AMERICAN BANKRUPTCY INSTITUTE

2019 Rocky Mountain Bankruptcy Conference

Some Like It Hot: Topics and Rules Update

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CONCURRENT SESSION

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HOT TOPICS IN BANKRUPTCY

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I. RECENT SUPREME COURT DECISIONS

A. *Lamar* & § 523(a)(2)(B)

Lamar v. Archer & Cofrin, LLP v. Appling, 138 S.Ct. 1752 (2018).

1. *Background:* Appling hired the law firm Lamar, Archer & Cofrin to represent him in business litigation, and did not pay legal fees in excess of $60,000. The firm gave him an ultimatum: pay or it would withdraw and place a lien on its work product until the bill was paid. The firm agreed to continue its engagement based on Appling's representation that he was expecting a tax refund of approximately $100,000. Appling only applied for and received a refund of approximately $59,000, and he spent that money on his business. The firm eventually sued and obtained a state court judgment in excess of $100,000. Appling and his wife thereafter sought protection under chapter 7 of the Bankruptcy Code. The firm sought to except its debt from discharge under 11 U.S.C. § 523(a)(2)(A), which governs debts arising from "false pretenses, a false representation, or actual fraud, *other than a statement respecting the debtor's . . . financial condition*." (emphasis added). The debtor defended, maintaining that § 523(a)(2)(A) did not apply because his statement about his single asset – the refund – were about his financial condition, and these types of statements are only nondischargeable if they are in writing under § 523(a)(2)(B).

2. *Lower Court Rulings:* The bankruptcy court held Appling's statements to be non-dischargeable and the district court affirmed. The Eleventh Circuit reversed, holding that § 523(a)(2)(A) did not apply inasmuch as Appling's statement was one "respecting" his financial condition. In so doing, the court concluded that statements respecting a debtor's financial condition may include a statement about a single asset. Because Appling's statements were not in writing, the law firm could not satisfy the requirements of § 523(a)(2)(B) and, therefore, the debt was dischargeable.

3. *Issue Before the Supreme Court*: Whether a statement about a single asset as opposed to one regarding the debtor's overall financial condition or net worth qualifies as "a statement respecting the debtor's financial condition" under § 523(a)(2)(A)?

4. *Supreme Court Ruling*: The Supreme Court affirmed the Eleventh Circuit, holding that a statement about a single asset qualifies as a "statement respecting the debtor's . . . financial condition" for of purposes of § 523(a)(2)(A). If the single-asset statement is not in writing, the associated debt may be discharged. The Court focused on the word "respecting," concluding that it should be read expansively, similar to the phrase "relating to." It went on to state: "[A] statement is 'respecting' a debtor's financial condition if it has a direct relation to or impact on the debtor's overall financial status. A single asset has a direct relation to and

impact on aggregate financial condition, so a statement about a single asset bears on a debtor's overall financial condition and can help indicate whether a debtor is solvent or insolvent, able to repay a given debt or not." 138 S. Ct. at 1761.

5. *Implications*: Creditors should get all information about a debtor's ability to pay debts in writing.

B. *Lakeridge* & § 101(31) Insider Status

U.S. Bank N.A. v. Village at Lakeridge, 138 S.Ct. 960 (2018).

1. *Background:* Village at Lakeridge (VOL), a corporate entity, owned by MBP Equity Partners (MBP), owed over $10 million to U.S. Bank and $2.76 million to MBP. Its chapter 11 plan separately classified U.S. Bank and MBP and proposed to impair both their interests. Confirmation stalled when U.S. Bank objected, arguing that "an insider cannot provide the partial agreement needed for a cramdown plan." *Lakeridge*, 138 S. Ct. at 964. At that point, MBP transferred its claim against VOL to a retired surgeon who had a romantic relationship with a MBP board member for $5,000. The surgeon and the board member lived apart and kept their finances separate.

2. *Lower Court Rulings:* The bankruptcy court found the surgeon to be a non-insider because the transaction was at arms' length, and this decision was affirmed by the district court. The Ninth Circuit also affirmed. It applied the following standard for determining whether a non-statutory insider is an insider: "[A] creditor qualifies as a non-statutory insider if two conditions are met: '(1) the closeness of its relationship with the debtor is comparable to that of the enumerated insider classifications in [the Code], and (2) the relevant transaction is negotiated at less than arms' length.'" *Id.* at 965 (citation omitted) (alteration in original). The bankruptcy court's factual finding that the transaction was negotiated at arms' length was not clear error.

3. *Issue Before the Supreme Court*: Whether a bankruptcy court's determination that a person or entity is a "non-statutory insider" should be reviewed for clear error?

4. *Supreme Court Ruling*: The Supreme Court affirmed the Ninth Circuit, holding that clear error standard should apply when an appellate court reviews a lower court's determination of a person or entity's insider status. When a mixed question of law and fact is primarily factual in nature, the appropriate standard of review is clear error. Although the question presented to the Ninth Circuit was a mixed question of law and fact, it was "about as factual sounding as any mixed question gets." *Id.* at 968. Questions of fact are reviewed for clear error because the trial courts are in the best position to review and weigh the evidence.

5. *Concurring Opinions*: Concurring opinions were written by Justices Kennedy and Sotomayor, each highlighting the lack of clarity on the appropriate test for determining who is a "non-statutory insider."

a. Justice Kennedy wrote to make clear that the Court's decision did not adopt the Ninth Circuit's two-part test quoted above.

b. Justice Sotomayor, whose opinion was joined by Justices Kennedy, Thomas, and Gorsuch, questioned the effectiveness of the Ninth Circuit's two-part test, stating it "is not clear to me" that the Ninth Circuit's test "is consistent with the plain meaning of the term 'insider' as it appears" in 11 U.S.C. §101(31).

6. Implications: The definition of what is a "non-statutory insider" remains open. And, if a different test than that used by the Ninth Circuit is ultimately adopted, *Lakeridge* may have no application.

II. CASES GRANTED CERT & SOON TO BE GRANTED CERT

A. *Mission Products* & § 365(n)

Mission Prods., Inc. v. Tempnology, LLC (In re Tempnology), 879 F.3d 389 (1st Cir. 2018).

The Supreme Court has accepted cert to resolve a split in the circuits over the proper treatment of executory contracts that include the use of intellectual property. As a general rule, § 365(a) allows the DIP or trustee to reject burdensome contracts that are no longer in the best interests of the estate. However, rejection is not equivalent to termination or recission of the contract. It merely transforms the debtor's obligations of specific performance into a pre-petition claim for damages against the estate according to § 365(g). But this does not necessarily mean that the non-debtor party has no other rights remaining under the contract.

Prior to the enactment of § 365(n), in *Lubrizol Enters., Inc. v. Richmond Metal Finishers, Inc.,* 756 F.2d 1043 (4th Cir. 1985), the Fourth Circuit held that licenses of intellectual property may be executory contracts vulnerable to rejection under § 365(a). This created quite a stir in legal circles, threatening to curtail the development of licensing intellectual property. Three years later, Congress responded by enacting § 365(n). This section allows a debtor to reject such a license, but it gives licensees the right to elect one of two treatments of their intellectual property rights following rejection. First, they may elect to treat the contract as terminated and assert their damage claim against the estate. 11 U.S.C. § 365(n)(1)(A). Alternatively, they may retain their contractual rights to the intellectual property, as those rights existed on the petition date, through the duration of the contract and any extension of the contract, provided that the licensee has a right to extend it. 11 U.S.C. § 365(n)(1)(B). If the non-debtor elects the latter, it must continue to compensate the estate or the debtor for its use of the intellectual property. 11 U.S.C. § 365(n)(2)(B). It then also waives any setoff rights and administrative expense claims due to the debtor's breach. 11 U.S.C. § 365(n)(2)(C).

What this new amendment did not fully address was the status of the non-debtor party's *other rights* under contract. In *Sunbeam Products, Inc. v. Chicago Amer. Mfg., LLC,* 686 F.3d 372 (7th Cir. 2012), the Seventh Circuit ruled that the debtor licensor's rejection of the contract did not devoid the licensee of its rights to use the debtor's trademark. In this case, the debtor was losing money manufacturing its own box fans and so it contracted with CAM to allow CAM

to use its patents and trademarks to make the fans. The debtor continued to line up contracts to sell the fans to retailers but CAM would ship them directly to the retailers on the debtor's instruction. This arrangement did not resolve all the debtor's financial problems and eventually creditors placed the debtor into bankruptcy involuntarily. The trustee then sold the debtor's assets to Sunbeam, including the debtor's intellectual property. In the meantime, CAM continued to manufacture and sell the box fans, with the debtor's trademark on them. Sunbeam and the trustee sued CAM to stop its production and sales.

The Seventh Circuit acknowledged that § 365(n) only applies to "intellectual property" rights. This term is defined in § 101(35A) to include a trade secret, an invention, process, design, or plant protected under title 35, a patent application, a plant variety, the work of authorship protected under title 17, and mask work protected under chapter 9 of title 17 to the extent such interests are protected under applicable nonbankruptcy law. Omitted from this definition is the term "trademark."

> Congress expressly listed six kinds of intellectual property. . . . Trademark licenses (hardly something one would forget about) are not listed, even though relatively obscure property such as "mask work protected under chapter 9 of title 17" is included. . . . Nor does the statute contain any catchall or residual clause from which one might infer the inclusion of properties beyond those expressly listed.. . . [T]he Senate Report states that Congress "postpone[d]" action on trademark licenses "to allow the development of equitable treatment of this situation by bankruptcy courts." S. Rep. No. 100-505, at 5.

Mission Prods., Inc. v. Tempnology, LLC, supra, 879 F.3d at 401.

