

BUSINESS RESTRUCTURING REVIEW

REPORTS OF THE DEMISE OF “GIFTING” CHAPTER 11 PLANS ARE AN EXAGGERATION

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In *Hargreaves v. Nuverra Environmental Solutions Inc.* (*In re Nuverra Environmental Solutions Inc.*), 590 B.R. 75 (D. Del. 2018), the U.S. District Court for the District of Delaware affirmed a bankruptcy court order confirming a nonconsensual chapter 11 plan that included “gifted” consideration from a senior secured creditor to fund unequal distributions to two separate classes of unsecured creditors. The court also ruled that, even though the appeal was equitably moot, the plan’s separate classification and differing treatment of unsecured noteholders and trade creditors: (i) did not unfairly discriminate between, or improperly classify, the two unsecured classes because there was a rational basis for the classification scheme; and (ii) were “fair and equitable” because they did not constitute “vertical gifting” that violated applicable precedent and they promoted the debtor’s reorganization.

In so ruling, the district court dispelled speculation that the U.S. Supreme Court’s 2017 decision in *Czyzewski v. Jevic Holding Corp.* concerning “structured dismissals” might presage an end to all kinds of gifting chapter 11 plans. Because the district court’s *Nuverra* ruling has been appealed, the U.S. Court of Appeals for the Third Circuit may soon have yet another opportunity to weigh in on gifting chapter 11 plans.

CLASSIFICATION OF CLAIMS AND INTERESTS UNDER A CHAPTER 11 PLAN

Section 1122 of the Bankruptcy Code provides that, except with respect to a class of “administrative convenience” claims (i.e., relatively small unsecured claims, such as trade claims below a certain dollar amount), a plan may place a claim or interest in a particular class “only if such claim or interest is substantially similar to the claims or interests of such class.” The statute, however, does not define “substantially similar.”

This task was left to the courts. They have relied largely upon past practice under the former Bankruptcy Act and lawmakers’ statements in connection with the enactment of the Bankruptcy Code that indicate that the term should be construed to mean similar in legal character or effect as a claim against the debtor’s assets or as an interest in the debtor. See *COLLIER ON BANKRUPTCY* ¶ 1122.03 (16th ed. 2018) (citing cases). Thus, for example,

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interests, such as stock, may not be classified together with claims, such as trade or bond debt, because the relationship between the debtor and its creditors, who assume credit risk but not enterprise risk, is fundamentally different from the relationship between the debtor and its stockholders, who undertake enterprise risk as investors. In addition, secured claims cannot be placed in the same class as unsecured claims, because a secured creditor has recourse to collateral to satisfy its debt in the event of nonpayment.

CRAMDOWN CONFIRMATION OF A CHAPTER 11 PLAN

Section 1129(a) of the Bankruptcy Code requires, among other things, that for a plan to be confirmable, each class of claims or interests must either accept the plan or not be “impaired.” However, “cramdown” confirmation is possible in the absence of acceptance by impaired classes under section 1129(b) if all of the other plan requirements are satisfied and the plan: (i) “does not discriminate unfairly”; and (ii) is “fair and equitable” with respect to each class of claims or interests that is impaired under, and has not accepted, the plan.

Unfair Discrimination

The Bankruptcy Code provides no definition of “unfair discrimination.” As noted by a leading commentator, “Courts have struggled to give the unfair discrimination test an objective standard.” **COLLIER ON BANKRUPTCY** ¶ 1129.03 (16th ed. 2018). Nevertheless, most courts agree that the purpose underlying the requirement is to “ensure[] that a dissenting class will receive value equal to the value given to all other similarly situated classes.” *In re Johns-Manville Corp.*, 68 B.R. 618, 636 (Bankr. S.D.N.Y. 1986), *aff’d*, 78 B.R. 407 (S.D.N.Y. 1987), *aff’d*, 843 F.2d 636 (2d Cir. 1988); *accord In re SunEdison, Inc.*, 575 B.R. 220 (Bankr. S.D.N.Y. 2017); *In re 20 Bayard Views, LLC*, 445 B.R. 83 (Bankr. E.D.N.Y. 2011).

Several courts have adopted some form of the unfair discrimination test (the “Markell test”) articulated by Bruce A. Markell in his article *A New Perspective on Unfair Discrimination in Chapter 11*, 72 **AM. BANKR. L.J.** 227, 249 (1998). See, e.g., *Law Debenture Trust Co. of New York v. Tribune Media Co. (In re Tribune Media Co.)*, 587 B.R. 606, 618 (D. Del. 2018); *In re Armstrong World Indus., Inc.*, 348 B.R. 111 (D. Del. 2006); *In re Quay Corp., Inc.*, 372 B.R. 378 (Bankr. N.D. Ill. 2007); *In re Exide Techs.*, 303 B.R. 48 (Bankr. D. Del. 2003). The Markell test was first applied by a bankruptcy court in *In re Dow Corning Corp.*, 244 B.R. 705 (Bankr. E.D. Mich. 1999), *aff’d*

in relevant part, 255 B.R. 445 (E.D. Mich. 2000), *aff'd in part and remanded*, 280 F.3d 648 (6th Cir. 2002).

Under the Markell test, a rebuttable presumption that a plan unfairly discriminates will arise when the following elements exist:

- (1) a dissenting class; (2) another class of the same priority; and (3) a difference in the plan's treatment of the two classes that results in either (a) a materially lower percentage recovery for the dissenting class (measured in terms of the net present value of all payments), or (b) regardless of percentage recovery, an allocation under the plan of materially greater risk to the dissenting class in connection with its proposed distribution.

Id. at 702. The burden then lies with the plan proponent to rebut the presumption by demonstrating that “outside of bankruptcy, the dissenting class would similarly receive less than the class receiving a greater recovery, or that the alleged preferred class had infused new value into the reorganization which offset its gain.” *Id.*

Fair and Equitable

Section 1129(b)(2) of the Bankruptcy Code specifies what is necessary for a plan to be “fair and equitable” with respect to secured claims, unsecured claims, and interests. With respect to a class of unsecured creditors, the plan must provide that either: (i) holders of claims in the rejecting class will receive value, as of the effective date, equal to the allowed amount of their claims; or (ii) holders of claims or interests in a more junior class will not receive or retain any property under the plan on account of their claims or interests. The “fair and equitable” requirement as to unsecured creditors thus includes a form of the “absolute priority rule,” which implicates the Bankruptcy Code’s priority-of-distribution scheme.

THE BANKRUPTCY CODE’S DISTRIBUTION SCHEME

The Bankruptcy Code recognizes a secured creditor’s interest in estate property only to the extent that the value of the underlying collateral is equal to, or greater than, the face amount of the indebtedness. If this is not the case, the creditor will hold a secured claim in the amount of the collateral value and an unsecured claim for the deficiency. Applicable nonbankruptcy law and any agreements between the debtor and its secured creditors (or among such creditors) generally determine the relative priority of secured claims. However, if certain requirements are met, the Bankruptcy Code provides for the creation of priming liens superior to pre-existing liens in connection with financing extended to a debtor during a bankruptcy case.

The priority treatment of certain types of unsecured claims is specified in section 507(a) of the Bankruptcy Code. Priorities are afforded to a wide variety of unsecured claims, including specified categories and (in some cases) amounts of domestic

support obligations, administrative expenses, employee wages, and taxes.

In a chapter 7 case, the order of distribution of unencumbered bankruptcy estate assets is determined by section 726 of the Bankruptcy Code. This order ranges from payments on claims in the order of priority specified in section 507(a), which have the highest ranking, to payment of any residual assets to the debtor, which has the lowest. Distributions are to be made pro rata to claimants of equal ranking within each of the six categories of claims specified in section 726. If claimants in a higher category of distribution receive less than full payment of their claims, lower-category claimants are to receive no distributions.

