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DUE-ON-SALE CLAUSE NOT MANDATORY IN CRAMDOWN CHAPTER 11 PLAN, AND PLAN ACCEPTANCE REQUIREMENT APPLIES ON "PER PLAN" BASIS

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In *Grasslawn Lodging, LLC v. Transwest Resort Properties Inc. (In re Transwest Resort Properties, Inc.)*, 881 F.3d 724 (9th Cir. 2018), the U.S. Court of Appeals for the Ninth Circuit considered, in connection with a "cramdown" chapter 11 plan, whether an undersecured creditor's election to be treated as fully secured under section 1111(b)(2) of the Bankruptcy Code means that the plan must include a due-on-sale clause and whether the section 1129(a)(10) impaired class acceptance requirement applies on a "per plan" or a "per debtor" basis. The Ninth Circuit affirmed a district court decision concluding that section 1111(b)(2) does not mandate inclusion of a due-on-sale clause in such a plan and, as a matter of first impression among the circuit courts of appeals, that section 1129(a)(10) applies on a "per plan" basis. The section 1129(a)(10) ruling reignites a debate on this issue that has been smoldering for many years.

ELECTION OF FULLY SECURED STATUS UNDER SECTION 1111(b)(2)

In situations where a secured creditor's claim is not fully secured by the value of its collateral, section 506 of the Bankruptcy Code provides that the undersecured creditor's claim is bifurcated into: (a) a secured claim up to the value of the collateral; and (b) an unsecured deficiency claim for the remainder. This means that the undersecured creditor is entitled to the inherent protections afforded to secured creditors with respect to its secured claim, while it also is given the right to vote on any chapter 11 plan which does not leave its unsecured claim unimpaired. This presents strategic advantages in cases where the amount of the unsecured claim provides the creditor with leverage at the plan bargaining table because its unsecured deficiency claim may be large enough to block confirmation.

An undersecured creditor may bypass the effects of section 506 by making an election to have its entire claim treated as secured under section 1111(b)(2) of the Bankruptcy Code. By making this election, the undersecured creditor relinquishes the possibility of recovering on the unsecured deficiency claim as well as its right to vote on the plan as an unsecured creditor. *See In re Weinstein*, 227 B.R. 284, 293, n.10 (B.A.P. 9th Cir. 1998).

However, a section 1111(b)(2) election can be beneficial. If the debtor or other plan proponent attempts to seek confirmation of a chapter 11 plan over the objection of an electing

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secured creditor, section 1129(b)(2)(A) of the Bankruptcy Code contains three options for treatment of its secured claim. One (and the most commonly used) of those—specified in section 1129(b)(2)(A)(i)—mandates that the electing creditor retain its lien on the collateral and receive deferred cash payments equal to the present value of the collateral, while the sum of the payments must equal the total amount of the creditor's allowed secured claim as of the plan's effective date. These requirements typically are met by a balloon payment for the remaining balance of the claim at the end of the term or a note bearing a below-market rate of interest.

Thus, by having its claim treated as fully secured, an electing undersecured creditor typically will hold a discounted note after confirmation of a chapter 11 plan, but it can share in the upside if its collateral increases in value and the debtor either sells the property and repays the note or defaults on the loan post-bankruptcy.

"PER DEBTOR" VERSUS "PER PLAN" IMPAIRED CREDITOR ACCEPTANCE

Section 1129(a)(10) of the Bankruptcy Code provides that, if a creditor class is impaired under a chapter 11 plan, at least one impaired class must vote in favor of the plan, excluding any acceptance of the plan by an insider. This provision, which has been called the "statutory gatekeeper" to cramdown, must also be satisfied for a chapter 11 plan to be confirmed under the nonconsensual plan confirmation requirements set forth in section 1129(b). *See In re 266 Washington Assocs.*, 141 B.R. 275, 287 (Bankr. E.D.N.Y.), *aff'd*, 147 B.R. 827 (E.D.N.Y. 1992). Thus, a cramdown chapter 11 plan cannot be confirmed in the absence of an accepting impaired class.

Determining whether a plan satisfies section 1129(a)(10) is relatively easy in cases involving a single debtor and its classes of creditors (although even simple cases present the prospect of "artificial impairment" or "gerrymandering" to create an accepting impaired class). Complex chapter 11 cases, however, commonly involve multiple debtors and joint chapter 11 plans.

In such cases, courts have been divided as to whether section 1129(a)(10) applies on a "per debtor" or "per plan" basis. If the requirement applies on a "per debtor" basis, at least one impaired class of creditors for each debtor would have to accept the plan for it to be confirmed. By contrast, the "per plan" approach requires only that at least one impaired class of creditors votes to accept the plan, irrespective of whether the creditors in the class hold claims against one, some, or all of the debtors.

Another common aspect of chapter 11 cases involving multiple affiliated debtors is "substantive consolidation." Under this remedy, all assets and liabilities of multiple debtors are grouped together to form a single estate to satisfy the claims of all creditors and interest holders. Substantive consolidation is typically granted under circumstances where creditors dealt with affiliated debtors as a "single economic unit" or when the debtors' affairs "are so entangled that consolidation will benefit all creditors." *In re Bonham*, 229 F.3d 750 (9th Cir. 2000). When multiple debtors in a complex chapter 11 case have been substantively consolidated, the section 1129(a)(10) voting requirement is straightforward because the substantively consolidated entities are treated as a single debtor.

Substantive consolidation is to be distinguished from "joint administration," where the bankruptcy cases of affiliated debtors are jointly administered for administrative convenience, while the debtors' estates and creditors remain separate. *See* Fed. Bankr. P. 1015(b).

In multidebtor chapter 11 cases, judges in the U.S. Bankruptcy Court for the District of Delaware have adopted the "per debtor" approach when applying section 1129(a)(10). *See In re Tribune Co.*, 464 B.R. 126, 182–83 (Bankr. D. Del. 2011); *In re JER/Jameson Mezz Borrower II, LLC*, 461 B.R. 293, 303 (Bankr. D. Del. 2011). In these cases, the bankruptcy courts reasoned that, if the debtors' estates have not been substantively consolidated, the joint plan is effectively a separate plan for each debtor.

Bankruptcy judges in the Southern District of New York and the Middle District of Pennsylvania have embraced the opposite view, ruling that the plain meaning of section 1129(a)(10) requires a "per plan" approach. *See JPMorgan Chase Bank, N.A. v. Charter Commc'ns Operating, LLC (In re Charter Commc'ns)*, 419 B.R. 221 (Bankr. S.D.N.Y. 2009); *In re Enron Corp.*, 2004 Bankr. LEXIS 2549 (Bankr. S.D.N.Y. July 15, 2004); *In re SPGA Inc.*, 2001 Bankr. LEXIS 2291 (Bankr. M.D. Pa. Sept. 28, 2001).

TRANSWEST

Transwest involved five affiliated debtor entities that acquired two resort hotels several years prior to filing for bankruptcy. The hotel acquisitions were financed by loans secured by the resort properties and one debtor's ownership interests in two of the operating debtors. The five debtors filed for chapter 11 in 2010 in the District of Arizona, and the cases were jointly administered but not substantively consolidated.

The lender was undersecured—it was owed $247 million, but the hotels were valued at no more than $92 million—and elected under section 1111(b)(2) to have its entire claim treated as secured. The debtors' joint chapter 11 plan proposed to give the lender a new secured note calling for monthly interest-only payments and then a balloon payment of the outstanding principal at the end of a 21-year term.

Under the plan, the new loan would also include a due-on-sale clause requiring the debtors to pay the lender's claim in full if the hotels were sold, but the due-on-sale clause would not apply if the hotels were sold between Years 5 and 15.

The lender was the only voting creditor for two of the five debtors and voted to reject the plan. The lender also objected to confirmation of the plan. In its objection, the lender argued that: (i) the 10-year window in which the due-on-sale clause did not apply "partially negate[d] the benefit of the Lender's section 1111(b)(2) election"; and (ii) the joint plan could not be confirmed because section 1129(a)(10) applies on a "per debtor" basis, and certain of the debtors had no accepting impaired class. The bankruptcy court overruled the objection on both counts and confirmed the plan.

The district court affirmed on appeal, and the lender appealed to the Ninth Circuit.

THE NINTH CIRCUIT'S RULING

A three-judge panel of the Ninth Circuit affirmed.

Looking to the plain language of section 1111(b)(2), the panel concluded that the provision does not explicitly or implicitly mandate that a due-on-sale clause be part of a plan. In addition, the Ninth Circuit panel explained that section 1123, which lists the required contents of a chapter 11 plan, does not include any reference to a due-on-sale clause. Rather, the court noted, section 1123 provides that a plan may "modify the rights of holders of secured claims," which, at most, suggests that the inclusion of a due-on-sale clause is entirely discretionary.

