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FOCUS ON HEALTH CARE PROVIDER BANKRUPTCIES

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The next few years are expected to see a significant increase in the volume of bankruptcy cases filed by health care providers. Thus far in 2017, the number of bankruptcies in health care-related sectors, including hospitals, physicians' offices and clinics, specialty outpatient facilities, assisted-living facilities, and other providers, has been surpassed only by bankruptcies in the oil and gas, finance, and retail industries. According to Standard & Poor's Global Ratings, the health care sector has seen a significant jump in the number of distressed companies, although it still ranks behind oil and gas, financial institutions, consumer products, media/entertainment, capital goods, and retail on the agency's list.

This uptick can be attributed to a number of factors, including continuing uncertainty concerning the possible collapse, replacement, or defunding of the Affordable Care Act; increased competition; the need for investment in additional personnel and technology; the erosion of profitability due to the evolution from a "fee for service" payment model to a "bundle of services" payment model; liquidity problems caused in part by delays or disputes regarding reimbursement from government and private payers as well as the recoupment or setoff of overpayments; operational changes; increased pharmaceutical costs; and rising wages. These and other factors have led an increasing number of financially distressed providers to consider bankruptcy as a vehicle for effectuating closures, consolidation, restructurings, and related transactions.

HEALTH CARE PROVIDER BANKRUPTCY ISSUES

Certain provisions in the Bankruptcy Code deal specifically with health care debtors. Others apply more generally to nonprofit (eleemosynary) entities, among which are many hospitals and other health care providers. Finally, certain issues arising in bankruptcy cases have special significance for health care providers. These provisions and issues include, but are not limited to:

Disposal of Patient Records. "Patient records" (defined in section 101(40B) of the Bankruptcy Code) are vitally important documents in the health care industry and as such are subject to stringent federal and state confidentiality and disclosure

IN THIS ISSUE

1 Focus on Health Care Provider Bankruptcies

8 Yet Another Ruling Deepens the Divide on Whether the Bankruptcy Code's Avoidance Provisions Apply Extraterritorially

13 Ninth Circuit Reverses Course on Measure of Collateral Value in Cramdown Confirmation of Chapter 11 Plan

14 Newsworthy

17 Eroding the Majority Rule: Another Circuit Concludes That Lease Can Be Extinguished in Free-and-Clear Bankruptcy Sale

22 International Legislative Update

regulations. Section 351 of the Bankruptcy Code, as supplemented by Rule 6011 of the Federal Rules of Bankruptcy Procedure (the "Bankruptcy Rules"), provides specific requirements for the disposal of patient records that apply only if, in the bankruptcy case of a "health care business," the trustee has insufficient funds to pay for the storage of patient records "in the manner required under applicable Federal or State law." The trustee is obligated to provide personal and publication notice that the records will be either entrusted to an appropriate federal agency or destroyed unless claimed within one year.

Section 101(27A) of the Bankruptcy Code defines a "health care business" as:

> [A]ny public or private entity (without regard to whether that entity is organized for profit or not for profit) that is primarily engaged in offering to the general public facilities and services for . . . the diagnosis or treatment of injury, deformity, or disease; and . . . surgical, drug treatment, psychiatric, or obstetric care; [and includes, among other providers, hospitals; emergency treatment facilities; hospices; home health agencies; and nursing, assisted-living, and long-term care facilities].

There have been very few reported decisions regarding section 351, which, like most of the health care bankruptcy provisions, was added to the Bankruptcy Code in 2005. *See, e.g., In re LLSS Mgmt. Co.,* 2008 BL 26599 (Bankr. E.D.N.C. Feb. 11, 2008) (applying section 351's requirements to a chapter 7 trustee's destruction of medical records where applicable state law did not include any record retention requirement); *In re 7-Hills Radiology, LLC*, 350 B.R. 902 (Bankr. D. Nev. 2006) (ruling that a chapter 11 debtor was not a "health care business" subject to the "patient care ombudsman" provision (section 333), section 351, or other health care business debtor provisions).

Patient Care Ombudsmen. Section 333 of the Bankruptcy Code provides for the appointment of a patient care "ombudsman" within 30 days after the commencement of any health care business bankruptcy case. The ombudsman serves as a "patient advocate," as distinguished from a representative of creditors, entrusted with monitoring the quality of patient care, representing the interests of patients, and reporting to the bankruptcy court every 60 days on the status of patient care. *See, e.g., In re Alternate Family Care,* 377 B.R. 754 (Bankr. S.D. Fla. 2007) (adopting the widely cited, nonexclusive nine-factor test for determining whether a patient care ombudsman should be appointed); *In re Banes*, 355 B.R. 532 (Bankr. M.D.N.C. 2006) (denying a motion for the appointment of a patient care ombudsman where the chapter 7 debtor, a former dental services provider, was no longer doing business and was therefore not a "health care business" under section 101(27A)). Bankruptcy Rule 2007.2 sets forth the procedure for appointing a patient care ombudsman. Bankruptcy Rule 2015.1 obligates the ombudsman to file certain reports with the court. Section 330(a) of the Bankruptcy Code provides that patient care ombudsmen are professionals entitled to apply for compensation from the estate.

Duty to Transfer Patients of Closing Health Care Business and Restrictions on Transfers. Sections 704(a)(12) and 1106(a)(1) of the Bankruptcy Code obligate a trustee to use "all reasonable and best efforts" to transfer patients ("patient" is defined in section 101(40A)) from a health care business debtor that is to be closed to an "appropriate" health care business in the vicinity providing substantially similar services and a reasonable quality of care. *See, e.g., In re Anderson*, 2008 BL 134069 (Bankr. N.D. Cal. June 23, 2008) (ruling that a chapter 7 trustee may abandon a nursing-home facility but must comply with the transfer obligations in section 704(a)(12)). Bankruptcy Rule 2015.2 provides that, unless the court orders otherwise, the trustee in a health care business case may not transfer a patient to another health care business under section 704(a)(12) without giving 14 days' notice of the transfer to any patient care ombudsman, the patient, and any contacts provided by the patient, subject to applicable patient privacy laws. Section 503(b)(8) of the Bankruptcy Code grants a special administrative expense priority for the expenses of winding up a health care business.

Exemption From Automatic Stay for Exclusion From Medicare Participation. Section 362(b)(28) of the Bankruptcy Code exempts from the automatic stay the "exclusion" of a debtor from participation in Medicare or any other federal health care program by the U.S. Secretary of Health and Human Services. "Exclusion" is a specific remedy contemplated by 42 U.S.C. § 1320a-7. It refers to the prohibition of certain individuals and entities from participation in any federal health care program for a period of one to five years, and it can be either mandatory or permissive. Mandatory exclusion is required for criminal convictions on various grounds. Among the permissive exclusion grounds are convictions relating to fraud or obstruction of an investigation or audit, license revocation or suspension, failure to take corrective action, claims for excessive charges or unnecessary services, and the failure of certain organizations to furnish medically necessary services. *See, e.g., MMM Healthcare, Inc. v. Santiago (In re Santiago),* 563 B.R. 457, 475 (Bankr. D.P.R. 2017) (noting that "[c]ase law regarding the application of section 362(b)(28) is scant" and refusing to decide on a motion for summary judgment whether the termination of a physician's provider agreement by health maintenance organizations was covered by section 362(b)(28) exclusion from the automatic stay).

Termination of Provider Agreements. A commonly contested issue in health care provider bankruptcy cases is whether a federal or state agency can terminate a health care debtor's Medicare or Medicaid provider agreement. The relationship between Medicare or Medicaid programs and providers is expressed in a written provider agreement, which allows providers to participate in the programs' prospective reimbursement programs.

Medicare and Medicaid were created by the Social Security Amendments of 1965. The programs are subject to certain provisions in the Social Security Act of 1935, as amended, 42 U.S.C. Ch. 7 (the "SSA"), which originally omitted medical benefits, as well as other regulations. The Medicare program is administered by the Centers for Medicare & Medicaid Services ("CMS"). CMS, in turn, contracts with regional providers, called "fiscal intermediaries," to review, process, and pay Medicare claims. Medicaid is generally administered by state agencies through medical assistance programs.

Federal and state officials may terminate a provider agreement if they determine that the provider is not complying with its terms or other legal requirements. *See* SSA §§ 1396i-3(h)(2) and 1396r(h)(2); 42 C.F.R. §§ 488.406 and 488.408(e). A provider is entitled to written notice of any deficiencies noted in a state survey, a statement of any remedies imposed, and a statement of the provider's right to appeal. 42 C.F.R. §§ 488.330(c) and 488.402(f). If a sanction is imposed, the provider may generally contest the underlying findings in a formal evidentiary hearing before an administrative law judge. 42 C.F.R. §§ 498.3(b), 498.5, and 431.153(i).

The SSA limits a provider's ability to pursue claims arising under the law in federal court. Sections 405(g) and 405(h) of the SSA are made applicable to Medicare and Medicaid under SSA §§ 1395ff(b)(1)(A) and 1395ii. Section 405(g) requires the exhaustion of administrative remedies concerning, among other things, a decision by the government to terminate a provider agreement. Section 405(h) provides that, in connection with the government's actions or decisions concerning Medicare and Medicaid (including the termination of provider agreements), no claim may be brought against the government under 28 U.S.C. § 1331 (federal question jurisdiction) or 28 U.S.C. § 1346 (jurisdiction when the United States is a defendant).

The majority of circuits have adopted the view that, although section 405(h) omits any reference to grants of jurisdiction under 28 U.S.C. § 1334, which governs jurisdiction in bankruptcy cases, the jurisdictional bar nevertheless applies to grants of jurisdiction in bankruptcy cases, meaning that the

bankruptcy court lacks jurisdiction to resolve a dispute over the termination of a provider agreement until the provider has exhausted administrative remedies. *See Fla. Agency for Health Care Admin. v. Bayou Shores SNF, LLC (In re Bayou Shores SNF, LLC),* 828 F.3d 1297 (11th Cir. 2016); *Nichole Med. Equip. & Supply, Inc. v. TriCenturion, Inc.,* 694 F.3d 340 (3d Cir. 2012); *Midland Psychiatric Assocs., Inc. v. United States,* 145 F.3d 1000 (8th Cir. 1998); *Bodimetric Health Servs., Inc. v. Aetna Life & Cas.*, 903 F.2d 480 (7th Cir. 1990); *accord Parkview Adventist Med. Ctr. v. United States,* 2016 BL 166858 (D. Me. May 25, 2016). The Ninth Circuit has adopted a contrary position. *See Do Sung Uhm v. Humana, Inc.*, 620 F.3d 1134 (9th Cir. 2010); *see also Nurses' Registry & Home Health Corp. v. Burwell,* 533 B.R. 590 (Bankr. E.D. Ky. 2015) (noting in connection with a motion for a stay pending appeal that the court previously ruled that section 405(h) does not preclude the issuance of an injunction and order to continue payments under a provider agreement in a Medicare dispute where administrative remedies have not been exhausted because it omits reference to 28 U.S.C. § 1334; however, the court vacated the order in December 2015 following a settlement and joint request for vacatur).

