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SECTION 363 DOES NOT APPLY TO CHAPTER 11 PLAN SALES

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In *In re Ditech Holding Corp.*, 2019 WL 4073378 (Bankr. S.D.N.Y. Aug. 28, 2019), the U.S. Bankruptcy Court for the Southern District of New York addressed several objections to confirmation of a chapter 11 plan that proposed to sell home mortgage loans "free and clear" of certain claims and defenses of the homeowner creditors, contrary to a provision of the Bankruptcy Code—section 363(o)—which was enacted in 2005 to prevent free and clear sales of certain claims and defenses relating to consumer credit agreements. The court ultimately ruled that section 363 of the Bankruptcy Code does not apply to sales in a chapter 11 plan and that the debtors proposed their plan in good faith.

Importantly, however, the court initially denied confirmation of the plan and refused to approve a related global settlement because the debtors were unable to satisfy the "best interests" test, which requires that creditors (the homeowners in this instance) receive more under a plan than they would in a chapter 7 liquidation. The debtors obtained the court's approval of the plan after amending it to increase the funds available to satisfy consumer creditor claims and to provide that such creditors' recoupment claims and defenses would remain intact.

BANKRUPTCY SALES

Assets can be sold in a bankruptcy case under either section 363 or section 1123 of the Bankruptcy Code. *See In re New 118th Inc.*, 398 B.R. 791, 794 (Bankr. S.D.N.Y. 2009) ("A trustee may sell property prior to confirmation, 11 U.S.C. § 363, or through a plan."). With certain exceptions, section 363 and the remaining provisions of chapter 3 of the Bankruptcy Code apply to cases filed under chapters 7, 11, 12, and 13 of the Bankruptcy Code (11 U.S.C. § 103(a)), and apply in a chapter 15 case upon recognition of a foreign proceeding by a U.S. bankruptcy court (11 U.S.C. § 1520(a)(2)).

Section 363(b) authorizes a bankruptcy trustee or chapter 11 debtor-in-possession ("DIP") to use, sell, or lease estate property other than in the ordinary course of business only after court approval. To obtain such approval, a trustee or DIP must first provide notice to stakeholders and an opportunity for a hearing. The court will generally approve a sale of estate property under section 363(b) if the trustee or DIP offers a "good business reason" for the sale. *See In re Lionel Corp.*, 722 F.2d 1063, 1071 (2d Cir. 1983); *accord Matter of VCR I, L.L.C.*,

IN THIS ISSUE

922 F.3d 323, 326 (5th Cir. 2019); *In re Nine W. Holdings, Inc.*, 588 B.R. 678, 686 (Bankr. S.D.N.Y. 2018).

A sale of substantially all of a chapter 11 debtor's assets or business may be approved under section 363(b). *See, e.g., In re Advanced Contracting Sols., LLC*, 582 B.R. 285 (Bankr. S.D.N.Y. 2018); *In re 9 Houston LLC*, 578 B.R. 600 (Bankr. S.D. Tex. 2017). Courts are sometimes wary of approving such sales, however, because they represent a court-sanctioned liquidation without the substantive and procedural safeguards of the chapter 11 plan confirmation process, including the disclosure of adequate information to stakeholders, an opportunity for impaired creditors and interest holders to vote, and other requirements that must be satisfied to confirm a plan. *See Motorola v. Comm. of Unsecured Creditors (In re Iridium Operating, LLC)*, 478 F.3d 452, 466 (2d Cir. 2007) ("The reason *sub rosa* plans are prohibited is based on a fear that a debtor-in-possession will enter into transactions that will, in effect, 'short circuit the requirements of [C]hapter 11 for confirmation of a reorganization plan.'") (quoting *Pension Benefit Guar. Corp. v. Braniff Airways, Inc. (In re Braniff Airways, Inc.)*, 700 F.2d 935, 940 (5th Cir. 1983)).

In addition to the sale of assets under section 363(b), a DIP or trustee may sell estate assets as part of a chapter 11 plan. Section 1123(a)(5) of the Bankruptcy Code states that a chapter 11 plan shall provide for adequate means of its implementation, such as the "sale of all or any part of the property of the estate, either subject to or *free of any lien*" (emphasis added). Similarly, section 1123(b)(4) provides that a plan may "provide for the sale of all or substantially all of the property of the estate, and the distribution of the proceeds of such sale among holders of claims or interests." Finally, section 1141(c) of the Bankruptcy Code provides that, with certain exceptions, "after confirmation of a plan, the property dealt with by the plan is free and clear of all claims and interests of creditors, equity security holders, and of general partners in the debtor."

SALES FREE AND CLEAR

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 conditions include, among other things, if applicable nonbankruptcy law permits such a free-and-clear sale, if the sale price exceeds the aggregate value of all liens encumbering the property, or if the interest is in bona fide dispute.

Section 363(f) has been applied to a wide range of interests. *See generally* Collier on Bankruptcy ("Collier") ¶ 363.06 (16th ed. 2019). Courts, however, have sometimes struggled to identify the outer limits of the term "interest," which is not defined in the Bankruptcy Code or its accompanying legislative history. Most courts reject the narrow approach under which the reach of section 363(f) is limited to *in rem* property interests or only those claims that have already been asserted at the time the property is sold. Instead, the majority of courts 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.*, *Ind. 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)) and even leasehold interests. *See, e.g.*, *Pinnacle Rest. at Big Sky, LLC v. CH SP Acquisitions, LLC (In re Spanish Peaks Holding II, LLC)*, 872 F.3d 892 (9th Cir. 2017) (notwithstanding the tenant protections set forth in section 365(h)(1), real property can be sold by a debtor-lessor free and clear of a leasehold interest under section 363(f)).

EXCEPTION FOR CONSUMER CREDIT TRANSACTION INTERESTS

In 2005, Congress amended section 363 of the Bankruptcy Code to add what is now section 363(o). That subsection provides as follows:

> Notwithstanding subsection (f), if a person purchases any interest in a consumer credit transaction that is subject to the Truth in Lending Act or any interest in a consumer credit contract (as defined in section 433.1 of title 16 of the Code of Federal Regulations (January 1, 2004), as amended from time to time), and if such interest is purchased through a sale under this section, then such person shall remain subject to all claims and defenses that are related to such consumer credit transaction or such consumer credit contract, to the same extent as such person would be subject to such claims and defenses of the consumer had such interest been purchased at a sale not under this section.

Thus, in a bankruptcy sale involving an interest in a qualifying "consumer credit transaction" or a "consumer credit contract," the sale does not "cleanse" the assets of certain successor liability claims.

Section 363(o) was added to the Bankruptcy Code in 2005 in an effort to address problems with "predatory lenders," which were described in 2001 as follows:

> We have a new problem with these predatory lenders.... In recent months, several large subprime lenders have obtained orders from bankruptcy courts, providing for the sale of their loans or the servicing rights associated with them under section 363 of the bankruptcy code. Consumers who have attempted to challenge these loans or their servicing obligations based on violations of fair lending laws have been told by the purchasers of these loans they were sold free and clear of any consumer claims and defenses. The fact that innocent borrowers can be left in the lurch is flat out wrong.

147 Cong. Rec. 2018, at *2032 (Mar. 8, 2001) (remarks of Sen. Schumer).

SETOFF AND RECOUPMENT

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

The related common law remedy of "recoupment" allows a setoff of mutual obligations that arise under the same contract or transaction. *See In re Thomas*, 529 B.R. 628 (Bankr. W.D. Pa. 2015).

A creditor is precluded by the automatic stay from exercising its setoff rights with respect to a prepetition claim without bankruptcy court approval. *See* 11 U.S.C. § 362(a)(7). Upon application by the creditor, however, the court will generally permit a setoff if the requirements under applicable law are met, except under circumstances where it would be inequitable to do so. *See In re Ealy*, 392 B.R. 408 (Bankr. E.D. Ark. 2008). By contrast, the exercise of a right of recoupment does not require court authority, and the automatic stay does not apply. *See In re McMahon*, 129 F.3d 93, 96 (2d Cir. 1997) ("While a 'setoff' is subject to the automatic stay provision of 11 U.S.C. § 362, a recoupment is not."); *In re Thigpen*, 590 B.R. 810, 812 (N.D. Ill. 2018) (property subject to recoupment is exempt from the automatic stay).

CHAPTER 11 PLAN CONFIRMATION REQUIREMENTS: COMPLIANCE WITH BANKRUPTCY CODE, GOOD FAITH, AND BEST INTERESTS OF CREDITORS

Section 1129 of the Bankruptcy Code sets forth the requirements for consensual and cram-down confirmation of a chapter 11 plan. Sections 1129(a)(1) and (a)(2) mandate that the plan and the plan proponent, respectively, comply with the applicable provisions of the Bankruptcy Code.

Section 1129(a)(3) provides that every chapter 11 plan must be "proposed in good faith and not by any means forbidden by law." This provision has been construed to require that a plan be proposed with honesty and good intentions and with a basis for expecting that a reorganization or liquidation, as the case may be, can be effected. *See In re Breitburn Energy Partners LP*, 582 B.R. 321, 352 (Bankr. S.D.N.Y. 2018) (citing cases). In keeping with that mantra, bankruptcy courts are required to determine whether a chapter 11 plan, viewed in light of the totality of the circumstances, fairly "achieve[s] a result consistent with the objectives and purposes of the Bankruptcy Code." *Matter of Madison Hotel Assocs.*, 749 F.2d 410, 425 (7th Cir. 1984) (citations omitted); *accord Breitburn*, 582 B.R. at 352; *see generally* Collier at ¶ 1129.02[3].

