AMERICAN BANKRUPTCY INSTITUTE

2019 Bankruptcy Battleground West

The Great Divide: Overview of Circuit Splits on Current Issues

Hon. Scott C. Clarkson, Moderator
U.S. Bankruptcy Court (C.D. Cal.); Santa Ana

Jeffrey Bjork
Latham & Watkins; Los Angeles

Dawn M. Cica
Mushkin Cica Coppedge; Las Vegas

Gabriel I. Glazer
Pachulski Stang Ziehl & Jones LLP; Los Angeles

Shanti M. Katona
Polsinelli P.C.; Wilmington, Del.

ABI BATTLEGROUND WEST

- **Topic 1: Third Party Plan Releases**
  - *Prohibition Circuits* – Presented by Jeff Bjork
  - *Permissive Circuits* – Presented by Dawn Cica
- **Topic 2: Whether a Licensee Can Keep Trademark Rights After Rejection**
  - *7th Circuit* **–** Presented by Shanti Katona
  - *1st Circuit* **–** Presented by Gabriel Glazer
- **Topic 3: Assumption/Assignment of Intellectual Property Issues**
  - *Hypothetical Test* **–** Presented by Jeff Bjork
  - *Actual Test* **–** Presented by Shanti Katona
  - *Alternative* **–** Presented by Shanti Katona
- **Topic 4: Make-Whole Premiums**
  - *Prohibition Circuits* – Presented by Gabriel Glazer
  - *Permissive Circuits* – Presented by Dawn Cica
- **Topic 5: Calculation of Stub Rent – Lease Rejection Damages**
  - *Time Approach* **–** Presented by Jeff Bjork
  - *Rent Approach* **–** Presented by Shanti Katona
- **Topic 6: Application of "One Consenting Impaired Creditor Class" Requirement**
  - *Per Plan Circuits* **–** Presented by Gabriel Glazer
  - *Per Debtor Circuits* **–** Presented by Dawn Cica

TOPIC 1: THIRD PARTY PLAN RELEASES

Prohibition Circuits - Presented by Jeff Bjork

In re Lowenschuss, 67 F.3d 1394 (9th Cir. 1995)

The Ninth Circuit Court of Appeals held that § 524(e) prevents bankruptcy courts from discharging the liabilities of non-debtors.

Fred Lowenschuss ("Lowenschuss") established a professional corporation, Fred Lowenschuss Associates, with a pension plan for all employees of the corporation. Lowenschuss acted as trustee, administrator, sponsor and sole beneficiary of the pension plan at all relevant time periods. The pension plan held assets that included substantial holdings in Resorts International, Inc. ("Resorts") stocks and bonds. Resorts filed an action against Lowenschuss in federal district court, individually and as trustee of the pension plan, claiming that Lowenschuss had defrauded Resorts of $3,805,200 by tendering shares of Resorts stock for $36 per share when he knew that an appraisal proceeding was pending. Resorts later filed for chapter 11 in New Jersey, and the action against Lowenschuss was removed to the New Jersey Bankruptcy Court. In that proceeding, the New Jersey Bankruptcy Court determined that the transaction was an illegal contract, but left the remedies of rescission and restitution open for trial. However, because it was unable to ascertain the location of the money received in exchange for the illegally tendered stock, it entered an order to enjoin the transfer of funds, which applied to Lowenschuss personally and as trustee of any fund.

Lowenschuss then filed a chapter 11 petition in the District of Nevada, and Resorts' action against Lowenschuss was stayed under § 362(a). Lowenschuss filed a plan that included a Global Release Provision, which released Lowenschuss and the pension plan from all claims upon its confirmation. Resorts asserted itself as a creditor, believing that the transferred funds might constitute property of the bankruptcy estate. Resorts objected to the confirmation of the plan on the grounds that the bankruptcy court lacked authority to grant the Global Release Provision, as it purported to release claims against non-debtors, including the pension plan. The bankruptcy court determined that the Global Release Provision was improper and held that the provision could not release non-debtors such as the pension plan. Resorts subsequently ascertained that the pension plan held the allegedly illegally transferred funds, and withdrew as a creditor because its complaint was against the pension plan.

At the confirmation hearing, the originally proposed plan, including the Global Release Provision, was confirmed by the bankruptcy court. Resorts appealed the various bankruptcy court orders, and the district court vacated the Global Release Provision, holding that the bankruptcy court lacked the power to approve a provision which released claims against non-debtors. Lowenschuss then appealed the district court's decision.

The Ninth Circuit found that the Global Release Provision was improper. The Ninth Circuit first noted that bankruptcy courts lack the power to confirm plans of reorganization that do not comply with applicable Bankruptcy Code provisions as required by § 1129(a)(1). The Ninth

Circuit then looked to the plain language of § 524(e),[1] which does not provide for the release of third parties from liability, and concluded that the inclusion of such releases is inconsistent with the Bankruptcy Code. The Ninth Circuit found support for this interpretation in a number of Ninth Circuit cases, stating that the Ninth Circuit "has repeatedly held, without exception, that §524(e) precludes bankruptcy courts from discharging the liabilities of non-debtors."

Lowenschuss argued that the bankruptcy court had authority to discharge the liabilities of non-debtors under its general equitable powers pursuant to § 105(a).[2] Rejecting this argument, the Ninth Circuit stated that § 105 does not authorize relief inconsistent with more specific law, in this case, § 524(e). The Ninth Circuit noted that the addition of § 524(g) to the Bankruptcy Code, which gives bankruptcy courts the authority to issue injunctions in favor of third parties in certain asbestos cases, supported its conclusion. The Ninth Circuit reasoned that, because Congress provided explicit authority to issue injunctions in favor of third parties in this extremely limited class of cases, § 524(e) must deny such authority in other, non-asbestos, cases.

In re Am. Hardwoods, Inc., 885 F.2d 621 (9th Cir. 1989)

The Ninth Circuit Court of Appeals held that the bankruptcy court did not have the power to permanently enjoin, beyond confirmation of a plan, a creditor from enforcing a state court judgment against non-debtors.

The Keelers were president and vice president of American Hardwoods, Inc. ("American"). The Keelers purchased machinery financed by Deutsche Credit Corporation ("Deutsche") and transferred it to American in consideration for the company's assumption of liability for the debt. Deutsche obtained an order in state court permitting Deutsche to seize American's machinery. American subsequently filed for bankruptcy under chapter 11, triggering the automatic stay protections under § 362(a). Deutsche moved for summary judgment in state court against the Keelers, who remained jointly and severally liable for American's debt. American commenced an adversary proceeding in the bankruptcy court, seeking to enjoin Deutsche preliminarily and permanently from both continuing its state court action against the Keelers and from enforcing any state court judgment against them. American argued that the bankruptcy court had power to grant the permanent injunction pursuant to its equitable power under § 105(a), and that the relief was justified because Deutsche's pursuit of its state court action against the Keelers would irreparably harm American's efforts to confirm and administer its plan of reorganization.

The bankruptcy court enjoined Deutsche from enforcing the state court judgment against the Keelers until the plan was confirmed, but held that it lacked both jurisdiction and power to

---

[1] Section 524(e) states in pertinent part 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."

[2] Section 105(a) provides:

> The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title. No provision of this title providing for the raising of an issue by a party in interest shall be construed to preclude the court from, sua sponte, taking any action or making any determination necessary or appropriate to enforce or implement court orders or rules, or to prevent an abuse of process.

order a permanent injunction against non-debtors. The district court affirmed the bankruptcy court's judgment, and American appealed to the Ninth Circuit.

Addressing the scope of the bankruptcy court's equitable powers under § 105(a), the Ninth Circuit stated that § 105(a) permits the court to enjoin preliminarily a creditor from continuing an action or enforcing a state court judgment against a non-debtor prior to confirmation of the plan. The Ninth Circuit also noted that § 105(a) permits the court to issue both preliminary and permanent injunctions after confirmation of a plan to protect the debtor and the administration of the bankruptcy estate. However, the Ninth Circuit found that § 524(e) limits the court's equitable power under § 105(a) to order the discharge of the liabilities of non-debtors.

The Ninth Circuit rejected American's argument that a permanent injunction against the enforcement of a judgment is distinguishable from discharge. The Ninth Circuit found that a discharge under § 524(a)(2)[3] is effectively a special type of permanent injunction, as it does not void a liability outright, but rather constructs a legal bar to its recovery. Accordingly, the Ninth Circuit determined that the permanent injunction requested by American was within the definition of a discharge under § 524(a)(2), and § 524(e) prevented the court from using its general equitable powers under § 105(a) to grant the permanent injunction.

Underhill v. Royal, 768 F.2d 1426 (9th Cir. 1985)

The Ninth Circuit Court of Appeals held that the bankruptcy court had no power to discharge the liabilities of a non-debtor as part of a plan.

Carlos Royal was the founder and principal shareholder of National Mortgage Exchange of Southern California ("NMESC"), a company that operated an investment program. NMESC filed for chapter 11. The Underhills, investors in the program, subsequently commenced an action in federal court against Royal for federal securities law violations in connection with NMESC's investment program.

In the bankruptcy proceedings, Royal introduced a plan that included a release from the participants in the investment program of all claims against the debtor, any affiliate of the debtor, and any insider of the debtor. The plan was approved by 89% of creditors. The Underhills objected to the release provision, and the plan was confirmed after a stipulation was entered which left the scope of the release and its enforceability subject to the district court's ruling in the Underhill federal court action. The district court held that the release was invalid, and found Royal vicariously liable for violating federal securities law. Royal appealed to the Ninth Circuit.

Relying on the broad language limiting the scope of a discharge under § 524(e), the Ninth Circuit held that the bankruptcy court had no power to discharge the liabilities of a non-debtor as part of a plan. The Ninth Circuit rejected Royal's argument that the release barred the action against him for securities law violations because the release was approved by creditors when they

[3] Section 524(a)(2) describes the effect of a discharge "as an injunction against the commencement or continuation of an action, the employment of process, or an act, to collect, recover, or offset any such debt as a personal liability of the debtor, whether or not discharge of such debt is waived."

accepted the plan. The Ninth Circuit explained that discharge of a debtor is accomplished by operation of the bankruptcy laws, not by consent of the creditors. Accordingly, a payment which effects a discharge is not consideration for any promise by the creditors, including one to release non-debtors from liability.

***Landsing Diversified Props. II v. First National Bank and Trust Co. of Tulsa* (*In re W. Real Estate Fund, Inc.*)**, 922 F.2d 592 (10th Cir. 1990)

The Tenth Circuit Court of Appeals held that the bankruptcy court lacked authority to grant a permanent injunction precluding a state law claim against a non-debtor.

Landsing Diversified Properties ("LDP") retained an attorney, Abel, to pursue litigation against the Public Service Company of Oklahoma ("PSO") for damage to an LDP facility. The retainer agreement provided for a hybrid form of compensation, consisting of an hourly fee and a contingency fee. Abel obtained a settlement offer for LDP, and secured his contract fee by filing an attorney's lien under state law. LDP subsequently filed for bankruptcy under chapter 11, and commenced an adversary proceeding against First National Bank and Trust Company of Tulsa ("FNB") (holder of a mortgage on the damaged LDP property) to determine the relative priority of rights in any potential settlement of the suit against PSO.

The bankruptcy court held that, in the event LDP rejected the retainer agreement, Abel's recovery for his contingency fee would be determined by quantum meruit principles. Shortly thereafter, LDP rejected the retainer agreement under § 365 and discharged Abel. The litigation settled and PSO paid LDP and FNB in exchange for their agreement to indemnify PSO should it be held liable to Abel for ignoring his attorney's lien. Abel filed a state attorney's lien action against PSO in state court to recover the portion of his fee remaining unsatisfied in the chapter 11 proceeding.

At issue was whether the bankruptcy court had the authority to enjoin Abel from prosecuting his state court action against PSO. Relying on § 105(a), the bankruptcy court permanently enjoined Abel from further prosecution of his state court action against PSO, conditioned on the timely payment of the fee claim it allowed against LDP. Abel appealed and the district court affirmed the bankruptcy court's decision. Abel appealed to the Tenth Circuit.

The Tenth Circuit first addressed the permissibility of using § 105(a) to temporarily enjoin court proceedings against non-debtor parties, and stated that a case-by-case decision must be made as to whether any particular action excepted from the automatic stay will result in sufficient harm or interference with the bankruptcy case to warrant the issuance of a specific injunction. The Tenth Circuit found that the only viable justification for the temporary injunction rested on the need to protect LDP during the bankruptcy proceeding, and explained that this rationale is limited to the portion of the potential recovery from PSO for which LDP, rather than FNB, may be held responsible under the settlement agreement.

The Tenth Circuit then addressed the permanent nature of the injunction issued by the bankruptcy court. The Tenth Circuit found that, by permanently enjoining Abel's claim against PSO, the bankruptcy court effectively discharged PSO's liability to Abel under state lien law. The Tenth Circuit stated that the bankruptcy court's supplementary equitable powers under § 105(a)

cannot be used in a manner that is inconsistent with the other, more specific provisions of the Bankruptcy Code, and found that a permanent injunction resulting in a discharge of liability of non-debtors would violate the more specific § 524(e). Further, the Tenth Circuit stated that the permanent injunction lacked justification, as LDP's partial indemnification obligation is irrelevant post-confirmation, since the protections of § 524(a) prevent anyone from pursuing the debtor on a discharged debt, including parties that seek reimbursement from the debtor through indemnification.

Accordingly, the Tenth Circuit held that the bankruptcy court lacked authority to issue the permanent injunction precluding Abel's state action against PSO. The Tenth Circuit affirmed the issuance of the injunction insofar as it temporary precluded, during the pendency of the bankruptcy proceeding, the pursuit of fees subject to indemnification by LDP; however, it vacated the injunction in all other respects.

In re Pac. Lumber Co., 584 F.3d 229 (5th Cir. 2009)

The Fifth Circuit Court of Appeals held that non-consensual releases of non-debtors are not permitted under § 524(e).