In addition, the court explained that section 1129(b)(2)(A)(i)(I) requires that the holder of a secured claim retain the lien securing that claim, even when "the property subject to such liens is . . . transferred to another entity." Thus, the Ninth Circuit panel reasoned, that provision expressly allows a debtor to sell the collateral to another entity so long as the creditor retains the lien securing its claim, yet the provision does not mention any due-on-sale requirement, "further undermining the Lender's position that a due-on-sale clause must be included in the Plan." Citing *In re Airadigm Commc'ns, Inc.*, 519 F.3d 640 (7th Cir. 2008), the court adopted the Seventh Circuit's reasoning that a due-on-sale clause is not a lien that must be preserved to confirm a plan. Rather, the Ninth Circuit panel held that "a due-on-sale clause is a mechanism regarding the terms of a payment of debt, not a substantive right of creditors making an election pursuant to section 1111(b)(2)."

The Ninth Circuit also examined the plain language of section 1129(a)(10) to determine whether the provision should apply on a "per plan" basis. The court reasoned that the provision "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." Rather, the court concluded, the section 1129(a)(10) cramdown threshold for a joint plan is satisfied where "a single impaired class accepts a plan."

Finally, the Ninth Circuit panel rejected the lender's argument that the joint administration of the chapter 11 cases was tantamount to substantive consolidation of the debtors. The court also dismissed the lender's argument that the "per plan" approach had the effect of substantively consolidating the debtors and therefore would wreak havoc on mezzanine lenders who rely on debtors' separate existence for purposes of preserving their collateral. According to the court, "[S]uch hypothetical concerns are policy considerations best left for Congress to resolve."

In a concurring opinion, circuit judge Friedland wrote that, because the chapter 11 plan effectively merged the debtors without any assessment of whether substantive consolidation was appropriate, the lender's argument that it was unfairly deprived of the ability to object effectively to confirmation had some foundation. Even so, he noted, the lender failed to raise that objection in the bankruptcy court, choosing instead to rely on its objections under section 1129(a)(10).

MOVING FORWARD

The Ninth Circuit panel's approach to section 1111(b)(2) in *Transwest* is unwelcome news for secured creditors, which have viewed the election as an important protection against depressed collateral value in bankruptcy. This protection is diminished somewhat by the panel's ruling that a cramdown plan need not include a due-on-sale clause for an undersecured creditor electing treatment under section 1111(b)(2) of the Bankruptcy Code.

The principal significance of *Transwest* is that, by embracing the "per plan" approach to section 1129(a)(10), the ruling gives debtors in multidebtor chapter 11 cases an easier road to cramdown confirmation of a joint chapter 11 plan, regardless of whether the debtors have been substantively consolidated. Although this is welcome news for debtors, it reignites the debate on the issue and creates additional uncertainty for debtors and creditors in jurisdictions where the courts have not addressed it. The ruling may also encourage debtors that face this issue and have a choice of bankruptcy venue to file for bankruptcy in the Ninth Circuit, the Southern District of New York, or the Middle District of Pennsylvania.

CONNECTICUT BANKRUPTCY COURT ADDS FUEL TO THE FIRE IN DEBATE OVER EFFECT OF REJECTION OF TRADEMARK LICENSE

Ben Rosenblum and **Mark G. Douglas**

In *In re SIMA Int'l, Inc.*, 2018 WL 2293705 (Bankr. D. Conn. May 17, 2018), the U.S. Bankruptcy Court for the District of Connecticut ruled that a chapter 7 trustee's rejection of an intellectual property license agreement did not deprive the licensee of the continuing right to use the licensed intellectual property, including a trademark, because the licensee made a timely election under section 365(n) of the Bankruptcy Code. According to the court, rejection of the agreement, of which the trademark license was an integral component, resulted in a nonmaterial breach, rather than termination, and the section 365(n) election "indisputably" preserved the licensee's exclusive right to use the intellectual property during the remaining term of the license agreement.

In so ruling, the bankruptcy court embraced the approach articulated by the U.S. Court of Appeals for the Seventh Circuit in *Sunbeam Prods., Inc. v. Chicago Am. Manuf., LLC*, 686 F.3d 372 (7th Cir. 2012), *cert. denied*, 133 S. Ct. 790 (2012), and rejected the contrary view endorsed by the Fourth and First Circuits—the only other circuit courts of appeals that have directly addressed the issue—in *Lubrizol Enters., Inc. v. Richmond Metal Finishers, Inc. (In re Richmond Metal Finishers, Inc.)*, 756 F.2d 1043 (4th Cir. 1985), and *Mission Product Holdings, Inc. v. Tempnology, LLC (In re Tempnology, LLC)*, 879 F.3d 389 (1st Cir. 2018).

The widening rift among the courts on this issue may be an invitation to U.S. Supreme Court review.

SPECIAL RULES GOVERNING REJECTION OF CERTAIN INTELLECTUAL PROPERTY LICENSES IN BANKRUPTCY

Absent special statutory protection, the rejection of an intellectual property ("IP") license by a chapter 11 debtor-in-possession ("DIP") or a bankruptcy trustee can have a severe impact on the licensee's business and leave the licensee scrambling to procure other IP to keep its business afloat. This concern was heightened by the Fourth Circuit's 1985 ruling in *Lubrizol*. In that case, the court held that, if a debtor rejects an executory IP license, the licensee loses the right to use any licensed copyrights, trademarks, and patents. The court also concluded that the licensee's only remedy was to file a claim for money damages, since the licensee could not seek specific performance of the license agreement.

In order to better protect such licensees, Congress amended the Bankruptcy Code in 1988 to add section 365(n). Under section 365(n), licensees of some (but not all) IP licenses have two options when a DIP or trustee rejects the license. The licensee may either: (i) treat the agreement as terminated and assert a claim for damages; or (ii) retain the right to use the licensed IP for the duration of the license (with certain limitations). By adding section 365(n), Congress intended to make clear that the rights of an IP licensee to use licensed property cannot be unilaterally cut off as a result of the rejection of the license.

However, notwithstanding the addition of section 365(n) to the Bankruptcy Code, the legacy of *Lubrizol* endures—since by its terms, section 365(n) does not apply to trademark licenses and other kinds of "intellectual property" outside the Bankruptcy Code's definition of the term. In particular, trademarks, trade names, and service marks are not included in the definition of "intellectual property" under section 101(35A) of the Bankruptcy Code. Because of this omission, courts continue to struggle when determining the proper treatment of trademark licenses in bankruptcy.

SUNBEAM GIVES TRADEMARK LICENSEES A GLIMMER OF HOPE

In *Sunbeam*, the Seventh Circuit expressly rejected the *Lubrizol* court's approach to trademark licenses. Focusing on the impact of section 365(g) of the Bankruptcy Code (which specifies the consequences of rejection), the Seventh Circuit explained that, outside bankruptcy, a licensor's breach does not terminate a licensee's right to use IP. According to the court, "What § 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." The debtor's unfulfilled obligations under the contract are converted to damages, which, if the contract has not been assumed, are treated as a prepetition obligation. "[N]othing about this process," the court remarked, "implies that any rights of the other contracting party have been vaporized." Instead, rejection "merely frees the estate from the obligation to perform and has absolutely no effect upon the contract's continued existence" (internal quotation marks and citation omitted).

The Seventh Circuit reasoned that lawmakers' failure to include trademark licenses among the "intellectual property" protected by section 365(n) should not be viewed as an endorsement of any particular approach regarding rejection of a trademark license agreement. Rather, the Seventh Circuit wrote, the legislative history indicates that "the omission was designed to allow more time for study, not to approve *Lubrizol*."

The Third and Eighth Circuits also have had the opportunity to weigh in on the validity of the *Lubrizol* approach but declined to reach the issue for a variety of reasons. *See Lewis Bros. Bakeries Inc. v. Interstate Brands Corp. (In re Interstate Bakeries Corp.)*, 751 F.3d 955 (8th Cir. 2014) (ruling that a license agreement was not executory and thus could not be assumed or rejected because the license was part of a larger, integrated agreement which had been substantially performed by the debtor prior to filing for bankruptcy); *In re Exide Technologies*, 607 F.3d 957 (3d Cir. 2010) (sidestepping the issue and concluding that a trademark license agreement was not executory; in a concurring opinion, Judge Ambro noted that Congress's decision to leave treatment of trademark licenses to the courts signals nothing more than Congress's inability, when it enacted section 365(n), to devote enough time to consideration of trademarks in the bankruptcy context).

FIRST CIRCUIT TAKES OPPOSITE APPROACH IN *TEMPNOLOGY*

A divided First Circuit rejected the *Sunbeam* approach in *Tempnology*. According to the First Circuit majority, the "unstated premise" of *Sunbeam* is flawed because freeing a debtor from any continuing performance obligations under a trademark license, while preserving the licensee's right to use the trademark, simply does not comport with Congress's principal aim in providing for rejection of a contract—namely, to "release the debtor's estate from burdensome obligations that can impede a successful reorganization" (citing *NLRB v. Bildisco & Bildisco*, 465 U.S. 513, 528 (1984)).

The majority explained that the effective licensing of a trademark requires the trademark owner (or any purchaser of its assets) to monitor and exercise control over the quality of the goods sold to the public under cover of the trademark, failing which the trademark owner would be left with a "naked license" that would jeopardize the continued validity of its trademark rights. The *Sunbeam* approach, the majority emphasized, would allow the licensee to retain the use of licensed trademarks "in a manner that would force the company to choose between performing executory obligations under the license or risk the permanent loss of its trademarks."