In a chapter 11 case, the plan determines the treatment of secured and unsecured claims (as well as equity interests) in accordance with the provisions of the Bankruptcy Code. As noted, if a creditor does not consent to impairment of its claim under a plan and votes to reject the plan, the bankruptcy court may confirm the plan only under certain specified conditions. Among these conditions are the following: (i) the creditor must receive at least as much under the plan as it would receive in a chapter 7 case (section 1129(a)(7)), a requirement that incorporates the priority and distribution schemes delineated in sections 507(a) and 726; and (ii) the plan must be “fair and equitable” (i.e., the plan satisfies the absolute priority rule).

CLASS “GIFTING” UNDER CHAPTER 11 PLANS

A matter of considerable debate concerning section 1129(b)’s “fair and equitable” mandate is whether the provision allows a class of senior creditors voluntarily to “gift” a portion of its recovery under a chapter 11 plan to a junior class of creditors or equity holders, while an intermediate class does not receive payment in full. This is sometimes referred to as “vertical gifting” or “class skipping.”

In approving senior-class gifting, some courts rely on the First Circuit’s ruling in *Official Unsecured Creditors’ Comm. v. Stern (In re SPM Manufacturing Corp.)*, 984 F.2d 1305 (1st Cir. 1993). In *SPM*, the First Circuit upheld the validity of a “sharing agreement” under which a substantially undersecured first-priority secured creditor in an administratively insolvent, converted chapter 7 case agreed to gift a portion of the proceeds of the sale of its collateral to general unsecured creditors even though priority tax claims were not paid. Reasoning that the lender was otherwise entitled to the entire amount of any proceeds of the sale of the debtor’s assets, the court wrote that “[w]hile the debtor and the trustee are not allowed to pay nonpriority creditors ahead of priority creditors . . . , creditors are generally free to do whatever they wish with the bankruptcy dividends they receive, including to share them with other creditors.”

Even though *SPM* was a chapter 7 case, some courts have cited the ruling as authority for confirming a nonconsensual chapter 11 plan in which a senior secured creditor assigns a portion of its recovery to creditors (or shareholders) who would

otherwise receive nothing by operation of section 1129(b) and the Bankruptcy Code's priority scheme. See, e.g., *In re MCorp. Financial, Inc.*, 160 B.R. 941 (S.D. Tex. 1993); *In re Journal Register Co.*, 407 B.R. 520 (Bankr. S.D.N.Y. 2009); *In re World Health Alternatives, Inc.*, 344 B.R. 291 (Bankr. D. Del. 2006); *In re Union Fin. Servs. Grp.*, 303 B.R. 390 (Bankr. E.D. Mo. 2003); *In re Genesis Health Ventures, Inc.*, 266 B.R. 591 (Bankr. D. Del. 2001).

Other courts have rejected SPM and the gifting doctrine as being contrary to both the Bankruptcy Code and notions of fairness. See, e.g., *DISH Network Corp. v. DBSD N. Am., Inc.* (*In re DBSD N. Am., Inc.*), 634 F.3d 79 (2d Cir. 2011) (ruling that a class-skipping gift made by an undersecured creditor to old equity under a plan violated the absolute priority rule, but declining to determine whether the creditor, after receiving a distribution under the plan, could in turn distribute a portion of that recovery to old equity "outside the plan").

In *In re Armstrong World Indus., Inc.*, 432 F.3d 507 (3d Cir. 2005), the Third Circuit affirmed an order denying confirmation of a chapter 11 plan under which equity holders would receive warrants waived by one class of unsecured creditors even though another class of unsecured creditors received less than full payment. According to the Third Circuit, if the distribution scheme proposed in the debtor's plan were permitted, it "would encourage parties to impermissibly sidestep the carefully crafted strictures of the Bankruptcy Code, and would undermine Congress's intention to give unsecured creditors bargaining power in this context." However, the Third Circuit did not categorically reject the gifting doctrine. Rather, as noted by the court in *World Health Alternatives*, 344 B.R. at 299, "*Armstrong* distinguished, but did not disapprove of," the gifting doctrine because it left open the possibility that gifts by a senior class under a plan might pass muster under other circumstances.

SETTLEMENTS, STRUCTURED DISMISSALS, AND JEVIC

Most rulings construing the "fair and equitable" requirement in section 1129(b) involve proposals under a chapter 11 plan providing for the distribution of value to junior creditors without paying more senior creditors in full. Even so, the dictates of the absolute priority rule must be considered in other related contexts as well. For example, in *Motorola, Inc. v. Official Comm. of Unsecured Creditors* (*In re Iridium Operating LLC*), 478 F.3d 452 (2d Cir. 2007), the Second Circuit ruled that the most important consideration in determining whether the court should approve a pre-chapter 11 plan settlement of disputed claims as being "fair and equitable" is whether the terms of the settlement comply with the Bankruptcy Code's distribution scheme. In remanding a proposed "gifting" settlement to the bankruptcy court for further factual findings, the Second Circuit reserved the question of whether the gifting doctrine "could ever apply to Chapter 11 settlements." The Second Circuit, however, rejected a per se rule invalidating the practice, such as that adopted by the Fifth Circuit in *United States v. AWECO, Inc.* (*In re AWECO, Inc.*), 725 F.2d 293 (5th Cir. 1984).

Because of the significant time and costs associated with confirming a liquidating chapter 11 plan or converting the case to chapter 7 following the sale of substantially all of a debtor's assets under section 363(b) of the Bankruptcy Code, "structured dismissals" of chapter 11 cases have become a popular mechanism for concluding liquidating chapter 11 cases. A structured dismissal is conditioned upon certain elements agreed to in advance by stakeholders and then approved by the court, as distinguished from an unconditional dismissal of the chapter 11 case ordered by the court under section 1112(b). One such structured dismissal reached the U.S. Supreme Court on appeal from the *Jevic* bankruptcy case.

In *In re Jevic Holding Corp.*, 787 F.3d 173 (3d Cir. 2015), the Third Circuit ruled that "absent a showing that a structured dismissal has been contrived to evade the procedural protections and safeguards of the plan confirmation or conversion processes, a bankruptcy court has discretion to order such a disposition." The court also held that "bankruptcy courts may approve settlements that deviate from the priority scheme of [the Bankruptcy Code]," but only if the court has "specific and credible grounds" to justify the deviation. The Third Circuit affirmed approval of a structured dismissal of a chapter 11 case that incorporated a settlement under which unsecured creditors would receive a distribution from secured creditors' collateral, but certain holders of priority wage claims would receive nothing. According to the court, "dire circumstances" justified the remedy—the debtor had no prospect of confirming a plan, and conversion of the case to chapter 7 would mean that only secured creditors would recover anything.

The U.S. Supreme Court reversed in *Czyzewski v. Jevic Holding Corp.*, 137 S. Ct. 973 (2017). By a vote of 6-2, the Court held that, without the consent of affected creditors, bankruptcy courts may not approve "structured dismissals" providing for distributions that "deviate from the basic priority rules that apply under the primary mechanisms the [Bankruptcy] Code establishes for final distributions of estate value in business bankruptcies."