In *Bayou Shores,* for example, the Eleventh Circuit ruled that a bankruptcy court does not have jurisdiction to enjoin the federal government from terminating Medicare and Medicaid provider agreements due to Medicare's jurisdictional bar in section 405(h) of the SSA. The Eleventh Circuit accordingly affirmed a district court order overturning bankruptcy court orders enjoining termination of such a provider agreement and confirming a plan under which the debtor assumed the agreement. The U.S. Supreme Court refused to review the ruling on June 5, 2017. *See Bayou Shores SNF, LLC v. Fla. Agency for Health Care Admin.*, 198 L. Ed. 2d 658 (U.S. 2017).

In *Parkview Adventist Med. Ctr. v. United States*, 842 F.3d 757 (1st Cir. 2016), the First Circuit acknowledged the majority view on the issue but resolved the case before it on narrower grounds. It considered a bankruptcy court's determination that, pending a hospital's exhaustion of administrative remedies, as required by section 405(h), the court lacked jurisdiction over a hospital debtor's motion seeking a determination that the government's termination of a Medicaid provider agreement violated the automatic stay (among other things). However, instead of wading into the jurisdictional morass, the First Circuit ruled that termination of the provider agreement was excepted from the automatic stay under section 362(b)(4), which provides that the automatic stay of actions against the debtor does not apply to an action or proceeding by a "governmental unit" to enforce its "police and regulatory power."

A Seventh Circuit panel refused to rule on the jurisdictional question in *Home Care Providers, Inc. v. Hemmelgarn*, 2017 BL 221083 (7th Cir. June 27, 2017). It held instead that the appeal of a bankruptcy court's injunction preventing the federal government from terminating provider agreements was moot because the agreements expired before the district court ruled that the bankruptcy court lacked jurisdiction under section 405(h). The health care provider petitioned for en banc reconsideration of the ruling on July 11, 2017.

Special Problems Regarding Recoupment and Setoff. Under Medicare and Medicaid's periodic interim payment system, reimbursement payments under provider agreements are made before the government agency has determined whether the provider is fully entitled to reimbursement. *See* 42 C.F.R. § 413.60. Section 1395g(a) of the SSA provides that:

> [t]he Secretary shall periodically determine the amount which should be paid under this part to each provider of services with respect to the services furnished by it, and the provider of services shall be paid, at such time or times as the Secretary believes appropriate . . . the amounts so determined, with necessary adjustments on account of previously made overpayments or underpayments.

The provider is legally obligated to return any overpayments.

If a provider files for bankruptcy before remitting overpayments to CMS or a regional agency, the automatic stay may or may not prevent actions by CMS or the agency to recover the overpayments. Most courts have concluded that a provider's participation in the Medicare program involves a single, integrated, and ongoing transaction between the government and the provider, such that the government's recovery of overpayments is a "recoupment" rather than a setoff. *See, e.g., In re Slater Health Ctr., Inc. (Slater)*, 398 F.3d 98 (1st Cir. 2005); *In re Holyoke Nursing Home, Inc.*, 372 F.3d 1 (1st Cir. 2004); *In re Doctors Hosp. of Hyde Park, Inc.*, 337 F.3d 951 (7th Cir. 2003); *In re TLC Hosps., Inc.*, 224 F.3d 1008 (9th Cir. 2000); *United States v. Consumer Health Servs. of Am., Inc.*, 108 F.3d 390 (D.C. Cir. 1997). *But see In re Univ. Med. Ctr.*, 973 F.2d 1065 (3d. Cir. 1992) (reasoning that because each government payment provides compensation for services performed in a set time span, each payment concerned different services rendered and thus constituted a separate transaction).

The distinction is important, because any post-bankruptcy setoff of mutual pre-bankruptcy claims arising from separate transactions under section 553 of the Bankruptcy Code is subject to the automatic stay (*see* 11 U.S.C. § 362(a)(7)), whereas recoupment—involving a single transaction—is not. *See Fischbach v. Ctrs. for Medicare & Medicaid Servs. (In re Fischbach)*, 464 B.R. 258, 262 (Bankr. D.S.C. 2012) (citing *In re Univ. Med. Ctr.*, 973 F.2d 1065 (3d Cir. 1992)), *aff'd*, 2013 BL 76232 (D.S.C. Mar. 22, 2013).

The doctrine of recoupment is not applied uniformly in all jurisdictions when it comes to health care bankruptcy cases. For example, courts disagree as to whether different provider "cost report years" are part of the "same transaction or occurrence" for purposes of determining whether the government can recoup overpayments from future Medicare reimbursement payments. *Compare Sims v. U.S. Dep't of Health & Human Servs. (In re TLC Hosps., Inc.)*, 224 F.3d 1008, 1013 (9th Cir. 2000) (for purposes of recoupment, "[t]he fact that the overpayments and underpayments relate to different fiscal years does not destroy their logical relationship or indicate that they pertain to separate transactions"), *with Univ. Med. Ctr. v. Sullivan (In re Univ. Med. Ctr.)*, 973 F.2d 1065, 1080 (3d Cir. 1992) ("reimbursement payments made for any one year arise from transactions wholly distinct from reimbursement payments made for subsequent years").

Sale or Closure of Health Care Business—Assumption and Assignment of Provider Agreements. Many distressed health care providers with little prospect for improvement of their financial condition have only two options: shutter the business or attempt to sell it in bankruptcy free and clear of liabilities, including overpayment claims. The viability of a bankruptcy sale depends on a number of factors, including whether the debtor's Medicare or Medicaid provider agreements or provider numbers can be sold or assigned. Other issues impacting a sale may include zoning or regulatory restrictions, potential successor liability for medical malpractice claims, and the impact that a nonprofit health care debtor's charitable mission has on determining the "highest and best" offer for assets. *See In re United Healthcare Sys., Inc.*, 1997 BL 8656 (D.N.J. Mar. 27, 1997); *In re HHH Choices Health Plan LLC,* 554 B.R. 687 (Bankr. S.D.N.Y. 2016).

Section 363(f) of the Bankruptcy Code authorizes the trustee or chapter 11 debtor-in-possession ("DIP") to sell property of the bankruptcy estate "free and clear of any interest in such property of an entity other than the estate" under certain specified conditions. If the health care business debtor is an operating nonprofit, section 363(d)(1) provides that the trustee or DIP may use, sell, or lease the debtor's property "only in accordance with nonbankruptcy law applicable to the transfer of property" by such debtor. *See In re Gardens Reg'l Hosp. & Med. Ctr., Inc.*, 567 B.R. 820 (Bankr. C.D. Cal. 2017) (because a closed nonprofit hospital does not qualify as a "health facility" under California law, the debtor was not required to obtain the California attorney general's consent prior to selling a material portion of its assets). In addition, pursuant to section 541(f), the assets of a nonprofit corporation debtor may be sold to a for-profit corporation only under the same conditions that govern under applicable nonbankruptcy law. *See Ky. Emps. Ret. Sys. v. Seven Cntys Servs., Inc. (In re Seven Cntys Servs., Inc.),* 511 B.R. 431 (Bankr. W.D. Ky. 2014) (sections 363(d)(1) and 541(f) did not mandate that a nonprofit debtor remain a member of the state retirement system).

Section 365 of the Bankruptcy Code governs the assumption and assignment of provider agreements. Section 365(b) provides that, with certain exceptions and conditions, an

"executory" contract, such as a provider agreement, can be assumed only if the trustee or DIP cures all monetary payment defaults under the agreement. Section 365(f) permits the assignment of an assumed contract if certain additional prerequisites are met.

The monetary cure costs of assuming a provider agreement can be high if the debtor has received significant overpayments. Thus, the ability to sell a provider agreement free and clear of liability for such overpayments can result in significant savings. Few reported decisions have actually addressed whether provider agreements are executory contracts (requiring cure as a condition to assumption and assignment) or assets of the estate that can be sold free and clear of liabilities. Most bankruptcy courts considering the issue, however, have concluded that the Medicare provider agreement is an executory contract. *See In re Vitalsigns Homecare, Inc.*, 396 B.R. 232, 239 (Bankr. D. Mass. 2008) (citing and discussing cases).

However, in *In re BDK Health Management, Inc.*, 1998 WL 34188241 (Bankr. M.D. Fla. Nov. 16, 1998), the bankruptcy court held that Medicare provider agreements are statutory entitlements which can be sold free and clear of claims and interests. The court reasoned that: (i) the rights and duties of health care providers and CMS are set forth in statutes and regulations, rather than contracts; and (ii) a provider must initiate administrative proceedings rather than sue for breach of contract to contest CMS's reimbursement decisions.

By contrast, the bankruptcy court in *Vitalsigns* ruled that Medicare provider numbers arise out of executory contracts which cannot be assumed and assigned to buyers as part of a sale without curing the associated liabilities. Requiring the provider agreement to be assumed, the court reasoned, "harmonizes both the Medicare and Bankruptcy statutes" without rendering either a nullity (because Medicare statutes and regulations expressly provide for recoupment of overpayments and the Bankruptcy Code expressly authorizes free-and-clear asset sales). *Vitalsigns*, 396 B.R. at 240–41.

Lender Issues. A health care provider's accounts receivable are frequently pledged as collateral for a loan. However, government accounts receivable, such as Medicare and Medicaid reimbursement payments, are subject to federal and state "anti-assignment rules" that require the payments to be deposited in accounts controlled solely by providers. *See* 42 U.S.C. §§ 1395g(c) and 1396a(32). As a consequence, government accounts receivable serving as collateral are generally deposited directly into a provider's bank account, from which the funds, in accordance with a "double lockbox" structure, are swept into an account under the lender's control on a daily basis. If the provider files for bankruptcy, the automatic stay prohibits the cash sweep, obligating the debtor and the lender to negotiate a cash-collateral agreement providing for, among other things, "adequate protection" payments to the lender.

RECENT CASE STUDY: *GARDENS REGIONAL HOSPITAL*

One of the challenges commonly faced by health care providers that file for bankruptcy protection was the subject of a ruling handed down by the U.S. Bankruptcy Court for the Central District of California in *In re Gardens Reg'l Hosp. & Med. Ctr., Inc.*, 569 B.R. 788 (Bankr. C.D. Cal. 2017).