In the chapter 11 proceedings of six affiliated entities, the bankruptcy court confirmed a plan that was proposed by a secured creditor along with one of the debtor's competitors. The plan contained a provision that released the plan proponents, the reorganized debtors and the unsecured creditors' committee from liability, other than for willfulness and gross negligence, related to proposing, implementing and administering the plan. The plan proponents insisted that the exculpation was part of their bargain with the debtors because, without such a provision, neither plan proponent would have provided the financing for the plan. The bankruptcy court confirmed the plan and the indenture trustee appealed on the ground that the plan was not confirmable, because among other things, it contained impermissible third party releases.

Relying on § 524(e), the Fifth Circuit held that non-consensual releases of non-debtors are not permitted. The plan proponents suggested that the Fifth Circuit adopt a more lenient approach to non-debtor releases taken by other courts, however, the Fifth Circuit distinguished the cases in which third party releases were permitted by noting that they involved global settlements of mass claims against the debtors and co-liable parties. The Fifth Circuit stated that the addition of § 524(g) to the Bankruptcy Code, which permits bankruptcy courts to enjoin third-party asbestos claims under certain circumstances, "suggests non-debtor releases are most appropriate as a method to channel mass claims toward a specific pool of assets."

The Fifth Circuit found that, because the plan proponents were not liable for any of the debtors' prepetition debts, the purpose of the exculpation clause was to absolve the non-debtors from negligent conduct occurring during the proceedings. The Fifth Circuit stated that the fresh start that § 524 provides to debtors is not intended to serve this purpose. The Fifth Circuit determined, however, that the exculpation was appropriate as to the unsecured creditors committee and its members because § 1103(c) implies that committee members have qualified immunity for actions within the scope of their duties. Accordingly, the Fifth Circuit held that the non-debtor releases must be struck except with respect to the creditors' committee.

Permissive Circuits – Presented by Dawn Cica

In re Dow Corning Corp., 280 F.3d 648 (6th Cir. 2002)

Dow Corning, the predominant manufacturer of silicone gel breast implants, was pushed into bankruptcy after medical studies indicated that the silicone gel caused auto-immune diseases and tens of thousands of women sued, claiming these injuries.

Litigation was consolidated by the Judicial Panel of Multidistrict Litigation and a settlement was reached; however, hundreds of thousands more suits were anticipated. The bankruptcy court, on the parties' motions, transferred the causes of action against Dow Corning, its shareholders, and other implant manufacturers (to whom Dow Corning sold silicone) to the bankruptcy court's jurisdiction.

After lengthy examination of the bankruptcy issues over a period of several years, a plan was confirmed by the bankruptcy court. Under the plan of reorganization, a $2.35 billion fund was established for payment of claims with funds pooled from Dow Corning's insurers, shareholders and cash reserves. Also included in the plan were two provisions that released Dow Corning's insurers and shareholders from further liability on personal injury claims and permanently enjoined parties from bringing action against Dow Corning's insurers, shareholders, or subsidiaries once those claims were satisfied as against Dow Corning. The joint plan permanently enjoined persons who had filed or might file claims from pursuing those claims against the released parties.

The bankruptcy court interpreted § 524(e) to provide that a third party's liability is not discharged by virtue of a discharge of the debtor's liability and that entry of a non-debtor injunction regardless of whether it is consensual is not incompatible with §524(e). The bankruptcy court went on to conclude that since no other provision in the Bankruptcy Code addressed the issue exactly, the injunction and release provisions in Dow Corning's reorganization plan were "not inconsistent with the Code even if they apply to creditors who did not accept the Plan." However, the bankruptcy court then determined that this type of permanent injunction may only apply to consenting creditors.

The district court affirmed the bankruptcy court's decision, which was appealed to the Sixth Circuit. The amended and approved reorganization plan was reviewed by the district court, which concluded that an injunction of claims in favor of non-debtor third parties may apply to both consenting and nonconsenting creditors. The Sixth Circuit affirmed the district court's analysis but remanded the case to the district court for further factual determinations.

The district court then found that the bankruptcy court had authority to enjoin the claims of nonconsenting creditors. When the matter was appealed to the Sixth Circuit for the second time, the Sixth Circuit affirmed, holding that a bankruptcy court may grant a permanent injunction under "unusual circumstances" which enjoins both consenting and nonconsenting creditor claims against a non-debtor as part of a bankruptcy reorganization.

The Sixth Circuit held that § 105(a) gives bankruptcy courts the "broad equitable power" to grant injunctions when they are "necessary or appropriate" to furthering the policies of the

Bankruptcy Code. Furthermore, § 524(e) was not a bar to the injunction of non-debtor claims. Specifically, to facilitate reorganization and resolution of large and complex mass tort litigations, a bankruptcy court may enjoin a nonconsenting creditor's claims when seven requisite factors are present: (1) There is an identity of interests between the debtor and the third party, usually an indemnity relationship, such that a suit against the non-debtor is, in essence, a suit against the debtor or will deplete the assets of the estate; (2) The non-debtor has contributed substantial assets to the reorganization; (3) The injunction is essential to reorganization, namely, the reorganization hinges on the debtor being free from indirect suits against parties who would have indemnity or contribution claims against the debtor; (4) The impact class, or classes, has overwhelmingly voted to accept the plan; (5) The plan provides a mechanism to pay for all, or substantially all, of the class or classes affected by the injunction; (6) The plan provides an opportunity for those claimants who choose not to settle to recover in full; and (7) The bankruptcy court made a record of specific factual findings that support its conclusions.

However in its application of the factors, the Sixth Circuit held that the record produced by the bankruptcy court did not support a finding of "unusual circumstances" warranting the approval of the third party release because the bankruptcy court provided no explanation or discussion of the evidence underlying the factors and did not discuss facts as they related specifically to the various released parties.

In re Metromedia Fiber Network*, *Inc., 416 F.3d 136 (2d. Cir. 2005)

The Second Circuit Court of Appeals held that the bankruptcy court's findings were insufficient to support the validity of the plan's nonconsensual non-debtor release, but dismissed the appeal of the releases as equitably moot in order to avoid disturbing the plan of reorganization that had already been implemented.

A trust established by insiders of the debtors offered to (i) convert $15.7 million in secured claims to equity in the reorganized debtors; (ii) forgive unsecured claims against the debtors in the amount of $150 million; (iii) invest $12.1 million in the reorganized debtors; and (iv) purchase $25 million of unsold common stock in the reorganized debtors' stock offering (the "Trust Contribution"). In return for the Trust Contribution, the trust and certain non-debtor insiders would receive 10.8% common stock in the reorganized debtors and obtain a broad release from "any holder of a claim of any nature . . . any and all claims, obligations, rights, causes of action and liabilities arising out of or in connection with any matter related to [the debtors] . . . based in whole or in part upon any act or omission or transaction taking place on or before the Effective Date."

In evaluating whether the third-party releases were permissible, the Second Circuit noted that "this is not a matter of factors or prongs," stating that non-debtor releases were only appropriate in rare cases where the court finds unique circumstances.

The Second Circuit expressed significant reluctance regarding approval of non-debtor releases for two reasons. First, the Second Circuit stated that the only explicit authority in the Bankruptcy Code for such releases is § 524(g), and noted that while § 105(a) contains broad equitable authority for a court to issue orders to carry out the provisions of the Bankruptcy Code,

it does not in and of itself allow creation of substantive rights that are otherwise not available under the Bankruptcy Code. Second, the Second Circuit was wary of misuse because "a non-debtor release is a device that lends itself to abuse . . . . In form, it is a release; in effect, it may operate as a bankruptcy discharge arranged without a filing and without the safeguards of the Code." The Second Circuit was troubled by the broadness of the releases in that the releases protected against any debtor-related claims "whether for tort, fraud, contract, violations of federal or state securities laws, or otherwise, whether known or unknown, foreseen or unforeseen, liquidated or unliquidated, fixed or contingent, matured or unmatured."

The Second Circuit also pointed out the district court's failure to inquire whether such broad releases, including a discharge for non-contributing parties, were given under unusual circumstances and actually necessary to the plan.

In re Washington Mutual, 442 B.R. 314 (Bankr. D. Del. 2011)

The bankruptcy court approved a global settlement agreement (the "Global Settlement") reached by the Federal Deposit Insurance Corporation ("FDIC"), as receiver for Washington Mutual Bank ("WaMu Bank"); JPMorgan Chase Bank, N.A. ("JPMC"), as purchaser of the WaMu Bank assets in the fourth quarter of 2008; WMI; and certain other parties. The Global Settlement resolved litigation stemming from the failure of WaMu Bank in 2008 and the subsequent purchase of WaMu Bank's assets by JPMC and was the basis for the debtors' plan of reorganization (the "Plan"). Despite finding that the Global Settlement was fair and reasonable, the bankruptcy court denied confirmation of the Plan because it found the releases granted by the debtors to certain parties under the Plan to be excessively broad and impermissible under applicable law.

The Global Settlement, which the debtors intended to implement through the Plan, provided approximately $6.1 to $6.8 billion in funds to the debtors' estates for distribution to creditors. Under the Plan and the Global Settlement, the debtors released JPMC, the FDIC, and WaMu Bank from claims held by the debtors against those parties. The debtors also released and waived claims against other parties to the Global Settlement and "Related Persons," including current and former officers and directors of the debtors. In reviewing and evaluating the releases granted by the debtors under the Plan, the bankruptcy court utilized a multi-factor test set forth in a Missouri bankruptcy court's 1994 ruling in *In re Master Mortgage Invest. Fund, Inc*., 168 B.R. 930 (Bankr. W.D. Mo. 1994) (which was also utilized in *In re Zenith Electronics Corp*., 241 B.R. 92 (Bankr. D. Del. 1999)). Under the *Master Mortgage* multi-factor test, a bankruptcy court evaluating the release of claims against a non-debtor third party, without the consent or agreement of the party deemed to be bound by such release, should consider: (1) an identity of interest between the debtor and the third party, such that a suit against the non-debtor is, in essence, a suit against the debtor or will deplete assets of the estate; (2) substantial contribution by the non-debtor of assets to the reorganization; (3) the essential nature of the injunction to the reorganization to the extent that, without the injunction, there is little likelihood of success; (4) an agreement by a substantial majority of creditors to support the injunction, specifically if the impacted class or classes "overwhelmingly" vote to accept the plan; and (5) provision in the plan for payment of all or substantially all of the claims of the class or classes affected by the injunction.[4]

[4] Ultimately, the court in *Master Mortgage* held that a release of, and injunction against, claims a creditor held against the debtors' non-debtor affiliate and plan supporter were appropriate. In *Zenith*, the court applied the

The bankruptcy court applied the *Master Mortgage* test to all releases granted by the debtors. The bankruptcy court found reasonable and approved the debtors' releases of Plan supporters, JPMC, the FDIC, and WaMu Bank. However, the bankruptcy court concluded that the releases granted by the debtors to settling noteholders, the official committee of unsecured creditors and its members, certain indenture trustees, and the liquidating trust and trustee under the Plan were not reasonable because, among other things, none of the parties contributed significantly to the reorganization; there was no identity of interest between the debtors and such parties; and, in the case of the creditors' committee, its members did nothing more than fulfill their fiduciary duties and were otherwise covered by the Plan's exculpation provisions.

Starting from the premise that "[t]his Court has previously held that it does not have the power to grant a third party release of a non-debtor," the bankruptcy court refused to approve third party releases, where, among other things, such releases would have been deemed accepted by creditors who did not submit a ballot, stating that "[f]ailing to return a ballot is not a sufficient manifestation of consent to a third party release." The bankruptcy court concluded that a third party release is effective only against those who affirmatively consented to it by voting in favor of the plan and not opting out of the releases.

In re Indianapolis Downs, LLC, 486 B.R. 286 (Bankr. D. Del. 2013)

The debtors operated a horse racing track and casino in Indiana. The debtors filed for chapter 11 protection in April 2011, and within a year had proposed a plan, which included certain third party releases.

The debtors' plan applied certain third party release provisions to claimholders who "(i) affirmatively vote to accept or reject the Plan and do not opt out of granting the releases, (ii) are unimpaired pursuant to the Plan and therefore deemed to accept the Plan pursuant to section 1126(f) of the Bankruptcy Code, or (iii) abstain from voting on the Plan and who do not otherwise submit a Ballot indicating their desire to opt out of the releases."

The bankruptcy court cited other jurisdictions for their "flexible approach in evaluating whether a third party release was consensual." Finding that no "hard and fast rule" of affirmative consent to third party releases exists, the bankruptcy court held that where claimholders abstained from voting on a plan, or voted to reject the plan but did not otherwise opt out of the third party releases despite having detailed instructions on how to do so, those third party releases were properly characterized as consensual and could therefore be approved.

Nat'l Heritage Found., Inc. v. Highbourne Found., 760 F.3d 344 (4th Cir. 2014)

National Heritage Foundation ("National") is a public non-profit charity that administers and maintains donor advised funds. In 2009, National filed for chapter 11 protection after a state court entered a multi-million dollar judgment against it. Following a contentious plan

multifactor *Master Mortgage* test to releases granted by debtors to third parties, finding that the debtors' releases of third parties in that case satisfied the *Master Mortgage* test. With respect to third-party releases, however, the court found that a release of claims held by a third party against another third party was not appropriate under the plan without the affirmative agreement or consent of the creditor whose claim would be enjoined.

confirmation process, the bankruptcy court approved the debtor's plan of reorganization. The plan included a third party release provision that released claims against the debtor, the creditor's committee, and any officer, director, or employee of the debtor or the committee. Following confirmation of the debtor's plan, certain creditors affected by the release challenged the bankruptcy court's approval of the plan on the ground that the release provision was invalid. The creditor's appeal was remanded back to the bankruptcy court by the Fourth Circuit, on the ground that the bankruptcy court failed to make sufficient factual findings to support approval of the release. On remand, the bankruptcy court (with a new bankruptcy judge) reversed and declared the release unenforceable. This time, the debtor appealed, and the district court affirmed the bankruptcy court's ruling. The debtor then appealed to the Fourth Circuit.