Section 1129(a)(7) requires that "each creditor in an impaired class "(i) has accepted the plan; or (ii) will receive or retain under the plan on account of such claim . . . property of a value, as of the effective date of the plan, that is not less than the amount that such holder would so receive or retain if the debtor were liquidated under chapter 7 of this title on such date." Sometimes referred to as the "best interests of creditors test," section 1129(a)(7) is designed to protect rejecting and non-voting members of an impaired class by establishing the minimum that they must receive or retain under the plan. *See Kane v. Johns–Manville Corp.*, 843 F.2d 636, 649 (2d Cir. 1988) ("Subsection 1129(a)(7) incorporates the former 'best interest[] of creditors' test and requires a finding that each holder of a claim or interest either has accepted the plan or has received no less under the plan than what he would have received in a Chapter 7 liquidation."); *accord In re Ultra Petroleum Corp.*, 913 F.3d 533, 545 (5th Cir. 2019).

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

BANKRUPTCY SETTLEMENTS

Rule 9019 of the Federal Rules of Bankruptcy Procedure gives a bankruptcy court the power to approve a proposed compromise or settlement. A court may approve a settlement if it finds that the settlement is fair and equitable, and in the best interests of the estate. *See In re Drexel Burnham Lambert Grp., Inc.*, 134 B.R. 493, 496 (Bankr. S.D.N.Y. 1991) (citing *Protective Comm. for Indep. Stockholders of TMT Trailers Ferry, Inc. v. Anderson*, 390 U.S. 414, 424 (1968)); *accord In re Chemtura Corp.*, 439 B.R. 561, 593-94 (Bankr. S.D.N.Y. 2010). Such a determination is committed to the discretion of the court. *See In re Purofied Down Prods. Corp.*, 150 B.R. 519, 522 (S.D.N.Y. 1993).

In addition, section 1123(b)(3)(A) of the Bankruptcy Code states that a chapter 11 plan may "provide for . . . the settlement or adjustment of any claim or interest belonging to the debtor or the estate." Even if a settlement does not concern a claim or interest belonging to the debtor or its estate, section 1123(b)(6) provides that a plan may "include any other appropriate provision not inconsistent with the applicable provisions of this title." Therefore, although section 1123(b)(3)(A) expressly permits settlements only of claims and interests belonging to the debtor and its estate, courts consider plan settlements of non-debtor claims under the same standards applied to Rule 9019 settlements. *See In re Texaco Inc.*, 84 B.R. 893, 901 (Bankr. S.D.N.Y. 1988); *accord In re Woodbridge Grp. of Cos.*, 592 B.R. 761 (Bankr. D. Del. 2018); *In re NII Holdings, Inc.*, 536 B.R. 61 (Bankr. S.D.N.Y. 2015).

DITECH HOLDING

Ditech Holding Corporation (f/k/a Walter Investment Management Corp.) and its affiliates (collectively, "Ditech") operate as a servicer and originator of home mortgage loans and reverse mortgage loans. Ditech is party to approximately one million consumer credit agreements that fall within the scope of section 363(o).

Ditech filed for chapter 11 protection on February 27, 2019, in the Southern District of New York, barely 11 months after the bankruptcy court confirmed a prepackaged chapter 11 plan for its predecessor that eliminated $806 million in debt and turned ownership of most of the company over to bondholders. At the time of the filing, Ditech was subject to thousands of formal and informal proceedings in which consumer creditors asserted claims and defenses of the types described in section 363(o). Those claims covered a "wide range of alleged misconduct" by Ditech relating to the ownership, origination, and/or servicing of mortgages.

In May 2019, the U.S. Trustee appointed an additional official committee ("consumers' committee") to represent homeowners with mortgages that Ditech originated or serviced ("consumer creditors"). The consumers' committee was formed after Ditech's official unsecured creditors' committee agreed to the terms of a global settlement that did not preserve consumer creditors' claims and defenses regarding their mortgages.

The global settlement was the foundation for Ditech's chapter 11 plan, which contemplated an auction sale of Ditech's assets for $1.8 billion to two purchasers. The sale agreements required Ditech to sell the assets in a chapter 11 plan free and clear of consumer creditor claims, including those covered by section 363(o). However, one of the purchasers was willing to consummate the sale at a reduced price if the sale did not "strip" off the claims. Although the plan would have barred consumer creditors from suing the purchasers, it created a "creditor recovery trust" to cover consumer creditor claims that was to be funded by a $5 million carve-out from the collateral of Ditech's term loan lenders.

The only class of creditors entitled to vote, the term loan lenders, accepted the plan. The term loan lenders, the purchasers, and the unsecured creditors' committee supported confirmation of the plan as well as approval of the sale transactions and the global settlement. According to Ditech, because it would be selling the consumer credit agreements under the chapter 11 plan, rather than pursuant to section 363, section 363(o) did not apply, and it could sell the agreements free and clear of the consumer creditor claims and defenses.

The consumers' committee, the U.S. Trustee, and numerous other parties objected to plan confirmation and approval of the related transactions. They argued that, among other things:

- Ditech could not transfer the consumer credit agreements "free and clear" of claims and defenses under the plan without complying with section 363(f) and the limitations set forth in section 363(o);
- Because the plan did not provide for the sale of those assets pursuant to section 363, subject to the limitations set forth in section 363(o), it violated sections 1129(a)(1)-(3);
- Ditech was improperly trying to sell the consumer credit agreements free and clear of rights that cannot be expunged through bankruptcy, including the consumer creditors' common law rights of setoff and recoupment;
- The plan did not satisfy the "best interests" test under section 1129(a)(7) because Ditech's liquidation analysis failed to account for the fact that, in a chapter 7 liquidation, the consumer credit agreements could be transferred only pursuant to a section 363 sale in which section 363(o) would apply; and

- The global settlement was not "fair and equitable" because the $5 million fund did not adequately account for the consumer credit claims.

THE BANKRUPTCY COURT'S RULING

Bankruptcy Judge James L. Garrity, Jr. initially denied confirmation of the plan and refused to approve the global settlement.

Section 363 Is Inapplicable to Chapter 11 Plan Asset Sales. Judge Garrity rejected the argument that section 363(o) applies to sales under a chapter 11 plan. First, the judge examined the interplay between sections 363 and 1123, both of which, as noted, authorize the sale of assets in a bankruptcy case. However, he explained, "the 'free and clear' relief available to a debtor under section 363(f) is narrower than that afforded to a debtor under a confirmed plan because the relief is limited to 'interests' in property and only to the extent provided for under section 363(f)(1)-(5)."

Judge Garrity analyzed the legislative history of section 363(o) and concluded that "Congress intended to limit Section 363(o)'s effect to pre-plan sales, not chapter 11 reorganizations, including those effectuated through plan sales." In particular, he noted, as originally proposed in 2001, the amendment that ultimately became section 363(o) would have made "the sale by a trustee or transfer *under a plan of reorganization* of any interest in a consumer credit transaction" subject to "all claims and defenses which the consumer could assert against the debtor" (emphasis added) (citing 147 Cong. Rec. 2018, at *2031 (Mar. 8, 2001)). However, prior to being finalized in its current form, the language of the proposed provision was altered to remove "under a plan of reorganization," to narrow the scope of section 363(o) to a sale under section 363, and to limit potential successor liability to such claims and defenses available to the consumer had the sale taken place other than under the Bankruptcy Code (citing 147 Cong. Rec. 2184, at *2189-90 (Mar. 13, 2001)). According to Judge Garrity, "there is nothing in the legislative history that suggests that Congress's last change to the amendment that would become section 363(o) was intended to undo the initial compromise which limited the amendment's application to section 363 sales, as opposed to section 363 and plan sales."

Judge Garrity accordingly ruled that "plan sales can be free and clear of claims without invoking Section 363(f)." He acknowledged that chapter 3 of the Bankruptcy Code applies in chapter 11 cases. Even so, he explained that "it does not follow that all such provisions are applicable in every chapter 11 case." Judge Garrity wrote that "where a debtor proposes a sale pursuant to a plan, the sale is not under section 363 and, by its plain terms, section 363(f) is inapplicable."

Judge Garrity held that Ditech's chapter 11 plan, which did not preserve the consumer creditors' rights under section 363(o), nonetheless complied with the "applicable provisions" of the Bankruptcy Code and was not proposed by "means forbidden by law" within the meaning of sections 1129(a)(1)-(3), because section 363 was inapplicable to the sale of assets under a chapter 11 plan.

Recoupment Rights Must Be Left Undisturbed. Ditech and the consumer creditors settled their dispute concerning setoff rights by including a provision in the proposed confirmation order to clarify that confirmation of the plan would not affect the rights of any creditor, with court approval, to exercise common-law setoff rights preserved by section 553 against Ditech or the post-confirmation creditor recovery trust.

Addressing recoupment rights, Judge Garrity explained that "[t]he doctrine of recoupment is a creature of non-bankruptcy law, and a defense—sometimes asserted affirmatively—that does not give rise to a claim or debt that is dischargeable in bankruptcy, or a right to demand payment." He concluded that there was no basis to deny or limit the consumer creditors' common law recoupment rights. Judge Garrity accordingly ruled that the proposed confirmation order should leave those rights undisturbed, provided the exercise of such rights did not require the purchasers "to pay money damages to, refund amounts paid by, or pay monies (except escrow advances) on behalf of or for the account of, the [consumer creditors]."