Following Congress' lead, the bankruptcy court in *Sunbeam* applied equitable principles and weighed the relative burdens that would be experienced by CAM and Sunbeam, concluding that equity would allow CAM to complete its contract of manufacturing and selling the box fans with the debtor's trademark. On appeal to the circuit, the court found the bankruptcy court's reliance on "equitable principles" to be untenable, but nevertheless affirmed on other grounds. It held that the contract's rejection was not equivalent to its rescission. Outside of bankruptcy, had the debtor breached its obligations (to provide motors and cord sets and to pay for completed fans), CAM could have continued to assert its rights to manufacture and sell the box fans, but would have been entitled to assert a damage claim against the debtor for the amount it had to expend to cover in the marketplace with other motors and cord sets. Finding nothing in the Code to eliminate these rights, it ruled that CAM's right to continue to use the trademark was unaffected by anything in § 365(a). "[N]othing about this process implies that any rights of the other contracting party have been vaporized." *Sunbeam Prods., Inc v. Chicago Amer. Mfg., LLC, supra, 686 F.3d* at 377. Thus, according to the Seventh Circuit, there was no need for Congress to amend § 365. The *Lubrizol* court had focused only on the question of whether an intellectual property license was in fact an executory contract, and not on the implications of rejection of the contract. *Id.*

Twenty years later, Congress has still not addressed the issue of trademarks in bankruptcy and the courts are divided on their treatment under the Code. Recently, the First Circuit entered the fray, disagreeing with the Seventh Circuit. In *Mission Products,* the debtor had developed

specialized sports accessories, such as towels, socks, and headbands, that remained cool despite their use during exercise. It entered into a contract with Mission for the distribution of some of its products. It granted both exclusive and non-exclusive rights of distribution, depending on the product. Their contract also gave Mission a non-exclusive license to the debtor's intellectual property and its trademarks. At the time of the debtor's chapter 11 filing, there were two years remaining on their contractual relationship when the debtor elected to reject the contract. Mission opposed the rejection, arguing that § 365(n) allowed it to retain both its intellectual property license and its exclusion distribution rights. The First Circuit acknowledged that the scope of § 365(n) is narrowly tailored. It allowed Mission to continue to use the debtor's intellectual property, but the debtor was relieved from the burden imposed by other rights granted to Mission under the contract. Specifically, rejection under § 365(a) allowed the debtor to be freed from Mission's exclusive distribution rights. "An exclusive right to sell a product is not equivalent to an exclusive right to exploit the product's underlying intellectual property." *Id.* at 398. If there had been no patent involved in manufacturing the debtor's products, the debtor clearly could have rejected a contract for exclusive distribution of its products. The court rejected Mission's argument that "its nonexclusive license of intellectual property 'lacks meaningful value' unless it retains an exclusive right to sell certain of Debtor's products." *Id.* at 399.

> Likewise, the court cut off Mission's use of the debtor's trademark.
>
> Trademarks, unlike patents, are public-facing messages to consumers about the relationship between the goods and the trademark owner. They signal uniform quality and also protect a business from competitors who attempt to profit from its developed goodwill. . . . The Agreement provides that Debtor "shall have the right to review and approve all uses of its Marks, . . ." Importantly, failure to monitor and exercise this control results in a so-called "naked license," jeopardizing the continued validity of the owner's own trademark rights. . . . The Seventh Circuit's approach, therefore, would allow Mission to retain the use of Debtor's trademarks in a manner that would force Debtor to choose between performing executory obligations arising from the continuance of the license or risking the permanent loss of its trademarks. . . .

Id. at 402.

Mission Products calls into question how finely a contract can be separated into constituent parts, with some parts remaining in effect and others abrogated or evaded by the estate's rejection. Parties who enter into contracts view the contract as a whole and its value is based on the sum of its parts. When a debtor assumes a contract, it must take the contract with all its benefits and burdens. It cannot parse the contract into the parts it likes and reject the rest. Yet with rejection, the general principle is that the debtor is relieved from all its performance obligations in exchange for giving the non-debtor party a claim for pre-petition damages. Section 365(n) only limits this general principle by allowing continued use of intellectual property rights. What is left unanswered is the effect of rejection on other non-debtor rights under the contract that do not require specific performance by the debtor. This may be more a question of contract interpretation and both federal and state common law, rather than a question of bankruptcy law interpretation. Thus, it will be interesting to see how the Supreme Court

focuses the inquiry in resolving this split. The answer may have broad implications for all sorts of contracts beyond the context of intellectual property licenses.

B. *Obduskey* & FDCPA

Obduskey v. Wells Fargo, 879 F.3d 1216 (10th Cir. 2018).

The Supremes have recently conducted oral argument on this case. It involves a fairly straightforward issue but one with application to many cases. The question is whether the Fair Debt Collection Practices Act, 15 U.S.C. §§ 1692–1692p ("FDCPA") applies to nonjudicial foreclosure actions. In reliance on the plan language of the statute, the court ruled that the loan servicer was not a "debt collector" under the Act because it had acquired the servicing contract on this loan prior to a default on it. The FDCPA's definition of a debt collector expressly excludes any person attempting to collect a debt "which was not in default at the time it was obtained by such person." 15 U.S.C. § 1692(a)(6)(F).

The bigger question involved the law firm hired to initiate a public trustee foreclosure proceeding. As required by Colorado statute, the law firm sent the debtor a letter notifying him that it had been hired to initiate foreclosure. The letter made no references to collecting a debt. The debtor responded with a letter disputing the debt. The law firm did not respond to this letter for more than one year. It went forward with the nonjudicial foreclosure. Subsequently, the debtor sued under various tort theories as well as for alleged violations of the FDCPA due to, among other things, the lack of a timely response to his letter.

The Tenth Circuit noted the split of authority on whether a nonjudicial foreclosure proceeding is covered by the FDCPA. The Ninth Circuit has held that it is not covered (*Vien-Phuong Thi Ho v. ReconTrust Co.*, 858 F.3d 568 (9th Cir. 2016)), but the Fourth, Fifth, and Sixth Circuits, as well as the Colorado Supreme Court, have held that it is covered. *Wilson v. Draper & Goldberg, P.L.L.C.*, 443 F.3d 373 (4th Cir. 2006); *Kaltenbach v. Richards*, 464 F.3d 524 (5th Cir. 2006); *Glazer v. Chase Home Fin. LLC*, 704 F.3d 453 (6th Cir. 2013); *Shapiro & Meinhold v. Zartman*, 823 P.2d 120 (Colo. 1992) (en banc).

The difference between these rulings is whether the court views the act of foreclosing as an ultimate means of collecting on the debt. In *Glazer,* the Sixth Circuit opined that "*every* mortgage foreclosure, judicial or otherwise, is undertaken for the very purpose of obtaining payment on the underlying debt, either by persuasion (*i.e.,* forcing a settlement) or compulsion (*i.e.,* obtaining a judgment of foreclosure, selling the home at auction, and applying the proceeds from the sale to pay down the outstanding debt)." *Glazer v. Chase Home Fin. LLC*, 704 F.3d at 463.

The Tenth Circuit noted that, under Colorado law, a creditor may only collect a deficiency after the public trustee foreclosure and through a separate legal action. One of the specific provisions of the FDCPA that mentions foreclosures only applies to "actions" to enforce an interest in real property, which is generally understood to imply a judicial proceeding. *Obduskey v. Wells Fargo,* 879 F.3d at 1222. Moreover, although it found the language of the FDCPA to be clear and unambiguous, it also found that policy considerations supported its interpretation. Colorado's public trustee foreclosure procedures require notifying all affected

parties of the foreclosure action, which is inconsistent with the FDCPA's prohibition against communications with third parties about the debt. It also requires posting of a notice on the subject property, which would violate the FDCPA's requirement that a debt collector cease all direct communications with a borrower who is represented by an attorney. Reading the FDCPA to supplant state foreclosure law without a clear and manifest intent demonstrated by Congress would upset an essential state interest in regulating foreclosures. The court left questions: (1) whether judicial foreclosure actions are subject to the FDCPA; and (2) whether a debt collector may violate the FDCPA by threatening foreclosure as a form of debt collection activity.

C. *Taggart* & § 524

Lorenzen v. Taggart (In re Taggart), 888 F.3d 438 (9th Cir. 2018).

This case falls into the category of the "ex" factor. Some cases involving "exes," whether an ex-spouse or an ex-business partner, can devolve into endless litigation with no rational thought given as to the expenses incurred. This one involved an ex-business partner in a real estate LLC who transferred his ownership interest in the LLC to his attorney after he had a falling out with the other members. When the other members found out about the transfer, they sued him for breach of the operating agreement. This agreement contained some provision for the recovery of attorney fees incurred over disputes, mostly likely a prevailing party clause. Much of the subsequent litigation involved claims for recovery of fees.

Prior to trial on the members' state court action, the debtor filed a chapter 7 petition. He received his discharge in due course. After the discharge, the members continued the state court litigation against him. His attorney informed the state court of the bankruptcy discharge but the court was persuaded by the other members to go forward because the debtor was "a necessary party." The state court ruled in favor of the other members by avoiding the transfer of the membership interest and expelling the debtor from the LLC. The court requested a form of judgment from the prevailing parties. The form submitted allowed the other members to recover their fees. The debtor's attorney objected to this and at a hearing on the form of judgment, the debtor testified. The fee request had been limited as to the debtor to only cover fees necessitated by his conduct in "returning to the fray" post-discharge. Meanwhile, the debtor reopened his bankruptcy case to seek discharge injunction violations against the other members. The bankruptcy court, relying on the state court's finding that the debtor had re-entered the fray, denied the request for sanctions. The district court on appeal reversed, finding that the debtor's actions did not constitute a "return to the fray." It then remanded to the bankruptcy court to determine whether the discharge injunction had been violated.

On remand, the bankruptcy court found that the members had violated the discharge injunction. On appeal, the Ninth Circuit Bankruptcy Appellate Panel found that the members could not be held in contempt unless they "knowingly" violated the injunction. In the meantime, the state court court of appeals reversed the trial court's ruling on fees. Thus, the members were no longer entitled to a claim against the debt post-discharge, but they were still facing potential liability on the debtor's sanctions request.

On appeal to the Ninth Circuit, the question was whether a good faith belief, whether or not it was reasonable, would negate the necessary element of a "knowing" violation of the

discharge injunction. The court reiterated its test for sanctions as a two-part test. "[T]o justify sanctions, the movant must prove that the creditor (1) knew the discharge injunction was applicable and (2) intended the actions which violated the injunction." *Id.* at 443 (citations omitted). It concluded that the bankruptcy court had abused its discretion in finding a knowing violation because the members held a subjective belief that they were not acting in violation of the injunction.

In making its ruling, the Ninth Circuit did not note any split in authority as to the test for § 524 sanctions, but in the debtor's request for certiorari, the Supreme Court received many *amici* briefs from bankruptcy law professors, retired bankruptcy judges, the National Consumer Bankruptcy Rights Center, and the National Association of Consumer Bankruptcy Attorneys.

D. *Cowen* & § 362(a)

Circuit Split on "Acts" in Violation of the Automatic Stay

1. Section 362(a) of the Bankruptcy Code states, in relevant part, that the filing of a petition operates as a stay of "*any act*" --

    a. "to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate[.]" 11 U.S.C. § 362(a)(3).

    b. "to create, perfect, or enforce any lien against property of the estate[.]" *Id*., § 362(a)(4).

    c. "to create, perfect, or enforce against property of the debtor any lien to the extent that such lien secures a claim that arose before the commencement of the case under this title." *Id*., § 362(a)(5).

    d. "to collect, assess, or recover a claim against the debtor that arose before the commencement of the case under this title[.]" *Id*., § 362(a)(6).