The Fourth Circuit, on rehearing, reaffirmed the decision of the lower courts, holding that the debtor's chapter 11 plan contained unenforceable non-debtor release provisions.[5] The debtor faced existing and potential state court lawsuits and sought, in part, to enjoin those claimants from suing its officers and directors. After the case was remanded, the bankruptcy court held that the release provisions were unenforceable, and the appeal followed. In analyzing the issue of whether or not the non-debtor releases contained in a chapter 11 plan were enforceable and appropriate, the Fourth Circuit applied the *Dow* Factors from the Sixth Circuit's opinion in *In re Dow Corning Corp.*, 280 F.3d 648 (6th Cir. 2002).[6]

Applying the *Dow* Factors, the Fourth Circuit affirmed the lower court's holding that only the first *Dow* Factor was present and that the debtor failed to present sufficient evidence in support of the other *Dow* Factors. The Fourth Circuit did note, however, that a "debtor need not demonstrate that every [*Dow* Factor] weighs in its favor" for a third party release to be approved. However, "a debtor must provide adequate factual support to show that the circumstances warrant such exceptional relief."

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

The Eleventh Circuit Court of Appeals affirmed the bankruptcy and district court decisions approving a debtor's chapter 11 plan that contained a provision releasing the debtor's former principals over the objection of a non-insider equity holder.

Seaside Engineering & Surveying, Inc. ("Seaside") was a closely held civil engineering and surveying firm that conducted hydrographic surveying and navigational mapping. Seaside's five principal shareholders were also its officers, directors, and key operating personnel.

---

[5] This was the Fourth Circuit's third decision in just over three years addressing issues relating to the plan's non-debtor release provisions. *See Behrmann v. Nat'l Heritage Foundation, Inc.*, 663 F.3d 704 (4th Cir. 2011) (insufficient findings of fact to support essentiality of release provisions); see also *Nat'l Heritage Foundation, Inc. v. Behrmann* (*In re Nat'l Heritage Foundation, Inc.*), No. 13-1608, 2014 U.S. App. LEXIS 12144 (4th Cir. June 27, 2014).

[6] The *Dow* Factors are: (i) the identity of interests between the debtor and the non-debtor; (ii) the non-debtor's contribution of substantial assets to the reorganization; (iii) the essentiality of the injunction to the reorganization; (iv) the affected class or classes have voted in support of the plan; (v) the plan provides a means to pay all or substantially all of the affected class or classes; and (vi) the plan provides a means for non-settling claimants to recover in full.

Seaside filed for chapter 11 after a third party acquired the Seaside shares in one of its principal shareholder's chapter 11 cases. Seaside filed a chapter 11 plan (the "Plan"), under which Seaside proposed to reorganize and continue operating under the name Gulf Atlantic, LLC ("Gulf"). Gulf would be owned by irrevocable family trusts settled for Seaside's principal shareholders, who would also manage the reorganized company. Under the Plan, non-manager equity holders, including Vision, were to receive promissory notes with interest accruing at the rate of 4.25 percent annually in exchange for their interests in Seaside and would not receive an ownership interest in Gulf.

The Plan also included provisions releasing Seaside's officers, directors, and members; Gulf; Gulf's officers, directors, and members; and the representatives of each of these non-debtor entities. The releases covered liability for acts, omissions, transactions, and other occurrences related to Seaside's chapter 11 case, except actions amounting to fraud, gross negligence, or willful misconduct. Vision objected to the releases as being "inappropriate, unjust and unnecessary" and improperly sought to frustrate Vision's efforts to collect from the principal shareholders and their respective bankruptcy estates.

The bankruptcy court approved the releases after Seaside amended the Plan provisions to remove subsidiaries and affiliates from the list of released parties and agreed to terminate litigation against Vision seeking sanctions. In doing so, the bankruptcy court applied the *Dow* Factors.

The bankruptcy court confirmed the amended Plan over Vision's objections. Vision appealed to the district court, which affirmed the confirmation order. Vision then appealed to the Eleventh Circuit.

At the outset of its ruling, the Eleventh Circuit noted that, in *In re Munford,* 97 F.3d 449 (11th Cir. 1996), the Eleventh Circuit previously held that § 105(a) of the Bankruptcy Code provides bankruptcy courts with authority to approve non-consensual third-party releases. The Eleventh Circuit approved the release in *Munford* because: (i) it was "integral to settlement in an adversary proceeding," and (ii) the released party was a settling defendant that would not have agreed to the settlement without the release. Despite the factual dissimilarities between the two cases, the Eleventh Circuit stated that Munford was the controlling authority and held that the Eleventh Circuit follows the "majority view" (*i.e.*, that non-consensual third-party releases are permissible under certain circumstances).

The Eleventh Circuit rejected the argument endorsed by the "minority circuits" that such releases are prohibited by § 524(e) of the Bankruptcy Code. In doing so, the Eleventh Circuit agreed with the Seventh Circuit's rationale in *Airadigm*, where the court stated that "[t]he natural reading of this provision does not foreclose a third-party release from a creditor's claims." Moreover, the Eleventh Circuit explained, if Congress had intended to limit the power of bankruptcy courts in this respect, it would have done so unequivocally.

With this groundwork, the Eleventh Circuit ruled that the bankruptcy court's application of the *Dow* Factors was consistent with existing Eleventh Circuit precedent. In commending those factors to bankruptcy courts within the circuit, the Eleventh Circuit emphasized that bankruptcy courts have discretion to determine which of the factors will be relevant in each case and that the

factors should be considered a non-exclusive list of considerations. Moreover, the Eleventh Circuit noted, the *Dow* Factors should be applied flexibly, always keeping in mind that such releases should be used "cautiously and infrequently" and only where essential, fair, and equitable.

The Eleventh Circuit determined that the bankruptcy court did not abuse its discretion in finding that, overall, application of the *Dow* Factors demonstrated that the Plan releases were appropriate.

However, the Eleventh Circuit explained that, in accordance with *Munford*, bankruptcy courts should also consider whether a proposed release is "fair and equitable." Although the bankruptcy court did not explicitly make such a finding, the Eleventh Circuit was satisfied that the bankruptcy court, in discussing considerations relevant to such a finding and requiring Seaside to cease litigation against Vision, properly considered whether the releases had satisfied this requirement. Among other things, the Eleventh Circuit, noting that the Bankruptcy Court had described the chapter 11 case as a "death struggle," stated that "the non-debtor releases are a valid tool to halt that fight."

In re Airadigm Communications, Inc., 519 F.3d 640 (7th Cir. 2008)

The Seventh Circuit determined that a bankruptcy court may grant an involuntary third-party release under appropriate circumstances.

This case involved an appeal of entry of a confirmation order in the second chapter 11 case of a cellular service provider that had bid for licenses from the Federal Communications Commission ("FCC") in the mid-1990s. Like several other licensees that had financed their purchases from the FCC with debt, Airadigm filed for chapter 11 when the value of those licenses had dropped precipitously. At that time, the FCC took the position that the licenses were forfeited as a result of Airadigm's failure to pay for the licenses in full, and Airadigm's first chapter 11 case proceeded as if the licenses were no longer an asset of the estate. In 2003, however, the Supreme Court concluded in *NextWave Personal Communications, Inc. v. FCC*, 537 U.S. 293 (2003), that the FCC could not cancel a C-block license simply because the licensee had filed for bankruptcy prior to payment for the license.

Airadigm refiled for chapter 11 in 2006 to, among other things, account for the Supreme Court's decision. Airadigm's chapter 11 plan was dependent upon financing provided to Airadigm by Telephone and Data Systems ("TDS"). The plan, in consideration for the financing, provided TDS with a third-party release for post-petition actions related to the debtor's second bankruptcy filing. Specifically, the plan provided TDS a release against claims "for any act or omission arising out of or in connection with the Case, the confirmation of [the] Plan, the consummation of [the] Plan, or the administration of [the] Plan or property to be distributed under this Plan, except for willful misconduct."

The FCC argued that such an involuntary third-party release was not authorized by the Bankruptcy Code. The Seventh Circuit disagreed, holding that a bankruptcy court may grant an involuntary third-party release under appropriate circumstances.

The Seventh Circuit considered two questions. First, the Seventh Circuit addressed whether § 524(e) prohibited nonconsensual non-debtor releases. On this point, the Seventh Circuit

upheld its earlier conclusion in *Specialty Equipment*, wherein the Seventh Circuit determined that § 524(e) is a saving clause which limits the operation of other parts of the Bankruptcy Code and preserves rights that might otherwise be construed as lost after the reorganization. The Seventh Circuit also noted that § 524(e) does not purport to limit a bankruptcy court's powers to release a non-debtor from a creditor's claims.

The Seventh Circuit then considered whether bankruptcy courts possessed the authority to approve the release of third parties with respect to a creditor's claims when the creditor has not consented. The Seventh Circuit looked to both § 105(a), which grants a bankruptcy court power to effect any "necessary or appropriate" order to carry out the provisions of the Bankruptcy Code, and § 1123(b)(6), which "permits a court to include any other appropriate provision not inconsistent with the applicable provisions of this title." In light of these Bankruptcy Code sections, the Seventh Circuit stated that "this 'residual authority' permits the bankruptcy court to release third parties from liability to participating creditors if the release is 'appropriate' and not inconsistent with any provision of the bankruptcy code."

Looking to the facts, the Seventh Circuit found that the release included within the 2006 plan was appropriate because it was narrowly tailored and necessary for the reorganization. Specifically, the release provision did not offer blanket immunity, but applied only to claims "arising out of or in connection with the reorganization" and did not include willful misconduct. Further, the Seventh Circuit noted that TDS made a substantial contribution to Airadigm's reorganization efforts, and without its funding, the reorganization "simply would not have occurred."

TOPIC 2: WHETHER A LICENSEE CAN KEEP TRADEMARK RIGHTS AFTER REJECTION

7th Circuit – Presented by Shanti Katona

Sunbeam Products, Inc. v. Chicago American Manufacturing, LLC, 686 F.3d 372 (7th Cir. 2012)

The Seventh Circuit Court of Appeals held that a Chapter 7 trustee's rejection of debtor's trademark licensing contract did not abrogate the license under the contract to use the trademark, because the trustee's contract rejection constituted a breach, not a rescission, therefore leaving the licensee's rights under the contract in place.

Lakewood Engineering and Mfg. Co. ("Lakewood"), a manufacturer and seller of consumer products, contracted with Chicago American Manufacturing ("CAM") to manufacture fans. Three months into the contract, Lakewood's creditors filed an involuntary bankruptcy petition against it. During these proceedings, Sunbeam Products, Inc. ("Sunbeam") purchased Debtor Lakewood's business, and Lakewood's trustee rejected Lakewood's contract with CAM under § 365(a). Despite the rejection, CAM continued to make and sell Lakewood-branded fans. In response, Sunbeam filed an adversary action against it.

The bankruptcy court allowed CAM to continue to make and sell the goods for the 2009 selling season. The bankruptcy court did not decide whether a contract's rejection under § 365(a) ends the licensee's right to use the trademarks, but determined that CAM would be allowed to continue to use the mark for the season on equitable grounds because CAM invested substantial resources in making the goods bearing the debtor's mark. The bankruptcy court found that § 365(n), which "allows licensees to continue using the intellectual property after rejection, provided they meet certain conditions" applied to CAM. Sunbeam appealed.

On appeal, Sunbeam contended that "CAM had to stop making and selling fans once Lakewood stopped having requirements for them." The Seventh Circuit affirmed the bankruptcy court's judgment, but on different grounds.

Section 365(g) specifies the consequences of a rejection under § 365(a).[7] The Seventh Circuit noted that § 365(g) classifies rejection as a breach of contract. "Outside of bankruptcy, a

---

[7] Section 365(g) provides:

Except as provided in subsections (h)(2) and (i)(2) of this section, the rejection of an executory contract or unexpired lease of the debtor constitutes a breach of such contract or lease—

(1) if such contract or lease has not been assumed under this section or under a plan confirmed under chapter 9, 11, 12, or 13 of this title, immediately before the date of the filing of the petition; or

(2) if such contract or lease has been assumed under this section or under a plan confirmed under chapter 9, 11, 12, or 13 of this title—

(A) if before such rejection the case has not been converted under section 1112, 1208, or 1307 of this title, at the time of such rejection; or

licensor's breach does not terminate a licensee's right to use intellectual property." Therefore, "[w]hat § 365(g) does by classifying rejection as breach is establish that in bankruptcy, as outside of it, the other party's rights remain in place."

Here, the trustee rejected the contract with defendant; the trustee did not use avoiding powers to rescind the contract with CAM. "Rejection is not 'the functional equivalent of a rescission, rendering void the contract and requiring that the parties be put back in the positions they occupied before the contract was formed.' It 'merely frees the estate from the obligation to perform' and 'has absolutely no effect upon the contract's continued existence.'" Therefore, the trustee's rejection of Lakewood's contract with CAM did not do away with CAM's rights under the contract.

In interpreting § 365(g), the Seventh Circuit was not persuaded by the Fourth Circuit's decision in *Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc.*, 756 F.2d 1043 (4th Cir. 1985), which holds that "when an intellectual-property license is rejected in bankruptcy, the licensee loses the ability to use any licensed copyrights, trademarks, and patents." According to the Seventh Circuit, *Lubrizol* "confuses rejection with the use of an avoiding power."

1st Circuit – Presented by Gabriel Glazer

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

The First Circuit Court of Appeals held that (i) § 365(n) does not apply to a trademark license rejected by the debtor/licensor and (ii) rejection by the debtor licensor of a trademark license deprived the licensee of the right to utilize the licensed trademark. The U.S. Supreme Court has granted certiorari to resolve the split in authority raised in this decision.

Tempnology, LLC ("Tempnology") was a party to a prepetition agreement with Mission Product Holdings Inc. ("Mission") that granted Mission the exclusive right to sell certain of Tempnology's products to certain retailers in specified territories. In addition, Tempnology granted Mission a nonexclusive, perpetual license to exploit the debtor's intellectual property and a limited license during the term of the agreement to exploit the debtor's trademark, brand, and logo. Either party could terminate with or without cause by providing written notice. Any event of termination, however, would trigger a two-year wind down period during which Mission would retain certain rights to purchase, distribute, and sell certain products in accordance with the agreement.

(B) if before such rejection the case has been converted under section 1112, 1208, or 1307 of this title—

(i) immediately before the date of such conversion, if such contract or lease was assumed before such conversion; or

(ii) at the time of such rejection, if such contract or lease was assumed after such conversion.

Tempnology filed a bankruptcy petition, then subsequently filed a motion to reject the agreement. It also filed a motion seeking bankruptcy court approval for the sale of substantially all of its assets free and clear of liens, claims, and encumbrances. Mission objected to both the sale motion and the rejection motion and gave notice of its election pursuant to § 365(n)(1)(B) to retain use of the rejected intellectual property.