Gardens Regional Hospital and Medical Center, Inc. (the "debtor") operated a general acute-care hospital in California. In 2014, the debtor entered into an agreement to provide Medicaid services under the California Medical Assistance Program, more commonly known as "Medi-Cal," which is administered by the California Department of Health Care Services (the "DHCS"). The debtor provided health care to Medi-Cal beneficiaries on a fee-for-service basis and, as a result, was entitled to receive Medi-Cal fee-for-service payments. The debtor was also entitled to receive supplemental hospital quality assurance payments ("HQA payments") on account of certain services provided to Medi-Cal beneficiaries.

As a condition to participating as a Medi-Cal provider, the debtor, like other acute-care hospitals, was obligated under California law to pay a quarterly hospital quality assurance fee (an "HQA fee").

In March 2015, the debtor stopped paying its quarterly HQA fees, and it filed for chapter 11 protection in the Central District of California on June 6, 2016. As of the petition date, the debtor owed nearly $700,000 in HQA fees. After the bankruptcy filing, to recover the unpaid prepetition fees, the DHCS began withholding 20 percent of the Medi-Cal payments owed to the debtor, as well as an unspecified percentage of the HQA payments owed to it.

By July 18, 2016, the DHCS had recovered all of the unpaid prepetition HQA fees as a result of its withholding. However, the DHCS continued withholding because the debtor failed to pay postpetition HQA fees. During the case, the DHCS withheld a total of approximately $4.3 million in HQA payments

and Medi-Cal payments and applied the withheld funds to unpaid HQA fees. Even with the withholding, the debtor still owed more than $2.5 million in postpetition HQA fees.

The debtor sought a court order compelling the DHCS to disgorge the approximately $4.3 million in payments it had withheld, claiming that the withholding was a setoff which represented an ongoing willful violation of the automatic stay by the DHCS. The debtor further argued that the DHCS could not have effectuated the setoff even if it had obtained stay relief because section 553 of the Bankruptcy Code does not permit postpetition obligations to be set off against prepetition debt.

The DHCS countered that the withholding was a recoupment rather than a setoff because the HQA fees, the HQA payments, and the Medi-Cal payments all arose from the same transaction. In response, the debtor argued that its HQA fee obligation did not arise from the same transaction as its entitlement to HQA payments and Medi-Cal payments because: (i) the HQA fee liability exists whether or not a provider participates in the Medi-Cal program; and (ii) different statutory formulas are used to calculate the HQA fees and the entitlements to HQA payments and Medi-Cal payments.

The bankruptcy court ruled that the doctrine of recoupment allowed the DHCS to withhold the HQA payments without obtaining stay relief. The court explained as follows:

> [R]ecoupment is an equitable doctrine that exempts a debt from the automatic stay when the debt is inextricably tied up in the post-petition claim. Unlike setoff, recoupment is not limited to pre-petition claims and thus may be employed to recover across the petition date. The limitation of recoupment that balances this advantage is that the claims or rights giving rise to recoupment must arise from the same transaction or occurrence that gave rise to the liability sought to be enforced by the bankruptcy estate. . . . For recoupment purposes, a transaction may include a series of many occurrences, depending not so much upon the immediateness of their connection as upon their logical relationship, . . . provided that the "logical relationship" test is not applied so loosely that multiple occurrences in any one continuous commercial relationship would constitute one transaction.

2017 BL 213538, at *4 (internal quotation marks and citations omitted).

The court found that a logical relationship existed between the HQA fees and the HQA payments because, without HQA fees, the DHCS could not collect federal matching funds in an amount sufficient to make HQA payments. It noted that courts in the Ninth Circuit have given the term "transaction" a "liberal and flexible construction," requiring only that obligations be "sufficiently interconnected so that it would be unjust to insist that one party fulfill its obligation without requiring the same of the other party." *Id.* (citing *Aetna U.S. Healthcare, Inc. v. Madigan (In re Madigan)*, 270 B.R. 749, 755 (B.A.P. 9th Cir. 2001)). According to the bankruptcy court, even though different statutory formulas are used to calculate HQA fees and HQA payments, a "fundamental logical connection" exists between them.

The bankruptcy court also determined that the DHCS properly recouped the HQA fees by withholding the Medi-Cal payments. The court explained that the debtor's eligibility to participate in the Medi-Cal program was conditioned on compliance with its provider agreement, including the statutory obligation to pay HQA fees, failing which the DHCS was expressly authorized to deduct unpaid fees from Medi-Cal payments. Thus, the court found that the provider agreement "create[d] a sufficient logical relationship" between the debtor's HQA fee liability and its Medi-Cal payments. *Id.* at *6.

OUTLOOK

Gardens Regional Hospital is emblematic of the challenges currently faced by many financially distressed health care providers. Even so, the recoupment/setoff distinction is only one of many issues that may be implicated if a provider files for bankruptcy. Others besides those addressed in this article may arise.

For example, because the "absolute priority rule" in section 1129(b)(2) of the Bankruptcy Code may not apply to nonprofit debtors, a health care provider organized as a nonprofit may be able to obtain confirmation of a cramdown chapter 11 plan that retains the pre-bankruptcy ownership structure without paying creditors in full. *See In re Whittaker Memorial Hospital Ass'n,* 149 B.R. 812 (Bankr. E.D. Va. 1993); *In re Independence Village Inc.*, 52 B.R. 715 (Bankr. E.D. Mich. 1985); *see also In re Corcoran Hosp. Dist.,* 233 B.R. 449, 458 (Bankr. E.D. Cal. 1999) (stating in a hospital case under chapter 9 that "[i]n a reorganization of a municipality under Chapter 9 or of a non-profit corporation under Chapter 11, the [absolute priority] requirement must be interpreted somewhat differently"). This obviously would be an important consideration in a nonprofit company's pre-bankruptcy planning.

Another issue that arises in health care provider bankruptcy cases is whether quality assurance fees levied by state agencies administering Medicaid (such as the HQA fees addressed in *Gardens Regional Hospital*) are entitled to priority as excise taxes under section 507(a)(8) of the Bankruptcy Code. *See In re Ridgecrest Healthcare, Inc.,* 2017 BL 297740 (Bankr. C.D. Cal. Aug. 24, 2017) (ruling that such fees meet the Ninth Circuit's five-factor test for determining whether a fee is an excise tax).

In addition, although nonprofit health care entities are eligible to file for protection under chapters 7 and 11 (and chapter 9, under certain circumstances), they are not subject to involuntary bankruptcy petitions (*see* 11 U.S.C. § 303(a)), nor can the chapter 11 case of a nonprofit debtor be converted to a chapter 7 liquidation without the debtor's consent. *See* 11 U.S.C. § 1112(c).

Still another thorny issue in cases involving distressed nonprofit health care providers is directors' and officers' fiduciary duties, which typically are owed to a charitable mission rather than shareholders when the company is solvent.

YET ANOTHER RULING DEEPENS THE DIVIDE ON WHETHER THE BANKRUPTCY CODE'S AVOIDANCE PROVISIONS APPLY EXTRATERRITORIALLY

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The ability to avoid fraudulent or preferential transfers is a fundamental part of U.S. bankruptcy law. However, when a transfer by a U.S. entity takes place outside the U.S. to a non-U.S. transferee—as is increasingly common in the global economy—courts disagree as to whether the Bankruptcy Code's avoidance provisions apply extraterritorially to avoid the transfer and recover the transferred assets. A pair of bankruptcy court rulings handed down in 2017 widened a rift among the courts on this issue.

In *Spizz v. Goldfarb Seligman & Co. (In re Ampal-Am. Israel Corp.*), 562 B.R. 601 (Bankr. S.D.N.Y. 2017)—discussed in the March/April 2017 edition of the *Business Restructuring Review*—the court, disagreeing with other courts both within and outside its own district, ruled that the avoidance provisions of the Bankruptcy Code do not apply outside the U.S. because, on the basis of the language and context of the provisions, Congress did not intend for them to apply extraterritorially. More recently, in *Emerald Capital Advisors Corp. v. Bayerische Motoren Werke Aktiengesellschaft (In re FAH Liquidating Corp.)*, 2017 BL 200517 (Bankr. D. Del. June 13, 2017), the court held to the contrary. It ruled that Congress intended section 548 of the Bankruptcy Code (permitting avoidance of fraudulent transfers) to apply extraterritorially

and that a liquidating trustee's avoidance claims under section 544(b) must be dismissed because they were governed by German law.

THE PRESUMPTION AGAINST EXTRATERRITORIALITY

"It is a longstanding principle of American law 'that legislation of Congress, unless a contrary intent appears, is meant to apply only within the territorial jurisdiction of the United States.' " *EEOC v. Arabian American Oil Co.*, 499 U.S. 244, 248 (1991) (quoting *Foley Bros. v. Filardo*, 336 U.S. 281, 285 (1949)). This "presumption against extraterritoriality" is a judicially developed rule of statutory construction whereby federal law is presumed not to apply to conduct or property outside the United States "unless a contrary intent appears." *Morrison v. National Australia Bank Ltd.,* 561 U.S. 247, 255 (2010). In *Smith v. United States,* 507 U.S. 197, 204 n.5 (1993), the U.S. Supreme Court explained that this presumption is at least partially "the commonsense notion that Congress generally legislates with domestic concerns in mind." The presumption also "serves to protect against unintended clashes between our laws and those of other nations which could result in international discord." *Arabian American,* 499 U.S. at 248 (citing *McCulloch v. Sociedad Nacional de Marineros de Honduras,* 372 U.S. 10, 20–22 (1963)).

Contrary intent is shown through "clear evidence," in either the statutory text or the "legislative purpose underlying it." *Id.* at 204. However, a law need not explicitly state that "this law applies abroad" to have extraterritorial effect, and context is relevant to infer the statute's meaning. *Morrison,* 561 U.S. at 255.

In *Morrison and RJR Nabisco, Inc. v. European Cmty.,* 136 S. Ct. 2090 (2010), the Supreme Court outlined a two-step approach to determining whether the presumption against extraterritoriality forecloses a claim. First, the court examines "whether the presumption against extraterritoriality has been rebutted—that is, whether the statute gives a clear, affirmative indication that it applies extraterritorially." *Nabisco,* 136 S. Ct. at 2101; *accord Morrison*, 561 U.S. at 255. If the conclusion is that the presumption has been rebutted, the inquiry ends.