2. Tenth Circuit - Minority View: *WD Equip., LLC v. Cowen (In re Cowen)*, 849 F.3d 943 (10th Cir. 2017): The phrase "any act" under § 362(a)(3) requires an "affirmative action to gain possession of, or to exercise control over, property of the estate . . . ." *Id.*, at 950. Thus, retaining possession of a repossessed vehicle after a debtor files bankruptcy and requests turnover is not a violation of the automatic stay. *Accord United States v. Inslaw, Inc.*, 932 F.3d 1467 (D.C. Cir. 1991). Even if turnover requirements set forth in 11 U.S.C. § 542 were self-executing, there is "no textual link" between that section and § 362(a)(3). *Id.* The Tenth Circuit concluded: "[B]ankruptcy courts do not need § 362 to enforce the turnover of property to the estate. Bankruptcy courts have board equitable powers under 11 U.S.C. § 105(a), and can provide equitable relief as necessary or appropriate to care out the provisions of § 542(a). Moreover, §105(a) grants bankruptcy courts the power to sanction conduct abusive of the judicial process." *Id.* (citations and internal quotations omitted).

a. *Cowen* was recently reaffirmed by the Tenth Circuit in the context of § 362(a)(4) in *Davis v. Tyson Prepared Foods, Inc. (In re Garcia)*, 740 F. Appx. 163 (10th Cir. filed Oct. 17, 2018). The attachment of a statutory lien on postpetition workers' compensation payments to the Chapter 13 debtor did not violate the automatic stay because there was no "affirmative conduct on the part of the lienholder" giving rise to an "act" within the meaning of § 362(a)(4) as interpreted in *Cowen*. *Id,* at *2. Since it was undisputed that the lien arose "solely by operation of law, the logic and the holding of *Cowen* compel our conclusion that the lien is valid and enforceable, and that no violation of the automatic stay has occurred." *Id.* Section 552 is not discussed.

b. Based on *Cowen and Garcia*, it is clear that the automatic stay only applies in the Tenth Circuit to affirmative actions under § 362(a)(3) – (6).

c. This position may have begun to gain traction. *See Denby-Peterson v. NU2U Auto World & Pine Valley Motors*, 2018 U.S. Dist. LEXIS 187686 (D. N.J. filed Nov. 1, 2018). The minority view is more persuasive because § 362 is "prospective in nature." *Id*., at *10. The language of the statute is clear that "the *exercise* of control is not stayed, but the act to exercise control is stayed." *Id.* (emphasis in original).

3. Majority View: A creditor violates the automatic stay if it refuses to return property of the estate postpetition. *See Weber v. SEFCU (In re Weber)*, 719 F.3d 72 (2nd Cir. 2013); *Thompson v. Gen. Motors Acceptance Corp.,* LLC, 566 F.3d 699 (7th Cir. 2009); *Cal. Emp't Dev. Dept. v. Taxel (In re Del Mission, Ltd.),* 98 F.3d 1147 (9th Cir. 1996); *Knaus v. Concordia Lumber Co. (In re Knaus),* 889 F.2d 773 (8th Cir. 1989).

On September 4, 2018, the Seventh Circuit entered an order consolidating the following cases for direct appeal: *In re Peake*, 588 B.R. 811 (Bankr. N.D. Ill. 2018); *In re Fulton*, 2018 Bankr. LEXIS 1555 (Bankr. N.D. Ill. filed May 25, 2018); *In re Scott*, 584 B.R. 252 (Bankr. N.D. Ill.). Relying on *Thompson*, the bankruptcy courts in these cases held that § 362(a)(3) prevents the City of Chicago from retaining possession of impounded cars. Among other things, exceptions to the automatic stay in § 362(b)(3) and (4) do not apply. *Accord Cross v. City of Chicago (In re Cross)*, 584 B.R. 833 (Bankr. N.D. Ill. 2018).

III. UPDATE ON NEW, BUT LESS RECENT SUPREME COURT DECISIONS

A. *Jevic* & Priority Skipping Measures

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

Following the Supreme Court's decision in *Jevic,*[1] questions remained as to how bankruptcy courts would apply the holding of *Jevic* beyond its application in structured

[1] 137 S. Ct. 973 (2017).

dismissals. While the Supreme Court drew a narrow line with respect to the absolute priority rule, the ability of the bankruptcy courts to grant relief that would disrupt the priority scheme in the Bankruptcy Code was called into question.[2] The bankruptcy court's ability to grant relief in the context of first day motions to pay pre-petition employee wages and critical vendors or approving settlement agreements that disrupted the priority scheme in the Bankruptcy Court was called into question following the Supreme Court's rigid adherence to the Bankruptcy Code's priority scheme.

In *Jevic*, the Supreme Court was asked to determine whether a bankruptcy debtor could approve a structured dismissal that allowed certain creditors to be paid outside of the priority scheme set forth in the Bankruptcy Code.[3] Sun Capital Partners ("Sun") acquired Jevic Transportation Company in leveraged buyout.[4] Two years after the acquisition, the debtor filed a Chapter 11 bankruptcy case, after which a group of former employees filed a lawsuit against Sun and the debtor, and the unsecured creditors committee brought a suit to recover fraudulent conveyances against Sun and the primary secured lender.[5] As settlement of the fraudulent transfer action, the secured lender agreed to pay $2 million into an account for payment of the committee's legal fees and administrative expenses, and Sun would assign its lien on the debtor's remaining $1.7 million in funds to a trust that would pay taxes, administrative expenses, and general unsecured creditors without making any distribution to former drivers who held $8.3 million in priority wage claims.[6] The parties further agreed that the debtor's Chapter 11 case would be dismissed.[7] The bankruptcy court approved the settlement over the objection of the priority claim holders, holding that while the settlement disrupted the ordinary priority scheme, the settlement could nonetheless be approved, as it called for a dismissal as opposed to confirmation of a plan, there was no prospect for a reasonable payout to anyone other than secured creditors outside of the settlement, and confirmation of a plan would be unattainable given the priority and administrative expense claims against the estate.[8] The bankruptcy court's approval of the settlement agreement and dismissal of the case was subsequently affirmed by the district court and the Third Circuit.[9]

On appeal, the Supreme Court held that the bankruptcy court could not approve a settlement that altered the priority scheme.[10] The Court stated that "[t]he Code's priority system

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[2] Stephen J. Lubben, *Supreme Court Ruling Draws a Vague Line in Bankruptcy Cases*, Apr. 14, 2017, NEW YORK TIMES, https://www.nytimes.com/2017/04/14/business/dealbook/supreme-court-ruling-draws-a-vague-line-in-bankruptcy-cases.html.

[3] *Id.* at 679-80.

[4] *Id.* at 980.

[5] *Id.* at 980-81.

[6] *Id.* at 981.

[7] *Id.*

[8] *Id.* at 981-82.

[9] *Id.* at 982. *See also In re Jevic Holding Corp.*, 2014 U.S. Dist. LEXIS 8813, 2014 WL 268613, at *3 (D. Del. Jan. 24, 2014); *Official Comm. of Unsecured Creditors v. CIT Grp./Bus. Credit Inc. (In re Jevic Holding Corp.)*, 787 F.3d 173, 175 (3d Cir. 2015).

[10] 137 S. Ct. at 983.

constitutes a basic underpinning of business bankruptcy law." [11] While the priority scheme could be more flexible in a Chapter 11 as opposed to a Chapter 7, Congress would nonetheless have to give some affirmative indication if they intended to allow for a disruption of the bankruptcy priority scheme when making final distributions to creditors.[12] The Court further held that the consequences of allowing for structured dismissals that altered the priority scheme, even in rare cases, could have potentially serious consequences, as it opened the door to a risk of collusion, changed the bargaining power of different classes, and departed from the protections intended by Congress in establishing the priority scheme.[13] As a result, the Supreme Court held that it would not "alter the balance struck by the statute," and therefore held that structured dismissals that altered the priority scheme were impermissible in any circumstances.[14]

In reaching this conclusion, the Supreme Court did draw a narrow distinction between final distributions that occur in a Chapter 11 case and interim distributions.[15] The Court held that in the case of interim distributions, such as first day motions to pay pre-petition employee wages, "one can generally find significant Code-related objectives that the priority-violating distributions serve."[16] The Court recognized that interim distributions that occur outside of the priority scheme are frequently necessary to enable a successful reorganization and maximize the value of the estate.[17]

The narrow ruling in *Jevic* has provided an avenue for bankruptcy courts to continue to grant relief outside of the priority scheme in the Bankruptcy Code so long as the relief is granted during the case, and not in the context of a final distribution to creditors, and so long as there is a substantial bankruptcy-related purpose to be served by granting the requested relief. In *In re Pioneer Health Svcs., Inc.*, the debtor filed a motion seeking the immediate payment of a supplier and three emergency room doctors in order to ensure continuity of services.[18] The debtor argued that payment in full of the doctors' pre-petition claims was necessary to ensure that the doctors would continue to provide services to the debtor, and that without the doctors, the debtor would be forced to close its doors.[19] The motion was filed approximately 10 months after the case was filed, and the amounts the debtor sought to pay were higher than the amount that could be allowed as a priority wage claim.[20] The court denied the debtor's motion, holding that, following *Jevic*, the debtor was required to show a significant bankruptcy-related justification when asking the court to disrupt the bankruptcy priority scheme.[21] In ruling on the

[11] *Id.*

[12] *Id.* at 984.

[13] *Id.* at 986-87.

[14] *Id.* at 987 (quoting *Law v. Siegel*, 134 S. Ct. 1188 (2014)).

[15] *Id.* at 985.

[16] *Id.*

[17] *Id.* at 985.

[18] 570 B.R. 228, 230-31 (Bankruptcy. S.D. Miss. 2017).

[19] *Id.* at 231.

[20] *Id.* at 231-32.

