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Secured Creditor May Choose to Take No Action During Chapter 11 Case Without Hazarding Lien Stripping

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In Acceptance Loan Co., Inc. v. S. White Transp., Inc., the U.S. Court of Appeals for the Fifth Circuit ruled that the level of participation necessary to trigger extinguishment of a lien under Section 1141(c) “requires more than mere passive receipt of effective notice” of the Chapter 11 case.

The authors of this article discuss the case, noting that the ruling is a cautionary tale for plan proponents intent upon ensuring that the terms of a Chapter 11 plan providing for the treatment of secured creditor claims are binding.

A long-standing legal principle is that liens pass through bankruptcy unaffected. Like every general rule, however, this tenet has exceptions. One of them can be found in Section 1141(c) of the Bankruptcy Code, which provides that, under certain circumstances, “property dealt with by [a Chapter 11] plan is free and clear of all claims and interests of creditors.” Although the language of the provision is unambiguous, several courts have added a judicial gloss by requiring the creditor to “participate in the reorganization” as a prerequisite to the application of Section 1141(c).

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Precisely what constitutes “participation,” however, is an unsettled question. This controversial issue was recently addressed by the U.S. Court of Appeals for the Fifth Circuit. In *Acceptance Loan Co., Inc. v. S. White Transp., Inc.*,¹ the Fifth Circuit ruled that the level of participation necessary to trigger extinguishment of a lien under Section 1141(c) “requires more than mere passive receipt of effective notice” of the Chapter 11 case. The ruling is a cautionary tale for plan proponents intent upon ensuring that the terms of a Chapter 11 plan providing for the treatment of secured creditor claims are binding.

EFFECT OF BANKRUPTCY ON SECURED CLAIMS

The general rule that a bankruptcy filing by a borrower does not affect the enforceability of a security interest in collateral has been part of U.S. bankruptcy jurisprudence for well over a century.²

The Bankruptcy Code contains certain exceptions to this default rule.³ For example, Section 1141(c) provides as follows:

Except as provided in subsections (d)(2) [debts of individual debtors excepted from discharge under section 523] and (d)(3) [denial of discharge for liquidating corporations] of this section and except as otherwise provided in the plan or in the order confirming the plan, after confirmation of a plan, the property dealt with by the plan is free and clear of all claims and interests of creditors, equity security holders, and of general partners in the debtor.

With respect to liens and security interests, Section 1141(c) means that “unless the plan of reorganization, or the order confirming the plan, says that a lien is preserved, it is extinguished by the confirmation.”⁴

The draconian impact of lien stripping pursuant to a plan has led a number of (principally appellate) courts to add a judicial gloss to Section 1141(c) requiring the secured creditor to “participate[] in the reorganization” before its lien will be deemed extinguished. This approach is consistent with Section 506(d) of the Bankruptcy Code, which preserves a lien that would be voided as a consequence of disallowance of a claim if, among other things, the claim

was disallowed only because the creditor failed to file a proof of claim.

In *Penrod* — apparently the first court to add the participation gloss to Section 1141(c) — the debtor’s Chapter 11 plan made provision for payment of a secured claim, but neither the plan nor the order confirming it provided whether the lien would be extinguished. Acknowledging the “old saw” that liens pass through bankruptcy unaffected, the Seventh Circuit nevertheless concluded that “when lienholders participate in a bankruptcy proceeding, and especially in a reorganization, they know that their liens are likely to be affected, and indeed altered.” It ruled that liens are “interests” covered by Section 1141(c) and that “unless the plan of reorganization, or the order confirming the plan, says that a lien is preserved, it is extinguished by the confirmation...[,] provided, we emphasize, that the holder of the lien participated in the reorganization.”

In *Elixir Indus., Inc. v. City Bank & Trust Co.*,⁵ the Fifth Circuit held that four conditions must be met for a lien to be voided under Section 1141(c):

- the plan must be confirmed;
- the collateral must be dealt with by the plan;
- the lien holder must participate in the reorganization; and
- the lien must not be preserved under the plan.

Other courts have similarly required secured creditor participation in the case as a condition to lien extinguishment under Section 1141(c).⁶

Although the four-part *Ahern* test has been adopted in one form or another by many other courts, relatively few courts have examined the “participation” element of the test.⁷ The Fifth Circuit added to this slim body of bankruptcy jurisprudence in *White Transportation*.

