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SECTION 553 OF THE BANKRUPTCY CODE PRESERVES RATHER THAN CREATES SETOFF RIGHTS

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In *Feltman v. Noor Staffing Grp., LLC (In re Corp. Res. Servs. Inc.)*, 564 B.R. 196 (Bankr. S.D.N.Y. 2017), the bankruptcy court considered whether section 553 of the Bankruptcy Code creates a right of setoff when no such right is available under applicable nonbankruptcy law. The court concluded that section 553 does not create an independent federal right of setoff, but merely preserves any such right that exists under applicable nonbankruptcy law. It ruled that, because New York law did not allow setoff of contingent claims, the defendants in an adversary proceeding could not assert a right of setoff for admittedly contingent claims as a defense.

SETOFF

Section 553(a) of the Bankruptcy Code provides, subject to certain exceptions, that the Bankruptcy Code "does not affect any right of a creditor to offset a mutual debt owing by such creditor to the debtor that arose before the commencement of the case under this title against a claim of such creditor against the debtor that arose before the commencement of the case." Section 553 does not create setoff rights—it merely preserves certain setoff rights that otherwise would exist under contract or applicable nonbankruptcy law. *See* COLLIER ON BANKRUPTCY ¶ 553.04 (16th ed. 2017) (citing *Citizens Bank of Maryland v. Strumpf*, 516 U.S. 16 (1995)).

A "debt" is defined in section 101(12) of the Bankruptcy Code as a "liability on a claim." Section 101(5) defines "claim" to include a "right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured." Under bankruptcy case law, the term "contingent" means contingent as to liability. *See Grady v. A.H. Robins Co. (In re A.H. Robins Co.)*, 839 F.2d 198 (4th Cir. 1988), *cert. dismissed*, 487 U.S. 1260 (1988).

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Although the Bankruptcy Code does not define "mutual," debts are generally understood to be mutual when they are due to and from the same persons or entities in the same capacity. *See* COLLIER ON BANKRUPTCY ¶ 553.03[3] (16th ed. 2017).

Even though section 553 expressly refers to prepetition mutual debts and claims, many courts have held that mutual post-petition obligations may also be offset. *See Zions First Nat'l Bank, N.A. v. Christiansen Bros., Inc. (In re Davidson Lumber Sales, Inc.)*, 66 F.3d 1560 (10th Cir. 1995); *Palm Beach Cty. Bd. of Pub. Instruction v. Alfar Dairy, Inc. (In re Alfar Dairy, Inc.)*, 458 F.2d 1258 (5th Cir. 1972); *Official Comm. of Unsecured Creditors of Quantum Foods, LLC v. Tyson Foods, Inc. (In re Quantum Foods, LLC)*, 554 B.R. 729 (Bankr. D. Del. 2016).

However, setoff is available in bankruptcy only "when the opposing obligations arise on the same side of the . . . bankruptcy petition date." *Pa. State Employees' Ret. Sys. v. Thomas (In re Thomas)*, 529 B.R. 628, 637 n.2 (Bankr. W.D. Pa. 2015). Thus, prepetition obligations may not be set off against postpetition debts and vice versa. *See In re Enright*, 2015 BL 261143 (Bankr. D.N.J. Aug. 13, 2015); *In re Passafiume*, 242 B.R. 630 (Bankr. W.D. Ky. 1999).

A creditor is precluded by the automatic stay from exercising its setoff rights with respect to a prepetition claim without bankruptcy court approval. *See* 11 U.S.C. § 362(a)(7). Upon application by the creditor, however, the court will generally permit a setoff if the requirements under applicable law are met, except under circumstances where it would be inequitable to do so. *See In re Ealy*, 392 B.R. 408 (Bankr. E.D. Ark. 2008). By contrast, if there is a right of "recoupment" (i.e., where mutual obligations arise under the same contract), the exercise of the right does not require court authority, and the automatic stay does not apply. A creditor stayed from exercising a valid setoff right must be granted "adequate protection" (*see* 11 U.S.C. § 361) against any diminution in the value of its interest caused by the debtor's use of the creditor's property. *Ealy*, 392 B.R. at 414.

Under section 101(5)'s broad definition of "claim," contingent claims arguably would be eligible for setoff under section 553 if applicable nonbankruptcy law permitted setoff of such claims. The *Feltman* court addressed this issue.

FELTMAN

In February 2015, Noor Associates, Inc., and Noor Staffing Group, LLC (collectively, "Noor") purchased substantially all of the assets of Corporate Resource Services, Inc. ("CRS") under a purchase agreement governed by New York law.

On July 23, 2015, CRS and certain affiliates filed for chapter 11 protection in the Southern District of New York. The bankruptcy filings occurred shortly after Noor discovered that CRS or its affiliates failed to remit more than $100 million in employee withholding taxes to the IRS and state taxing authorities. It was unclear at the time of the filing whether Noor, as the purchaser of CRS's assets and its successor, might be liable for the unpaid taxes. The taxing authorities had not asserted any claim against Noor as of the petition date.

In March 2016, a chapter 11 trustee appointed in the case commenced an adversary proceeding against Noor, alleging, among other things, that Noor breached the sale agreement. The trustee also sought to avoid the sale as a constructive fraudulent transfer under section 548 of the Bankruptcy Code because, allegedly, the value of CRS's assets substantially exceeded the sale price and CRS was insolvent at the time of the transaction.

In its answer and a proof of claim filed in December 2016, Noor asserted, among other things, that it had a right to set off contingent liabilities to taxing authorities or CRS customers in the amount of approximately $8.4 million against any liability to the trustee in the avoidance and breach of contract litigation. As noted, no claims for those liabilities had been asserted against Noor.

The trustee moved to strike the setoff defense and to disallow the proof of claim to the extent it asserted a right to set off contingent claims.

THE BANKRUPTCY COURT'S RULING

The bankruptcy court ruled in favor of the trustee.

The court explained that "in order to establish a right to setoff under section 553, a creditor must first demonstrate a preexisting right of setoff under nonbankruptcy or state law." It rejected

Noor's argument that the Bankruptcy Code creates a federal right of setoff. According to the court, the U.S. Supreme Court's ruling in *Strumpf* "definitively resolved that the Bankruptcy Code does not create a right of setoff," but merely "preserves a right to setoff created by state law or federal nonbankruptcy law." As a consequence, the bankruptcy court in *Feltman* noted, pre-*Strumpf* rulings cited by Noor to the contrary were inapposite or no longer good law, and a post-*Strumpf* decision relied on by Noor—*In re Comm'n Dynamics, Inc.*, 382 B.R. 219 (Bankr. D. Del. 2008)—was distinguishable.

In *Comm'n Dynamics*, the court held that, for purposes of section 553, a contract rejection damages claim under section 365(g) is a prepetition claim that qualifies for setoff. In so holding, the court identified an ambiguity in section 553, in that it does not identify the sources of a setoff right, but speaks only of not "affect[ing]" such a right. Thus, the court reasoned, section 553 should not prevent setoff of a claim arising under another section of the Bankruptcy Code—in that case, section 365(g). The *Feltman* court, however, did not view the existence of this ambiguity as support for the proposition that there is a federal right of setoff.

Nor did the *Feltman* court agree with the argument that a federal right of setoff exists because section 101(5) broadly defines "claim" to include contingent claims. According to the court, reading sections 101(5) and 553 together as creating a federal right of setoff, when no such right exists under applicable nonbankruptcy law, would result in elevating contingent "unsecured claims to secured status to the disadvantage of all other unsecured creditors, a result contrary to the Code's policy promoting a distribution to unsecured creditors *in pari passu*."

The *Feltman* court explained that section 151 of the New York Debtor and Creditor Law, which codifies equitable and common law setoff rights, provides that a debtor has the right "to set off and apply against any indebtedness, whether matured or unmatured," any amount owing from the debtor to the creditor. However, the provision does not permit setoff of contingent claims.

Without any setoff right under state law, the court ruled, Noor could not use its contingent claim to offset liability to the trustee under section 553.

OUTLOOK

Feltman reinforces the settled proposition that section 553 preserves setoff rights under applicable nonbankruptcy law but does not create such rights. This principle of preservation, but not creation of rights for creditors, is reflected in other provisions of the Bankruptcy Code. For example, section 546(c) of the Bankruptcy Code, which addresses a creditor's right to reclamation of goods supplied to a debtor prepetition, does not create a new "federal right of reclamation," nor does it create a comprehensive federal scheme for reclamation, but rather, preserves a seller's reclamation rights under applicable nonbankruptcy law. *In re Dana Corp.*, 367 B.R. 409 (Bankr. S.D.N.Y. 2007).