The Court distinguished cases where courts have approved *interim* settlements that distributed estate assets in violation of the priority rules, such as *Iridium*, from *Jevic*, which involved *final* distributions pursuant to a structured dismissal. The Court found that *Iridium* "does not state or suggest that the Code authorizes nonconsensual departures from ordinary priority rules in the context of a dismissal—which is the final distribution of estate value—and in the absence of any further unresolved bankruptcy issues." In this sense, the Court explained, the situation in *Iridium* is similar to certain "first-day" orders, where courts have allowed for, among other things, payments ahead of secured and priority creditors to employees for prepetition wages or to "critical vendors" on account of their prepetition invoices. However, the Court noted that "in such instances one can generally find significant Code-related objectives that the priority-violating distributions serve." By contrast, the Court explained, the structured dismissal in *Jevic* served no such objectives—it did not benefit disfavored creditors by preserving the debtor as a going concern in order



for the debtor to possibly emerge under a confirmable plan of reorganization.

Nevertheless, the Court wrote, “We express no view about the legality of structured dismissals in general.”

At least one court has invoked *Jevic* in refusing to approve a settlement involving distributions in violation of the Bankruptcy Code’s priority scheme. See *In re Fryar*, 570 B.R. 602 (Bankr. E.D. Tenn. 2017). Until *Nuverra*, however, no court had addressed whether a gifting chapter 11 plan is categorically prohibited by the Supreme Court’s ruling in *Jevic*.

NUVERRA

Nuverra Environmental Solutions, Inc., and certain affiliates (collectively, “NES”) filed a prepackaged chapter 11 case on May 1, 2017, in the District of Delaware with \$500 million in secured debt and a value of approximately \$300 million. NES’s chapter 11 plan proposed a secured debt-for-equity swap as well as distributions to unsecured creditors consisting of: (i) a combination of new stock and cash to unsecured noteholders amounting to a 4 to 6 percent recovery; and (ii) reinstatement and payment in full of trade and certain other business-related unsecured claims (collectively, “trade claims”). Senior secured creditors agreed to fund all payments to unsecured creditors, which otherwise would receive nothing under the plan.

The unsecured noteholder class voted to reject the plan. An unsecured noteholder (“Hargreaves”) objected to confirmation, arguing that: (i) the plan’s proposed treatment of the dissenting unsecured noteholder class was not “fair and equitable,” because

the plan distributed less value to that class than to the trade claim class; and (ii) the plan’s classification scheme was improper.

The bankruptcy court overruled the objection and confirmed the plan. The court determined that separate classification of the noteholder claims and the trade claims was reasonable, because trade creditors were critical to the success of reorganized NES. In addition, the court ruled that, although the disparate treatment of the classes gave rise to a rebuttable presumption of unfair discrimination, that presumption had been rebutted because the noteholder class was “indisputably out of the money and not, otherwise, entitled to any distribution under the [B]ankruptcy [C]ode’s priority scheme[,] and ... the proposed classification and treatment of the unsecured creditors fosters a reorganization of these debtors.” The court also held that the plan satisfied the absolute priority rule, because the secured creditors’ “gift” was not from estate property.

Hargreaves appealed the confirmation order to the district court. The bankruptcy court denied his request to stay the confirmation order beyond the 10-day period specified in the order, finding that he was unlikely to succeed on the merits and would not suffer irreparable harm absent a stay.

THE DISTRICT COURT’S RULING

The district court affirmed. As an initial matter, the court ruled that the appeal was equitably moot. The judge-fashioned remedy of “equitable mootness” bars adjudication of an appeal when a comprehensive change of circumstances has occurred such that it would be inequitable for a reviewing court to address the merits of the appeal. In bankruptcy cases, appellees often invoke

equitable mootness as a basis for precluding appellate review of an order confirming a chapter 11 plan. See, e.g., *In re LCI Holding Company, Inc.*, 802 F.3d 547, 554 (3d Cir. 2015) (stating that the doctrine “comes into play in bankruptcy (so far as we know, its only playground) after a plan of reorganization is approved” and ruling that equitable mootness would not cut off the authority to hear an appeal outside the plan context).

In *Nuverra*, the district court concluded that NES had “substantially consummated” its chapter 11 plan and that the relief sought by Hargreaves—equal distributions to noteholders and trade creditors—would “require undoing the [p]lan” and necessarily result in harm to third parties. Specifically, the court noted, “disgorgement would require the clawback, not only of cash payments made to hundreds of individual creditors, but also the clawback of stock that is trading on the national stock exchange, and may now be held by third parties who purchased these securities in the ordinary course.”

In addition, the district court addressed the merits of the appeal. It ruled that NES’s chapter 11 plan did not unfairly discriminate between the trade creditor and noteholder classes and that the plan’s classification scheme was permissible.

Considering the Markell test for unfair discrimination, the court noted that: (i) the Third Circuit has not mandated that the test be applied in determining whether a plan discriminates unfairly; and (ii) the test does not address a situation in which the disparately treated classes are to receive distributions provided solely by means of a senior-class gift.

Even so, the district court concluded that the bankruptcy court did not err in applying the test. Specifically, the district court found no fault in the bankruptcy court’s holdings that: (i) the presumption of unfair discrimination had been rebutted because the noteholder class was not otherwise entitled to any distribution under the Bankruptcy Code’s priority scheme; and (ii) the plan’s treatment of the trade creditor class fostered NES’s reorganization. Because Hargreaves and his class were not entitled to any distribution in the first place, the court wrote, “providing a greater distribution to a different class of unsecured creditors does not alter the distribution” to which the noteholder class was entitled.

In so ruling, the district court distinguished between vertical and horizontal gifting. It explained that gifting in a manner that skips over an intermediate junior class of dissenting creditors—vertical gifting—violates the absolute priority rule. By contrast, horizontal gifting “concerns unequal gifts by a secured creditor to two classes of junior creditors.” Only the former, the district court emphasized, is foreclosed by Third Circuit precedent, whereas horizontal gifting was expressly sanctioned by the bankruptcy courts in *General Health Ventures* and *World Health Alternatives* and is not foreclosed by the Third Circuit’s ruling in *Armstrong*.

According to the court, nearly all of the cases cited by Hargreaves involved vertical gifting, and the only decision finding horizontal gifting invalid—*In re Sentry Operating Co. of Texas*, 264 B.R. 850 (Bankr. S.D. Tex. 2001)—was both nonbinding and distinguishable. In *Sentry*, the *Nuverra* district court explained, the court held that a plan under which a secured creditor gifted funds to pay trade creditor claims, but provided only a *de minimis* distribution to other unsecured creditors, unfairly discriminated because of conflicts of interest—the debtors’ competitor controlled the secured creditor, and the secured creditor’s corporate parent conducted substantial business with the trade creditors.

Finally, the district court ruled that separate classification of the trade and noteholder claims in NES’s chapter 11 plan was permissible, because there was a rational basis for the classification. The court noted that numerous courts permit the practice “on the grounds that such claims have different legal attributes” (citing *In re Coram Healthcare Corp.*, 315 B.R. 321 (Bankr. D. Del. 2004)). According to the district court, the evidentiary record supported the bankruptcy court’s conclusion that separate classification: (i) fostered NES’s reorganization; (ii) was not arbitrary or fraudulent; and (iii) was necessary to preserve what little trade credit NES still had, because NES’s businesses typically operated in smaller towns with limited vendors and because failing to pay any vendor accordingly would likely tarnish NES’s reputation and harm relationships with other current or potential vendors.

OUTLOOK

Senior-class gifting is an important tool for building consensus on the terms of a confirmable chapter 11 plan. *Nuverra* indicates that horizontal gifting is still alive and well, at least under the facts involved, because it offends neither Third Circuit precedent nor the Supreme Court’s prohibition of final distributions that violate the Bankruptcy Code’s priority scheme. The harder question—i.e., the validity of vertical gifting or other distributions (interim or final) that run afoul of the Bankruptcy Code’s priority scheme but serve a valid reorganizational purpose or another “Code-related objective”—remains for another day. Hargreaves appealed the district court’s ruling on September 19, 2018. Thus, the Third Circuit may have yet another opportunity to weigh in on gifting chapter 11 plans.

