, and in any case, the stay already had been lifted, so the property being distributed actually belonged to the senior creditor, not the estate. By contrast, the absolute priority rule of 1129(b)(2)(B) applies to "any property" of the estate distributed through a plan, whether or not such property otherwise was subject to a lien. *See, e.g.*, *DBSD*, 634 F.3d at 98-99.

Do these rules apply to permit gifting outside the plan context? In *TMT Trailer Ferry, Inc. v. Anderson*, 390 U.S. 414, 424 (1968), the Supreme Court held that a settlement presented for approval in connection with the confirmation of a plan must be "fair and equitable" and thus comply with the absolute priority rule. In *Matter of AWECO, Inc.,* 725 F.2d 293, 298 (5th Cir. 1984), the Fifth Circuit expanded *TMT*, holding that the absolute priority rule applies to settlements submitted outside the confines of a plan. Other courts have rejected this approach, however, finding it to be too rigid. For example, the Second Circuit in *In re Iridium Operating LLC*, 478 F.3d 452, 464-65 (2d Cir. 2007) held that "whether a settlement's distribution plan complies with the Bankruptcy Code's priority scheme will often be the dispositive factor…. where the remaining factors weigh heavily in favor of approving a settlement, the bankruptcy court, in its discretion, could endorse a settlement that does not comply in some minor respects with the priority rule if the parties to the settlement justify, and the reviewing court clearly articulates the reasons for approving, a settlement that deviates from the priority rule."

As noted above, by its terms, the absolute priority rule does not apply to liquidations under chapter 7, and the distribution scheme of chapter 7 does not apply until all valid liens on property are satisfied. For this reason, gifting has been permitted in cases under chapter 7. *See, e.g., SPM*, 984 F.2d at 1305.

Since *Armstrong*, Bankruptcy Courts in the Third Circuit have approved settlements in which the senior secured creditor agrees to make a gift of the secured creditor's property to one or more junior creditors to eliminate objections to 363 sale transactions without paying parties with higher priority claims or interests. *See, e.g*., *In re World Health Alts., Inc*., 344 B.R. 291, 296-301 (Bankr. D. Del. 2006) (approving settlement that provided for carve out of portion of secured creditor's collateral in exchange for waiver of committee's objection to 363 sale); *In re TSIC, Inc*., 393 B.R. 71, 75-76 (Bankr. D. Del. 2008) (approving settlement by which secured creditor agreed to fund trust for benefit of unsecured creditors in exchange for committee's waiver of objections to 363 sale). In each of these cases, the court found that the absolute priority rule was not implicated by the transaction because the secured creditor's "gift" was not being distributed in connection with a chapter 11 plan and, in any case, because the court found that the gift was not being funded directly by estate property or by property to which the estate would have access, but rather by property belonging to the gifting creditor. Under the circumstances, the mere fact that the parties' agreement resulted in payment of creditors outside the Bankruptcy Code's regular order of priority did not, by itself, prohibit approval of the settlement given that the settlement otherwise satisfied the other requirements for approval.

Likewise, in *In re Journal Register Co.,* 407 B.R. 520 (Bankr. S.D.N.Y. 2009), the Bankruptcy Court for the Southern District of New York confirmed a plan that provided for an extra payment to only one class of unsecured creditors, to be funded by the debtor's secured creditor out of its own property. The court found that the payment did not violate the absolute priority rule because it was not being made with estate property, and was not being paid for an improper purpose. *Id*. at 533-534.

Recently, in *In re ICL Holding Co., Inc.,* 802 F.3d 547, 555-558 (3d Cir. 2015), the Third Circuit held that the Bankruptcy Code's priority schemes are not implicated by gifts made in the sale context, at least when those gifts can be construed as being derived from non-estate property. In that case, the debtors sought to sell substantially all of their assets, including all of their cash, pursuant to a court supervised auction under section 363 of the Bankruptcy Code. Despite significant marketing efforts, the best offer the debtors received was a credit bid for less than the full amount of the secured creditor's claim, plus the buyer's agreement to use a portion of the assets it purchased from the debtors to fund a cash escrow to pay professional fees and certain wind-down expenses but no other administrative claims. Objections to the sale were asserted by the Official Committee of Unsecured Creditors (the "Committee") and the United States Government, the latter in respect of an administrative capital gains tax claim that would arise from the sale but not be paid. The buyer ultimately settled the Committee's objection by agreeing to pay $3.5 million in cash directly to unsecured creditors, but did not agree to pay anything in respect of other creditors, including the Government.

On appeal, the Third Circuit affirmed the Bankruptcy Court's decision to approve the sale and the settlement with the Committee. 802 F.3d at 557-558. It based this decision solely on its finding that the money used to fund the various escrows was not property of the estate. As such, even if the Bankruptcy Court's priority rules applied to 363 sales, an issue it specifically left open, the Third Circuit found that those rules would not be implicated in the case because the "gifts" at issue were not paid with property of the debtors' estates. *Id*.

2. Structured Dismissals

Chapter 11 cases generally end with the confirmation of a plan, which, as noted above, must comply with the Bankruptcy Code's priority scheme unless parties in interest agree to alternative treatment of their claims. When confirmation of a plan is not possible, such as when the debtor cannot achieve a consensus among its various creditor constituencies or the business cannot be rehabilitated, the debtor or parties in interest may seek to convert the case to a liquidation under chapter 7 or to dismiss the case altogether for cause. *See* 11 U.S.C. § 1112.

Traditionally, dismissal results in a rewind, vacating orders entered during the case, reinstating transfers or liens that had been avoided during the case and, subject to any sale orders entered pursuant to section 363, re-vesting property of the estate with the entity that owned it immediately before the case commenced. *See* 11 U.S.C. § 349(b). This type of hard reset may not be desirable, particularly if it the result is post-dismissal litigation. Section 349(b) thus permits the bankruptcy court to fashion a dismissal order that does not simply act as a full reset. *See* 11 U.S.C. § 349(b) ("Unless the court, for cause, orders otherwise.").

Recently, parties have sought to use structured dismissals presented as a settlement under Fed. R. Bankr. P. 9019 as another way out of chapter 11. *See, e.g.*, *In re Buffet Partners, L.P.,* 2014 WL 3735804, at *4 (Bankr. N.D. Tex. July 28, 2014) (approving structured dismissal); *In re Naartjie Custom Kids, Inc*., 534 B.R. 416, 425-27 (Bankr. D. Utah 2015) (same); *In re Petersburg Regency LLC*, 540 B.R. 508, 537 (Bankr. D.N.J. 2015) (same); *In re Levitz Home Furnishings, Inc*., No. 05-45189 (BRL) (Bankr. S.D.N.Y. Nov. 2, 2007) (dkt. # 1138) (same); *In re Magnolia Energy, L.P*., No. 06-11069 (MFW) (Bankr. D. Del. Feb. 12, 2007) (dkt. # 196) (same). Structured dismissals typically incorporate some of the protections of a plan and confirmation order without the expense associated therewith. In such cases, orders entered during the case are not necessarily vacated and the Bankruptcy Court may provide in the dismissal order for the distribution of certain assets and for the release of various claims. Courts assessing the propriety of such settlements often consider whether they are being proposed on a consensual basis, by all parties with an economic stake in the case, and satisfy other important Bankruptcy Code requirements such as disclosure and compliance with statutory priorities. *Compare Buffet Partners*, 2014 WL 3735804, at *3-4 (approving structured dismissal); *with In re Biolitec*, 528 B.R. 261, 269-272 (Bankr. D.N.J. 2014) (denying approval of structured dismissal).

Although structured dismissals have been entered in many types of cases, they are most commonly seen in cases in which the sale of substantially all of the debtor's assets occurs through a credit bid and there is not sufficient cash to pay administrative claims, much less a recovery for unsecured or priority creditors. *See supra*. In such cases, the buyer/secured lender may nevertheless seek to resolve challenges to the sale or other litigation issues with the official committee of unsecured creditors, and may also be willing to contribute some monies to fund payments to estate professionals, and to wind down the estate in exchange for a release or other protection from suit.

In *In re Jevic Holding Corp.,* 787 F.3d 173, 181-82 (3d Cir. 2015), *petition for cert. filed*, Case No. 15-649 (U.S. Nov. 16, 2015), the Third Circuit considered whether a Bankruptcy Court has authority to enter a structured dismissal under any circumstances and if so, whether a structured dismissal that is not fully consensual and does not comply with Bankruptcy Code priorities can ever be permissible.

The structured dismissal in *Jevic* arose out of the settlement of post-petition litigation. The debtor, a trucking company, had filed bankruptcy two years after being acquired by Sun Capital Partners ("Sun") in a leveraged buyout. The debtor ceased substantially all of its operations and terminated its employees the day before it filed chapter 11. Post-petition, a class of Jevic's former drivers (the "Drivers") filed an action against the debtor and its parent alleging violations of the federal and state Worker Adjustment and Retraining Notification (WARN) Acts. The official committee of Jevic's unsecured creditors (the "Committee") sued Jevic's secured lender and Sun to avoid the leveraged buyout of Jevic as a fraudulent conveyance or preference. The Drivers' litigation, if successful, would have resulted in a priority claim against the estate.

Three years later, substantially all of Jevic's property was liquidated, and the only remaining matters to be resolved were the disposition of the two litigation claims and \$1.7 million in cash held subject to Sun's lien, but there was no unencumbered cash available to pay administrative claims or to fund further litigation by the Committee or a plan. After discussions among the parties, the debtor, the Committee, Sun and the secured lender agreed to dismiss the chapter 11 case and exchange releases, in exchange for which the lender and Sun agreed to fund certain payments for professional fees, administrative expenses, tax and unsecured creditors. The settlement did not, however, provide any recovery in respect of the Drivers' priority WARN Act claims, so the Drivers and the United States Trustee objected to the settlement, arguing that the Bankruptcy Code does not permit a structured settlement under any circumstances, much less one that distributed estate property contrary to section 507 and the Bankruptcy Code's other priority provisions.

The Bankruptcy Court disagreed, finding that the circumstances warranted approval of the parties' settlement. It found there was no prospect for a confirmable chapter 11 plan, conversion would not be helpful as there was no unencumbered cash to fund the activities of a chapter 7 trustee, and that settlements need not comply with the Bankruptcy Code's priority scheme. Given that given the lack of estate resources to fund further litigation made the

Committee's prospects for recovery on its avoidance litigation uncertain at best, it held that "the paramount interests of the creditors mandates approval of the settlement." 787 F.3d at 178 (quoting Bankr. Op. 14). The District Court affirmed. *See Jevic Holding Corp.*, 2014 WL 268613, at *3-4 (D. Del. Jan. 24, 2014).