If not, the court must determine whether the case involves a domestic application of the statute by examining its "focus." If the conduct relevant to that focus occurred in the U.S., "the case involves a permissible domestic application even if other conduct occurred abroad." *Id.*; *accord Morrison*, 561 U.S. at 266–67. However, if the conduct relevant to the focus of the statute did not occur in the U.S., "the case involves an impermissible extraterritorial application regardless of any other conduct that occurred in U.S. territory." *Id.*; *accord Societe Generale plc v. Maxwell Commc'n Corp. plc (In re Maxwell Commc'n Corp. plc),* 186 B.R. 807, 816 (S.D.N.Y. 1995) ("*Maxwell I*"), *aff'd on other grounds*, 93 F.3d 1036 (2d Cir. 1996) ("*Maxwell II*").

Most courts have adopted a flexible approach in determining whether a transaction is extraterritorial. Many apply a "center of gravity" test, whereby the court examines the facts of the case to ascertain whether they have a center of gravity outside the U.S. *See, e.g., French v. Liebmann (In re French),* 440 F.3d 145, 149 (4th Cir. 2006), *cert. denied,* 549 U.S. 815 (2006); *In re Florsheim Group Inc.,* 336 B.R. 126, 130 (Bankr. N.D. Ill. 2005). This analysis may involve consideration of "all component events of the transfer[]," *Maxwell I,* 186 B.R. at 816, such as "whether the participants, acts, targets, and effects involved in the transaction at issue are primarily foreign or primarily domestic." *French*, 440 F.3d at 150.

EXTRATERRITORIAL OPERATION OF U.S. BANKRUPTCY LAW?

In certain respects, U.S. bankruptcy law has explicitly applied extraterritorially for more than 60 years. In 1952, due to confusion about the scope of a debtor's property to be administered by a bankruptcy trustee under the Bankruptcy Act of 1898, Congress inserted the phrase "wherever located" into section 70a of the act "to make clear that a trustee in bankruptcy is vested with the title of the bankrupt in property which is located without, as well as within, the United States." H.R. Rep. No. 82-2320, at 15 (1952), *reprinted in* 1952 U.S.C.C.A.N. 1960, 1976; *see also* Pub. L. No. 82-456, 66 Stat. 420 (July 7, 1952). This language was preserved in section 541(a) of the Bankruptcy Code (enacted in 1978), which states that the bankruptcy estate includes the debtor's property "wherever located and by whomever held." Section 541(a) provides further that such property includes various "interests" of the debtor in property. Similarly, 28 U.S.C. § 1334(e) gives federal district courts—and, by jurisdictional grant pursuant to 28 U.S.C. § 157(a), bankruptcy courts within each district—exclusive jurisdiction of all property of the debtor and its estate, "wherever located."

Many courts have concluded that, because the automatic stay imposed by section 362(a) of the Bankruptcy Code expressly prohibits, among other things, acts to obtain possession of "property of the estate," the stay bars creditor collection efforts with respect to estate property located both within and

outside the U.S. *See, e.g., Milbank v. Philips Lighting Elecs. N. Am. (In re Elcoteq, Inc.),* 521 B.R. 189 (Bankr. N.D. Tex. 2014); *In re Nakash,* 190 B.R. 763 (Bankr. S.D.N.Y. 1996).

However, the provisions of the Bankruptcy Code permitting avoidance and recovery of preferential or fraudulent transfers—e.g., sections 544, 547, 548, and 550—do not expressly refer to "property of the estate" as that term is defined in section 541 or even to section 541 itself. Instead, section 544 permits the trustee to avoid certain transfers of "property of the debtor" or interests of the "debtor in property"; sections 547(b) and 548(a)(1) provide for the avoidance of "an interest of the debtor in property"; and section 550 permits the trustee to recover "the property transferred" or its value from the transferee.

Furthermore, some courts, noting that section 541(a)(3) of the Bankruptcy Code provides that any "interest in property that the trustee recovers under section . . . 550" is part of the estate, have concluded that fraudulently or preferentially transferred property is not estate property *unless and until* it is recovered by the trustee. *See, e.g., FDIC v. Hirsch (In re Colonial Realty Co.),* 980 F.2d 125 (2d Cir. 1992) (if property that has been fraudulently transferred is included in "property of the estate" under section 541(a)(1), section 541(a)(3) is rendered meaningless with respect to property recovered pursuant to fraudulent transfer actions); *accord Rajala v. Gardner,* 709 F.3d 1031 (10th Cir. 2013). *But see Am. Nat'l Bank of Austin v. MortgageAmerica Corp. (In re MortgageAmerica Corp.),* 714 F.2d 1266, 1277 (5th Cir. 1983) ("[p]roperty fraudulently conveyed and recoverable under the Texas Fraudulent Transfers Act remains, despite the purported transfer, property of the estate within the meaning of section 541(a)(1)").

The different language used in the avoidance provisions, on the one hand, and the statutory jurisdictional grant and the definition of "estate property," on the other, has created confusion in the courts as to whether the avoidance provisions were intended by Congress to apply to property outside the U.S.

RECENT DECISIONS ADDRESSING EXTRATERRITORIALITY OF AVOIDANCE PROVISIONS

Prior to *Morrison*, the courts in *Maxwell I*, *Maxwell II*, *French*, and *Barclay v. Swiss Fin. Corp. Ltd. (In re Bankr. Estate of Midland Euro Exch. Inc.),* 347 B.R. 708 (Bankr. C.D. Cal. 2006), addressed whether the Bankruptcy Code's avoidance provisions apply extraterritorially. In *Maxwell I*, the district court ruled that Congress did not clearly express its intention, in statutory language or elsewhere, for section 547 to empower a trustee to avoid foreign preferential transfers. The U.S. Court of Appeals for the Second Circuit affirmed, but on the separate basis that, under principles of international comity, the U.S. court must defer to the courts and laws of the U.K., and U.S. avoidance and recovery provisions should not apply to the transfers at issue. *See Maxwell II*, 93 F.3d at 1054–55.

The U.S. Court of Appeals for the Fourth Circuit held to the contrary in *French*. Agreeing with an argument rejected in *Maxwell I*, the Fourth Circuit held that it need not decide whether the transfer of a Bahamian residence was extraterritorial because "Congress made manifest its intent that § 548 apply to all property that, absent a prepetition transfer, would have been property of the estate, wherever that property is located." By incorporating the language of section 541 to define what property a trustee may recover, the Fourth Circuit wrote, section 548 "plainly allows a trustee to avoid any transfer of property that *would* have been 'property of the estate' prior to the transfer in question—as defined by § 541—even if that property is not 'property of the estate' *now*."

The Fourth Circuit cited *Begier v. IRS*, 496 U.S. 53 (1990), in support of its conclusion that Congress intended section 548 to apply extraterritorially. The issue in *Begier* was not extraterritorial application of U.S. avoidance law, but whether property preferentially transferred was "property of the debtor" at the time of the transfer. As noted previously, section 541(a) defines "property of the estate," and section 547(b) authorizes the trustee to avoid transfers of "an interest of the debtor in property," but the Bankruptcy Code does not define the latter.

According to the Supreme Court in *Begier,* "property of the debtor," the transfer of which is subject to avoidance under section 547(b), "is best understood as that property that would have been part of the estate had it not been transferred" prebankruptcy. *Id.* at 58–59. The Court looked for guidance to section 541. In delineating the scope of "property of the estate," the Court wrote, section 541 "serves as the postpetition analog to § 547(b)'s 'property of the debtor.' " *Id.* It ruled that because property held by the debtor in trust is neither "property of the estate" under section 541 nor "property of the debtor" for purposes of section 547(b), a chapter 7 trustee could not avoid a transfer of such property held in trust as a preference.

In *Midland Euro*, the bankruptcy court considered whether section 548 could be used to avoid a transfer by a Barbados corporation to an English company of funds from an English bank through a U.S. bank to another English bank. Stating that in *French*, the Fourth Circuit "totally ignores § 541(a)(3) and uses an unclear and convoluted method to reach its conclusion," the *Midland Euro* court ruled that it could "find no basis for holding that Congress intended the trustee's avoiding powers to apply extraterritorially." 347 B.R. at 719. The court also held that allegedly fraudulent transfers do not become property of the estate until they are avoided.

At least five courts since *Morrison* have addressed the extraterritoriality of the Bankruptcy Code's avoidance and recovery provisions. In *Picard v. Bureau of Labor Ins. (In re Bernard L. Madoff Inv. Sec. LLC)*, 480 B.R. 501 (Bankr. S.D.N.Y. 2012) (*"BLI"*), the bankruptcy court applied the two-step analysis required by *Morrison* to determine whether a trustee could recover redemption payments under section 550 that were made to the New York and London accounts of a Taiwanese entity. The court ruled that, because the initial transfers of the debtor's assets had occurred in New York, the trustee was not seeking extraterritorial application of section 550. The court also concluded in dicta that "Congress demonstrated its clear intent for the extraterritorial application of Section 550 through interweaving terminology and cross-references to relevant Code provisions," including sections 541 and 548 and 28 U.S.C. § 1334(e)(1). *Id.* at 527. According to the court, "[T]he concepts of 'property of the estate' and 'property of the debtor' are the same, separated only by time." *Id.*

The district court reached the opposite conclusion in *S.I.P.C. v. Bernard L. Madoff Inv. Sec. LLC,* 513 B.R. 222 (S.D.N.Y. 2014) ("*Madoff*"). In ruling that section 550 does not apply extraterritorially, the court wrote:

> Under the logic of *Colonial Realty,* whether "property of the estate" includes property "wherever located" is irrelevant to the instant inquiry: fraudulently transferred property becomes property of the estate only after it has been recovered by the Trustee, so section 541 cannot supply any extraterritorial authority that the avoidance and recovery provisions lack on their own.

513 B.R. at 230.

In *Weisfelner v. Blavatnik (In re Lyondell),* 543 B.R. 127 (Bankr. S.D.N.Y. 2016), the bankruptcy court refused to dismiss a claim seeking avoidance of a fraudulent transfer under section 548 on the ground that the challenged transfer occurred outside the U.S. The court reasoned that Congress could not have intended to exclude extraterritorial transfers from avoidance under section 548 while explicitly defining "property of the bankruptcy estate" under section 541 to include all of the debtor's property "wherever located and by whomever held."

Persuaded by the reasoning in *French*, the court distinguished the case before it from *Colonial Realty.* In *Colonial Realty,* the *Lyondell* court explained, the Second Circuit's recognition that sections 541(a)(1) and (a)(3) "were speaking as of different times" fell "far short of holding that property not in the estate as of the commencement of the case cannot be brought into the estate because it is in a foreign locale." The *Lyondell* court held that Congress could not have intended for property anywhere in the world to enter the bankruptcy estate once recovered pursuant to the avoidance powers while simultaneously not intending for such powers to reach anywhere in the world.