Such a restriction on the licensor's ability to free itself from its executory obligations, even if limited to trademark licenses, the majority wrote, "would depart from the manner in which section 365(a) otherwise operates."

In a dissenting opinion, circuit judge Juan R. Torruella disagreed with the majority's "bright-line rule that the omission of trademarks from the protections of section 365(n) leaves a non-rejecting party without any remaining rights to use a debtor's trademark and logo." Instead, Judge Torruella would follow *Sunbeam* in concluding that a licensee's rights to use the licensed trademark "d[o] not vaporize" because of rejection of the agreement.

The First Circuit majority was critical of the dissent, writing that "our dissenting colleague seems to reject [*Sunbeam*'s] categorical approach in favor of what *Sunbeam* itself rejected—an 'equitable remedy' that would consider in some unspecified manner the 'terms of the Agreement, and non-bankruptcy law' " (quoting *Sunbeam*, 686 F.3d at 375–76). According to the majority, the dissent accorded too much weight to a few lines in the legislative history and overlooked the fact that when Congress otherwise intended to grant bankruptcy courts the ability to "equitably" craft exceptions to rules set forth in the Bankruptcy Code, "it did so in the statute itself" (citing sections 365(d)(5), 502(j), 552(b)(1), 557(d)(2)(D), 723(d), 1113(c), and 1114(g)).

OTHER RECENT CASE LAW

In the six years since *Sunbeam* was decided, only a handful of reported decisions have discussed the impact of the rejection of a trademark license on the licensee's ability to use licensed trademarks. In addition to the First Circuit (and lower courts) in *Tempnology*, only two courts have actually decided the issue.

In *In re Crumbs Bake Shop, Inc.*, 522 B.R. 766 (Bankr. D.N.J. 2014), the U.S. Bankruptcy Court for the District of New Jersey followed *Sunbeam* in ruling that trademark licensees are entitled to the protections of section 365(n) of the Bankruptcy Code, notwithstanding the omission of trademarks from section 101(35A)'s definition of "intellectual property." The court also held that a sale of assets "free and clear" under section 363(f) does not trump or extinguish the rights of a third-party licensee under section 365(n) unless the licensee consents. *See also Interstate Bakeries*, 751 F.3d at 963 (a trademark license agreement was not executory and thus could not be assumed or rejected); *Harrell v. Colonial Holdings, Inc.*, 923 F. Supp. 2d 813, 818 n.4 (E.D. Va. 2013) (noting the disagreement between *Lubrizol* and *Sunbeam*, but also that the parties had not raised the issue of the impact which the debtor's rejection of a trademark license had on the licensee's rights).

Another bankruptcy court recently joined the fray in *SIMA Int'l*.

SIMA INT'L

SIMA International, Inc. ("SIMA") owns certain copyrights, trademarks, and other IP relating to a process that analyzes motivational patterns to assist individuals and employers in making career and employment decisions. Prior to filing a chapter 7 petition on November 17, 2017, in the District of Connecticut, SIMA, in exchange for royalties, licensed the process, including associated trademarks, to various parties under agreements that allowed the licensees or sublicensees to use the IP to create or develop derivative works, modifications, adaptations, or other improvements relating to the technology.

Such a license agreement with Marlys Hanson, Inc. ("MHI") provided in relevant part that the licensed technology "includes but is not limited to the [scheduled] trademarks and copyrights" in relation to product adaptations developed by MHI, and the agreement required SIMA's approval for any usage of the license in connection with adaptations. The agreement also provided that any licensed products must carry an attribution statement indicating SIMA's ownership of the technology.

Shortly after entering into the license agreement, MHI developed valuable software incorporating the licensed technology.

SIMA's chapter 7 trustee moved to reject the license agreement with MHI in December 2017. MHI objected and filed a notice pursuant to section 365(n) of its election to retain its rights under the license agreement. The parties did not dispute that the license agreement was an executory contract or that rejection of the agreement would benefit SIMA's estate by enhancing the value of the IP in a bankruptcy sale.

Instead, the parties disputed whether: (i) the section 365(n) election entitled MHI to the continued use of the licensed trademark; and (ii) the election preserved MHI's exclusive rights under the license agreement to develop and sell products using the licensed technology.

THE BANKRUPTCY COURT'S RULING

After examining the language of section 365(n), its historical context, and relevant case law, the bankruptcy court noted that "[t]his Court, like many others, does not endorse the reasoning in *Lubrizol* and is not alone in concluding that its reasoning is flawed" (citing *Sunbeam*, 686 F.3d at 377–78).

Instead, the bankruptcy court aligned itself "with the plain language reading of Section 365(g) advanced" by the Seventh Circuit in *Sunbeam*. First, the court explained, under section 365(g), the rejection of a contract constitutes a breach rather than termination of the contract. Under Connecticut law (the law governing the license agreement), a counterparty is relieved of continued performance under a contract if the breach is material. In this case, the court concluded, the "rejection breach" was not material. Because "the Section 365(n) election indisputably preserves MHI's right to the intellectual property and exclusivity, . . . the core of the bargain and substantial purpose of the License Agreement [have] been preserved."

Second, the bankruptcy court noted, the use of the trademark was "directly imbedded within, supplemental to, and integral to the intellectual property license."

Finally, the court explained, the chapter 7 trustee conceded that he was more concerned about the bid-chilling impact of the license agreement's exclusivity provisions than MHI's use of the trademark, as he understood that the trademark was intertwined with the IP license.

On the basis of these findings, the bankruptcy court ruled that MHI's section 365(n) election entitled it to the continued use of the trademark throughout the duration of the license agreement. In addition, because of the plain language of section 365(n), the court held that: (i) the election preserved MHI's exclusive rights to prevent the development of competing products; and (ii) all royalty and payment provisions due under the license agreement remained in full force and effect.

OUTLOOK

After the alarm bells resulting from *Tempnology*, the bankruptcy court's ruling in *SIMA Int'l* is welcome news to trademark licensees, even if the decision does not carry the same weight as the First Circuit's ruling. To be sure, the unsettled state of the law on this important issue is not a positive development for trademark licensors or licensees. As the case law currently stands, to the extent a potential licensor has a choice of venue for a bankruptcy filing, that choice can have significant consequences for the fate of licensed trademarks.

Despite its refusal to review *Sunbeam* in 2012, the U.S. Supreme Court may finally agree to weigh in on this important issue because of the widening rift in lower and appellate courts.

On June 14, 2018, Mission Product Holdings Inc. ("MPH") filed a petition for a writ of certiorari requesting that the Supreme Court review the First Circuit's January 2018 ruling in *Tempnology*. According to the petition filed by MPH, which was stripped of its right to use licensed trademarks by rejection of its license agreement, the First Circuit "worsen[ed]" the circuit split on this issue, and its decision undermined the effectiveness of a provision that Congress enacted to protect licensor rights, "cast[ing] a cloud of uncertainty over significant commercial transactions that are central to our nation's system for encouraging and rewarding innovation."

BANKRUPTCY COURT ENFORCES NONCONSENSUAL THIRD-PARTY RELEASES IN CHAPTER 15 CASE

Dan T. Moss, Ryan Sims, and **Mark G. Douglas**

In *In re Avanti Commc'ns Grp. PLC*, 582 B.R. 603 (Bankr. S.D.N.Y. 2018), Judge Martin Glenn of the U.S. Bankruptcy Court for the Southern District of New York entered an order under chapter 15 of the Bankruptcy Code enforcing a scheme of arrangement sanctioned by a court in England that included nonconsensual third-party releases. Judge Glenn determined that such releases should be recognized and enforced consistent with principles of "comity" and cooperation with foreign courts inherent under chapter 15.

Nonconsensual third-party releases in a chapter 11 plan are generally problematic, and as discussed below, such releases are categorically prohibited in certain jurisdictions. *Avanti* is consistent with certain of Judge Glenn's prior decisions. It may also be a harbinger for future chapter 15 cases in which foreign representatives seek recognition of nonconsensual third-party releases.

PROCEDURES AND RECOGNITION UNDER CHAPTER 15

Under section 1515 of the Bankruptcy Code, the representative of a foreign debtor may file a petition in a U.S. bankruptcy court seeking "recognition" of a "foreign proceeding." Section 101(24) of the Bankruptcy Code defines "foreign representative" as "a person or body, including a person or body appointed on an interim basis, authorized in a foreign proceeding to administer the reorganization or the liquidation of the debtor's assets or affairs or to act as a representative of such foreign proceeding."

Section 109(a) of the Bankruptcy Code provides that, "[n]otwithstanding any other provision of this section, only a person that resides or has a domicile, a place of business, or property in the United States, or a municipality, may be a debtor under [the Bankruptcy Code]." In *Drawbridge Special Opportunities Fund LP v. Barnet (In re Barnet)*, 737 F.3d 238 (2d Cir. 2013), the U.S. Court of Appeals for the Second Circuit ruled that section 109(a) applies to cases under chapter 15 of the Bankruptcy Code.