Mission argued that under § 365(n) it retained its exclusive distribution rights, its rights under the IP license, and its rights under the trademark license. Tempnology argued that, although § 365(n) protected the IP license, it did not protect its distribution or trademark rights.

Section 365(n) allows a counterparty that is the licensee under an intellectual property license to elect to retain certain rights under the contract notwithstanding its rejection.[8] In addition, § 365(n)(3)(B) provides, "[i]f the licensee elects to retain its rights . . . the trustee shall . . . not interfere with the rights of the licensee as provided in such contract . . . to such intellectual property . . . including any right to obtain such intellectual property . . . from another entity."[9]

---

[8] Section 365(n) provides in pertinent part:

> (1) If the trustee rejects an executory contract under which the debtor is a licensor of a right to intellectual property, the licensee under such contract may elect . . .
>
> > (B) to retain its rights (including a right to enforce any exclusivity provision of such contract, but excluding any other right under applicable nonbankruptcy law to specific performance of such contract) under such contract and under any agreement supplementary to such contract, to such intellectual property (including any embodiment of such intellectual property to the extent protected by applicable nonbankruptcy law), as such rights existed immediately before the case commenced, for—
> >
> > > (i) the duration of such contract; and
> > >
> > > (ii) any period for which such contract may be extended by the licensee as of right under applicable nonbankruptcy law.
>
> (2) If the licensee elects to retain its rights, as described in paragraph (1)(B) of this subsection, under such contract—
>
> > (A) the trustee shall allow the licensee to exercise such rights;
> >
> > (B) the licensee shall make all royalty payments due under such contract for the duration of such contract and for any period described in paragraph (1)(B) of this subsection for which the licensee extends such contract; and
> >
> > (C) the licensee shall be deemed to waive—
> >
> > > (i) any right of setoff it may have with respect to such contract under this title or applicable nonbankruptcy law; and
> > >
> > > (ii) any claim allowable under section 503(b) of this title arising from the performance of such contract.

[9] Congress enacted § 365(n) in response to the decision in *Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc*., 756 F.2d 1043 (4th Cir. 1985), in which the court had held that rejection of an intellectual property license deprived the licensee of all rights previously granted under the license. The legislative history reflects that the purpose of § 365(n) was "to make clear that the rights of an intellectual property licensee to use the licensed property cannot be unilaterally cut off as a result of the rejection of the license pursuant to [§] 365 in the event of the licensor's bankruptcy." S. Rep. No. 100-505, 5 (1988).

Mission argued that its exclusive distribution rights were preserved because § 365(n) provides that a licensee of intellectual property may retain its rights under the contract, "including a right to enforce any exclusivity provision of such contract" and "including any embodiment of such intellectual property," and Tempnology's grant of the exclusive distribution rights was an "exclusivity provision" that related to the IP license.

The bankruptcy court held that § 365(n) protected Mission's rights under the IP license, but not the exclusive distribution rights or trademark license rights.

Mission appealed to the Bankruptcy Appellate Panel, and the BAP held that the bankruptcy court did not err in ruling that the exclusive distribution rights were unprotected by § 365(n). With respect to the trademark license, the BAP noted that while the purpose of § 365(n) is to protect licensees of intellectual property, the definition of "intellectual property" in § 101(35A) does not include trademarks.[10]

Although Mission acknowledged that the definition of intellectual property in § 101(35A) did not encompass trademarks, it argued that the bankruptcy court should have used its equitable powers (as some other courts have) to determine that Mission's rights in the debtor's trademark were protected. The BAP declined to do so:

> We agree that § 365(n) incorporates the definition of intellectual property set forth in § 101(35A), and that the definition does not encompass trademarks and logos. But we decline Mission's invitation to rule that, despite the omission of trademarks from the Code's definition of intellectual property, Mission's licensee rights in the Debtor's trademark and logo should be preserved under § 365(n) on equitable grounds as suggested in § 365(n)'s legislative history. "[C]ourts must presume that a legislature says in a statute what it means and means in a statute what it says there." *Conn. Nat'l Bank v. Germain*, 503 U.S. 249, 253–54, 112 S. Ct. 1146, 117 L. Ed. 2d 391 (1992). . . .
>
> We agree with the bankruptcy court that, based on a plain reading of the statute, Mission's rights in the Debtor's trademark and logo were not and could not be protected by its § 365(n) election.

---

[10] Section 101(35A) provides: "The term "intellectual property" means—

(A) trade secret;

(B) invention, process, design, or plant protected under title 35;

(C) patent application;

(D) plant variety;

(E) work of authorship protected under title 17 [relating to copyrights]; or

(F) mask work protected under chapter 9 of title 17 [relating to microchips];

to the extent protected by applicable nonbankruptcy law."

However, the BAP went on to hold that, irrespective of the applicability of § 365(n), rejection of a trademark license by a debtor/licensor does not result in the termination of the rights of the licensee:

> We must part company with the bankruptcy court, however, on the *effect* the Debtor's rejection of the Agreement had on Mission's licensee rights in the Debtor's trademark and logo. The bankruptcy court ruled that, because the Debtor's trademark and logo were not protected by Mission's election under § 365(n), Mission did "not retain rights to the Debtor's trademarks and logos post-rejection." This conclusion endorses *Lubrizol's* approach to the rejection of executory contracts, namely that rejection terminates the contract. *Lubrizol*, however, is not binding precedent in this circuit and, like the many others who have criticized its reasoning, we do not believe it articulates correctly the consequences of rejection of an executory contract under § 365(g). We adopt *Sunbeam's* interpretation of the effect of rejection of an executory contract under § 365 involving a trademark license.
>
> "After rejecting a contract, a debtor is not subject to an order of specific performance." The debtor's unfulfilled obligations are converted to damages; when a debtor does not assume the contract before rejecting it, these damages are treated as a pre-petition obligation, which may be written down in common with other debts of the same class. But nothing about this process implies that any rights of the other contracting party have been vaporized."
>
> Applying *Sunbeam's* rationale, we conclude that, while the Debtor's trademark and logo were not encompassed in the categories of intellectual property entitled to special protections under § 365(n), the Debtor's rejection of the Agreement did not vaporize Mission's trademark rights under the Agreement. Whatever post-rejection rights Mission retained in the Debtor's trademark and logo are governed by the terms of the Agreement and applicable non-bankruptcy law.
>
> Thus, we conclude that the bankruptcy court did not err in ruling that Mission's § 365(n) election failed to protect its rights under the Agreement as licensee of the Debtor's trademark and logo, but it erred in ruling that Mission's rights in the Debtor's trademark and logo as set forth in the Agreement terminated upon the Debtor's rejection of the Agreement.

The BAP's decision was appealed to the First Circuit. The First Circuit agreed with the lower courts that the exclusive distribution rights and the trademarks were not protected, because they did not satisfy the definition of "intellectual property" under § 101(35A) and, therefore, were not covered by § 365(n).

The First Circuit rejected the reasoning of *Sunbeam*, followed *Lubrizol*, and held that rejection of the trademark license deprived the licensee of its rights to use of the trademarks:

> *Sunbeam* therefore largely rests on the unstated premise that it is possible to free a debtor from any continuing performance obligations under a trademark license even while preserving the licensee's right to use the trademark.
>
> Careful examination undercuts that premise because the effective licensing of a trademark requires that the trademark owner—here Debtor, followed by any purchaser of its assets—monitor and exercise control over the quality of the goods sold to the public under cover of the 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 licensor's monitoring and control thus serve to ensure that the public is not deceived as to the nature or quality of the goods sold. Presumably, for this reason, the Agreement expressly reserves to Debtor the ability to exercise this control: The Agreement provides that Debtor "shall have the right to review and approve all uses of its Marks," except for certain pre-approved uses. 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, thereby diminishing their value to Debtor, whether realized directly or through an asset sale. Such a restriction on Debtor's ability to free itself from its executory obligations, even if limited to trademark licenses alone, would depart from the manner in which section 365(a) otherwise operates. And the logic behind that approach (no rights of the counterparty should be "vaporized" in favor of a damages claim) would seem to invite further leakage. If trademark rights categorically survive rejection, then why not exclusive distribution rights as well? Or a right to receive advance notice before termination of performance? And so on.
>
> . . . .
>
> In sum, the approach taken by *Sunbeam* entirely ignores the residual enforcement burden it would impose on the debtor just as the Code otherwise allows the debtor to free itself from executory burdens. The approach also rests on a logic that invites further degradation of

> the debtor's fresh start options. . . . For these reasons, we favor the categorical approach of leaving trademark licenses unprotected from court-approved rejection, unless and until Congress should decide otherwise.

TOPIC 3: ASSUMPTION AND ASSIGNMENT OF INTELLECTUAL PROPERTY

Hypothetical Test – Presented by Jeff Bjork

In re Catapult Entertainment, Inc., 165 F.3d 747 (9th Cir. 1999)

The Ninth Circuit Court of Appeals adopted the "hypothetical" test in its interpretation of § 365(c)(1).

Perlman, the owner of certain patents, granted two non-exclusive licenses to Catapult. Catapult entered into a merger agreement with MPath Interactive, Inc. ("MPath") pursuant to which Catapult would become a wholly-owned subsidiary of Mpath. Catapult subsequently filed for bankruptcy under chapter 11, and as part of its plan of reorganization, moved to assume the Perlman licenses pursuant to § 365(a).[11]

Perlman objected to the assumption motion, arguing that § 365(c)(1)[12] prevented Catapult from assuming the licenses. Perlman argued that § 365(c)(1) requires application of a "hypothetical" test that precludes a debtor from assuming an executory contract over a non-debtor's objection if applicable law would bar assignment to a hypothetical third party, even if the debtor does not intend to assign the contract. Catapult contended that § 365(c)(1) embodies an "actual" test that permits assumption of an executory contract by the debtor, regardless of whether the non-debtor consents, if the debtor does not intend to actually assign the contract to a third party. The bankruptcy court granted Catapult's motion to assume. The district court affirmed the bankruptcy court's decision and Perlman appealed to the Ninth Circuit.

Based on a plain reading of the Bankruptcy Code, the Ninth Circuit adopted the "hypothetical" test and held that "where applicable nonbankruptcy law makes an executory contract nonassignable because the identity of the nondebtor is material, a debtor in possession may not assume the contract absent consent of the nondebtor party." Under federal patent law (the applicable non-bankruptcy law), non-exclusive patent licenses are personal and assignable only with the consent of the licensor. Because Perlman did not consent to the assumption, the Ninth Circuit determined that § 365(c)(1) prevented Catapult from assuming the licenses.

---

[11] Pursuant to § 365(a), debtors are permitted to assume or reject their executory contracts with court approval. After assuming an executory contract, debtors are permitted to assign the executory contract, notwithstanding a restriction, prohibition or condition in a provision of the contract or in applicable law if certain conditions are met.

[12] Section 365(c)(1) provides:

The trustee may not assume or assign any executory contract or unexpired lease of the debtor, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties, if—

> (A) applicable law excuses a party, other than the debtor, to such contract or lease from accepting performance from or rendering performance to an entity other than the debtor or the debtor in possession, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties; and
>
> (B) such party does not consent to such assumption or assignment[.]

The Ninth Circuit rejected Catapult's arguments that adoption of the "hypothetical" test would lead to inconsistencies within the Bankruptcy Code. Catapult pointed to § 365(f)(1), § 365(c)(1), and § 365(c)(2) to support its position.

Catapult argued that interpreting § 365(c)(1) to prohibit assumption if "applicable law" would prohibit assignment renders § 365(f)(1)[13] superfluous because assumption is a prerequisite to assignment. The Ninth Circuit disagreed, and stated that each subsection recognizes an "applicable law" of different scope. Under § 365(c)(1), "applicable law" relates to whether a licensor is excused from accepting performance from a licensee, while "applicable law" under § 365(f)(1) relates to whether a contract can be assigned generally, without regard to whether the reason relates to the identity of the assignee.

The Ninth Circuit then rejected Catapult's argument that the phrase "or the debtor in possession" in § 365(c)(1)(A) would be rendered superfluous, since this interpretation could prohibit assumption by a debtor in possession, even though the provision contemplates that a debtor in possession may perform under executory contracts. The Ninth Circuit explained the inclusion of "or the debtor in possession" relates to the fact that § 365(c)(1) governs assumption *and* assignment, each contingent on the non-debtor's separate consent.

Finally, Catapult argued that this interpretation rendered § 365(c)(2)[14] superfluous, since all contracts encompassed by § 365(c)(2) are non-assignable as a matter of applicable state law. The Ninth Circuit dismissed this argument by stating that the trend towards national uniformity in state laws governing such contracts rendered § 365(c)(2) superfluous, not § 365(c)(1). Further, the Ninth Circuit found that § 365(c)(1) does not fully encompass § 365(c)(2), since § 365(c)(2) prohibits the assumption and assignment of these particular contracts, regardless of whether the non-debtor consents.

In re West Electronics, 852 F.2d 79 (3d Cir. 1988)

The Third Circuit Court of Appeals interpreted § 365(c)(1) to create a "hypothetical" test governing the assumption and assignment of executory contracts.

West Electronics ("West") entered into a contract with the U.S. government calling for the production of military equipment. The U.S. government determined that the contract should be suspended, and sent notice to West to show cause why the contract should not be terminated. West subsequently filed a petition under chapter 11, triggering the automatic stay.

West moved for an order compelling progress payments on the contract, and the government filed a cross-motion seeking an order permitting it to terminate the contract by the

---

[13] Section 365(f)(1) provides, in pertinent part, that executory contracts, once assumed, may be assigned notwithstanding any contrary provisions contained in the contract or applicable law.

[14] Section 365(c)(2) provides, in pertinent part, that an executory contract cannot be assumed or assigned if such contract is a contract to make a loan, or extend other debt financing or financial accommodations, to or for the benefit of the debtor, or to issue a security of the debtor

court lifting the automatic stay. The bankruptcy court denied both motions. The district court affirmed the bankruptcy court's order, and the government appealed to the Third Circuit

Based on a literal reading of the statute, the Third Circuit held that § 365(c)(1) creates a "hypothetical" test, which prevents the debtor in possession from assuming the contract if non-bankruptcy law provides that the non-debtor would have to consent to an assignment of the contract to a third-party (*i.e.*, someone other than the debtor or the debtor in possession). The Third Circuit found that 41 U.S.C. § 15, which prohibits the assignment of government contracts without the government's consent, applied to the contract at issue. Since the government refused to consent, § 365(c)(1) prohibited West from assuming the contract.