WHITE TRANSPORTATION

S. White Transportation (“SWT”) is a freight-shipping and trucking company based in Gulfport, Mississippi. In 2004, Acceptance Loan Co. (“Acceptance”) perfected a lien on SWT’s principal asset, an office building in Saucier, Mississippi, as security for a promissory note in the amount of ap-

proximately \$98,000. Three other creditors later perfected liens on the same property.

SWT disputed the validity of the deed of trust underlying Acceptance's secured claim, contending that it was invalid due to a lack of authority by the individuals who executed the deed on SWT's behalf. Five years of state-court litigation failed to resolve the dispute.

SWT filed for Chapter 11 protection in Mississippi on May 17, 2010. In its schedules, SWT listed Acceptance's claim and lien as "disputed" but acknowledged the validity of the remaining secured claims and liens against the office building. Acceptance never filed a proof of claim or otherwise became involved in the bankruptcy case.

SWT filed a Chapter 11 plan providing for no recovery with respect to Acceptance's disputed claim. The plan stated that Acceptance failed to file a proof of claim and that SWT contested the validity of Acceptance's purported lien. The bankruptcy court confirmed the plan on December 21, 2010.

On January 4, 2011, Acceptance sought an order of the bankruptcy court declaring that Acceptance's lien survived confirmation or, in the alternative, amending the confirmation order to provide for Acceptance's lien. The court denied the motion and ruled that confirmation of SWT's plan voided any lien which Acceptance held pursuant to Section 1141(c). According to the court, Acceptance had "participated" in the case by receiving notice of SWT's Chapter 11 case. The district court reversed on appeal, holding that mere receipt of notice does not constitute participation within the meaning of the Fifth Circuit's ruling in *Ahern*. SWT appealed to the Fifth Circuit.

THE FIFTH CIRCUIT'S RULING

A three-judge panel of the Fifth Circuit affirmed the district court's decision. The court framed the dispute before it as "whether Acceptance's passive receipt of notice constitutes participation within the meaning of [the] test" stated in *Ahern*. It ruled that passive receipt of notice does not constitute participation.

"[P]articipation," the Fifth Circuit explained, "connotes activity, and not mere nonfeasance," consistent with the definition contained in *Black's Law Dictionary* as well as the U.S. Supreme Court's ruling in *Nat'l Fed'n of*

Indep. Bus. v. Sebelius.⁸ Moreover, the Fifth Circuit emphasized, at least two rulings from the circuit courts of appeal — *Penrod* and *Be-Mac* — addressing similar issues have required more than notice.

While acknowledging that the bankruptcy court in *Regional Bldg. Systems* stated a contrary rule, the Fifth Circuit emphasized that the opinion of the Fourth Circuit affirming that decision “makes clear that at issue was a secured creditor that had involved itself extensively in the bankruptcy proceedings, [by] filing a proof of claim, serving on an unsecured creditors’ committee, and discussing its putative secured claim with that committee’s counsel.” According to the Fifth Circuit in *White Transportation*, “We have been unable to find any case voiding a lien in the face of *no involvement* by a secured creditor other than the passive receipt of notice.”

In a footnote, the Fifth Circuit rejected SWT’s argument that the U.S. Supreme Court’s ruling in *United Student Aid Funds v. Espinosa*⁹ militates in favor of notice alone being sufficient. In *Espinosa*, the Supreme Court held that under Federal Rule of Civil Procedure 60(b)(4), a student-loan provider was not entitled to relief from a bankruptcy-court order confirming a Chapter 13 plan which discharged the debtor’s student-loan debt even though the bankruptcy court made no finding of “undue hardship” in an adversary proceeding, as required by Section 523(a)(8) of the Bankruptcy Code and Federal Rule of Bankruptcy Procedure 7001(6). In affirming a ruling by the Ninth Circuit, the court concluded that although the bankruptcy court’s failure to find undue hardship was a legal error, given the Bankruptcy Code’s clear and self-executing requirement for an undue-hardship determination, the confirmation order was enforceable and binding on the lender because it had actual notice of the error and failed to object or timely appeal.