"[P]roperty in the United States" for purposes of section 109(a) has been held to include an attorney retainer in a U.S. bank account; causes of action under U.S. law against parties in the U.S.; and contract rights governed by U.S. law, including those in connection with U.S. dollar-denominated debt issued under an indenture governed by New York law with a New York choice-of-forum clause. *See In re Cell C Proprietary Ltd.*, 571 B.R. 542 (Bankr. S.D.N.Y. 2017); *In re Berau Capital Resources Pte Ltd*, 540 B.R. 80 (Bankr. S.D.N.Y. 2015); *In re Octaviar Administration Pty Ltd*, 511 B.R. 361 (Bankr. S.D.N.Y. 2014).

"Foreign proceeding" is defined in section 101(23) of the Bankruptcy Code as:

> [A] collective judicial or administrative proceeding in a foreign country, including an interim proceeding, under a law relating to insolvency or adjustment of debt in which proceeding the assets and affairs of the debtor are subject to control or supervision by a foreign court, for the purpose of reorganization or liquidation.

More than one bankruptcy or insolvency proceeding may be pending with respect to the same foreign debtor in different countries. Chapter 15 therefore contemplates recognition in the U.S. of both a "foreign main proceeding"—a case pending in the country where the debtor's center of main interest ("COMI") is located (*see* 11 U.S.C. § 1502(4))—and "foreign nonmain proceedings," which may have been commenced in countries where the debtor merely has an "establishment" (*see* 11 U.S.C. § 1502(5)).

The Bankruptcy Code does not define "COMI." However, section 1516(c) provides that, "[i]n the absence of evidence to the contrary, the debtor's registered office, or habitual residence in the case of an individual, is presumed to be" the debtor's COMI.

An "establishment" is defined in section 1502(2) as "any place of operations where the debtor carries out a nontransitory economic activity." Unlike with the determination of COMI, there is no statutory presumption regarding the determination of whether a foreign debtor has an establishment in any particular location. *See In re British Am. Ins. Co.*, 425 B.R. 884 (Bankr. S.D. Fla. 2010). The debtor's foreign representative bears the burden of demonstrating that the debtor has an establishment in a particular jurisdiction. *Id.* at 915.

RELIEF THAT CAN BE GRANTED UPON RECOGNITION

Upon recognition of a "foreign main proceeding," section 1520(a) provides that certain provisions of the Bankruptcy Code automatically come into force, including section 361, which entitles any entity asserting an interest in the debtor's U.S. assets to "adequate protection" of that interest; section 362, which imposes an automatic stay preventing creditor collection efforts with respect to the debtor or its U.S. assets; section 363, which restricts the debtor's ability to use, sell, or lease its U.S. property outside the ordinary course of its business; section 549, which gives a trustee the power to avoid unauthorized postpetition asset transfers; and section 552, which provides that, with certain exceptions (e.g., pledged proceeds and rents), prepetition security interests do not encumber U.S. property acquired by the bankruptcy estate or by the debtor postpetition.

If the bankruptcy court recognizes a foreign proceeding as either a main or nonmain proceeding, section 1521(a) authorizes the court to grant a broad range of provisional and other relief designed to preserve the foreign debtor's assets or otherwise provide assistance to the court or other entity presiding over the debtor's foreign main proceeding. Under section 1521(a)(1), such relief can include "staying the commencement or continuation of an individual action or proceeding concerning the debtor's assets, rights, obligations or liabilities to the extent they have not been stayed under section 1520(a)."

Under section 1521(a)(7), the court may also "grant[] any additional relief that may be available to a trustee, except for relief available under sections 522, 544, 545, 547, 548, 550, and 724(a)." These excepted sections authorize a bankruptcy trustee to, among other things, avoid and recover transfers that are fraudulent under the Bankruptcy Code and/or, under certain circumstances, "applicable" law (generally state law).

Section 1522 provides that the bankruptcy court may grant relief under section 1521 "only if the interests of the creditors and other interested entities, including the debtor, are sufficiently protected."

Section 1506 of the Bankruptcy Code sets forth a public policy exception to the relief otherwise authorized in chapter 15, providing that "[n]othing in this chapter prevents the court from refusing to take an action governed by this chapter if the action would be manifestly contrary to the public policy of the United States."

Under section 1507 of the Bankruptcy Code, in determining whether a U.S. bankruptcy court should provide "additional assistance" to a foreign representative in a chapter 15 case, the court must consider whether such assistance, "consistent with the principles of comity," will reasonably ensure, among other things: (i) the just treatment of all creditors and interest holders; (ii) protection of U.S. creditors "against prejudice and inconvenience in the processing of claims in such foreign proceeding"; and (iii) "distribution of proceeds of the debtor's property substantially in accordance with the order prescribed" in the Bankruptcy Code.

Cooperation between U.S. and foreign courts—a form of "comity"—is an indispensable element of the chapter 15 paradigm. Comity is "the recognition which one nation allows within its territory to the legislative, executive or judicial acts of another nation, having due regard both to international duty and convenience, and to the rights of its own citizens or of other persons who are under the protection of its laws." *Hilton v. Guyot*, 159 U.S. 113, 164 (1895); *accord Shen v. Leo A. Daly Co.*, 222 F.3d 472, 476 (8th Cir. 2000).

VALIDITY OF NONCONSENSUAL THIRD-PARTY RELEASES IN CHAPTER 11 PLANS UNDER U.S. LAW

The U.S. circuit courts of appeals are split as to whether a bankruptcy court has the authority to approve chapter 11 plan provisions that, over the objection of creditors or other stakeholders, release specified nondebtors from liability and/or enjoin dissenting stakeholders from asserting claims against such nondebtors. The minority view, held by the Fifth, Ninth, and Tenth Circuits, bans such nonconsensual releases on the basis that section 524(e) of the Bankruptcy Code, which provides generally 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," prohibits them. *See Bank of N.Y. Trust Co. v. Official Unsecured Creditors' Comm. (In re Pac. Lumber Co.)*, 584 F.3d 229 (5th Cir. 2009); *In re Lowenschuss*, 67 F.3d 1394 (9th Cir. 1995); *In re W. Real Estate Fund, Inc.*, 922 F.2d 592 (10th Cir. 1990).

On the other hand, the majority of circuits to consider the issue—the Second, Fourth, Sixth, Seventh, and Eleventh Circuits—have found such releases and injunctions permissible under certain circumstances. *See In re Drexel Burnham Lambert Grp., Inc.*, 960 F.2d 285 (2d Cir. 1992); *In re A.H. Robins Co., Inc.*, 880 F.2d 694 (4th Cir. 1989); *In re Dow Corning Corp.*, 280 F.3d 648 (6th Cir. 2002); *In re Airadigm Commc'ns, Inc.*, 519 F.3d 640 (7th Cir. 2008); *SE Prop. Holdings, LLC v. Seaside Eng'g & Surveying, Inc. (In re Seaside Eng'g & Surveying, Inc.)*, 780 F.3d 1070 (11th Cir. 2015). For authority, these courts generally rely on section 105(a) of the Bankruptcy Code, which authorizes courts to "issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of [the Bankruptcy Code]." Moreover, as the Seventh Circuit held in *Airadigm,* the majority view is that section 524(e) does not limit a bankruptcy court's authority to grant such releases.

The First and D.C. Circuits have suggested that they agree with the "pro-release" majority. *See In re Monarch Life Ins. Co.*, 65 F.3d 973 (1st Cir. 1995) (a subsidiary was collaterally estopped by a plan confirmation order from belatedly challenging the jurisdiction of the bankruptcy court to permanently enjoin lawsuits against the debtor's attorneys and other nondebtors not contributing to the debtor's reorganization); *In re AOV Industries*, 792 F.2d 1140 (D.C. Cir. 1986) (a plan provision releasing liabilities of nondebtors was unfair because the plan did not provide additional compensation to a creditor whose claim against the nondebtor was being released; adequate consideration must be provided to a creditor forced to release claims against nondebtors). The Third Circuit declined to decide the issue in *In re Continental Airlines*, 203 F.3d 203 (3d Cir. 2000), ruling that a plan release provision did not pass muster under even the most flexible tests for the validity of nondebtor releases.

Although majority-view courts employ various tests to determine whether such releases are appropriate, courts generally approve third-party plan releases or injunctions when they are essential to the reorganization, the parties being released are making a substantial financial contribution to the reorganization, and the affected creditors overwhelmingly support the plan. *See Dow Corning Corp.*, 280 F.3d at 658 (listing factors).