[21] *Id.* at 235.

motion, the bankruptcy court held that the debtor had failed to establish such a substantial bankruptcy related justification, as the motion was filed well after the bankruptcy case had been filed, there was no evidence that the doctors would leave if not paid, the doctors were not established as critical vendors, and there were other legal remedies available to the debtor.[22] Because the debtor failed to establish substantial justification for the departure from the priority scheme in the Bankruptcy Code, the bankruptcy court could not allow for the payment of general unsecured claims ahead of other creditors.[23]

Jevic has also been interpreted by the courts to prohibit a debtor from taking advantage of the protections afforded by the Bankruptcy Code while refusing to pay creditors following a voluntary dismissal.[24] In *Haddad*, the chapter 13 debtor sought to voluntarily dismiss her case following settlement of a large personal injury claim arising from a post-petition automotive accident.[25] The Chapter 13 trustee subsequently moved to amend the order dismissing the debtor's case in order to distribute proceeds from the settlement to unsecured creditors, arguing that, while 11 U.S.C. § 349(b) seeks to unwind the bankruptcy case to the extent possible, the trustee should still be allowed to distribute a portion of the settlement proceeds to creditors.[26] Citing to the Supreme Court's recognition that the absolute priority rule was the "basic underpinning" of the Bankruptcy Code, the bankruptcy court held that the debtor's dismissal of her case acted as an attempt to avoid the absolute priority rule and retain the full amount of the settlement proceeds for herself.[27] The court focused on the debtor's unequivocal testimony that upon dismissal, she had no intention of repaying her creditors, despite having enjoyed the protections afforded by the Bankruptcy Code for 4 ½ years, and the unsecured creditors' reliance on her assertions that she had no assets with which to pay her creditors.[28] As a result, the court found that cause existed to amend the dismissal order to allow the Chapter 13 trustee to distribute sale proceeds to creditors in order to preserve the priority scheme in the Bankruptcy Code.[29]

Courts have also analyzed the Supreme Court's holding in *Jevic* in the analysis of subsequent structured dismissals to determine whether administrative claimants must be paid equally in a dismissal following interim disbursements to administrative priority claimants.[30] In *United States v. Seiller Waterman LLC*, the debtors, a hospital located in Indiana, was represented in its Chapter 11 bankruptcy case by Seiller Waterman, LLC ("Law Firm").[31] During the course of the Chapter 11 case, the Law Firm received approximately $135,000 from

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[22] *Id*. at 235-36.

[23] *Id.* at 236.

[24] *In re Haddad*, 572 B.R. 661, 676-77 (Bankr. E.D. Mich. 2017).

[25] *Id.* at 663.

[26] *Id.* at 663, 674-75.

[27] *Id.* at 676.

[28] *Id.* at 676-77.

[29] *Id.* at 677.

[30] *United States v. Seiller Waterman LLC (In re St. Catherine Hosp. of Ind., LLC)*, 2018 WL 4620273, 2018 U.S. Dist. LEXIS 165112, at *10-11 (S.D. Ind. Sept. 26, 2018).

[31] *Id.* at * 1-2.

the debtor pursuant to two interim fee applications that had been approved by the bankruptcy court.[32] After a Chapter 11 trustee was appointed, the Law Firm filed a third fee application, to which the Chapter 11 trustee filed a limited objection.[33] The third fee application was resolved in a settlement that provided that, while the fees and costs in the third fee application were allowed, the Law Firm would not receive any payment for the fees.[34] Two years after the Chapter 11 trustee was appointed, the trustee determined that the estate had insufficient funds to pay all administrative expenses, including taxes and attorney fees, in full, and sought approval of an orderly dismissal of the case.[35] The United States sought disgorgement of the fees paid to the Law Firm, arguing that funds had to be paid to administrative priority creditors pro rata.[36] The bankruptcy court denied the motion, holding that the Law Firm had "more than earned its fees."[37]

On appeal to the district court, the United States argued that the Supreme Court's ruling in *Jevic* required the bankruptcy court to adhere to the absolute priority rule, which in turn required pro rata distribution of funds to creditors in accordance with 11 U.S.C. § 726(b).[38] The district court disagreed, holding that while *Jevic* required addressed the basic priority scheme under the Bankruptcy Code, it did not address payments within classes of creditors, particularly where the bankruptcy court had already authorized the interim disbursement to creditors within that class.[39] The district court therefore held that there was no basis to require disgorgement of the fees paid to the Law Firm, and affirmed the decision of the bankruptcy court.[40]

The narrow ruling in *Jevic* leaves a number of issues related to the absolute priority rule unanswered, leaving bankruptcy courts to fill in the gaps. In the context of interim distributions, questions remain as to how these distributions should be accounted for when making final distributions to creditors to ensure compliance with the absolute priority rule. Issues related to the absolute priority rule could also be raised in the context of a sale under section 363 if the sale proposes to make distributions to any parties other than secured creditors. While distributions made pursuant to a sale order may not be a final distribution, if the proposed sale covers substantially all of the debtor's assets, issues related to the Supreme Court's holding in *Jevic* may need to be raised to ensure that the Bankruptcy Code's priority scheme is preserved ahead of the final disposition of the case. Until additional district courts and circuit courts weigh in on these issues, the impact of the Supreme Court's holding in *Jevic* may not be fully realized.

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[32] *Id.* at *2.

[33] *Id.* at *2-3.

[34] *Id.* at *4.

[35] *Id.* at *5.

[36] *Id.* at *5-6, 9.

[37] *Id.* at *17.

[38] *Id.* at *9.

[39] *Id.* at *10.

[40] *Id.* at *11, 18.

B. *Merit Management* & the Safe Harbor

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

Under 11 U.S.C. §§ 544, 547 and 548[41], a bankruptcy trustee (or debtor-in-possession) is vested with certain "strong arm" or "avoiding" powers to set aside and recover certain pre-petition transfers. Such transfers include fraudulent transfers under applicable non-bankruptcy law and under the Bankruptcy Code, as well as preferential transfers.[42] *Id.*

"All of the avoiding powers have the policy of fair treatment among creditors at their base. The details of the avoiding powers differ and some can be quite complex at points. The theoretical underpinning of all of them remains the equal treatment among creditors by forcing those who have received an unfair advantage to disgorge the ill gotten gains." R. Aaron, Bankruptcy Law Fundamentals § 10.01 (Clark Boardman Co.).[43]

Under Section 546 of the Bankruptcy Code, there are certain limits on the avoidance powers. Section 546(a) sets a statute of limitations for such avoidance actions. Sections 546(c) - (d) limit avoidance powers when the transfers involve reclamation claims. Section 546(e) also provides a "safe harbor" for other types of payments. Specifically,

> [n]otwithstanding sections 544, 545, 547, 548(a)(1)(B), and 548(b) of this title, the trustee may not avoid a transfer that is a margin payment, as defined in section 101, 741, or 761 of this title, or settlement payment, as defined in section 101 or 741 of this title, made by or to (or for the benefit of) a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency, or that is a transfer made by or to (or for the benefit of) a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency, in connection with a securities contract, as defined in section 741(7), commodity contract, as defined in section 761(4), or forward contract, that is made before the commencement of the case, except under section 548(a)(1)(A) of this title.

11 U.S.C. §546(e). Under the Code, a "financial institution" includes banks and trust companies "acting as agent or custodian for a customer . . . in connection with a securities contract," 11 U.S.C. § 101(22). Similarly, a "settlement payment" includes a "payment commonly used in the securities trade." 11 U.S.C. § 741(8).

The purpose of section 546(e) is to prevent "the insolvency of one commodity or security firm from spreading to other firms and possibly threatening the collapse of the affected market." H.R. Rep. No. 97-420, at 1 (1982), reprinted in 1982 U.S.C.C.A.N. 583, 583, 1982 WL 25042. The provision was "intended to minimize the displacement caused in the commodities and securities markets in the event of a major bankruptcy affecting those industries." *Id.* Under

[41] All references to the Bankruptcy Code or Code and/or Sections refer to Title 11 of the United States Code.

[42] *See Sender v. Simon,* 84 F.3d 1299 (10th Cir. 1996); *Sender v. Mann*, 423 F.Supp.2d 1155 (D.Colo. 2006).

[43] *See Delgado Oil Co. v. Torres*, 785 F.2d 857, 861-62 (10th Cir.1986); *Texas General Petroleum Corp. v. Evans (In re Texas General Petroleum Corp.)*, 58 B.R. 357, 358 (Bankr.S.D. Tex.1986).

Section 546(e), Congress also sought to promote customer confidence in the markets by protecting market stability.[44]

Prior to the Supreme Court's recent decision in *Merit Management*, the circuits were split on the application of Section 546(e) when determining whether financial institutions serve as a mere "conduit" for the transfer of funds from the debtor to the ultimate transferee. Five circuits refused to apply the safe harbor of Section 546(e).[45] The Eleventh and Seventh Circuits held otherwise.[46]

By unanimous decision in *Merit,* the Supreme Court changed how the safe harbor contained in § 546(e) is applied to avoidance actions. The Court held that Section 546(e) does not prohibit the avoidance of transfers made "by or to" a financial institution when the financial institution served merely as a conduit. 138 S.Ct. at 895-96. In other words, certain transfers that were once subject to the Code's safe harbor are now avoidable by trustees and debtors-in-possession. This could result in significant additional recoveries for bankruptcy estates and creditors.

Merit arose out of a horse racing business transaction. In 2007, Valley View Downs, LP ("Valley View"), a would-be racing casino, agreed to purchase the stock of Bedford Downs Management Corporation ("Bedford Downs") for $55 million to reduce competition and obtain the last available "harness-racing" license in Pennsylvania. *Id.* at 890-91. Credit Suisse financed the acquisition and paid $55 million into an escrow account at Citizens Bank, which eventually transferred $16.5 million to Merit Management Group, LP ("Merit"), the seller of 30% of Bedford Downs. *Id.* After the acquisition, Valley View was unable to secure a second license and subsequently filed for chapter 11. *Id.*

FTI Consulting, Inc. ("FTI"), as trustee for Valley View's post-confirmation litigation trust, sought to avoid the $16.5 million paid to Merit as constructively fraudulent. *Id.* The parties stipulated that the transfers were settlement payments made in connection with a securities contract. *Id.* Similarly, they agreed that Credit Suisse and Citizens Bank were financial

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[44] *See Kaiser Steel Corp. v. Charles Schwab & Co.*, 913 F.2d 846 (10th Cir. 1990) (citing S. Rep. No. 989, at 8 (1978)).

[45] *See In re Quebecor World (USA) Inc.*, 719 F.3d 94 (2d Cir. 2013) (the safe harbor is applicable where the financial institution was a trustee, and the actual exchange was between two private entities); *Contemporary Indus. Corp. v. Frost*, 564 F.3d 981 (8th Cir. 2009) (section 546(e) is not limited to public securities transactions and protects from avoidance a debtor's payments deposited in a national bank in exchange for the shareholders' privately held stock during an LBO); *In re QSI Holdings, Inc.*, 571 F.3d 545 (6th Cir. 2009) (the safe harbor applied even though the financial institution involved in the LBO was only the exchange agent); *In re Resorts Int'l, Inc.*, 181 F.3d 505, 516 (3d Cir. 1999) (noting that "the requirement that the 'commodity brokers, forward contract merchants, stockbrokers, financial institutions, and securities clearing agencies' obtain a 'beneficial interest' in the funds they handle . . . is not explicit in section 546"); *In re Kaiser Steel Corp.*, 952 F.2d 1230, 1240 (10th Cir. 1991) (rejecting the argument that "even if the payments were settlement payments, § 546(e) does not protect a settlement payment 'by' a stockbroker, financial institution, or clearing agency, unless that payment is to another participant in the clearance and settlement system and not to an equity security holder").