NINTH CIRCUIT RULES THAT HYPOTHETICAL PREFERENCE ACTIONS MAY BE CONSIDERED IN APPLYING THE GREATER AMOUNT TEST

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In *Schoenmann v. Bank of the West (In re Tenderloin Health)*, 849 F.3d 1231 (9th Cir. 2017), a divided panel of the U.S. Court of Appeals for the Ninth Circuit recently addressed as a matter of apparent first impression whether or not a bankruptcy court can consider hypothetical preference actions in analyzing whether a creditor-transferee in preference litigation received more than it would have received in a hypothetical chapter 7 liquidation, as required by section 547(b)(5) of the Bankruptcy Code. The majority ruled that a court may account for hypothetical preference actions against the creditor in applying this "greater amount test" when "factually warranted, supported by appropriate evidence, and so long as the hypothetical preference action would not result in a direct conflict with another section of the Bankruptcy Code."

AVOIDANCE OF PREFERENTIAL TRANSFERS: THE GREATER AMOUNT TEST

Under section 547(b) of the Bankruptcy Code, a trustee or chapter 11 debtor in possession may avoid a transfer made by a debtor to or for the benefit of a creditor for or on account of an antecedent debt within 90 days of a bankruptcy filing (or one year, if the transferee is an "insider") if the debtor was insolvent at the time of the transfer and if the transfer allows the creditor to receive more than it would have received in a hypothetical liquidation under chapter 7 of the Bankruptcy Code had the transfer not occurred. The hypothetical liquidation element of the preference analysis, which is contained in section 547(b)(5), is sometimes referred to as the "greater amount test."

Specifically, section 547(b)(5) provides that an otherwise qualifying transfer may be avoided if it enables the transferee creditor:

> to receive more than such creditor would receive if—
> (A) the case were a case under chapter 7 of this title;
> (B) the transfer had not been made; and
> (C) such creditor received payment of such debt *to the extent provided by the provisions of this title* (emphasis added).

As one court stated, this requirement is based upon:

> the common-sense notion that a creditor need not return a sum received from the debtor prior to bankruptcy if the creditor is no better off vis-à-vis the other creditors of the bankruptcy estate than he or she would have been had the creditor waited for liquidation and distribution of the assets of the estate.

Hager v. Gibson (In re Hager), 109 F.3d 201, 210 (4th Cir. 1997).

To determine what a creditor-transferee would receive in a hypothetical chapter 7 liquidation, it is necessary to understand the Bankruptcy Code's priority scheme. Secured claims enjoy the highest priority in bankruptcy. A claim is secured to the extent of the value of the underlying collateral. If the collateral's value is less than the face amount of the indebtedness, the creditor will hold a secured claim in the amount of the collateral value, along with an unsecured claim for the deficiency. Applicable nonbankruptcy law and agreements between and among the debtor and its secured creditors generally determine the relative priority of secured claims. In addition, the Bankruptcy Code provides for the creation of "priming" liens under certain circumstances in connection with financing extended to a debtor during a bankruptcy case.

Unsecured claims follow secured claims in priority. Certain categories of unsecured claims enjoy higher priority than general unsecured claims under section 507(a) of the Bankruptcy Code. The categories of unsecured claims that receive priority treatment include, among others, certain domestic support obligations, administrative expenses, employee wages, and taxes.

In a chapter 7 case, the order of priority for the distribution of unencumbered assets is specified further by section 726 of the Bankruptcy Code. The order of priority ranges from payments on claims in the order specified in section 507(a), which have the highest priority, to payment of any residual assets to the debtor (after payment of all claims plus interest), which

has the lowest priority. Distributions are to be made pro rata to claimants of equal priority within each of the six categories specified in section 726. If claimants in a higher category do not receive full payment of their claims, no payments can be made to lower category claimants.

Section 547(b)(5) is not the only provision in the Bankruptcy Code that mandates a comparison to distributions in a hypothetical chapter 7 liquidation. Pursuant to section 1129(a)(7), a chapter 11 plan can be confirmed only if the holder of a claim or interest in an impaired class of claims or interests accepts the plan or, failing acceptance, the holder:

> will receive or retain under the plan on account of such claim or interest property of a value, as of the effective date of the plan, that is not less than the amount that such holder would so receive or retain if the debtor were liquidated under chapter 7 of this title on such date[].

A similar "best interests test" is required with respect to all allowed unsecured claims for confirmation of a chapter 13 plan pursuant to section 1325(a)(4).

Apart from the express language of sections 547(b)(5), 1129(a)(7), and 1325(a)(4), as well as the provisions governing distributions in a chapter 7 case, the Bankruptcy Code offers little guidance as to how the court is to perform a chapter 7 liquidation analysis. As noted by the court in *In re Affiliated Foods, Inc.*, 249 B.R. 770, 788 (Bankr. W.D. Mo. 2000), "The valuation of a hypothetical Chapter 7 . . . is not an exact science." The exercise "entails a considerable degree of speculation about a situation that will not occur unless the case is actually converted to chapter 7." *In re Sierra-Cal*, 210 B.R. 168, 172 (Bankr. E.D. Cal. 1997).

Some courts have concluded that, in performing such an analysis, it is appropriate to consider other provisions of the Bankruptcy Code which would apply in a chapter 7 case, such as the avoidance, claims disallowance, and setoff provisions. *See, e.g.*, *Braniff Airways, Inc. v. Exxon Co., U.S.A.*, 814 F.2d 1030, 1040 (5th Cir. 1987) (in the hypothetical chapter 7 analysis under section 547(b)(5), the court should consider the creditor transferee's setoff rights under section 553); *Affiliated Foods*, 249 B.R. at 788 (the section 1129(a)(7) best interests test requires an estimation of the value of all of the estate's assets, including hard-to-determine asset values like disputed and contingent claims, the potential disallowance of claims, the probability of success and the value of causes of action held by the estate, and potential preference actions); *In re Larson*, 245 B.R. 609, 614 (Bankr. D. Minn. 2000) (in the hypothetical liquidation analysis under section 1129(a)(7), the court "must look not only at the Debtor's assets as listed on his schedules, but must also consider the recovery of assets by the trustee through fraudulent transfer and preference actions"); *Sierra-Cal*, 210 B.R. at 174 (the hypothetical liquidation analysis should include potential avoidance recoveries under sections 544 and 549); *Mason & Dixon Lines, Inc. v. St. Johnsbury Trucking Co. (In re Mason & Dixon Lines, Inc.)*, 65 B.R. 973, 976 (Bankr. M.D.N.C. 1986) (the section 547(b)(5) analysis should consider the creditor-transferee's setoff rights); *see also* COLLIER ON BANKRUPTCY ¶ 1129.02 [7][b][iv][C] (16th ed. 2017) (noting that "a trustee's avoiding powers in a hypothetical chapter 7 case may also affect the analysis" under section 1129(a)(7)).

Support for this approach can be found in the language of section 547(b)(5) and its legislative history. As noted, section 547(b)(5) provides that "such creditor received payment of such debt to the extent provided by the provisions of this title," suggesting that the hypothetical liquidation analysis should consider provisions in the Bankruptcy Code apart from the section 726 distribution scheme and the provisions incorporated by it.

The legislative history of section 547(b)(5) also refers to the "distributive provisions" of the Bankruptcy Code. S. Rep. No. 95-989, at 87 (1978). It further notes that "[a] preference is a transfer that enables a creditor to receive payment of a greater percentage of his claim than he would have received if the transfer had not been made and he had participated in the distribution of the assets of the bankruptcy estate." H.R. Rep. No. 95-595, at 177 (1977). Moreover, the legislative history explains that the hypothetical chapter 7 liquidation analysis under section 547(b)(5) "requires the court to focus on the allowability of the claim for which the preference was made" and states that "[i]f the claim would have been entirely disallowed, for example, then the test of [section 547(b)(5)] will be

met, because the creditor would have received nothing under the distributive provisions of the bankruptcy code." *Id.* at 372.

In *Tenderloin Health*, the Ninth Circuit considered whether, in applying the greater amount test, a court should consider hypothetical preference recoveries that could impact the amount a creditor would likely receive in a hypothetical chapter 7 liquidation.

TENDERLOIN HEALTH

In May 2009, Bank of the West ("BW") extended a $200,000 line of credit to Tenderloin Health ("Tenderloin"), a walk-in clinic serving AIDS patients in San Francisco. Two years later, BW loaned Tenderloin another $100,000. The loans were secured by Tenderloin's personal property, including its deposit accounts with BW.

Tenderloin began winding up its affairs in late 2011 and sold its only real property for approximately $1.3 million. On June 13, 2012, Tenderloin used a portion of the proceeds to pay BW approximately $191,000 to satisfy fully its outstanding loan obligations and moved the remaining $526,000 from an escrow account to its BW deposit account.