RECOGNITION AND ENFORCEMENT OF NONDEBTOR RELEASES IN CHAPTER 15 CASES

In a chapter 15 case, unlike in a chapter 11 case, a U.S. bankruptcy court is not asked to confirm a plan of reorganization or liquidation. However, the court may be asked to recognize and enforce a plan, composition with creditors, scheme of arrangement, or court order sanctioned or issued by a foreign court presiding over a foreign debtor's main proceeding. Such a plan or order may enjoin creditors from suing or otherwise proceeding against

Heather Lennox (Cleveland and New York), ***Sidney P. Levinson (New York)***, ***Kevyn D. Orr (Washington)***, ***Carl E. Black (Cleveland)***, ***Pedro A. Jimenez (Miami and New York)***, ***Scott J. Greenberg (New York)***, ***Thomas A. Howley (Houston)***, ***James O. Johnston (Los Angeles)***, ***Brad B. Erens (Chicago)***, ***Jeffrey B. Ellman (Atlanta)***, ***Corinne Ball (New York)***, ***Bruce Bennett (Los Angeles and New York)***, ***Charles M. Oellermann (Columbus)***, and ***Gregory M. Gordon (Dallas)*** were designated "Leaders in their Field" in the area of Bankruptcy / Restructuring in *Chambers USA* 2018.

Jones Day has been selected for the *GRR 30* 2018, a guide to the world's leading restructuring and insolvency practices that is compiled, written, and researched exclusively by independent *Global Restructuring Review* editorial staff.

Kevyn D. Orr (Washington) recently joined the board of directors of the Lincoln Institute of Land Policy, which seeks to improve quality of life through the effective use, taxation, and stewardship of land. A nonprofit private operating foundation whose origins date to 1946, the Lincoln Institute researches and recommends creative approaches to land as a solution to economic, social, and environmental challenges.

On May 17, 2018, ***Corinne Ball (New York)*** served as a panelist in a "TED Talk" discussion entitled "What I'd Change About the Corporate Bankruptcy System" at the VALCON 2018 conference, hosted jointly by the American Bankruptcy Institute and the Association of Insolvency & Restructuring Advisors in Las Vegas.

Bruce Bennett (Los Angeles and New York) was named a "Leading Lawyer" in the fields of "Finance—Restructuring (including bankruptcy): corporate" and "Finance—Restructuring (including bankruptcy): municipal" in *The Legal 500 United States* 2018.

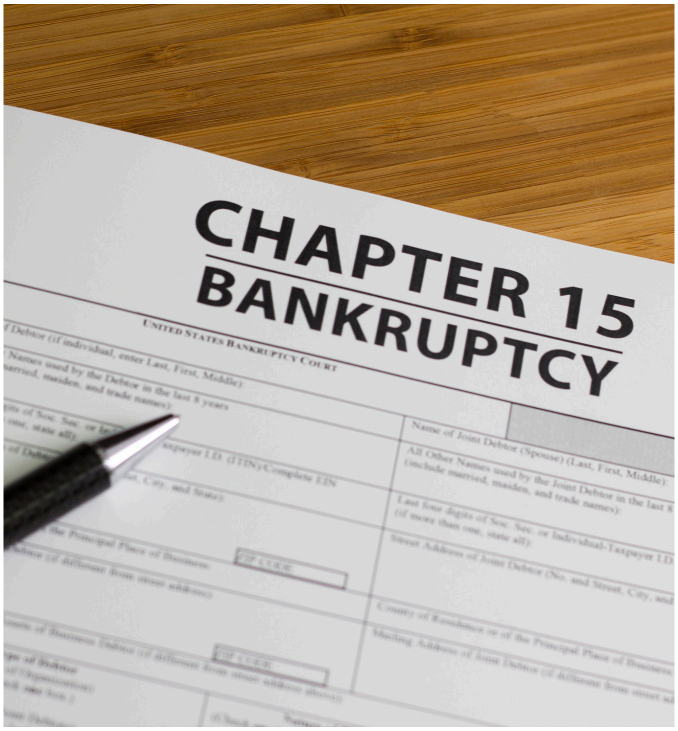
Heather Lennox (Cleveland and New York) was named a "Leading Lawyer" in the field of "Finance—Restructuring (including bankruptcy): corporate" in *The Legal 500 United States* 2018.

Scott J. Greenberg (New York) was named a "Next Generation Lawyer" in the field of "Finance—Restructuring (including bankruptcy): corporate" in *The Legal 500 United States* 2018.

Joshua M. Mester (Los Angeles), ***Sidney P. Levinson (New York)***, and ***Kevyn D. Orr (Washington)*** were recommended in the field of "Finance—Restructuring (including bankruptcy): corporate" and / or "Finance—Restructuring (including bankruptcy): municipal" in *The Legal 500 United States* 2018.

Scott J. Greenberg (New York), ***Thomas A. Howley (Houston)***, ***Michael J. Cohen (New York)***, ***Nicholas J. Morin (New York)***, ***Anna Kordas (New York)***, and ***Rachel Biblo Block (Dallas)*** are part of Jones Day's team of professionals representing Rex Energy in connection with its pre-negotiated chapter 11 filing on May 18, 2018, in the U.S. Bankruptcy Court for the Western District of Pennsylvania.

An article written by ***Charles M. Oellermann (Columbus)*** and ***Mark G. Douglas (New York)*** entitled "Debate Intensifies as to Whether the Bankruptcy Code's Avoidance Provisions Apply Extraterritorially" was posted on the June 26, 2018, *Harvard Law School Bankruptcy Roundtable*.



parties other than the foreign debtor. In such a case, whether a release or injunction should be enforced by a U.S. bankruptcy court is a more nuanced issue.

For example, in *In re Metcalfe & Mansfield Alternative Investments*, 421 B.R. 685 (Bankr. S.D.N.Y. 2010), bankruptcy judge Martin Glenn, to provide "additional assistance" in a chapter 15 case involving a Canadian debtor, enforced a Canadian court's order confirming a restructuring plan that contained nondebtor releases and injunctions, even though it was uncertain whether a U.S. court would have approved the releases and injunctions in a case under chapter 11 of the Bankruptcy Code. Judge Glenn reasoned that such uncertainty was of little consequence in the case before it, which involved not the propriety of nondebtor injunctions and releases in a plenary bankruptcy case, but rather, a request to enforce a foreign judgment in a chapter 15 case. The court concluded that "principles of enforcement of foreign judgments and comity in chapter 15 cases strongly counsel approval of enforcement in the United States of the third-party non-debtor release and injunction provisions included in the Canadian Orders, even if those provisions could not be entered in a plenary chapter 11 case."

By contrast, in *Vitro S.A.B. de C.V. v. ACP Master, Ltd. (In re Vitro S.A.B. de C.V.)*, 473 B.R. 117 (Bankr. N.D. Tex.), *aff'd*, 701 F.3d 1031 (5th Cir. 2012), the bankruptcy court ruled that releases of nondebtor affiliates included in a Mexican debtor's reorganization plan were unenforceable as contrary to U.S. public policy. On appeal, the U.S. Court of Appeals for the Fifth Circuit ruled that the prohibition of such releases under Fifth Circuit precedent (citing *Pac. Lumber*) did not necessarily mean that a U.S. bankruptcy court could not enforce them under section 1507 as a permissible form of "additional assistance" not otherwise available under the Bankruptcy Code or U.S. law. However, the Fifth Circuit concluded that the bankruptcy court did not abuse its discretion in refusing to enforce the nonconsensual releases where affected creditors were not given any alternative means to recover and would receive only a tiny fraction of what was owed to them, and where the votes in favor of the Mexican debtor's reorganization plan comprised largely insider votes (which are not counted as acceptances under chapter 11 pursuant to section 1129(a)(10) of the Bankruptcy Code). Because it concluded that relief was not warranted under section 1507 and would not be available under section 1521, the Fifth Circuit did "not reach whether the [Mexican reorganization] plan would be manifestly contrary to a fundamental public policy of the United States" within the meaning of section 1506.

In *In re Sino-Forest Corp.*, 501 B.R. 655 (Bankr. S.D.N.Y. 2013), Judge Glenn employed his rationale in *Metcalfe* in recognizing as a form of "additional assistance" under section 1507 a Canadian court-approved settlement containing a global release provision. In addition, he noted that, in the Second Circuit, "where the third-party releases are not categorically prohibited, it cannot be argued that the issuance of such releases is manifestly contrary to public policy" within the meaning of section 1506 (*citing In re Metromedia Fiber Network, Inc.*, 416 F.3d 136, 141 (2d Cir. 2005)).

ENFORCEMENT OF THIRD-PARTY NONCONSENSUAL RELEASES IN *AVANTI*

Following his earlier precedent, Judge Glenn recently used similar reasoning in *Avanti*. Avanti Communications Group PLC ("Avanti"), a public limited company incorporated under the laws of England and Wales with subsidiaries throughout the world, was a satellite operator that provided services in Europe, the Middle East, and Africa. Avanti issued senior secured notes maturing in 2021 and 2023 that certain of Avanti's direct and indirect subsidiaries guaranteed. Because of operational setbacks and an overleveraged balance sheet, Avanti and an ad hoc group of its noteholders entered into a restructuring support agreement, which formed the basis for a scheme of arrangement under English law. Pursuant to the scheme, the parties agreed to equitize the 2023 notes, which, although originally governed by New York law, were amended to be governed by English law, and to amend the terms of the 2021 notes. The scheme also included the grant of releases to, among others, certain third-party guarantors, which prevented dissenting holders of the 2023 notes from pursuing claims against the guarantors.