Ditech's Plan Was Proposed in Good Faith. Judge Garrity held that Ditech proposed its plan in good faith, as required by section 1129(a)(3). Among other things, he found that: (i) Ditech filed for bankruptcy "with the legitimate chapter 11 goal of effectuating a reorganization" that would either preserve its business as a going concern or effect a sale of its business to maximize distributions to creditors and/or allow the business to continue under new ownership; (ii) Ditech filed for chapter 11 because it was facing approximately $110 million in amortization payments due in 2019 and a possible going-concern qualification, which might have triggered defaults and terminations in its capital structure; (iii) during its chapter 11 case, Ditech engaged in meaningful and transparent dialogue with various constituencies, including the consumer creditors; and (iv) Ditech conducted a "robust marketing and sale process" for its businesses.

The Plan Failed the Best Interests of Creditors Test. However, Judge Garrity initially ruled that Ditech's plan failed the best interests test in section 1129(a)(7). Ditech argued that, because its liquidation analysis showed that consumer creditors would receive nothing in a chapter 7 case but would receive $5 million under the plan, the test was satisfied. In a chapter 7 case, Judge Garrity explained, any sale of the consumer credit agreements would be subject to section 363, including section 363(o). Because Ditech's liquidation analysis did not include amounts that might be realized by the consumer creditors from the purchasers, which would likely exceed $5 million, Judge Garrity held that the plan failed the best interests test.

The court rejected Ditech's argument that, as in chapter 13 cases, where a comparable best interests test contained in section 1325(a)(4) does not require consideration of claims against non-debtor third parties, section 1129(a)(7) should also be read to exclude such claims. In short, Judge Garrity concluded, "the best interests tests in sections 1129(a)(7) and 1325(a)(4) are different."

Judge Garrity found Judge Stuart M. Bernstein's ruling in *In re Quigley Co., Inc.*, 437 B.R. 102, 147 (Bankr. S.D.N.Y. 2010), to be persuasive on this issue. In *Quigley*, Judge Bernstein ruled that a chapter 11 plan that provided the debtor's sole shareholder with a release in exchange for funding an asbestos trust did not satisfy section 1129(a)(7). This was because the debtor's liquidation analysis did not account for the fact that, in a chapter 7 liquidation, the parent would not receive a release and non-settling asbestos creditors would retain the right to pursue their substantial derivative claims against the parent. Judge Bernstein reasoned that, according to its plain terms, section 1129(a)(7) mandates that, "in conducting the best interest analysis, the court must consider both the distributions under the plan and in a hypothetical chapter 7 case, and the 'value of the property that each dissenting creditor will retain under the plan and in the hypothetical chapter 7.'" *Id.* at 145-46.

In *Ditech Holding*, Judge Garrity found that Ditech put misplaced reliance on *In re Plant Insulation Co.*, 469 B.R. 843 (Bankr. N.D. Cal. 2012), *aff'd*, 485 B.R. 203 (N.D. Ca. 2012), *rev'd on other grounds*, 734 F.3d 900 (9th Cir. 2013), *aff'd*, 544 F. App'x 669 (9th Cir. 2013). As in *Quigley*, the debtor in *Plant Insulation* proposed a chapter 11 plan that contemplated the creation of an asbestos trust and a channeling injunction under section 524(g) of the Bankruptcy Code. The plan provided that insurers who funded the trust would be shielded from future liability for asbestos claims, including claims for equitable contribution asserted by other insurers. Non-settling insurers objected to confirmation of the plan, claiming that it failed the best interests test. They argued that, because the channeling injunction applies only in chapter 11 cases, in a hypothetical chapter 7 liquidation, they would retain their equitable contribution claims against the settling insurers. Once those claims were accounted for, the non-settling insurers contended, the liquidation analysis showed that they would receive a greater recovery in a hypothetical chapter 7 case than under the plan.

The *Plant Insulation* court rejected that argument. It reasoned that, because the Bankruptcy Code definition of "claim" effectively (albeit not expressly) refers to "the liability *of the debtor*" and the Bankruptcy Code defines "creditor" to be an "entity that has a [prepetition] claim against the debtor," construing the term "claim" in section 1129(a)(7) to refer only to a liability of the debtor, as distinguished from a third party, "is consistent with the overall content and structure of the Bankruptcy Code." *Id.* at 887.

Judge Garrity declined to follow *Plant Insulation*. "It is true that the Bankruptcy Code defines a 'claim' as liability of the debtor," he wrote, "[b]ut it does not follow that section 1129(a)(7)'s reference to 'receiving or retaining' [in] a chapter 7 [case] imports the requirement 'from the debtor' based on that claim." Guided by the express language of section 1129(a)(7) and his conclusion that *Quigley* was better reasoned, Judge Garrity held that the consumer credit claims were claims against Ditech in the same way that the derivative claims in *Quigley* were claims against the debtor in that case. He accordingly ruled that such claims must be considered in applying section 1129(a)(7).

Approval of the Global Settlement Denied. Judge Garrity also initially refused to approve the global settlement. In doing so, he noted that the consumers' committee was not party to the settlement and objected to its approval. In addition, according to Judge Garrity, although Ditech asserted that $5 million was a reasonable settlement amount, "the evidence simply does not support that assertion" because Ditech failed to analyze the consumer credit claims "or otherwise attempt to place a value on those claims." He accordingly ruled that Ditech failed to meet its burden of demonstrating that the proposed settlement was fair and equitable to the consumer creditors.

POSTSCRIPT AND OUTLOOK

Shortly after Judge Garrity issued his decision, Ditech filed an amended chapter 11 plan. Under the amended plan, consumer creditors will receive their pro rata share of a $10 million cash pool created as a carve-out from the secured term lender's collateral. Consumer creditors will be enjoined from asserting claims against the purchasers. However, consumer creditors' defenses or rights of recoupment under applicable law are preserved, as long as the purchasers are not required to pay money damages to, refund amounts paid by, or pay monies (except escrow advances) on behalf of a consumer creditor. In addition, consumer creditors retain the right to correct any inaccuracies in their account statements or loan documentation. They will also share with general unsecured creditors in any net cash remaining from Ditech's operations, proceeds of the sale, and certain other amounts after all other claims have been paid in full.

By order dated September 26, 2019, Judge Garrity confirmed the amended plan and approved the related settlement, both of which were supported by the consumers' committee.

Judge Garrity's ruling in *Ditech* is a positive development for consumer creditors. The ruling also provides useful guidance regarding, among other things, the distinctions between bankruptcy asset sales under section 363 and sales under a chapter 11 plan. Finally, the decision illustrates the importance of establishing a solid evidentiary record supporting each of the required elements for confirmation of a chapter 11 plan—something that Ditech failed to do initially, but ultimately remedied.

Interestingly, prior to *Ditech*, apparently only a single bankruptcy court had addressed the scope of section 363(o) in a reported decision. *See In re MacNeal*, 308 F. App'x 311 (11th Cir. 2009) (Truth in Lending Act ("TILA") exemption in section 363(o) did not apply to trustee's "sale" of debtor's claims under TILA to defendant lender, since lender purchased debtor's claims under TILA, not interest in underlying credit transaction).

MIXED SIGNALS ON ENFORCEMENT OF PROVISIONS PRECLUDING BANKRUPTCY FILING ABSENT LENDER'S CONSENT

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Courts sometimes disagree over whether provisions in a borrower's organizational documents designed to prevent the borrower from filing for bankruptcy are enforceable as a matter of federal public policy or applicable state law. Two recent rulings addressing this issue illustrate the divide. In *Franchise Services of North America, Inc. v. Macquarie Capital (USA), Inc. (In re Franchise Services of North America, Inc.)*, 891 F.3d 198 (5th Cir. 2018), the U.S. Court of Appeals for the Fifth Circuit affirmed a bankruptcy court order dismissing a chapter 11 case filed by a corporation without obtaining—as required by its corporate charter—the consent of a preferred shareholder that was also controlled by a creditor of the corporation. The Fifth Circuit ruled that federal law does not strip a bona fide equity holder of its preemptive voting rights merely because it is also a creditor. It also held that the preferred shareholder-creditor was not a controlling shareholder under applicable state law such that it had a fiduciary duty to the corporation that would impact any decision to approve or prevent a bankruptcy filing.

More recently, in *In re Insight Terminal Solutions*, LLC, 2019 WL 4640773 (Bankr. W.D. Ky. Sept. 23, 2019), the U.S. Bankruptcy Court for the Western District of Kentucky denied a motion to dismiss the chapter 11 cases of two affiliated limited liability companies that, at the behest of their secured lender, amended their organizational documents to provide that the companies could not file for bankruptcy without the consent of all holders of one of the company's membership units, which had been pledged to secure the loan. According to the court, this attempt by the lender to circumvent the bankruptcy laws and federal public policy was ineffective.

BANKRUPTCY RISK MANAGEMENT BY LENDERS

Astute lenders are always looking for ways to minimize exposure, protect remedies, and maximize recoveries in connection with a loan, especially with respect to borrowers that have the potential to become financially distressed. Some of these efforts have been directed toward minimizing the likelihood of a borrower's bankruptcy filing by making the borrower "bankruptcy remote," such as by implementing a "blocking director" organizational structure. Others have involved attempts to structure a loan transaction to maximize the likelihood that, despite a bankruptcy filing by or against the borrower, the lender can exercise its remedies without unreasonable delay—by means of, for example, a pre-bankruptcy waiver of the automatic stay or an agreement not to contest a motion for stay relief.