In *Ampal-American*, the bankruptcy court agreed with *Madoff* and *Maxwell I* that the avoidance provisions of the Bankruptcy Code, including section 547(b), do not apply extraterritorially. According to the court, "Property transferred to a third party prior to bankruptcy . . . is neither property of the estate nor property of the debtor *at the time the bankruptcy case is commenced*, the only two categories of property mentioned in Bankruptcy Code § 541(a)(1)." The court also wrote that "the *Begier* Court's conclusion that 'property of the debtor' is best understood as property that would have become 'property of the estate' but for the transfer does not support the *French* and *BLI* courts' interpretation of section 548." In *Begier*, the court explained, the Supreme Court read section 541(a) "as a limitation on the trustee's avoiding powers, not as an expansion of those powers."

The *Ampal-American* court noted that, although some provisions of the Bankruptcy Code and corresponding jurisdictional statutes, such as section 541(a) and 28 U.S.C. § 1334(e)(1), contain clear statements that they apply extraterritorially, section 547 does not—nor, it added in a footnote, does section 548. Because the transfer at issue occurred outside the U.S., the court ruled that it could not be avoided by the trustee.

FAH LIQUIDATING

Electric vehicle manufacturer Fisker Automotive Holdings, Inc., and Fisker Automotive, Inc. (collectively, "Fisker") filed for chapter 11 protection in November 2013 in the District of Delaware.

Prior to filing for bankruptcy, Fisker entered into supply and service agreements (the "Agreements") with Bayerische Motoren Werke Aktiengesellschaft ("BMW"), a German corporation headquartered in Munich. The Agreements were expressly governed by German law and included a German forum selection clause. From June 2011 through April 2012, Fisker made wire transfers to BMW under the Agreements aggregating approximately $32.5 million.

The bankruptcy court authorized Fisker to sell substantially all of its assets under a liquidating chapter 11 plan that the court confirmed in July 2014. The plan assigned the estate's potential causes of action to a liquidating trust.

The liquidating trustee sued BMW, alleging that BMW did not manufacture or deliver any engines to Fisker under the Agreements or otherwise provide value to Fisker in exchange for the $32.5 million in wire transfers. In its complaint, the trustee sought, among other things, to avoid and recover the wire transfers as constructively fraudulent transfers under sections 544, 548, and 550 of the Bankruptcy Code. BMW moved to dismiss the complaint, arguing, among other things, that the wire transfers were extraterritorial and could not be avoided.

The bankruptcy court granted the motion to dismiss in part and denied it in part.

Initially, adopting the reasoning of *Lyondell*, the *FAH Liquidating* court found that, although the wire transfers were extraterritorial, the presumption against extraterritoriality did not prevent the trustee's use of section 548 to avoid the transfers because Congress intended for the provision to apply extraterritorially.

The court found that the "center of gravity" for the transfers was Germany, observing that "[t]he most compelling facts showing domestic activity—that the transfers originated in the United States from a Delaware corporation—are insufficient to overcome the primarily foreign nature of the Agreements." In particular, the court explained, the Agreements provided for milestones to be achieved at BMW's factory in Germany, mandated the resolution of disputes in Germany under German law, and required payment in euros.

Having concluded that the challenged transfers were extraterritorial, the court ruled that the presumption against extraterritoriality with respect to section 548 was overcome because Congress intended the provision to "reach such foreign transfers." On this point, the *FAH Liquidating* court agreed with the courts' reasoning in *Lyondell* and *French*.

The court then examined the sufficiency of the trustee's allegations in the complaint with respect to, among other things, constructive fraudulent transfer under sections 548 and 544(b). It concluded that because wire transfers amounting to approximately $31.7 million had been made more than two years (the look-back period specified in section 548) before Fisker filed for bankruptcy, the complaint stated a valid claim for avoidance of no more than approximately $800,000.

The court further held that German law, rather than the Uniform Fraudulent Transfer Act, as enacted in either California or Delaware, governed the trustee's avoidance claims under section 544(b) because: (i) the Agreements contained a German choice of law and forum selection clause; (ii) the parties "centered their relationship under the Agreements" at BMW's factory in Germany; and (iii) the wire transfers originated from the U.S., but were received in Germany, in euros. According to the court, these factors were not countervailed by Fisker's incorporation in Delaware and its California headquarters or by the fact that most of the creditors harmed by the transfers were within the U.S.

Because the trustee and BMW stipulated that the trustee would not have a remedy to avoid the transfers under section 544(b) if German law applied, the court dismissed the section 544(b) claim.

OUTLOOK

FAH Liquidating further muddies the waters on an issue that has become increasingly prominent as the volume of cross-border bankruptcy cases continues to grow. The split on this issue exists not merely between courts in different jurisdictions, but also between courts in the Southern District of New York, where the majority of cross-border bankruptcy cases have traditionally been filed. As things stand, the courts in *Ampal-American*, *Madoff*, *Midland Euro*, and *Maxwell I* have ruled that the Bankruptcy Code's avoidance provisions do not apply extraterritorially. The courts in *FAH Liquidating*, *Lyondell*, *BLI*, and *French*—the only circuit court of appeals decision on this issue—have ruled to the contrary.

Without the ability to avoid transfers by U.S. debtors to non-U.S. entities under U.S. law, the only recourse available to many bankruptcy trustees, chapter 11 debtors-in-possession, or other representatives of U.S. debtors (such as chapter 11 plan trustees or the representative of a U.S. debtor in a case filed in another country that has enacted the UNCITRAL Model Law on Cross-Border Insolvency) would likely be litigation abroad to seek avoidance and recovery of transferred property under foreign law. *But see Hosking v. TPG Capital Mgmt., L.P. (In re Hellas Telecomms. (Luxembourg) II SCA)*, 535 B.R. 543 (Bankr. S.D.N.Y. 2015) (in a chapter 15 case, even though U.K. law governed actual fraudulent transfer claims asserted by the liquidators of a foreign debtor, a U.S. bankruptcy court has jurisdiction to adjudicate the claims applying U.K. law). However, relatively few countries other than the U.S. have enacted such laws. This means that non-U.S. transferees are in many cases effectively insulated from avoidance liability.

Failing congressional action, the Second Circuit could resolve the uncertainty on this issue at least in the Southern District of New York by definitively ruling one way or another. However, even if the Second Circuit were to hold that the Bankruptcy Code's avoidance provisions apply extraterritorially, practical problems would remain. For example, a U.S. court may lack personal jurisdiction over a non-U.S. transferee, a fact that would significantly complicate efforts to enforce any avoidance ruling. See *Lyondell*, 543 B.R. at 147 (concluding that a litigation trustee in a chapter 11 case failed to make a prima facie case for the court's exercise of personal jurisdiction consistent with due process over a foreign transferee in avoidance litigation).

NINTH CIRCUIT REVERSES COURSE ON MEASURE OF COLLATERAL VALUE IN CRAMDOWN CONFIRMATION OF CHAPTER 11 PLAN

Anna M. Wetzel

In *First Southern Nat'l Bank v. Sunnyslope Hous. LP (In re Sunnyslope Hous. LP)*, 2017 BL 216965 (9th Cir. June 23, 2017), the U.S. Court of Appeals for the Ninth Circuit held en banc that, in determining whether a chapter 11 plan may be confirmed over the objection of a secured creditor, the creditor's collateral must be valued in accordance with the debtor's intended use of the property, even if the property would realize more in a foreclosure sale because of the existence of restrictive covenants. According to the Ninth Circuit, this conclusion was mandated by section 506(a)(1) of the Bankruptcy Code and U.S. Supreme Court precedent.

VALUING A SECURED CREDITOR'S COLLATERAL IN A CRAMDOWN

Section 1129(b) of the Bankruptcy Code provides that a chapter 11 plan may alter the payment terms of an objecting secured lender's loan if, among other things, the plan's treatment of the dissenting secured creditor's claim is "fair and equitable." In such a "cramdown" confirmation, section 1129(b)(2) provides that "fair and equitable" means that: (i) the dissenting secured creditor retains the lien on its collateral and receives deferred payments totaling at least the allowed amount of its secured claim at an appropriate rate of interest; (ii) the collateral is sold and the creditor's lien attaches to the

sale proceeds; or (iii) the creditor receives the "indubitable equivalent" of its secured claim.

The Bankruptcy Code does not mandate any specific method for valuing collateral. However, section 506(a)(1) provides that the value of collateral must be "determined in light of the purpose of the valuation and of the proposed disposition or use of such property." In *Associates Commercial Corp. v. Rash*, 520 U.S. 953 (1997), the U.S. Supreme Court held that, to confirm a chapter 13 plan over the objection of a dissenting secured creditor, section 506(a)(1) requires a "replacement value," rather than a "foreclosure value," standard.

Under a replacement value standard, the value of the collateral equals "the cost the debtor would incur to obtain a like asset for the same 'proposed . . . use.' " *Id.* at 965 (quoting section 506(a)(1)). By contrast, under a foreclosure value standard, value is determined on the basis of the amount a creditor would realize upon immediate foreclosure and sale of the property. In nearly all cases, replacement value will exceed foreclosure value.

According to the Supreme Court in *Rash*, only a replacement value standard takes into account the debtor's "proposed disposition or use of such property" because the debtor—by virtue of its bankruptcy filing—opted to avoid foreclosure. The Court also emphasized that the replacement value standard protects creditors from the "double risks" they face when a defaulting debtor opts to retain and continue using collateral instead of allowing the creditor to repossess it. If a debtor retains collateral instead of surrendering it to the secured creditor, the creditor risks: (1) another default by the debtor; and (2) a decline in the value of the property because of extended use. Neither risk is present, the Court noted, if a creditor can repossess the property and immediately realize its value.

Sunnyslope Housing presented the Ninth Circuit with an unusual scenario: mortgaged real property owned by the debtor was subject to certain covenants that reduced the value of the property if the debtor retained ownership, but could be shed in a foreclosure sale.

NEWSWORTHY

Dan T. Moss (Washington) was featured in *The National Law Journal* as a 2017 Washington, D.C., Rising Star. The *NLJ* selects its Rising Stars on the basis of key elements, including success on the highest stages, diversity of practice groups and law firms, and recommendations. This year's lawyers wield great influence in their practice areas in Washington and beyond. They are innovators, developing individualized practice niches and demonstrating strong leadership qualities.

Carl E. Black (Cleveland) was named a "Lawyer of the Year" in the field of Litigation – Bankruptcy by *Best Lawyers in America* (2018).