Tenderloin filed a chapter 7 petition on July 20, 2012, in the Northern District of California. Ninety days before the petition date, Tenderloin's BW account contained approximately $173,000, which had shrunk to $53,000 on June 13, 2012 (the date of the escrow transfers), and increased to $577,000 immediately after the bank deposit on that date. Approximately $564,000 remained in the BW deposit account on the petition date.

The chapter 7 trustee sued BW to avoid the $191,000 debt payment as a preferential transfer. In the complaint, the trustee argued, among other things, that the payment was a preference because, in a hypothetical liquidation of Tenderloin under chapter 7, the $526,000 deposit could be avoided as a preference. As a result of that avoidance, Tenderloin's BW account would have contained only $38,000 on the petition date, meaning that BW received a greater amount in respect of its claim than it would have received in a chapter 7 liquidation if the $191,000 payment had not been made. The bankruptcy court granted BW's motion for summary judgment, ruling that the trustee could not show that BW received more than it would have in a hypothetical liquidation. The district court affirmed on appeal.

THE NINTH CIRCUIT'S RULING

A three-judge panel of the Ninth Circuit reversed and remanded the rulings below.

Initially, the court concluded that section 547(b)(5) does not "directly forbid" courts from considering hypothetical preference actions. The phrase "provisions of this title" in section 547(b)(5), the majority explained, "appears to refer to the totality of Title 11 of the Code, which includes the preference provisions appearing in section 547."

According to the court, this conclusion is supported by the legislative history. Reference in the legislative history to "participate[s] in the distribution," the majority wrote, "leaves room to assume the hypothetical chapter 7 trustee might initiate preference actions in conjunction with the 'distribution' of the assets of the estate." The court also explained that "by invoking 'allowability,' which refers generally to whether payment of a claim would violate some independent provision of the Bankruptcy Code, the [legislative history] suggests it is appropriate to consider whether a hypothetical claim would be affected by the preference provisions."

Further support for this approach, the Ninth Circuit majority noted, can be found in rulings by other courts (as noted above) that have considered "hypothetical preference actions within hypothetical chapter 7 liquidations" in construing the best interests test under sections 1129(a)(7) and 1325(a)(4), as well as decisions applying "hypothetical setoff analyses under section 553 within hypothetical chapter 7 liquidations."

The Ninth Circuit distinguished its prior holding in *Alvarado v. Walsh (In re LCO Enters.)*, 12 F.3d 938 (9th Cir. 1993). In *LCO*, the debtor assumed a commercial real property lease by curing all defaults, as required by section 365(b) of the Bankruptcy Code, and later obtained confirmation of a chapter 11 plan. A trustee appointed to pursue avoidance actions sued the

landlord to avoid and recover pre-bankruptcy rent payments as preferential transfers. The trustee argued that in a hypothetical chapter 7 liquidation, the trustee might have rejected the lease, giving the landlord an unsecured claim for unpaid rent, rather than payment in full, as actually occurred in accordance with section 365(b).

The Ninth Circuit rejected this argument, ruling that "the phrase 'hypothetical chapter 7' [in section 547(b)(5)] . . . does not mean that the bankruptcy court can construct its own hypothetical from whole cloth or from only some of the facts." According to the court, because the lease had been assumed, "the [bankruptcy] court could neither speculate that there was no lease nor assume that the lease was rejected." Holding otherwise, the Ninth Circuit noted, would permit section 547(b) "to circumvent the requirements of § 365(b)."

The Ninth Circuit ruled that the facts in *Tenderloin Health* were different. "Unlike in *LCO*," the court wrote, "permitting such an action would not violate any other statutory provision, and it is consistent with the text and legislative history . . . ." Therefore, the court ruled that *LCO* did not prevent it from assuming in a hypothetical liquidation that a chapter 7 trustee would sue to avoid and recover the $526,000 deposit from BW as a preference.

The Ninth Circuit thus explained that in a hypothetical liquidation: (i) BW would have a right under section 553 to set off amounts in Tenderloin's deposit account against Tenderloin's debt; (ii) because section 502(d) requires disallowance of any claim unless and until a transferee returns a challenged transfer to the estate, the bankruptcy court would likely adjudicate the trustee's hypothetical preference claim before allowing BW's claim and adjudicating BW's setoff rights; (iii) Tenderloin's $526,000 deposit into its BW deposit account was a "transfer" of Tenderloin's property which is avoidable under section 547(b); and (iv) the $526,000 deposit would be avoided as a preference because, in addition to the other preference elements, the transfer diminished the funds available to Tenderloin's creditors by increasing the size of BW's secured claim against the bankruptcy estate. As a consequence, the Ninth Circuit concluded, "Tenderloin's account functionally would contain [$38,000] on the petition date, a sum far less than the [$190,000] BW received," meaning that "[u]nder the hypothetical facts," the trustee could satisfy the greater amount test set forth in section 547(b)(5).

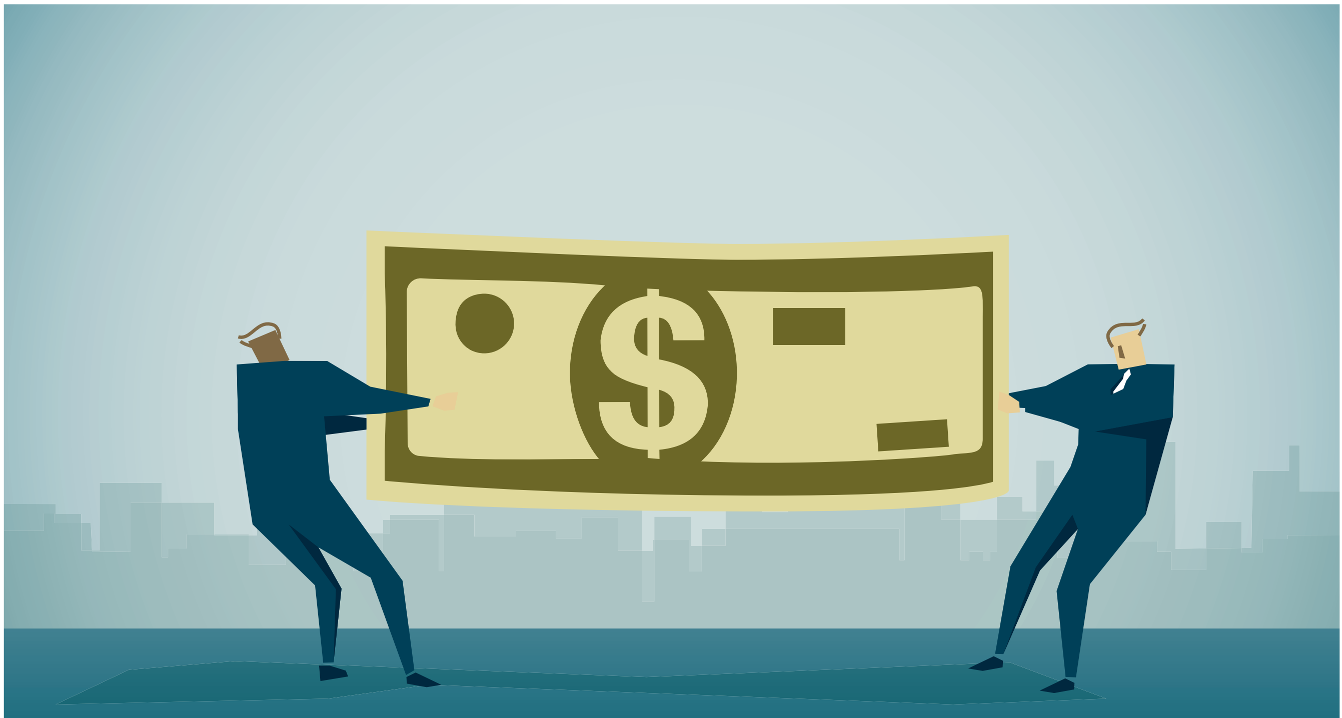
CONCURRING OPINION

District judge Edward R. Korman (sitting by designation) concurred in part. Although he concurred in the judgment, Judge Korman disagreed with the hypothetical analysis undertaken by the majority, particularly with respect to BW's setoff rights and the requirement for bankruptcy court approval under section 553(b):

> [I]n a hypothetical liquidation, there is no such gatekeeper to protect other claimants. There is of course no actual bankruptcy judge available to exercise discretion in such a case, and it would push the already somewhat strained boundaries of our hypothetical analysis too far to exercise our own discretion, sitting as a three-headed hypothetical bankruptcy judge, weighing the imaginary equities of a fantasy liquidation. The majority asserts that this adds a new variable to what is supposed to be a controlled experiment . . . but so would exercising our own discretion—by substituting our judgment for that of the real bankruptcy judge.