On appeal, the Third Circuit affirmed the lower courts' holdings, but those holdings were particularly tied to the particular circumstances of the case—that no plan could be confirmed and conversion to chapter 7 would not be useful given that there were no unencumbered estate assets to fund the activities of a trustee. For example, the court explained that, in its view, structured dismissals are nothing more than dismissals preceded by orders of the bankruptcy court that remain in effect post dismissal, so they are explicitly permitted by section 349 of the Bankruptcy Code. That being said, the Third Circuit took no position as to whether a structured dismissal would ever be appropriate in a case in which confirmation of a chapter 11 plan or conversion to chapter 7 were viable alternatives. Rather, it simply found that, since the evidence indicated that neither alternative was available in *Jevic*, the Bankruptcy Court had discretion to enter a structured dismissal in that case.

The United States Trustee argued that even if structured dismissals were permissible in theory, even an "ugly result" would be preferable to a settlement that failed to comply with Bankruptcy Code priorities. *Jevic*, 787 F.3d at 185. The Third Circuit disagreed, finding that "we doubt that our national bankruptcy policy is quite so nihilistic and distrustful of bankruptcy judges." *Id.*. Instead, the Third Circuit adopted the Second Circuit's flexible approach from *Iridium*. Like the *Iridium* court, it held that while the absolute priority rule does not specifically apply to settlements, compliance with the Bankruptcy Code's priority scheme will "usually be dispositive" of whether a proposed settlement may be approved as "fair and equitable." 787 F.3d at 184. Nevertheless, the Court held that in particular circumstances, bankruptcy courts may approve settlements that deviate from the section 507 priority scheme if there are "specific and credible grounds to justify the deviation." *Id*., citing *Iridium*, 478 F.3d at 466. Because it agreed with the lower courts that the structured dismissal approved in *Jevic* resulted in the "least bad alternative," particularly given that there was no other prospect of a distribution to unsecured creditors and no evidence of a viable alternative that would have better served the estate and creditors as a whole, even if the settlement at issue left out one group of creditors who did not consent, it found that deviation from the Bankruptcy Code's priority scheme was justified in that case. *Id*. at 185.

Although *Jevic* confirms that bankruptcy courts have discretion to approve structured dismissals that do not conform to Bankruptcy Code priorities, the Third Circuit made it clear that this result should be "justified only rarely." *Id*. at 186. Since then, the Bankruptcy Court for the District of New Jersey has approved at least one structured dismissal over the objection of the debtor and old equity, finding that the terms of the settlement were fair and equitable and served the best interests of the estate in part because they complied with the Bankruptcy Code's priority scheme and without the settlement, there would be no possibility of a distribution to unsecured creditors and there was no possibility of reorganization for the debtor at issue. *See In re Petersburg Regency LLC*, 540 B.R. 508, 537-38 (Bankr. D.N.J. 2015). It remains to be seen what "rare" facts will justify approval of a structured dismissal that does not comply with such priorities in the future.

3. Equitable Mootness

Equitable mootness is a prudential doctrine by which an appellate court may decline to hear an appeal from a bankruptcy court order even if relief could be fashioned on the grounds that implementation of such relief would be inequitable. *In re Charter Commc'ns, Inc.,* 691 F.3d

476, 481 (2d Cir. 2012). Unlike constitutional mootness, which asks whether there is a justiciable case or controversy and thus if the appellate court has jurisdiction to issue relief in the first instance, equitable mootness concerns whether the appellate court, fully possessed of jurisdiction, nevertheless should abstain from granting relief. *Id.; see also In re Semcrude, L.P.*, 728 F.3d 314, 317 (3d Cir. 2013); *In re UNR Indus.*, *Inc.,* 20 F.3d 766, 769 (7th Cir. 1994). Equitable mootness also may be distinguished from statutory mootness , whereby the statute itself provides that a reversal on appeal from a bankruptcy court's order does not affect the validity of the original relief granted. *See, e.g*., 11 U.S.C. § 363(m) (reversal or modification on appeal of a bankruptcy court order authorizing the sale or lease of property under sections 363(b) or (c) does not affect the validity of the sale or lease to a good faith purchaser/lessor); 364(e) (unless stayed pending appeal, reversal or modification on appeal of bankruptcy court order authorizing a debtor to obtain credit, incur debt, or the granting of a priority or a lien under section 364 does not affect the validity of the debt so incurred or the priority or lien granted to an entity that extended such credit in good faith).

The doctrine of equitable mootness can be traced to a decision under the former Bankruptcy Act, *In re Roberts Farms, Inc.,* 652 F.2d 793, 796-97 (9th Cir. 1981). In that case, the Ninth Circuit affirmed the district court's dismissal of an appeal from a confirmation order on mootness grounds, finding that because the plan involved many intricate and involved transactions, reversal of the confirmation order would create an "unmanageable, uncontrollable situation" for the bankruptcy court. The Ninth Circuit also cited the creditor's failure to seek a stay of execution of the confirmation order as a basis for its decision, finding that the creditor's failure to do so "creates a situation rendering it inequitable to reverse the orders appealed from." *Id*. at 795-97.

The Third Circuit adopted the doctrine of equitable mootness in its review of the chapter 11 confirmation order in *In re Cont'l Airlines*, 91 F.3d 553, 559-60 (3d Cir. 1996) (*en banc*). It cited several factors to be considered when determining whether to dismiss an appeal from a confirmation order as equitably moot, including: (i) whether it would be equitable to reach the merits; (ii) was a stay obtained; (iii) would the relief requested affect the rights of parties not before the court; (iv) would the relief requested affect the success of the plan; and (v) the public policy favoring finality with respect to bankruptcy judgments and applied an abuse of discretion standard. 91 F.3d at 560. Two decades later, in *Semcrude,* the Third Circuit suggested that the *Continental* factors, which often produced overlapping results, should be considered in two analytical steps: first, whether the plan has been substantially consummated such that turning back may be imprudent; and second, if so, whether granting the relief requested in the appeal will fatally scramble the plan or significantly harm third parties who have justifiably relied upon the confirmation order such as by investing money. 728 F.3d at 321. The *Semcrude* panel further held that the burden of proof rests with the party seeking dismissal of the appeal, finding that the failure to seek a stay should not shift the burden of proof to the appellant given that there is no statutory requirement to seek a stay on appeal from a confirmation order. *Id*. at 322.

Every other circuit has adopted a version of the equitable mootness doctrine, although courts in those circuits may use varying formulations of the factors to be considered and in some cases, apply a de novo/clear error standard of review for questions of law/fact rather than abuse of discretion. *See, e.g.*, *Charter Commc'ns*, 691 F.3d at 482-483 (stating factors, adopting abuse of discretion standard for review); *Victory Park Credit Opportunities Co. v. VPR Liquidation Trust ex rel. Milligan*, 539 B.R. 305, 311-312 (N.D. Tex. 2015) (stating factors, applying de novo/clear error standard of review applicable in the Fifth Circuit); *In re Schwartz*, 2016 WL

323364 (6th Cir. Jan. 26, 2016) (stating factors applicable in Sixth Circuit, finding appeal was equitably moot because appellant failed to seek stay and relief requested would cause harm to third parties).

The doctrine of equitable mootness is designed to be a narrow exception to the appellate courts' "unflagging obligation to exercise jurisdiction," applied to specific claims, not entire appeals, and be applied with "a scalpel, not an axe." *See Charter*, 691 F.3d at 481-82 (citing cases). Equitable mootness is applied most often in the context of appeals from confirmation orders in chapter 11 cases, but appellate courts in many circuits have relied on that doctrine in dismissing appeals from other types of bankruptcy court orders as well. *See, e.g., In re BGI, Inc.*, 772 F.3d 102, 109 (2d Cir. 2014) (equitable mootness applies to appeals from orders confirming chapter 11 liquidating plans as well as reorganization plans, and noting that the doctrine has been applied by the district courts in other contexts as well); *In re Arcapita Bank B.S.C. (c)*, 2014 WL 46552, at *5 (S.D.N.Y. Jan. 6, 2014) (collecting cases); *In re Shawnee Hills, Inc.*, 125 Fed. Appx. 466, 469-470 (4th Cir. 2005) (dismissing as equitably moot appeal from order directing banks to honor pre-petition payroll checks in chapter 7 case); *Desert Fire Protection v. Fontainebleau Las Vegas Holdings, LLC (In re Fontainebleau Las Vegas Holdings, LLC)*, 434 B.R. 716, 743-44 (S.D. Fla. 2010) (applying equitable mootness to appeal from financing order).

By contrast, in *Semcrude*, the Third Circuit appeared to limit equitable mootness to appeals from plans of reorganization. 728 F.3d at 317 ("Equitable mootness comes into play in bankruptcy … after a plan of reorganization is approved."). More recently, a series of decisions by the Third Circuit have further explored the contours of this doctrine in that circuit.

First, in *One2One Commc'ns LLC*, 805 F.3d 428, 435-36 (3d Cir. 2015), *appeal denied,* (3d Cir. 2015), the Third Circuit reversed the lower court's dismissal of an appeal from a chapter

11 confirmation order on equitable mootness grounds. In its July 2015 decision, the *One2One* panel specifically found that equitable mootness should only apply in "complex bankruptcy reorganizations" and had no application to a small case involving a $200,000 investment in the reorganized debtor, one secured creditor with a blanket lien and a claim for less than $100,000, and seventeen unsecured creditors not including insiders. *Id*. (quoting *In re Phila. Newspapers,* LLC, 690 F.3d 161, 169 (3d Cir. 2012). It also found that the debtor did not present sufficient evidence that the plan would be difficult to unravel, nor did it involve the issuance of publicly traded debt or securities or other circumstances that would make it difficult to grant relief. Under the circumstances, the *One2One* panel found that it was an abuse of discretion not to hear the appeal on the merits. *Id*. at 438.

Notably, the appellant in *One2One* had argued both that it was an abuse of discretion to dismiss the appeal on equitable mootness grounds and that the doctrine itself is unconstitutional under *Stern v. Marshall*, ___ U.S. ___, 131 S. Ct. 2594, 2619-20 (2011) and contrary to the Bankruptcy Code. The *One2One* majority decision found that *Stern* had no applicability to equitable mootness, but nevertheless signaled an interest in an en banc review of the doctrine. 805 F.3d at 432, 437-38. Judge Krause's concurrence went much farther, questioning the legitimacy of the doctrine and arguing in detail why equitable mootness is a "doctrine adrift" that has been applied far more broadly than originally intended and should be reconsidered and revised. *Id.* at 439 (Krause, J., concurring).