Another key takeaway from *Nuverra* is the principle that separate classification and treatment of different groups of general unsecured creditors, even where separate classification of such creditors creates an accepting impaired class needed for cram-down confirmation, violates neither section 1122 nor 1129(b)(2) so long as the plan proponent can articulate a rational basis for separate classification and show that it promotes reorganization.

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On October 29, 2018, **Jones Day** won the “Broken Bench” Award at the National Conference of Bankruptcy Judges’ 92nd Annual Meeting in San Antonio, Texas, for the Best “Cinderella” rescue since the enactment of the Bankruptcy Code in 1978 for its work on behalf of the City of Detroit in its landmark chapter 9 case. The other nominees were the chapter 11 cases of Texaco, Inc.; Marvel Entertainment Group; Macy’s, Inc./Federated Department Stores, Inc.; and General Motors Corp.

Dan T. Moss (Washington) has been selected by the American Bankruptcy Institute as one of its “40 Under 40” honorees for 2018. The ABI received applications from more than 300 individuals representing a large range of firms in the insolvency community. The ABI Steering Committee deliberated for two months before narrowing the list down to 40 honorees.

Corinne Ball (New York) was included in the “Top 50: 2018 Women New York—Metro Super Lawyers List.”

Juan Ferré (Madrid) has been included among the world’s leading Restructuring & Insolvency lawyers by *Who’s Who Legal* for 2019. He has also been listed as a “Notable Practitioner” in the 2019 edition of *IFLR1000*—The Guide to the World’s Leading Financial Law Firms.

Dan B. Prieto (Dallas) has been endorsed as a “Leading Lawyer—Rising Star” in the 2019 edition of *IFLR1000*—The Guide to the World’s Leading Financial Law Firms.

Kevyn D. Orr (Washington) participated in a fireside-chat panel titled “Bankruptcy Five Years Later” at the 5th Anniversary of the Detroit Homecoming, a three-day event held September 12–14, 2018, in Detroit.

Juan Ferré (Madrid) has been selected for inclusion in the 11th Edition of *Best Lawyers* in Spain for his work in the fields of Banking and Finance Law and Insolvency and Reorganization Law. He has also been recognized as a 2019 “Lawyer of the Year” for his work in Insolvency and Reorganization Law in Madrid.

On September 20, 2018, **Kevyn D. Orr (Washington)** served as a panelist at the Ninth Annual D.C. Legal Market Conference in Washington, D.C. The topics of discussion included:

(i) “State of the Market: Growing the Top Line and Bottom Line”; (ii) “Talent—Not Just Recruiting, But Retaining the Best People”; and (iii) “Making Diversity Relevant: New Models of Inclusion.”

An article written by **Mark A. Cody (Chicago)** and **Mark G. Douglas (New York)** entitled “Fifth Circuit Rules That Corporate Charter Provision Requiring Shareholder Consent for Bankruptcy Filing Is Enforceable but Declines to Rule on Validity of ‘Golden Shares’” was posted on the November 6, 2018, *Harvard Law School Bankruptcy Roundtable*.

FIRST IMPRESSIONS: ELEVENTH CIRCUIT RULES THAT EQUITABLE MOOTNESS APPLIES IN CHAPTER 9 CASES

Thomas A. Wilson
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In *Bennett v. Jefferson County, Alabama*, 899 F.3d 1240 (11th Cir. 2018), a panel of the U.S. Court of Appeals for the Eleventh Circuit ruled as a matter of first impression that the doctrine of equitable mootness applies in chapter 9 cases. According to the Eleventh Circuit panel, “[T]he correct result is to join the Sixth Circuit and the Ninth Circuit B.A.P. in allowing equitable mootness to apply in the Chapter 9 context.” The panel held that an appeal filed by county sewer ratepayers of an order confirming a plan of adjustment was equitably moot because the ratepayers failed to seek a stay pending appeal and the plan had been substantially consummated. The panel also concluded that a chapter 9 plan subjecting ratepayers to rate increases over time, “instead of forcing them to bear the financial pain all at once, does not transmogrify it into one that per se violates the ratepayers’ constitutional rights.”

EQUITABLE MOOTNESS

“Mootness” is a doctrine that precludes a reviewing court from reaching the underlying merits of a controversy.

The judge-fashioned remedy of “equitable mootness” bars adjudication of an appeal when a comprehensive change of circumstances has occurred such that it would be inequitable for a reviewing court to address the merits of the appeal. In bankruptcy cases, appellees often invoke equitable mootness as a basis for precluding appellate review of an order confirming a chapter 11 plan. See, e.g., *In re LCI Holding Company, Inc.*, 802 F.3d 547, 554 (3d Cir. 2015) (stating that the doctrine “comes into play in bankruptcy (so far as we know, its only playground) after a plan of reorganization is approved” and ruling that equitable mootness would not cut off the authority to hear an appeal outside the plan context).

The doctrine of equitable mootness is sometimes criticized as an abrogation of federal courts’ “virtually unflagging obligation” to hear appeals within their jurisdiction. *In re City of Detroit, Michigan*, 838 F.3d 792, 805 (6th Cir. 2016) (dissenting opinion), cert. denied sub nom. *Ochadleus v. City of Detroit, Mich.*, 137 S. Ct. 1584 (2017), and cert. denied sub nom. *Quinn v. City of Detroit, Mich.*, 137 S. Ct. 2270 (2017); *In re One2One Commc’ns, LLC*, 805 F.3d 428, 433 (3d Cir. 2015) (citing cases); *In re Charter Commc’ns, Inc.*, 691 F.3d 476, 481 (2d Cir. 2012) (same). According to this view, dismissing an appeal on equitable mootness grounds “should be the rare exception.” *In re Tribune Media Co.*, 799 F.3d 272, 288 (3d Cir. 2015).

STANDARD FOR EQUITABLE MOOTNESS

Several circuit courts of appeals have formally adopted the doctrine of equitable mootness in considering whether to hear appeals of chapter 11 plan confirmation orders. For example, in *In re Manges*, 29 F.3d 1034 (5th Cir. 1994), the Fifth Circuit identified three factors in determining whether the doctrine should moot appellate review of a confirmation order: (i) whether a stay has been obtained; (ii) whether the plan has been “substantially consummated”; and (iii) whether the relief requested would affect either the rights of parties not before the court or the success of the plan. *Id.* at 1039 (citations omitted).