[46] *See In re Munford, Inc.*, 98 F.3d 604 (11th Cir. 1996) (holding that bank was "financial institution" but served only as conduit for the transfer of funds and securities; bank never held "beneficial interest" sufficient to qualify as a "transferee"); *Munford in FTI Consulting, Inc. v. Merit Management Group, LP*, 830 F.3d 690 (7th Cir. 2016) (adopting rational in *In re Munford, Inc.*)

institutions. *Id.* The central issue was whether the transfer could be clawed back under the strong arm powers of the Code. *Id.* Specifically, the dispute concerned the meaning of the elemental phrase "by or to (or for the benefit of) a financial institution" as it applied to the roles of Credit Suisse and Citizens Bank in the transaction. *Id.* In other words, the question was whether the transfer to Merit was "by or to (or for the benefit of) a financial institution" because it went through Credit Suisse or Citizens Bank? *Id.* at 892.

The Court held that, for purposes of determining whether the Section 546(e) safe harbor applies, the only relevant transfer is the one the trustee seeks to avoid, and not the component transfers that make up a larger transaction. *Id. at 895.* The Court looked at the plain language of Section 546(e). *Id.* at 893. Section 546(e) applies "notwithstanding" the avoidance powers contained in chapter 5 of the Bankruptcy Code. *Id.* The Court concluded that the only transfers covered by Section 546(e) are those subject to avoidance, not the intermediate parts of a transaction. *Id.* In other words, even when a challenged transaction involves multiple transfers that could be safe harbored if challenged separately, if the trustee challenges the end-to-end transfer (A → B → C → D) and not the component parts (B → C). *Id.* Section 546(e) only applies to the ultimate transfer (A → D). *Id.*

The Court also relied on the structure of the Bankruptcy Code, noting that chapter 5 creates a system for avoiding certain transfers and for protecting specified transfers from avoidance. *Id.* at 894. The Court stated that where a trustee properly identifies a transfer for avoidance under the chapter 5 framework, courts have no reason to examine the intervening component parts of the transfer. *Id.* at 894-95.

After *Merit*, Section 546(e) protects transfers ***to*** a covered entity, not ***through*** a covered entity. *Id.* at 895. In other words, routing a transfer through a covered entity will no longer shield the transaction. *Id.*

Merit will likely result in more avoidance litigation as chapter 11 debtors, creditors' committees, and trustees may have grounds to attack transactions that previously were shielded from avoidance by a majority of the circuits. Indeed, *Merit* may lead to greater recoveries and more equitable outcomes for unsecured creditors in bankruptcy.

Merit could also significantly shift the leverage points in bankruptcy negotiations, particularly where trustees in the past have lacked leverage *(e.g.*, in leveraged buyout transactions). Now, potential defendants will have to focus on the substantive elements of the avoidance causes of action to fend off such claims.

IV. THE INTERSECTION BETWEEN BANKRUPTCY AND MARIJUANA

Bankruptcy courts across the country have had to navigate the intersection between federal and state law with increased regularity as more states legalize the sale and production of marijuana. In 2018, Michigan voted to become the tenth state to legalize recreational and medical marijuana, joining Colorado, Washington, Oregon, California, Nevada, Alaska, Vermont, Massachusetts, Maine and Washington, DC.[47] An additional twenty states have voted

[47] Business Insider, Nov. 7, 2018, https://www.businessinsider.com/legal-marijuana-states-2018-1

to legalize cannabis for medical use. While the trend of legalization of marijuana for medical and recreational use is likely to continue on a state level, it remains illegal on a federal level, forcing bankruptcy courts to navigate the intersection when businesses and individuals with some connection to marijuana file for bankruptcy.

Current Federal Law

The Controlled Substances Act [21 U.S.C. §§801 *et seq*.] ("CSA") was enacted by Congress in 1970 to consolidate the piecemeal drug laws and enhance federal enforcement powers.[48] In doing so, "Congress devised a closed regulatory system making it unlawful to manufacture, distribute, dispense, or possess any controlled substance except in a manner authorized by the CSA[,]" resulting in the creation of five schedules into which drugs are categorized based on use, effects, and addictive traits.[49] At the time of enacting the CSA, cannabis[50] was listed as a Schedule I drug, and remains a Schedule I drug to this day.[51]

In defining acts that are unlawful under the CSA, 21 U.S.C. § 841 provides:

> **(a)** Unlawful acts. Except as authorized by this title, it shall be unlawful for any person knowingly or intentionally--
> **(1)** to manufacture, distribute, or dispense, or possess with intent to manufacture, distribute, or dispense, a controlled substance; or
> **(2)** to create, distribute, or dispense, or possess with intent to distribute or dispense, a counterfeit substance.

In addition to acts that are defined as unlawful under section 841, the CSA further provides that it shall be unlawful to engage in maintaining a drug-involved premises[52] or to sell drug-related paraphernalia[53], as defined by 21 U.S.C. § 863(d). In defining these unlawful acts,

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[48] *Gonzales v. Rich*, 545 U.S. 1, 12 (2005).

[49] *Id.* at 13-14.

[50] The CSA refers specifically to "marihuana" which has become interchangeable with "marijuana" and "cannabis" in subsequent years.

[51] *See* 21 U.S.C. § 812(c); 12 U.S.C. § 802(15); *Nat'l Org. for Reform of Marijuana Laws (NORML) v. Drug Enforcement Administration, U.S. Dep't of Justice*, 559 F.2d 735, 738 (D.C. Cir. 1977).

[52] 21 U.S.C. § 856 states:

> (a) Unlawful acts. Except as authorized by this title, it shall be unlawful to--
>
> (1) knowingly open, lease, rent, use, or maintain any place, whether permanently or temporarily, for the purpose of manufacturing, distributing, or using any controlled substance;
>
> (2) manage or control any place, whether permanently or temporarily, either as an owner, lessee, agent, employee, occupant, or mortgagee, and knowingly and intentionally rent, lease, profit from, or make available for use, with or without compensation, the place for the purpose of unlawfully manufacturing, storing, distributing, or using a controlled substance.

[53] 21 U.S.C. § 863 states:

> (a) In general. It is unlawful for any person--

the CSA expressly sets forth the activities related to controlled substances, including cannabis, that are illegal under federal law.

Direct Connections to Marijuana

While marijuana may be legal under state law, bankruptcy courts must still turn to the CSA to determine if a debtor's business operations conflict with federal law, thus making the debtor ineligible for the protections afforded by the Bankruptcy Code. In the context of a Chapter 11 and a Chapter 13, a debtor must propose a plan in "good faith and not be any means forbidden by law."[54] In the context of a Chapter 7, a trustee cannot take control of or administer assets when doing so would require the trustee to commit a felony.[55]

In those cases where the debtor has a connection to marijuana, the courts have based their decisions on whether the debtor was acting in direct violation of the CSA.[56] In the seminal case of *Rent-Rite*, the bankruptcy court focused on the ongoing violation of the CSA by the Chapter 11 debtor in holding that its case was subject to dismissal.[57] The debtor owned a warehouse located in Denver, Colorado, which was leased in part to tenants who used the space for the ongoing cultivation of cannabis.[58] Approximately 25% of the debtor's revenue was derived from leasing space to the cannabis cultivators.[59] After the debtor filed its Chapter 11 bankruptcy case, the primary secured creditor filed a motion to dismiss the case, arguing that the debtor's ongoing criminal activities should deprive the debtor of the protections afforded by the Bankruptcy Code.[60] In ruling on the motion to dismiss, the court held that the debtor was in direct violation of 28 U.S.C. § 856 by knowingly renting the space for the purposes of allowing the tenants to cultivate cannabis.[61] Because the debtor was knowingly violating the CSA under the assumption that Colorado law would preempt federal law, the court held that the bankruptcy court, as a federal court, could not be asked to enforce the protections of the Bankruptcy Code in aid of a

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(1) to sell or offer for sale drug paraphernalia;

(2) to use the mails or any other facility of interstate commerce to transport drug paraphernalia; or

(3) to import or export drug paraphernalia.

[54] 11 U.S.C. §§ 1129(a)(3), 1325(a)(3).

[55] *See In re Arenas*, 514 B.R. 887, 895 (Bankr. D. Colo. 2014).

[56] *E.g.*, *Arenas v. United States Trustee (In re Arenas)*, 535 B.R. 845, 851 (B.A.P. 10th Cir. 2015)(affirming the bankruptcy court's dismissal of the debtors' case because the debtors were violating the CSA by growing and selling cannabis, as well as leasing space to a cannabis dispensary); *In re Rent-Rite Super Kegs W. Ltd.*, 484 B.R. 799, 803-04 (Bankr. D. Colo. 2012); *Olson v. Van Meter (In re Olson)*, BAP No. NV-17-1168-LTiF, 2018 Bankr. LEXIS 480, at *17-18 (B.A.P 9th Cir. Feb. 5, 2018)(holding that the bankruptcy court had committed reversible error by failing to make findings that the elements of the alleged CSA violation, including establishing the intent elements of the violation); *In re Johnson*, 532 B.R. 53, 58-59 (Bankr. W.D. Mich. 2015)(holding that the debtors' cultivation and sale of cannabis was "patently incompatible with a bankruptcy proceeding").

[57] 484 B.R. at 803-04.

[58] *Id.* at 803.

[59] *Id.*

[60] *Id.* at 802.

[61] *Id.* at 803-04.

debtor whose actions "constitute a continuing federal crime."[62] As a result, because of the debtor's ongoing criminal conduct, the court held that cause existed for dismissal or conversion of the debtor's case pursuant to 11 U.S.C. § 1112(b), subject to a determination as to which would be in the best interests of creditors.[63]

In *Arenas*, the debtors' violation of the CSA again formed the basis for dismissal of a Chapter 7 bankruptcy case.[64] The debtors were engaged in the cultivation and sale of marijuana, and also owned real property that was leased to a marijuana dispensary.[65] The debtors only other source of income was social security and pension benefits in an amount significantly less than their monthly expenses.[66] After the debtors filed their Chapter 7 bankruptcy case, the United States Trustee filed a motion to dismiss, asserting that it would be impossible for the Chapter 7 trustee to administer the assets of the estate without violating federal law.[67] In an effort to avoid dismissal, the debtors instead moved to convert their case to Chapter 13.[68] The bankruptcy court held that because the trustee would be in violation of the CSA if he took possession of the assets of the estate, namely the leased real property and the cannabis plants, the trustee could not administer the estate assets, allowing the debtors to receive the benefit of a discharge without allowing creditors to receive the benefit of the trustee's administration of the estate.[69] The court further held that the debtors could not convert their case to a Chapter 13, as the debtors could not propose a confirmable plan because they lacked sufficient income to do so, even with the income from cannabis.[70] Accordingly, the bankruptcy court held that cause existed to dismiss the debtors' case.[71]

On appeal to the Tenth Circuit Bankruptcy Appellate Panel, the debtors argued that the trustee could have abandoned the marijuana assets out of the estate as a means of curing the violation of the CSA.[72] The Bankruptcy Appellate Panel rejected this argument, holding that the debtors had violated federal law and were continuing to do so.[73] The court held that the debtors had exposed the trustee to violations of federal criminal law to the extent he administered the assets, stating that "nothing could be more burdensome to the Trustee's administration than requiring him to take possession, sell, and distribute marijuana assets in violation of federal

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[62] *Id.* at 805.