One of the cases cited by Judge Krause in her concurrence in *One2One* was the district court's decision dismissing the appeal in *Jevic*, which was based in part on equitable mootness grounds even though that appeal arose out of the bankruptcy court's order approving a settlement and structured dismissal, not a plan confirmation order. Notably, the district court decision in

Jevic was issued *after* and *relied* on *Semcrude,*. 2014 WL 268613, at *4 (D. Del. Jan. 24, 2014). On appeal to the Third Circuit, the *Jevic* majority opinion affirmed the merits of the district court's holding but did not discuss its equitable mootness holding. 787 F.3d at 184-85. By contrast, the *Jevic* dissent specifically noted that "this is not a case where equitable mootness applies. We recently made clear in [*Semcrude*] that this doctrine only applies where there is a confirmed plan of reorganization." 787 F.3d at 186 (Scirica, J., dissenting). Thus, at least one member of the *Jevic* panel thought that *Semcrude* had definitively limited equitable mootness to appeals from confirmation orders.

The Third Circuit's amended decision in *Jevic* was issued on August 18, 2015. A day later, on August 19, the Third Circuit issued *In re Tribune Media Co*., 799 F.3d 272, 280-82 (3d Cir. 2015), *reh'g denied*, (3d Cir. Sept. 11, 2015), *cert. denied*, ___ S. Ct. ___, 2016 WL 164847 (March 21, 2016). Unlike *One2One*, *Tribune* involved a highly complex restructuring involving billions of dollars of claims, the settlement of complex avoidance litigation and numerous classes of creditors. Appeals from the confirmation order were taken by two sets of creditors, one challenging the avoidance litigation settlements that were at the heart of the confirmed and substantially consummated plan, which argued that the appellant's competing plan should have been confirmed instead, and another claiming that the plan failed to properly enforce a subordination agreement that would have directed the distribution payable to one subclass of creditors to another subclass.

The *Tribune* panel affirmed the district court's determination that the appeal challenging the settlements should be dismissed as equitably moot because any relief would necessarily undermine the entire plan and cause harm to third parties who have justifiably relied on plan confirmation. *Id.* at 280-8n2. The *Tribune* panel further noted that this appellant could have stayed consummation of the confirmed plan and avoided equitable mootness by posting a bond, but failed to do so. While the amount of the bond set by the bankruptcy court was high—$1.5 billion—this appellant failed to make any effort to argue for a lower amount. *Id.*

However, the *Tribune* panel found that effective relief could be afforded to the other appellant without doing significant damage to the plan itself, as the relief sought simply would involve redirecting the distribution that one subgroup of creditors within a class might receive to another subgroup group within the class, either through disgorgement or through recalculation of future distributions. 799 F.3d at 283. The court further found that if this appellant was correct, then the creditors at issue could not have justifiably relied on the finality of the confirmed plan, so they were not entitled to be protected by the doctrine of equitable mootness. As such, it reversed the district court's dismissal of the second appeal and remanded for further proceedings. 799 F.3d at 283-84.

The Third Circuit's decision in *Tribune* includes a concurrence by Judge Ambro, who also authored the majority opinion, that responds and refutes the arguments raised in Judge Krause's *One2One* concurrence. The *Tribune* concurrence, which was joined by Judge Vanaskie, further argues that, even if equitable mootness might cause unfairness in a particular case and a successful appeal might not, this is not a reason to abandon the doctrine altogether, but rather "counsels us to adhere to our precedent that equitable mootness should be the rare exception and not the rule." 799 F.3d at 288 (Ambro, J., concurring) (internal quotations omitted). Judge Ambro further suggests that the doctrine of equitable mootness is necessary to guard against the very real possibility that "any dissenting creditor with a plausible (or even not-so-plausible) sounding argument against plan confirmation could effectively hold up emergence from bankruptcy for years (or until such time as other constituents decide to pay the dissenter sufficient settlement consideration to drop the appeal), a most costly proposition." *Id*. at 288-89.

After *Tribune* was decided, the Third Circuit denied the motion for *en banc* review in *One2One*, thereby declining the invitation to reconsider *Continental* and equitable mootness. A month later, the Third Circuit decided *ICL*, which, as noted above, involved an order approving a "gifting" settlement. 802 F.3d 547. On appeal, appellees had argued that the government's appeal was equitably moot, among other things. *See ICL*, 802 F.3d at 553. Unlike the majority opinion in *Jevic*, this time the Third Circuit specifically addressed and rejected the appellee's equitable mootness argument, finding that the doctrine had no application to that case. *Id*. at 554-555. Although it could have, the *ICL* panel did not take the opportunity to rule definitively on this issue. Instead, it simply reiterated the holding in *Semcrude* and stated that "[o]utside the plan context, we have yet to hold that equitable mootness would cut off our authority to hear an appeal and *do not do so here*." *Id*. (emphasis added).

Given the result in *Tribune* and *ICL*, there may yet be a narrow context other than plan confirmation in which the Third Circuit might find that equitable mootness could apply. In the meantime, the Supreme Court's refusal to take certiorari from the *Tribune* appeal and recent cases indicate that, at a minimum, in the Third Circuit, the equitable mootness doctrine remains a viable defense to appeals from orders confirming complex restructuring plans, but may or may not be applicable in appeals from other types of orders, while the doctrine remains available as a means of dismissing appeals from other Bankruptcy Court orders in some other circuits.

Nonconsensual Releases And The Scope Of Section 524(e), Post Confirmation Plan Modification, And Claims Impairment

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1. Nonconsensual Releases and the Scope of Section 524(e)

1.1. Introduction

Federal Circuit Courts of Appeal are split as to whether a bankruptcy court may release non-debtors from liability and/or enjoin third parties from asserting their direct claims[1] against such non-debtors without the releasing parties' consent. Relying on the bankruptcy court's broad equitable powers under Section 105(a) of the Bankruptcy Code and the lack of any express restriction in Section 524(e), the majority of circuits, *i.e.*, the Second, Third, Fourth, Sixth, Seventh, and Eleventh Circuits, hold that nonconsensual releases and injunctions are permissible in certain limited circumstances. The Fifth, Ninth, and Tenth Circuits, on the other hand, interpret Section 524(e) as a strict prohibition against the bankruptcy court's ability to issue nonconsensual releases of third-party claims against non-debtors.

1.2. Overview of the Current Law

Chapter 11 plans often propose (whether by settlement of claims or otherwise) to release non-debtors from direct claims held by creditors or other third-party stakeholders. Commonly referred to as "non-debtor" or "third-party" releases, these provisions release and/or enjoin claims (present or future) against the debtor's principals, officers, directors, affiliates, guarantors, insurers, creditors, and other stakeholders. While increasingly common in corporate reorganizations, the Bankruptcy Code provides no explicit authority to issue such third-party releases, except in the limited context of asbestos liability.[2]

As a practical matter, third-party releases can facilitate resolution of the debtor's bankruptcy by motivating key non-debtor constituencies to compromise their claims or

[1] This section discusses releases of personal claims held by third parties, as opposed to those that are derivative of claims held by the debtor.

[2] *See* 11 U.S.C. § 524(g) (allowing third-party releases of asbestos liability under certain conditions).

contribute funds or "sweat equity" to the reorganization effort in exchange for releases and assurances that they will not be sued after confirmation. Such plan release provisions can also enhance the reorganized debtor's assets in cases where the debtor is obligated to indemnify the released parties. On the other hand, by shielding non-debtors from liability, third-party releases may lend themselves to abuse; in effect, the non-debtor party is able to obtain a discharge without having to subject itself to the bankruptcy process or adhere to the safeguards and creditor protections in the Bankruptcy Code.[3]

1.2.1. Sections 105(a) and 524(e): Harmony or Conflict?

Outside the asbestos context, the statutory bases for nonconsensual third-party releases are found in Sections 105(a) and 524(e) of the Bankruptcy Code.[4] Section 105(a) grants the court broad equitable powers to "issue any order, process or judgment that is necessary or appropriate

[3] While a complete discussion of the bankruptcy court's jurisdiction to issue third-party releases and/or enjoin third parties from asserting direct claims against non-debtors is beyond the scope of this article, the general rule is that "a bankruptcy court only has jurisdiction to enjoin third-party non-debtor claims that directly affect the *res* of the bankruptcy estate." *In re Johns-Manville Corp.*, 517 F.3d 52, 66 (2d Cir. 2008), *rev'd on other grounds*, *Travelers Indem. Co. v. Bailey*, 557 U.S. 137 (2009); *see also In re Quigley Co., Inc.*, 676 F.3d 45, 57 (2d Cir. 2012) ("the touchstone for bankruptcy jurisdiction remains whether its outcome might have any 'conceivable effect' on the bankruptcy estate" (internal quotation marks omitted)); *In re Millennium Lab Holdings, II, LLC, et al.*, No. 15-12284 (LSS) (Bankr. D. Del. Dec. 11, 2015), ECF No. 206, at 13 (finding jurisdiction to issue nonconsensual, third-party releases based on "conceivable effect" test, citing *Pacor, Inc. v. Higgins*, 743 F.2d 984, 994 (3d Cir. 1984) ("related to" jurisdiction over action between two non-debtor third parties exists "if the outcome could alter the debtor's rights, liabilities, options, or freedom of action (either positively or negatively) and which in any way impacts upon the handling and administration of the bankrupt estate")). Some courts also require that language be added to the plan limiting the scope of any third-party releases and injunctions to matters that affect the debtor or the debtor's estate. *See, e.g.*, *In re Chassix Holdings, Inc.*, 533 B.R. 64, 82 (Bankr. S.D.N.Y. 2015) (limiting third-party releases "only to matters that directly involve the Debtors and the parties' dealings with the Debtors").