Gregory M. Gordon (Dallas) was named a "Lawyer of the Year" in the field of Bankruptcy and Creditor Debtor Rights/Insolvency and Reorganization Law by *Best Lawyers in America* (2018).

Jeffrey B. Ellman (Atlanta), Dan B. Prieto (Dallas), Kevyn D. Orr (Washington), Thomas M. Wearsch (Cleveland), Scott J. Greenberg (New York), Thomas A. Howley (Houston), Richard L. Wynne (Los Angeles), Pedro A. Jimenez (Miami and New York), James O. Johnston (Los Angeles), Aldo L. LaFiandra (Atlanta and New York), Heather Lennox (New York and Cleveland), Gregory M. Gordon (Dallas), David G. Heiman (Cleveland), Corinne Ball (New York), Carl E. Black (Cleveland), Bruce Bennett (Los Angeles and New York), and ***Brad B. Erens (Chicago)*** were recognized in *Best Lawyers in America* (2018) in the field of Bankruptcy and Creditor Debtor Rights/Insolvency and Reorganization Law.

David G. Heiman (Cleveland) was recognized in *Best Lawyers in America* (2018) in the field of Equipment Finance Law.

Gregory M. Gordon (Dallas) and ***Thomas A. Howley (Houston)*** were named Texas Super Lawyers for 2017 in the field of Bankruptcy: Business.

Sidney P. Levinson (New York), Carl E. Black (Cleveland), Corinne Ball (New York), James O. Johnston (Los Angeles), and ***Bruce Bennett (Los Angeles and New York)*** were recognized in *Best Lawyers in America* (2018) in the field of Litigation – Bankruptcy.

On October 10, 2017, ***Heather Lennox (New York and Cleveland)*** participated in an American Bankruptcy Institute roundtable discussion held in conjunction with the 2017 National Conference of Bankruptcy Judges in Las Vegas, entitled "The 'Biggest' Plan Confirmation Issues of 2016 and 2017."

SUNNYSLOPE HOUSING

Sunnyslope Housing Limited Partnership ("Sunnyslope") owned an apartment complex in Arizona. Capstone Advisors, LLC ("Capstone") provided $8.5 million in construction financing for the complex. The Capstone loan, which had an annual interest rate of 5.35 percent, was secured by a first-priority deed of trust on the complex and guaranteed by the U.S. Department of Housing and Urban Development ("HUD"). In order to obtain the HUD guarantee, Sunnyslope entered into a regulatory agreement mandating that the complex be used for affordable housing. Sunnyslope also entered into other agreements with state and city agencies that required portions of the complex to be reserved for low-income housing. These covenants ran with the land but terminated upon foreclosure.

In 2009, Sunnyslope defaulted on the Capstone loan. HUD acquired the Capstone loan shortly thereafter and later sold it to First Southern National Bank ("First Southern") for $5.05 million. Although HUD terminated its regulatory agreement as part of the sale, the other low-income housing covenants remained in effect.

First Southern initiated foreclosure proceedings, and a state court appointed a receiver for the apartment complex. A proposed sale of the complex for $7.65 million was pending when Sunnyslope's general partner filed an involuntary chapter 11 petition for Sunnyslope in January 2011 in the District of Arizona.

Sunnyslope proposed a chapter 11 plan under which it would retain the apartment complex and modify the terms of First Southern's secured loan. First Southern objected to the proposed treatment of its claims.

Sunnyslope and First Southern disputed the value of the apartment complex for purposes of confirmation of a cramdown chapter 11 plan. The bankruptcy court ruled that, even though the restrictive covenants lowered the property's value, that value should be "the value of the property as it is owned by the Debtor, which means as low-income property." After the bankruptcy court made its valuation determination, First Southern elected to treat the entirety of its claim as fully secured under section 1111(b) of the Bankruptcy Code.

The bankruptcy court later confirmed Sunnyslope's chapter 11 plan. Under the plan, First Southern's secured claim, valued at $2.6 million (the value of the complex as a low-income housing project), would be paid over 40 years at a 4.4 percent annual rate of interest. Any remaining balance on the claim would be paid through a balloon payment at the end of the 40-year period. The court found the plan to be fair and equitable because First Southern retained its lien, would receive market-rate interest, and maintained the right to foreclose on the property in the event of default.

On appeal, the district court affirmed the bankruptcy court's valuation of the complex. According to the district court, *Rash* established that "value is based on what a willing buyer in the debtor's trade, business, or situation would pay to obtain like property from a willing seller." Since a willing buyer would be able to operate the complex as affordable housing only while the restrictive covenants were in place, the district court reasoned, the bankruptcy court correctly found that the property's foreclosure value (albeit higher than the replacement value) was irrelevant to the valuation analysis under section 506(a)(1).

The district court ruled, however, that the bankruptcy court erred in omitting certain tax credits from its valuation. On

remand, the bankruptcy court adjusted the value of the collateral (with the tax credits applied) to $3.9 million. First Southern then sought to modify its section 1111(b) election so that a portion of its claim would be unsecured. The court denied this request, finding the change to be immaterial and ruling that First Southern was not entitled to a "second bite at the apple" and a new opportunity to reject the plan and unwind the reorganization.

A divided three-judge panel of the Ninth Circuit reversed the bankruptcy court's confirmation order. *See In re Sunnyslope Hous. Ltd. P'ship*, 818 F.3d 937 (9th Cir.), *vacated*, 838 F.3d 975 (9th Cir. 2016). The majority ruled that: (i) *Rash* requires the court to use replacement value in determining the value of collateral; (ii) in accordance with section 506(a)(1), replacement cost "is a measure of what it would cost to produce or acquire an equivalent" parcel of property; and (iii) "the replacement value of a 150-unit apartment complex does not take into account the fact that there is a restriction on the use of the complex." *Rash* cannot be interpreted, the majority explained, to impose the double risks (debtor default and property deterioration resulting from extended use) on creditors while providing them with "about one-third of what the creditor could obtain if the property were surrendered." By contrast, the dissenting opinion argued that "a straightforward application" of *Rash* "compels valuing First Southern's collateral . . . in light of Sunnyslope's proposed use of the property in its plan of reorganization as affordable housing."

The Ninth Circuit later agreed to reconsider the panel's decision en banc and vacated the ruling.

THE NINTH CIRCUIT'S EN BANC RULING

After a rehearing en banc, an 8-3 majority of the Ninth Circuit reversed course and affirmed the lower court rulings. At the outset, the majority recognized that the case was unusual, since the foreclosure value of the apartment complex exceeded the replacement value.

Writing for the majority, circuit judge Andrew Hurwitz stated that the "essential inquiry under *Rash* is to determine the price that a debtor in Sunnyslope's position would pay to obtain an asset like the collateral for the particular use proposed in the plan of reorganization." Under *Rash*, Judge Hurwitz concluded, the property must be valued at the debtor's "proposed disposition or use" even if the property could achieve a higher value if used differently.

He cautioned against using a "hypothetical" foreclosure value, because the debtor opted to retain the property in the reorganization: "We cannot depart from [the replacement value] standard without doing precisely what *Rash* instructed bankruptcy courts to avoid—assuming a foreclosure that the Chapter 11 petition prevented." In this instance, Judge Hurwitz explained, the valuation must take into account the restrictive covenants because the property could be used for no other purpose absent foreclosure.

Judge Hurwitz also responded to various policy arguments by noting that the primary purpose of chapter 11 is to maximize the value of the debtor's estate, not protect creditor interests. He rejected the argument that "valuing the collateral with the low-income restrictions in place would discourage future lending on like projections." According to the judge, First Southern was aware of the restrictions when it purchased the loan at a discount, and thus, the bankruptcy court's valuation subjected First Southern to "no more risk than it consciously undertook."

The majority ultimately held that Sunnyslope's chapter 11 plan was fair and equitable because First Southern would receive payments equal to the present value of its secured claim. It also ruled that the bankruptcy court committed no error by denying First Southern's request to modify its section 1111(b) election on remand because the amended plan adjusted the valuation of the collateral but did not alter First Southern's treatment.

THE DISSENT

Three judges dissented. According to the dissent, the majority "adopted a test that is not dictated by the letter of *Rash* and is contradicted by its reasoning." The dissent would instead base the valuation on the "market price of the building without restrictive covenants." Although *Rash* adopted a replacement value standard, the dissent explained, the Court intended that standard to be flexible and dependent on the "type of debtor and the nature of the property." Otherwise, the debtor's unique preferences could, in some instances, drastically undervalue the property to the detriment of the creditor.

OUTLOOK

The scope and significance of *Sunnyslope Housing* are uncertain. It remains to be seen whether other circuits will interpret *Rash* as mandating that replacement value be used in valuing collateral for purposes of nonconsensual confirmation of a chapter 11 plan, even where replacement value is demonstrably less than foreclosure value. Courts not bound by the Ninth Circuit's ruling may distinguish *Sunnyslope Housing* because of its unusual facts. However, secured creditors should be aware of the prospect that debtors may rely on the ruling to argue that collateral must be valued on the basis of its proposed use under a plan, even if that valuation is less than foreclosure value.

ERODING THE MAJORITY RULE: ANOTHER CIRCUIT CONCLUDES THAT LEASE CAN BE EXTINGUISHED IN 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 competing interests in the property has long been recognized as one of the most important advantages of a bankruptcy filing as a vehicle for restructuring a debtor's balance sheet and generating value. Still, section 363(f) of the Bankruptcy Code, which delineates the circumstances under which an asset can be sold free and clear of "any interest in such property," has generated a fair amount of controversy. This is so in part because the statute itself does not define "interest."

Although generally acknowledged to encompass liens and security interests, section 363(f)'s scope would appear to be much broader, taking into account both the language of the provision and its underlying purpose. Broadly applied, however, section 363(f) arguably conflicts with certain other provisions of the Bankruptcy Code.

One of those provisions is section 365(h)(1). Section 365(h)(1) provides that, if the trustee or DIP rejects an unexpired real property lease under which the debtor is the lessor, the nondebtor lessee (and any permitted successor or assign, pursuant to subsection (h)(1)(D)) has the option of retaining its rights under the lease for the balance of the lease term. Courts disagree as to whether the rights of a lessee or sublessee under section 365(h)(1) are effectively extinguished if the leased real property is sold free and clear of any "interest" under section 363(f). Until this year, only one court of appeals had weighed in on this question. In *Precision Industries, Inc. v. Qualitech Steel SBQ*, 327 F.3d 537 (7th Cir. 2003), the Seventh Circuit articulated what has become the minority position on this issue, holding that a real property lease can be extinguished in a free-and-clear sale of the property under section 363(f). However, more recently, in *Pinnacle Rest. at Big Sky, LLC v. CH SP Acquisitions, LLC (In re Spanish Peaks Holding II, LLC)*, 2017 BL 241737 (9th Cir. July 13, 2017), the Ninth Circuit also adopted this position, indicating that the majority rule may be eroding.