Substantially similar tests for equitable mootness have been adopted by several circuits. See *JPMCC 2007-C1 Grasslawn Lodging, LLC v. Transwest Resort Props., Inc. (In re Transwest Resort Props., Inc.)*, 801 F.3d 1161, 1167–68 (9th Cir. 2015) (applying a four-factor test, including whether the court “can fashion effective and equitable relief without completely knocking the props out from under the plan and thereby creating an uncontrollable situation for the bankruptcy court”); *Search Market Direct, Inc. v. Jubber (In re Paige)*, 584 F.3d 1327, 1339 (10th Cir. 2009) (applying a six-factor test, including: (i) whether the public-policy need for reliance on confirmed bankruptcy plans—and the need for creditors generally to be able to rely on bankruptcy court decisions—would be undermined by reversal of the confirmation order; (ii) the likely impact upon a successful reorganization of the debtor if the appellant’s challenge is successful; and (iii) whether, on the basis of a brief examination of the merits of the appeal, the challenge is legally meritorious or equitably compelling); *In re United Producers, Inc.*, 526 F.3d 942, 947–48 (6th Cir. 2008) (three-factor test); *Nordhoff Invs., Inc. v. Zenith Elecs. Corp.*, 258 F.3d 180, 185 (3d Cir. 2001) (five-factor test, including whether the relief requested would affect the success of the plan, and the public policy of affording finality to bankruptcy judgments); *TNB Fin., Inc. v. James F. Parker Interests (In re Grimland, Inc.)*, 243 F.3d 228, 231 (5th Cir. 2001) (three-factor test); see also *In re Philadelphia Newspapers, LLC*, 690 F.3d 161, 168–69 (3d Cir. 2012) (holding that the foremost consideration is “whether allowing an appeal to go forward will undermine the plan, and not merely whether the plan has been substantially consummated”); *Frito-Lay, Inc. v. LTV Steel Co. (In re Chateaugay Corp.)*, 10 F.3d 944, 952–53 (2d Cir. 1993) (noting that substantial consummation will not moot an appeal if: (i) the court can still order some effective relief; (ii) such relief will not affect the emergence of the debtor as a revitalized entity; (iii) such relief will not unravel intricate transactions so as to knock the props out from under the plan; (iv) the parties adversely affected by the modification have notice of the appeal and an opportunity to participate in the proceedings; and (v) the appellant diligently pursued a stay pending appeal).

A common element of these tests is that the chapter 11 plan has been substantially consummated. Section 1101(2) of the Bankruptcy Code provides that “substantial consummation” of a chapter 11 plan occurs when substantially all property transfers proposed by the plan have been completed, the reorganized



debtor or its successor has assumed control of the debtor's business and property, and plan distributions have commenced.

APPLICATION OF EQUITABLE MOOTNESS IN CHAPTER 9 CASES

Prior to *Jefferson County*, a handful of courts ruled that the doctrine of equitable mootness applies in chapter 9 cases. In *City of Detroit*, the Sixth Circuit concluded that "equitable mootness applies to Chapter 9 cases just as it applies to Chapter 11." 838 F.3d at 805. In so ruling, the court reasoned that equitable mootness likely applies "with greater force to the City's Chapter 9 Plan, which affects thousands of creditors and residents," than it might in a case under any other chapter with far fewer potentially impacted stakeholders. *Id.*

Relying on the district court's (later affirmed) ruling in *City of Detroit*, a Ninth Circuit bankruptcy appellate panel came to the same conclusion in *In re City of Stockton, California*, 542 B.R. 261, 274 (B.A.P. 9th Cir. 2015), noting that "equitable mootness has a legitimate role to play in bankruptcy reorganization cases of all types, chapter 11, chapter 13 and chapter 9." In addition, three other courts have applied it in chapter 9 cases, but with little or no analysis. See *In re City of Vallejo*, 551 Fed. Appx. 339 (9th Cir. 2013) (ruling that a bankruptcy appellate panel properly dismissed appeals of a settlement agreement with a chapter 9 debtor as moot because the appellant did not seek a stay pending appeal and the agreement had been fully executed, rendering the bankruptcy court unable to fashion effective and equitable relief); *In re City of San Bernardino*, 2018 WL 317798 (C.D. Cal. Jan. 4, 2018) (applying the three-part test articulated in *In re Thorpe Insulation Co.*, 677 F.3d 869 (9th Cir. 2012), and ruling that an appeal of an order confirming a chapter 9 plan was equitably

moot); *Alexander v. Barnwell Cnty. Hosp.*, 498 B.R. 550 (D.S.C. 2013) (applying the four-part test articulated in *Mac Panel Co. v. Va. Panel Corp.*, 283 F.3d 622 (4th Cir. 2002), and ruling that an appeal of a chapter 9 plan confirmation order was equitably moot).

JEFFERSON COUNTY

In *Jefferson County*, the Eleventh Circuit considered whether equitable mootness should foreclose an appeal of an order confirming a plan of adjustment in a chapter 9 case.

Jefferson County, Alabama (the "County") filed a chapter 9 petition in 2011 in an effort to restructure \$3.2 billion in sewer-system-related debt. In 2013, the County proposed a chapter 9 plan under which: (i) the proceeds of new publicly marketed sewer warrants would retire the County's old sewer warrants; (ii) sewer-warrant creditors would write off approximately 45 percent of their debt; and (iii) the County would implement a series of rate increases over 40 years that could be reduced only if the County secured an equivalent amount of income from an alternate source.

A group of County ratepayers objected to confirmation of the plan, arguing that: (i) the plan validated corrupt government activity in connection with issuance of the original warrants, which violated the Alabama Constitution and caused the debt crisis; (ii) by preventing County commissioners from adjusting sewer rates, the plan violated Alabama law and infringed on ratepayers' rights to vote and to be free from overly burdensome debt without due process; and (iii) the plan was not feasible because it was imposed over a service area with a declining population and falling income levels.

The bankruptcy court overruled the objections and confirmed the County's chapter 9 plan in November 2013. In its confirmation order, the court retained jurisdiction for the 40-year life of the new sewer warrants to adjudicate any disputes regarding the validity of any actions implemented by the plan. The plan became effective on December 3, 2013, when the County issued the new sewer warrants and distributed the proceeds via clearinghouses to old warrant holders.

The ratepayers filed a notice of appeal of the confirmation order two days prior to the effective date of the plan. However, they neither: (i) objected to a motion filed by the County two weeks previously to waive the 14-day stay of the confirmation order imposed by Fed. R. Bankr. Proc. 3020(e); nor (ii) asked the bankruptcy court or the district court to stay the confirmation order pending appeal.

THE DISTRICT COURT'S RULING

In the district court, the County moved to dismiss the ratepayers' appeal on the basis that it was constitutionally, statutorily, and equitably moot because the plan had been consummated and the transactions implemented by the plan could not be unwound.

The district court concluded that the appeal was not equitably moot because it found the doctrine to be inapplicable to constitutional challenges to a confirmation order in a chapter 9 case. According to the district court, "[A]pplying the doctrine of equitable mootness as the County espouses would prevent both state and federal Article III courts from deciding ... 'knotty state law' and constitutional issues and would prevent any review of a federal bankruptcy court's assumption of jurisdiction to enforce its unreviewed actions."

Even if the doctrine applied in chapter 9, the district court explained, it would not dismiss the ratepayers' appeal because it could grant them some relief by striking the retention of jurisdiction and rate adjustment provisions in the confirmation order. It also noted that the ratepayers' failure to obtain a stay was not dispositive because there had been a rush to consummation, and seeking a stay "was futile and cost-prohibitive."

The district court granted the County's motion for leave to appeal its ruling to the Eleventh Circuit.

THE ELEVENTH CIRCUIT'S RULING

A three-judge panel of the Eleventh Circuit reversed. The panel faulted, among other things, the district court's legal conclusion that equitable mootness does not apply in chapter 9.

Examining the history and application of equitable mootness, the Eleventh Circuit panel explained that the U.S. Supreme Court has never weighed in on its legitimacy, but no court of appeals—including the Eleventh Circuit—has rejected the doctrine outright.

In previous rulings, the panel noted, it identified a number of important considerations bearing on whether the doctrine bars an appeal, including—most important—the extent to which allowing an appeal to proceed would impinge upon actions taken by stakeholders in good-faith reliance on a final and unstayed judgment.

The Eleventh Circuit panel then held as a matter of first impression that, because equitable mootness is "driven by its principles rather than any particular codification or arbitrary limitation ... we see no reason to reject the doctrine" in chapter 9. Indeed, the court wrote that "in ways these principles will sometimes weigh more heavily in the Chapter 9 context precisely because of how many people will be affected by municipal bankruptcies."