In February 2018, Avanti initiated a proceeding under the U.K. Companies Act of 2006 before the High Court of Justice of England and Wales. Through this proceeding, the parties sought permission from the High Court to convene a meeting of creditors comprising holders of the 2023 notes—the only impaired creditors under the scheme—to vote on the scheme. The court approved the request, and creditors holding more than 98 percent of the value of the 2023 notes voted in favor of the scheme. Thereafter, the High Court approved the scheme of arrangement.

Later in February 2018, Avanti's foreign representative filed a petition in the U.S. Bankruptcy Court seeking recognition of the U.K. proceeding as a foreign main proceeding under chapter 15. Because Avanti's legal counsel held a retainer in a New York account and because the indenture for the 2023 notes was governed by New York law, Judge Glenn ruled that Avanti satisfied section 109(a)'s "property in the United States" requirement, and the court recognized Avanti's U.K. proceeding as a foreign main proceeding.

The recognition order also provided for enforcement of the scheme's nonconsensual third-party releases. Judge Glenn, after examining the requirements of sections 1507 and 1521 of the Bankruptcy Code, concluded, among other things, that: (i) affected creditors were afforded due process consistent with U.S. standards; (ii) third-party nondebtor releases, particularly for affiliate guarantors of debt adjusted by a scheme of arrangement, are common under English law (and are often enforced in the Second Circuit in chapter 15 proceedings); and (iii) if the scheme were not recognized and enforced in the chapter 15 case, creditors could be prejudiced and could "prevent the fair and efficient administration of the [r]estructuring."

Judge Glenn distinguished *Vitro*. In particular, he pointed out that the Mexican reorganization plan in *Vitro* was supported by a significant number of insider votes, in contrast to *Avanti*, where the scheme received essentially unanimous consent from all impaired creditors.

OUTLOOK

Avanti is welcome news for foreign debtors seeking to obtain enforcement of nonconsensual third-party releases approved by foreign courts as part of restructuring plans. Given this and prior precedents in the Southern District of New York, that venue may be preferred by foreign debtors wishing to grant such releases in their non-U.S. insolvency proceedings.

Under *Avanti* and some cases in other districts and circuits, the standard for approving nonconsensual third-party releases depends upon whether the debtor is in chapter 11 or chapter 15. As noted by Judge Glenn in *Avanti*, in chapter 15, the inquiry focuses on, among other things, whether the foreign forum provides:

> [A] full and fair trial . . . before a court of competent jurisdiction [that was] conduct[ed] upon regular proceedings . . . and under a system of jurisprudence likely to secure an impartial administration of justice . . . and there is nothing to show either prejudice in the court, or in the system of laws under which it [presides].

BANKRUPTCY COURT LACKS POWER TO SUBSTANTIVELY CONSOLIDATE NONDEBTOR, NONPROFIT ENTITIES WITH ARCHDIOCESE DEBTOR

Charles M. Oellermann and **Mark G. Douglas**

In the wake of scandal-driven bankruptcies filed by nearly 20 U.S. Roman Catholic dioceses and religious orders, scrutiny has been increasingly brought to bear on the benefits and burdens that federal bankruptcy laws offer to eleemosynary (nonprofit) corporations. Nonprofits seek bankruptcy protection for a variety of reasons. In the case of the dioceses and religious orders, chapter 11 has been a vehicle to head off (at least temporarily) thousands of pending and potential clergy sexual-abuse cases seeking hundreds of millions of dollars in damages. Other nonprofit filings have been designed to restructure balance sheets bloated with debt, to facilitate sales of nonprofits' assets, to effect orderly liquidations, to give nonprofits a needed breathing spell in a climate of regulatory change and uncertainty, or to more effectively manage claims of fiduciary infractions or fraud.

One issue that commonly arises in nonprofit bankruptcies—the scope of the debtor's bankruptcy estate—was recently addressed by the U.S. Court of Appeals for the Eighth Circuit in *Official Committee of Unsecured Creditors v. Archdiocese of St. Paul and Minneapolis (In re Archdiocese of St. Paul and Minneapolis)*, 888 F.3d 944 (8th Cir. 2018). The court affirmed lower court rulings that the assets of parishes and other entities associated with an archdiocese were not, by means of "substantive consolidation," available to fund bankruptcy settlements with clergy abuse victims. According to the Eighth Circuit, a bankruptcy court's authority to issue "necessary or appropriate" orders does not permit it to order substantive consolidation of the assets and liabilities of a debtor archdiocese with the assets and liabilities of nondebtor entities that also operated as nonprofits because the remedy would contravene the prohibition of involuntary bankruptcy filings against nonprofits.

ELIGIBILITY OF NONPROFITS FOR BANKRUPTCY RELIEF

One of the threshold issues that must be considered is whether a nonprofit can file for bankruptcy in the first place. A related issue is whether a nonprofit's bankruptcy case, once filed, is subject to conversion to a case under another chapter of the Bankruptcy Code.

Section 109 of the Bankruptcy Code sets forth the eligibility requirements for a bankruptcy filing, including requirements for filings under certain chapters. Section 109(a) provides that "only a person that resides or has a domicile, a place of business, or property in the United States, or a municipality, may be a debtor under [the Bankruptcy Code.]" The Bankruptcy Code defines "person" to include (in addition to certain governmental units) any individual, partnership, or corporation.

Other subsections of section 109 expressly make some entities ineligible for certain kinds of bankruptcy relief, including railroads (which can file only for chapter 11); municipalities (which can file only for chapter 9); and domestic insurance companies, banks, and savings and loan associations, all of which are subject to different legislative schemes enacted for their reorganization or dissolution.

Corporations qualifying for nonprofit status under applicable state law are eligible to file under both chapter 7 and chapter 11 of the Bankruptcy Code. *See* COLLIER ON BANKRUPTCY ¶ 109.02 (16th ed. 2018) ("A nonprofit corporation, like a for-profit corporation, is eligible to file for relief under the Bankruptcy Code despite the fact that its assets may be subject to the beneficial ownership of governmental agencies."). Even unincorporated nonprofit enterprises may qualify. However, where a nonprofit enterprise is not organized as a corporation, a business trust, a joint stock company, or an association with the power or privilege of a private corporation, it will not be eligible for relief under the Bankruptcy Code. *See* 11 U.S.C. §§ 101(9) and 109.

PROHIBITION OF INVOLUNTARY NONPROFIT BANKRUPTCIES

Section 303 of the Bankruptcy Code provides that an involuntary bankruptcy case may be commenced under chapter 7 or chapter 11 "only against a person, except a farmer, family farmer, or a corporation that is not a moneyed, business, or commercial corporation," if the requisite number of eligible creditors files an involuntary petition against the entity. Although the Bankruptcy Code does not define "moneyed, business, or commercial corporation," the legislative history of section 303 indicates that "churches, schools, charitable organizations and foundations" are exempt from involuntary bankruptcy. H.R. Rep. No. 95-595, 321 (1977); S. Rep. No. 95-989, 33 (1978). Courts, which generally decide whether this exemption applies by examining the charter of the entity, as well as its activities and its characteristics and powers under state law, have interpreted the provision to exclude nonprofits from involuntary bankruptcy filings. *See Archdiocese of St. Paul*, 888 F.3d at 952 ("We agree with the bankruptcy court's interpretation that 'not a moneyed' is equivalent to the modern-day terms 'not-for-profit' or 'non-profit.' ").

CONVERSION OF NONPROFIT CHAPTER 11 CASE TO CHAPTER 7 LIQUIDATION PROHIBITED

The Bankruptcy Code provides for the conversion of a chapter 11 case to a chapter 7 liquidation upon demonstration of "cause," including continuing loss to or diminution of the estate, the absence of a reasonable likelihood of rehabilitation, and the inability to effectuate substantial consummation of a confirmed chapter 11 plan. However, section 1112(c) of the Bankruptcy Code prohibits the involuntary conversion of a case from chapter 11 to chapter 7 if the debtor is not a "moneyed, business, or commercial corporation." Courts have interpreted these terms to refer to nonprofit entities. *See, e.g.*, *In re Cult Awareness Network, Inc.*, 151 F.3d 605, 609 (7th Cir. 1998); *In re Forum Health*, 444 B.R. 848, 860 n.13 (Bankr. N.D. Ohio 2011).

WHAT QUALIFIES AS PROPERTY OF A NONPROFIT'S BANKRUPTCY ESTATE?

Among the issues most frequently litigated in bankruptcy cases filed by nonprofit corporations is whether assets, money, or other property in the debtor's possession (or nominally under its control) at the time it files for bankruptcy should be included in the debtor's bankruptcy estate, such that they are available in whole or in part for distribution to creditors. This is so because assets held by nonprofits are frequently acquired by means of government grants or bequests from private individuals or foundations that are subject to use limitations.