[63] *Id.* at 810-11.

[64] *In re Arenas*, 514 B.R. 887, 895 (Bankr. D. Colo. 2014).

[65] *Id.* at 888.

[66] *Id.* at 894.

[67] *Id.* at 889, 891.

[68] *Id.* at 891.

[69] *Id.* at 891-92.

[70] *Id.* at 894.

[71] *Id.* at 895.

[72] *Arenas*, 535 B.R. at 848, 854.

[73] *Id.* at 853-54.

criminal law."[74] The court further held that if assets were abandoned, the debtors would be able to retain their business while providing creditors with little to no recovery while receiving the benefit of a discharge, resulting in a prejudicial delay that would itself be cause for dismissal.[75] The court therefore held that dismissal of the case was warranted given the ongoing violation of the CSA, and therefore affirmed the decision of the bankruptcy court.[76]

While these seminal cases seem to suggest that a case must be dismissed once it has been tainted by the presence of marijuana, recent cases suggest that when the CSA violation is curable, the debtor may still be entitled to the protections afforded by the Bankruptcy Code. For instance, in *Johnson*, the Chapter 13 debtor was given the choice between continuing with his bankruptcy case, or continuing to cultivate and sell marijuana.[77] At the time of his bankruptcy filing, he was deriving income from cultivating and selling cannabis to three patients and a regulated dispensary in compliance with applicable Michigan law in addition to receiving social security income.[78] After filing his Chapter 13 bankruptcy case, the United States Trustee filed a motion to dismiss, asserting that because the debtor was engaged in growing and selling marijuana, the debtor should not be afforded the protections of the Bankruptcy Code to "aid violations of the federal Controlled Substances Act."[79] In ruling on the motion to dismiss, the court held that the debtor's financial life was "inextricably bound up with his federal criminal activity through his chapter 13 plan[.]"[80] The court held that that just as a trustee was precluded from using estate assets to violate federal law, including federal criminal law, so too is a debtor in possession.[81] The court held that the debtor's actions in growing and selling cannabis were a violation of the CSA, and stated that:

> The Debtor's business is patently incompatible with a bankruptcy proceeding, but his financial circumstances are not. In other words, if the Debtor were not engaged in post-petition criminal activity, there would likely be no controversy about his eligibility for relief under chapter 13. The problem, of course, is that he derives nearly half of his income from activity that Congress forbids as criminal. The Debtor, it seems, must choose between conducting his medical marijuana business and pursuing relief under the Bankruptcy Code.[82]

[74] *Id.* at 852.

[75] *Id.* at 853-54.

[76] *Id.* at 854.

[77] 532 B.R. at 57.

[78] *Id.* at 55.

[79] *Id.* at 54.

[80] *Id.* at 57.

[81] *Id.* at 57.

[82] *Id.*

Because the debtor's business activity in cultivating and selling cannabis was a violation of the CSA, the court held that the debtor was required to choose between continuing to cultivate and sell cannabis, or continue with his bankruptcy case.[83]

In *Arm Ventures, LLC*, the debtor was again given the choice between continuing to derive income from the sale of cannabis, or proceed with a reorganization under Chapter 11.[84] The Debtor owned a 48.8% interest in a commercial building leased to three separate companies.[85] After filing its bankruptcy case, the debtor proposed a plan which proposed to lease a portion of the building to a medical marijuana dispensary.[86] The primary secured creditor filed a motion to dismiss, asserting that the debtor had filed its case in bad faith pursuant to 11 U.S.C. § 1112(b).[87] In ruling on the motion to dismiss, the court held that it was highly unlikely that the proposed tenant would be able to operate in accordance with federal law, as growing and selling cannabis was illegal under Federal Law and only one research facility had obtained a federal permit to grow and sell marijuana.[88] As a result, any income the debtor derived from leasing the facility to a medical marijuana dispensary would also be illegal under federal law.[89] The court ultimately declined to dismiss the case, recognizing that the best interests of creditors would be best served by allowing the debtor to remain in bankruptcy, but holding that the debtor must propose a plan that did not rely on income from marijuana, barring which the debtor's case would be subject to conversion to a case under Chapter 7.[90]

In each of these cases, the debtors were in clear violation of the CSA, whether by growing and selling marijuana, or by leasing a space to a grower or seller of marijuana. With a clear cut violation of federal law, the only question that remained for the courts to decide was whether the respective debtors could be successfully rehabilitated by stripping away the conduct that was violating federal law. If the bankruptcy case could not proceed without violating federal law, the only remaining option was dismissal.

The interplay between state and federal laws is also starting to reach those businesses that can be considered "downstream" marijuana-related businesses, such as material and equipment suppliers or management companies. In these cases, the violation of the CSA may not be as clear cut, but bankruptcy courts are still required to determine whether these debtors can receive the benefits of the Bankruptcy Code. The first example of a "downstream" marijuana related company is *In re Medpoint Management,* LLC. In *Medpoint Management*, the debtor was engaged in business as the holder of intellectual property, including a trade name for cannabis

[83] *Id.* at 59.

[84] 564 B.R. 77, 86 (Bankr. D. Fla. 2017).

[85] *Id.* at 79.

[86] *Id.* at 81.

[87] *Id* at 80.

[88] *Id.* at 85.

[89] *Id.* at 84-85.

[90] *Id.* at 86.

products, which it licensed to a medical marijuana dispensary.[91] The debtor had previously acted as the manager for the dispensary, creating an avenue for the dispensary to drain off cash to allow the dispensary to operate on a not-for-profit basis as required by Arizona state law.[92] Following the termination of the management contract, the debtor's only source of revenue was from licensing its intellectual property to the dispensary.[93] After a creditor filed an involuntary bankruptcy petition against Medpoint, the debtor moved to dismiss the case, asserting that all of its assets and revenues were directly tied to cannabis, and that a Chapter 7 trustee could not administer the assets without violating the CSA.[94] The bankruptcy court agreed with the debtor, stating that it "observ[ed], without deciding, that it is quite possible that Medpoint's IP and the IP licensing revenues could be seized or forfeited, and that Medpoint could be or could have been guilty of facilitation of a crime under the CSA."[95] Accordingly, the court dismissed the involuntary petition.[96]

As more states continue to legalize marijuana, these issues will become increasingly frequent in bankruptcy cases. In cases where the debtor's operations can be traced in some form to marijuana, whether by supplying equipment, providing management services, or deriving some form of income from a dispensary or a grow house, such as a janitor providing cleaning services, the bankruptcy court will likely be required to determine if the debtor can seek relief under the Bankruptcy Code. Questions will arise as to the percentage of income the debtor is receiving from marijuana-based operations, and the extent of the connection. In many of these cases, the bankruptcy courts will likely be required to make a fact intensive determination early in the case whenever the possibility of a connection to marijuana is raised until clear cut lines are determined at a district court or circuit court level.

V. THE INTERSECTION BETWEEN BANKRUPTCY AND ARBITRATION

1. Federal Arbitration Act, 9 U.S.C. § 1 *et seq*. ("FAA"):

"A written provision in . . . a contract evidencing a transaction involving commerce to settle by arbitration a controversy thereafter arising out of such contract or transaction . . . shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract." 9 U.S.C. § 2. The phrase "a transaction involving commerce" means interstate commerce, *id.* § 1, and therefore only contracts that effect interstate commerce are subject to the FAA. But, it is well-established that only slight connections to interstate commerce are necessary to implicate the FAA. *See Allied-Bruce Terminix Co. v. Dobson*, 513 U.S. 265 (1995); *Circuit City Stores, Inc. v. Adams*, 532 U.S. 105 (2001); *Citizens Bank v. Alafabco, Inc.,* 539 U.S. 52 (2003).

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[91] *In re Medpoint Mgmt.*, 528 B.R. 178, 181 (Bankr. D. Ariz 2015), vacated on other grounds by *Medpoint Mgmt. v. Jensen (In re Medpoint Mgmt.)*, 2016 Bankr. LEXIS 2197 (B.A.P. 9th Cir. June 3, 2016).

[92] *Id.* at 180, 186.

[93] *Id.* at 181.

[94] *Id.* at 183.

[95] *Id.* at 185.

[96] *Id.* at 188.

2. Federal law strongly favors the arbitration of disputes in accordance with arbitration agreements.

Shearson/American Express, Inc. v. McMahon, 482 U.S. 220 (1987) ("*McMahon*"). Federal courts must "rigorously enforce agreements to arbitrate, even if the result is 'piecemeal' litigation, at least absent a countervailing policy manifested in another federal statute." *Dean Witter Reynolds, Inc. v. Byrd*, 470 U.S. 213, 221 (1985).

3. Recent Application in the District of Colorado: *In re Touchstone Home Health, LLC*, 572 B.R. 255 (Bankr. D. Colo. 2018).

Background: Prior to the filing of the debtor's chapter 11 case, the debtor engaged a law firm to represent it in an intellectual property dispute. The engagement contract contained an arbitration clause, requiring disputes between the parties to be resolved by binding arbitration. The law firm commenced arbitration to resolve a dispute about its unpaid fees, and the debtor asserted a malpractice counterclaim. On the eve of trial, after the malpractice counterclaim was dismissed and a sanctions motion against the debtor was pending, the debtor filed its chapter 11 petition. The law firm filed a motion seeking relief from stay under § 362(d)(1) to finish the arbitration, as well as a proof of claim asserting unpaid fees and costs of over $500,000. The debtor objected to the motion, arguing that the bankruptcy court should decide the dispute as part of the claims allowance process under § 502.

Import: The bankruptcy court stated: "What happens when arbitration and bankruptcy meet? This is a difficult question that neither the U.S. Supreme Court nor the Circuit Court of Appeals for the Tenth Circuit has addressed directly." 572 B.R. at 272.