Depending on the jurisdiction involved and the particular circumstances, including the terms of the relevant documents, these mechanisms may or may not be enforceable.

Bankruptcy/Automatic Stay Waivers. The enforceability of prepetition waivers of the right to seek bankruptcy protection or specific bankruptcy benefits (such as the automatic stay) has been the subject of substantial litigation. Under case law dating back to at least the 1930s, the general rule as a matter of public policy has been that a waiver of the right to file for bankruptcy is unenforceable. *See In re Weitzen*, 3 F. Supp. 698 (S.D.N.Y. 1933); *accord Continental Ins. Co. v. Thorpe Insulation Co. (In re Thorpe Insulation Co.)*, 671 F.3d 1011 (9th Cir. 2012); *Wank v. Gordon (In re Wank)*, 505 B.R. 878 (B.A.P. 9th Cir. 2014); *Nw. Bank & Trust Co. v. Edwards (In re Edwards)*, 439 B.R. 870 (Bankr. C.D. Ill. 2010); *Double v. Cole (In re Cole)*, 428 B.R. 747 (Bankr. N.D. Ohio 2009); *see also In re Madison*, 184 B.R. 686 (Bankr. E.D. Pa. 1995) (the agreement not to file for bankruptcy for a certain time period is not binding). If the law were otherwise, "astute creditors would require their debtors to waive." *Bank of China v. Huang (In re Huang)*, 275 F.3d 1173, 1177 (9th Cir. 2002).

Pre-bankruptcy waivers of the automatic stay, however, are sometimes enforceable. *See, e.g., In re A. Hirsch Realty, LLC*, 583 B.R. 583 (Bankr. D. Mass. 2018) (a prepetition bankruptcy waiver of the automatic stay contained in the debtor's prior confirmed chapter 11 plan is not per se enforceable; although the prepetition waiver is "cause" for stay relief, the court must conduct a fact-intensive examination to determine whether the waiver should be enforced); *In re Bryan Road, LLC*, 382 B.R. 844, 849 (Bankr. S.D. Fla. 2008) (setting forth factors for the court to consider in deciding whether to enforce a stay waiver agreement, including: (i) the sophistication of the waiving party; (ii) the consideration for the waiver, including the creditor's risk and the length of time covered by the waiver; (iii) whether other parties are affected; and

(iv) the feasibility of the debtor's plan); *In re Frye*, 320 B.R. 786 (Bankr. D. Vt. 2005) (a prepetition waiver is neither per se unenforceable nor enforceable; a waiver would be enforced unless the debtor could show sufficient equity in the property, a sufficient likelihood of an effective reorganization, or sufficient prejudice to other creditors); *accord SummitBridge Nat'l Investments VI, v. Orchard Hills Baptist Church, Inc. (In re Orchard Hills Baptist Church, Inc.)*, 2019 WL 5586638 (Bankr. N.D. Ga. Oct. 28, 2019). *But see In re Jeff Benfield Nursery, Inc.*, 565 B.R. 603 (Bankr. W.D.N.C. 2017) (concluding that such provisions, which effectively render the automatic stay meaningless, are unenforceable as a matter of public policy and noting that, even if they were not, the court would not enforce the waiver under the circumstances because the debtor did not receive significant consideration in return for it, as might be the case in a more specific forbearance agreement).

Courts have typically enforced prepetition stay waivers as part of forbearance agreements, as distinguished from original loan documentation, or as agreements that have been approved by courts in previous bankruptcy cases. *See Bryan Road*, 382 B.R. at 848; *accord In re BGM Pasadena, LLC*, 2016 BL 134299, *3 (Bankr. C.D. Cal. Apr. 27, 2016) ("While it is true that courts have generally treated waivers of the automatic stay as unenforceable when they are contained in prepetition agreements between a lender and a borrower (because the interests of third parties, such as unsecured creditors, for whose benefit the automatic stay exists were not considered at the time the agreement was made), the same cannot be said of waivers that are approved after notice and an opportunity for hearing in the context of an earlier bankruptcy case."); *In re DB Capital Holdings, LLC*, 454 B.R. 804, 816 (Bankr. D. Colo. 2011) (prepetition stay waivers may be enforced if they are part of a confirmed plan or stipulation resolving an earlier motion for relief but otherwise "appear to conflict with the policies and purposes of the Bankruptcy Code, and should not be enforced"); *In re Atrium High Point Ltd. P'ship*, 189 B.R. 599 (Bankr. M.D.N.C. 1995) (enforcing the automatic stay waiver in a plan of reorganization confirmed in a previous chapter 11 case).

Bankruptcy Remoteness, Blocking Provisions, and Golden Shares. As a rule, corporate formalities and applicable state law must be satisfied in commencing a bankruptcy case. *See In re NNN 123 N. Wacker, LLC*, 510 B.R. 854 (Bankr. N.D. Ill. 2014) (citing *Price v. Gurney*, 324 U.S. 100 (1945)); *In re Gen-Air Plumbing & Remodeling, Inc.*, 208 B.R. 426 (Bankr. N.D. Ill. 1997); *In re Comscape Telecommunications, Inc.*, 423 B.R. 816 (Bankr. S.D. Ohio 2010). As a result, while contractual provisions that prohibit a bankruptcy filing may be unenforceable as a matter of public policy, other measures designed to preclude a debtor from filing for bankruptcy may be available.

Lenders, investors, and other parties seeking to prevent or limit the possibility of a bankruptcy filing have attempted to sidestep the public policy invalidating contractual waivers of a debtor's right to file for bankruptcy protection by eroding or eliminating the debtor's authority to file for bankruptcy under its governing organizational documents. *See, e.g.*, *DB Capital Holdings, LLC v. Aspen HH Ventures, LLC (In re DB Capital Holdings, LLC)*, 2010 WL 4925811 (B.A.P. 10th Cir. Dec. 6, 2010); *NNN 123 N. Wacker*, 510 B.R. at 862; *In re Houston Regional Sports Network, LP*, 505 B.R. 468 (Bankr. S.D. Tex. 2014); *In re Quad-C Funding LLC*, 496 B.R. 135 (Bankr. S.D.N.Y. 2013); *Green Bridge Capital S.A. v. Ira Shapiro (In re FKF Madison Park Group Owner, LLC)*, 2011 BL 24531 (Bankr. D. Del. Jan. 31, 2011); *In re Global Ship Sys. LLC*, 391 B.R. 193 (Bankr. S.D. Ga. 2007); *In re Kingston Square Associates*, 214 B.R. 713 (Bankr. S.D.N.Y. 1997).

These types of provisions have not always been enforced, particularly where the organizational documents include an outright prohibition of any bankruptcy filing. *See In re Lexington Hospitality Group*, 577 B.R. 676 (Bankr. E.D. Ky. 2017) (where an LLC debtor's operating agreement provided for a lender representative to be a 50% member of the debtor until the loan was repaid and included various restrictions on the debtor's ability to file for bankruptcy while the loan was outstanding, the bankruptcy filing restrictions acted as an absolute bar to a bankruptcy filing, which is void as against public policy); *In re Bay Club Partners-472, LLC*, 2014 BL 125871 (Bankr. D. Or. May 6, 2014) (refusing to enforce a restrictive covenant in a debtor LLC's operating agreement prohibiting a bankruptcy filing and stating that the covenant "is no less the maneuver of an 'astute creditor' to preclude [the LLC] from availing itself of the protections of the Bankruptcy Code prepetition, and it is unenforceable as such, as a matter of public policy").

Many of these efforts have been directed toward "bankruptcy remote" special purpose entities ("SPEs"). An SPE is an entity created in connection with a financing or securitization transaction structured to ring-fence the SPE's assets from creditors other than secured creditors or investors (e.g., trust certificate holders) that provide financing or capital to the SPE.

For example, in *In re Gen. Growth Props., Inc.*, 409 B.R. 43 (Bankr. S.D.N.Y. 2009), the court denied a motion by secured lenders to dismiss voluntary chapter 11 filings by several SPE subsidiaries of a real estate investment trust. The lenders argued, among other things, that the loan agreements with the SPEs provided that an SPE could not file for bankruptcy without the approval of an independent director nominated by the lenders. The lenders also argued that, because the SPEs had no business need to file for bankruptcy and because the trust exercised its right to replace the independent directors less than 30 days before the bankruptcy filings, the SPE's chapter 11 filings had not been undertaken in good faith.

The *General Growth* court ruled that it was not bad faith to replace the SPEs' independent directors with new independent directors days before the bankruptcy filings because the new directors had expertise in real estate, commercial mortgage-backed securities, and bankruptcy matters. The court determined that, even though the SPEs had strong cash flows, bankruptcy remote structures, and no debt defaults, the chapter 11 filings had not been made in bad faith. The court found that it could consider the interests of the entire group of affiliated debtors as well as each individual debtor in assessing the legitimacy of the chapter 11 filings.

Among the potential flaws in the bankruptcy remote SPE structure brought to light by *General Growth* is the requirement under applicable Delaware law for independent directors to consider not only the interests of creditors, as mandated in the charter or other organizational documents, but also the interests of shareholders. Thus, an independent director or manager who simply votes to block a bankruptcy filing at the behest of a secured creditor without considering the impact on shareholders could be deemed to have violated his or her fiduciary duties of care and loyalty. *See In re Lake Mich. Beach Pottawattamie Resort LLC*, 547 B.R. 899 (Bankr. N.D. Ill. 2016) (a "blocking" member provision in the membership agreement of a special purpose limited liability company was unenforceable because it did not require the member to comply with its fiduciary obligations under applicable non-bankruptcy law).