FREE-AND-CLEAR SALES

Section 363(f) of the Bankruptcy Code 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. These include, among other things, if applicable nonbankruptcy law permits a sale free and clear, if the sale price exceeds the aggregate value of all liens encumbering the property, or if the interest is in bona fide dispute.

A bankruptcy court's power to order sales free and clear of competing 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). It promotes the expeditious liquidation of estate assets by avoiding delay attendant to sorting out disputes concerning the validity and extent of competing interests, which can later be resolved in a centralized forum. It also facilitates the estate's realization of the maximum value possible from an asset. A prospective buyer would discount its offer significantly if it faced the prospect of protracted litigation to obtain clear title to an asset.

Section 363(e) of the Bankruptcy Code provides that, upon the request of an entity which has an "interest" in property proposed to be sold by the trustee or DIP, the court "shall prohibit or condition" the sale "as is necessary to provide adequate protection of such interest." Section 361 provides that "adequate protection may be provided" by periodic cash payments to protect against any decrease in value of the interest; an additional or replacement lien (if the interest is a lien); or other relief, such as an administrative expense claim, "as will result in the realization by such entity of the indubitable equivalent of such entity's interest in such property."

"ANY INTEREST" BROADLY CONSTRUED

Section 363(f) has been applied to a wide range of interests. Courts, however, have sometimes struggled to comprehend the precise scope of the term "interest," which is not defined in the Bankruptcy Code or its accompanying legislative history. Most courts reject the narrow approach adopted by courts that find section 363(f) to be confined to *in rem* property interests or only those claims which have already been asserted at the time the property is sold. Instead, the majority have construed the term broadly to encompass other obligations that may flow from ownership of property, including, for example, successor liability claims. *See, e.g.*, *Indiana State Police Pension Trust v. Chrysler LLC (In re Chrysler LLC)*, 576 F.3d 108 (2d Cir. 2009), *cert. granted and judgment vacated on other grounds*, 558 U.S. 1087 (2009); *In re Trans World Airlines, Inc.*, 322 F.3d 283 (3d Cir. 2003); *UMWA 1992 Benefit Plan v. Leckie Smokeless Coal Co. (In re Leckie Smokeless Coal Co.)*, 99 F.3d 573 (4th Cir. 1996); *In re PBBPC, Inc.*, 484 B.R. 860 (B.A.P. 1st Cir. 2013); *In re ARSN Liquidating Corp.*, 2017 BL 17185 (Bankr. D.N.H. Jan. 20, 2017). *But see Elliott v. Gen. Motors LLC (In re Motors Liquidation Co.)*, 829 F.3d 135 (2d Cir. 2016) (agreeing that successor liability claims can be "interests" when they flow from a debtor's ownership of transferred assets, but ruling that certain claims were not barred because they had not yet arisen at the time a section 363(f) sale closed and that certain other claimants received inadequate notice of the sale); *Olson v. Frederico (In re Grumman Olson Indus., Inc.)*, 445 B.R. 243 (Bankr. S.D.N.Y. 2011) (a section 363 sale order cannot exonerate purchasers from successor liability claims by claimants who, at the time of the sale, had not yet been injured and had no contact or relationship with the debtor or its products).

The scope of section 363(f) becomes an issue if a debtor-lessor seeks to sell property free and clear of the possessory interests of tenants or subtenants. This is so because section 365(h)(1) specifically protects such interests. As noted previously, section 365(h)(1) provides that, if the trustee or DIP rejects an unexpired real property lease under which the debtor is the lessor, the nondebtor lessee (and any permitted successor or assign) has the option either: (i) to treat the lease as terminated and file a claim for breach; or (ii) to retain its rights under the lease for the balance of the lease term (including any renewal or extension periods). Section 365(h)(2) provides similar protections to the purchaser of a debtor's timeshare interest.

In enacting section 365(h)(1), lawmakers sought to "codify a delicate balance between the rights of a debtor-lessor and the rights of its tenants" by preserving the parties' expectations in a real estate transaction. *In re Lee Road Partners, Ltd.*, 155 B.R. 55, 60 (Bankr. E.D.N.Y. 1993). The provision's legislative history indicates that lawmakers intended that rejection of a lease by a debtor-lessor should not deprive the tenant of its estate for the term for which it bargained. *See* H.R. Rep. No. 95-595, 349–50 (1977); S. Rep. No. 95-989, 60 (1978).

QUALITECH STEEL

In 2003, the apparent conflict between sections 363(f) and 365(h)(1) was considered as a matter of first impression in the circuit courts of appeal in *Qualitech Steel*. In that case, a chapter 11 debtor sold substantially all of its assets (including a steel mill with a warehouse leased to Precision Industries, Inc. ("Precision") for 10 years) to the mortgagee of the property. The order approving the sale provided that the assets were to be conveyed "free and clear of all liens, claims, encumbrances, and interests," other than those specifically excepted. The Precision lease, which was unrecorded, was not among the exceptions. Precision was notified of the sale but chose not to object. Instead, it negotiated with the ultimate buyer of the property regarding the assumption of its lease. Those negotiations proved futile, and Precision's lease agreement was deemed rejected in accordance with the terms of the debtor's chapter 11 plan.

Precision commenced litigation seeking a determination that it retained a possessory interest in the warehouse notwithstanding the sale of the property. The bankruptcy court ruled that, under the terms of both section 363(f) and the sale order, the new owner had obtained title to the property free and clear of Precision's leasehold interest. According to the court, that interest clearly qualified as "any interest" under the statute and was unequivocally "extinguished" by the terms of the sale order. The court also implicitly rejected the idea that section 365(h) somehow preserved Precision's rights.

Precision appealed to the district court, which reversed. Reasoning that sections 363(f) and 365(h) are incongruous, the district court held that "the terms of section 365(h) prevail over those of section 363(f) as applied to the rights of lessees." It concluded that the more specific terms of section 365(h) must override the more general scope of section 363(f), observing that "[t]here is no statutory basis for allowing the debtor-lessor to terminate the lessee's position by selling the property out from under the lessee, and thus limiting a lessee's post-rejection rights solely to cases where the debtor-lessor remains in possession of its property." The new owner of the property appealed to the Seventh Circuit.

The Seventh Circuit reversed. The court was mindful of its obligation to construe the two statutory provisions in a way that avoids conflict if at all possible. Despite the Bankruptcy Code's silence on the exact meaning of "any interest," the court emphasized, the term itself is sufficiently comprehensive to encompass a broad range of competing rights. Given the U.S. Supreme Court's observations in other contexts that "interest" is a broad term, the Seventh Circuit concluded that the right conferred by a leasehold upon the lessee "readily may be understood as an 'interest' in the property" within the meaning of section 363(f).

The Seventh Circuit faulted the district court's reliance upon an apparent contradiction between the two provisions as a basis for reversing the bankruptcy court. First, the Seventh Circuit noted, the provisions themselves do not suggest that one supersedes or limits the other, whereas other subsections of both sections 363 and 365 contain specific cross-references to other provisions which have a limiting effect on their scope. The court then observed that the plain language of section 365(h) suggests that it is limited in scope. In particular, section 365(h) expressly applies only to situations where the trustee rejects a lease but retains possession of the property. By contrast, if the trustee does not reject the lease but sells the underlying property under section 363(f), the sale will be free and clear of the tenant's possessory interest (provided it meets one of the five conditions in section 363(f)).

According to the Seventh Circuit, a lessee is not without recourse if its leasehold rights are extinguished in this way. Section 363(e) gives the lessee the right to demand adequate protection of its interest in the property. This would most likely take the form of compensation for the value of its forfeited leasehold interest.

A number of lower courts have reached the same conclusion as the Seventh Circuit for some or all of the same reasons. *See, e.g.*, *In re Downtown Athletic Club of New York City, Inc.*, 2000 WL 744126 (S.D.N.Y. June 9, 2000); *In re Spanish Peaks Holdings II, LLC*, 2014 BL 64226 (Bankr. D. Mont. Mar. 10, 2014), *aff'd*, 2015 BL 191603 (D. Mont. June 16, 2015), *aff'd*, 2017 BL 241737 (9th Cir. July 13, 2017); *South Motor Co. v. Carter-Pritchett-Hodges, Inc. (In re MMH Automotive Group, LLC)*, 385 B.R. 347 (Bankr. S.D. Fla. 2008).

Other courts have ruled to the contrary, reasoning that section 363(f) and section 365(h) conflict when they overlap, but that the more specific section 365(h) trumps section 363(f), and the legislative history of the former clearly indicates that lawmakers intended to protect a tenant's estate when the landlord files for bankruptcy. *See, e.g.*, *Dishi & Sons v. Bay Condos LLC*, 510 B.R. 696 (S.D.N.Y. 2014); *In re Zota Petroleums, LLC*, 482 B.R. 154 (Bankr. E.D. Va. 2012); *In re Samaritan Alliance, LLC*, 2007 BL 156456 (Bankr. E.D. Ky. Nov. 21, 2007); *In re Haskell, L.P.*, 321 B.R. 1 (Bankr. D. Mass. 2005); *In re Churchill Properties III, Ltd. Partnership*, 197 B.R. 283 (Bankr. N.D. Ill. 1996). Despite the

Seventh Circuit's contrary approach, those courts represent the majority view on this issue.

SPANISH PEAKS

Spanish Peaks was a resort in Big Sky, Montana, owned by Spanish Peaks Holdings, LLC ("SPH"), an entity controlled by James J. Dolan, Jr., and Timothy L. Blixseth. The resort properties were financed by a $130 million secured loan that was ultimately assigned to CH SP Acquisitions ("CH SP").

In 2006, SPH leased restaurant space at the resort under a below-market lease that was later assigned to The Pinnacle Restaurant at Big Sky ("Pinnacle"), an SPH affiliate. SPH entered into another commercial lease in 2009 with Montana Opticom, LLC ("Opticom"), also an affiliate. Neither lease contained a subordination or nondisturbance clause protecting the tenant from foreclosure on the underlying property by the mortgagee of the properties.

SPH and two affiliates filed chapter 7 petitions in October 2011 in the District of Delaware, but venue of the cases was transferred to the District of Montana. The chapter 7 trustee proposed to sell the resort properties free and clear of all liens, claims, encumbrances, and interests, with certain exceptions, under section 363(f). Pinnacle and Opticom objected, claiming they were entitled to retain possession of the leased premises under section 365(h).