Section 541(a)(1) of the Bankruptcy Code broadly defines property of a debtor's bankruptcy estate to include "all legal or equitable interests of the debtor in property as of the commencement of the case." Although the scope of section 541 is broad, applicable non-bankruptcy law defines the debtor's property interests and thereby determines the extent of the bankruptcy estate. *See Butner v. U.S.*, 440 U.S. 48, 55 (1979).

Pre-bankruptcy restrictions on property held by a nonprofit debtor, such as those associated with donor-restricted funds, can significantly limit the broad grasp of section 541. *See In re Joliet-Will County Community Action Agency*, 847 F.2d 430 (7th Cir. 1988) (federal and state agency grants to nonprofits that imposed restrictions on use were made to the organization as a trustee, such that the debtor lacked beneficial title to the funds, and hence they were not property of the estate); *In re Roman Catholic Archbishop of Portland in Oregon*, 345 B.R. 686, 705 (Bankr. D. Or. 2006) (a charitable trust of which the debtor was not the sole beneficiary was not the property of the bankruptcy estate, as the debtor held legal but not entire equitable title to the fund, but the debtor's interest in the trust as the beneficiary was part of its estate); *Parkview Hospital v. St. Vincent Medical Center*, 211 B.R. 619 (Bankr. N.D. Ohio 1997) (because the debtor hospital's contributors manifested an intent that the hospital's development fund would be used for specific charitable purposes, an express charitable trust was created that excluded the funds from the bankruptcy estate). Accordingly, section 541(d) of the Bankruptcy Code provides that:

> [p]roperty in which the debtor holds, as of the commencement of the case, only legal title and not an equitable interest . . . becomes property of the estate . . . only to the extent of the debtor's legal title to such property, but not to the extent of any equitable interest in such property that the debtor does not hold.

A related issue that has received a great deal of coverage in connection with the Catholic archdiocese chapter 11 filings is the conflict between federal bankruptcy law and canon law in determining what qualifies as estate property. *See generally* RELIGIOUS

Organizations and the Law § 13:22 (2018); Justin Baumgartner, *Remedying Scandal: Pooling the Assets of Catholic Entities to Pay Off Tort Creditors Through Substantive Consolidation in a Bankruptcy Proceeding*, 18 Rutgers J. L. & Religion 388 (2017). Within the Catholic Church, dioceses, i.e., geographic districts established by the church, control local parishes, i.e., congregations. Each diocese is governed by a bishop (or an archbishop, if the area is extensive enough to be designated an archdiocese).

The bishop holds title to all parish properties in the name of the church. However, under canon law, such properties are held in trust for parishioners. Church officials commonly argue that only the bishop's direct holdings, as opposed to properties held in trust for parishes, should be included in an archdiocese's bankruptcy estate. *See In re Catholic Diocese of Wilmington, Inc.*, 432 B.R. 135 (Bankr. D. Del. 2010) (funds that a debtor-diocese received from different parishes for investment in a pooled investment fund were held in the resulting trust, but because the funds were held in the debtor's general account and the parishes could not trace them, they were estate property; funds deposited in a separate account pursuant to an express trust agreement were not estate property); *Comm. of Tort Litigants v. Catholic Diocese of Spokane*, 364 B.R. 81 (E.D. Wash. 2006) (issues of fact existed as to whether the debtor-diocese was the unencumbered owner of parish properties or whether the parishes were the beneficial owners of the real properties upon which their churches and schools were located, precluding summary judgment for either the diocese or for the committee of tort litigants and the claimant on the issue of whether the properties belonged to the chapter 11 estate); *In re Roman Catholic Archbishop of Portland in Oregon*, 335 B.R. 842, 861 (Bankr. D. Or. 2005) ("[I]f defendants can show that, under state law, the disputed properties are held by the Archdiocese in trust for the parishes and schools, § 541 would recognize that trust relationship, subject to the avoidance provisions of § 544(a)(3).").

In light of these issues, claimants and their representatives have sought to avail themselves of the assets of entities affiliated with a nonprofit to satisfy claims by means of alter ego-type theories or "substantive consolidation."

SUBSTANTIVE CONSOLIDATION

Substantive consolidation is an equitable remedy pursuant to which a bankruptcy court may order that the assets and liabilities of separate entities be treated as if they belonged to a single, combined entity.

The Bankruptcy Code does not expressly authorize substantive consolidation, but it recognizes that a chapter 11 plan may provide for the "consolidation of the debtor with one or more persons" as a means of implementation. *See* 11 U.S.C. § 1123(a)(5)(C). In addition, Fed. R. Bankr. P. 1015(b) provides that a bankruptcy court may direct that cases involving affiliated debtors be jointly administered, but the rule is silent regarding substantive consolidation.

A majority of courts have concluded that bankruptcy courts have the power to substantively consolidate debtor entities under section 105(a) of the Bankruptcy Code, which provides that a court "may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions" of the Bankruptcy Code. However, because forcing the creditors of one entity to share equally with the creditors of a less solvent entity is not appropriate in many circumstances, courts generally hold that substantive consolidation is an extraordinary remedy that should be used sparingly. *See Buridi v. KMC Real Estate Investors, LLC (In re KMC Real Estate Investors, LLC)*, 531 B.R. 758 (S.D. Ind. 2015).

Different standards have been employed by courts to determine the propriety of substantive consolidation. For example, in *Eastgroup Properties v. Southern Motel Assoc., Ltd.*, 935 F.2d 245 (11th Cir. 1991), the Eleventh Circuit adopted a modified version of the standard articulated by the District of Columbia Circuit in *Drabkin v. Midland Ross Corp. (In re Auto-Train Corp., Inc.)*, 810 F.2d 270, 276 (D.C. Cir. 1987). According to this standard: (i) the proponent of consolidation must demonstrate that there is substantial identity between the entities to be consolidated and that consolidation is necessary to avoid some harm or to realize some benefit; and (ii) a creditor may object on the grounds that it relied on the entities' separate credit and will be prejudiced by consolidation, in which case the court can order consolidation only if it determines that the benefits of consolidation "heavily" outweigh the harm.

The Second Circuit established a somewhat different two-part disjunctive standard for gauging the propriety of substantive consolidation in *Union Savings Bank v. Augie/Restivo Baking Co., Ltd. (In re Augie/Restivo Baking Co., Ltd.)*, 860 F.2d 515, 518 (2d Cir. 1988). There, the court concluded that the factual elements considered by the courts are "merely variants on two critical factors: (i) whether creditors dealt with the entities as a single economic unit and did not rely on their separate identity in extending credit, . . . or (ii) whether the affairs of the debtors are so entangled that consolidation will benefit all creditors."

Factors that may be relevant in satisfying these requirements include the following:

(1) Fraud or other complete domination of the corporation that harms a third party;

(2) The absence of corporate formalities;

(3) Inadequate capitalization of the corporation;

(4) Whether funds are put in and taken out of the corporation for personal rather than corporate purposes;

(5) Overlap in ownership and management of affiliated corporations;

(6) Whether affiliated corporations have dealt with one another at arm's length;

(7) The payment or guarantee of debts of the dominated corporation by other affiliated corporations;

(8) The commingling of affiliated corporations' funds; and

(9) The inability to separate affiliated corporations' assets and liabilities.

Id. at 518–19. The *Augie/Restivo* test was adopted by the Ninth Circuit in *Bonham v. Compton (In re Bonham)*, 229 F.3d 750 (9th Cir. 2000). Many other circuit and lower courts have adopted tests similar to the *Augie/Restivo* and *Eastgroup* standards. In *In re Owens Corning*, 419 F.3d 195, 210 (3d Cir. 2005), however, the Third Circuit opted for an "open-ended, equitable inquiry" rather than a factor-based analysis, as employed by many courts, in reversing lower court rulings approving "deemed" consolidation of 18 debtors and three nondebtor subsidiaries under a plan.

SUBSTANTIVE CONSOLIDATION OF DEBTORS AND NONDEBTORS

Although most courts have held that the substantive consolidation of debtor entities is permitted, they disagree as to whether the substantive consolidation of debtors and nondebtors should be allowed. Some courts have concluded that such substantive consolidation is appropriate on the basis of: (i) section 105's broad grant of authority; (ii) a bankruptcy court's ability to assert personal and subject matter jurisdiction over nondebtors; and/or (iii) a bankruptcy court's mandate to ensure the equitable treatment of all creditors. *See, e.g.*, *Bonham*, 229 F.3d at 769–71; *Lassman v. Cameron Constr. LLC (In re Cameron Constr. & Roofing Co.)*, 565 B.R. 1, 10 (Bankr. D. Mass. 2016); *In re S&G Fin. Servs.*, 451 B.R. 573, 579–82 (Bankr. S.D. Fla. 2011); *Simon v. ASIMCO Techs., Inc. (In re Am. Camshaft Specialties, Inc.)*, 410 B.R. 765, 786 (Bankr. E.D. Mich. 2009); *Walls v. Centurion Asset Mgmt., Inc. (In re Bolze)*, 2009 BL 157145, *4 (Bankr. E.D. Tenn. July 23, 2009); *Dominion Fin. Corp. v. Morfesis (In re Morfesis)*, 270 B.R. 28, 31 (Bankr. D.N.J. 2001); *see also Clark's Crystal Springs Ranch, LLC v. Gugino (In re Clark)*, 692 Fed. Appx. 946, 2017 BL 240043 (9th Cir. July 12, 2017) (because the Bankruptcy Code does not expressly forbid the substantive consolidation of debtors and nondebtors, the U.S. Supreme Court's decision in *Law v. Siegel*, 134 S. Ct. 1188 (2014), does not bar bankruptcy courts from ordering the remedy).