Courts disagree as to the enforceability of blocking provisions and, in particular, "golden shares" that, as the term is used in a bankruptcy context, give the holder the right to preempt a bankruptcy filing. *Compare In re Lexington Hospitality*, 577 B.R. at 684–85 (denying a motion to dismiss a bankruptcy case filed by a wholly owned entity of a creditor that held a golden share/blocking provision where the entity was not truly independent); *In re Intervention Energy Holdings, LLC*, 553 B.R. 258, 265 (Bankr. D. Del. 2016) (ruling that a provision in a limited liability company's governance document, "the sole purpose and effect of which is to place into the hands of a single, minority equity holder [by means of a 'golden share'] the ultimate authority to eviscerate the right of that entity to seek federal bankruptcy relief, and the nature and substance of whose primary relationship with the debtor is that of creditor—not equity holder—and which owes no duty to anyone but itself in connection with an LLC's decision to seek federal bankruptcy relief, is tantamount to an absolute waiver of that right, and, even if arguably permitted by state law, is void as contrary to federal public policy") *with Squire Court Partners v. CenterLine Credit Enhanced Partners (In re Squire Court Partners)*, 574 B.R. 701 (E.D. Ark. 2017) (where a partnership agreement required the unanimous consent of the partners before the limited partnership could "file a petition seeking, or consent to, reorganization or relief under any applicable federal or state law relating to bankruptcy," a bankruptcy filing by the managing partner without the consent of the other partners was properly dismissed); *see also In re Tara Retail Group, LLC*, 2017 WL 1788428 (Bankr. N.D. W. Va. May 4, 2017) (even though a creditor held a golden share or blocking provision, it ratified the debtor's bankruptcy filing by its silence), *appeal dismissed*, 2017 WL 2837015 (N.D. W. Va. June 30, 2017).

RECENT COURT RULINGS

Franchise Services. In *Franchise Services*, a bank invested $15 million in Franchise Services of North America ("FSNA") as part of a transaction to purchase an FSNA competitor in exchange for 100% of FSNA's convertible preferred stock. The preferred stock was convertible to slightly less than 50% of FSNA's common stock. FSNA was also obligated to pay certain investment fees to the bank's parent in connection with the transaction. As a condition to the investment, FSNA amended its certificate of incorporation to provide that FSNA could not "effect any Liquidation Event" (defined to include a bankruptcy filing) without the approval of the holders of a majority of both its preferred and common stock.

FSNA filed for chapter 11 protection in 2017 without obtaining the consent of a majority of its preferred and common stockholders. FSNA still owed certain amounts to the bank's parent at time of the bankruptcy filing. The bank moved to dismiss the petition as having been filed without proper authorization. The bankruptcy court found that the bank itself was an owner, rather than a creditor, of FSNA and ruled that the shareholder consent provision was not contrary to federal bankruptcy policy. The court opted to leave to Delaware state courts the determination as to whether the provision violated Delaware law. It accordingly dismissed FSNA's chapter 11 case.

On direct appeal, the Fifth Circuit affirmed. It rejected FSNA's argument that, even if Delaware law authorized the corporate charter provision at issue, federal law forbids such a provision due to the public policy against waiving bankruptcy protections. The court wrote that "[t]here is no prohibition in federal bankruptcy law against granting a preferred shareholder the right to prevent a voluntary bankruptcy filing just because the shareholder also happens to be [controlled by] an unsecured creditor…."

The Fifth Circuit also rejected FSNA's contention that, even if a shareholder-creditor can hold a bankruptcy veto right, such a right "remains void in the absence of a concomitant fiduciary duty." No statute or binding case law, the court explained, "licenses this court to ignore corporate foundational documents, deprive a bona fide shareholder of its voting rights, and reallocate corporate authority to file for bankruptcy just because the shareholder also happens to be an unsecured creditor." In the absence of evidence showing that the bank was a controlling minority shareholder, the Fifth Circuit found that the bank did not have fiduciary duties to FSNA. Even if it were a controlling shareholder, the Fifth Circuit noted, the proper remedy for a breach of fiduciary duty "is not to allow a corporation to disregard its charter and declare bankruptcy without shareholder consent," but to seek redress under state law.

Insight. In 2018, Autumn Wind Lending, LLC ("Autumn Wind") provided up to $6.8 million in financing under a term loan facility to Delaware limited liability company Insight Terminal Solutions, LLC ("ITS"). The original maturity date of the loan was December 31, 2018. The loan was guaranteed by an ITS affiliate holding all of the outstanding ITS membership units and secured by a lien on substantially all of the assets of ITS and the guarantor. The pledged collateral included the ITS membership units held by the guarantor as well as certain warrants for ITS membership units.

In connection with an extension of the maturity date of the loan to June 30, 2019, Autumn Wind amended the loan agreement to include a bankruptcy rights waiver. It provided that: (i) if the loan was not paid in full on or before June 30, 2019 and Autumn Wind refused to grant an additional extension of the maturity date, the guarantor agreed to relinquish its rights to the pledged ITS membership units; and (ii) ITS and the guarantor agreed to amend their respective organizational documents so that neither would be permitted to file for bankruptcy protection unless they first obtained the prior written consent of all holders of ITS membership units and any party holding warrants for such units. Both ITS and the guarantor later amended their operating agreements to include the bankruptcy rights waiver.

On July 1, 2019, ITS and the guarantor defaulted on the loan. The following day, Autumn Wind notified ITS and the guarantor that it intended to retain the pledged ITS membership units and that, in accordance with the Uniform Commercial Code (the "UCC"), they had 20 days to object to the proposed retention. After further amending their operating agreements to authorize a bankruptcy filing and adopting resolutions authorizing such a filing, ITS and the guarantor (collectively, the "debtors") filed for chapter 11 protection in the Western District of Kentucky on July 17, 2019—prior to the expiration of the 20-day period.

Autumn Wind moved to dismiss the chapter 11 cases, arguing that, in accordance with the bankruptcy rights waiver, the debtors lacked the authority to file for bankruptcy. According to Autumn Wind, when the debtors defaulted on the loan, the guarantor's right to exercise voting and/or consensual rights and powers over the ITS membership units ceased immediately and such rights became vested solely and exclusively in Autumn Wind. Moreover, Autumn Wind contended that, in its capacity as a holder of warrants for ITS membership units, Autumn Wind's consent was required for any bankruptcy filings by the debtors.

The bankruptcy court denied the motion to dismiss. Initially, the court found that, by amending their operating agreements in July 2019 and adopting resolutions authorizing a bankruptcy filing, the debtors had authority under Delaware law to file for chapter 11 protection.

The debtors argued that the ITS membership units were never transferred to Autumn Wind because it did comply with the UCC's strict foreclosure requirements. The court acknowledged that "this is a compelling argument." However, the court noted that it need not address this argument because "there is a more compelling reason" to deny the motion to dismiss—specifically, the bankruptcy rights waiver violated federal public policy.

The court explained as follows:

> Autumn Wind's primary witness testified that it was well aware that a contractual provision limiting a debtor's right to seek relief under the Bankruptcy Code was legally unenforceable as against public policy. It was for this very reason that Autumn Wind included terms in the waiver and amendment that if Debtors did not achieve additional financing during the 3-1/2 month period they provided, then the agreement would provide a prohibition on filing for bankruptcy under this amendment. On July 1, 2019, the collateral would be turned over to Autumn Wind. Autumn Wind believed that by using this provision, they would avoid the public policy issue. . . . However, the terms of the surrender of the collateral were not fully consummated as there was no completion of the strict foreclosure process. Furthermore, the attempt to circumvent the bankruptcy laws and public policy by "circuitry of arrangement," were ineffective. Autumn Wind tried to get around this argument by making itself an equity holder, however, the process to achieve this was not completed. Autumn Wind did not become an equity holder, nor did they become the owner of the collateral through the strict foreclosure process. Furthermore, attempts to limit the Debtors' access to the bankruptcy process were against public policy and invalid.

OUTLOOK

Recent court rulings have done little to resolve the ongoing dispute over the enforceability of blocking provisions, golden shares, and other provisions designed to manage access to bankruptcy protection.

Because it involved a minority shareholder (whose parent company was an unsecured creditor) without any fiduciary obligations, *Franchise Services* did not involve many of the more difficult questions posed by other cases involving these issues. Even so, the Fifth Circuit's conclusion that a shareholder cannot be stripped of its bankruptcy preemption rights merely because it is also controlled a creditor is noteworthy, especially for private equity sponsors and other investors who take both equity and debt positions in a portfolio company.

The bankruptcy court in *Insight* arguably adopted a more categorical approach, invalidating a blocking provision outright as a matter of federal public policy. Given this rationale, the court never considered whether any fiduciary duties potentially borne by the lender as the sole holder of a debtor's membership units should have had any bearing on the lender's decision to permit or prevent a bankruptcy filing.

Finally, *Franchise Services*, *Insight* and other relevant decisions reinforce the importance of knowing what approach the courts have endorsed in any likely bankruptcy venue.