OUTLOOK

Tenderloin Health indicates that when applying the greater amount test, bankruptcy courts in the Ninth Circuit may consider the potential impact of various provisions in the Bankruptcy Code other than the chapter 7 distribution scheme. According to the court, that discretion must be informed and constrained by the evidentiary record, and it cannot be exercised in a manner which would violate other provisions of the statute. The decision also highlights potential pitfalls in applying a hypothetical analysis that obligates the court to engage in speculation and a complex analysis of what might have happened, as distinguished from the actual facts of a bankruptcy case.



TWO RECENT DECISIONS DEMONSTRATE CONTINUED DISAGREEMENT OVER WHETHER ECONOMIC VALUE OR FACE AMOUNT OF LIENS IS APPROPRIATE METRIC IN AUTHORIZING FREE AND CLEAR BANKRUPTCY SALE

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The ability of a trustee or chapter 11 debtor in possession ("DIP") to sell bankruptcy estate assets "free and clear" of liens on the property under section 363(f) of the Bankruptcy Code has long been recognized as one of the most powerful tools for restructuring a debtor's balance sheet and generating value in bankruptcy. Section 363(f)(3) permits a sale free and clear if "such interest is a lien and the price at which such property is to be sold is greater than the aggregate value of all liens on such property." However, courts disagree as to the meaning of the phrase "the aggregate value of all liens."

Two recent rulings add to the ongoing rift among bankruptcy and appellate courts regarding this issue. In *In re Bay Circle Properties, LLC*, 2017 BL 44637 (Bankr. N.D. Ga. Feb. 14, 2017), the United States Bankruptcy Court for the Northern District of Georgia determined that a sale of real property free and clear under section 363(f)(3) was permitted because the sale price met or exceeded the *economic value* of the liens encumbering the property, even though the price did not exceed the *face amount* of the liens. The United States Bankruptcy Court for the District of New Jersey reached the opposite conclusion in *In re Lutz*, 2017 BL 147967 (Bankr. D.N.J. May 3, 2017), ruling that "value" in section 363(f)(3) "means the face value of the lien."

SALES FREE AND CLEAR UNDER SECTION 363(f)

Section 363(f) authorizes a trustee or DIP to sell property "free and clear of any interest in such property of an entity other than the estate" under any one of five specified conditions (only one of which involves consent). A bankruptcy court's power to order sales free and clear of such interests without the consent of the party asserting the interest has been recognized for more than a century. *See Ray v. Norseworthy*, 90 U.S. 128, 131–32 (1875); *Van Huffel v. Harkelrode*, 284 U.S. 225, 227 (1931). Free and clear sales promote the expeditious liquidation of estate assets by avoiding the delay attendant to resolving disputes concerning the validity and extent of liens and other interests, which can later be adjudicated in a centralized forum. They also promote the maximization of the value of

estate assets. After all, a prospective buyer would discount its offer for an asset significantly if it were faced with the prospect of protracted litigation to obtain clear title or if it had to accept title subject to liens or other interests. To obtain the benefit of a free and clear sale, section 363(e) of the Bankruptcy Code provides that the nondebtor is entitled to "adequate protection" of its interest, which most commonly takes the form of a replacement lien on the proceeds of the sale.

One of the five alternative conditions—set forth in section 363(f)(3)—to permit a sale free and clear of an interest is that "such interest is a lien and the price at which such property is to be sold is greater than the aggregate value of all liens on such property." 11 U.S.C. § 363(f)(3). The Bankruptcy Code does not elaborate on the meaning of the phrase "aggregate value of all liens" in section 363(f)(3), and two approaches have emerged among courts as to its interpretation in the context of this provision.

Some courts have held that section 363(f)(3) refers to the *economic value* of a lien, which is determined by the value of the collateral. *See, e.g.*, *In re WPRV-TV Inc.*, 143 B.R. 315 (D.P.R. 1991); *In re Boston Generating LLC*, 440 B.R. 302 (Bankr. S.D.N.Y. 2010). Under this "Economic Value Approach," courts reason that the term "value" should be given the same meaning in section 363(f) which it has in sections 506(a) and 361 of the Bankruptcy Code.

Section 506(a) provides that the claim of a creditor secured by a lien on the debtor's property "is a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property" and an unsecured claim to the extent that the claim exceeds the value of the collateral. 11 U.S.C. § 506(a). Similarly, section 361 requires "adequate protection" payments to a secured creditor to protect against any "decrease in the value of such entity's interest" in property under certain circumstances. 11 U.S.C. § 361(1). Thus, both provisions refer to the economic value of the underlying collateral, rather than the face amount of the claim secured by a lien on such collateral.

Courts adopting the Economic Value Approach reason that their interpretation of section 363(f)(3) supports the maximization of value for creditors—one of the central purposes of the Bankruptcy Code—by precluding out-of-the-money lienholders from blocking sales which otherwise would be beneficial to the estate and its stakeholders.

Other courts have held that the language of section 363(f)(3) refers to the aggregate face amount of all liens secured by the property, rather than their economic value. *See, e.g.*, *Clear Channel Outdoor, Inc. v. Knupfer (In re PW, LLC)*, 391 B.R. 25 (B.A.P. 9th Cir. 2008); *Criimi Mae Servs. Ltd. P'ship v. WDH Howell LLC (In re WDH Howell LLC)*, 298 B.R. 527 (D.N.J. 2003). Courts' principal argument under this "Face Amount Approach" is that the Economic Value Approach can never be satisfied because the sale price determines the value of the property and so must equal (and thus cannot be greater than) the aggregate economic value of the liens (unless the price also exceeds their face value). These courts resist interpreting section 363(f)(3) of the Bankruptcy Code consistently with sections 506(a) and 361 on the basis that those provisions expressly denote economic value by referring to the extent of the lienholder's or estate's interest in the property. If Congress intended to refer to the economic value of the lien in section 363(f)(3), these courts suggest, it would have worded the provision similarly.

The bankruptcy courts weighed in on this debate in *Bay Circle* and *Lutz*.

BAY CIRCLE

Bay Circle Properties, LLC ("Bay Circle" or the "Debtor") and certain affiliates filed for chapter 11 protection in the Northern District of Georgia on May 4, 2015. Among Bay Circle's assets were two warehouse buildings (the "Property") in Gwinnett County, Georgia.

In October 2014, Good Gateway, LLC, and SEG Gateway, LLC (together, the "Lienholders") obtained $14.5 million in judgments in Florida state court against Bay Circle's principal and certain affiliates, none of which later filed for bankruptcy. In December 2014, the Lienholders recorded judgment liens with respect to the Property. Shortly thereafter, Bay Circle's principal transferred his interest in the Property to Bay Circle, subject to the Lienholders' liens. The Property also was encumbered by a first-priority lien securing a $22 million loan to Bay Circle (the "Loan"). The Property was not the only collateral for the Loan; obligations under the Loan were further secured by

liens on various other assets of Bay Circle and its nondebtor affiliates. Ultimately, Bay Circle commenced a chapter 11 bankruptcy case.

Bay Circle and the first-priority secured lender, which later assigned its Loan to Bay Point Capital Partners, LP (the "Lender"), entered into a settlement agreement that was approved by the bankruptcy court. Among other things, the agreement: (a) required the Debtor to make "milestone payments" to the Lender; and (b) specified minimum sale prices—or "release prices"—for the collateral, including a $5 million release price for the Property. The agreement also provided that, upon default, the Lender could foreclose on the Property by means of a nonjudicial foreclosure under Florida law.

The bankruptcy court denied the Debtor's motion to refinance the debt on the Property so that it could make a $3.5 million milestone payment. The Debtor responded by filing an emergency motion to sell the property at auction, free and clear of liens (including the Lienholders' junior liens) under section 363(f) of the Bankruptcy Code.

The Lender objected, asserting that it had the right to credit bid its secured claim (which at this point had been reduced to $15 million) in any sale of the Property. The Lienholders also objected to the sale, arguing, among other things, that a sale of the property free and clear of their junior liens violated section 363(f)(3) because the face amount of all liens encumbering the property—totaling approximately $30 million—exceeded the anticipated $5 million proceeds from the auction sale. The court ultimately overruled the Lienholders' objections and approved the sale of the Property at auction to the Lender for a $5.35 million credit bid, effectively stripping the Lienholders' junior liens from the property.

The bankruptcy court evaluated the ability of the Debtor to sell the Property free and clear of liens under section 363(f). In doing so, it adopted the Economic Value Approach, ruling that section 363(f)(3) requires only that the sale price be greater than or equal to the value of the liens encumbering it, as distinguished from the face value of the secured claims asserted against it. The court concluded that the plain language of the statute supports using economic value as a metric. Section 363(f)(3), the court wrote, plainly refers to the "value" of the liens, "not the amount of the liens." In addition, the court reasoned that section 363(f)(3) would be superfluous if it were construed to require payment in full of the face amount of all liens, noting that "a sale which results in the payment in full of the liens, of course, is free and clear of them."

