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BUSINESS RESTRUCTURING REVIEW

FUNDS EARMARKED BY SECTION 363 PURCHASER TO PAY CREDITORS NEED NOT BE DISTRIBUTED IN ACCORDANCE WITH BANKRUPTCY CODE'S PRIORITY SCHEME

Timothy Hoffmann and Mark G. Douglas

A ruling recently handed down by the U.S. Court of Appeals for the Third Circuit may provide significant flexibility to debtors in that circuit who are implementing sales of substantially all of their assets. In *In re LCI Holding Company, Inc.*, 2015 BL 295784 (3d Cir. Sept. 14, 2015), the court of appeals ruled that funds provided by a secured lender which purchased a debtor's assets by means of a credit bid, pursuant to section 363(b) of the Bankruptcy Code, for the payment of administrative fees, wind-down costs, and unsecured claims need not be distributed in accordance with the Bankruptcy Code's priority rules because the funds were not property of the debtor's estate.

THE BANKRUPTCY CODE'S PRIORITY SCHEME

Secured claims have the highest priority under the Bankruptcy Code, to the extent of the value of the secured claimant's collateral. A claim is secured 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 and among the debtor and its secured 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 even to pre-existing liens in connection with financing extended to a debtor during a bankruptcy case.

The order of priority of unsecured claims is specified in section 507(a) of the Bankruptcy Code. Priorities are afforded to a wide variety of unsecured claims, including, among others, specified categories and (in some cases) amounts of domestic support obligations, administrative expenses, employee wages, taxes, and certain wrongful death damages awards.

IN THIS ISSUE

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 do not receive full payment of their claims, no distributions can be made to lower category claimants.

With *LCI Holding* and its ruling earlier this year in *Jevic Holding*, the Third Circuit has provided debtors flexibility to utilize section 363 sales or settlements outside the plan content to expedite the resolution of chapter 11 cases. This flexible approach will be desirable to certain stakeholders in cases where confirmation of a nonconsensual plan is not a viable alternative; however, if utilized improperly, it has the potential to contravene the creditor and shareholder protections built into chapter 11.

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. If a creditor does not consent to "impairment" of its claim under a plan—such as by agreeing to receive less than payment in full—and votes to reject the plan, the plan can be confirmed only under certain specified conditions. Among these 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." Section 1129(b)(2) of the Bankruptcy Code provides that a plan is "fair and equitable" with respect to a dissenting impaired class of unsecured claims if the creditors in the class receive or retain property of a value equal to the allowed amount of their claims or, failing that, if no creditor or equity holder of lesser priority receives any distribution under the plan. This requirement is sometimes referred to as the "absolute priority rule."

SENIOR-CLASS "GIFTING" UNDER CHAPTER 11 PLANS

A matter of considerable debate concerning section 1129(b)(2) is whether the provision allows a class of senior creditors voluntarily to cede, or "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.

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*, a secured lender holding a first-priority security interest in substantially all of a chapter 11 debtor's assets, in an amount exceeding the value of the assets, entered into a "sharing agreement" with general unsecured creditors to divide the proceeds that would result from the reorganization, presumably as a way to obtain their cooperation in the case. After the case was converted to a chapter 7 liquidation—in which section 1129(b)(2) does not apply—the secured lender and the unsecured creditors tried to force the chapter 7 trustee to distribute the proceeds from the sale of the bankruptcy estate's assets in accordance with the sharing agreement. The agreement, however, contravened the Bankruptcy Code's distribution scheme because it provided for distributions to general unsecured creditors before payment of priority tax claims. The bankruptcy court ordered the trustee to ignore the sharing agreement and to distribute the proceeds of the sale in accordance with the statutory distribution scheme. The district court upheld that determination on appeal.

The First Circuit reversed, reasoning that, as a first-priority secured lien holder, the lender was entitled to the entire amount of any proceeds of the sale of the debtor's assets, whether or not there was a sharing agreement. According to the court, "While 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)(2) 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). However, 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 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 to purchase new common stock even though unsecured creditors were not paid in full. 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 give-ups by a senior class under a plan might pass muster under other circumstances.

Finally, some courts have refused to condone gifting when the practice is used for an ulterior, improper purpose. For example, in *In re Scott Cable Commc'ns, Inc.*, 227 B.R. 596 (Bankr. D. Conn. 1998), a debtor proposed a liquidating chapter 11 plan that provided for payment of administrative, priority, and unsecured claims from recoveries which were otherwise payable to secured creditors but did not provide for payment of capital gains taxes arising from the sale of the debtor's assets. The bankruptcy court refused to confirm the plan, ruling that its principal purpose was to avoid taxes, which is expressly prohibited by section 1129(d). The court ruled that reliance on *SPM* as authority for the proposed gifting was misplaced, given the different circumstances involved in that chapter 7 case (e.g., the inapplicability of section 1129).

DO THE PRIORITY RULES APPLY TO BANKRUPTCY SETTLEMENTS?

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 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 a pre-chapter 11 plan settlement of disputed claims should be approved 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 doctrine "could ever apply to Chapter 11 settlements," but it rejected a per se rule invalidating the practice, as adopted by the Fifth Circuit in *United States v. AWECO, Inc. (In re AWECO, Inc.)*, 725 F.2d 293 (5th Cir. 1984).

In *Official Comm. of Unsecured Creditors v. CIT Grp./Business Credit Inc. (In re Jevic Holding Corp.)*, 787 F.3d 173 (3d Cir. 2015), the Third Circuit ruled 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 departure. In *Jevic Holding*, the Third Circuit concluded that the bankruptcy court, as part of a structured dismissal of a chapter 11 case, had sufficient reason to approve a settlement whereby general unsecured creditors would receive a distribution even though priority administrative wage claimants would receive nothing. According to the Third Circuit, "This disposition, unsatisfying as it was, remained the least bad alternative since there was 'no prospect' of a plan being confirmed and conversion to Chapter 7 would have resulted in the secured creditors taking all that remained of the estate in 'short order.' "

In *LCI Holding*, the Third Circuit considered whether any payments by the purchaser of a debtor's assets in a sale under section 363 of the Bankruptcy Code must be distributed "according to the Bankruptcy Code's creditor-payment hierarchy."

LCI HOLDING

LifeCare Holdings, Inc. ("LifeCare"), once a leading operator of long-term acute care hospitals, filed for chapter 11 protection in the District of Delaware in December 2012. The filing occurred shortly after the financially struggling company signed an asset purchase agreement with its secured lender whereby an acquisition entity formed by the lender would acquire substantially all of LifeCare's assets in a sale under section 363 by means of a $320 million credit bid. In addition to the credit bid, the purchaser agreed to pay the legal and accounting fees of LifeCare and the official committee of unsecured creditors appointed in the chapter 11 case, as well as LifeCare's wind-down costs. The purchaser funded escrow accounts for that purpose. Any proceeds remaining in the escrow accounts after payment of those fees and costs were to be returned to the purchaser.

After an auction, the bankruptcy court determined that the secured lender entity's credit bid was the most attractive offer for LifeCare's assets. The creditors' committee and the federal government objected to the sale. According to those parties, neither unsecured creditors nor the government, which claimed that it was entitled to a $24 million administrative expense priority claim for capital gains taxes arising from the sale, would recover anything in respect of their claims if the sale were approved. The committee argued, among other things, that the sale was a "veiled foreclosure" which benefited only the secured lender and would leave the bankruptcy estate administratively insolvent.

The committee later reached a deal with the secured lender, which agreed to deposit $3.5 million in trust for the benefit of general unsecured creditors in accordance with the terms of a settlement agreement subject to court approval.

The bankruptcy court approved the sale in April 2013. Characterizing LifeCare as a "melting ice cube," the court found that the sale was the only alternative to liquidation and was also the best opportunity to realize the full value of LifeCare's assets. It also concluded that the secured lender's offer was the "best and only one" and that a chapter 11 plan of reorganization would not have yielded as favorable an economic result. The court overruled the government's objection, holding that the funds placed into escrow by the purchaser were not property of LifeCare's bankruptcy estate and were therefore not available for general distribution to LifeCare's creditors.