[4] In addition to Bankruptcy Code Sections 105(a) and 524(e), some courts cite Section 1123(a)(5) (means for implementation of a plan) as a statutory basis for third-party releases. *See, e.g.*, *In re Charles St. African Methodist Episcopal Church of Boston*, 499 B.R. 66, 100 (Bankr. D. Mass. 2013); *In re Am. Media, Inc.*, No. 10-16140 (MG), 2010 WL 5483463, at *11 (Bankr. S.D.N.Y. Dec. 20, 2010); *In re Citadel Broad. Corp.*, No. 09-17442 (BRL), 2010 WL 2010808, at *8 (Bankr. S.D.N.Y. May 19, 2010); *In re Am. Media, Inc.*, No. 10-16140 (MG), 2010 WL 5483463, at *11 (Bankr. S.D.N.Y. Dec. 20, 2010); *but see In re Wool Growers Cent. Storage Co.*, 371 B.R. 768, 777 (Bankr. N.D. Tex. 2007) ("Neither section 105 of the Bankruptcy Code nor …section[] 1123(a)(5)
can be construed "to provide for a release or discharge of valid creditor claims against a nondebtor third-party").

to carry out the provisions of [the Bankruptcy Code]" so long as such relief is not inconsistent with other provisions of the Bankruptcy Code.[5]

Section 524(e) provides that, except for certain narrow circumstances, 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."[6]

Whether the Bankruptcy Code permits nonconsensual releases first turns on the interpretation of Section 524(e). If, as the majority of Circuit Courts believe, Section 524(e) merely ensures that the discharge of a debtor's debts does not automatically release a co-obligor from liability, third-party releases are not inconsistent with Section 524(e) and the court is free[7] to use its Section 105(a) powers to authorize such relief when necessary to carry out a legitimate bankruptcy purpose.[8]

The competing view adopted by a minority of Circuit Courts is that Section 524(e) prohibits the discharge of any and all non-debtor debts.[9] Under this view, a third-party release or

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[5] 11 U.S.C. § 105(a); *see also id.* § 1123(b)(6) (providing that a plan may "include any other appropriate provision not inconsistent with the applicable provisions of this title"); *but see Law v. Seigel*, 134 S. Ct. 1188, 1194 (2014) ("But in exercising [its authority under section 105] and inherent powers, a bankruptcy court may not contravene specific statutory provisions.").

[6] 11 U.S.C. § 524(e).

[7] Courts are free to use Section 105 subject to its own limitations. *See supra* notes 4 & 5.

[8] *See, e.g.*, *In re Airadigm Commc'ns, Inc.*, 519 F.3d 640, 656 (7th Cir. 2008).

[9] *See, e.g.*, *FB Acquisition Prop. I LLC v. Gentry (In re Gentry)*, 807 F.3d 1222. 1224-228 (10th Cir. 2015) (notwithstanding Colorado state law adhering to rule of "equivalent liability," which limits guarantor liability to that of the principal obligor, under Section 524(e) the partial discharge of company's loan in its prior Chapter 11 case did not prevent lender from pursuing recovery of entire loan debt against individual principals under the personal guarantees they issued; Tenth Circuit further explained that "a discharge does not extinguish the underlying debt[,] rather it changes a debtor's liability for that debt").

injunction would be inconsistent with Section 524(e)[10] and render a plan unconfirmable as a matter of law.

1.2.2. The Circuit Split: Majority and Minority Views

The Fifth,[11] Ninth,[12] and Tenth Circuits[13] adopt the minority view prohibiting nonconsensual releases, whereas the Second,[14] Third,[15] Fourth,[16] Sixth,[17] Seventh,[18] and Eleventh Circuits[19] each follow a majority view allowing nonconsensual releases in limited circumstances where supported by necessary factual findings and procedural safeguards. The First and D.C. Circuits have not ruled on the issue directly, but have indicated a willingness to

[10] Some courts believe Section 524(g)—which was added to the Bankruptcy Code in 1994 and allows third parties to be released from asbestos liability in certain circumstances—further supports the minority view, reasoning that Congress's express authorization of third-party releases in one specific context implies that the Bankruptcy Code denies this authority in non-asbestos contexts. *See, e.g.*, *In re Pac. Lumber Co.*, 584 F.3d 229, 252 (5th Cir. 2009).

[11] *Id.* (although Fifth Circuit precedent "seem[s] broadly to foreclose non-consensual non-debtor releases and permanent injunctions," the court ruled that it would uphold the plan provisions releasing the creditors' committee and its members based on the qualified immunity afforded under Section 1103(c) for actions within the scope of their duties other than willful misconduct or gross negligence).

[12] *See Resorts Int'l, Inc. v. Lowenschuss (In re Lowenschuss)*, 67 F.3d 1394, 1401 (9th Cir. 1995).

[13] *See Landsing Diversified Props.-II v. First Nat'l Bank & Trust Co. of Tulsa (In re Western Real Estate Fund, Inc.)*, 922 F.2d 592, 600 (10th Cir. 1990).

[14] *See In re Metromedia Fiber Network, Inc.*, 416 F.3d 136, 141 (2d Cir. 2005).

[15] *See In re Lower Bucks Hosp.*, 571 F. App'x 139, 144 (3d Cir. 2014); *Gillman v. Cont'l Airlines (In re Cont'l Airlines)*, 203 F.3d 203, 214 n. 11 (3d Cir. 2000); *In re Global Indus. Techs., Inc.*, 645 F.3d 201 (3d Cir. 2011); *but see In re Combustion Eng'g*, 391 F.3d 190, 235-37 (3d Cir. 2005) (holding that "general powers of [Section] 105(a) cannot be used to achieve a result not contemplated by the more specific provisions of [Section] 524(g)" and vacating the third-party releases violating the requirements for a channeling injunction barring asbestos claims under Section 524(g)).

[16] *See Behrmann v. Nat'l Heritage Found.*, 663 F.3d 704 (4th Cir. 2011).

[17] *See Class Five Nev. Claimants v. Dow Corning Corp. (In re Dow Corning Corp.)*, 280 F.3d 648 (6th Cir. 2002).

[18] *See Airadigm Commc'ns, Inc.*, 519 F.3d at 640.

[19] *See SE Prop. Holdings, LLC v. Seaside Eng'g & Surveying, Inc. (In re Seaside Eng'g & Surveying, Inc.)*, 780 F.3d 1070 (11th Cir. 2015) (discussed *infra*).

follow the majority view.[20] And, although the Eighth Circuit has yet to address the issue, a leading case endorsing the majority view was issued by a bankruptcy court within its jurisdiction.[21]

1.2.3. Applicable Standards

While there is no uniform standard to determine when a nonconsensual third-party release is appropriate, courts utilizing the majority view agree that it involves a fact-intensive, case-by-case analysis.[22] Various tests are used:

- In *Metromedia*, the Second Circuit instructed that the analysis is "not a matter of factors and prongs," and inclusion of non-debtor releases requires "truly unusual circumstances render[ing] the release terms important to the success of the plan."[23] To the extent relevant, courts should consider whether:

  (1) The estate received substantial consideration;

  (2) The enjoined claims were channeled to a settlement fund, rather than extinguished;

  (3) The enjoined claims would indirectly impact the debtor's reorganization by way of indemnity or contribution; and

  (4) The plan provided for full payment of the enjoined claims.[24]

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[20] *See Monarch Life Ins. Co. v. Ropes & Gray*, 65 F.3d 973, 979-80 (1st Cir. 1995); *In re AOV Indus., Inc.*, 792 F.2d 1140 (D.C. Cir. 1986).

[21] *See In re Master Mortgage Inv. Fund*, 168 B.R. 930 (Bankr. W.D. Mo. 1994).

[22] *See, e.g.*, *Airadigm Commc'ns, Inc.*, 519 F.3d at 657.

[23] *Metromedia Fiber Network, Inc.*, 416 F.3d at 141-43. The Second Circuit, however, offered no bright line or guidance on how to apply or weigh these factors.

[24] *Id*.

- In *Continental Airlines*, the Third Circuit did not have occasion to adopt a specific standard, but stated that the "hallmarks" of appropriate nonconsensual releases are "fairness, necessity to the reorganization[,] specific factual findings to support these conclusions," and "adequate consideration to a claimholder being forced to release claims against non-debtors."[25] In addition to these guiding principles, Delaware bankruptcy courts often apply the five-factor test articulated by the bankruptcy court for the Western District of Missouri in *Master Mortgage*.[26] These *Master Mortgage* factors were also incorporated into the Sixth Circuit's seven-factor test in *Dow Corning*.
- In *Dow Corning*, the Sixth Circuit cautioned that a non-consenting creditor's claim should be enjoined only in "unusual circumstances" that meet the following seven-factor test,[27] which has since been adopted (albeit somewhat more flexibly) by the Fourth and Eleventh Circuits:

  (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;

[25] *Cont'l Airlines*, 203 F.3d at 213-14 (because the bankruptcy court failed to make include findings as to whether the releases were fair and necessary, the court held the releases could not stand under any standard).

[26] *Master Mortgage Inv. Fund*, 168 B.R. 930 (Bankr. W.D. Mo. 1994); *see, e.g.*, *Millennium Lab Holdings, II, LLC, et al.*, No. 15-12284 (LSS), ECF No. 206, at 17-18; *In re Washington Mutual, Inc.*, 442 B.R. 314, 346 (Bankr. D. Del. 2011); *In re Exide Techs.*, 303 B.R. 48, 72 (Bankr. D. Del. 2003).

[27] *Dow Corning Corp.*, 280 F.3d at 658. Like the Second Circuit, the Sixth Circuit gave little guidance on how lower courts should apply the facts under each factor or weigh these factors.

(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;

(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.

- In *Airadigm Communications*, the Seventh Circuit set forth the most lenient standard of the Circuit Courts. There, the court approved nonconsensual third-party releases upon finding those release were "appropriate," "not inconsistent" with the Bankruptcy Code, "necessary for the reorganization," and "appropriately tailored."[28]

1.2.4. Procedural Safeguards: Consent?

Recent decisions in the Southern District of New York and the District of Delaware highlight the different and inconsistent procedures that courts require before approving releases. Stated simply, the focus of these courts is how much and the type of notice is given to creditors, and/or whether the releases require some affirmative action on the part of the creditor.

For instance, courts differ on the degree to which "affirmative consent" is required to

[28] *Airadigm Commc'ns, Inc.*, 519 F.3d at 657.

bind a creditor to a release. In *Indianapolis Downs*, the Delaware bankruptcy court (Shannon, J.) held that a party could be deemed to consent to third-party releases even where it did not vote on the plan or voted to reject the plan.[29] The ballot contained an "opt-out" mechanism with respect to the releases such that the creditor could vote to accept or reject the plan, and still opt out of the releases. If, however, the creditor did not submit a ballot, submitted a blank ballot, or voted either to accept or reject the plan but did *not* check the opt-out box, the creditor would be subject to the releases.[30]

In contrast, the Delaware bankruptcy court in *Washington Mutual* (Walrath, J.) held that affirmative consent was required for a party to be bound by third-party releases in the plan.[31] As in *Indianapolis Downs*, the voting ballots in *Washington Mutual* included an "opt-out" provision. Unlike *Indianapolis Downs*, however, the *Washington Mutual* court held that the consent could not be implied if a party did not submit a ballot, submitted a blank ballot, or voted against the plan. Rather, the only way a party could provide consent to the third-party releases was to vote in favor of the plan and *not* opt out of the releases.