Holding: The bankruptcy court granted the law firm's motion for relief from stay and authorized the claim to be liquidated in arbitration. Finding that there was a binding arbitration agreement that was subject to the FAA, the court applied a two-part test established in *McMahon*, and concluded that the Bankruptcy Code does not override the application of the FAA in the context of claim liquidation. Specifically, the court first found that neither the Bankruptcy Code nor its legislative history evidenced congressional intent to override the FAA. The court then concluded that was no "inherent conflict" between arbitration and the underlying purpose of the Bankruptcy Code in this case. Discussing the "inherent conflict" standard, the court first noted that non-core proceedings must be arbitrated. There was no such "hard-and-fast rule barring arbitration of core proceedings", such as the one in the case before it, because not all such proceedings "are premised upon provisions of the Code that 'inherently conflict' with the [FAA]; nor would arbitration of such proceedings necessarily jeopardize the objectives of the Bankruptcy Code." *Id.,* at 275. The court stated that "substantively" core proceedings arising solely because of bankruptcy (*e.g.,* avoidance actions) were more likely to present an "inherent conflict" than "procedurally" core proceedings, such as claim disputes that exist outside of bankruptcy and are designated "core" due to the context in which they are brought in the bankruptcy case. Here, despite the bankruptcy goal of providing a centralized forum for claim disputes, the debtor did not establish that the claim being arbitrated prepetition should be liquidated in the bankruptcy case. Indeed, § 362(d)(1), the *Curtis* factors and the "majority" position expressed by courts, expressly recognize that non-bankruptcy courts may liquidate claims and therefore, there was no "inherent conflict" between the Bankruptcy Code and the

FAA. *Citing D.E. Frey Group, Inc. v. FAS Holdings, Inc. (In re D.E. Frey Group, Inc.)*, 387 B.R. 799 (D. Colo. 2008). Also, even if an "inherent conflict" existed, the bankruptcy court held that it had discretion to compel arbitration given the facts of the case. Particularly compelling was that the evidence showed that the debtor's bankruptcy filing was "last-minute forum shopping to avoid completion of the Arbitration . . . ." 572 B.R. at 280.

4. Recent Supreme Court Cases That May Impact Bankruptcy

Epic Sys. Corp. v. Lewis, 138 S.Ct. 1612 (filed May 21, 2018). While *McMahon* allows relief from the FAA if there is an "inherent conflict" between arbitration and the underlying purpose of a federal statute, the language of the federal statute itself must be "clear and manifest" before a court can disregard an arbitration agreement. Thus, an arbitration provision prevented the commencement of a class action by former employees' against their employers under the Fair Labor Standards Act.

i. *See One Bank N.A. v. Anderson (In re Anderson)*, 884 F.3d 382 (2nd Cir. filed March 7, 2018): A bankruptcy court may decline to compel arbitration if the issue is "core" and arbitration would represent a "severe conflict" with the Bankruptcy Code. Thus, despite an arbitration agreement, a debtor was allowed to bring a class action related to claimed violations of § 524. In so holding, the Second Circuit held relied on importance of discharge in bankruptcy and the need for bankruptcy courts to be able to enforce the § 524 injunction.

ii. The creditor in *Anderson* filed a *cert.* petition with the Supreme Court based on *Epiq*, but the Court denied it on October 1, 2018.

iii. Going forward, Courts of Appeals in other Circuits may reject the holding in *Anderson* based on the *Epiq* "clear and manifest" test giving rise to a split that could be decided by the Supreme Court.

Schein, Inc. v. Archer & White Sales, Inc., Case. No. 17-1272 (filed Jan. 8, 2019). Under the FAA, parties to a contract may agree that an arbitrator, rather than a court, should resolve whether the contract is subject to arbitration, and such provisions must be enforced. *Rent-A-Center, West, Inc. v. Jackson*, 561 U.S. 63 (2010); *First Options of Chicago, Inc. v. Kaplin*, 514 U.S. 938 (1995). In *Schein*, the Court held that it is not appropriate for federal courts to "'short-circuit' [this] process and decide the arbitrability question themselves if the argument that the arbitration agreement applies to the particular dispute is 'wholly groundless.'" Slip. Op. at 1-2. In so doing, the Court resolved a Circuit split and adopted the "minority" position that the "wholly groundless" exception is inconsistent with the FAA. *Id.,* at 3 (citing cases, including *Belnap v. Iasis Healthcare,* 844 F.3 1272 (10th Cir. 2017) (minority position)).

i. When a prepetition arbitration clause requires an arbitrator to decide the validity and application of the arbitration clause, will the bankruptcy court be required to turn such issues over to the arbitrator to decide?

Will an arbitrator or a bankruptcy court be allowed to rule on the effectiveness of a bankruptcy-specific arbitration clause (*e.g.,* a clause that requires arbitration of core bankruptcy actions, such as preference, dischargeability and

VI. OTHER NOTEWORTHY CASES

A. *Peterson* & Statute of Limitations on Enforcing Mortgage Debt

Bank of New York Mellon v. Peterson, 2018 WL 6564860 (Colo. App. December 13, 2018).

There has been a recent spate in Colorado of state court attorneys arguing in the bankruptcy court that the mortgage holder is barred from asserting its claim or its security interest on the debtor's principal residence due to the expiration of the statute of limitations applicable to enforcing the promissory note. This case, as well as many others, reveals a series of fits and starts in the foreclosure process. In this case, the bank initiated a foreclosure following a default in payments in 2008. It later entered into a loan modification at the debtor's request and withdrew the foreclosure action. In 2010, when the debtor again defaulted, it reinitiated foreclosure. No mention in the decision was made as to why that foreclosure did not proceed, but nearly five years later in 2015, the bank once again filed for foreclosure and this time it completed the process, with the bank purchasing the property at sale. When it brought an action to evict the debtor, the debtor asserted the statute of limitations defense. The debtor claimed that the first foreclosure in 2008 had triggered an acceleration of the debt and the six-year statute of limitations. The bank did not contest that foreclosure accelerated the debt. Instead it argued that the subsequent abandonment of the foreclosure action reinstated the loan's original maturity date. The Colorado Court of Appeals in an unpublished decision agreed with the bank.

In this case of first impression, the court adopted the concept of abandonment based on the general principle of waiver. It found that the abandonment of an acceleration of a note may be made by agreement or other action of the parties. *Id.* at p. 4. And once abandoned, the note's original maturity date is reinstated. *Id.*

B. *Midway Gold* & Third-Party Releases

1. What are Third-Party Releases?

Third-party releases in the context of a chapter 11 plan occur when a chapter 11 plan includes a clause whereby non-debtor third-parties release claims against other non-debtor third-parties. If the third-parties releasing the claims do not consent to give the release, then it is a compelled third-party release.

Since none of the third-parties who are affected by a third-party release have filed for bankruptcy relief and since the claims being released are not held by or against a debtor in a bankruptcy case, third-party releases in chapter 11 plans are the subject of significant controversy. Such releases are only proper in rare and unique circumstances.[97]

[97] *In re SunEdison, Inc., et. al.*, 576 B.R. 453, 461-462 (Bankr. S.D.N.Y. 2017).

2. Split of Authority

There is a split of authority as to whether third-party releases are permitted in a chapter 11 plan. The Fifth, Ninth, and DC circuits follow the minority view that third-party releases are prohibited in chapter 11 plans unless the third-parties purportedly giving the releases consent.[98] The Tenth Circuit is also generally considered to follow the minority view, but that is now in question after the Colorado bankruptcy court recently followed the majority view. The reasoning behind the minority view that such releases are prohibited by the bankruptcy code is that 11 U.S.C. § 524(e) states that "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."[99]

The Second, Third, Fourth, Sixth, Seventh, and Eleventh Circuits, as well as lower courts in the First and Eighth Circuits, follow the majority view that compelled third party releases in a chapter 11 plan may be granted in limited circumstances provided they are appropriate based on the facts of the particular case and certain nonexclusive factors.[100] The majority view finds that section 524(e) only prohibits the release of a third-party from a claim for which the debtor is also liable, and that section 1123(b)(6), which permits a bankruptcy court to approve appropriate provisions in a plan that are not inconsistent with other sections of the Bankruptcy Code, along with the court's authority under section 105(a), provide a bankruptcy court with authority to approve a third-party release in a chapter 11 plan if it is appropriate.[101]

3. Factors Considered & Reasons for Objections

Courts that do not prohibit third-party releases in chapter 11 plans determine whether the third-party release is appropriate and allowable by analyzing a number of nonexclusive factors based on the facts and circumstances of the specific case. Factors that are reviewed include whether: (a) there is an interest between the third-party and the Debtor, usually through an indemnity agreement; (b) the third-party has contributed to the debtor's reorganization; (c) the release is essential to the debtor's reorganization; (d) the class impacted by the release overwhelmingly votes to accept the plan; (e) the plan provides for the payment of substantially all the claims of the class affected by the release; (f) the plan provides an opportunity for claimants who do not settle to recover in full; and (g) the bankruptcy court makes a record of specific facts to support the release.[102]

The general arguments in support of compelled third-party releases in a chapter 11 plan consist of the fact that the releases are narrowly-tailored and necessary to the reorganization of the Debtor. Additionally, since plans containing third-party releases often contain opt-out clauses that provide a third-party subject to a third-party release the option to opt-out of the release by

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[98] Robert J. Keach & Lindsay Zahradka Mine, *Persuasive Authority: Compelled Third-Party Releases*, 37 Am Bankr Inst J 14, 14 (2018).

[99] *Id.*; *In re Midway Gold*, 575 B.R. 475 (Bankr.D.Colo. 2017).

[100] Keach, *supra.*

[101] *Id.*; *See In re Midway Gold*, 575 B.R. at 501-2.

[102] *See In re Master Mortg. Fund, Inc.*, 168 B.R. 930, 935 (Bankr. W.D.Mo. 1994); *In re Dow Corning Corp.*, 280 F.3d 648, 658 (6th Cir. 2002).

checking the appropriate box on the ballot for the plan if they vote to reject the plan, plan proponents argue that the third-parties have actually consented to the release if they do not opt-out. Third-party releases are generally challenged on three grounds: (1) the merits; (2) the subject-matter jurisdiction of a bankruptcy court to consider them; and (3) the constitutional authority for a bankruptcy court to grant them.[103]

4. Change in the Tenth Circuit?

The United States Bankruptcy Court for the District of Colorado's ruling in *In re Midway Gold US, Inc.*, 575 B.R. 475 (Bankr. D.Colo. 2017) was a departure from the previously held belief that compelled third-party releases were prohibited in the Tenth Circuit. The plan in *Midway* contained third-party releases and a procedure for parties who were deemed to vote to reject the plan or voted to reject the plan to opt-out of the third-party releases. If such parties did not opt out of the releases by marking the appropriate box on the ballot or on the balloting agent's website, they were deemed to have acknowledged and affirmatively consented to the third-party releases. The US Trustee objected to confirmation of the plan on the grounds that it was proposed in contravention of § 1129(a)(3), that the bankruptcy court did not have jurisdiction to rule on issues related to the release, and that the opt-out provisions relating to the release were insufficient.