West argued that 41 U.S.C. § 15 should not be construed to foreclose an assignment of a contract from a debtor to a debtor in possession because they are such closely related entities. The Third Circuit stated that the argument missed the point, since the relevant inquiry under the "hypothetical" test is not whether the applicable non-bankruptcy law would preclude an assignment from the debtor to the debtor in possession. Rather, a court must ask whether, under the applicable non-bankruptcy law, the non-debtor could refuse performance from "an entity other than the debtor or the debtor in possession." According to the Third Circuit, by including the words "or the debtor in possession" in § 365(c)(1), Congress anticipated an argument like West's and wanted the section to reflect its judgment that a solvent entity and an insolvent debtor in possession going through bankruptcy are materially distinct entities in the context of assumption and assignment of executory contracts.

Because § 365(c)(1) prevented West from assuming the contract without the government's consent, and because the government refused to give that consent, the Third Circuit held that West did not have a legally cognizable interest in the contract and it was an abuse of discretion for the bankruptcy court to decline to lift the stay.

RCI Technology v. Sunterra Corp. (In re Sunterra Corp.), 361 F.3d 257 (4th Cir. 2004)

The Fourth Circuit Court of Appeals adopted a literal ("hypothetical") test in its interpretation of § 365(c)(1).

Sunterra Corporation ("Sunterra") paid RCI Technology Corporation ("RCI") a one-time fee of $3.5 million for a non-exclusive, worldwide, perpetual, irrevocable, royalty-free license to use, modify and distribute certain software of RCI. The agreement specified that Sunterra owned any enhancements it made to the software and, in turn, Sunterra granted RCI a license to use the Sunterra enhancements. Sunterra filed for bankruptcy 9 years later. Prior to the confirmation of the plan, RCI filed a motion to deem the agreement rejected on the grounds that Sunterra could not assume the agreement absent RCI's consent, which RCI would not give.

The bankruptcy court held that § 365(c) did not prevent Sunterra from assuming the agreement because it was not an executory contract, and even if it were, § 365(c) did not prevent assumption because Sunterra did not intend to assign the agreement. The district court disagreed with the bankruptcy court's finding that the agreement was not executory, but concluded that § 365(c)(1) did not preclude Sunterra from assuming the agreement. RCI appealed to the Fourth Circuit.

The Fourth Circuit first determined that the license agreement was an executory contract under the Countryman test.[15] When Sunterra filed for bankruptcy, each party owed at least one continuing material duty to the other under the license agreement because they each possessed an ongoing obligation to maintain the confidentiality of the source code of the software developed by the other. Since the agreement was deemed to be an executory contract, it was subject to § 365.

Sunterra argued that the Fourth Circuit should depart from the plain meaning of the statutory language and apply the "actual" test, which reads the disjunctive "or" in § 365(c)(1) as the conjunctive "and" because application of the literal ("hypothetical") test would produce a result that is both absurd and demonstrably at odds with clearly expressed legislative intent. Like the debtor in *Catapult*, Sunterra made arguments based on statutory interpretation, bankruptcy policy, and legislative history, which the Fourth Circuit rejected for similar reasons as the Ninth Circuit.

Additionally, Sunterra argued that RCI consented to Sunterra's assumption of the license agreement because it contained a transfer provision that provided that transfer of the license to a successor in interest of substantially all of Sunterra's assets would not be prohibited if the assignee agreed in writing to be bound by the license. RCI argued that any consent provided in the transfer provision was irrelevant because § 365(c)(1)(A) applied whether or not such contract prohibits or restricts assignments of rights. The Fourth Circuit stated that RCI's reliance on the language in § 365(c)(1) was misplaced, as the transfer provision favored assignment, rather than prohibiting or restricting it. The Fourth Circuit explained that the issue of contractual consent could be determinative of whether § 365(c)(1) barred Sunterra's assignment of the license, however, the issue in this case was over assumption of the license. The Fourth Circuit found that the transfer provision only applied to assignments, and given that assumption and assignment are two conceptually distinct events that require separate consent under § 365(c)(1), RCI did not consent to the assumption by a debtor in possession through the transfer provision.

Applying the literal interpretation of § 365(c)(1), the Fourth Circuit held that Sunterra was prohibited from assuming the license agreement absent RCI's consent because the applicable non-bankruptcy law (copyright law), would excuse RCI from accepting performance under the agreement from an entity other than Sunterra.

Actual Test – Presented by Shanti Katona

Institut Pasteur v. Cambridge Biotech Corp., 104 F.3d 489 (1st Cir. 1997)

The First Circuit Court of Appeals held that contractual restrictions against assignment of a patent does not preclude a debtor in possession from assuming that patent because that debtor in possession is not a different entity post-petition.

Cambridge Biotech Corporation ("CBC") sells and manufactures HIV detection tests. Before filing for bankruptcy, Institut Pasteur ("Pasteur") entered into a mutual cross-license agreement with CBC through which each acquired a nonexclusive perpetual license to use some

[15] Under the Countryman test, a contract is executory if the obligations of both the debtor and the other party to the contract are so far unperformed that the failure of either to complete the performance would constitute a material breach excusing the performance of the other.

of the technology patented/licensed by the other. Each cross-license prohibited the licensee from assigning or sublicensing to others. Years later, CBC filed its chapter 11 petition. As part of its plan, CBC proposed to sell its stock to a subsidiary of one of Pasteur's major competitors, bioMerieux. The bankruptcy court approved the stock sale.

Pasteur objected to the bankruptcy court's approval of debtor's plan. The bankruptcy court affirmed approval, holding that sale of CBC's stock to bioMerieux's subsidiary was not a de facto assignment of cross-licenses, just an assumption by the reorganized debtor under new ownership. Pasteur appealed the bankruptcy court decision to the district court, which affirmed the bankruptcy court's order. Pasteur appealed again to the First Circuit.

Pasteur argued that CBC's stock sale would constitute a "de facto assignment of its cross-licenses to bioMerieux, contrary to Bankruptcy Code § 365(c)(1)[.]"

The First Circuit affirmed the prior ruling, holding that because the reorganized debtor was not a different entity post-petition, there was no assignment of the license to the competitor. Pasteur could not show that the stock purchase deprived it of the full benefit of its bargain, and the assumption of the license post-petition was allowed.

In reaching its conclusion, the First Circuit used an "actual performance" test, holding "that subsections 365(c) and (e) contemplate a case-by-case inquiry into whether the nondebtor party (viz., Pasteur) actually was being 'forced to accept performance under its executory contract from someone other than the debtor party with whom it originally contracted.'" Under this test, the First Circuit focused on the performance actually to be rendered by the debtor in possession with a view to ensuring that the appellant will receive the full benefit of its bargain.

The First Circuit rejected the "hypothetical test," because under that approach, the debtor would lose its option to assume the contract, even if it never intended to assign it, "if either the contract or applicable nonbankruptcy law purported to terminate the contract automatically upon the filing of the chapter 11 petition or to preclude its assignment to an entity not a party to the contract."

Here, throughout the bankruptcy process, CBC planned to continue (and did continue) its "enterprise as the same corporate entity which functioned prepetition." There was no outright assignment of CBC's license to bioMerieux. According to the Court, "[s]tock sales are not mergers whereby outright title and ownership of the licensee-corporation's assets (including its patent licenses) pass to the acquiring corporation." As a corporation, CBC "is a legal entity distinct from its shareholders." Therefore, CBC's separate legal identity and ownership of patent licenses survive, even though ownership changed. Pasteur still retained its benefit of the bargain post-petition.

Moreover, the First Circuit noted that as the patent holder, Pasteur could have, but failed to, contract around this type of situation by negotiating restrictions on CBC's continuing rights under the licenses based on changes in stock ownership or corporate control.

Alternative – Presented by Shanti Katona

In re Footstar, Inc., 323 B.R. 566 (Bankr. S.D.N.Y. 2005)

The bankruptcy court held that a plain meaning reading of § 365(c)(1) limits a trustee's power to assume or assign a contract, but only limits a debtor in possession's ability to assign a contract.

Footstar, Inc. ("Footstar") operated two distinct businesses, discount and family footwear and athletic footwear and apparel. Footstar filed for chapter 11 and divested itself of its unprofitable athletic footwear and apparel operations. Footstar was left with agreements between it and Kmart, wherein each shoe department in Kmart is operated by "Shoemart Corporation," which Footstar owns a 51% stake in. Shoemart Corporation has the exclusive right to operate a footwear department in each Kmart. Ninety-five percent of Footstar's revenue is generated from the Kmart sales. To avoid liquidation and confirm a plan that would provide a 100% payment to creditors, Footstar sought to assume these agreements under § 365(a).

Kmart objected to Footstar's motion to assume, asserting that assumption was barred under § 365(c)(1). The bankruptcy court overruled Kmart's objections to assumption, holding that § 365(c)(1) was not applicable to Footstar because it was a debtor in possession which sought to assume, but not assign, its non-assignable contract.

The bankruptcy court agreed with the "actual performance" test proposed by *Institut Pasteur* (and not the hypothetical test, which interprets the statutory language in its plain meaning). However, the bankruptcy court proposed that § 365 should be interpreted in its plain meaning. Specifically, the bankruptcy court looked to § 365(c)(1), which states that "[t]he *trustee* may not assume or assign[.]" According to the bankruptcy court, the prohibition regarding assumption or assignment applies on its face to the "trustee," not the debtor or debtor in possession. Moreover, the Bankruptcy Code does not define trustee as synonymous with debtor or debtor in possession. Therefore, because there is no trustee in this case, nothing prohibits Footstar from assuming its agreements with Kmart. Furthermore, "[t]he basic objective of Section 365(c)(1)—to protect the contract counterparty from unlawful assignment of the contract —simply is not implicated when a debtor in possession itself seeks to assume, but not assign, the contract."

The bankruptcy court rejected the hypothetical test, stating that the courts that have adopted this test are operating under the misconception that use of the term "trustee" in § 365(c)(1) includes a debtor or debtor in possession.

In sum, "[s]ection 365(c)(1) limits the trustee's power to assume or assign by confirming rights under applicable law of a contract counterparty. Applying this limitation to the trustee, the trustee cannot either assume or assign because in either case the counterparty would be forced to accept performance by 'an entity other than the debtor or the debtor in possession.' Likewise, applying the limitation to the debtor, a debtor in possession cannot assign because the counterparty would be in the same position. However, also applying the limitation of applicable law to the debtor, the debtor in possession can assume because by the limitation's express terms it can have no consequence or effect as to a debtor in possession, which is not 'an entity other than' itself."

TOPIC 4: MAKE-WHOLE PREMIUMS

Prohibition Circuits – Presented by Gabriel Glazer

Apollo Global Mgmt v. BOKF, NA (In re MPM Silicones, LLC), 874 F.3d 787 (2d Cir. 2017)

The Second Circuit Court of Appeals held that secured lenders could not enforce a "make-whole" premium that would have been due if the lenders' notes were "redeemed" at the debtors' option prior to a certain date, because the lenders' debt had been accelerated automatically upon the debtors' filing for bankruptcy.

The debtors filed a chapter 11 plan that proposed, inter alia, to pay their senior secured lenders all principal and accrued interest outstanding on the effective date of the plan, in cash, if their class accepted the plan. However, the cash option did not include any payment of the make-whole premium that was required under the indenture governing the notes if the debtors prepaid the notes before a specific date. Alternatively, if the senior secured lenders' class voted to reject the plan, they would be crammed down with replacement notes providing for a payment stream having a present value equal to the allowed amount of their claims. The bankruptcy court would determine whether the allowed amount of their claim must include the make-whole premium.

The senior secured lenders voted to reject the plan, which the bankruptcy court confirmed over their objection. The bankruptcy court and the district court for the Southern District of New York both ruled that the senior secured lenders were not entitled to the make-whole premium.

On appeal to the Second Circuit, the senior secured lenders argued, among other things, that the lower courts had erred when they failed to award the make-whole premium, which the indenture and the notes required if the debtors "redeemed" the notes before October 15, 2015. The lenders contended that the debtors' commencement of the chapter 11 cases constituted such a premature redemption. The debtors argued that filing the bankruptcy petition was an event of default under the documents, which caused an automatic, mandatory acceleration of "the principal of, premium, *if any*, and interest on all the [Senior Lien] Notes"; the transactional documents did not provide expressly for a make-whole premium upon acceleration; and under New York law, acceleration is not the same as redemption. Therefore, the debtors argued, no make-whole premium was due. The Second Circuit agreed with the debtors.

The Second Circuit reasoned that the automatic acceleration of the debt upon the bankruptcy filing changed the date of maturity from some specified point in the future to a new, earlier maturity date for the debt, *i.e.*, the date of the bankruptcy filing, and that any repayment or restructuring of the debt after that date would no longer be either a "redemption" or "optional" for purposes of the indenture's optional redemption provision.

Notably, the Third Circuit Court of Appeals had reached a contrary decision with respect to a nearly identical make-whole issue in *Delaware Trust Co. v. Energy Future Intermediate Holding Co. (In re Energy Future Holdings Corp.)*, 842 F.3d 247 (3d Cir. 2016). Although the Second Circuit cited the contrary opinion of the Third Circuit, it did not explicitly address the Third Circuit's reasoning in that case.

In re Tara Retail Grp., LLC, Case No. 17-57 (Bankr. N.D.W. Va. Sept. 19, 2018)

This bankruptcy court decision arose over a dispute between Tara Retail Group, LLC ("Debtor") and its principal secured lender, Comm2013-CCRE12 Crossings Mall Road, LLC ("Comm2013"), regarding the amount of Comm2013's proof of claim. Specifically, the parties disputed whether Comm2013 could collect a "prepayment premium" of $3,139,776.71. The loan documents at issue were governed by New York law.