Bankruptcy Judge Michael E. Wiles of the Southern District of New York addressed these issues in detail in his July 2015 decision in *Chassix Holdings*.[32] Judge Wiles found "little to no guidance in the reported cases as to the factors that a Court properly should consider in deciding whether to approve opt-in/opt-out procedures."[33] He analyzed typical mechanisms that have been approved in the past to obtain consent or "deemed consent," and found that the "opt-

[29] *In re Indianapolis Downs, LLC.*, 486 B.R. 286, 304 (Bankr. D. Del. 2013).

[30] *Id.* at 305-06.

[31] *Washington Mutual, Inc.*, 442 B.R. at 354-55.

[32] *Chassix Holdings, Inc.*, 533 B.R. at 75-83.

[33] *Id.* at 78.

out" system proposed by the debtors—whereby the only creditors who would *not* be deemed to consent to the third-party releases were those who voted to reject *and* took the additional step to opt out of the releases—conferred consent "in situations where no affirmative consent had actually been manifested."[34] Such a system, he explained, was counter to the Second Circuit's directive that third-party releases are appropriate only in narrow and unusual circumstances.

As a result, the court modified the debtor's proposed solicitation procedures and ballots, effectively requiring all presumptions against a finding of consent. Once modified, only those creditors that voted in favor of the plan, or voted to reject *and* affirmatively opted in to the releases, were bound by the third-party releases. Creditors who abstained, submitted blank ballots, were unimpaired, or were deemed to reject were all treated as *not* consenting to the releases.[35]

1.3. Recent Decisions: Seaside Engineering and Millennium Health

1.3.1. *Seaside Engineering. SE Prop. Holdings, LLC v. Seaside Eng'g & Surveying, Inc. (In re Seaside Eng'g & Surveying, Inc.)*, 780 F.3d 1070 (11th Cir. 2015).

In *Seaside Engineering*, the Eleventh Circuit considered the bankruptcy court's authority to issue "non-consensual, non-debtor releases or bar orders," and when "such bar orders might be appropriate."[36]

1.3.1.1. Facts

The debtor, Seaside Engineering & Surveying, Inc. ("Seaside"), was a closely-held engineering firm owned and operated by five principals, all of whom were engineers. Prior to the

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[34] *Id.*

[35] *Id.* at 80-82. While not addressed in *Chassix*, future bankruptcy court decisions may address the issue of, in the event some or many creditors opt out, what happens to the contributions made by the releasees?

[36] *Seaside Eng'g & Surveying, Inc.*, 780 F.3d at 1074; *see also id.* at 1076 n.2 (noting that the terms "non-debtor releases" and "bar orders" are used interchangeably).

Seaside bankruptcy, the company's principals formed two real estate development entities, both of which borrowed funds from SE Property Holdings, LLC and Vision-Park Properties, LLC (collectively, "Vision"). Seaside's principals each personally guaranteed the loans. The real estate entities defaulted on the loans and Vision sought to enforce the guarantees. As a result, three of the guarantor principals filed Chapter 7 petitions, thereby staying Vision's pre-bankruptcy guaranty actions. The Chapter 7 trustee in one of those cases held an auction to sell the principal's equity in Seaside, and Vision purchased the interest (presumably by satisfying its guaranty claim). Soon thereafter, Seaside commenced a case under Chapter 11 of the Bankruptcy Code. Seaside proposed a reorganization plan to continue operating under a new entity, Gulf Atlantic, LLC ("Gulf"), which would be owned and managed by four of the original principals. In exchange for its ownership interest in Seaside, Vision received a promissory note.

Seaside's plan included the following third-party release:

> None of the Debtor, … Reorganized Debtor, Gulf Atlantic … (and any officer or directors or members of the aforementioned [entities]) and any of their respective Representatives (the "Releasees") shall have or incur any liability to any Holder of a Claim against or Interest in Debtor, or any other party-in-interest … for any act, omission, transaction or other occurrence in connection with, relating to, or arising out of the Chapter 11 Case, the pursuit of confirmation of the Amended Plan … or the consummation of the Amended Plan … except and solely to the extent such liability is based on fraud, gross negligence or willful misconduct.[37]

[37] *Id.* at 1076 (quoting Reorganization Plan Art. IX.C.).

Vision objected to plan confirmation, arguing that the release failed to satisfy the *Dow Corning* factors. The bankruptcy court overruled Vision's objection and confirmed the plan with the third-party release. The district court affirmed, and Vision appealed.

1.3.1.2. Holding

The Eleventh Circuit affirmed.[38] In doing so, the court first acknowledged its prior precedent approving a release of claims against a non-debtor in *In re Munford*, 97 F.3d 449 (11th Cir. 1996). In *Munford*, a defendant in an adversary proceeding offered to settle the lawsuit but conditioned the settlement on a court-approved bar order enjoining the non-settling defendants from seeking recovery against the settling defendant. The bankruptcy court issued the bar order, which the Eleventh Circuit ultimately upheld under Section 105(a), based on findings that (i) the settlement was necessary to fund the bankruptcy estate, (ii) the defendant would not have settled without the order, and (iii) the order was fair and equitable.[39]

While the *Seaside Engineering* court described *Munford* as "controlling precedent," the court noted that the two cases presented different sets of facts: "Instead of the settlement context in *Munford,* here the releases prevent claims against non-debtors that would undermine the operations of, and doom the possibility of success for, the reorganized entity, Gulf."[40]

The court then considered the split of authority among the Circuits and held that Eleventh Circuit precedent, along with its interpretation of Sections 524(e) and 105(a), placed it within the majority view that nonconsensual releases are permissible under certain circumstances. Noting

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[38] Interestingly, while the *Seaside Engineering* opinion was authored by Eleventh Circuit Judge Hon. R. Lanier Anderson, the case was decided by a three-judge panel that included Hon. Denise Cote, United States District Judge for the Southern District of New York, sitting by designation. *Id.* at 1074.

[39] *Id.* at 1076, 1078.

[40] *Id.* at 1077.

that had Congress intended to limit the court's power, it would have done so clearly, the court adopted the Seventh Circuit's view on Section 524(e) that the provision does not restrict the court's authority to issue a non-debtor release from a creditor's claim.[41]

Having determined that nonconsensual releases are permissible, the Court emphasized that such releases:

> [should] 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***.[42]

The court then turned to the proper standard that should be applied. Following the Fourth Circuit's lead in *National Heritage Foundation*,[43] the Eleventh Circuit held that the bankruptcy courts should apply the Sixth Circuit's seven-factor *Dow Corning* test (*see supra*). The court instructed that the seven factors should be considered "non-exclusive" and applied "flexibly," with the bankruptcy court having discretion to determine which factors are most relevant.[44] Taking each factor in turn, the court found as follows:

1. <u>Identity of Interests between the Debtor and the Non-debtor Releasee.</u> The court agreed with the finding that this factor favored inclusion of the release as Gulf was "completely dependent on the skilled labor" of the engineer-principals. Without the bar order, the principals' preoccupation with additional lawsuits

[41] *Id.* at 1078.

[42] *Id.* at 1078-79 (emphasis added).

[43] 663 F.3d at 712.

[44] *Seaside Eng'g & Surveying, Inc.*, 780 F.3d at 1079.

would "interrupt the labor-intensive surveying," and lead "to a deterioration of the estate as Gulf loses valuable relationship-based work contracts."[45]

2. Non-debtor's Contribution of Substantial Assets to the Reorganization. While the releasees did not contribute "any new value" to the reorganized debtor "other than the contribution of their labor," the court concluded that this factor favors Seaside as the principals were the "life blood" of the reorganized debtor.[46]

3. The Injunction is Essential to Reorganization. Noting the overlap with the first factor, the court agreed with the bankruptcy court's findings that the bar order was "absolutely essential" as the case was "highly litigious" and litigation would "bleed[] Gulf dry and dash[] any hope for a successful reorganization" in the absence of a release.[47]

4. The Impacted Class Has Voted Overwhelmingly to Accept the Plan. Although Vision and two of the Chapter 7 trustees rejected the plan, all other classes unanimously accepted it. The bankruptcy court further found that the rejecting equity holders would be paid in full under the plan. While this factor did not favor the debtor, it did not favor Vision either.

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[45] *Id.* at 1079-80.

[46] *Id.* at 1080 (emphasis omitted). *Compare Millennium Lab Holdings, II, LLC, et al.*, No. 15-12284 (LSS), ECF No. 259, at 20-21 (finding directors and officers "sweat equity" sufficient where "record is unrebutted that the efforts of management successfully resulted in a viable plan …, results in 100 percent payment to all creditors other than prepetition lenders, and management …is critical to unlocking the reorganized debtors' total enterprise value") *with Washington Mutual, Inc.*, 442 B.R. at 354 (finding directors and officers role in negotiating global settlement and plan were "nothing more than what is required of directors and officers of debtors in possession (for which they have received compensation and will be exculpated)" and thus were an insufficient contribution to support releases of directors and officers).

[47] *Seaside Eng'g & Surveying, Inc.*, 780 F.3d at 1080.

5. Payment to All, or Substantially All, of the Affected Class(es) Under the Plan. Noting again the bankruptcy court's finding that Vision will be paid in full for its equity in Seaside, the court concluded that this factor weighed heavily in favor of permitting the releases.[48]

6. Non-settling Claimants Have Opportunity to be Paid in Full Under the Plan. The bankruptcy court ruled that this factor was inapplicable. Since Vision's had only "vaguely" identified potential claims other than payment of its equity interest (as Vision's guaranty claim was presumably satisfied when it purchased the stock for its debt), the Eleventh Circuit stated that the bankruptcy court had not abused its discretion in this respect.