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THE ROLE OF SELF-INTEREST IN ALLOWANCE OF SUBSTANTIAL CONTRIBUTION CLAIMS IN BANKRUPTCY

Anna Kordas
Mark G. Douglas

To encourage creditors, equity interest holders, indenture trustees and unofficial committees to take actions that benefit a bankruptcy estate, section 503(b)(3)(D) of the Bankruptcy Code confers administrative priority on their claims for expenses incurred in making a "substantial contribution" in a chapter 9 or chapter 11 case. Administrative expense status is also given under section 503(b)(4) to their claims for reimbursement of reasonable professional fees incurred in making a substantial contribution. The U.S. District Court for the Eastern District of Pennsylvania addressed substantial contribution claims in *In re DeVal Corp.*, 601 B.R. 725 (E.D. Pa. 2019). Even applying the Third Circuit's relatively stringent standard for substantial contribution claims, the district court affirmed a bankruptcy court's decision to award administrative expense claims to a secured creditor that acted "to save [the debtor] from a total implosion and becoming administratively insolvent … [and] forced the debtor to wake up and try to save the company from its own inaction."

ADMINISTRATIVE-EXPENSE PRIORITY FOR MAKING A "SUBSTANTIAL CONTRIBUTION"

Section 503(b)(3)(D) of the Bankruptcy Code grants administrative-expense priority for the "actual, necessary expenses" incurred by "a creditor, an indenture trustee, an equity security holder, or a committee representing creditors or equity security holders other than [an official committee] in making a substantial contribution in a case under chapter 9 or chapter 11." In addition, section 503(b)(4) of the Bankruptcy Code grants administrative-expense priority for "reasonable compensation for professional services rendered by an attorney … of an entity whose expense is allowable under" section 503(b)(3)(D) and "reimbursement for actual, necessary expenses incurred by such attorney." These provisions are an "accommodation between the two objectives of encouraging meaningful creditor participation in the reorganization process and keeping administrative expenses and fees at a minimum to maximize the estate for creditors." *In re AmFin Fin. Corp.*, 468 B.R. 827, 831 (Bankr. N.D. Ohio 2012) (citing *Lebron v. Mechem Fin. Inc.*, 27 F.3d 937, 944 (3d Cir. 1994)); *Pacificorp Ky. Energy Corp. v. Big Rivers Elec. Corp. (In re Big Rivers Elec. Corp.)*, 233 B.R. 739, 746 (W.D. Ky. 1998)).

The Bankruptcy Code neither defines "substantial contribution" nor sets forth criteria to be used in determining whether a substantial contribution has been made in a chapter 9 or chapter 11 case. The legislative history of the provisions similarly provides little clarity. The issue, therefore, of whether an entity has made a "substantial contribution" is a question of fact, with the moving party bearing the burden of proof. Most courts narrowly construe what constitutes a "substantial contribution" in a chapter 11 case (in which the vast majority of substantial contribution claims are made), and most have taken the position that substantial-contribution claims, like other section 503(b) claims, should be strictly limited.

Courts generally distinguish between parties' actions that "incidentally" benefit the estate and those that provide direct and demonstrable benefit. In recent years, a conflict has developed among the circuits regarding whether a court, in weighing whether the benefit was incidental, should consider the claimant's motivation in undertaking an assertive role.

On the one hand, in the Third and Tenth Circuits, actions motivated solely by self-interest generally do not give rise to compensable substantial contribution claims. *See Lebron v. Mechem Financial, Inc.*, 27 F.3d 937 (3d Cir. 1994); *In re Lister*, 846 F.2d 55 (10th Cir. 1988).

In *Lebron*, the Third Circuit explained that, in order to be "substantial," the contribution "must be more than an incidental one arising from activities the applicant has pursued in protecting his or her own interests." *Lebron*, 27 F.3d at 944. Therefore, a lower court in the Third Circuit is required to apply a presumption of self-interest, which the claimant may overcome only by demonstrating that its efforts have transcended self-interest.

In *Lister*, the Tenth Circuit similarly emphasized that "[e]fforts undertaken by a creditor solely to further his own self-interest … will not be compensable, notwithstanding any incidental benefit accruing to the bankruptcy estate." *Lister*, 846 F.2d at 57.

The Fifth and Eleventh Circuits, on the other hand, apply an objective standard, which recognizes, as expressed by the Fifth Circuit, that "nothing in the Bankruptcy Code requires a self-deprecating, altruistic intent as a prerequisite to recovery of fees and expenses under section 503." *Hall Fin. Grp. v. DP Partners, Ltd. P'shp (In re DP Partners, Ltd. P'shp)*, 106 F.3d 667, 673 (5th Cir. 1997). The Fifth Circuit further noted in *DP Partners* that "[t]he benefits, if any, conferred upon an estate are not diminished by selfish or shrewd motivations," and that "a creditor's motive in taking actions that benefit the estate has little relevance in the determination whether the creditor has incurred actual and necessary expenses in making a substantial contribution to a case." *Id.* In *Speights & Runyan v. Celotex Corp. (In re Celotex Corp.)*, 227 F.3d 1336, 1338 (11th Cir. 2000), the Eleventh Circuit similarly held that "[e]xamining a creditor's intent unnecessarily complicates the analysis of whether a contribution of considerable value or worth has been made."

DEVAL

DeVal Corporation ("DVC") was a high-tech manufacturer of aircraft and weapon support equipment. As of 2016, DVC owed approximately $980,000 to PDI/DeVal Acquisitions, LLC ("PDI") under a defaulted unsecured loan that later resulted in a state court judgment. DVI also owed approximately $700,000 to its senior secured lender.

PDI, which had expressed interest in acquiring DVC and had managed the company pending completion of an aborted sale transaction, proposed that DVC file for bankruptcy so that PDI could acquire the company's assets in an auction sale under section 363 of the Bankruptcy Code for $750,000, subject to better and higher offers. The proposed purchase price would have left nothing to distribute to DVC's unsecured creditors.

DVC spurned the offer but, after PDI executed on its judgment and the secured lender froze DVC's accounts, DVC nonetheless filed for chapter 11 protection in the Eastern District of Pennsylvania in November 2016. PDI renewed its offer to purchase DVC's personal property assets in exchange for payments of $675,000 to the senior secured lender, $25,000 to DVC, and forgiveness of PDI's debt. This proposal would have allowed DVC to retain equity in its real estate, and it potentially could have allowed a distribution to DVC's unsecured creditors from the proceeds of certain litigation claims. DVC declined to pursue this proposal as well.

In March 2017, DVC filed a motion to extend its exclusive periods to propose and solicit acceptances for a chapter 11 plan. At the hearing, DVC announced that the cornerstone of its plan would be a sale to another prospective buyer, Parts Life, Inc. ("Parts Life"), but that DVC needed additional time to facilitate the transaction.

PDI objected to the extension of exclusivity and requested the appointment of a chapter 11 trustee. According to PDI, by refusing to pursue viable sale offers already made (such as the offers put forth by PDI), DVC was effectively driving the business into the ground. PDI also argued that DVC had valuable contracts with the U.S. Navy that were in imminent danger of cancellation because DVC did not have the necessary liquidity to perform.

The bankruptcy court agreed to extend DVC's plan filing exclusivity for 20 days. A week after exclusivity expired, DVC filed a chapter 11 plan contemplating the sale to Parts Life, but subject to numerous contingencies. DVC also asked for an additional extension of exclusivity. The court denied the request, calling the plan "patently unconfirmable," and granted PDI's request to propose an alternative chapter 11 plan.

PDI filed a competing plan and repeated its request to appoint a chapter 11 trustee, arguing that DVC was not adequately pursuing a deal with either of the two interested purchasers. The court ultimately appointed a chief restructuring officer in lieu of a trustee to oversee the bankruptcy case.

PDI and DVC subsequently filed several other iterations of their proposed chapter 11 plans. The bankruptcy court confirmed DVC's third amended plan in August 2017 (providing for the sale to Parts Life), and denied confirmation of PDI's fifth amended plan. The final versions of both plans provided for a 100% distribution to DVC's general unsecured creditors.

PDI later sought an approximately $180,000 substantial contribution claim under sections 503(b)(3)(D) and 503(b)(4). PDI argued that it was the only creditor that took an active role in the case and that, as a result of its actions, DVC undertook active marketing efforts, resulting in an eventual sale of the business and full recovery for all creditors. While acknowledging that the ultimate goal of its involvement was to get paid on its judgment, PDI contended that it recognized several months into the bankruptcy that DVC was failing to do anything of substance to emerge from bankruptcy and PDI elected to take on an aggressive role in the case to ensure recovery not only for itself but also for other creditors.

PDI subsequently lowered its substantial contribution request to approximately $89,000. After meticulously reviewing the evidence, the bankruptcy court ruled that PDI made a substantial contribution to the case and qualified for an administrative expense claim in the amount of $84,000 under sections 503(b)(3)(D) and 503(b)(4), after reductions for various transportation expenses and counsel fees for tax analysis. The court found that "PDI's efforts conferred an actual and demonstrable benefit to [DVC's] creditors because PDI's Objection, Trustee Motion and initial PDI Plan pressured [DVC] into finally taking action to consummate a sale of its assets, after months of inaction, before it ran out of cash and collapsed." Without PDI's aggressive approach, the court found, "the unsecured creditors likely would have received nothing in this case."

The court further found that PDI overcame the "presumption of self-interest" because the aggressive actions taken by PDI were for the benefit of all creditors in the case, not just PDI. The court emphasized that PDI's actions were not fully aligned with its own self-interest, and that PDI took a huge risk in deciding to incur significant costs in seeking the appointment of a trustee and in pushing the sale through.

Parts Life and PDI appealed the decision.