In a later ruling, the court approved the settlement agreement as being "fair and equitable" under the four-factor test articulated in *In re Martin*, 91 F.3d 389 (3d Cir. 1996), which mandates that a court weigh: (i) the probability of success in litigation; (ii) any likely difficulties in collecting on a judgment; (iii) the complexity of the litigation and its attendant expense, inconvenience, and delay; and (iv) the overriding interest of creditors. The bankruptcy court rejected the government's argument that the settlement violated the absolute priority rule because it would distribute estate property to junior creditors over the objection of a senior creditor. According to the court, because the settlement agreement contemplated a distribution directly to the unsecured creditors from the purchaser, the funds were not estate property, so the absolute priority rule did not apply. The court approved the settlement, noting that the committee's objection to the sale had a very small chance of success, and thus, the $3.5 million distribution was an excellent outcome for unsecured creditors.

Both the bankruptcy court and the district court denied the government's request for a stay of the orders approving the sale and the settlement pending appeal. Like the bankruptcy court, the district court ruled that the government was unlikely to prevail on the merits because the funds were not property of LifeCare's bankruptcy estate, and therefore, the distributions need not comply with the absolute priority rule. The government appealed to the Third Circuit.

THE THIRD CIRCUIT'S RULING

A three-judge panel of the Third Circuit affirmed the rulings below.

Writing for the panel, circuit judge Thomas L. Ambro explained at the outset that the appeals were not moot: (i) constitutionally, because the government's prospect of a recovery in respect of its administrative claim, although remote, still existed even though the purchaser retained a $35 million first-priority lien on LifeCare's assets after applying its credit bid; (ii) statutorily, because section 363(m) of the Bankruptcy Code, which moots any challenge to an asset sale to a good-faith purchaser absent a stay pending appeal, "stamps out only those challenges that would claw back the sale from a good faith purchaser . . . [and] does not moot '*every* term that might be included in a sale agreement' " (quoting the government's brief); or (iii) equitably, because "[o]utside the plan context, we have yet to hold that equitable mootness would cut off our authority to hear an appeal, and do not do so here."

The court ruled that neither the settlement funds nor the escrowed funds were property of LifeCare's bankruptcy estate because the funds were not "proceeds . . . of or property of the estate" as required by section 541(a)(6) of the Bankruptcy Code.

The Third Circuit rejected the government's contention that the secured lender's $3.5 million deposit in a trust for the benefit of unsecured creditors was in substance an increased bid for LifeCare's assets and that the funds should therefore be deemed estate property. Looking for guidance to a factually similar case, *In re TSIC*, 393 B.R. 71 (Bankr. D. Del. 2008), as well as the Third Circuit's ruling in *Armstrong*, Judge Ambro concluded that "the settlement sums paid by the purchaser were not proceeds from its liens, did not at any time belong to LifeCare's estate, and will not become part of its estate even as a pass-through." The judge characterized as "form over substance" the government's argument that the committee conceded in its settlement approval motion that the parties' compromise "represents an agreement between the Buyer, the Lenders and the Committee *to allocate proceeds derived from the sale*."

The Third Circuit conceded that whether the escrowed funds earmarked for professional fees and wind-down expenses were estate property "is a more difficult question." Judge Ambro noted that the funds were listed as "consideration" for LifeCare's assets in the asset purchase agreement. Even so, he wrote that "we cannot ignore the economic reality of what actually occurred." The purchaser, he explained, acquired LifeCare's assets with a $320 million credit bid, after which "there technically was no more estate property."

According to the court, the government's argument "presumes that any residual cash from the sale—namely, the monies earmarked for fees and wind-down costs—would become property of LifeCare." Judge Ambro characterized this eventuality as "impossible" because LifeCare agreed to surrender all of its cash under the asset purchase agreement, and any residual funds in the professional fee and wind-down expense escrows belonged to the purchaser. "Though the sale agreement gives the impression that the secured lender group agreed to pay the enumerated liabilities as partial consideration for LifeCare's assets," the judge wrote, "it was really 'to facilitate . . . a smooth . . . transfer of the assets from [LifeCare's estate] to the [secured lenders]' by resolving objections to that transfer." The court accordingly held that "as a matter of substance, we cannot conclude that the escrowed funds were estate property."

In *dicta*, Judge Ambro noted that, had the government contended that the escrowed funds represented "an ordinary carve-out" from the secured lender's collateral and were therefore estate property, that argument would have failed as well. According to the Third Circuit, "We are not dealing with collateral (if we were, this would suggest it was LifeCare's property), but with the purchaser's property because the payments by the purchaser were of its own funds and not LifeCare's bankruptcy estate."

OUTLOOK

With *LCI Holding* and its ruling earlier this year in *Jevic Holding*, the Third Circuit has provided debtors flexibility to utilize section 363 sales or settlements outside the plan content to expedite the resolution of chapter 11 cases. This flexible approach will be desirable to certain stakeholders in cases where confirmation of a nonconsensual plan is not a viable alternative; however, if utilized improperly, it has the potential to contravene the creditor and shareholder protections built into chapter 11.

In the aftermath of *LCI Holding*, instead of resorting to collateral carve-outs or plan gifting to junior classes as a means of achieving confirmation of a plan, secured creditors in cases pending in the Third Circuit may fund escrows for the payment of certain classes of creditors or shareholders in connection with section 363 sales of their collateral—leaving other creditors and shareholders with little or no recovery. As the committee's initial objection to the sale in *LCI Holding* indicated, this case will further fuel the ongoing debate over whether bankruptcy is being improperly used by secured creditors as a more efficient and less costly alternative to foreclosure.

Interestingly, in *LCI Holding*, the government appears not to have argued that the section 363 sale transaction represented a *sub rosa* chapter 11 plan that impermissibly circumvented the plan confirmation requirements in the Bankruptcy Code (such as the requirement for administrative claims to be paid in full as a condition to confirmation). However, the Third Circuit may not have been receptive to this line of attack. Without the secured creditor's agreement to fund professional fees, wind-down costs, and a partial recovery to unsecured creditors, the only viable alternatives under the circumstances apparently were dismissal or conversion to chapter 7.

NEWSWORTHY

The "Best Law Firms" survey published jointly by *U.S. News* and *Best Lawyers* named ***Jones Day*** "Law Firm of the Year" for 2016 in the field of Bankruptcy and Creditor Debtor Rights/Insolvency and Reorganization Law.

A Jones Day team led by ***Gregory M. Gordon (Dallas)*** and including Business Restructuring & Reorganization Practice members ***Dan B. Prieto (Dallas)***, ***Thomas A. Howley (Houston)***, ***Paul M. Green (Houston)***, ***Amanda Suzuki (Dallas)***, and ***Jonathan M. Fisher (Dallas)*** represented RadioShack Corporation in the successful culmination of its chapter 11 case in October 2015, including confirmation of RadioShack's plan of liquidation and the establishment of a trust to liquidate remaining assets and make payments to creditors. Two months after it commenced its bankruptcy in February 2015, RadioShack sold more than 1,700 of its stores to an affiliate of hedge fund Standard General LP, preserving some 7,500 jobs and paving the way for the pared-down company to remain in business as an electronics retailer. Thereafter, RadioShack sold various intellectual property, real estate, inventory, and other assets and entered into settlements with wireless carriers and other parties that generated hundreds of millions of dollars of proceeds for the benefit of the RadioShack bankruptcy estate and creditors.

Paul D. Leake (New York), ***Corinne Ball (New York)***, ***Bruce Bennett (Los Angeles)***, ***David G. Heiman (Cleveland)***, ***Heather Lennox (New York and Cleveland)***, ***Ben Larkin (London)***, and ***Sidney P. Levinson (Los Angeles)*** were included among the world's leading Restructuring & Insolvency lawyers by *Who's Who Legal: Restructuring & Insolvency 2016*.

Scott J. Greenberg (New York), ***Christopher Lovrien (Los Angeles)***, ***Erin N. Brady (Los Angeles)***, ***Richard L. Wynne (Los Angeles)***, ***Michael J. Cohen (New York)***, ***Genna L. Ghaul (New York)***, and ***Justin Morgan (New York)*** are representing clothing retailer American Apparel, Inc., in connection with the company's chapter 11 filing on October 5 in the District of Delaware to implement a debt-for-equity swap with its secured lenders. The reorganization is expected to reduce the company's debt from $300 million to no more than $135 million and reduce annual interest expenses by $20 million.

Jones Day's ***London Office*** received a "highly regarded" designation in the practice area of Restructuring/Insolvency from *Chambers UK 2016*. The practice area's ranked professionals are **Sion Richards (London)** and **Ben Larkin (London)**.

Pedro A. Jimenez (Miami) was recommended by *The Legal 500 Latin America 2015* in the field of Banking & Finance.