The court explained that the Lienholders' liens had no economic value because the Lender's senior lien on the property exceeded $15 million on a property worth much less than that. Noting that the Debtor scheduled the value of the warehouse property at $5.5 million, and the Lender's minimum release price for the property was $5.0 million, the court concluded that the $5.35 million auction price "meets or exceeds" the economic value of the Lender's lien. Thus, the court ruled that section 363(f)(3) had been satisfied.

LUTZ

After separately filing for chapter 11 protection in the District of New Jersey in 2016, Richard and Susan Lutz (the "Lutzes") filed a motion to sell their jointly owned Moorestown, New Jersey, real property for $1.3 million, free and clear of liens under section 363(f). The property was encumbered by a mortgage held by a lender (the "Mortgagee") that filed a secured claim in the amount of approximately $2.4 million.

The Mortgagee objected to the sale free and clear of its lien, arguing that the sale could not satisfy section 363(f)(3) because the anticipated sales price for the property was not greater than the face value of its lien. The Lutzes contended that "value" in section 363(f)(3) should mean "economic value," which they argued is the "actual value to be determined by the Court."

The bankruptcy court noted that the United States District Court for the District of New Jersey rejected the Lutzes' interpretation of "value" in the *Howell* case. In *Howell*, the district court employed a common sense analysis of the plain language of section 363(f)(3) to determine congressional intent. It ruled that "value" cannot mean "economic value" when read in the context of the preceding phrase "greater than" because "the sale price for the overencumbered property can never be greater than the aggregate economic value of the liens on the property." *Howell*, 298 B.R. at 532 (citation omitted).

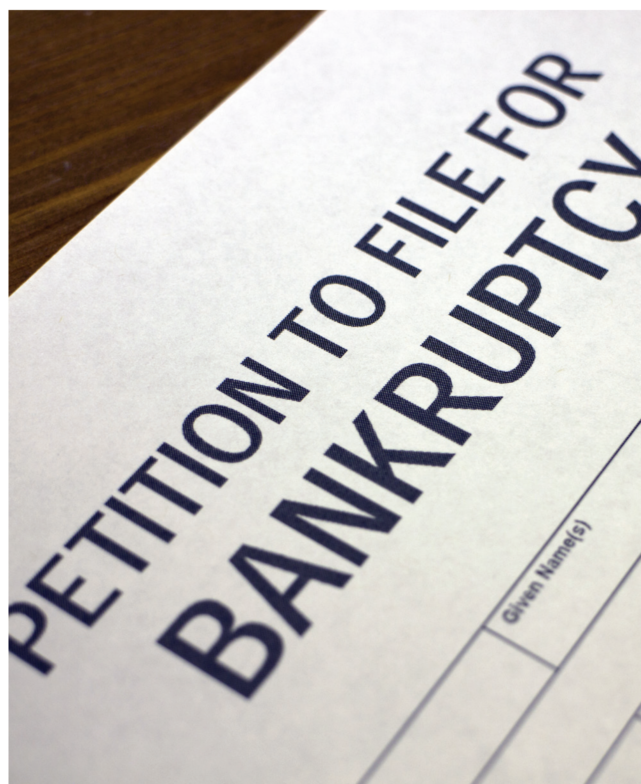
The *Lutz* court found *Howell* to be persuasive, ruling that the term "value" in section 363(f)(3) means the face value of the lien. The court accordingly held that the property could not be sold free and clear of the Mortgagee's lien under section 363(f)(3) because the proposed sale price was less than the face value of the lien.

OUTLOOK

Bay Circle and *Lutz* do little to end the debate on the meaning of section 363(f)(3) of the Bankruptcy Code. The cases' dramatic differences in approach and outcome reflect the courts' continuing struggle to interpret a provision that is commonly relied on in bankruptcy cases to facilitate quick asset sales which generate much-needed value for the estate.

This struggle is understandable. Although there is logic to the Economic Value Approach, it does not squarely comport with the language of section 363(f)(3), which allows sales free and clear of liens only where "the price at which such property is to be sold *is greater than* the aggregate value of all liens on such property." Arguably, this language can never be satisfied where there are underwater liens—a common situation in bankruptcy—because a market sale price will never "exceed" the value of liens. The *Bay Circle* court apparently reads the statute to include sales "*equal to or* greater than" the value of liens—a practical approach that by necessity reframes the statutory language to allow lienholders to realize the value of their liens and no more, consistent with other provisions of the Bankruptcy Code.

Considering itself constrained by the plain language of section 363(f)(3), the *Lutz* court joined those courts that have adopted the alternative Face Amount Approach. The *Bay Circle* court makes a strong point, however, that the Face Amount Approach renders section 363(f)(3) a virtual nullity (i.e., a debtor may pay off liens at face value without the help of the Bankruptcy Code) and seems to assign value to valueless liens (i.e., a debtor may not sell free and clear of underwater liens under section 363(f)(3) if the sale price does not pay them in full). Absent congressional clarification to the statutory language, the resolution of this debate may require more rulings at the appellate level.



SECOND CIRCUIT AFFIRMS BANKRUPTCY COURT'S NULLIFICATION OF CHAPTER 15 DEBTOR'S SALE OF CLAIM DUE TO WOEFULLY INADEQUATE PRICE

Dan T. Moss
Anna M. Wetzel
Mark G. Douglas

In the March/April 2013 edition of the *Business Restructuring Review*, we reported on an opinion by the U.S. Bankruptcy Court for the Southern District of New York concluding that a chapter 15 debtor's sale of claims against Bernard Madoff's defunct brokerage company was not subject to review as an asset sale under section 363(b) of the Bankruptcy Code. The Court of Appeals for the Second Circuit vacated that decision in 2014 and remanded the case to the bankruptcy court, with specific instructions to subject the sale to review under section 363.

In October 2015, the bankruptcy court granted a motion by the chapter 15 debtor's foreign representative to abandon the sale. After conducting a section 363(b) analysis, the court held that the liquidator of the debtor's estate should be permitted

either to collect on distributions made in respect of the claims or to sell them at a much higher price. After the district court affirmed that ruling on appeal, the decision was appealed to the Second Circuit. In *Farnum Place, LLC v. Krys (In re Fairfield Sentry Ltd.)*, 2017 BL 169478 (2d Cir. May 22, 2017), the Second Circuit affirmed the decisions below.

FAIRFIELD SENTRY

Fairfield Sentry Limited ("Fairfield Sentry") was established for the purpose of investing in Bernard L. Madoff Investment Securities ("BLMIS"). Shortly after Madoff's Ponzi scheme came to light and BLMIS collapsed, Fairfield Sentry was placed into liquidation in a British Virgin Islands ("BVI") court. On July 22, 2010, the U.S. bankruptcy court issued an order recognizing the BVI proceeding as a foreign main proceeding under chapter 15.

BLMIS was placed in liquidation in the U.S. under the Securities Investor Protection Act ("SIPA"). Fairfield Sentry filed customer claims in this proceeding. Pursuant to a settlement agreement, these claims were allowed in the amount of $230 million. In 2010, the U.S. bankruptcy court entered an order under section 1521(a)(5) of the Bankruptcy Code "entrusting the administration or realization of all or part of the debtor's assets within the territorial jurisdiction of the United States to the foreign representative." Following a competitive auction, Fairfield Sentry's foreign representative accepted an offer from Farnum Place, LLC ("Farnum") to purchase the claims for approximately 32 percent of their allowed amount. In December 2010, shortly after the parties signed a trade confirmation, the pool of assets available for distribution to BLMIS customers increased by approximately $7.2 billion due to a separate settlement. As a result, the prices offered for claims against BLMIS rose sharply.

By its terms, the trade confirmation was subject to: (i) approval by the BVI court; and (ii) orders of both the BVI court and the U.S. bankruptcy court approving the assignment of Fairfield Sentry's claims. The BVI court approved the trade confirmation and the claim assignment after a three-day evidentiary hearing. Fairfield then sought approval from the U.S. bankruptcy court, which had to determine whether it was bound to review the assignment under section 363 and, if so, whether the transaction was in the best interests of Fairfield Sentry's estate.

THE BANKRUPTCY COURT'S DECISION

The bankruptcy court found in *In re Fairfield Sentry Ltd.*, 484 B.R. 615, 617 (Bankr. S.D.N.Y. 2013), that section 363(b) was inapplicable to the assignment because the property at issue—Fairfield Sentry's SIPA claim—was not "within the territorial jurisdiction of the United States." Pursuant to section 1520(a)(2) of the Bankruptcy Code, section 363 applies to chapter 15 debtors only when the sale or assignment involves property within the territorial jurisdiction of the United States. Section 1502(8) defines the phrase "within the territorial jurisdiction of the United States" as:

> [T]angible property located within the territory of the United States and intangible property deemed under applicable nonbankruptcy law to be located within that territory, including any property subject to attachment or garnishment that may properly be seized or garnished by an action in a Federal or State court in the United States.