7. Bankruptcy Court's Conclusions were Supported by Specific Factual Findings. The court found that "[t]he bankruptcy court made *thorough* factual findings …amply supported by the evidence. The bankruptcy court's extensive consideration of this case weighs heavily against any abuse of discretion."[49]

After assessing the *Dow Corning* factors, the Eleventh Circuit reviewed the additional considerations of the bankruptcy court that supported a finding that the releases were fair and equitable. First, according to the bankruptcy court, the parties were locked in a "death struggle"

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[48] In exchange for its equity interests, Vision received a promissory note accruing with an interest rate of 4.25%, which the bankruptcy court determined by applying the formula approach set forth in *Till v. SCS Credit Corp.*, 541 U.S. 465 (2004), adding a 1% risk adjustment to the prime rate of 3.25%. *Id.* at 1083. Vision argued that "this rate does not adequately compensate for the highly prospective nature of the notes," *id.*, but the district court and Eleventh Circuit disagreed, finding no clear error and adopting *Till* in the context of an equity holder in Chapter 11. The Fifth and Sixth Circuits have also endorsed the *Till* approach in certain Chapter 11 contexts. *See Wells Fargo Bank National Ass'n v. Texas Grand Prairie Hotel Realty, LLC (In re Texas Grand Prairie Hotel Realty, LLC)*, 710 F.3d 324 (5th Cir. 2013); *Bank of Montreal v. Official Comm. of Unsecured Creditors (In re American HomePatient, Inc.)*, 420 F.3d 559, 658 (6th Cir. 2006) ("[T]he market rate should be applied in Chapter 11 cases where there exists an efficient market. But where no efficient market exists for a Chapter 11 debtor, then the bankruptcy court should employ the formula approach endorsed by the *Till* plurality.").

[49] *Seaside Eng'g & Surveying, Inc.*, 780 F.3d at 1081 (emphasis in original).

with Vision expending a disproportionate amount of time for a company valued at $960,000. Second, the bankruptcy court required the Seaside to cease its lawsuit seeking sanctions against Vision, thereby preventing any asymmetrical benefit in favor of Seaside.

Lastly, the release was limited in scope to claims occurring in connection with, relating to, or arising out of the Chapter 11 case and excluded claims for fraud, gross negligence, and willful misconduct.[50] Thus, apparently, the release did not cover Vision's pre-bankruptcy guaranty actions against any of the principals except the one whose equity interest Vision purchased as those claims had no nexus to Seaside Engineering's bankruptcy (and/or those claims were resolved prior to Seaside Engineering's filing) as a result of being stayed by the prior Chapter 7 filings. But, as the court did not address these non-debtor claims, it is unclear whether they were affected by the third-party releases in *Seaside Engineering.*[51]

1.3.1.3. Takeaway

Following *Seaside Engineering*, the Eleventh Circuit is squarely in the majority-view camp on nonconsensual third-party releases. That said, *Seaside Engineering* is more noteworthy for its emphasis on the rare and unusual circumstances that would warrant such releases. The case also highlights the need to establish a robust factual basis before including third-party releases in a reorganization plan, being mindful not only of the *Dow Corning* factors, but also of

[50] *See Hernandez v. Larry Miller Roofing, Inc.*, 626 Fed. App'x 281 (5th Cir. 2016) (holding that general, boilerplate third-party release of a corporate debtor's officers in the debtor's bankruptcy plan were insufficiently specific to release claim held by the debtor's employee against an officer with personal "managerial" liability under the Fair Labor Standards Act ("FLSA"), notwithstanding claimant's affirmative vote in favor of plan, where release provision neither specified that claims under FLSA, or, more generally, employment law violations, were being released, nor did it mention debtor's officer by name).

[51] *See Seaside Eng'g & Surveying, Inc.*, 780 F.3d at 1081 n.10 (noting that while an additional plan provision provided that the plan results in "full satisfaction of all claims and interest[s]" claimholders have against the debtor, its officer, directors and shareholders, Seaside Engineering affirmed that such provision was intended to be no broader that the release provision quoted above).

the overriding considerations that such releases should be used only where "essential, fair, and equitable."[52]

Seaside Engineering was appealed, but the Supreme Court denied certiorari, effectively guaranteeing that the existing Circuit split will remain for the foreseeable future.[53]

1.3.2. *Millennium Health. In re Millennium Lab Holdings, II, LLC, et al.*, No. 15-12284 (LSS) (Bankr. D. Del. 2015, 2016), ECF Nos. 206, 259.

1.3.2.1. Facts

Millennium Health filed a prepackaged chapter 11 case in November 2015, shortly after reaching a settlement with the Justice Department ("DOJ") under which it would pay $256 million to settle allegations that it fraudulently billed Medicare and Medicaid. The company also negotiated a prepetition restructuring of part of its then-existing $1.825 billion credit agreement, which, in combination with the DOJ settlement, formed the centerpiece of the debtors' bankruptcy plan. The plan provided for a $325 million cash infusion to the debtors from two equity holders, Millennium Lab Holdings, Inc. ("MLH") and TA Millennium, Inc. ("TA"), to pay the settlement fee, and in exchange, MLH, TA, and certain other non-debtor parties were granted third-party releases. Certain "Out-Out Lenders," which allegedly held direct claims against the non-debtor releasees, and even commenced an action against them the day before the confirmation hearing, objected to the third party release, arguing that their direct claims may not be released under the plan for two reasons: first, the court lacked jurisdiction to approve the third-party releases; and, second, the releases contravene Section 524(e).

[52] *Id.* at 1079.

[53] *Vision-Park Properties, LLC v. Seaside Eng'g & Surveying, LLC*, 136 S. Ct. 109 (2015).

1.3.2.2. Holding

The Delaware bankruptcy court overruled the Opt-Out Lender's objection and confirmed Millennium Health's chapter 11 plan. Taking up the court's jurisdiction first, the court found that at least one of the debtors had a contractual obligation to indemnify each of the released parties. Thus, the outcome of the Opt-Out Lenders' lawsuit could have conceivably affected the debtors' estate, thereby bringing it within the bankruptcy court's related-to jurisdiction.[54] And, briefly addressing Supreme Court's decision in *Stern v. Marshall*,[55] the court held that *Stern* and its progeny did not change the court's conclusion that it had jurisdiction to issue the third-party releases.

Turning to the propriety of the third-party releases, the court found that the Third Circuit's decision in *Continental Airlines* permitted third-party releases when certain "hallmarks" were present.[56] Since *Continental Airlines*, bankruptcy courts in the Third Circuit have approved plans containing third-party releases both on the basis of the hallmarks and considering the factors set forth in *Master Mortgage*: (1) an identity of interests, such that a suit against the non-debtor will deplete the debtor's assets; (2) substantial contribution by the non-debtor; (3) the release is essential to the reorganization; (4) a substantial majority of creditors supporting the release; and (5) payment of all or substantially all of the claims in the classes affected by the release.

Addressing the *Master Mortgage* factors, the court found that all five prongs were met: (1) there was an identity of interests between the debtors and the released parties due to the

[54] *See supra* note 3.

[55] 564 U.S. 2 (2011).

[56] *See supra* note 25 and its accompanying text.

debtors' indemnification and advancement obligations, and because the parties shared the common goal of confirming and implementing the plan and maximizing the debtors' value; (2) the released parties made a substantial contribution in that (x) upon confirmation, MLH and TA will contribute $325 million and relinquish their equity in the debtors, and (y) the released lenders relinquished their credit agreement claims, and (z) the directors and officers made a substantial contribution by securing global settlements resulting in 100% payment to all creditors other than the prepetition enders; (3) the releases were essential to securing the new funding and confirming the plan; (4) over 90% of creditors in the affected class voted to accept the plan; and (5) the affected class would receive roughly $900 million in terms of equity in the reorganized debtors.[57]

The court further found that the *Continental Airlines* "hallmarks" of fairness and necessity to the reorganization were also met based on the following findings in addition to those above: (1) without MLH and TA funding, the company would not have been able to settle with the DOJ, and would have gone out of business; (2) the enormously greater distributions to creditors through a reorganization rather than a liquidation; (3) the prepetition lenders subordinated their claims to permit unsecureds to receive 100%; (4) all parties were included in settlement negotiations; (5) there was no objection to settlement; and (6) the uncontroverted testimony is that the debtors, equity holders, and settling prepetition lenders insisted on the releases.

<u>Direct Appeal to the Third Circuit:</u> Immediately following Judge Silverstein's bench ruling confirming the debtors' plan, including the third-party releases, the Opt-Out Lenders

[57] As mentioned above, *supra* notes 23 & 25 and the discussion of *Seaside Engineering*, it is unclear whether all factors must be established before the bankruptcy court can approve third-party releases, or under what circumstances the court should approve such releases when one or more factors are not present.

sought a direct appeal to the Third Circuit.[58] The core issue presented on appeal was whether the bankruptcy court has the authority to grant nonconsensual third-party releases over the objection of a releasing party.

Judge Silverstein analyzed the issue under the statutory grounds on which a party may seek a direct appeal to the Circuit Court of Appeals, with a focus on the first two bases: (1) the appeal involves a question of law for which there is no controlling law, (2) the appeal involves a question of law requiring resolution of conflicting decisions, (3) the appeal involves a matter of public importance, or (4) an immediate appeal may materially advance the case.

Reviewing Third Circuit precedent under *Continental Airlines* and its progeny, including lower court decisions, Judge Silverstein concluded that sufficient controlling precedent exists in the Third Circuit.

Next, she assessed whether the issue was subject to conflicting decisions, and found that her ruling in *Millennium Health* directly conflicts with Delaware Bankruptcy Judge Mary Walrath's 2011 decision in *Washington Mutual*.[59] Specifically, while Judge Walrath acknowledged that Third Circuit precedent does not foreclose third-party releases, she nevertheless required any such releases to be based on affirmative consent. In contrast, Judge Silverstein's interpretation of *Continental Airlines*' "hallmarks" of fairness and necessity to the reorganization, and her application of the *Master Mortgage* factors in *Millennium Health*, imposed no affirmative consent requirement. As a result, Judge Silverstein certified the "consent" issue to the Third Circuit.

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[58] *Millennium Lab Holdings, II, LLC, et al.*, No. 15-12284 (LSS), ECF No. 259.

[59] *Washington Mutual, Inc.*, 442 B.R. at 314.

The Third Circuit, however, declined to exercise its jurisdiction to hear the Opt-Out Lender's appeal.[60] The appeal is now pending before the Delaware District Court.

1.3.2.3. Takeaway

Millennium Health is important because, by the court's own admission, it provides a clear departure from *Washington Mutual*. Although the Third Circuit declined to hear the direct appeal, the contrast between Judge Silverstein's and Judge Walrath's interpretations of the *Continental Airlines* precedent likely sets the stage for a later appeal to the Third Circuit and much needed clarity on the standards governing nonconsensual third-party releases in this Circuit. The seemingly growing importance—and scrutiny—placed on third-party releases means that a Third Circuit ruling on the issue may have long-lasting ramifications.

1.4. Practice Tips

1.4.1. Know your District and Circuit.

As Supreme Court clarification on the permissibility of nonconsensual releases is unlikely to happen anytime soon, practitioners should consider the importance of obtaining third-party releases and/or injunctions to the reorganization effort during their pre-bankruptcy preparations and the likelihood of obtaining such relief in the various jurisdictions in which the case can be venued.[61]

1.4.2. Know your factors and facts.

The close security of third party-releases and injunctions during the plan confirmation

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[60] *In re Millennium Lab Holdings, II, LLC, et al.*, No. 15-12284 (LSS) (Bankr. D. Del. Feb. 25, 2016), ECF No. 291.