THE DISTRICT COURT'S RULING

The district court affirmed.

Parts Life argued that the bankruptcy court failed to abide by controlling Third Circuit precedent, and instead applied the more lenient legal standards adopted by the Fifth and Eleventh Circuit. According to Parts Life, because PDI acknowledged that the ultimate goal of its participation in the bankruptcy case was to secure repayment of its claim, its objectives were not devoid of self-interest.

District Judge Mark A. Kearney disagreed. He explained that the bankruptcy court correctly looked at PDI's various actions in isolation, rather than conflating "a creditor's purpose in the entire case with the creditor's purpose in taking the acts for which it [sought] an award of administrative expenses." According to Judge Kearney, in accordance with the Third Circuit's ruling in *Lebron*, the partial motivation of self-interest alone cannot preclude reimbursement, because most activities of an interested party that contribute to the estate will also benefit that party.

Judge Kearney found no fault with the bankruptcy court's diligent review of the documentation of PDI's expenses and the way the court identified conduct that benefited the estate, as distinguished from conduct that solely advanced PDI's interests. He also agreed with the bankruptcy court's findings that: (i) PDI would not have taken such an aggressive position in the bankruptcy case were it simply looking out for its own self-interest; and (ii) PDI's primary motivation was to rouse the debtor from inertia to avoid further depletion of the estate.

OUTLOOK

DeVal is indicative of the high bar for a party seeking reimbursement of expenses under section 503(b) in making a substantial contribution in a chapter 9 or chapter 11 case. Notwithstanding the favorable ruling in *DeVal*, substantial contribution claimants in the Third and Tenth Circuits face a relatively high standard for approval of their claims, whereas such claimants in the Fifth and Eleventh Circuits will experience or more lenient standard.

LEGISLATIVE AND REGULATORY UPDATE: PROPOSED U.S. TREASURY AND IRS REGULATIONS LIMITING USE OF NOLs

On September 9, 2019, the U.S. Treasury Department and the Internal Revenue Service issued proposed regulations addressing the application of certain rules regarding the ability of many companies to utilize net operating losses ("NOLs") and other tax attributes following an "ownership change" under section 382 of the Internal Revenue Code. If adopted in their current form, the proposed regulations would have a potentially severe impact on financially-troubled companies, the pre-ownership change tax attributes of which are frequently a valuable asset facilitating a company's ability to restructure in or outside of chapter 11.

Coupled with additional limits on NOL usage adopted in the 2017 Tax Cuts and Jobs Act, the proposed regulations, which are discussed in more detail here, would reverse long-standing taxpayer-favorable guidance and dramatically reduce the value of NOLs in many cases.

The deadline for comment on the proposed regulations was November 12, 2019. Proposed regulations are generally not effective until finalized.

U.S. BANKRUPTCY VENUE BILL INTRODUCED

On September 19, 2019, a bipartisan group of lawmakers in the U.S. House of Representatives introduced a bill designed to end the dominance of the Southern District of New York and the District of Delaware as the chosen venues for large business restructuring cases. If passed, the Bankruptcy Venue Reform Act of 2019, H.R. 4421, would force companies to file for bankruptcy in either: (i) the district where their principal assets or principal place of business has been located for the 180 days immediately preceding the filing (with certain exceptions); or (ii) the district where a properly venued case is pending of an affiliate holding 50 percent or more of the later-filed debtor's outstanding voting securities.

Under the proposed bill, in many cases, bankruptcy courts in the company's state of incorporation would not be a proper venue. Changes in a corporation's ownership or its location of principal assets or place of business within one year of a bankruptcy filing would not affect the company's venue choices. For public companies, principal place of business would be defined to be "the address of the principal executive office of the person or entity as stated in the last annual report filed . . . prior to the commencement of a case . . . , unless another address is shown to be the principal place of business by clear and convincing evidence." Principal assets would not include cash or cash equivalents. A nearly identical measure died in the Senate in 2018 (S. 2282), and substantially similar bills have been regularly introduced for many years, but never became law.

CANADIAN BANKRUPTCY LAW AMENDMENTS EFFECTIVE

Amendments to Canada's Bankruptcy and Insolvency Act (the "BIA") and Canada's Companies' Creditors Arrangement Act (the "CCAA") became effective on November 1, 2019. The general policy objective of the changes is to make the insolvency process fairer, more transparent and more accessible.

Notable features of the amendments include:

Disclosure of Economic Interest—The CCAA now provides that, upon application by an interested party, the court may order another interested party to disclose its "economic interest" in an insolvent company. "Economic interest" is defined broadly to include, among other things, claims, certain financial contracts, options, mortgages, pledges, charges, liens and other security interests, as well as the consideration paid for any of the forgoing or any other right or interest. In determining whether to order disclosure, the court must consider whether disclosure would enhance the prospects for a viable compromise or arrangement and whether the party from whom disclosure is sought would be materially prejudiced.

Duty of Good Faith—Both the CCAA and the BIA now contain a statutory duty to act in "good faith" applicable to any party-in-interest in an insolvency proceeding. If any party fails to act in good faith, the court may issue any order that it deems appropriate under the circumstances. "Good faith" is not defined in either the CCAA or the BIA, but the strictures of the concept have been well developed in court rulings.

Duration of Stay on Initial Applications—The maximum duration of the period during which certain actions against a debtor or its assets are stayed pursuant to an "initial order" issued by the court at the inception of a CCAA proceeding has been reduced from 30 days to 10 days. Furthermore, initial orders must be "limited to relief that is reasonably necessary for the continued operations of the debtor company in the ordinary course of business during that period." The same requirement applies to debtor-in-possession financing. The customary "comeback hearing" with respect to an initial order will be convened after the 10-day period expires.

Expanded Director Liability—The BIA previously authorized the court to impose liability on the directors of a corporation equal to the amount of any non-stock dividends or share redemptions or repurchases made during the year preceding the corporation's "initial bankruptcy event." As amended, the BIA authorizes the court to examine any termination pay, severance or incentive or other benefits paid during that same period to a director, an officer or any other person who manages or supervises the corporation's business. The court may impose liability upon such parties if: (i) the payments were made while the corporation was insolvent, or the payments rendered the corporation insolvent; (ii) the payments were "conspicuously" in excess of the fair market value of the consideration received by the corporation; (iii) the payments were made outside the ordinary course of business; and (iv) the directors did not have reasonable grounds to believe that any of the forgoing elements were not satisfied.

Preservation of Intellectual Property Rights—Amendments designed to ensure the preservation of intellectual property rights during insolvency proceedings also became effective on November 1, 2019, pursuant to the Budget Implementation Act of 2018. Intellectual property licensees may now retain their rights to use licensed "intellectual property" (which is not defined), even though such rights are either disclaimed or transferred in an insolvency proceeding under the BIA or the CCAA.

The amendments apply to proceedings filed after November 1, 2019.

CHAPTER 15 GAP PERIOD RELIEF SUBJECT TO PRELIMINARY INJUNCTION STANDARD BUT NO ADVERSARY PROCEEDING REQUIRED

Dan T. Moss
Mark G. Douglas

Unlike in cases filed under other chapters of the Bankruptcy Code, the filing of a petition for recognition of a foreign bankruptcy case under chapter 15 does not automatically trigger a stay of actions against a debtor or its U.S. assets. Instead, the automatic stay generally applies only at such time that the U.S. bankruptcy court later enters an order recognizing the foreign bankruptcy as a "main" proceeding under chapter 15 or, in the event of recognition as a foreign "nonmain" proceeding, the court exercises its discretion to grant equivalent provisional relief.

This can be problematic if creditor collection efforts continue during the "gap" period between the filing of the chapter 15 petition and the entry of a recognition order. However, section 1519 of the Bankruptcy Code authorizes bankruptcy courts to grant provisional relief including extension of the automatic stay to protect the foreign debtor's U.S. assets during the gap period "where relief is urgently needed to protect the assets of the debtor or the interests of the creditors."

Courts disagree as to the standard that should govern the issuance of such relief during the gap period and whether an adversary proceeding is required to obtain it. The U.S. Bankruptcy Court for the Southern District of New York recently weighed in on this issue. In *In re Beechwood Re*, 2019 WL 3025283 (Bankr. S.D.N.Y. July 10, 2019), the court ruled that "the standards for issuance of a preliminary injunction" apply to determine whether provisional relief should be granted under section 1509(a). The court also held that such relief need not necessarily be sought in an adversary proceeding.

PROCEDURES AND RELIEF UNDER CHAPTER 15

Under section 1515 of the Bankruptcy Code, the representative of a foreign debtor may file a petition in a U.S. bankruptcy court seeking "recognition" of a "foreign proceeding." Section 101(24) of the Bankruptcy Code defines "foreign representative" as "a person or body, including a person or body appointed on an interim basis, authorized in a foreign proceeding to administer the reorganization or the liquidation of the debtor's assets or affairs or to act as a representative of such foreign proceeding."

"Foreign proceeding" is defined in section 101(23) of the Bankruptcy Code as:

> [A] collective judicial or administrative proceeding in a foreign country, including an interim proceeding, under a law relating to insolvency or adjustment of debt in which proceeding the assets and affairs of the debtor are subject

to control or supervision by a foreign court, for the purpose of reorganization or liquidation.