The court held that BVI—not the United States—was the situs of the intangible SIPA claim "under applicable nonbankruptcy law" (agreed by the parties to be the law of New York). The bankruptcy court also found that the BVI court had the paramount interest in the sale, whereas the New York court lacked any meaningful interest. Under circumstances where U.S. interests are minimal, the court reasoned, comity dictates deference to the BVI court and its judgment.

The district court affirmed the ruling in *Krys v. Farnum Place, LLC (In re Fairfield Sentry Ltd.)*, 2013 BL 370732 (S.D.N.Y. July 3, 2013).

THE SECOND CIRCUIT'S INITIAL RULING

In *Krys v. Farnum Place, LLC (In re Fairfield Sentry Ltd.)*, 768 F.3d 239 (2d Cir. 2014), the Second Circuit vacated the orders below and remanded the case to the bankruptcy court.

While the Second Circuit agreed with the bankruptcy court's determination that the "property" at issue was the SIPA claims, the court disagreed with the bankruptcy court's finding that these claims were not "within the territorial jurisdiction of the

United States." According to the Second Circuit, the bankruptcy court's analysis of section 1520(a)(2) was incomplete because section 1502(8) deems "any property subject to attachment or garnishment that may be properly seized or garnished by an action" in a U.S. court to be "within the territory of the United States."

The SIPA claims, the Second Circuit reasoned, are subject to attachment or garnishment and may be properly seized by an action in a U.S. federal or state court because, under New York law, " 'any property which could be assigned or transferred' is subject to attachment and garnishment" (citing N.Y. C.P.L.R. §§ 5201(b) and 6202). Moreover, the court explained, "[f]or attachment purposes, with respect to intangible property that has as its subject a legal obligation to perform, the situs is the location of the party from whom performance is required pursuant to the obligation" (citing *In ABKCO Industries, Inc. v. Apple Films, Inc.*, 39 N.Y.2d 670 (N.Y. 1976)).

Although Fairfield Sentry and BLMIS's SIPA trustee do not have a contractual relationship, the Second Circuit noted, the SIPA trustee is statutorily obligated to distribute to Fairfield Sentry its pro rata share of the recovered assets. Therefore, the SIPA trustee's location is the situs of the SIPA claims. Because the SIPA trustee is located in New York, the assignment is a "transfer of an interest of the debtor in property that is within the territorial jurisdiction of the United States" under section 1520(a)(2), and pursuant to section 1520(a)(2), the bankruptcy court must apply section 363 to the sale.

The Second Circuit also held that the bankruptcy court erred in using principles of comity to defer to the BVI court's approval of the transfer of the SIPA claims. According to the Second Circuit, "[T]he language of section 1520(a)(2) is plain; the bankruptcy court is *required* to conduct a section 363 review when the debtor seeks a transfer of an interest in property within the territorial jurisdiction of the United States." Given the Bankruptcy Code's plain language on the applicability of section 363, the bankruptcy court should not have deferred to the BVI court's determination.

The Second Circuit vacated the ruling and remanded the case below. It directed the bankruptcy court to conduct the section 363 review, taking into consideration, among other things, "the increase in value of the SIPA Claim[s] between the signing of the Trade Confirmation and approval by the bankruptcy court." According to the Second Circuit, "Nothing in the language of section 363 or our case law limits the bankruptcy court's review to the date of signing the Trade Confirmation."

THE BANKRUPTCY COURT'S RULING ON REMAND

On remand, the bankruptcy court granted a motion by Fairfield Sentry's foreign representative to abandon the sale, ruling that the liquidator of Fairfield Sentry's estate should be permitted either to retain the claims and receive recoveries for the fund's creditors or to sell the claims at a much higher price. *See In re Fairfield Sentry Ltd.*, 539 B.R. 658 (Bankr. S.D.N.Y. 2015).

According to the court, the foreign representative demonstrated a sound business reason under the standard established in *Comm. of Equity Sec. Holders v. Lionel Corp. (In re Lionel Corp.)*, 722 F.2d 1063 (2d Cir. 1983), for seeking disapproval of the sale of the SIPA claims. If the sale were consummated, the representative would be obligated to pay Farnum in excess of $112 million in distributions in respect of the SIPA claims in exchange for Farnum's payment of approximately $74 million. Thus, the court found that: (i) the sale price of the claims was disproportionately low in light of their increased value; and (ii) retention of the claims by the foreign representative and the receipt of distributions or sale of the claims at a much higher price was in the best interest of Fairfield Sentry's estate.

Mindful of concerns regarding the integrity and finality of bankruptcy asset sales, the court noted that the decision whether to reopen an auction is committed to a bankruptcy court's discretion. Exercising that discretion in this case was appropriate, the court concluded, because changed circumstances made the purchase price "woefully inadequate."

The bankruptcy court also denied Farnum's motion for an order modifying the July 22, 2010, chapter 15 recognition order to provide that section 363 does not apply in the chapter 15 case, or alternatively, even if section 363 does apply, that section 363 review of the sale transaction is not required because, among other things, the sale was an ordinary course transaction. According to the bankruptcy court, the motion "attempts

an end run around the Second Circuit's mandate." The bankruptcy court ruled, among other things, that section 1520(a)(2) "unambiguously makes § 363 applicable to chapter 15 cases" and that, although the foreign representative's current mandate may be to liquidate Fairfield Sentry's assets, that activity was never Fairfield Sentry's "normal, daily business." After the district court affirmed the bankruptcy court's ruling on remand, Farnum appealed to the Second Circuit.

THE SECOND CIRCUIT'S MOST RECENT RULING

A three-judge panel of the Second Circuit affirmed in a summary order. The panel rejected Farnum's arguments that the bankruptcy court: (i) erred in disapproving the sale because its 2010 order under section 1521(a)(5) entrusted the realization of the debtor's U.S. assets to the foreign representative; and (ii) gave insufficient weight in section 363(b) analysis to comity.

Reiterating its previous conclusion that section 1520(a)(2) mandates the application of section 363(b) to a proposed transfer of a chapter 15 debtor's U.S. assets, the Second Circuit held that Farnum's arguments were largely nullified by the express terms of its 2014 ruling. In that ruling, the panel explained, the Second Circuit had specifically directed the bankruptcy court to "consider as part of its section 363 review the increase in value of [the claim against BLMIS] between the signing of the [sale agreement] and approval by the bankruptcy court." The Second Circuit noted that it had also rejected the bankruptcy court's alternative holding regarding comity. In this decision, the panel instructed that although comity is a "central[]" component of chapter 15, section 1520(a)(2)'s requirement for section 363(b) review operates as a "brake or limitation on comity."

Given its previous ruling, the Second Circuit panel held that, under the "mandate rule," Farnum was foreclosed from relitigating these issues. It also denied Farnum's request that the court reconsider its previous ruling, observing that "[w]e here identify no clear error" which would warrant consideration.

NEWSWORTHY

Bruce Bennett (Los Angeles and New York) and ***Corinne Ball (New York)*** were named "Leading Lawyers" in the field of "Finance—Restructuring (including bankruptcy)—corporate" and "Finance—Restructuring (including bankruptcy)—municipal" in *The Legal 500 United States* 2017.

Dan T. Moss (Washington), ***Daniel J. Merrett (Atlanta)***, ***Joshua M. Mester (Los Angeles)***, ***Paul M. Green (Houston)***, ***Thomas M. Wearsch (Cleveland)***, ***Sidney P. Levinson (New York)***, ***Bruce Bennett (Los Angeles and New York)***, ***Michael J. Cohen (New York)***, ***Kevyn D. Orr (Washington)***, ***Heather Lennox (New York and Cleveland)***, and ***Scott J. Greenberg (New York)*** were recommended in the field of "Corporate Bankruptcy" and/or "Municipal Bankruptcy" in *The Legal 500 United States* 2017.

In June 2017, ***Corinne Ball (New York)*** was admitted to the bar of the United States Supreme Court. She was also inducted as a member of the International Insolvency Institute.

On June 9, 2017, ***Thomas M. Wearsch (Cleveland)*** participated in a panel discussion on energy restructuring at the American Bankruptcy Institute's 24th Annual Central States Bankruptcy Workshop in Traverse City, Michigan.

An article written by ***Erin N. Brady (Los Angeles)*** and ***Anna Kordas (New York)***, entitled "The Supreme Court Will Rule on the Breadth of the Bankruptcy Code's Safe Harbor," was published in the June 19, 2017, edition of *Commercial Bankruptcy Litigation*.