Brad B. Erens (Chicago), ***Thomas A. Howley (Houston)***, and ***Joseph A. Florczak (Chicago)*** are representing ERG Resources, a private oil and gas company with operations in California and Texas, in connection with the company's chapter 11 cases. On October 30, the U.S. Bankruptcy Court for the Northern District of Texas confirmed a chapter 11 plan of reorganization for ERG Resources. The plan will provide $150 million in additional financing in order for ERG Resources to emerge from bankruptcy and make capital investments that will enable expanded operations.

Scott J. Greenberg (New York) and ***Gregory M. Gordon (Dallas)*** were named MVPs of the Year in the field of bankruptcy by *Law360*.

Juan Ferré (Madrid) was selected by *Best Lawyers* as one of the leading lawyers for insolvency and reorganization in Spain for 2016.

NEWSWORTHY *(continued)*

Kevyn D. Orr (Washington) moderated a panel discussion on October 23 entitled "America Now!" at the American Bankruptcy Institute's 11th Annual International Insolvency & Restructuring Symposium in Madrid.

An article written by ***Paul D. Leake (New York)***, entitled "Risk of Limits on Credit Bidding in Bankruptcy May be Overstated," was published in the October 2015 issue of the *Journal of Corporate Renewal*.

Kevyn D. Orr (Washington) spoke at the Summit on the Cost of Government 2015 in Washington, D.C., on September 24. His session, titled "Bouncing Back Stronger: Distress, Recovery & New Tools for Fiscal Resiliency," offered his leadership perspective and insights on debt restructuring, fiscal recovery, and municipal revival. This annual summit is a premier leadership retreat for the top finance officials from state and local government.

An article written by ***Pedro A. Jimenez (Miami and New York)*** and ***Mark G. Douglas (New York)***, entitled "Chapter 15 Provides Restructuring Avenue for Brazilian Companies," was published in the September 2015 issue of the *INSOL International News Update*.

Kevyn D. Orr (Washington) spoke at the Judicial Symposium on the Economics and Law of Public Pension Reform sponsored by George Mason University School of Law on October 5 in San Francisco.

Thomas A. Howley (Houston) moderated a panel discussion on October 15 in Pittsburgh at the 2015 Regional Energy Conference: Navigating Turbulences in Global Oil & Gas Markets.

Kevyn D. Orr (Washington) was the keynote speaker at the 2015 Annual Training Conference of the Association of Inspectors General on October 21 in Detroit.

An article written by ***Alex M. Sher (New York)*** and ***Mark G. Douglas (New York)***, entitled "Fifth Circuit Jettisons *Pro-Snax* 'Material Benefit' Standard for Bankruptcy Professional Compensation," was published in the November 2015 edition of *The Bankruptcy Strategist*.

Kevyn D. Orr (Washington) participated in a "Distressed Dealmaking" panel discussion at Penn Law School on October 26 in Philadelphia.

THE NINTH CIRCUIT REINS IN THE EQUITABLE MOOTNESS DOCTRINE

Danielle Barav-Johnson and Mark G. Douglas

Since the development of the doctrine of equitable mootness nearly a quarter century ago, courts have struggled to apply it in a way that strikes the appropriate balance between the need to ensure the finality and certainty of a chapter 11 plan for stakeholders, on the one hand, and the need to exercise the court's jurisdiction and honor the right to appellate review, on the other. In *JPMCC 2007-C1 Grasslawn Lodging, LLC v. Transwest Resort Props. Inc. (In re Transwest Resort Props., Inc.)*, 2015 BL 302540 (9th Cir. Sept. 15, 2015), the Ninth Circuit Court of Appeals curbed the application of the equitable mootness doctrine where the appellant diligently sought to stay consummation of the plan. The decision reflects broader concerns over the appropriateness of the doctrine, as well as the ongoing process of refining the circumstances under which it should be applied.

MOOTNESS

"Mootness" is a doctrine that precludes a reviewing court from reaching the underlying merits of a controversy. In federal courts, an appeal can be either constitutionally or equitably moot. Constitutional mootness is derived from Article III of the U.S. Constitution, which limits the jurisdiction of federal courts to actual cases or controversies and, in furtherance of the goal of conserving judicial resources, precludes adjudication of cases that are hypothetical or merely advisory.

In contrast, the judge-fashioned remedy of "equitable mootness" bars adjudication of an appeal when a comprehensive change of circumstances occurs 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 to preclude appellate review of an order confirming a chapter 11 plan. *See, e.g.*, *In re ICL Holding Company, Inc.*, 2015 BL 295784 (3d Cir. Sept. 15, 2015) (stating that 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).

Several circuit courts of appeal have formally adopted the doctrine of equitable mootness in considering whether to hear appeals of plan confirmation orders. For example, in *Search Market Direct, Inc. v. Jubber (In re Paige)*, 584 F.3d 1327 (10th Cir. 2009), the Tenth Circuit considered six factors in determining whether the doctrine should moot appellate review of a confirmation order: (i) whether the appellant sought and/or obtained a stay pending appeal; (ii) whether the plan has been substantially consummated; (iii) whether the rights of innocent third parties would be adversely affected by reversal of the confirmation order; (iv) 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; (v) the likely impact upon a successful reorganization of the debtor if the appellant's challenge is successful; and (vi) whether, on the basis of a brief examination of the merits of the appeal, the appellant's challenge is legally meritorious or equitably compelling.

Substantially similar tests for equitable mootness have been adopted by the Second, Third, Fifth, and Ninth Circuits. *See Frito-Lay, Inc. v. LTV Steel Co. (In re Chateaugay Corp.)*, 10 F.3d 944 (2d Cir. 1993); *Nordhoff Invs., Inc. v. Zenith Elecs. Corp.*, 258 F.3d 180 (3d Cir. 2001); *TNB Fin., Inc. v. James F. Parker Interests (In re Grimland, Inc.)*, 243 F.3d 228 (5th Cir. 2001); *Motor Vehicle Cas. Co. v. Thorpe Insulation Co. (In re Thorpe Insulation Co.)*, 671 F.3d 980 (9th Cir. 2012), *amended and superseded on denial of rehearing en banc*, 677 F.3d 869 (9th Cir. 2012). In *In re Philadelphia Newspapers, LLC*, 690 F.3d 161, 168–69 (3d Cir. 2012), however, a panel of the Third Circuit adopted a more nuanced approach, 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."

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.

The Second Circuit reaffirmed the doctrine of equitable mootness in *In re Charter Commc'ns, Inc.*, 691 F.3d 476 (2d Cir. 2012), but its ruling deepened a split among the circuits with respect to the standard of review and burden of proof to be applied. In *Charter*, the Second Circuit held that once a chapter 11 plan has been substantially consummated, an appeal is presumed to be equitably moot unless the appellant can demonstrate that it has met all of the criteria delineated in its previous ruling in

Chateaugay—which are substantially similar to the Sixth Circuit's *Paige* factors. By appearing to abandon the balancing approach employed by other circuits in this context, the Second Circuit stands alone in presuming that an appeal is equitably moot following substantial consummation of a chapter 11 plan.

More recently, in *Beeman v. BGI Creditors' Liquidating Trust (In re BGI, Inc.)*, 772 F.3d 102 (2d Cir. 2014), the Second Circuit ruled that the standards governing equitable mootness in connection with an appeal of an order confirming a chapter 11 plan of reorganization also apply in the context of a chapter 11 liquidation. The court of appeals affirmed a ruling dismissing an appeal because the appellants failed to overcome the presumption of mootness triggered by substantial consummation of a liquidating chapter 11 plan.

The Ninth Circuit revisited the doctrine of equitable mootness in *Transwest*.

TRANSWEST

Transwest Resort Properties, Inc., and its affiliates (collectively, "Transwest") acquired resort hotels in Hilton Head, South Carolina, and Tucson, Arizona, in 2007. The acquisition was financed by a $209 million mortgage loan at the operating entity level and $21.5 million in mezzanine financing provided to certain nonoperating affiliates (the "mezzanine loan debtors") and secured by the stock of the operating entities.

After defaulting on the loans, Transwest filed for chapter 11 protection in 2010 in the District of Arizona. At the time of the filing, the mortgage loan had been acquired by JPMCC 2007-C1 Grasslawn Lodging, LLC ("JPMCC"), and the mezzanine loan had been acquired by PIM Ashford Subsidiary I LLC ("PIM"). JPMCC filed a proof of claim in the case for $299 million (later allowed at $247 million), while PIM asserted a claim for $39 million. The hotel properties were valued at no more than $92 million.