[61] For instance, Debtwire reported that the relatively easier path to obtaining releases for directors, management, and sponsors from creditor claims was one of the primary reasons Caesars Entertainment Operating Corp. decided to file for Chapter 11 in Illinois rather than in Delaware. *See* Jack M. Tracy II, *Caesars venue fight threatens protections of sponsors and non-debtor parent*, Debtwire (Jan. 22, 2015, 5:29 PM), https://www.debtwire.com/intelligence/view/1952993.

process means that debtors need to be prepared to justify such releases and/or injunctions should they be challenged. Practitioners should be prepared to substantiate the specific tests and factors applicable to the jurisdiction with as much evidentiary support as possible, keeping in mind "more is better," *i.e.*, the more facts addressed to satisfy the various factors, the greater the likelihood of obtaining approval of the releases.

1.4.3. Notice and affirmative consent.

Following recent decisions like *Washington Mutual* and *Chassix*, practitioners should carefully consider the various opt-in/opt-out mechanisms used to obtain affirmative or implied consent as part of the plan solicitation process, and how non-voting parties (*i.e.*, unimpaired classes, deemed-rejecting classes, and creditor who do not submit or submit a non-compliant ballot) will be treated, and the effect thereof: for example, will approval of releases require 100% payment on creditors' claims?[62] The current trends of (i) decoupling a creditor's vote on the plan from such party's consent to third-party releases, and (ii) finding consent only where based on some affirmative action taken by the release, as opposed to implied or "deemed" consent based on the failure to act, are likely to continue for the foreseeable future.

Plan proponents should be also:

- draft any plan releases with sufficient specificity so as to leave no doubt that an accepting creditor (or a creditor deemed to be accepting) is bound by the release,
- provide ample notice and disclosure concerning the specific parties and claims which would benefit by or be subject to plan releases and injunctions, and

[62] *But see Chassix Holdings, Inc.*, 533 B.R. at 81 (finding that having claims satisfied in full is an insufficient justification for finding that unimpaired creditors are "deemed" to consent to third-party releases).

- fully comply with procedural rules—*e.g.*, Rules 2002(c)(3), 3016(c), and 3020(c)(1)—governing disclosure of releases and injunctions.[63]

1.4.4. Creditors: object and appeal.

To preserve claims against non-debtors, creditors must object to any third-party release in a proposed plan, and appeal if the plan is confirmed. Otherwise, regardless of whether the releases were permissible in the first instance, the creditor will be unable to challenge the plan provisions as exceeding the bankruptcy court's authority.[64]

2. Post-Confirmation Plan Modification

2.1. Introduction

A debtor or plan proponent may modify a confirmed plan any time before the plan is substantially consummated so long as circumstances warrant the modification and the court, after notice and a hearing, confirms the plan as modified under Section 1129 of the Bankruptcy Code. *See* 11 U.S.C. § 1127(b). The provision recognizes the fluidity of the reorganization process while also reinforcing the principle of finality in chapter 11 cases. Unfortunately, the Bankruptcy Code does not define "modification" or give guidance on which "circumstances warrant" modification, and courts have had to consider these issues on a case-by-case basis.

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[63] *See also Lower Bucks Hospital*, 571 Fed. App'x at 144 (affirming bankruptcy court decision denying approval of third-party release upon finding that it was not adequately disclosed in debtors' disclosure statement, noting "[k]ey terms of a plan of confirmation, particularly those that release a non-debtor from claims by creditors, must be adequately disclosed. Failure to do so in a clear and conspicuous manner risks excision of the release from the plan").

[64] *See Travelers Indemnity Co.*, 557 U.S. at 152-54 (2009); *Hernandez*, 628 Fed. App'x at 285-86 (citing *In re Applewood*, 203 F.3d 914, 919 (5th Cir. 2000)). A discussion of cases revisiting or limiting the use of equitable mootness is beyond the scope of this article.

2.1.1. What Constitutes a Modification Under Section 1127(b)? *SCH Corp. v. CFI Class Action Claimants*, 597 Fed. Appx. 143 (3rd Cir. 2015).

The most recent case to date on the issue of what constitutes a plan modification is an unpublished decision in *SCH Corp. v. CFI Class Action Claimants*. In that case, the debtor's debt collection business was sold to its largest secured creditor ("LLCP") and LLCP's subsidiary became the plan funder. Under the confirmed plan,[65] the funder was to make annual payments to the estate (which would be used to pay unsecured creditors) commencing in April 2010 and ending in April 2014. The payments were, however, subject to offsets by certain legal fees and losses incurred by LLCP or its subsidiary in defending against future consumer lawsuits.

Post-confirmation, the funder became embroiled in lawsuits filed by a class of claimants (the "CFI Claimants"), offsetting its fees and losses against the payments it was to make under the plan. By late 2013, very little had been paid to unsecured creditors (i.e., there was no substantial consummation). The debtor's responsible officer began disputing the offsets, and the parties negotiated a "settlement" that included, among other things, an extension of the time in which the plan funder could make payments to creditors under the plan from April 2014 to April 2017 and a termination of the right to offset those payments against past fees and losses incurred but unreimbursed. The Delaware Bankruptcy Court approved the settlement, the CFI Claimants appealed, and the Delaware District Court affirmed the bankruptcy court's order approving the settlement.

On appeal, the Third Circuit held that the settlement was really a plan modification. Initially, the Court distinguished the Court's ability to "clarify" a plan that is silent or ambiguous or "interpret" a plan for equitable considerations from the Court's inability to "modify" a plan

[65] Most likely, the confirmation order was final long before the settlement was tendered to the Court.

without satisfying the Section 1127 requirements. Then, the Court found that "the extension of …'the life of the economic relationships that we have' rises to the level of a plan modification subject to § 1127."[66] The Court concluded that "turning a five-year plan into an eight-year plan constitutes a modification of the plan itself," particularly where the settlement had the practical effect of preventing the CFI Class claimants from litigating certain class action consumer claims against the plan funder for an additional three years.[67] This was true even though the settlement or modification purportedly provided greater economic benefits to the estate and its creditors by limiting the plan funder's expense-related offset rights.

In arriving at its decision, the Court reviewed several other holdings from bankruptcy courts in Texas, New York and Ohio, though not all of them dealt directly with plan modifications. Indeed, one case cited by the Court focused on the kinds of pre-confirmation plan modifications that would require new disclosure, underscoring the purpose of Section 1127(b) to protect stakeholders who voted to accept the plan treatment on which they had adequate disclosure. Moreover, the Court distinguished between minor timing tweaks in a plan post-confirmation and significant time delays, noting that a 60-day extension of a payment date was much different than the 3-year extension contemplated in the *SCH* settlement. The Court remanded to the bankruptcy court to consider the settlement as a modification under Section 1127(b).

2.2. When Do Circumstances Warrant Modification? *In re Boylan Int'l Ltd.*, 452 B.R. 43 (Bankr. S.D.N.Y. 2011).

After confirmation, a plan proponent must show that circumstances warrant a modification of the plan. In *Boylan*, the Bankruptcy Court for the Southern District of New York

[66] *SCH Corp. v. CFI Class Action Claimants*, 597 Fed. App'x 143, 149 (3d Cir. 2015).

[67] *Id.*

explored what circumstances might warrant post-confirmation plan modification.[68] The Court looked to Colliers for guidance, quoting "'if unforeseen circumstances render the confirmed plan unworkable, modification may be warranted'" but "if a modification would 'upset the expectations of creditors,' the court should prohibit such modification."[69] Examples of circumstances warranting modification cited by the bankruptcy court included unforeseen delays in zoning approval that delayed the debtor's ability to sell its most valuable asset in or protracted appeals of the confirmation order (and other orders) that delayed the plan's effective date beyond the point in which the plan would still be workable.

In *Boylan*, the debtor's primary asset from which recoveries were to be made was a malpractice claim. The plan had established a liquidating trust to prosecute the claim, but, as a result of unforeseen delay in pre-trial and appellate litigation, the trust was scheduled to expire before the claim could be fully prosecuted. The trustee requested that the plan be modified to extend the life of the trust by two years.[70] The fact that (i) the protracted pre-trial litigation was unforeseeable at the time the plan was confirmed, (ii) no creditor had opposed the request for modification and (iii) the modification would enable the liquidating trustee to achieve value from its most important asset all contributed to the court's decision to approve the modification. Like the examples the court cited in its decision, the *Boylan* decision focused on the unforseeability of

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[68] *In re Boylan*, 452 B.R. at 43.

[69] *Id*. at 50.

[70] It is noteworthy that the Court did address whether the trustee had standing to request the modification and concluded that, as the liquidating trustee under the plan charged with prosecuting the malpractice claim, the trustee was "certainly a plan proponent," but the Court did not explain how it arrived at that conclusion. *Id*. at 48. A more recent case determined that a liquidating trust "must succeed to the Debtor's right to seek modification where necessary, otherwise no one would have the standing modify the plan, an absurd result." *Litig. Trust for the Trust Beneficiaries of SNTL Corp. v. JPMorgan Chase (In re Superior Nat'l Ins.)*, 2013 Bankr. LEXIS 5325, *47 (Bankr. C.D. Ca. Dec. 19, 2013).

changed circumstances which were out of the debtor's control and the impact on creditor recoveries that a failure to modify the plan would cause.

2.3. Practice Points

The Bankruptcy Code is silent on what constitutes a modification for purposes of Section 1127(b) and what circumstances warrant such a modification. *SCH* suggests that, to the extent a post-confirmation agreement effects the treatment or expectations of creditors under the confirmed plan, the courts may treat the agreement as a plan modification. *Boylan* and cases like it limit the circumstances that warrant modification to those over which the debtor has no control, that were unforeseen at the time the plan was confirmed and which will significantly affect the ability of creditors to obtain any recoveries under the plan, as well as whether any creditors are challenging the modification.