Kevyn D. Orr (Washington) and ***Dan T. Moss (Washington)*** gave a presentation on June 28, 2017, entitled "When Cities Fail: What Can We Learn from the Detroit Insolvency?" at a meeting of the World Bank Group Finance & Markets and Governance Global Practices in Washington, D.C.

IN BRIEF: SECOND CIRCUIT REAFFIRMS BROAD SCOPE OF BANKRUPTCY CODE'S SUBORDINATION OF SHAREHOLDER CLAIMS

Section 510(b) of the Bankruptcy Code provides a mechanism designed to preserve the creditor/shareholder risk allocation paradigm by categorically subordinating most types of claims asserted against a debtor by equityholders in respect of their equity holdings. However, courts do not always agree on the scope of this provision in attempting to implement its underlying policy objectives. In *In re Lehman Brothers Holdings Inc.*, 2017 WL 1718438 (2d Cir. May 4, 2017), the Second Circuit reaffirmed the broad scope of section 510(b), ruling that breach of contract claims asserted by employees who were awarded restricted stock units entitling them to common stock were properly subordinated under section 510(b).

SUBORDINATION IN BANKRUPTCY

The concept of claim, debt, or lien subordination is well recognized under federal bankruptcy law. A bankruptcy court's ability to reorder the relative priority of claims or debts under appropriate circumstances is part and parcel of its broad powers as a court of equity. The statutory vehicle for applying these powers in bankruptcy is section 510 of the Bankruptcy Code.

Section 510(a) makes a valid contractual subordination agreement enforceable in a bankruptcy case to the same extent that it would be enforceable outside bankruptcy.

Section 510(b) subordinates claims arising from the purchase or sale of a security of the debtor or an affiliate of the debtor to "all claims or interests that are senior to or equal the claim or interest represented by the security, except that if such security is common stock, such claim has the same priority as common stock."

Finally, misconduct that results in injury to creditors can warrant the "equitable" subordination of a claim under section 510(c).

A related but distinct remedy is "recharacterization," whereby a court orders an asserted claim to be treated as if it were an interest. Because the Bankruptcy Code does not expressly

empower a bankruptcy court to recharacterize debt as equity, some courts disagree as to whether they have the authority to do so and, if so, the source of such authority.

To date, seven circuit courts of appeal have held that a bankruptcy court's power to recharacterize debt derives either from the court's broad equitable powers, including those set forth in section 105(a) of the Bankruptcy Code, which provides that "[t]he court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of [the Bankruptcy Code]," or from section 502(b)(1), which provides in relevant part 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."

SUBORDINATION OF SHAREHOLDER CLAIMS UNDER SECTION 510(b)

Section 510(b) provides as follows:

> For the purpose of distribution under this title, a claim arising from rescission of a purchase or sale of a security of the debtor or of an affiliate of the debtor, for damages arising from the purchase or sale of such a security, or for reimbursement or contribution allowed under section 502 on account of such a claim, shall be subordinated to all claims or interests that are senior to or equal the claim or interest represented by such security, except that if such security is common stock, such claim has the same priority as common stock.

The purpose of section 510(b), consistent with the Bankruptcy Code's "absolute priority" rule, is to prevent the bootstrapping of equity interests into claims that are on a par with other creditor claims. According to this rule, unless creditors are paid in full or agree otherwise, shareholders cannot receive any distribution from a bankruptcy estate.

Many courts have decided cases under section 510(b) by reviewing the traditional allocation of risk between a company's shareholders and its creditors. Under this policy-based analysis, shareholders are deemed to undertake more risk in exchange for the potential to participate in the profits of the company, whereas creditors can expect only repayment of their fixed debts. Accordingly, shareholders, and not creditors, assume the risk of a wrongful or unlawful purchase or sale of securities. This risk allocation model is sometimes referred to as the "Slain/Kripke theory of risk allocation." Because of the parties' differing expectations for risk and return, it is perceived as unfair to allow a shareholder to recover from the limited assets of a debtor as a creditor by "converting" its equity stake into a claim through the prosecution of a successful securities lawsuit. The method by which such a conversion is thwarted is subordination of the shareholder's claim under section 510(b).

LEHMAN

Prior to filing the largest chapter 11 case in history in September 2008, Lehman Brothers Holdings Inc. ("Lehman") gave its employees restricted stock units ("RSUs") as part of their compensation. Each RSU represented a contingent right to own shares of Lehman's common stock that would vest after five years. During the five-year holding period, the shares of common stock were held in a trust for the benefit of RSU holders.

The documents governing the RSUs obligated Lehman only to deliver the stock and expressly provided that Lehman was not obligated to pay any cash in respect of the RSUs. The documents also contained subordination provisions, which provided that RSU claims asserted against Lehman in bankruptcy would be subordinated under section 510(b) and should be afforded the same priority as equity interests. Finally, the trust agreement provided that all assets held in the trust (including shares of common stock) were subject to the claims of Lehman's general creditors in bankruptcy.

Lehman employees holding RSUs that had not yet been converted into common stock when Lehman filed for bankruptcy filed claims asserting, among other things, breach of contract for Lehman's failure to pay the cash value of RSUs that never vested. Lehman objected to the claims, seeking to disallow them as equity interests or, in the alternative, to subordinate

the claims to the claims of general unsecured creditors under section 510(b).

The bankruptcy court ruled that the RSU claims should be disallowed as equity interests or, alternatively, that they should be subordinated under section 510(b). The district court affirmed the decision on both grounds.

THE SECOND CIRCUIT'S RULING

A three-judge panel of the Second Circuit agreed with the lower courts that the RSU claims must be subordinated under section 510(b). However, the court ruled that not all of the RSU claims should be disallowed.

At the outset, the Second Circuit noted that it need not, as the bankruptcy court had determined, decide whether an RSU is an "equity security" pursuant to section 101(16) of the Bankruptcy Code. Even if it were, the Second Circuit explained, the RSU holders were not barred from asserting proofs of claim because "at least some of their claims are not duplicative of proofs of interest."

Citing *In re USA Commercial Mortg. Co.*, 377 B.R. 608 (B.A.P. 9th Cir. 2007), the court explained that a proof of claim can be disallowed as an equity interest only if it is duplicative of an interest in an equity security. Therefore, the Second Circuit panel reasoned, if the holder of an equity interest asserts a claim based on fraud or breach of contract that occurred in connection with its purchase of the equity interest, such claim is distinct from the claimant's underlying equity interest and cannot be reclassified as an equity interest.

According to the panel, because claims asserted by the RSU holders alleging breach of contract were not duplicative of equity interests that the RSUs represented, such claims should not be disallowed, even if the underlying RSUs qualified as equity securities.

However, the Second Circuit concluded, in keeping with the broad interpretation of section 510(b) and its legislative history, the RSU claims should be subordinated because they "arose from the purchase or sale of a security." First, the court found that an RSU is a "security" because: (i) it falls within the scope of the broad language used to define "security" in section 101(49) of the Bankruptcy Code; (ii) it "bear[s] many of the hallmark characteristics of a security," including limited voting rights and the receipt of dividends in the form of additional RSUs; and (iii) the RSU holders had the same risk and benefit expectations as common stock holders, since the value of the RSUs depended on the value of Lehman's common stock.

Next, the Second Circuit panel found that, applying the interpretation of "purchase" articulated in *In re Enron Corp.*, 341 B.R. 141 (Bankr. S.D.N.Y. 2006), the employees' receipt of RSUs in exchange for labor constituted a "purchase" for purposes of section 510(b). According to the court, cases cited by the RSU claimants regarding involuntary exchanges were inapposite because the claimants in this case could have left the company instead of accepting RSUs.

Finally, the court determined that the RSU claims "arose from" securities transactions because they would not have existed but for the claimants' agreement to receive part of their compensation in the form of RSUs.

OUTLOOK

Lehman reinforces the broad scope of section 510(b), consistent with its underlying policy objective of preventing interest holders from transforming their rights as shareholders to claims with priority on a par with the claims of creditors.

Interestingly, in ruling that the bankruptcy court erred in ruling that the employees' claims must be disallowed because an RSU constitutes an "equity security" (as defined by section 101(16) of the Bankruptcy Code), rather than a "claim" (as defined by section 101(5)), the Second Circuit panel did not discuss a bankruptcy court's power to recharacterize debt as equity. Although the Second Circuit has not weighed in on recharacterization, many courts in the circuit have recognized the legitimacy of the remedy under appropriate circumstances. *See, e.g.*, *In re Aeropostale, Inc.*, 555 B.R. 369 (Bankr. S.D.N.Y. 2016); *Weisfelner v. Blavatnik (In re Lyondell Chem. Co.)*, 544 B.R. 75 (Bankr. S.D.N.Y. 2016).