JPMCC acquired the mezzanine loan from PIM shortly after Transwest filed its chapter 11 plan. JPMCC also elected to have its claims secured by the mortgage loan treated as fully secured under section 1111(b) of the Bankruptcy Code.

Under the joint plan: (i) the mortgage loan would be restructured to require monthly interest-only payments for 21 years followed by a balloon payment, subject to a "due-on-sale" clause with a 10-year exception whereby the hotels could be sold during the period from five to 15 years after the plan's effective date without triggering the obligation to repay the loan; (ii) the Transwest borrowers obligated to repay the mezzanine loan would be dissolved; (iii) no distribution would be made in respect of the claims based on the mezzanine loan, unless PIM voted in favor of the plan, in which case it would receive a small distribution from the reorganized Transwest's future cash flow; and (iv) the reorganized Transwest debtors would be acquired by Southwest Value Partners Fund XV, LP ("SWVP") in exchange for a $30 million investment.

In *Transwest*, the Ninth Circuit was reluctant—and ultimately refused—to apply the doctrine where the appellant took all reasonable steps to seek a stay of the confirmation order and where the plan was not so complex that uninvolved third parties would be harmed. The court also rejected the Second Circuit's strict approach of imposing a presumption of mootness upon substantial consummation.

JPMCC voted to reject the plan (with respect to its claims based on both the mortgage loan and the mezzanine loan) and objected to confirmation. Although a class of the Transwest operating debtors' unsecured creditors voted to accept the plan, there was no accepting impaired class of the mezzanine loan debtors. JPMCC argued that the 10-year exception to the due-on-sale provision impaired its section 1111(b) election because JPMCC's now fully secured claim would not be satisfied from any sale proceeds during that 10-year window. It also claimed that the plan confirmation requirements should be applied on a debtor-by-debtor rather than a per-plan basis and that, because no impaired class of creditors of the mezzanine loan debtors had accepted the joint chapter 11 plan, it could not be confirmed under section 1129(a)(10) of the Bankruptcy Code.

The bankruptcy court overruled JPMCC's objections and confirmed the plan. Both the bankruptcy court and the district court denied JPMCC's timely motions for a stay of the confirmation order pending appeal. The district court subsequently dismissed the appeal as equitably moot because the plan had been substantially consummated and third parties had relied on the confirmation order. JPMCC appealed to the Ninth Circuit.

THE NINTH CIRCUIT'S RULING

The Ninth Circuit reversed.

The court of appeals applied the four-part test previously articulated in *Thorpe Insulation*, which considers: (i) whether the appellant diligently pursued its rights by seeking a stay of the confirmation order; (ii) whether the plan has been substantially consummated; (iii) the effect a remedy may have on third parties not before the court; and (iv) whether the bankruptcy 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."

Although Transwest's chapter 11 plan had been substantially consummated, the Ninth Circuit explained, JPMCC was diligent in seeking an appeal and a stay of the confirmation order, which "cuts strongly in favor of appellate review." The court rejected the argument that, in accordance with the Second Circuit's rulings in *Chateaugay* and *Charter*, JPMCC's appeal should be presumed to be equitably moot due to substantial consummation of the plan. "Our circuit's articulation of the equitable mootness test," the Ninth Circuit wrote, "has never included such a presumption."

Addressing the remaining *Thorpe Insulation* factors, the court reasoned that, if JPMCC were to prevail on its argument that the exception to the due-on-sale clause improperly impaired its section 1111(b) election, only JPMCC, reorganized Transwest, and SWVP would be materially affected by the resulting change in the allocation of any sale proceeds of the hotels. The Ninth Circuit noted that SWVP participated in every stage of the chapter 11 proceedings, including deliberations concerning the treatment of JPMCC's claims under a plan. For this reason, SWVP, the Ninth Circuit wrote, is "not an innocent third party" that reasonably relied on the confirmation order, but "a sophisticated investor" for which "appellate consequences are a foreseeable result," particularly because SWVP helped to draft a chapter 11 plan that " 'press[es] the limits' of the bankruptcy laws" (quoting *Bank of N.Y. Trust Co. v. Official Unsecured Creditors' Comm. (In re Pac. Lumber Co.)*, 584 F.3d 229, 244 (5th Cir. 2009)).

Finally, the Ninth Circuit ruled that partial relief could be granted to JPMCC without "knocking the props out from under the plan." The court wrote, "Even if the relief would be only partial, where equitable relief, though incomplete, is available, the appeal is not moot" (internal citation omitted). The court reasoned that: (i) the bankruptcy court could reduce the duration of the exception to the due-on-sale clause or direct that, if a sale occurred during the window, JPMCC would be entitled to a portion of the difference between the remainder of the total loan amount and the loan's present value; and (ii) if JPMCC, as the holder of the mezzanine loan, were to receive even a partial distribution under the plan in respect of its $39 million claim, the payment "may not eliminate the § 1129(a)(10) objection altogether, but would at least offer a partial remedy."

DISSENT

In a dissenting opinion, circuit judge Milan D. Smith, Jr., argued that the court's ruling "ignores the realities of the marketplace" and discourages future investment in restructuring enterprises. According to Judge Smith, by discouraging investment during the bankruptcy process, the court's ruling also decreases the value of bankruptcy estates, thereby disadvantaging creditors and hampering reorganization efforts. Instead, he suggested, the court should place greater emphasis on the value of promoting finality in the bankruptcy process.

Judge Smith objected to the court's emphasis on partial relief, noting that a nominal remedy is always available. If the nominal relief described by the court were deemed "effective and equitable relief" as required under the equitable mootness doctrine, he wrote, "no case would ever be equitably moot" (internal citation omitted).

OUTLOOK

Transwest illustrates some of the challenges faced by courts when applying the equitable mootness doctrine to appeals of chapter 11 plan confirmation orders. On the one hand, courts recognize the importance of promoting reliance on confirmed plans to encourage successful restructurings. On the other, avenues for appellate review must be protected.

In *Transwest*, the Ninth Circuit was reluctant—and ultimately refused—to apply the doctrine where the appellant took all reasonable steps to seek a stay of the confirmation order and where the plan was not so complex that uninvolved third parties would be harmed. The court also rejected the Second Circuit's

strict approach of imposing a presumption of mootness upon substantial consummation.

In a broader sense, the ruling reflects growing concern among courts (especially in the Third Circuit) regarding overbroad application of the equitable mootness doctrine, with recent calls to limit the doctrine and, in some cases, eliminate it altogether, particularly where the parties affected by the appeal are well aware of the potential for reversal. *See, e.g.*, *JPMCC 2006-LDP7 Miami Beach Lodging, LLC v. Sagamore Partners, Ltd. (In re Sagamore Partners, Ltd.)*, 2015 BL 280922, *7 (11th Cir. Aug. 31, 2015) (stating that equitable mootness applies only when "effective relief is no longer available" and ruling that requiring the debtor to pay default-rate interest under a substantially consummated plan was effective relief); *In re One2One Commc'ns, LLC*, 2015 BL 232065, *5 (3d Cir. July 21, 2015) (declining to hold that the doctrine is unconstitutional or "contrary to the Bankruptcy Code," but ruling that the doctrine must be construed narrowly and should be applied only in complex reorganizations when the appellant should have acted before the plan became "extremely difficult to retract" (quoting *In re Phila. Newspapers, LLC*, 690 F.3d 161, 169 (3d Cir. 2012)); *United States v. Buchman*, 646 F.3d 409, 411 (7th Cir. 2011) (noting that the Seventh Circuit does not follow the doctrine of equitable mootness in bankruptcy law); *Pac. Lumber Co.*, 584 F.3d at 240 (a court should apply doctrine "with a scalpel rather than an axe" and may "fashion whatever relief is practicable" instead of declining review simply because full relief is not available).