In *White Transportation*, the Fifth Circuit distinguished *Espinosa* on the basis that the case dealt with a Rule 60(b) motion for relief from a final judgment rather than the level of participation required for lien stripping under Section 1141(c). According to the Fifth Circuit, the *Espinosa* court held that “a mere procedural flaw was not a ground to void a judgment under Rule 60(b)’s high bar, which requires there to have been either a jurisdictional defect or due process violation underlying the judgment.” Because the case before it did not implicate due process under Rule 60(b), the Fifth Circuit wrote, “*Espinosa* is therefore wholly inapposite.”

OUTLOOK

White Transportation is undeniably a positive development for secured creditors. The ruling means that a secured creditor cannot be stripped of its lien under Section 1141(c), even if it receives notice of a Chapter 11 case and deliberately ignores the case plan and the plan process, unless the creditor actively participates in the case by, among other things, filing a proof of claim. The ruling appears to signal that in the Fifth Circuit, absent participation by the secured creditor, a plan proponent will not be permitted to modify or avoid the creditor's lien solely through the plan-confirmation process, but instead will be required to affirmatively object to the secured claim or initiate an adversary proceeding to challenge the lien.¹⁰

The decision presents several issues going forward. First, Section 1141(c) does not make any mention of a participation requirement as a condition to lien stripping under a Chapter 11 plan. As such, the Fifth Circuit's opinion arguably is inconsistent with the U.S. Supreme Court's repeated admonition that provisions of the Bankruptcy Code should be interpreted in accordance with their plain meaning without any of the "judicial glosses" applied by the Fifth Circuit and other courts in this and similar cases.¹¹ In the past, the Fifth Circuit has rejected such enhancements of the plain meaning of other provisions of the Bankruptcy Code.¹²

Second, and closely related, is the fact that the Fifth Circuit's dismissal of *Espinosa* as inapposite is premised on the judicial gloss it places on Section 1141(c). Both cases involved whether the terms of a confirmed plan (albeit a Chapter 13 plan in *Espinosa*) bind a lender who had actual notice of the plan and the bankruptcy case and failed to object to the plan. In *Espinosa*, finding that the creditor's receipt of actual notice of the bankruptcy filing and the plan satisfied due process, the court ruled that the plan was binding on the secured creditor. In *White Transportation*, the Fifth Circuit ruled that the plan was not binding on the creditor even though it also received actual notice of the bankruptcy and the plan. Reconciling these disparate results is difficult without interpreting Section 1141(c) as requiring more due process than other contexts as a condition to lien stripping.

Finally, *White Transportation* leaves open how a Chapter 11 debtor should address a disputed lien where the secured creditor voluntarily refrains from participating in the case. The utility of Chapter 11 could be compromised

if every secured creditor could opt to wait in the wings during the case and proceed to exercise its remedies in a more favorable forum after confirmation of a plan that, under the *White Transportation* ruling, would leave the creditor's claim unfettered. A debtor or trustee could attempt to forestall this tactic by filing a proof of claim on behalf of the secured creditor (as permitted by Section 501(c)) and then objecting to the claim, or by filing an adversary proceeding "to determine the validity, priority, or extent of a lien," as specified in Bankruptcy Rule 7001(2). Presumably, a court would not permit a secured creditor to evade the claim-adjudication process by voluntarily deciding not to respond to such litigation.¹³

The Fifth Circuit's silence on this issue in *White Transportation*, however, leaves open for another day whether the mantra that liens pass through bankruptcy unaffected means that a secured creditor can entirely opt out of the Chapter 11 process without jeopardizing its lien.

NOTES

¹ *Acceptance Loan Co., Inc. v. S. White Transp., Inc. (In re S. White Transp., Inc.)*, 2013 BL 207801 (5th Cir. Aug. 5, 2013).

² *See Long v. Bullard*, 117 U.S. 617 (1886); *accord Dewsnup v. Timm*, 502 U.S. 410, 417 (1992) ("the creditor's lien stays with the real property until the foreclosure"); *Farrey v. Sanderfoot*, 500 U.S. 291, 297 (1991) ("Ordinarily, liens and other secured interests survive bankruptcy."); *Johnson v. Home State Bank*, 501 U.S. 78, 84 (1991) ("[A] bankruptcy discharge extinguishes only one mode of enforcing a claim—namely, an action against the debtor *in personam*—while leaving intact another—namely, an action against the debtor *in rem*.").