FROM THE TOP IN BRIEF

SUPREME COURT RULES THAT FILING BANKRUPTCY CLAIM ON TIME-BARRED DEBT DOES NOT VIOLATE FDCPA

In *Midland Funding, LLC v. Johnson*, No. 16-348, 2017 BL 161314 (U.S. May 15, 2017), the U.S. Supreme Court ruled that a credit collection agency does not violate the Fair Debt Collection Practices Act ("FDCPA") when it files a claim in a bankruptcy case to collect on a debt which would be time-barred in another court.

The FDCPA prohibits debt collectors from using "any false, deceptive, or misleading representation or means in connection with the collection of any debt."

In *Johnson v. Midland Funding, LLC*, 823 F.3d 1334 (11th Cir. 2016), the Eleventh Circuit ruled that there is no irreconcilable conflict between the Bankruptcy Code and the FDCPA. Thus, the court concluded, a creditor may file a proof of claim in a bankruptcy case even though the debt is time-barred, but when the creditor is a "debt collector," it may be liable under the FDCPA for "misleading" or "unfair" practices.

The Eleventh Circuit's ruling was at odds with decisions issued by other circuit courts of appeal. *See In re Dubois*, 834 F.3d 522 (4th Cir. 2016); *Owens v. LVNV Funding, LLC*, 832 F.3d 726 (7th Cir. 2016); *Nelson v. Midland Credit Management, Inc.*, 828 F.3d 749 (8th Cir. 2016). The circuit split created uncertainty concerning the extent to which professional debt buyers could attempt to pursue unpaid "stale" debts in bankruptcies.

Writing for a 5-3 majority, Justice Stephen G. Breyer stated that the filing of a proof of claim which is obviously time-barred "is not a false, deceptive, misleading, unfair, or unconscionable debt collection practice within the meaning of the [FDCPA]." Writing that "[t]he law has long treated unenforceability of a claim (due to the expiration of the limitations period) as an affirmative defense," he added that "we see nothing misleading or deceptive in the filing of a proof of claim that, in effect, follows the Code's similar system."

Justice Breyer rejected the argument that this issue was settled by the Advisory Committee on Rules of Bankruptcy Procedure (the "Committee") in connection with amendments to the Federal Rules of Bankruptcy Procedure in 2009. The Committee rejected a proposal which would have amended Rule 9019 to require a creditor to certify in a proof of claim that there is no valid statute of limitations defense—in part, because it did not want to impose an affirmative obligation on a creditor to conduct a pre-filing investigation of a potential time-bar defense. In rejecting that proposal, Justice Breyer added, the Committee noted that Rule 9011 imposes a general "obligation on a claimant to undertake an inquiry reasonable under the circumstances to determine . . . that a claim is warranted by existing law and that factual contentions have evidentiary support" and to certify as much in its proof of claim. The Committee acknowledged, however, that this requirement would "not addres[s] the statute of limitation issue," but would only ensure "the accuracy of the information provided."

Justice Sonia Sotomayor filed a dissenting opinion, in which Justices Ginsburg and Kagan joined. In her dissent, Justice Sotomayor explained that debt buyers have "deluge[d]" the bankruptcy courts with claims "on debts deemed unenforceable under state statutes of limitations" because they recognize that consumers are ill-equipped to respond and under-resourced (citing *Crawford v. LVNV Funding, LLC*, 758 F.3d 1254, 1256 (11th Cir. 2014); *In re Jenkins*, 456 B.R. 236, 239,

n.2 (Bankr. E.D.N.C. 2011) (noting a "plague of stale claims")). Stating that filing a stale claim in a bankruptcy case is unfair and unconscionable, Justice Sotomayor wrote that "[d]ebt collectors do not file these claims in good faith; they file them hoping and expecting the bankruptcy system will fail."

Justice Neil Gorsuch took no part in the consideration or decision of the case.

COURT RULES THAT PURCHASER OF DEFAULTED DEBT IS NOT "DEBT COLLECTOR" UNDER FDCPA

In another case construing the FDCPA, but not in a bankruptcy context, the Court ruled on June 12, 2017, in *Henson v. Santander Consumer USA Inc.*, No. 16-349, 2017 BL 198032 (U.S. June 12, 2017), that the purchaser of a defaulted debt is not a "debt collector" subject to the FDCPA.

The FDCPA applies to "debt collectors," a term defined in 15 U.S.C. § 1692a(6) as anyone who "regularly collects or attempts to collect . . . debts owed or due . . . another." The term includes "any creditor who, in the process of collecting his own debts, uses any name other than his own which would indicate that a third person is collecting or attempting to collect such debts."

The FDCPA defines the term "creditor" to mean:

> any person who offers or extends credit creating a debt or to whom a debt is owed, but such term does not include any person to the extent that he receives an assignment or transfer of a debt in default solely for the purpose of facilitating collection of such debt for another.

15 U.S.C. § 1692a(4).

The statutory definition of "debt collector" excludes a person attempting to collect a debt that was originated by such person, a debt that was *not in default* at the time it was acquired, or a debt obtained by a secured party in a commercial credit transaction involving the creditor. 15 U.S.C. § 1692a(6)(F).

Santander Consumer USA Inc. ("Santander") purchased a portfolio of defaulted auto loans from a bank. A federal district court and the U.S. Court of Appeals for the Fourth Circuit ruled that Santander did not qualify as a debt collector because it did not regularly seek to collect debts "owed . . . another," but instead, sought only to collect debts which it purchased and owned. However, the Fourth Circuit acknowledged that some circuits faced with the same question have ruled otherwise. *Compare Henson v. Santander Consumer USA, Inc.*, 817 F.3d 131 (4th Cir. 2016) (case below); *Davidson v. Capital One Bank (USA), N.A.*, 797 F.3d 1309 (11th Cir. 2015), *with McKinney v. Caldeway Properties, Inc.*, 548 F.3d 496 (7th Cir. 2008); *FTC v. Check Investors, Inc.*, 502 F.3d 159 (3d Cir. 2007).

Writing for a unanimous court in his first opinion, Justice Gorsuch framed the question as whether the FDCPA treats "the debt purchaser . . . more like the repo man or the loan originator."

Justice Gorsuch explained that the "plain language" of the definition "focuses our attention on third party collection agents working for a debt owner—not on a debt owner seeking to collect debts for itself." He further noted that the statute "does not appear to suggest that we should care how a debt owner came to be a debt owner."

"All that matters," Justice Gorsuch wrote, "is whether the target of the lawsuit regularly seeks to collect debts for its own account or does so for 'another.' " That analysis, he observed, "would seem" to mean that a debt purchaser does not fall under the statutory definition.

Justice Gorsuch rejected the policy argument that, because the business of purchasing defaulted debt did not exist when the FDCPA was adopted, lawmakers would have viewed defaulted debt purchasers more like debt collectors than debt originators. He wrote that "it is never our job to rewrite a constitutionally valid statutory text under the banner of speculation about what Congress might have done"; instead, that job is to "apply, not amend, the work of the People's representatives."

The Court declined to address the argument that Santander fell within the scope of the FDCPA because it regularly collected debts for another, since the question was not raised in the petition for review. In addition, the Court had not agreed to address another aspect of the definition of "debt collector" in 15 U.S.C. § 1692a(6), which includes someone "in any business the principal purpose of which is the collection of any debts."

COURT AGREES TO REVIEW RULING CONCERNING STANDARD FOR RECHARACTERIZING DEBT AS EQUITY, THEN RECONSIDERS

On June 27, 2017, the Court granted certiorari in *PEM Entities LLC v. Levin*, No. 16-492 (U.S. June 27, 2017), in which it will have the opportunity to consider "[w]hether bankruptcy courts should apply a federal rule of decision (as five circuits have held) or a state law rule of decision (as two circuits have held, expressly acknowledging a split of authority) when deciding to recharacterize a debt claim in bankruptcy as a capital contribution." The Court agreed to review the Fourth Circuit's ruling in *PEM Entities, LLC v. Province Grande Olde Liberty, LLC (In re Province Grande Olde Liberty, LLC)*, 655 Fed. Appx. 971, 2016 BL 261725 (4th Cir. 2016), where the court applied the 11-factor test adopted from federal tax law—an approach that has been adopted by at least four other circuits. The Fifth and Ninth Circuits have ruled that state law should determine whether a debt should be recharacterized as equity.

However, on August 10, 2017, the Court entered a summary disposition of the writ of certiorari in *PEM*. *See PEM Entities LLC v. Levin*, No. 16-492, 2017 BL 279440 (U.S. Aug. 10, 2017). The summary disposition states only that the "petition for a writ of certiorari is dismissed as improvidently granted." In light of the disposition, the Fourth Circuit's ruling stands.

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