ELEVENTH CIRCUIT WEIGHS IN ON SECTION 1123(d): REINSTATEMENT OF DEFAULTED LOAN AGREEMENT UNDER CHAPTER 11 PLAN REQUIRES PAYMENT OF DEFAULT-RATE INTEREST

Monika S. Wiener and Mark G. Douglas

In 1994, Congress amended the Bankruptcy Code to, among other things, add section 1123(d), which provides that, if a chapter 11 plan proposes to "cure" a default under a contract, the cure amount must be determined in accordance with the underlying agreement and applicable nonbankruptcy law. Since then, a majority of courts have held that such a cure amount must include any default-rate interest required under either the contract or applicable nonbankruptcy law. A ruling recently handed down by the U.S. Court of Appeals for the Eleventh Circuit endorses this view. In *JPMCC 2006-LDP7 Miami Beach Lodging, LLC v. Sagamore Partners, Ltd. (In re Sagamore Partners, Ltd.)*, 2015 BL 280922 (11th Cir. Aug. 31, 2015), the Eleventh Circuit ruled in favor of a secured lender demanding payment of default-rate interest as a condition of curing the debtor's default and reinstating the original terms of the loan agreement through a chapter 11 plan and reversed the determination of the bankruptcy and district courts below that the lender had waived its entitlement to such default-rate interest.

REINSTATEMENT AND CURE UNDER A CHAPTER 11 PLAN

Upon the occurrence of an event of payment default under a loan agreement, the lender generally has the right to accelerate the loan and exercise its legal and contractual collection remedies. However, if the borrower files for chapter 11 protection, the lender must refrain from exercising such remedies unless it obtains relief from the automatic stay to do so. Assuming that the stay remains in place, the borrower as chapter 11 debtor in possession may propose a plan which decelerates the loan, cures any defaults (with certain exceptions), and reinstates the original terms of the debt—in effect, "roll[ing] back the clock to the time before the default existed." *MW Post Portfolio Fund Ltd. v. Norwest Bank Minn., N.A. (In re Onco Inv. Co.)*, 316 B.R. 163, 167 (Bankr. D. Del. 2004); *see also* 11 U.S.C. § 1123(a)(5)(G) (providing that a plan shall provide adequate means for its implementation, such as "curing or waiving of any default").

To the extent that its claim qualifies as unimpaired under the terms of the proposed plan, the lender will be deemed to have accepted the plan and will not be entitled to vote on it. *See* 11 U.S.C. § 1126(f). Even though the lender is precluded from enforcing its contractual right of acceleration, the lender's claim will be deemed unimpaired if the plan: (i) cures any defaults (other than defaults triggered by the bankruptcy filing or certain nonmonetary defaults, as specified in section 365(b)(2) of the Bankruptcy Code); (ii) reinstates the pre-default maturity of the debt; (iii) compensates the lender for any damages sustained due to reasonable reliance on its contractual or legal ability to accelerate the debt; (iv) compensates the lender for any actual pecuniary loss arising from the debtor's failure to perform a nonmonetary obligation; and (v) does not "otherwise alter the legal, equitable or contractual rights" of the lender. *See* 11 U.S.C. § 1124(2).

Prior to 1994, the Bankruptcy Code did not define the term "cure," and courts were split as to whether payment of default-rate interest was required in order to cure a default. While most courts required payment of default-rate interest in order to cure defaults and reinstate an obligation under a plan, a minority of courts held that the payment of default-rate interest was not required because cure effectively nullifies all aspects of a default and rolls back the status quo to a time prior to its occurrence. *See*, *e.g.*, *Great Western Bank & Trust v. Entz-White Lumber and Supply, Inc. (Entz-White Lumber and Supply, Inc.)*, 850 F.2d 1338 (9th Cir. 1988); *Levy v. Forest Hills Assocs. (In re Forest Hills Assocs.)*, 40 B.R. 410 (Bankr. S.D.N.Y. 1984).

In 1994, however, lawmakers added section 1123(d) to the Bankruptcy Code, which provides that, notwithstanding the entitlement of oversecured creditors to collect post-petition interest under section 506(b), the "best interests" requirement of section 1129(a)(7), and the cramdown requirements of section 1129(b), "if it is proposed in a plan to cure a default[,] the amount necessary to cure the default shall be determined in accordance with the underlying agreement and applicable nonbankruptcy law." 11 U.S.C. § 1123(d). Most courts have interpreted section 1123(d) as requiring payment of default-rate interest as a condition of cure to the extent that it is required by the underlying agreement or applicable nonbankruptcy law. *See*, *e.g.*, *In re Moody Nat'l SHS Houston H, LLC*, 426 B.R. 667, 672 (Bankr. S.D. Tex. 2010) ("To the extent that there was ambiguity as to how to cure a default when *Entz-White* was written, that ambiguity evaporated in 1994 when § 1123(d) was added" to the Bankruptcy Code); *In re 1 Ashbury Court Partners, LLC,* 2011 BL 396895 (Bankr. D. Kan. Oct. 5, 2011); *In re General Growth Props., Inc.*, 451 B.R. 323 (Bankr. S.D.N.Y. 2011); *In re Schatz*, 426 B.R. 24 (Bankr. D.N.H. 2009).

This result is not necessarily supported by the legislative history of section 1123(d), however. Section 1123(d) and a companion provision in chapter 13, section 1322(e), were enacted to abrogate the U.S. Supreme Court's decision in *Rake v. Wade*, 508 U.S. 464 (1993). In *Rake*, the Court held that, in order to cure a mortgage default under a chapter 13 plan, the mortgagee must be paid interest on the defaulted payments, including interest on interest, regardless of whether such interest was provided for in the agreement or under state law. Congress overruled the decision by enacting section 1123(d) because the ruling "had the effect of providing a windfall to secured creditors at the expense of unsecured creditors by forcing debtors to pay the bulk of their income to satisfy the secured creditors' claims," which would include interest on interest, late charges, and other fees, "even where applicable law prohibits such interest and even when it was . . . not contemplated by either party in the original transaction." H.R. Rep. No. 103-835, at 55 (1994).

In light of this legislative history, some have argued that section 1123(d) should not be interpreted to require payment of default-rate interest, even where the contract provides for it. Additional support for this interpretation can arguably be found in : (i) section 365(b)(2), which was also added to the Bankruptcy Code in 1994 and provides that a "penalty rate" related to the debtor's failure to perform nonmonetary obligations need not be satisfied to cure a default under an executory contract or an unexpired lease; and (ii) section 1124(2), which does not require the holder of a claim to be paid default-rate interest for the claim to be rendered unimpaired. *In re Phoenix Bus. Park Ltd. P'Ship*, 257 B.R. 517, 522 (Bankr. D. Ariz. 2001) (construing the language of section 365(b)(2), which was adopted at the same time as section 1123(d), together with section 1124(2), and finding that "*Entz-White* remains good law in the Ninth Circuit" because "Congress did not legislatively overrule *Entz-White*" when it enacted section 1123(d)); *see also General Elec. Capital Corp. v. Future Media Productions, Inc.*, 536 F.3d 969 (9th Cir. 2008) (declining to rule that *Entz-White* was overruled by section 1123(d)). As discussed below, the Eleventh Circuit conclusively rejected this line of argument in *Sagamore Partners*.

SAGAMORE PARTNERS

Sagamore Partners, Ltd. ("Sagamore") is the owner of the Sagamore Hotel in Miami Beach, Florida. In 2006, Arbor Commercial Mortgage, LLC ("Arbor") loaned Sagamore $31.5 million to refinance its hotel indebtedness. The loan agreement provided that, in the event of default, Sagamore would be required to pay default-rate interest at the rate of 11.54 percent per annum.

After Sagamore stopped making payments on the loan in 2009, Arbor's assignee—JPMCC 2006-LDP7 Miami Beach Lodging, LLC ("JPMCC")—sent a notice of default to Sagamore, but not its New York counsel, as required under the loan agreement. Shortly afterward, JPMCC notified Sagamore's New York lawyers that it was accelerating the loan.

JPMCC commenced a foreclosure action in state court in December 2009. In its complaint, JPMCC demanded, among other things, both default-rate interest and late fees. In its internal records, the servicer of the Sagamore loan recorded accruing charges for late fees, but not default-rate interest.

Sagamore filed for chapter 11 protection on October 6, 2011, in the Southern District of Florida. JPMCC filed a proof of claim for $31.5 million, plus pre-default interest, default-rate interest, late fees, costs, attorneys' fees, and other charges due under the loan agreement. In response to Sagamore's objection that JPMCC could not claim both default-rate interest and late fees, JPMCC waived its claim to all late fees "for any time period for which the Court allows default rate interest."

Sagamore's chapter 11 plan proposed to reinstate the maturity of the loan and to cure and "nullify[] all consequences of any alleged default" by, among other things, payment of accrued interest at the nondefault rate.