³ *See, e.g.*, 11 U.S.C. §§ 1141(c), 1227(c), and 1327(c)).

⁴ *In re Penrod*, 50 F.3d 459, 463 (7th Cir. 1995); *accord JCB, Inc. v. Union Planters Bank, NA*, 539 F.3d 862 (8th Cir. 2008). *But see Bowen v. United States (In re Bowen)*, 174 B.R. 840 (S.D. Ga. 1994) (holding that a "lien" is not an "interest" within the meaning of Section 1141(c); any release of a lien must rely on Section 506(d)); *see also* 11 U.S.C. §§ 1123(a)(5) (a Chapter 11 plan must "provide adequate means for the plan's implementation, such as... (D) sale... either subject to or free of any lien [or] (E) satisfaction or modification of any lien") and 1123(b)(5) (a plan may "modify the rights of holders of secured claims").

⁵ *Elixir Indus., Inc. v. City Bank & Trust Co. (In re Ahern Enterprises, Inc.)*, 507

F.3d 817 (5th Cir. 2007).

⁶ See, e.g., *Airadigm Communications, Inc. v. FCC* (*In re Airadigm Communications, Inc.*), 519 F.3d 640 (7th Cir. 2008); *FDIC v. Union Entities* (*In re Be-Mac Transport Co.*), 83 F.3d 1020 (8th Cir. 1996); *Penrod*, 50 F.3d at 463; *Exide Techs. v. Enersys Delaware, Inc.* (*In re Exide Techs.*), 2013 BL 5423 (Bankr. D. Del. Jan. 8, 2013); *In re Omega Optical, Inc.*, 476 B.R. 157 (Bankr. E.D. Pa. 2012).

⁷ See, e.g., *Ahern*, 507 F.3d at 823 (filing a proof of claim as an unsecured priority claim constitutes participation); *In re Regional Bldg. Systems, Inc.*, 254 F.3d 528 (4th Cir. 2001) (participation was found where the creditor sat on the unsecured creditors' committee and filed proof of an unsecured claim, yet failed to object to confirmation of the plan after the realization of settlement proceeds that would have rendered its claim partially secured); *Omega Optical*, 467 B.R. at 165 (to the extent that participation is required by Section 1141(c), filing a proof of claim and entering a notice of appearance of counsel constitute participation); *Greater American Land Resources, Inc. v. Town of Brick*, 2012 BL 122346 (D.N.J. May 17, 2012) (finding no participation where the creditor taxing authority did not file a proof of claim, and the plan neither listed nor treated the tax claim); *In re WorldCom, Inc.*, 382 B.R. 610 (Bankr. S.D.N.Y. 2008) (the secured creditor participated by filing a proof of claim).

⁸ 132 S. Ct. 2566, 2587 (2012) (distinguishing between “activity” and a “dec[is]ion not to do something” or a “fail[ure] to do it”).

⁹ 559 U.S. 260 (2010).

¹⁰ See *In re Cook*, 25 F.3d 1043, 1994 WL 261083, *1 (5th Cir. June 2, 1994) (distinguishing between the “plan confirmation procedure, which is not ordinarily intended to be the arena for resolving individual claims, and the adversary process by which claims are disputed”).

¹¹ See, e.g., *Travelers Cas. & Surety Co. v. Pacific Gas & Electric Co.*, 549 U.S. 443 (2007) (rejecting the long-standing Ninth Circuit *Fobian* rule restricting contractual claims for postpetition attorneys' fees notwithstanding the absence of any such explicit restriction in the Bankruptcy Code).

¹² See, e.g., *Deodati v. M.M. Winkler & Assocs.* (*In re M.M. Winkler & Assocs.*), 239 F.3d 746, 751 (5th Cir. 2001) (“We have no warrant to add elements to bankruptcy statutes.”).

¹³ See *Sun Finance Co., Inc. v. Howard* (*In re Howard*), 972 F.2d 639, 642 (5th Cir. 1992) (“Once a [Chapter 13] debtor has objected to a claim, the creditor is on notice that full participation in the confirmation proceedings is required or its lien will be at risk.”).