3. Claims Impairment: The *EFH* Case

3.1. Introduction

A class of creditors that is unimpaired under a plan of reorganization is deemed to have accepted it and is not entitled to vote. Only impaired creditors (who are receiving or retaining some distribution) can vote on a plan. The question of what constitutes impairment was recently the focus of debate in *In re Energy Futures Holdings Corp.*, where holders of certain unsecured PIK notes (the "PIK Noteholders") issued by Energy Futures Intermediate Holding Company LLC ("EFIH"), whose claims were treated as unimpaired under the plan, argued they were indeed impaired, because the plan did not provide them with contract rate postpetition interest as provided under their indenture. Delaware Bankruptcy Judge Sontchi rejected the note holders' claims, distinguishing between plan impairment and statutory impairment and finding that the pre-Bankruptcy Code case of *Consolidated Rock* was inapplicable. He held that, while section 502(b)(2) mandates that the PIK Noteholders' *allowed* claims do not include postpetition interest, in a solvent debtor case, section 1124(1) and Third Circuit precedent does require some amount of postpetition interest be paid to the noteholders. He retained the right to determine the appropriate rate of interest under the Court's equitable powers.

3.1.1. Sections 502(b)(2) and 1129: Amount of Allowed Claims versus Treatment of Allowed Claims.

Judge Sontchi's analysis began with a discussion of what constitutes an allowed claim under section 502(b)(2) and whether an allowed unsecured claim includes post-petition interest. Section 502(b)(2) provides, in the context of claims allowance, that the court:

> "shall determine the amount of such claim …as of the filing of the petition, and shall allow such claim in such amount, except to the extent that …such claim is for unmatured interest."[71]

The PIK Noteholders argued that they were entitled to postpetition interest at the contract rate as part of their allowed claim, whereas the Debtors argued that, as a matter of law, the noteholders' unsecured claims were not entitled to unmatured, postpetition interest. The Court rejected the PIK Noteholders' argument as violating section 502(b)(2) but also criticized the Debtors for "missing the mark."

The Court said, "there is a distinction between the payment of interest ***on an allowed claim*** as opposed to ***as an allowed claim***."[72] The latter issue invoked section 502(b)(2)'s prohibition against including unmatured interest in the allowance of a claim; the former involves the confirmation provisions of the Bankruptcy Code and those provisions determine what the holders of claims must receive for the plan to be confirmed. The Court said, "[t]he receipt of post-petition interest, thus, does not arise as part of the allowed amount of the claim but, rather,

[71] 11 U.S.C. § 502(b)(2).

[72] *In re Energy Future Holdings Corp.*, *et al.*, 540 B.R. 109, 111 (Bankr. D. Del. 2015) (emphasis included).

as a requirement of confirmation."[73] In some instances, explained Sontchi, the holders of unsecured claims will not be entitled to receive anything but the allowed amount of the claim, and in other instances, holders will be entitled to the allowed amount of their unsecured claims plus additional consideration, which might include postpetition interest.

3.1.2. Statutory Impairment versus Plan Impairment.

After a lengthy discussion of the sections that governed plan proposal, voting and confirmation,[74] Sontchi addressed the question of impairment under section 1124. Section 1124(1) provides that a class of claims is impaired under a plan unless the plan "leaves unaltered the legal, equitable and contractual rights to which such claim …entitles the holder of such claim."[75] The EFH plan proposed to pay all general unsecured creditors, including the PIK Noteholders, the full <u>allowed</u> amount (i.e., the § 502 amount) of their claims in cash *plus* postpetition interest at the Federal Judgment Rate. The PIK Noteholders argued that, unless they received postpetition interest at the contract rate provided in their indenture, they were impaired under (and entitled to vote on) the plan.

Again Sontchi rejected the PIK Noteholders' argument. He explained that there is a difference between an allowed claim that is impaired by virtue of a plan's treatment and a claim that is impaired by virtue of statutory law, such as section 502(b). The Court referred to the earlier bankruptcy decision in *In re PPI Enterprises (U.S.), Inc.*, where it explained that there are

[73] *Id*.

[74] It is in this part of Sontchi's discussion that he dismisses the PIK Noteholders' reliance on *Consolidated Rock Products Co. v. Dubois*, 312 U.S. 510 (1941), for the proposition that, under the absolute priority rule, unsecured creditors must receive contract rate post-petition interest before equity holders receive any value. Sontchi found *Consolidated Rock* inapplicable, because (i) the case concerned secured, not unsecured, creditors; (ii) the issue before the Supreme Court as it applied to secured creditors was later codified in sections 506(b) and 1129(b)(2)(A) and (iii) no part of *Consolidated Rock* was incorporated into section 1129(b)(2)(B) governing the treatment of unsecured creditors. *Id.* at 116.

[75] 11 U.S.C. § 1124(1).

"'two distinct concepts: (i) plan impairment, under which the debtor alters the 'legal, equitable and contractual rights to which [their] claim entitles the holder of such claim,' and (ii) statutory impairment under which the operation of a provision of the Code alters the amount that the creditor is entitled to under nonbankruptcy law.'"[76] In that case, a landlord's allowed rejection claim was deemed unimpaired where the debtor paid the full amount of the landlord's capped claim plus interest, even though the lease itself entitled the landlord to more than just the capped amount. Like section 502(b)(2) in *Energy Future*, section 502(b)(6) in *PPI* determined the legal rights to which the landlord was entitled, and such statutory impairment did not render either the landlord's claim in *PPI*, nor the PIK Noteholders' claims in *Energy Future*, impaired for purposes of section 1124(1). Stated simply, Sontchi's holding is that section 1124(1)'s requirements apply only to allowed claims as determined by section 502.

3.1.3. Solvent Debtors Must Pay Post-Petition Interest to Unsecured Creditors.

Once he determined that the PIK Noteholders' claims were only statutorily impaired under section 502(b)(2) and not impaired under the EFH plan for purposes of section 1124(1), Sontchi found he had a problem reconciling his finding with the bankruptcy court and Third Circuit's holdings in the *PPI* cases that the holder of an unsecured claim against a solvent debtor can only be deemed unimpaired if the holder receives post-petition interest.[77] The bankruptcy judge resolved the conflict by analyzing the text of 1124(1) in light of the equity sought to be achieved in the *PPI* cases. Section 1124(1) refers to leaving unaltered a claimant's "legal, equitable and contractual rights." Sontchi focused on the PIK Noteholders "equitable" rights against the solvent EFIH debtor, reasoning by analogy that, if the fair and equitable requirement

[76] *In re Energy Future*, 540 B.R. at 121, quoting *In re PPI Enterprises (U.S.), Inc.*, 228 B.R. 339, 353 (Bankr. D. Del. 1998).

[77] *Id*. at 123.

of section 1129(b)(2) provides the court with the equitable power to award postpetition interest to *impaired* unsecured creditors when a junior class is receiving a distribution, then application of creditors' equitable rights under section 1124(1) must also permit the Court to award postpetition interest to unimpaired unsecured creditors in order to keep the two classed on equal footing. Accordingly, the Court, without citing any precedent,[78] imported the "fair and equitable" test of section 1129(b)(2) into section 1124(1) and held that "the fair and equitable test …must also be met in solvent debtor cases for such creditors to be unimpaired."[79] Maintaining the Court's equitable power to determine the contract rate, the Court concluded, "[a]s with the fair and equitable test, the rate of interest may be the contract rate or such other rate as the Court deems appropriate."[80]

3.1.4. Questions Raised by the Energy Future Decision.

Sontchi's decision raises several questions, including:

- What provision, reference or holding exists in the Bankruptcy Code, legislative history or case law which would enable the Court to impose the fair and equitable test of section 1129(b)(2) on the question of impairment in section 1124(1)? Other than the attempt to reconcile prior case holdings, the Court made no mention of a statute or case rule on which it could base its holding.
- Whether the Court's ruling on what constitutes impairment under section 1124(1)

[78] The Court could have cited to the legislative history of section 1124, which states, "courts have held that where an estate is solvent, in order for a plan to be fair and equitable, unsecured and undersecured creditors' claims must be paid in full, including postpetition interest, before equity holders may participate in any recovery." *140 Cong. Rec. H 10,768 (October 4, 1994)*, citing to *Consolidated Rock*, 312 U.S. at 527. Rather, the Court distinguished the *Consolidated Rock* case, but, nonetheless, ultimately imposed a fair and equitable standard on section 1124.

[79] *Id.* at 124.

[80] *Id.*

conflicts with the reinstatement provisions under section 1124(2). Reinstatement requires the debtor to cure any default that occurred before or after the commencement of the case and to pay the claimant any reasonable damages it has sustained. To be deemed unimpaired, reinstatement appears to require the payment of postpetition interest at the contract rate even on unsecured claims. There appears to be no reason for section 1124 to treat unimpairment differently depending on whether the debtor chooses to pay cash or reinstate the debt. Assuming the fair and equitable test applies to section 1124(1), perhaps reinstatement under section 1124(2) should inform the Court's determination as to what is "fair and equitable" under section 1124(1).

- How relevant to the analysis is the lack of the term "allowed" or "allowable" in describing impaired claims? The language of section 1124 states: "a class of claims or interests is impaired under a plan unless, with respect to each claim or interest. . .," without any reference to allowed claims.[81] Sections 502(b), 506 and 1126(a) expressly speak in terms of *allowed* claims. Moreover, old section 1124(3) which Sontchi explains was deleted precisely because it provided an option for unimpairment if the debtor paid unsecured claims in cash in the *allowed* amount of such claims (i.e., without post-petition interest). In solvent cases, such as *In re New Valley Corp.*,[82] section 1124(3) permitted the debtor to

[81] 11 U.S.C.§ 1124.

[82] *In re Valley Corp.*, 168 B.R. 73 (Bankr. D.N.J. 1994). The court left open whether the good faith plan proposal requirement of section 1129(a)(3) would require the payment of post-petition interest. This is somewhat similar to the recent Circuit Court debate in artificial impairment cases, where courts are split as to whether section 1124 permits artificial impairment or whether the intentional manufacturing of impairment solely for the purpose of satisfying the section 1129(a)(10) requirement implicates the good faith requirement of section 1129(a)(3) instead.

pay *only* the allowed amount of unsecured creditors' claims, while paying impaired creditors postpetition interest and distributing value to equity holders. To preclude this unfair result in the future, section 1124(3), and its reference to "allowed amount" was deleted. Does this suggest that the reference to "claim" and not "allowed claim" in section 1124 is meaningful, such that to be unimpaired, one must receive the full amount of one's claim, not the full amount of one's *allowed* claim?

3.2. Practice Tips

Judge Sontchi's decision in *In re Energy Future* is currently pending appeal before the Delaware District Court, though the appeal has been stayed. Judge Sontchi attempted to reconcile what appears to be divergent case law on the issue of whether unimpaired, unsecured creditors of a solvent debtor are required to receive postpetition interest. It behooves practitioners to keep a watchful eye on the developments on appeal, as debtors who are, or who become, solvent in bankruptcy may need to rethink how best to treat unsecured creditors if the goal is to keep them unimpaired.