Initially, the bankruptcy court ruled that the proposed plan was not confirmable because it did not provide for the payment of default-rate interest to JPMCC. Persuaded by the reasoning of courts which have concluded that *Entz-White* was abrogated by section 1123(d), the court held that: (i) section 1123(a)(5)(G) "governs the permissible contours of a plan of reorganization and serves as the authority for curing or waiving a default"; (ii) the cure amount is determined by section 1123(d), which reverts to the underlying agreement and applicable nonbankruptcy law; and (iii) section 1124(2) governs whether a secured creditor's claim can be treated as unimpaired but does not supplant section 1123(d). However, in its decision, the court noted that "[i]f the Debtor can establish . . . that any default may be excused, or that default interest is not otherwise due in accordance with the underlying agreement and/or applicable non-bankruptcy law, then the issue of entitlement to default interest is moot." *In re Sagamore Partners, Ltd.*, No. 11-37867-BKC-AJC (Bankr. S.D. Fla. July 10, 2012) (memorandum order at p. 10) [Doc. No. 213].

With *Sagamore Partners*, the Eleventh Circuit has joined the majority camp in concluding that section 1123(d) requires the payment of default-rate interest as a condition to curing a default under a loan agreement which is to be reinstated under a plan, provided that the obligation to pay default-rate interest is contained in the underlying loan agreement or authorized under applicable nonbankruptcy law.

After Sagamore filed an amended plan, the bankruptcy court ruled that JPMCC's notice of default was defective and "all that flowed from the Defective Notice is improper," including the acceleration letter; the foreclosure proceeding; and JPMCC's efforts to charge default-rate interest, attorneys' fees, and other charges. In the alternative, the bankruptcy court found that JPMCC failed to demand default-rate interest and waived any right to such interest by opting to collect late fees.

On appeal, the district court ruled that an event of default occurred despite insufficient notice and remanded the case to the bankruptcy court for a determination of whether JPMCC was entitled to an award of attorneys' fees and costs. However, the district court affirmed the bankruptcy court's ruling that JPMCC waived its right to default-rate interest. JPMCC appealed to the Eleventh Circuit.

THE ELEVENTH CIRCUIT'S RULING

The Eleventh Circuit acknowledged that "the requirements for reinstating the terms of a loan under § 1123 may appear to be in some tension with the framework for determining when parties have the right to vote on a debtor's reorganization plan." Even so, the court noted that "[i]t does not allow us to ignore the clear mandate of § 1123 that allows a creditor to demand default-rate interest as a condition for reinstating the loan." Because the loan agreement required the payment of default-rate interest and the provision complied with Florida law, the Eleventh Circuit ruled, Sagamore must pay default-rate interest to cure its default.

The Eleventh Circuit faulted the bankruptcy court's conclusion that JPMCC waived its right to default-rate interest by failing to timely demand such interest and by electing to collect late fees instead. According to the Eleventh Circuit, the record clearly demonstrated that JPMCC consistently demanded default-rate interest and withdrew its claim for late fees to the extent that it could not collect both default-rate interest and late fees. Moreover, the court noted, claims for late fees and default-rate interest are consistent remedies that may be pursued concurrently under Florida law, so long as a party does not receive "satisfaction of the claim by one remedy."

Accordingly, the Eleventh Circuit reversed the ruling below denying JPMCC's claim for default-rate interest. It affirmed the ruling that Sagamore's chapter 11 plan was feasible and remanded the case for certain additional findings, including determinations as to whether JPMCC was entitled to attorneys' fees and costs as part of its secured claim and the timing of Sagamore's obligation to pay the default-rate-interest amount.

OUTLOOK

With *Sagamore Partners*, the Eleventh Circuit has joined the majority camp in concluding that section 1123(d) requires the payment of default-rate interest as a condition to curing a default under a loan agreement which is to be reinstated under a plan, provided that the obligation to pay default-rate interest is contained in the underlying loan agreement or authorized under applicable nonbankruptcy law. The decision underscores the fact that courts in the Ninth Circuit are outliers on this issue and are likely to remain so unless and until the Ninth Circuit Court of Appeals expressly rules that *Entz-White* is no longer good law. The ruling may also serve as a reminder to lenders to be clear and consistent in enforcing their post-default rights if they wish to avoid claims that they waived the right to collect default-rate interest authorized under a loan agreement or applicable law.

TENTH CIRCUIT: RECHARACTERIZATION REMEDY IN BANKRUPTCY IS ALIVE AND WELL

Nicholas J. Morin

In *Redmond v. Jenkins (In re Alternate Fuels, Inc.)*, 789 F.3d 1139 (10th Cir. 2015), a panel of the U.S. Court of Appeals for the Tenth Circuit upheld bankruptcy courts' authority to recharacterize insider debt as equity. In so ruling, the court rejected an argument that recent U.S. Supreme Court precedent prevents bankruptcy courts from using section 105(a) of the Bankruptcy Code to recharacterize debt as equity. Nevertheless, after upholding the recharacterization doctrine, the Tenth Circuit panel split on the doctrine's application. The majority, stating that courts must "exercise caution" when determining whether recharacterization is appropriate, ultimately concluded that the insider's claims should not be recharacterized as equity. By contrast, the dissent contended that recharacterization was warranted.

ALTERNATE FUELS

Kansas-based Alternate Fuels, Inc. (the "debtor") engaged in coal-mining operations through a subsidiary. In connection with these operations, the debtor was obligated to restore certain mining sites to their original condition, including mines located in Missouri. To assure the State of Missouri that reclamation would be performed, the debtor posted reclamation bonds which were secured by approximately $1.4 million in certificates of deposit.

Subsequent to the debtor's posting of security for the reclamation bonds, William Karl Jenkins and M. Earlene Jenkins (collectively, the "Insiders") acquired 100 percent ownership of the debtor and 99 percent ownership of the subsidiary. The Insiders, however, did not acquire the companies for the purpose of continuing mining operations. Rather, the Insiders believed that they could use their political connections to modify the debtor's reclamation arrangements, such that they could obtain the proceeds of the certificates of deposit. In furtherance of this goal, the Insiders succeeded in arranging for the certificates of deposit to be assigned to them personally.

During the years following the Insiders' acquisition of the debtor, which had ceased mining operations, the debtor executed three promissory notes evidencing in total approximately $4 million in funding provided by the Insiders. Each of the notes stated that it would mature in a period of years, while also providing that "[t]his note shall be paid in full upon reclamation bond release from the State of Missouri." Because the debtor had no operations or income of its own, the Insiders' only anticipated source of repayment was the certificates of deposit.

Several years after the Insiders had acquired the debtor, the debtor temporarily ceased its reclamation efforts when it filed suit against third parties, alleging tortious interference with its reclamation process. Realizing that their likelihood of recovering the certificates of deposit was diminishing, the Insiders agreed to continue funding the debtor only after receiving, as security for their loans, a partial assignment of the debtor's reclamation suit recovery. On the same date as that assignment, the debtor executed a new promissory note, which renewed the first three promissory notes but also included an additional source of repayment: the proceeds of the reclamation suit.

The Tenth Circuit stated the rationale for its ruling in *Alternate Fuels* as follows: "Recharacterization under [section] 105(a) is essential to a court's ability to properly implement the priority scheme of the Bankruptcy Code."

Ultimately, after recovering $5 million from the reclamation suit, the debtor filed for chapter 11 protection in the District of Kansas in January 2009. The Insiders filed secured proofs of claim in the amount of $4.3 million based on, among other things, the promissory notes.

A chapter 11 trustee was appointed in the debtor's case, and the trustee filed a complaint against the Insiders, seeking to recharacterize the Insiders' promissory note debt as equity or, in the alternative, to equitably subordinate the Insiders' claims under section 510(c) of the Bankruptcy Code. Applying the factors articulated by the Tenth Circuit in *Sender v. Bronze Grp., Ltd. (In re Hedged-Investments Assocs., Inc.)*, 380 F.3d 1292 (10th Cir. 2004) (discussed below), the bankruptcy court ruled, among other things, that the Insiders' claims should be recharacterized as equity contributions. In the alternative, the court ruled that the claims should be equitably subordinated due to the Insiders' breach of fiduciary duties and other misconduct. After a Tenth Circuit bankruptcy appellate panel affirmed the ruling, the Insiders appealed to the Tenth Circuit.