The court rejected the ratepayers' argument that because municipal bankruptcies implicate issues of state sovereignty (whereas corporate and individual bankruptcies do not), a court should "tread carefully where self governance is concerned" and refuse to bar an appeal on constitutional grounds in a chapter 9 case under the doctrine of equitable mootness. The Eleventh Circuit panel found that "the mere fact that a potential or actual violation of a constitutional right exists does not generally excuse a party's failure to comply with procedural rules for assertion of the right."

The Eleventh Circuit panel then concluded that equitable mootness barred the ratepayers' appeal because: (i) "critically," the ratepayers never asked any court to stay the implementation of the plan, and seeking a stay or an expedited appeal was not a "fool's errand" because, among other reasons, the bankruptcy court may not have required a bond; (ii) the County and other stakeholders have "taken significant and largely irreversible steps in reliance" on the unstayed confirmation order, including the issuance of more than \$1 billion worth of new publicly traded sewer warrants; and (iii) considering the public interest, the fact "[t]hat a Chapter 9 bankruptcy plan subjects [County] residents ... to rate increases over time, instead of forcing them to bear the financial pain all at once, does not transmogrify it into one that per se violates the ratepayers' constitutional rights."

OUTLOOK

Chapter 9 of the Bankruptcy Code strikes a sometimes precarious balance between the bankruptcy policy of facilitating the restructuring of a debtor's obligations in a binding plan of adjustment and constitutional concerns that serve as a bulwark against the erosion of state sovereignty through a federal court's intrusion on municipal prerogatives. Even so, in *Jefferson County*, the Eleventh Circuit joined the Sixth Circuit and the Ninth Circuit bankruptcy appellate panel in concluding that, although important, those constitutional concerns do not prevent a bankruptcy court from concluding that an appeal of an order confirming a chapter 9 plan is equitably moot under appropriate circumstances.

IN BRIEF: DELAWARE AND NEW YORK DISTRICT COURTS AFFIRM CONSTITUTIONAL AUTHORITY TO GRANT NONCONSENSUAL RELEASES IN CHAPTER 11 PLAN

On September 21, 2018, the U.S. District Court for the District of Delaware affirmed a bankruptcy court's ruling that it had the constitutional authority to grant nonconsensual third-party releases in an order confirming the chapter 11 plan of laboratory testing company Millennium Lab Holdings II, LLC ("Millennium"). See *Opt-Out Lenders v. Millennium Lab Holdings II, LLC (In re Millennium Lab Holdings II, LLC)*, 2018 WL 4521941 (D. Del. Sept. 21, 2018). In so ruling, the court rejected an argument made by a group of creditors that a provision in Millennium's plan releasing racketeering claims against the debtor's former shareholders was prohibited by the U.S. Supreme Court's 2011 ruling in *Stern v. Marshall*, 564 U.S. 462 (2011), which limited claims that can be finally adjudicated by a bankruptcy judge. The court concluded that *Stern* does not apply because the "operative proceeding" before the court was a chapter 11 plan confirmation proceeding rather than litigation of the racketeering claims.

Less than three weeks afterward, the U.S. District Court for the Southern District of New York reached the same conclusion in *Lynch v. Lapidem Ltd. (In re Kirwan Offices SARL)*, 2018 WL 5095675 (S.D.N.Y. Oct. 10, 2018). In affirming an order confirming a cramdown chapter 11 plan that enjoined arbitration of claims over whether the bankruptcy filing was authorized, the court ruled that "[a] bankruptcy court acts pursuant to its core jurisdiction when it considers the involuntary release of claims against a third-party, non-debtor in connection with the confirmation of a proposed plan of reorganization, which is a statutorily defined core proceeding."

MILLENNIUM

The bankruptcy court confirmed Millennium's chapter 11 plan in December 2015. The plan released claims against various non-debtor entities, including Millennium's former shareholders, who contributed \$325 million to the estate, in part to fund a settlement with federal regulators.

A group of creditors led by Voya Investment Management ("Voya"), which asserted racketeering claims against the shareholders, objected to confirmation. Voya contended, among other things, that the court did not have subject matter jurisdiction to grant nonconsensual third-party releases and that the plan releases did not satisfy the test set forth in the Third Circuit's decision in *Gillman v. Continental Airlines (In re Continental Airlines)*, 203 F.3d 203 (3d Cir. 2000). That decision requires specific factual findings that proposed releases are fair and necessary to a reorganization.

The court overruled the objections, and Voya appealed the confirmation order. It argued on appeal, among other things, that the bankruptcy court lacked authority to grant the releases under *Stern* because barring the racketeering claims was tantamount to adjudicating them, which is outside a bankruptcy court's constitutional jurisdiction. Persuaded that releasing Voya's claims might be tantamount to adjudicating them and that *Stern's* constitutional limitations should apply as much to plan confirmation as to any other bankruptcy-related proceeding, the district court remanded the constitutionality issue to the bankruptcy court.

The Bankruptcy Court's Ruling on Remand

On remand, the bankruptcy court rejected Voya's "expansive reading of *Stern*, which not only applies *Stern* outside of the narrow context in which it was made, but far beyond the holding of any court." In *Stern*, the Supreme Court articulated a "disjunctive test" for whether a bankruptcy court can enter a final order on a trustee's counterclaim: "Congress may not bypass Article III [of the U.S. Constitution] simply because a proceeding may have some bearing on a bankruptcy case; the question is whether the action at issue stems from the bankruptcy itself *or* would necessarily be resolved in the claims allowance process." *Stern*, 564 U.S. at 499 (emphasis added). The Court ruled that a bankruptcy court cannot enter a final judgment on a state law counterclaim of the bankruptcy estate that is not resolved in the process of ruling on a creditor's proof of claim.

According to the bankruptcy court on remand in *Millennium*:

Stern did not hold, as Voya suggests, that regardless of which articulated (or unarticulated) core proceeding is before the court, the bankruptcy judge cannot, consistent with the Constitution, enter a final order in that proceeding if that order affects a party's entitlement to have a debtor's or trustee's state law claim heard by an Article III court.

The court also stated that Voya's *Stern*-based argument was misplaced because, among other reasons, the racketeering claims were federal and, although the releases undeniably "impacted" the racketeering claims, they did not actually adjudicate them, but were part of a settlement that would give the shareholders an affirmative defense in any racketeering litigation.

In addition, the bankruptcy court ruled that, even if it were to apply *Stern's* disjunctive test to a plan confirmation proceeding, the test would be satisfied because: (i) the chapter 11 plan and the releases "stem from the bankruptcy case"; and (ii) the releases were integral to confirmation and integral to the restructuring of the debtor-creditor relationship, thus being "necessarily resolved" in the confirmation process, the process of restructuring the debtor-creditor relationship, and the claims allowance process.



The bankruptcy court emphasized that Voya's interpretation of *Stern* would "dramatically change the division of labor between the bankruptcy and district courts." It explained that, without consent, which could be withheld as leverage, district courts would be compelled to enter final orders approving a wide range of relief traditionally granted by bankruptcy courts, including orders approving free-and-clear asset sales under section 363 of the Bankruptcy Code, substantive consolidation, and the recharacterization or subordination of claims.

Voya appealed the ruling.

The District Court's Ruling in Millennium

The district court affirmed. It agreed with the bankruptcy court that *Stern* did not address any context other than counterclaims or "announce a broad holding addressing every facet of the bankruptcy process." The district court also agreed that plan confirmation was the "operative proceeding" and that *Stern* does not require application of the disjunctive test in that context.