The bankruptcy court approved an auction sale of the resort properties in 2013 to CH SP for $26.1 million but expressly provided in its order that the sale was subject to any rights of lessees under section 365(h), which would be determined later. The trustee then filed a motion to reject the Pinnacle and Opticom leases, while CH SP separately sought a determination that the property was sold free and clear of the leases. At no time before or after the sale did Pinnacle and Opticom request adequate protection of their leasehold interests under section 363(e) or provide any evidence that they would suffer economic harm if their interests were terminated.

After finding, among other things, that the Pinnacle lease was well below market, that the Opticom lease was unrecorded, and that the validity of both leases was subject to bona fide dispute, the bankruptcy court held that the sale was free and clear of the leases. The district court affirmed on appeal. It reasoned that the sale extinguished the leases because the foreclosure of the property's mortgage would, under Montana law, terminate any leasehold interests junior to the mortgage.

THE NINTH CIRCUIT'S RULING

A three-judge panel of the Ninth Circuit affirmed.

According to the court, on the basis of a "proper understanding of the concept of 'rejection,' " sections 363(f) and 365(h) can "easily" be read to give effect to each while preserving their sense and purpose. Although a sale free and clear of a lease may be an effective rejection of the lease "in some everyday sense," the court wrote, "it is not the same thing as the 'rejection' contemplated by section 365," which requires an "affirmative declaration by the trustee that the estate will not take on the obligations of a lease or contract made by the debtor."

The Pinnacle and Opticom leases were not formally rejected by the trustee, and the leases were not deemed rejected under section 365(d)(1) or 365(d)(4)(A) because of the trustee's failure to act within a prescribed period. Thus, the Ninth Circuit panel concluded, section 365(h) was not implicated.

Citing the reasoning in *Qualitech Steel* with approval, the Ninth Circuit panel explained that section 363(e) makes mandatory the adequate protection of an interest to be terminated in a free-and-clear sale if requested by the holder of the interest. It further noted that the district court in *Dishi & Sons* concluded that adequate protection could take the form of a lessee's continued possession of its leasehold interest. The broad definition of "adequate protection," the Ninth Circuit panel wrote, "makes it a powerful check on potential abuses of free-and-clear sales."

Next, the court emphasized that section 363(f) authorizes free-and-clear sales only under certain circumstances. Although the bankruptcy court did not specify which alternative subsection of the provision applied to the sale of the resort properties, the Ninth Circuit panel focused on subsection (f)(1), which authorizes a free-and-clear sale if "applicable nonbankruptcy law permits sale of such property free and clear of such interest."

Under Montana law, the court explained, a foreclosure sale to satisfy a mortgage terminates a subsequent lease on the mortgaged property. According to the court, "SPH's bankruptcy proceeded, practically speaking, like a foreclosure sale . . . [and] had SPH not declared bankruptcy, we can confidently say that there would have been an actual foreclosure sale," which would have terminated the Pinnacle and Opticom leases.

The Ninth Circuit panel acknowledged that the court in *Dishi & Sons* held that section 363(f)(1) refers not to foreclosure sales, but to situations where an asset owner may sell an asset free and clear of an interest under nonbankruptcy law. The panel also acknowledged that debtors often seek bankruptcy protection "for the very purpose" of avoiding foreclosure. Still, the Ninth Circuit panel found it significant that section 365(h) recognizes appurtenant rights conferred by a lease "to the extent that such rights are enforceable under applicable nonbankruptcy law." Disagreeing with *Dishi & Sons*, the Ninth Circuit wrote that "[w]e see no reason to exclude the law governing foreclosure sales from the analogous language in section 363(f)(1)."

Finally, the Ninth Circuit panel explained that its analysis "highlights a limitation inherent in the 'majority' approach"—namely, although section 365(h) embodies lawmakers' intent to protect lessees, "that intent is not absolute" and coexists with competing purposes, such as the goal of maximizing creditor recovery. According to the court, its reading of sections 363(f) and 365(h) most nearly balances those competing purposes in the way Congress intended.

OUTLOOK

With *Spanish Peaks* and *Qualitech Steel*, two circuits have now ruled that a leasehold interest may be extinguished in a free-and-clear sale of property under section 363(f). Therefore, the majority approach on this important issue appears to be losing ground. The rulings may be a welcome development for landlords intent upon selling property in bankruptcy unburdened by leasehold interests, and anything but welcome news for lessees, but the resulting uncertainty is not a positive development for either group.

Absent judicial resolution of the issue at the highest level or legislative clarification, landlords and tenants should be mindful of the approach adopted by the courts in their jurisdictions. Tenants in a minority approach jurisdiction that face the prospect of a free-and-clear sale should demand adequate protection (including the possibility of continued possession) of their leasehold interests at the earliest opportunity.

Finally, *Spanish Peaks* was an unusual case. Because the lessees failed to demand adequate protection of their leasehold interests under section 363(e), the Ninth Circuit panel never addressed what form of adequate protection would have been appropriate under the circumstances, including the retention of possession. Moreover, because the leases were disputed, the sale could also have been approved under section 363(f)(3), which permits a free-and-clear sale if "such interest is in bona fide dispute."

INTERNATIONAL LEGISLATIVE UPDATE

Germany—Major German insolvency law reforms designed to facilitate corporate group insolvencies will become effective on April 21, 2018. When the reforms come into force, they will supplement and complement the Recast European Union Insolvency Regulation that became effective on June 26, 2017.

The new German legislation will permit corporate group insolvencies with individual proceedings, on an entity-by-entity basis, presided over by a single German insolvency court and administered by a single insolvency administrator, unless a unitary approach is impracticable. In the case of impracticability, the courts and administrators involved are obligated to cooperate for the purpose of coordinating the separate proceedings.

The new law also provides a mechanism for creating group creditors' committees, the role of which is to support insolvency administrators appointed in individual insolvency proceedings and to ensure that such proceedings are conducted in a coordinated manner. Each insolvent member of a group and each individual creditors' committee has the ability to initiate a "coordination proceeding" designed to facilitate the individual insolvency proceedings and to maximize creditor recoveries.

The new law does not permit substantive, as distinguished from procedural, consolidation of the group member debtors. Instead, the estates of each entity remain separate, and creditors can receive distributions only from the particular debtor(s) against which they hold claims. This reform is particularly significant because reliance on insolvency protocols is uncommon in German insolvency proceedings.

The legislation defines a "business group" *(Unternehmensgruppe)* as a group of legally autonomous businesses whose center of main interests is in Germany and who are directly or indirectly connected with each other by means of: (i) the ability to exert a dominating influence; or (ii) centralization under joint management *(einheitliche Leitung)*.

Among the new law's key provisions are the following:

Group venue **(Gruppen-Gerichtsstand).** If a member of a corporate group files an insolvency proceeding in a particular court, that court can declare that it also has jurisdiction over all the other members of the corporate group. There are certain safeguards designed to prevent smaller subsidiaries from being used to facilitate forum shopping. If the insolvency proceedings over the group members are not procedurally consolidated in one insolvency court, all courts involved must consider whether it would be advisable to have a single insolvency administrator appointed for all of the debtor companies. The courts must also cooperate and share with each other information concerning the insolvency proceedings; if more than one insolvency administrator has been appointed, the administrators must do the same; and in the case of debtor-in-possession ("DIP") proceedings (*Eigenverwaltung*), the debtor's management is obligated to cooperate and share information with the administrators or management of all other group member companies.

Group creditors' committee. The new law provides for the formation of a group creditors' committee *(Gruppen-Gläubigerausschuss)* in case of insolvency of a corporate group. The function of a group creditors' committee is to support the insolvency administrator(s), any DIP, and individual creditors' committees appointed in the group debtors' cases.

Coordination proceedings. The new law introduces a group-related coordination proceeding *(Koordinationsverfahren)* to be overseen and coordinated by a coordinating administrator *(Verfahrenskoordinator)*. The purpose of such coordination proceedings is to harmonize the separate insolvency proceedings pending with respect to the various group companies to the extent that coordination is in the best interests of creditors.

Coordination plans. Corporate groups will have the option of formulating a coordination plan *(Koordinationsplan)* providing for, among other things: (i) the implementation of measures (including entering into new contracts) necessary to restore the economic viability of the individual group companies and the corporate group as a whole; and (ii) the

resolution of internal group conflicts. Such a coordination plan can form the basis for an insolvency plan for each insolvent entity but has no binding effect on the insolvency administrator of each group entity. However, an administrator is obligated to justify any departures from the coordination plan.

Russia—Significant changes to Russian insolvency law became effective on July 30, 2017. Among other things, new Federal Law No. 266-FZ (July 29, 2017) (the "Amendment") supersedes provisions concerning the vicarious liability of "controlling persons" for a bankrupt corporate debtor's obligations set forth in RF Law No. 127-FZ on Insolvency (October 26, 2002) (the "Insolvency Law").

The Amendment defines a "controlling person" as any individual or entity who, during the three-year period preceding the existence of "signs of insolvency" or court approval of a bankruptcy petition, had the power to direct the debtor's affairs, including the execution of contracts.

Officers, directors, liquidators, members of a liquidating committee, controlling shareholders, and any person who benefited from the unlawful or bad-faith actions of persons authorized to represent the debtor under its constituent documents or by power of law are presumed to be controlling persons, although the presumption is rebuttable. Additional persons can also be deemed controlling if they meet specified criteria.

Under the Amendment, controlling persons may be held vicariously liable if: (i) creditor claims cannot be satisfied as a consequence of a controlling person's actions or inactions, including dismissal of bankruptcy proceedings because of lack of adequate funds; (ii) their actions or omissions resulted in serious harm to the debtor's financial condition, whether or not those actions or omissions caused the debtor's insolvency; (iii) they failed to timely file a bankruptcy application on the debtor's behalf; or (iv) they violated the Insolvency Law by, among other things, causing the debtor to file for bankruptcy when it was still able to pay its obligations in full.

An application to impose vicarious liability upon a controlling person may be filed with the bankruptcy court by a receiver, creditors, and existing or former employees to whom the debtor is indebted or their representatives. An application must be filed no later than three years after the date when the applicant became aware or should have become aware of grounds for vicarious liability, but in no case later than three years after the debtor was declared bankrupt (among other things), with certain exceptions that may extend the limitations period to 10 years.

If the court grants the application, it may, among other things, direct that creditor claims be satisfied as part of the debtor's insolvency proceedings; sold; or, in some cases, assigned in whole or in part to a creditor, in which case the creditor will have a direct claim against the controlling person. To the extent that the controlling person satisfies his or her vicarious liability, he or she will have a subordinated subrogation claim against the debtor's bankruptcy estate.

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