The Debtor asserted that Comm2013 was not entitled to that amount because, among other things, Comm2013's acceleration of the note changed the maturity date such that any present attempt to repay the debt as part of its reorganization could not constitute a "prepayment." In support of its argument, the Debtor relied upon *In re MPM Silicones*, *L.L.C.*, 874 F.3d 787 (2nd Cir. 2017). In opposition, Comm2013 contended that it was entitled to the premium because prepayment premiums compensate lenders for the loss of their bargain upon prepayment, that they are enforceable as liquidated damages, and they remain enforceable without regard to acceleration. Comm2013 recognized *MPM Silicones* as an affirmation of the general rule under New York law that acceleration negates a prepayment penalty, but asserted that the case at hand represented the exception. In support of its argument, it primarily relied upon *In re Energy Future Holdings Corp*., 842 F.3d 247 (3rd Cir. 2016) (applying New York law).

The bankruptcy court explained that the parties in *Energy Future Holdings* divorced the make-whole premium from other provisions related to the acceleration of the obligation. According to the *Energy Future Holdings* court, "[a]cceleration here has no bearing on whether and when the make-whole is due." Instead, the premium was due upon voluntary redemption. "Thus, while a premium contingent on 'prepayment' could not take effect after the debt's maturity, a premium tied to a 'redemption' would be unaffected by acceleration of a debt's maturity."

Here, the Debtor asserted that because the requested premium was based upon prepayment and because the debt was accelerated by the bankruptcy the payment was no longer "pre." The bankruptcy court agreed and further noted that the agreement did not specifically require the payment of the premium based upon the acceleration of the Note. Rather, in the bankruptcy court's view, the relevant language contemplated a "prepayment" during an event of default in the absence of an accelerated note. The bankruptcy court noted "there is no cause to depart from the general rule that acceleration neuters a make-whole provision and no offense is given to the contractual language for which the parties bargained."

Permissive Circuits – Presented by Dawn Cica

In Delaware Trust Co. v. Energy Future Intermediate Holding Co. LLC (In re Energy Future Holdings Corp.), 842 F.3d 247 (3d Cir. 2016)

The Third Circuit Court of Appeals held that Energy Future Intermediate Holding Co. LLC and EFIH Finance Inc. (collectively, "EFIH") were required to pay the make-whole obligation triggered when EFIH elected to pay outstanding notes (the "Notes") with post-petition funds. The Notes were automatically accelerated when EFIH filed for bankruptcy, but the Third Circuit held that the note indentures did not provide that acceleration cancelled the obligation to make the redemption premium.

The case revolved around two provisions in the indentures for the loan. Section 3.07 provided that "at any time prior to December 2015, [the debtor] may redeem all or part of the Notes at a redemption price equal to 100% of the principal amount of the Notes redeemed plus the Applicable Premium . . . and accrued and unpaid interest."

The Third Circuit stated that the "Applicable Premium" was a make-whole or yield-protection contractual substitute for interest lost on Notes redeemed prior to their original expected due dates. Section 6.02 provided that the Notes were accelerated if the debtor filed for bankruptcy but also gave the Noteholders the right to rescind any acceleration and its consequences. When market interest rates went down, the debtor considered refinancing the Notes. In accordance with Section 3.07, a refinancing would have triggered the right of the Noteholders to receiver the redemption premium.

The debtor, however, thought that it could avoid payment of the premium by filing for bankruptcy. The debtor laid out its plan in an 8-K filed with the Securities and Exchange Commission, where it stated that it would file for bankruptcy and refinance the Notes without having to pay the premium. True to its word, the debtor filed for bankruptcy and sought to refinance the Notes without paying the premium. The Noteholders commenced an adversary proceeding to enforce the premium. The bankruptcy court ruled against the Noteholders, reasoning that Section 6.02, the acceleration provision, did not expressly mention the premium, and due to such omission, the bankruptcy court ruled that none was due.

Before the Third Circuit, the debtor argued that "redemption," an undefined term in the indenture, meant repayment of debt that pre-date the maturity date of the Notes. The Third Circuit rejected this argument, noting that under the applicable New York law, redemption includes both pre- and post-maturity repayments of debt.

The Third Circuit also noted that the redemption by the debtor was voluntary and that the debtor had the option of reinstating the original maturity date under the Bankruptcy Code instead of repaying the notes.

The debtor also argued that the redemption was not optional after it filed for bankruptcy. The Third Circuit rejected this argument because the bankruptcy filing was voluntary, and the debtor had the option to reinstate the original maturity date of the Notes in its plan of reorganization under § 1124(2). In this regard, the debtor's pre-bankruptcy 8-K form did not help its cause.

Finally, the debtor argued that once the acceleration provided under Section 6.02 of the indenture was triggered, then Section 3.07 was no longer applicable. The Third Circuit rejected the debtor's reading of the indenture. In doing so, the Third Circuit declined to follow *In re MPM Silicones, LLC*, 2014 WL 4436335 (Bankr. S.D.N.Y. Sept. 9, 2014), *aff'd*, 531 B.R. 321 (S.D.N.Y. 2015) ("*Momentive*") and *Nw. Mutl. Life Ins. Co. v. Uniondale Realty Assocs*., 816 N.Y.S.2d 831 (N.Y. Sup. Ct. 2006) ("*Northwestern")*.

The Third Circuit noted that *Momentive* was wrongly decided because the court failed to enforce the contract as written, which expressly provided that after acceleration, "premiums, if any" were due.

With respect to *Momentive*, the Third Circuit interpreted the case as establishing the following rule: prepayments cannot occur when payment is now due by acceleration of the debt's maturity. If the parties want to mandate a "prepayment" premium following acceleration, they must clearly state it in their agreement.

The Third Circuit, however, did not see the redemption or yield protection payment in its case as a prepayment premium. Nor did the Third Circuit believe that the policy considerations behind *Northwestern* were applicable. There, the court was concerned that lenders should not be able to seek immediate repayment after a default and seek a premium on top of that. In contrast, the Noteholders did not seek immediate payment and it was the debtor who voluntarily redeemed the Notes.

Finally, the Third Circuit noted that the decision of the bankruptcy court erred in failing to enforce Section 3.07 by running afoul of the decision of the New York Court of Appeals in *NML Capital v. Argentina*, 952 N.E.2d 482 (N.Y. 2011). In *NML Capital*, Argentina argued that the acceleration of the bonds at issue terminated its obligation to make biannual interest payments as the indenture documents required. The New York Court of Appeals rejected Argentina's position, ruling that the bond language requiring the biannual payments made no reference to acceleration or maturity, and thus remained effective after the bond's acceleration. Following this reasoning, the Third Circuit ruled that Section 3.07 applied no less after the acceleration of the Notes than it would to a pre-acceleration redemption.

In re Ultra Petroleum Corp., 575 B.R. 361 (Bankr. S.D. Tex. 2017)

The bankruptcy court held that a make-whole premium was payable to lenders under the debtor's plan of reorganization, where the parties' loan agreement expressly provided that the premium was due upon an automatic acceleration triggered by the debtor's bankruptcy filing, despite the fact that the plan proposed to leave the lenders unimpaired pursuant to § 1124(1). The bankruptcy court certified its decision for direct appeal to the Fifth Circuit.

One of the debtors ("OpCo") issued $1.46 billion in unsecured notes (the "Notes") pursuant to a master note purchase agreement (the "MNPA"). OpCo had a right under the MNPA to prepay Notes at 100% of their principal amount plus a contractual "Make-Whole Amount." Upon the occurrence of any contractual event of default, which included OpCo's filing of a bankruptcy petition, the entire unpaid principal, all accrued and unpaid interest, and any Make-Whole Amount would become immediately due. Thus, the MNPA in effect made the Make-Whole Amount due upon the automatic acceleration of the debt triggered by a bankruptcy filing.

After it filed its chapter 11 petition, OpCo became solvent and proposed a chapter 11 plan providing for full payment of unsecured claims, including the Notes, and a substantial recovery for equity holders. However, the plan of reorganization did not propose to pay holders of the Notes the Make-Whole Amount or to pay postpetition interest on the holders' claims at the default rates provided under the MNPA. Notably, the plan treated the holders of the Notes as unimpaired under

§ 1124(1), which requires that the plan "leaves unaltered the legal, equitable, and contractual rights to which such claim or interest entitles the holder of such claim or interest."

An ad hoc committee of noteholders objected to the plan on the grounds that the holders' claims could not be unimpaired unless the Make-Whole Amount and postpetition interest were paid. OpCo argued that the claim for the Make-Whole Amount should be disallowed because: (i) the claim sought unmatured interest on unsecured claims barred by § 502(b)(2) and (ii) the Make-Whole Amount was an unenforceable penalty, rather than an enforceable liquidated-damages provision under New York law. The bankruptcy court observed that the Make-Whole Amount in dispute was over $350 million.

The bankruptcy court first held that the debtors had failed to prove that either the Make-Whole Amount or the default interest amounts were unenforceable under New York law. The bankruptcy court found that damages resulting from prepayment of the Notes were not readily ascertainable at the time the MNPA was executed and that the parties agreed on the reinvestment rate in the MNPA as a reasonable approximation of holders' damages. Further, the Make-Whole Amount and default interest did not lead to a double recovery of actual and liquidated damages for the same injury, because "the Make-Whole Amount only liquidates the noteholders' damages stemming from the early termination of their investment; in contrast, the postpetition default interest compensates the holders of the Noteholders for the debtors' failure to pay the principal, unpaid interest, and Make-Whole Amount as they came due at the time of acceleration of the Notes."

The bankruptcy court further rejected the debtors' argument that the issue of "impairment" should be applied only to the noteholders' "allowed claims under the Bankruptcy Code" (which, according to the debtors, would have excluded the Make-Whole Amount as disallowed unmatured interest), rather than being applied to the noteholders' full state-law claims. The bankruptcy court adopted the noteholders' argument that "unimpairment" required that the noteholders receive all that they were entitled to receive under state law, which included the Make-Whole Amount, stating that "'unimpairment' under § 1124(1) entitles a claimant's non-bankruptcy rights to be fully honored."

In Re Ultra Petroleum, No. 17-20793 (5th Cir. 2019)

In this recent case, the Fifth Circuit reverses the bankruptcy court's decision in *In re Ultra Petroleum Corp.*, 575 B.R. 361 (Bankr. S.D. Tex. 2017) in holding that if the Bankruptcy Code disallows a portion of a creditors claim (even if allowed under state law) then the claim is unimpaired. Section 1124(1) says "a class of claims or interests" is not impaired if "the plan . . . leaves unaltered the [claimant's] legal, equitable, and contractual rights." The bankruptcy court found that Bankruptcy Code, and not the plan, altered the right.

The Fifth Circuit went on to discuss the historical basis of the "solvent debtor" exception in the context of whether the Bankruptcy Code disallowed the claims for the Make-Whole Amount and the post-petition interest at the default rate.

The Fifth Circuit remanded the case back to the bankruptcy court to determine whether the "solvent debtor" exception survives the enactment of § 502(b)(2), although the Fifth Circuit doubts it did. If not, the Make-Whole Amount is not recoverable by the creditors.

The Fifth Circuit discussed whether the Make-Whole Amount is allowed by § 502(b)(2), and the Fifth Circuit found that the Make-Whole Amount, being the economic equivalent to "interest," was in fact unmatured when the debtors filed their chapter 11 petitions since the acceleration provision was an unenforceable *ipso facto* bankruptcy clause.

The Fifth Circuit also discussed whether, in the absence of any contractual provision, a creditor may be entitled to post-petition interest. It remanded this question as well.

TOPIC 5: CALCULATION OF STUB RENT - LEASE REJECTION DAMAGES[16]

Time Approach – Presented by Jeff Bjork

In re Connectix Corporation, 372 B.R. 488 (Bankr. N.D. Cal. 2007)

The bankruptcy court utilized the "time" approach to calculate future rent reserved under § 502(b)(6)(A), holding that the fifteen percent calculation is a function of time.

Connectix Corporation ("Connectix") leased a commercial property from EOP-Penninsula Office Park ("EOP"). The lease agreement specified that Connectix was to provide a letter of credit that EOP was entitled to draw upon in the event of default, but any amount drawn was to be held as a security deposit. Connectix stopped paying rent under the lease and surrendered the premises to EOP. EOP subsequently made two draws on the letter of credit. Connectix filed a chapter 7 petition, and EOP filed proof of claim against the estate which included a capped claim for future rent reserved under § 502(b)(6).[17]

EOP calculated this amount using the "rent" approach, multiplying the dollar amount of all rent that would have become due under the lease from the termination date through the end of the lease's natural term by fifteen percent. EOP then added this amount to the amount of unpaid prepetition rent to arrive at its total claim. EOP did not deduct for the draws on the letter of credit, asserting that the prepetition draws only reduced its substantive damages, not the capped claim. The Trustee objected to EOP's claim on the grounds that the amount of the capped claim under § 502(b)(6) is determined by using the "time" approach, which calculates fifteen percent of the months remaining under the lease following the termination date. Under this approach, the future rent claim is equal to the rent that would have become due in the number of months immediately following the termination date. The Trustee also asserted that, after determining the total capped

---

[16] Under § 365(g)(1), the rejection of an unexpired lease of the debtor constitutes a breach of the lease immediately before the date the petition was filed (if such lease had not been assumed). Actual damages are determined by applicable state law, however, § 502(b)(6) limits the amount of a landlord's allowed claim stemming from rejection of an unexpired lease to the extent actual damages exceed the cap set forth in the provision.

[17] Section 502(b)(6) provides:

Except as provided in subsections (e)(2), (f), (g), (h) and (i) of this section, if such objection to a claim is made, the court, after notice and a hearing, shall determine the amount of such claim in lawful currency of the United States as of the date of the filing of the petition, and shall allow such claim in such amount, except to the extent that -

> (6) if such claim is the claim of a lessor for damages resulting from the termination of a lease of real property, such claim exceeds—
>
> > (A) the rent reserved by such lease, without acceleration, for the greater of one year, or 15 percent, not to exceed three years, of the remaining term of such lease, following the earlier of—
> >
> > > (i) the date of the filing of the petition; and
> > >
> > > (ii) the date on which such lessor repossessed, or the lessee surrendered, the leased property; plus
> >
> > (B) any unpaid rent due under such lease, without acceleration, on the earlier of such dates

claim by adding the amount of unpaid prepetition rent, the draws on the letter of credit must be subtracted to determine the allowable claim under § 502(b)(6).