Finally, the district court did not fault the bankruptcy court's conclusion that approval of the chapter 11 plan releases did not amount to adjudication on the merits of Voya's racketeering claims. Like the bankruptcy court, the district court noted that Voya's position was at best "a substantive argument against third party releases, not an argument that confirmation orders containing releases must be entered by a district court."

KIRWAN

Kirwan Offices S.a.r.l. ("Kirwan") is a Luxembourg entity established as a special investment vehicle for the purpose of acquiring a subsidiary of Yukos Oil Company. In 2016, Kirwan's majority shareholders (who were also creditors) filed an involuntary

chapter 11 petition against Kirwan in the U.S. Bankruptcy Court for the Southern District of New York.

A minority shareholder opposed the filing. He argued that the court should dismiss or abstain from hearing the case so that he could pursue arbitration in London of a dispute over the majority shareholders' rights under a shareholders' agreement to file the involuntary bankruptcy case. The bankruptcy court ruled that majority shareholders had the authority to file the case in their capacity as creditors and that dismissal or abstention was not warranted because the dispute regarding the alleged breach of the shareholders' agreement was within the court's "core" jurisdiction. The minority shareholder did not appeal.

In 2017, the bankruptcy court confirmed a chapter 11 plan for Kirwan proposed by the majority shareholders. The plan included a nonconsensual, third-party release prohibiting the minority shareholder from initiating arbitration in London for the purpose of establishing that the majority shareholders breached the shareholders' agreement by filing Kirwan's chapter 11 case.

The minority shareholder did not object to the plan. However, he appealed the confirmation order, arguing that the bankruptcy court lacked jurisdiction and the constitutional power to enjoin subsequent litigation of nonbankruptcy claims under the shareholders' agreement.

The District Court's Ruling in Kirwan

The district court affirmed. Initially, the court noted that "involuntary releases of third-party, non-debtor claims that are entered by bankruptcy courts are subject to considerable scrutiny," but that a majority of circuit courts—including the U.S. Court of Appeals for the Second Circuit—"permit them, but only if they meet certain conditions."

In addition, the district court observed that there “is no consensus among the courts holding the majority view” about the jurisdictional basis for third-party releases. Some courts, the district court explained, including the Third and Fifth Circuit Courts of Appeals, “posit that the only jurisdictional basis for a bankruptcy court to extinguish third-party claims permanently is through an exercise of non-core jurisdiction.” Other courts, including the U.S. Court of Appeals for the D.C. Circuit and the district court in *Millennium*, have concluded that “when involuntary third-party releases are considered in connection with confirmation proceedings, bankruptcy courts act pursuant to their core jurisdiction.”

The *Kirwan* district court sided with the latter view. It ruled that “[a] bankruptcy court acts pursuant to its core jurisdiction when it considers the involuntary release of claims against a third-party, non-debtor in connection with the confirmation of a proposed plan of reorganization, which is a statutorily defined core proceeding. 28 U.S.C. § 157(b)(2)(L).”

Like the district court in *Millennium*, the *Kirwan* district court concluded that approving a nonconsensual, third-party release “does not address the merits of the claims being released.” The court reasoned that an “incidental effect on claims beyond the scope of the immediate bankruptcy proceeding does not render the bankruptcy court’s jurisdiction non-core.” Instead, the court wrote, the “involuntary third-party releases merely extinguish those claims as part of a core bankruptcy process” of confirming a plan within the strictures of sections 1123 and 1129 of the Bankruptcy Code.

The district court rejected the argument that third-party injunctions would give bankruptcy courts a “blank check” to exercise “infinite jurisdiction.” It would be constitutionally improper, the court noted, to confirm a plan with third-party releases that were “unrelated (or even tangentially related) to the debtor or the bankruptcy case.” Instead, a nonconsensual third-party release “must be sufficiently related to the issues before the bankruptcy court in order for core jurisdiction to cover an order extinguishing that claim.”

Approval of the injunction as part of *Kirwan*’s chapter 11 plan, the district court emphasized, was within the bankruptcy court’s core jurisdiction because it prevented the minority shareholder from collaterally attacking the confirmation order through arbitration in London.

The district court also held that *res judicata* precluded the minority shareholder from attacking the plan releases because the minority shareholder did not appeal the bankruptcy court’s earlier ruling that the dispute regarding the shareholders’ agreement was core and therefore within the final adjudicatory power of the bankruptcy court.

Finally, the district court ruled that, even if approval of the plan releases was not within the bankruptcy court’s core jurisdiction, the minority shareholder impliedly consented to final adjudication by the bankruptcy court by participating in the proceedings below without raising the constitutional issue.

FROM THE TOP: SUPREME COURT AGREES TO CONSIDER IMPACT OF TRADEMARK LICENSE AGREEMENT REJECTION IN BANKRUPTCY

On October 26, 2018, the U.S. Supreme Court granted a writ of certiorari in *Mission Products Holdings, Inc. v. Tempnology, LLC*, No. 17-1657, 2018 WL 2939184 (U.S. Oct. 26, 2018). In granting the petition, the Court agreed to consider whether, under section 365 of the Bankruptcy Code, a debtor-licensor’s rejection of a trademark license agreement, which constitutes a breach of such a contract under section 365(g), “terminates rights of the licensee that would survive the licensor’s breach under applicable non-bankruptcy law.” This question, arising out of a 1988 amendment to the Bankruptcy Code, has recently split the circuits.

In *Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc.* (*In re Richmond Metal Finishers, Inc.*), 756 F.2d 1043 (4th Cir. 1985), the U.S. Court of Appeals for the Fourth Circuit held that, if a debtor rejects an executory intellectual property license, the licensee loses the right to use any licensed copyrights, trademarks, and patents. In 1988, in response to the ruling, Congress amended the Bankruptcy Code to add section 365(n), which permits licensees of “intellectual property” to continue using licensed property under certain circumstances. However, those protections do not expressly extend to trademark licensees because the Bankruptcy Code’s definition of “intellectual property” does not include trademarks. For this reason, courts have disagreed about the impact of rejection of a trademark license in bankruptcy.

Some courts, including the Seventh Circuit, have ruled that rejection of a trademark license does not necessarily mean that the licensee cannot continue to use the licensed trademarks. See *Sunbeam Products, Inc. v. Chicago Am. Manuf., LLC*, 686 F.3d 372 (7th Cir. 2012); *In re SIMA Int’l, Inc.*, 2018 WL 2293705 (Bankr. D. Conn. May 17, 2018); *In re Crumbs Bake Shop, Inc.*, 522 B.R. 766 (Bankr. D.N.J. 2014).

The First Circuit held to the contrary in *Mission Products Holdings, Inc. v. Tempnology, LLC* (*In re Tempnology, LLC*), 879 F.3d 389 (1st Cir. 2018), ruling that the omission of trademarks from the scope of section 365(n) means that a trademark licensee is stripped of any continuing right to use a licensed trademark upon rejection of the license agreement. *Accord In re HQ Glob. Holdings, Inc.*, 290 B.R. 507 (Bankr. D. Del. 2003).

By agreeing to review the First Circuit’s ruling, the Supreme Court will have an opportunity to resolve the circuit split on this issue.

The Court declined to review the second question presented by the *Tempnology* petition—namely, whether an exclusive right to sell certain products “practicing a patent” in a particular geographic territory is a “right to intellectual property” within the meaning of section 365(n) of the Bankruptcy Code.

PROPOSED AMENDMENTS TO CHAPTER 15 OF THE BANKRUPTCY CODE

On August 20, 2018, the National Bankruptcy Conference (the “NBC”) submitted a letter (the “Letter”) to representatives of the House Subcommittee on Regulatory Reform and the House Committee on the Judiciary that proposed certain technical and substantive amendments to chapter 15 of the Bankruptcy Code. Chapter 15, which is patterned on the 1997 UNCITRAL Model Law on Cross-Border Insolvency (the “Model Law”), was enacted in 2005 and establishes procedures governing cross-border bankruptcy and insolvency proceedings. To date, the Model Law has been enacted by the U.S. and 44 countries, plus two overseas territories of the United Kingdom.