RECHARACTERIZATION GENERALLY AND IN THE TENTH CIRCUIT

Recharacterization is a tool used by bankruptcy courts to ensure that the Bankruptcy Code's payment priority scheme is properly implemented. When a court recharacterizes putative debt as equity, the court essentially ignores the label attached to the relevant transaction and instead recognizes its true substance. A claim that has been recharacterized as equity is moved to a lower rung on the bankruptcy priority ladder and generally is paid only after all claims have been satisfied in full.

In *Hedged-Investments*, the Tenth Circuit implicitly recognized section 105(a) of the Bankruptcy Code as a basis for recharacterization. Section 105(a) provides, in relevant part, that a bankruptcy court "may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of [the Bankruptcy Code]." The Third, Fourth, and Sixth Circuits have also relied on section 105(a) to provide authority for recharacterization. *See Cohen v. KB Mezzanine Fund, II, LP (In re SubMicron Systems Corp.)*, 432 F.3d 448 (3d Cir. 2006); *Comm. of Unsecured Creditors for Dornier Aviation (North America), Inc.*, 453 F.3d 225 (4th Cir. 2006); *Bayer Corp. v. MascoTech, Inc. (In re AutoStyle Plastics, Inc.)*, 269 F.3d 726 (6th Cir. 2001).

The Fifth and Ninth Circuits have taken a different approach, holding instead that section 502(b)(1) of the Bankruptcy Code, which provides that "the court . . . shall allow [a] claim . . . except to the extent that . . . such claim is unenforceable against the debtor and property of the debtor, under any agreement or applicable law," is the proper statutory authority for recharacterization. *See Grossman v. Lothian Oil Inc. (In re Lothian Oil Inc.)*, 650 F.3d 539 (5th Cir. 2011); *Official Comm. of Unsecured Creditors v. Hancock Park Capital II, L.P. (In re Fitness Holdings Int'l, Inc.)*, 714 F.3d 1141 (9th Cir. 2013).

In *Hedged-Investments*, the Tenth Circuit instructed bankruptcy courts, when analyzing whether to recharacterize debt as equity, to examine the following 13 nonexclusive factors:

(1) the names given to the certificates evidencing the indebtedness;

(2) the presence or absence of a fixed maturity date;

(3) the source of payments;

(4) the right to enforce payment of principal and interest;

(5) participation in management flowing as a result;

(6) the status of the contribution in relation to other corporate creditors;

(7) the intent of the parties;

(8) "thin" or adequate capitalization;

(9) the identity of interest between the creditor and stockholder;

(10) the source of interest payments;

(11) the ability of the corporation to obtain loans from outside lenders;

(12) the extent to which funds were used to acquire capital assets; and

(13) the failure of the debtor to repay on the due date or to seek a postponement.

Hedged-Investments, 380 F.3d at 1298 (citation omitted).

In *Alternate Fuels*, the Tenth Circuit reaffirmed a bankruptcy court's authority to recharacterize a debt as equity under section 105(a) in accordance with the multifactor test set down in *Hedged-Investments*.

THE TENTH CIRCUIT'S RULING

The Insiders argued to the Tenth Circuit that *Hedged-Investments* was abrogated by two recent Supreme Court decisions—*Travelers Cas. & Surety Co. of America v. Pac. Gas & Electric Co.*, 549 U.S. 443 (2007), and *Law v. Siegel*, 134 S. Ct. 1188 (2014).

In *Travelers*, the Supreme Court reversed a circuit court ruling that an unsecured creditor could not recover attorneys' fees that were authorized by a pre-petition agreement but incurred post-petition. The Supreme Court stated that, when applying section 502(b), "we generally presume that claims enforceable under applicable state law will be allowed in bankruptcy unless they are expressly disallowed." *Travelers*, 549 U.S. at 452. The Insiders argued that the Court thereby abrogated the *Hedged-Investments* test by holding that "a court may not fashion a test 'solely of its own creation' in determining what constitutes a 'claim' for purposes of bankruptcy."

In *Law*, the Supreme Court reversed a bankruptcy court's order under section 105(a) that expressly contravened another provision of the Bankruptcy Code (section 522, which specifies exempt property). The Supreme Court explained that although section 105(a) allows a bankruptcy court to issue orders "necessary or appropriate" to carry out the provisions of the Bankruptcy Code, it is "hornbook law" that section 105(a) does not allow a bankruptcy court to "override explicit mandates of other sections of the Bankruptcy Code." *Law*, 134 S. Ct. at 1192. Citing this analysis, the Insiders argued that recharacterization under section 105(a) is not permissible where it conflicts with section 502(b).

In *Alternate Fuels*, the Tenth Circuit rejected these arguments. First, the court noted that neither *Travelers* nor *Law* considered the doctrine of recharacterization or expressly overruled *Hedged-Investments*.

Next, the Tenth Circuit explained that the Insiders' expansive reading of *Travelers* and *Law* improperly conflates disallowance with recharacterization. According to the Tenth Circuit, the two concepts, although related, require different inquiries and serve different functions. Whereas disallowance of a claim under section 502(b) is appropriate "when the claimant has no rights vis-à-vis the bankrupt," recharacterization is an inquiry into the nature of the transaction underlying an asserted claim. Unlike disallowance, recharacterization of a loan as equity does not ultimately relieve the debtor from its obligation to repay the claimant. Rather, the Tenth Circuit emphasized, recharacterization simply moves the claimant's right to payment to a lower position in the priority scheme.

The Tenth Circuit panel thus unanimously reaffirmed section 105(a) as an appropriate statutory authority for recharacterizing debt as equity.

However, the Tenth Circuit panel split on whether the Insiders' claims should be treated as equity under the *Hedged-Investments* multifactor test.

The majority emphasized that the Insiders were "engaged in a venture with substantial risk," highlighting factors that weighed against recharacterization. For example, the majority explained that the first factor had been met because the instruments at issue were labeled "promissory notes." Here, the majority rejected the argument that this factor's inquiry is controlled by the sufficiency of consideration furnished to the debtor for incurring the indebtedness or that the consideration furnished in this case was insufficient. With regard to the fifth and 12th factors of the test, the majority noted that: (i) the Insiders did not increase their participation in the debtor's management following the loans; and (ii) the debtor used the Insiders' advances to fund operating expenses.

The majority also disagreed with the bankruptcy court's conclusions regarding a number of the other *Hedged-Investment* factors. For example, the majority stated that a court should not place too much emphasis on the eighth factor—the debtor's undercapitalization—as it would create an "unhealthy deterrent effect," disincentivizing business owners from providing capital to save their struggling businesses. Regarding the ninth factor—the identity of interest between the creditor and stockholder—the majority explained that this factor cannot be weighed too heavily in a single equity holder situation. "Otherwise," the court wrote, "this factor would militate against finding true debt in any situation involving a single stockholder."

While finding that some of the factors weighed in favor of recharacterization, the majority counseled that courts should "exercise caution in this arena" and held that, on balance, the factors weighed against recharacterizing the Insiders' claims as equity.

The dissent highlighted the Insiders' self-interested business purpose: the Insiders "made a business gamble—[they] bet that [they] would spend less helping [the debtor] reclaim the coal land than [they] would make from . . . collecting 24 certificates of deposit."

Although the dissenting judge agreed with the majority that certain of the factors signaled debt in "name and form," he went on to analyze the other factors concerning the "real-world backdrop" of the transaction. In the end, he concluded that four factors weighed against recharacterization, three factors were neutral, and six factors weighed in favor of recharacterization. On balance, the dissenting judge concluded that the *Hedged-Investments* test supported recharacterization.

Finally, emphasizing that equitable subordination is "an extraordinary remedy to be employed by courts sparingly," the Tenth Circuit panel unanimously ruled that the remedy did not apply because the Insiders had not engaged in inequitable or unfair conduct.

OUTLOOK

The Tenth Circuit stated the rationale for its ruling in *Alternate Fuels* as follows: "Recharacterization under [section] 105(a) is essential to a court's ability to properly implement the priority scheme of the Bankruptcy Code." In reaffirming its recharacterization precedents, the Tenth Circuit declined to read recent Supreme Court precedent as invalidating section 105(a) as a source of authority for the remedy. Even so, the Tenth Circuit panel split on whether that remedy should be employed in the case before it. Thus, while *Alternate Fuels* may provide a road map for rebutting similar attacks on the use of section 105(a) as authority for recharacterization, it is also a reminder that the recharacterization analysis itself is difficult to apply and may be subject to different applications by different judges.