The bankruptcy court held that the fifteen percent calculation is a function of time, not the remaining rent due under the lease. The bankruptcy court based its conclusion on the unambiguous statutory language, noting that the common use of the phrase "the term of the lease" refers to the length of a lease based on a measure of time. The bankruptcy court also pointed out that the subsection has other references to time, in that it fixes a minimum and maximum period of time for which a claim of future rent will be allowed. The bankruptcy court found further support for a temporal interpretation in that rent must be computed "without acceleration," reasoning that any computation of rent reserved based on the "rent" method would effectively accelerate any future rent increases that had not yet occurred.

In addition to finding that the language of § 502(b)(6) was more consistent with the "time" approach, the bankruptcy court explained that the legislative history and policy of § 502(b)(6) also support this interpretation. The Bankruptcy Act provided recovery for landlords with respect to future rent limited by certain time periods. The Bankruptcy Code maintained limitations on landlord rejection damages from the Bankruptcy Act, but used a percentage formula rather than the period set out in the Act. The bankruptcy court noted that the legislative history does not contain any indication that Congress intended to depart from calculating the cap based on a time approach, and concluded that it could not presume such an intent on the part of Congress absent a clear expression. While other courts have reasoned that the "rent" approach more closely approximates expectation damages, the bankruptcy court denied that Congress intended to approximate expectation damages, as Congress started from the premise that, historically, landlords had no claim at all. Further, the bankruptcy court reasoned that landlords, unlike other general unsecured creditors, have added protection at the termination of the lease arrangement in that they get their property back.

As to the prepetition draws on the letter of credit, the bankruptcy court found that the letter of credit was intended as a security deposit and held that the post-surrender, but prepetition draws must be deducted from the landlord's allowed claim. Although § 502(b)(6) is silent as to whether security deposit proceeds should be applied to a landlord's gross damages or its allowed claim, the bankruptcy court reasoned that, because the landlord's allowable claim must be calculated as of the date the lease was surrendered, any proceeds received following surrender should be applied against the capped claim. The bankruptcy court determined that the letter of credit should be treated as a security deposit because it was intended as a security deposit, as the lease specifically stated that the draws on the letter of credit were to be treated as an additional security deposit.

In re Iron-Oak Supply Corp., 169 B.R. 414 (Bankr. E.D. Cal. 1994)

The bankruptcy court held that the "time" approach is the correct method of calculating future rent reserved under §502(b)(6)(A) based on the plain language of the statute.

The landlord leased a warehouse to the debtor pursuant to a triple net lease, which required the debtor to pay the landlord a fixed monthly sum plus property taxes, insurance and other expenses related to the use of the premises. The lease also included legal fees as additional rent.

The debtor moved out of the leased premises and notified the landlord that he would no longer pay rent. The landlord declined to accept surrender and sued for rent payments due.

The debtor subsequently filed a chapter 11 petition and promptly rejected the lease. The landlord filed a claim for damages, requesting (i) fifteen percent of the rent reserved by the lease for its remaining term following the date of the filing of the petition and (ii) 5 months of unpaid prepetition rent that accrued after the debtor vacated the premises. The unsecured creditors committee objected to the landlord's claim.

The bankruptcy court stated that surrender in the context of § 502(b)(6) is determined by state law. The bankruptcy court found that the debtor did not surrender the leasehold under California law, which requires acceptance by the landlord, entitling the landlord to a claim under § 502(b)(6)(B) for unpaid prepetition rent in addition to future rent damages.

Based on the plain language of the statute, the bankruptcy court held that the phrase "remaining term" in § 502(b)(6)(A) is a measure of time, not rent. The bankruptcy court looked to the subsection's use of the phrase "without acceleration" and reasoned that it only makes sense in terms of a reference to the next succeeding periods. As the bankruptcy court viewed it, taking fifteen percent of all rent for the remaining term, particularly where escalation clauses are present, would be tantamount to effecting an acceleration. Under this interpretation, the bankruptcy court stated that any escalators that would take effect during the first fifteen percent of the remaining lease term would be honored, as well as any months of free or reduced rent scheduled under the lease during those months. The bankruptcy court also noted that any items specified in the lease as additional rent are to be treated as rent.

The creditors' committee argued that the calculation should be fifteen percent of the landlord's net amount of rent, after subtracting amounts received in mitigation, due for the remaining term. The bankruptcy court rejected this argument and stressed that § 502(b)(6) operated as a limit to actual damages. It clarified that the correct and complete statement of law is that a landlord's allowable damages are the lower of (1) the statutory cap computed in accordance with § 502(b)(6) ignoring mitigation or (2) total rejection damages, which take mitigation into account, available under non-bankruptcy law.

In re Shane Co., 464 B.R. 32 (Bankr. D. Colo. 2012)

The bankruptcy court held that the "time" approach is the correct method of calculating future rent reserved under §502(b)(6)(A), finding that the "rent" approach would be inconsistent with the statutory language.

Shane Co. ("Shane") leased two buildings from IBC Denver IV, LLC ("IBC"), pursuant to a lease agreement that required Shane to pay monthly base rent with specified increases, as well as monthly operating expenses based on its proportionate share. Prior to the commencement of the lease, Shane notified IBC that it would not take possession of the premises. However, Shane continued to make the required lease payments. Shane filed for bankruptcy and promptly rejected the lease. IBC filed its proof of claim for rental damages, and calculated its allowed claim under § 502(b)(6) using the "rent" approach, calculating the amount of rent due over the remaining term of the lease and multiplying that amount times fifteen percent. IBC transferred and assigned its

claim to Lapis Advisors LP ("Lapis"). IBC eventually leased one of the buildings, and sold the other. Shane objected to the claim.

The bankruptcy court first determined that calculating the precise amount of state law damages was unnecessary in this case, as both parties' estimation of the damages claim exceeded the § 502(b)(6) cap. Relying on the statutory language, the bankruptcy court held that the correct interpretation of the statute requires that rejection damages be capped at the greater of (1) the amount of rent due for the year following the effective date or (2) the rent due for fifteen percent of the remaining lease term up to three years, in addition to delinquent prepetition rent. The bankruptcy court declined to adopt the "rent" approach used by Lapis and other courts, concluding that such an interpretation would be inconsistent with the natural reading of the remainder of the subsection.

The bankruptcy court also rejected Shane's argument that the § 502(b)(6) calculation should be based on net damages after taking into account mitigation, rather than gross rent reserved under the lease. Shane took the position that the cap on the damages claim should be calculated by taking fifteen percent of the lessor's damages after reducing the damages amount by the value of the lessor's mitigation efforts. The bankruptcy court acknowledged that security deposits held by a lessor on a rejected lease must be applied against the maximum claim for lease termination damages under § 502(b)(6), but stated that this treatment is supported by legislative history and is consistent with the traditional function of security deposits. Because a landlord is a secured creditor to the extent of any security deposit it holds, the landlord must satisfy its claim against the lessee out of the security it holds before asserting a claim against the lessee's general assets. In contrast, the statutory language is devoid of any reference or suggestion of taking mitigation into account in calculating the damages cap under § 502(b)(6). The bankruptcy court determined that to import mitigation into the calculation of the cap would be to judicially amend a statute that is plain on its face. Accordingly, the bankruptcy court held that the calculation of the § 502(b)(6) cap does not take into account mitigation.

In re Ace Elec. Acquisition LLC, 342 B.R. 831 (Bankr. M.D. Fla. 2005)

The bankruptcy court held that the limitations set forth in § 502(b)(6) apply to claims against guarantors of leases.

A municipality issued industrial revenue bonds, and applied the bond proceeds to the construction of a plant site. The municipality then leased the plant site to a private firm, Ace Electrical Acquisition, LLC ("Ace Electrical"). The rental payments made by Ace Electrical were equal to the amount due under the bonds, and were used by the municipality to repay the bonds. The bonds were secured by guaranties given by Ace Electrical. The municipality assigned substantially all of its rights as lessor under the lease to the Indenture Trustee. In Ace Electrical's bankruptcy proceeding, the lease was rejected and the Indenture Trustee filed proof of claims for its claims under the lease and the guarantees, which Ace Electrical objected to.

The bankruptcy court stated that the limitation set forth in § 502(b)(6) applies to claims against guarantors of leases and found that Ace Electrical's guarantee of the industrial revenue bonds was in fact a guarantee of the lease. The bankruptcy court noted that bondholders only had recourse to the revenue derived from Ace Electrical's rental payments under the lease, effectively

making its guarantee of the bonds a guarantee of its rental payments under the lease. Accordingly, the bankruptcy court held that the Indenture Trustee's guarantee claim was subject to the limitations set forth in § 502(b)(6). In determining the allowed damages claim, the bankruptcy court held that the 15 percent limitation of § 502(b)(6) speaks in terms of time, not in terms of rent.

Sunbeam Oster Co. v. Lincoln Liberty Ave, Inc. (In re Allegheny Int'l Inc.), 145 B.R. 823 (W.D. Pa. 1992)

The district court held that the "time" approach is the correct method of calculating future rent reserved under § 502(b)(6)(A), and that "without acceleration" as used in § 502(b)(6) simply means that reserved rent is to be calculated without application of any acceleration clause. Moreover, "additional rent" under the Bankruptcy Code is correctly calculated as of the petition date.

Lincoln Liberty Avenue, Ltd. ("Lincoln Liberty"), as landlord, and Allegheny International, Inc. ("Allegheny"), as tenant, entered into two leases. The leases included a provision which permitted Lincoln Liberty to pass to its tenants the operating costs of the premises, which was referred to as "additional rent." Allegheny never occupied the premises. Allegheny filed a chapter 11 petition and subsequently rejected the leases. Pursuant to its plan of reorganization, Sunbeam-Oster ("Sunbeam") became the successor to Allegheny. Lincoln Liberty filed a proof of claim, which was objected to by the unsecured creditors committee. The bankruptcy court determined the amount of Lincoln Liberty's allowed claim based on the next succeeding fifteen percent of the remaining term of the lease, measured in time. Lincoln appealed the bankruptcy court's method of calculating the limit on its allowed claim.

The district court agreed with the bankruptcy court's interpretation of the method of calculation under § 502(b)(6), holding that the "remaining term" specifically refers to the total amount of time remaining in the term of the lease, as opposed to the total amount of rent reserved under the lease. The district court rejected Liberty's argument that this approach gave the debtor the benefit of the free rent period at the beginning of the lease, explaining that the statute clearly references time periods.

The district court rejected Sunbeam's argument that in order to give effect to the "without acceleration" language, the calculation of the amount of rent reserved under the lease must be reduced to net present value. Sunbeam argued that the inclusion of "without acceleration" creates an exception to the general rule that unmatured claims are automatically accelerated upon filing a petition in bankruptcy. Under this interpretation, the failure of the bankruptcy court to reduce the damage cap to its net present value as of the petition date was effectively an acceleration of the debtor's unmatured obligations. The district court disagreed with the meaning of "acceleration" advanced by Sunbeam, finding that "without acceleration" simply means that reserved rent is to be calculated without application of any acceleration clause. The district court held that the calculation under § 502(b)(6) does not reduce rent reserved to net present value. The district court stated that the cap imposed by § 502(b)(6) itself serves to limit claims, supporting the view that rent reserved should not be further reduced to net present value.

With respect to the operating costs designated as "additional rent" under the lease, Lincoln Liberty argued that the bankruptcy court erred in calculating the future rent claim because it used

the estimated costs in effect as of the petition date, rather than the actual costs of the post-filing years that were identified later in the proceedings. Liberty contended that, since the bankruptcy court used the actual operating costs of the year of filing to calculate the claim for the year of filing, even though the costs were identified after the petition date, the bankruptcy court should have applied the actual costs for post-filing years once ascertained. The district court disagreed and pointed to § 502(b), which provides that a bankruptcy court is to determine the amount of claims as of the petition date. The district court stated that the fact that the actual rate for the year of filing was not known until after the petition date does not change its applicability, and held that the bankruptcy court properly used the actual costs in effect on the petition date.

In re Peters, No. 03-11077-DWS, 2004 WL 1291125 (Bankr. E.D. Pa. May 7, 2004)

The bankruptcy court held that surrender of a premises is determined under state law, and determined that there was no surrender of the premises, entitling the landlord to a claim for rent reserved during the remainder of the lease.

Watertower Office Associates, L.P. ("Watertower") leased office space to James P. Peters. Peters eventually stopped paying rent and vacated the office space prior to the natural termination date of the lease. Watertower eventually re-leased the premises to another tenant for a portion of the time covered by the Peters lease. Peters subsequently filed for chapter 11 and rejected the lease. The parties disagreed over the date to be used in calculating the cap set forth in § 502(b)(6), but did not dispute that the appropriate measure of the claim for the purposes of determining the cap is the rent reserved by the lease for one year.

Peters claimed that Watertower accepted surrender of the premises when it relet the premises to another tenant. Because of the alleged surrender, Peters contended that any claim for remaining rent was extinguished, limiting the amount of Watertower's claim to the amount of unpaid rent up to the date the new tenant took occupancy. Watertower, on the other hand, alleged that there was no acceptance of surrender and that its claim included the rent reserved during the remainder of the lease term.

The bankruptcy court acknowledged that once a leasehold is surrendered, a landlord is no longer entitled to receive rent for the remainder of the lease term, and stated that surrender of a premises is determined by state law. The bankruptcy court found that there had been no acceptance of surrender by Watertower, which is required for surrender under Pennsylvania law, and held that Watertower was entitled to a claim for rent reserved under the lease.

The bankruptcy court stated in a footnote, citing *In re Iron Oak Supply*, that the appropriate time period was one year, because there was less than 80 months remaining on the lease. "Where this is so, the one year rent amount will control. Where more than 240 months remain, the three years remaining rent figure controls. Where the amount of time remaining on a lease falls between 80 and 240 months, the 15% figure will control."

Rent Approach – Presented by Shanti Katona

Schwartz v. C.M.C., Inc. (In re Communicall Cent., Inc.), 106 B.R. 540 (Bankr. N.D. Ill. 1989)

The bankruptcy court calculated the § 502(b)(6)(A) damage cap for damages resulting from a debtors' termination of a real property lease to be 15 percent of the remaining rent due under the lease.