The Bankruptcy Court reviewed the Tenth Circuit's decision in *Lansing Diversified Properties-II v. First Nat'l Bank and Trust Co. of Tulsa (In re Western Real Estate Fund, Inc.),* 922 F.2d 592 (10th Cir. 1990)("Western Real Estate"), which held that the third-party being granted the release had not invoked and submitted itself to the bankruptcy process and was, therefore, not entitled to the release contained in the plan. The holding in *Western Real Estate* was considered a ban on third-party releases in chapter 11 plans in the Tenth Circuit; however, the Bankruptcy Court in *Midway* found the holding in *Western Real Estate* to be consistent with the majority view and limited to cases where a plan releases a third-party from a claim for which the debtor is also liable, as opposed to a blanket ban on all third-party releases.

Turning to the third-party releases in the *Midway* plan, the Bankruptcy Court examined whether it had jurisdiction to approve the releases. The Bankruptcy Court held that the third-party releases did not arise under or in the Bankruptcy Code and, as a result, there would have to be "related to" jurisdiction for the Court to have jurisdiction. Since the Bankruptcy Court found the disputes subject to the releases could not conceivably have an effect on the estate, the Court held that it did not have jurisdiction to approve the releases. The Bankruptcy Court further held that the plan's opt-out clause did not provide the Bankruptcy Court jurisdiction through consent because it could not adjudicate matters outside its jurisdiction even with consent.

As a result, although the Bankruptcy Court found it could confirm a plan containing third-party releases despite the holding in *Western Real Estate*, it denied confirmation of the plan because it lacked jurisdiction based on the facts of the case. The holding in this case limiting the effect of *Western Real Estate* opens the question of whether third-party releases may be

[103] Keach, *supra.*

permissible in the Tenth Circuit. The Bankruptcy Court later confirmed a modified Chapter 11 Plan that did contain limited releases.

5. Other Cases Holding Third-Party Releases Allowable, But Denying Confirmation

The Court in *In re SunEdison, Inc., et. al.*, 576 B.R. 453 (Bankr. S.D.N.Y. 2017) found that the third-party releases contained in the chapter 11 plan were related to the estate since some of the claims being released could lead to potential indemnification or contribution claims against the estate. Despite this finding, like Midway, the Court held that it lacked subject matter jurisdiction regarding these third-party releases. The plan contained a third-party release where the releasing parties included "holders of claims entitled to vote for or against the plan that do not vote to reject the plan," and thus included entities that did not vote on the plan.

The Court found that due to the breadth of the release, it did more than simply cover the potential indemnification claims that may be brought against the debtors by the third-parties being released. The Court further found that the broad definition of the released parties included parties which did not have indemnification claims against the debtors and parties that added nothing to the bankruptcy case. Additionally, many of the claims being released had no effect on the Debtors' ability to reorganize. For these reasons, the Court held that even if it had jurisdiction, the releases still should not be approved.

The Court further denied the debtors' argument that the releasing parties consented to the release. The debtors argued that the silence of the releasing parties, who had not voted, should be deemed as consent to the release because the Disclosure Statement and the ballot contained warnings regarding the potential effect of these creditor's silence. The Court found these warnings to be insufficient to deem a creditor's silence to be consent. The Court found that there were various reasons why creditors may not have voted unrelated to the release, including the fact that unsecured creditors would receive less than 3% on their claims under the plan.

In *In re Archdiocese of Saint Paul and Minneapolis*, 578 B.R. 823 (Bankr. D. Minn. 2017), the court found that it had jurisdiction to approve the third-party releases in the plan, but still decided not to approve the releases in this particular plan. The releases prevented further suits by the victims related to their sexual abuse. The Court held that one of the requirements for it to approve these releases was that the plan had to be accepted by a “significant number” of the parties who would be giving up their claims. The Court refused to set a specific amount for what constituted “significant” in this context but determined that it meant more than the one-half required for an accepting class vote. Since the class of sexual abuse victims overwhelmingly rejected the plan, the Court denied its confirmation.

6. Effect of Third-Party Releases

The case of *In re Gawker, LLC*, 588 B.R. 337 (Bankr. S.D.N.Y. 2018) involves the effect of the language in a third-party release as opposed to a question as to whether to approve a release. In this case, the third-party plan release would have released claims against the debtor's employees and independent contractors who provided content on the debtor's website (a "Provider"). It defined a releasing party to be any entity "that has received or is deemed to have

received distributions made under the plan." As consideration for the release, the Providers waived their claims of indemnification against the debtor and voted to accept the plan. Additionally, the creditors and interest holders who received distributions under the plan benefitted from the release because it provided a means for the plan to be confirmed and for them to be immediately paid their distributions.

Two plaintiffs then sued a Provider for defamation and related claims based on an article written by the Provider and published on the debtor's website. The plaintiffs had not filed claims in the debtor's bankruptcy case and had received no distributions under the plan. The court held that the claims of these plaintiffs did not fall within the scope of the third-party release in the chapter 11 plan. While the Court acknowledged that its decision did not effectuate the bargain the Provider thought he would receive when he waived his indemnity claim against the debtor and voted in favor of the plan, it nevertheless held that the release did not cover entities that had not received a distribution under the plan.

7. Plan Containing Third-Party Releases Confirmed

In *Lynch v. Lapidem Ltd. (In re Kirwan Offices S.A.R.L.)*, Nos. 17 Civ. 4339, 17 Civ. 4340 (S.D.N.Y. October 10, 2018), the debtor entity had been formed by three shareholders, Lapidem Limited ("Lapidem"), Mascini Holdings Limited ("Mascini"), and Stephen Lynch ("Lynch") for the purpose of purchasing another entity at auction. After the debtor completed the purchase, litigation arose that prevented the debtor from obtaining clear title to the purchased assets. Lapidem and Mascini funded the litigation. Eventually, Lapidem and Mascini became entangled in various disputes with Lynch regarding settlement of the litigation and related matters. Lapidem and Mascini filed an involuntary petition against the debtor. In due course, the debtor confirmed a plan that contained a clause enjoining any person from suing Lapidem and Mascini in any other forum regarding the events arising from the debtor's bankruptcy and reorganization. Subsequently, Lynch moved for relief from the confirmation order due to the injunction, but the bankruptcy court denied relief. Lynch appealed, arguing that the bankruptcy court had neither subject matter jurisdiction nor constitutional authority to confirm a plan with these exculpation and injunction clauses.

Like the *Archdiocese* case, the court found that it was acting pursuant to its core jurisdiction when it confirmed a plan with these provisions. Additionally, the court found that the release sufficiently related to the issues before the bankruptcy court. The court stated that it was not addressing the merits of the claims being released, but cancelling those claims to permit the debtor's complete reorganization. It held that the third-party releases were necessary for the plan's operation and that Lynch had consented by failing to participate in the confirmation hearing process despite receiving notice of the objection deadline, the hearing on confirmation, and that the failure to object to confirmation would result in the entry of an order confirming the plan.

The court also denied Lynch's argument that the bankruptcy court lacked constitutional authority pursuant to *Stern v. Marshall,* 564 U.S. 462 (2011). A bankruptcy court's constitutional authority depends on how resolving the claim relates to a core Article I bankruptcy process. Although resolving claims against third-parties is only integral in rare cases, the Court found this case to be one of those rare cases. The release of Lynch's claims was necessary for the

operation of the Debtor's Plan. The Court found the releases in the plan to derive from bankruptcy law since they were embedded in a plan, and a plan is created solely by bankruptcy law and subject to the bankruptcy laws regarding confirmation of a plan.

In *In re: Millennium Lab Holdings II, LLC*, 2018 WL 4521941 (D. Del. Sept. 21, 2018), the debtors filed a chapter 11 plan that included third-party releases releasing non-debtors who were equity holders from certain claims of creditors. The creditors whose claims were released objected to confirmation, arguing that the Court did not have subject matter jurisdiction to approve the third-party releases.

Without making a determination as to its constitutional authority, the court determined it had subject matter jurisdiction based on "related to" jurisdiction because the released parties held indemnification claims against the debtors. [104] As a result, the Court confirmed the plan. On appeal, the district court remanded the matter back to the bankruptcy court to determine if it had constitutional authority to approve the releases.

The bankruptcy court held that it had constitutional authority to approve the releases. It found that *Stern v. Marshall* did not affect a court's authority to confirm a plan since confirmation of a plan is unique to bankruptcy law.[105] As such, it did not deem it necessary to apply the "disjunctive test" set out in *Stern v. Marshall,* however, the Court found that, even if it did apply the "disjunctive test," it still had constitutional authority because confirmation of a plan is a core proceeding and the Court was not making a ruling on the merits of the claims being released.[106]

On appeal, the district court affirmed, holding that it had constitutional authority to confirm a plan containing third-party releases. The district court agreed that confirmation of a plan was the subject of the proceeding in which the releases were approved, and the subject of the proceeding determines the constitutional authority, not the incidental effects that result from the hearing. Since confirmation of a plan is a core proceeding, the court also agreed that the "disjunctive test" in *Stern v. Marshall* was not relevant to determining the bankruptcy court's constitutional authority in this case. Finally, the district court agreed that it was not making an adjudication on the merits of the claims being released, but rather was releasing the claims in the process of confirming a plan.

In *In the Matter of Fansteel Foundry Corporation*, 2018 WL 5472928 (Bankr. S.D.Iowa Oct. 26, 2018), the court also confirmed a plan with third-party releases. In this case, the debtor and the unsecured creditors committee jointly proposed a combined Disclosure Statement and Plan of Liquidation, which contained a third-party release. It released the debtor, its officers, directors, and management, members of the unsecured creditors committee, a significant creditor of the debtor who was providing funding for the plan, and the professionals representing these parties. A creditor objected to the breadth of this release.

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[104] *See* Keach, *supra* at 109.

[105] *Id.*

[106] *Id.*

The Court found that the release: (a) did not expand a discharge since no discharge would enter under this liquidating plan; (b) did not attempt to avoid a third-party's joint liability for an obligation of the debtor; and (c) was narrowly tailored. The Court further found that: (a) the creditor's substantial contribution was the only available funding and the only means for proposing a viable Plan; (b) the professionals being released had worked diligently to reach a consensual exit from bankruptcy; (c) the overwhelming majority of creditors voted in favor of the plan; (d) the plan provided a recovery to creditors that would not be achieved under any other chapter; (e) the release was necessary since the creditor would not otherwise fund the plan; and (f) the purpose of the release was measured and limited in scope. As a result, it confirmed the plan.

8. CONCLUSION

Given the foregoing cases, undoubtedly more third-party release provisions will appear in chapter 11 plans. In many circumstances, they may be appropriate under the various tests employed by the courts. However, such provisions should be limited in scope and tailored to each specific case.