SOVEREIGN DEBT UPDATE

ARGENTINA

The long-running dispute continues between the Republic of Argentina, which defaulted on its sovereign debt for the second time in July 2014, and holdout bondholders from two previous debt restructurings.

On October 5, 2015, the U.S. Court of Appeals for the Second Circuit upheld U.S. district court judge Thomas Griesa's October 27, 2014, order denying requests by two groups of judgment creditors holding defaulted bonds issued by Argentina for an order forcing Bank of New York Mellon, in satisfaction of the Republic's judgment debt, to turn over $539 million that Argentina had deposited in 2014 to pay creditors who participated in its past debt restructurings. In its summary rulings, the Second Circuit agreed with Judge Griesa's ruling that, even assuming the turnover provisions in New York law applied to the funds, such a turnover would be barred by the Foreign Sovereign Immunities Act.

On October 16, 2015, Argentina's holdout bondholders, alleging that the Republic waived its privilege by failing to comply with Judge Griesa's August 13, 2015, order directing Argentina to identify privileged documents within 10 days, asked the judge to issue an order compelling Argentina and its counsel to produce all documents and information responsive to discovery requests seeking information concerning Argentina's U.S. assets. The bondholders claim that the privilege log submitted by Argentina does not comply with the court's order, which expressly provided that the Republic's failure to produce a timely privilege log " 'will be deemed to be a waiver of the claim of privilege.' "

GREECE

On August 14, 2015, eurozone finance ministers approved €86 billion ($96 billion) in new bailout loans for Greece. This third round of bailout financing in five years capped six months of turbulent negotiations between Greece's left-wing government, led by Prime Minister Alexis Tsipras, and Greece's creditors, including the European Central Bank (the "ECB") and the International Monetary Fund. Without a deal, Greece and the 19-nation eurozone confronted the prospect of "Grexit"—Greece's forced departure from the currency union.

The aid deal still faces major obstacles. On August 20, 2015, embattled Prime Minister Tsipras, in a gamble aimed at bolstering his power and ability to implement the bailout deal, resigned to clear the way for early elections slated for September 20. He was forced to call snap elections due to the large-scale defection of Syriza party lawmakers during the parliamentary vote on August 14.

On September 20, 2015, Tsipras was returned to power by Greek voters, many of whom stated that Tsipras had fought hard to get them a better deal from the nation's creditors and deserved a second chance at governing. The new government now faces the challenges of implementing unpopular austerity measures mandated by the bailout deal, including carrying out steep budget cuts, lobbying for action by other eurozone countries to ease Greece's debt load, and dealing with the added financial strain of Europe's refugee crisis.

On October 5, 2015, the new Greek government unveiled a tough draft budget for 2016, heralding a series of tax increases and spending cuts to comply with creditors' demands for the third bailout. The recession, according to the plan, will continue—the economy is expected to shrink by 2.3 percent this year and 1.3 percent in 2016. The draft budget also anticipates that government debt will increase to 198 percent of gross domestic product next year, from 187.6 percent in 2015. The new bailout loans account for much of the increase.

On October 31, 2015, the ECB announced that, according to the results of stress tests, Greece's top four lenders will need to inject up to €14.4 billion ($15.8 billion) in fresh funds to strengthen their capital base.

On November 5, 2015, the Greek parliament approved some of the 50 promised economic changes that international creditors have demanded in order to unlock the first loan installment (€2 billion or $2.15 billion) from the country's bailout program, but the legislation lacked some of the principal measures demanded by lenders.

On November 9, 2015, eurozone finance ministers announced that they would not release the first installment of funding in the bailout program, amid continued disagreements over new mortgage foreclosure rules demanded by the lenders. According to officials, while progress has been made on some of the 50 promised overhauls—including measures to substitute a tax on private education, the governance of the country's bailed-out banks, and the treatment of overdue loans—Athens and its creditors will need more time to sign off on all overhauls.

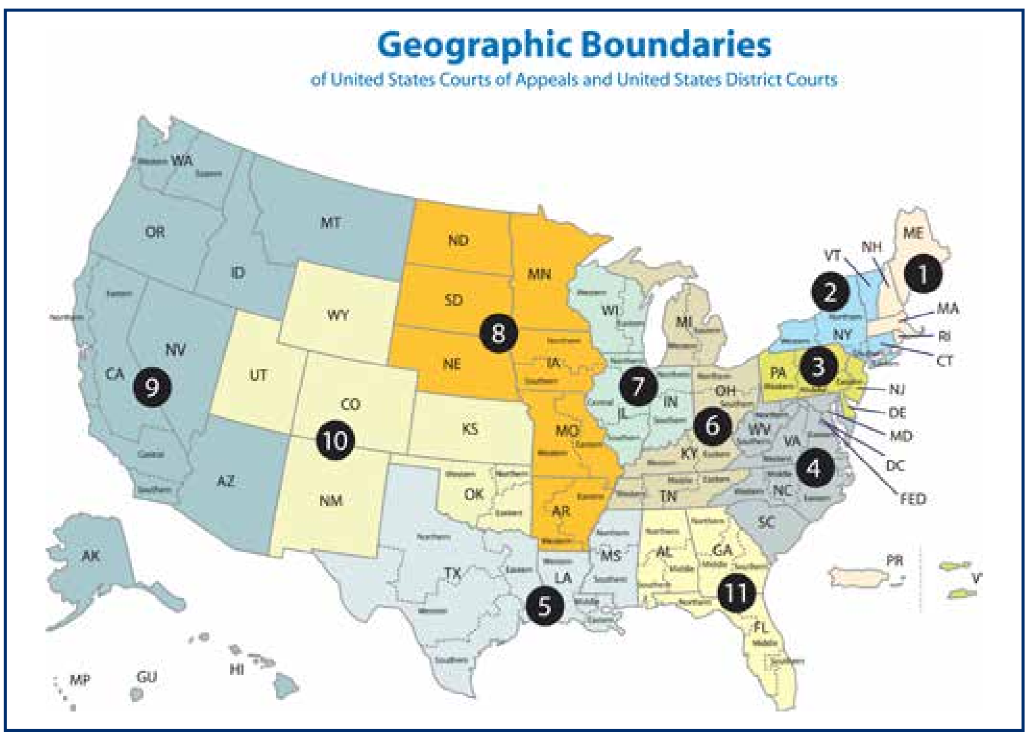
THE U.S. FEDERAL JUDICIARY

U.S. federal courts have frequently been referred to as the "guardians of the Constitution." Under Article III of the Constitution, federal judges are appointed for life by the U.S. president with the approval of the Senate. They can be removed from office only through impeachment and conviction by Congress. The first bill considered by the U.S. Senate—the Judiciary Act of 1789—divided the U.S. into what eventually became 12 judicial "circuits." In addition, the court system is divided geographically into 94 "districts" throughout the U.S. Within each district is a single court of appeals, regional district courts, bankruptcy appellate panels (in some districts), and bankruptcy courts.

As stipulated by Article III of the Constitution, the chief justice and the eight associate justices of the Supreme Court hear and decide cases involving important questions regarding the interpretation and fair application of the Constitution and federal law. A U.S. court of appeals sits in each of the 12 regional circuits. These circuit courts hear appeals of decisions of the district courts located within their respective circuits and appeals of decisions of federal regulatory agencies. Located in the District of Columbia, the Court of Appeals for the Federal Circuit has nationwide jurisdiction and hears specialized cases such as patent and international trade cases. The 94 district courts, located within the 12 regional circuits, hear nearly all cases involving federal civil and criminal laws. Decisions of the district courts are most commonly appealed to the district's court of appeals.

Bankruptcy courts are units of the federal district courts. Unlike that of other federal judges, the power of bankruptcy judges is derived principally from Article I of the Constitution, although bankruptcy judges serve as judicial officers of the district courts established under Article III. Bankruptcy judges are appointed for a term of 14 years (subject to extension or reappointment) by the federal circuit courts after considering the recommendations of the Judicial Conference of the United States. Appeals from bankruptcy court rulings are most commonly lodged either with the district court of which the bankruptcy court is a unit or with bankruptcy appellate panels, which presently exist in five circuits. Under certain circumstances, appeals from bankruptcy rulings may be made directly to the court of appeals.

Two special courts—the U.S. Court of International Trade and the U.S. Court of Federal Claims—have nationwide jurisdiction over special types of cases. Other special federal courts include the U.S. Court of Appeals for Veterans Claims and the U.S. Court of Appeals for the Armed Forces.



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