Prepetition, Communicall Central Inc. ("Communicall" or "Plaintiff") executed a five-year lease with C.M.C., Inc. ("CMC" or "Defendant") and tendered a $10,000 security deposit. Five months into the lease, Communicall filed for chapter 7 with a sum of $263,250.00 remaining on the lease. The Trustee rejected the lease and commenced an adversary proceeding to obtain the return of the security deposit.

In the adversary proceeding, CMC moved for summary judgment, asserting that (1) rejection of the lease created a prepetition claim for damages, and (2) Defendant had a perfected security interest in the security deposit and Trustee failed to offer adequate protection of that interest. Defendant sought to set-off its prepetition claim against the Trustee's claim for return of the security deposit.

The bankruptcy court granted Defendant's motion for summary judgment because Plaintiff failed to file a required Rule 12(m) statement asserting there was a genuine issue of material fact. The bankruptcy court held that Defendant had a mutual, prepetition claim for damages, and was therefore entitled to set-off the security deposit against its claim. The bankruptcy court calculated Defendant's total prepetition claim to be capped at $50,250 under § 502(b)(6). That claim was divided into two: the $10,000 security deposit was a secured claim, and the balance was allowed as a prepetition unsecured claim.

Under § 502(g), if an unexpired lease is rejected after the commencement of a case, it gives rise to a claim for damages sustained by the landlord, provided that there has not been a previous assumption by the trustee. To ensure that "other creditors recover more than the minimal portion of their claims they would receive if landlord claims resulting from termination of leases were allowed in full," that claim is limited to a maximum calculated under § 502(b)(6).

The bankruptcy court calculated CMC's maximum allowable claim under § 502(b)(6) by looking at the greater of two figures: rent for the first year after the petition was filed (here, $50,250.00) or *15% of the remaining rent due under the lease* (here, $39,487.50). Using the higher figure, CMC became a prepetition unsecured creditor in the allowed amount of $50,250.00.

The bankruptcy court also noted that the legislative comments to § 502 and Collier agree that when the security deposit is less than the amount of the allowed claim, it is to be applied in satisfaction of the allowed claim. Using this reasoning, the bankruptcy court allowed Defendant to set-off the security deposit against its claim.

In re Gantos Inc., 176 B.R. 793 (Bankr. W.D. Mich. 1995)

The bankruptcy court held that § 502(b)(6)'s fifteen percent cap on real property lease rejection damages claims is a function of rent, not time. Specifically, the cap quantifies the aggregate rent remaining under the lease, rather than the amount of time remaining under the lease.

The debtors managed women's apparel retail stores across the U.S. When the debtors voluntarily filed for chapter 11, their landlords asserted lease rejection damage claims. The parties sought a determination of the proper method under § 502(b)(6) to calculate the cap on the landlords' damages resulting from the debtors' termination of leases.

The debtors asserted that the "or 15 percent" clause in § 502(b)(6) quantifies the amount of time remaining in the term of the lease (*i.e.*, 15% of the time left under the term of the lease). The landlords asserted that the "or 15 percent" clause quantifies the amount of rent reserved under the remainder of the lease.

The bankruptcy court reviewed the legislative history and applicable case law, ultimately concluding that the § 502(b)(6) damage cap is a function of rent, not time. The bankruptcy court found it fair to base rejection damages on the total rent bargained for by the parties when they entered into the lease. Moreover, in a true lease of property, the lessor retains all risks and benefits as to the value of the real estate at lease termination. Therefore, because the landlords assume the risk that lessors may file bankruptcy, they should not be "stripped" of the benefit of the bargain.

The bankruptcy court further held that interpreting § 502(b)(6) to be a function of rent does not frustrate legislative intent. It more accurately compensates landlords for their loss and simultaneously limits rent enough to ensure other creditors can recover from the estate. According to the bankruptcy court, § 502(b)(6) "allows for lease rejection damage claims with a damage cap based on rent *and* time, with the claim being limited to the rent unpaid on the date of bankruptcy plus the greater of one year's rent under the lease or 15% of the rent remaining under the lease, but not to exceed three years rent. The 15% quantifies the aggregate rent remaining and not the time remaining under the lease. Although not a model of clarity, this appears to be the most natural interpretation of the statutory language."

In re Andover Togs Inc., 231 B.R. 521 (Bankr. S.D.N.Y. 1999)

In determining how to properly calculate lease rejection damages under § 502(b)(6), the bankruptcy court determined that the "fifteen percent" language referred to fifteen percent of total rent remaining due under the lease, and not the rent owed over the next fifteen percent of the remaining lease term.

Andover Togs, Inc. ("Andover"), a long-term tenant of landlord Mid-City Associates ("Mid-City"), attempted to negotiate more favorable lease terms with Mid-City during its chapter 11 proceedings. When the negotiations fell through, Andover rejected the lease. Mid-City relet a portion of the space, but only after it offered concessions to its new tenant and paid for substantial construction. Mid-City filed claims against Andover for damages sustained from the lease's rejection under § 502(b)(6), among other administrative claims, and Andover filed numerous objections.

For the primary issue regarding how the bankruptcy court should calculate Landlord's rejection claim under § 502(b)(6), the bankruptcy court followed the majority view that the statute referred to 15 percent of the total rent remaining under the lease, not 15 percent of the total time remaining under the lease.

Before agreeing with the majority view, the bankruptcy court specifically discussed the minority view outlined in *In re Allegheny Int'l, Inc.*, 136 B.R. 396 (Bankr. W.D. Pa. 1991), *aff'd* 145 B.R. 823 (W.D. Pa. 1992), "which bases damages on 15 percent of the total amount of time remaining as opposed to the amount of rent reserved under the lease. In affirming the decision of the bankruptcy court, the district court in *Allegheny* reasoned that damages ought to be measured according to the total amount of time remaining under the lease because the statute references time periods when speaking about the amount of rent due once the lease has been surrendered." In making its determination, the *Allegheny* court surmised that Congress intended "remaining term" to measure damages as a function of time and distinguished landlords from other creditors because landlords are able to recover and relet their spaces.

The bankruptcy court methodically reached its decision by first examining the language of the statute, which it found to be ambiguous in its plain meaning. The bankruptcy court next looked to the legislative history for guidance, finding that it too is "unilluminating." Finally, left with judicial interpretation of Congress' intent, the bankruptcy court concurred with the majority because it found "that it is the logically sounder approach." The bankruptcy court held that when "calculating damages pursuant to the section 502(b)(6) cap, a landlord must determine 15 percent of the total rents due under the lease, through the expiration date of the lease."

TOPIC 6: APPLICATION OF "ONE CONSENTING IMPAIRED CREDITOR CLASS" REQUIREMENT

Per Plan Circuits – Presented by Gabriel Glazer

JPMCC 2007-C1 Grasslawn Lodging, LLC v. Transwest Resort Props. (In re Transwest Resort Props.), 881 F.3d 724 (9th Cir. 2018)

The Ninth Circuit Court of Appeals held (i) that § 1111(b) does not require a due-on-sale clause to be included in restructured secured debt, and (ii) that the consenting impaired class requirement under § 1129(a)(10)[18] is satisfied if any impaired class in a joint, multi-debtor plan accepts the plan (rather than requiring each debtor to have a consenting impaired class).

This case involved five affiliated debtors, two of which (the "Operating Debtors") had acquired hotels prepetition. In connection with the acquisitions, the lender had loaned $209 million to the Operating Debtors, secured by a lien on the hotels. The lender also had loaned $21.5 million to the Operating Debtors' parent companies (the "Mezzanine Debtors"), secured by a lien on the Mezzanine Debtors' ownership interests in the Operating Debtors. After defaulting on the loans, the Operating Debtors, the Mezzanine Debtors, and their holding company each filed a chapter 11 petition.

The debtors proposed a joint plan of reorganization that would: (i) wipe out the Mezzanine Debtors' ownership interests in the Operating Debtors; (ii) grant all of the equity in the Operating Debtors to a third-party investor in exchange for $30 million; (iii) give the lender an allowed claim of $247 million on account of its loan to the Operating Debtors (all of which was to be treated as secured, because the lender had made the election under Bankruptcy Code § 1111(b); the agreed value of the hotels was $92 million); (iv) restructure that loan to provide for interest-only payments, a balloon after twenty-one years, and a due-on-sale clause pursuant to which the entire $247 million would be due on sale or restructure, except that during years 5 through 15, the hotels could be sold subject to the restructured loan without it being due on sale; and (v) give the lender nothing on account of its mezzanine loan if it rejected the plan, but some surplus cash from future operations if it accepted the plan.

The lender objected to the plan, but the bankruptcy court overruled the objections and confirmed the plan, which received support from certain other creditor classes. The district court affirmed and the lender appealed again to the Ninth Circuit.

Among other things, the lender argued on appeal that § 1129(a)(10), which requires that at least one impaired class of claims vote to accept the plan, applies to each individual debtor, not to the joint, multi-debtor plan as a whole. Because the lender was the sole creditor of the Mezzanine Debtors and it voted against the plan, the lender argued that § 1129(a)(10) was not satisfied.

---

[18] Section 1129(a)(10) provides: The court shall confirm a plan only if all of the following requirements are met:

> (10) If a class of claims is impaired under the plan, at least one class of claims that is impaired under the plan has accepted the plan, determined without including any acceptance of the plan by any insider.

Finding the plain language of the statute to be dispositive, the Ninth Circuit concluded that § 1129(a)(10) applies on a per plan (and not a per debtor) basis:

> According to the Lender, a complication arises when there is a jointly administered plan consisting of multiple debtors. The Lender argues that in such a situation, a "per debtor" approach that requires plan approval from at least one impaired creditor for each debtor involved in the plan is necessary. In contrast, the Debtors argue that the plain language of the statute contemplates a "per plan" approach in which a plan only requires approval from one impaired creditor for any debtor involved. As a matter of first impression among the circuit courts, we hold that section 1129(a)(10) applies on a "per plan" basis.
>
> . . . .
>
> The plain language of the statute supports the "per plan" approach. Section 1129(a)(10) requires that one impaired class "under the plan" approve "the plan." It makes no distinction concerning or reference to the creditors of different debtors under "the plan," nor does it distinguish between single-debtor and multi-debtor plans. Under its plain language, once a single impaired class accepts a plan, section 1129(a)(10) is satisfied as to the entire plan. Obviously, Congress could have required plan approval from an impaired class for each debtor involved in a plan, but it did not do so. It is not our role to modify the plain language of a statute by interpretation.
>
> The statutory context of section 1129(a)(10) does not aid the Lender's argument. The Lender, citing the only court that has applied the "per debtor" approach, argues that section 102(7) requires that section 1129(a)(10) apply on a "per debtor" basis. We disagree. Section 102(7), a rule of statutory construction, provides that "the singular includes the plural." This rule of construction does not change our analysis. Section 102(7) effectively amends section 1129(a)(10) to read: "at least one class of claims that is impaired under the plans has accepted the plans." The "per plan" approach is still consistent with this reading. Therefore, section 102(7) does not undermine our view that section 1129(a)(10) applies on a "per plan" basis.

Thus, the procedural convenience of joint administration (*i.e.*, filing all pleadings on a single docket) and filing a single joint plan, rather than separate plans for each of the related debtors, had significant substantive implications.

Per Debtor Circuits – Presented by Dawn Cica

In re Tribune Co., 464 B.R. 126 (Bankr D. Del. 2011)

The bankruptcy court held that each debtor participating in a multi-debtor, jointly administered plan must satisfy § 1129(a)(10) unless all of the debtors are substantively consolidated under a joint plan.

In the bankruptcy case of over 100 jointly administered (but not substantively consolidated) debtors, two competing plans were proposed. Each plan proponent advocated for a different approach. The bankruptcy court entered a lengthy *Opinion on Confirmation* in which it first noted the lack of "decisional authority" on the split of approaches, citing to *In re SGPA*, 2001 Bankr. LEXIS 2291 (Bankr. M.D. Pa. Sept. 29, 2001), *In re Enron*, 2004 Bankr. LEXIS 2549 (Bankr. S.D.N.Y. July 15, 2004), and *In re Charter Commc'n*, 419 B.R. 221 (Bankr. S.D.N.Y. 2009) . The bankruptcy court analyzed each case, but noted that none of the three courts considered the § 1129(a)(10) issue central to its decision in the matter before it. Because the parties had agreed only to joint administration and not substantive consolidation, the bankruptcy court was forced to determine whether § 1129(a)(10) required each debtor that was part of a joint plan to have at least one class of impaired creditors vote to accept the plan, or only one impaired accepting class for all of the debtors subject to the joint plan of reorganization.

The bankruptcy court first looked to the statutory construction of § 1129(a)(10). The bankruptcy court considered the effect of the Bankruptcy Code's own statutory rules of construction, specifically § 102(7), which states that "the singular includes the plural." Under this rule, the bankruptcy court concluded that § 1129(a)(10)'s reference to "plan" in the singular was not, on its own, a sufficient basis upon which to conclude that any less than all debtors must satisfy the requirements of § 1129(a) in a multi-debtor case.

The bankruptcy court also analyzed § 1129(a)(10) in context, concluding that because § 1129 included many plan confirmation requirements that had to be satisfied by each debtor—*e.g.*, § 1129(a)(7) (best interests of creditors test), § 1129(b) (cramdown), § 1129(a)(3) (good faith requirement)—so too did § 1129(a)(10). Coupled with the bankruptcy court's interpretation of the joint plan as actually a separate plan for each debtor (as the two plans under review each provided by their own terms), the bankruptcy court found the application of § 102(7) to § 1129(a)(10) "entirely logical". The bankruptcy court then parsed through the other subsections of § 1129(a), noting that each of the other requirements could be met only if *all* debtors proposing a joint plan satisfied them. Based on this analysis, and the doctrine of corporate separateness, the bankruptcy court held that the plain language of § 1129(a)(10) was unambiguous and requires, "absent substantive consolidation or consent," that § 1129(a)(10) be satisfied by each debtor in a joint plan.

Turning to the substance of the competing plans, the bankruptcy court determined that because both plans failed to provide for substantive consolidation of the debtors, each joint plan actually "consist[ed] of a separate plan for each Debtor." The bankruptcy court distinguished its case from prior cases where a per plan approach was adopted, such as *In re SGPA, Inc*. and *In re Enron Corp*., all on substantive consolidation grounds.