The NBC is a voluntary, nonpartisan, not-for-profit organization composed of approximately 60 of the nation's leading bankruptcy judges, professors, and practitioners. It has provided advice to Congress on bankruptcy legislation for 80 years. Certain of the proposed amendments are summarized below.

Applicability of Chapters. Section 103(a) of the Bankruptcy Code provides that chapters 1, 3, and 5 apply in chapter 7, 11, 12, and 13 cases and that chapter 1 and certain specified provisions of chapters 3 and 5 apply in chapter 15 cases. The Letter recommends that the list of provisions applicable to chapter 15 cases be expanded to more specifically include sections 305 (abstention); 306 (limited appearance); and 556, 560, 561, and 562 (safe harbors for and timing of measure of damages under commodities contracts, forward contracts, swap agreements, and master netting agreements) to avoid the possibility that, under the “plain meaning” approach, these provisions might be held to be inapplicable to chapter 15 cases.

Section 103(k) limits the applicability of the provisions of chapter 15 to chapter 15 cases, with the exception of sections 1505 (court may authorize trustee to act on behalf of bankruptcy estate in foreign country), 1513 (giving foreign creditors access to a U.S. bankruptcy case), and 1514 (foreign creditor notification requirements), which apply in all bankruptcy cases, and section 1509 (foreign representatives’ right to access U.S. courts), which applies whether or not a case under any chapter is pending.

The Letter recommends that the list of provisions applicable in all cases be expanded to include sections 1511 (authorizing foreign representative to commence case under another chapter after chapter 15 recognition), 1523 (giving foreign representative trustee’s avoidance and strong-arm powers in case filed under another chapter), 1531 (creating presumption that foreign debtor is insolvent for purposes of involuntary bankruptcy filing), and

1532 (prohibiting double payments on same claim in concurrent U.S. and non-U.S. bankruptcy cases).

The Letter also recommends that the list of provisions applicable whether or not a U.S. bankruptcy case is pending be augmented to include section 1510, which provides that a foreign representative’s filing of a chapter 15 petition for recognition does not subject the foreign representative to the jurisdiction of any U.S. court for any other purpose.

Eligibility for Chapter 15 Filing. 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 this title.” Even though section 1517 sets forth the requirements for recognition of a foreign bankruptcy proceeding under chapter 15, some courts have held that section 109(a) must also be satisfied for a foreign debtor to be eligible for chapter 15 relief. The NBC has taken the position that this is incorrect and recommends in the Letter that section 109(a) be amended to provide that it “does not apply in a case under chapter 15.”

Involuntary Bankruptcy Filing by Foreign Representative. The Letter recommends that section 303(b)(4) of the Bankruptcy Code be amended to eliminate a drafting inconsistency created by the 2005 amendments by clarifying that, upon recognition of a foreign proceeding under chapter 15 and consistent with section 1511, a foreign representative may file an involuntary chapter 7 or chapter 11 case against an eligible debtor.

Abstention and Dismissal. Section 305 of the Bankruptcy Code provides that a foreign representative may seek dismissal or suspension of a recognized foreign proceeding if “the purposes of chapter 15 ... would be best served by” dismissal or suspension. The Letter proposes that “there should be a clear statutory basis for the dismissal of cases involving debtors whose center of main interests [“COMI”] is outside of the United States when those cases either conflict with the purposes of chapter 15 or involve a debtor or assets over which the court does not have effective control.” The Letter accordingly recommends that section 305(a) be revised to include a new subsection, which would state: “[T]he debtor’s center of main interests is not the United States and the court cannot exercise effective control over either the debtor or the debtor’s material assets.”

Limited Appearance. Section 306 of the Bankruptcy Code provides that a foreign representative’s appearance in a U.S. bankruptcy court in connection with a petition or request under section 303 (involuntary



bankruptcy filing) or section 305 (abstention or dismissal) does not subject the foreign representative to a U.S. court's jurisdiction for any other purpose. The Letter recommends that the provision be amended to include sections 301 (voluntary bankruptcy filing) and 302 (joint bankruptcy filings).

Date for Determining Center of Main Interests. A growing number of court decisions have determined that a foreign debtor's COMI should be determined as of the date of the filing of its chapter 15 petition for recognition in the U.S. rather than the date upon which its foreign proceeding was commenced. The NBC takes the position that this is contrary to the Model Law and a recent revision to the Model Law's Guide to Enactment, both of which measure COMI as of the date of the commencement of the foreign proceeding. The Letter accordingly recommends that sections 1502(a)(4) and (5) and 1517(b) be amended to provide that COMI is to be determined as of the date of commencement of the debtor's foreign proceeding. If adopted, such a change would likely impede the ability of foreign provisional liquidators to effectuate "COMI shifting" or "COMI migration."

Venue of Cases Commenced Under Other Chapters.

The Letter recommends that section 1511 of the Bankruptcy Code and 28 U.S.C. § 1408 (specifying venue requirements for bankruptcy cases) be amended to provide that, upon recognition of a foreign proceeding under chapter 15, the foreign representative may commence an involuntary case under chapter 303 or a voluntary case under section 301 or 302 in the court presiding over the foreign debtor's chapter 15 case.

Abstention. Certain courts have held that section 305 of the Bankruptcy Code (providing that a bankruptcy

court may dismiss or suspend proceedings in a chapter 15 case if doing so best serves the purposes of chapter 15) does not apply in chapter 15 cases because it conflicts with 28 U.S.C. § 1334(c), which excepts from a U.S. federal court's permissive abstention powers "a case under chapter 15." The NBC takes the position that this was not the intent of the drafters of chapter 15. The Letter accordingly recommends that 28 U.S.C. § 1334(c) be amended to limit the provision "to its original narrowly intended purpose of assuring that chapter 15 petitions, as applications for recognition, must be heard and granted or denied" and to clarify that the provision was not intended to prevent abstention from proceedings "arising in" or "arising under" chapter 15 cases.

Avoidance of Transfers and Recovery of Property.

Due to drafting oversights, the Letter recommends that, consistent with the Model Law:

- Section 1520 be amended to clarify that, upon recognition of a foreign main proceeding: (i) section 552 (limiting the postpetition effect of security interests) automatically applies; (ii) the debtor may not transfer, encumber, or otherwise dispose of its U.S. assets; (iii) section 363 (governing the use, sale, or lease of the debtor's property) automatically applies to transfers of the debtor's U.S. assets by the foreign representative; and (iv) unless the court orders otherwise, the foreign representative may operate the debtor's business and exercise the rights and powers of a trustee under sections 363 and 553 (governing setoff).

Section 1521 be amended to clarify that, upon recognition of a foreign main or nonmain proceeding, the bankruptcy court has the discretion to authorize the foreign representative to recover transfers under section 550 in enforcing section 549 (prohibiting unauthorized postpetition transfers) or section 553 (setoffs).

The definition of "foreign representative" in section 101(24) be amended to provide that the foreign representative acts as a "trustee" in exercising avoidance or recovery powers under chapter 15.

Section 1523 be amended to clarify that the look-back period for avoidance proceedings brought under U.S. law by or on behalf of a foreign representative should be measured from the date of the filing of the foreign proceeding.

These proposed changes, some of which are controversial, are also being studied by other bankruptcy-related organizations, including the International Insolvency Institute and the American College of Bankruptcy.

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