Other courts have held that the substantive consolidation of debtors and nondebtors is inappropriate because, among other things, it circumvents the procedures concerning involuntary bankruptcies set forth in section 303 of the Bankruptcy Code. *See, e.g.*, *Audette v. Kasemir (In re Concepts America, Inc.)*, 2018 WL 2085615, *6 (N.D. Ill. May 3, 2018); *In re Pearlman*, 462 B.R. 849, 854 (Bankr. M.D. Fla. 2012); *Helena Chem. Co. v. Circle Land & Cattle Corp. (In re Circle Land & Cattle Corp.)*, 213 B.R. 870, 877 (Bankr. D. Kan. 1997); *In re Hamilton*, 186 B.R. 991, 993 (Bankr. D. Colo. 1995).

In *Archdiocese of St. Paul*, the Eighth Circuit considered whether an archdiocese debtor could be substantively consolidated with more than 200 nonprofit, nondebtor parishes and other related entities.

ARCHDIOCESE OF ST. PAUL

The nonprofit Archdiocese of St. Paul and Minneapolis (the "debtor") includes 187 parishes as well as several schools, cemeteries, and related organizations. After the State of Minnesota enacted legislation in 2013 extending the statute of limitations for clergy sexual-abuse lawsuits, hundreds of claimants filed claims against the debtor. To address the claims, the debtor filed a chapter 11 case in 2015 in the District of Minnesota.

In 2016, the unsecured creditors' committee sought an order from the bankruptcy court substantively consolidating the debtor with the more than 200 related nonprofit entities, none of which had filed for bankruptcy. Whereas the debtor had only $45 million in unencumbered assets, the related nondebtors' assets were reportedly worth as much as $1 billion. In its complaint, the committee alleged that the debtor "had direct control and supervision in all material aspects" of the nondebtor entities and that their assets should be treated as assets of the debtors.

The bankruptcy court ruled that it lacked the authority to substantively consolidate the debtor with its nonprofit, nondebtor affiliates because it violated section 303(a)'s exemption of nonprofits from involuntary bankruptcy. The court also held that, even if it had the authority to grant the remedy, the committee failed to allege facts sufficient to support substantive consolidation of the entities. The district court affirmed the bankruptcy court's dismissal of the committee's complaint, and the committee appealed to the Eighth Circuit.

THE EIGHTH CIRCUIT'S RULING

A three-judge panel of the Eighth Circuit affirmed.

Citing *Bonham*, the panel noted that, to date, only the Ninth Circuit has directly addressed the substantive consolidation of debtors with nondebtors at the court of appeals level and that "[n]o appellate court has recognized the substantive consolidation of a debtor and a *non-profit* debtor, let alone a debtor and *over 200* non-profit non-debtors."

Next, the Eighth Circuit panel cited *Law v. Siegel*, 134 S. Ct. 1188 (2014), for the proposition that, in exercising its broad equitable powers under section 105, "a bankruptcy court may not contravene specific statutory provisions" of the Bankruptcy Code. Concluding that the plain and ordinary meaning of "corporation that is not a moneyed, business, or commercial corporation" is the equivalent of "non-profit," the panel ruled that a bankruptcy court does not have the power to order substantive consolidation of a nonprofit entity because it would directly contravene section 303(a) of the Bankruptcy Code. According to the court:

> Section 303(a) prevents the use of § 105(a) to force truly independent non-profit entities into involuntary bankruptcy.
>
> We leave for another day the issue of whether a non-profit non-debtor that is the alter ego, under state law, of the debtor, or has been formed as part of a fraudulent scheme, such as a Ponzi scheme, can be consolidated.

The Eighth Circuit panel held that, even taken as true, the facts alleged by the committee in its complaint—"isolated incidents of lack of corporate formality and commingling of assets"—fell far short of the requirement for alter ego status under Minnesota law. Moreover, the court explained, the debtor's effective control over the related nondebtor entities is a function of Minnesota statutory law governing the operation of religious organizations, and the committee's arguments "would apply to virtually any non-profit organization" incorporated in Minnesota, thereby effectively "nullify[ing] the protections of § 303(a)."

OUTLOOK

The Eighth Circuit panel in *Archdiocese of St. Paul* was mindful of the plight of clergy abuse victims affected by its ruling, writing that "[w]e understand the Committee's sincere attempts at recovery for a class of creditors who have suffered clergy abuse." Even so, the court concluded that a bankruptcy court's equitable (i.e., nonstatutory) powers—here, the power to order substantive consolidation—cannot be deployed in a way that contradicts an express provision of the Bankruptcy Code. In the absence of any substantiated allegations that the nondebtor entities were alter egos of the debtor or that the separateness of the entities should be disregarded for other reasons, the Eighth Circuit was constrained to affirm lower court rulings denying the committee's attempt to enlarge the asset pool available for abuse-victim recoveries.

The decision is emblematic of the reluctance of some courts to order substantive consolidation of nondebtors with debtors because the remedy end-runs the general procedures governing involuntary bankruptcy cases in section 303 and, in this case, the specific prohibition of involuntary filings against nonprofit entities. It also indicates that, as in other contexts, the evidentiary showing needed to support alter ego-type claims in cases involving dioceses and other related entities organized under applicable state and canon law is more demanding than "isolated incidents of lack of corporate formality or commingling of assets."

In May 2018, the debtor reached a $210 million settlement with abuse victims—the largest ever by a Catholic diocese in bankruptcy. In June, the debtor and the committee filed a new joint chapter 11 plan providing that $40 million of the settlement amount not covered by insurance will be paid by means of budget cuts, asset sales, donations, and voluntary contributions from parishes.

FROM THE TOP IN BRIEF: U.S. SUPREME COURT CLARIFIES WHETHER DEBTS BASED ON FALSE STATEMENTS CAN BE DISCHARGED IN BANKRUPTCY

On June 4, 2018, the U.S. Supreme Court ruled in *Lamar, Archer & Cofrin, LLP v. Appling*, No. 16-1215, 138 S. Ct. 1752, 2018 WL 2465174 (U.S. June 4, 2018), that an individual debtor's false statement about a single asset, as distinguished from the debtor's overall financial status, can make a debt for money, property, services, or credit obtained on the basis of the statement nondischargeable in the debtor's bankruptcy case, *but only if the statement is in writing*.

Section 523(a)(2)(A) of the Bankruptcy Code excludes from an individual debtor's discharge debts for money, property, services, or credit obtained by "false pretenses, a false representation, or actual fraud, other than a statement respecting the debtor's ... financial condition." Section 523(a)(2)(B) makes such debts nondischargeable if they are based on a materially false *written* statement "respecting the debtor's ... financial condition." Thus, although the Bankruptcy Code generally excludes from discharge an individual debtor's debts stemming from dishonest or fraudulent conduct, an exception to the rule—requiring statements regarding the debtor's financial condition to be in writing—exists to protect individuals from abusive creditors.

R. Scott Appling owed law firm Lamar, Archer & Cofrin, LLP, more than $60,000 in legal fees for representing him in litigation. He orally promised to pay the bill with a tax refund but failed to do so. Appling later tried to discharge a $104,000 state court judgment awarded to the law firm in his chapter 7 case, but the bankruptcy and district courts ruled that his oral statement about a single asset—the tax refund—did not respect his financial condition and that the debt was accordingly nondischargeable under section 523(a)(2)(A). The U.S. Court of Appeals for the Eleventh Circuit reversed.

The unanimous Supreme Court agreed with the Eleventh Circuit, resolving a circuit split on the issue. Writing for the court, Justice Sotomayor explained that "[t]he statutory language makes plain that a statement about a single asset can be a 'statement respecting the debtor's financial condition.' " She further noted that if Congress had intended section 523(a)(2)(B) to encompass only "statements expressing the balance of a debtor's assets and liabilities, there are several ways in which it could have so specified," yet it chose not to do so.

If that statement is not in writing, she wrote, the "associated debt may be discharged, even if the statement was false."

Justices Thomas, Alito, and Gorsuch joined the opinion, except for one portion. That portion addressed the law firm's argument that Appling's interpretation was inconsistent with the overall principle that the Bankruptcy Code exists to give relief only to the "honest but unfortunate debtor" because it leaves "fraudsters" free to "swindle innocent victims for money, property or services by lying about their finances, then discharge the resulting debt in bankruptcy, just so long as they do so orally." Justice Sotomayor rejected this argument, noting that the heightened requirements set forth in section 523(a)(2) "are not a shield for dishonest debtors ... [but] [r]ather, they reflect Congress' effort to balance the potential misuse of such statements by both debtors and creditors."

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