More than one bankruptcy or insolvency proceeding may be pending with respect to the same foreign debtor in different countries. Section 1517(b) of the Bankruptcy Code accordingly provides that a "foreign proceeding shall be recognized . . . as a *foreign main proceeding* if it is pending in the country where the debtor has the center of its main interests; or . . . as a *foreign nonmain proceeding* if the debtor has an establishment . . . in the foreign country where the proceeding is pending" (emphasis added). *See also* 11 U.S.C. §§ 1502(4) and 1502(5) (defining "foreign main proceeding" and "foreign nonmain proceeding," respectively).

If a U.S. court recognizes a foreign main proceeding under chapter 15, section 1520(a)(1) of the Bankruptcy Code provides that actions against the foreign debtor or its property located in the U.S. are stayed under section 362—the Bankruptcy Code's "automatic stay." Following recognition of a foreign main or nonmain proceeding, a bankruptcy court is authorized under section 1521 to grant, among other things, injunctive relief staying actions or execution against the debtor's U.S. assets, the authority to distribute the proceeds of the debtor's U.S. assets and, with certain exceptions, any additional relief available to a bankruptcy trustee "where necessary to effectuate the purpose of [chapter 15] and to protect the assets of the debtor or the interests of the creditors." Section 1521(e) provides that "[t]he standards, procedures, and limitations applicable to an injunction shall apply to" requests for injunctive relief authorized by sections 1521(a)(1) and (2), to suspend the right to transfer the debtor's assets (section 1520(a)(3)), and for any extension of provisional relief previously granted during the gap period (section 1521(a)(6)).

During the gap period, section 1519(a) of the Bankruptcy Code authorizes a bankruptcy court to grant provisional injunctive relief and certain other forms of relief where "relief is urgently needed to protect the assets of the debtor or the interests of the creditors." In addition to an order staying execution against the debtor's U.S. assets, such relief can include an order that entrusts the administration of U.S. assets to the foreign representative (section 1519(a)(2)), provides for the examination of witnesses and the taking of evidence regarding the debtor's affairs (sections 1519(a)(3) and 1521(a)(4)), or grants additional relief (other than avoidance of transfers) available to a bankruptcy trustee (sections 1519(a)(3) and 1521(a)(7)).

Similar to section 1521(e), section 1519(e) provides that "[t]he standards, procedures, and limitations applicable to an injunction shall apply to relief under this section." Such relief terminates upon the court's ruling on the petition for recognition, although it may be extended in the court's discretion under section 1521(a)(6).

STANDARD APPLICABLE TO INJUNCTIVE RELIEF

Rule 7001(7) of the Federal Rules of Bankruptcy Procedure (the "Bankruptcy Rules") provides that "a proceeding to obtain an injunction or other equitable relief, except when a chapter 9, chapter 11, chapter 12, or chapter 13 plan provides for the relief," is an "adversary proceeding" governed by the rules of Part VII of the Bankruptcy Rules, including the requirements in Bankruptcy Rules 7003 and 7004 that the proceeding be commenced by the filing and service of a summons and complaint. Thus, most courts require that a request for an injunction must be made in an adversary proceeding. *See*, *e.g.*, *In re Residential Capital, LLC*, 480 B.R. 529, 538 (Bankr. S.D.N.Y. 2012) ("Where an injunction is sought by a debtor under section 105 to stay actions against non-debtors, the relief must be sought through an adversary proceeding under Fed. R. Bankr. P. 7001."); *In re Viney*, 369 B.R. 392, 393 (Bankr. N.D. Ind. 2007) ("The order denying the trustee's initial motion noted that the relief sought was in the nature of injunctive, equitable or declaratory relief, thereby requiring an adversary proceeding.").

However, many courts have ruled to the contrary in chapter 15 cases in connection with requests for provisional relief during the gap period. *See In re Ace Track Co., Ltd.*, 556 B.R. 887, 894 n.6 (Bankr. N.D. Ill. 2016) (noting that the protections of section 362, while injunctive in nature, are not the same as an injunction and that an adversary proceeding is unnecessary to trigger the protections of the automatic stay); *In re Worldwide Educ. Services, Inc.*, 494 B.R. 494, 499 n.1 (Bankr. C.D. Cal. 2013) ("[T]he court agrees . . . that an adversary proceeding is not required to obtain provisional relief under section 1519 of the Bankruptcy Code."; *In re Pro-Fit Int'l, Ltd.*, 391 B.R. 850, 855 (Bankr. C.D. Cal. 2008) (same); *In re Ho Seok Lee*, 348 B.R. 799 (Bankr. W.D. Wash. 2006) (same); *see also In re SIVEC SRL.*, 2011 WL 2445754 (Bankr. E.D. Okla. June 15, 2011) (extending the automatic stay under sections 105(a) and 1519 without an adversary proceeding).

Bankruptcy Rule 7065 provides that Rule 65 of the Federal Rules of Civil Procedure applies in adversary proceedings, except that a debtor, chapter 11 debtor-in-possession, or trustee may apply for a temporary restraining order or preliminary injunction without posting security. Rule 65 sets forth the procedures governing a request for an injunction or restraining order. Bankruptcy courts also sometimes grant injunctive relief under section 105(a) of the Bankruptcy Code, which provides that "[t]he court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title." *See In re GMI Grp., Inc.,* 598 B.R. 685 (Bankr. N.D. Ga. 2019) (exercising power under section 105(a) to enjoin creditors from pursuing litigation against guarantor of chapter 11 debtor's obligations).

Before granting a preliminary injunction under Rule 65, Bankruptcy Rule 7065, or section 105, most courts require the party seeking the provisional relief to demonstrate: (i) a reasonable likelihood of success on the merits; (ii) a likelihood of irreparable harm in the absence of relief; (iii) that the balance of hardships tips in the applicant's favor; and (iv) that the public interest would not be disserved if injunctive relief were granted. *See*, *e.g.*, *Broadstripe, LLC v. Natl. Cable Television Coop., Inc. (In re Broadstripe, LLC)*, 402 B.R. 646 (Bankr. D. Del. 2009); *Lyondell Chem. Co. v. CenterPoint Energy Gas Servs. Inc. (In re Lyondell*

Chem. Co.), 402 B.R. 571 (Bankr. S.D.N.Y. 2009); *see also In re Vitro, S.A.B. de C.V.*, 455 B.R. 571, 579 (Bankr. N.D. Tex. 2011) (applying the traditional preliminary injunction standard to a request for injunctive relief under sections 105 and 1519 during the gap period); *In re Innua Canada Ltd.*, 2009 WL 1025088 (Bankr. D.N.J. Mar. 25, 2009) (same).

DISAGREEMENT IN THE COURTS

Courts have disagreed regarding the standard that should apply to a request by a foreign representative for the temporary imposition of the automatic stay during the chapter 15 gap period.

For example, in *Pro-Fit*, the foreign representatives of affiliated debtors whose insolvency proceedings were pending in the U.K. sought an order applying the automatic stay during the gap period to stay execution by a judgment creditor against the debtors' U.S. assets.

A creditor objected to the request, contending that the foreign representatives' motion for provisional relief failed to comply with the "standards, procedures, and limitations applicable to an injunction," as mandated by section 1519(e). The *Pro-Fit* court rejected the creditor's reading of section 1519(e), finding it to be inconsistent with bankruptcy jurisprudence generally and the legislative history of the provision:

> [S]uch a reading would impose procedural barriers that are unknown in the bankruptcy law to the availability of at least some § 1519 remedies. For example, § 1519(a)(3) authorizes "any relief referred to in paragraph (3), (4), or (7) of section 1521(a)." This relief includes the "examination of witnesses pursuant to Rule 2004 and the delivery of information concerning the debtor's assets, affairs, rights, obligations or liabilities" (§ 1521(a)(4)). It is implausible to require an adversary proceeding for such actions in a chapter 15 case, where no adversary proceeding is required for such activity in a case under any other bankruptcy code chapter.

Pro-Fit, 391 B.R. at 860. The court also explained that the legislative history of section 1519(e) states that "[s]ubsection (e) makes clear that this section contemplates injunctive relief and that such relief is subject to specific rules and a body of jurisprudence." According to the court, this history suggests that "the rules and jurisprudence for an injunction apply . . . only where a foreign representative seeks an injunction under § 1519, and not where the relief sought is not an injunction."

The court in *Pro-Fit* ruled that the requested relief fell "outside of § 1519(e), because it is not an injunction or temporary restraining order," but was instead a request for "application of § 362 on a provisional basis, which does not require an adversary proceeding."

The court in *Worldwide* rejected that approach as being "flatly inconsistent with the plain and unambiguous language of section 1519(e)," which, as noted, provides that "[t]he standards, procedures, and limitations applicable to an injunction shall apply to relief under this section."

In *Worldwide*, the liquidator of a British Virgin Islands ("BVI") company filed a chapter 15 petition in a California bankruptcy court seeking recognition of the company's BVI liquidation. The liquidator later filed a motion with the bankruptcy court seeking the implementation of a provisional stay under sections 105, 362, and 1519 of all U.S. litigation against the debtor pending a ruling on the recognition petition.

The *Worldwide* court concluded that "the standard of proof for preliminary injunctive relief should apply here" and denied the motion because the liquidator failed to satisfy that standard. The court rejected the *Pro-Fit* court's conclusion that section 1519(e) is limited to motions that request *injunctive* relief (as distinguished from a motion seeking an extension of the automatic stay or any other form of relief delineated in the provision). The *Worldwide* court wrote that "the express language of the statute does not contain such a limitation and generally applies to all relief sought pursuant to Section 1519, including imposition of the automatic stay." Moreover, the court explained, the *Pro-Fit* court did not articulate "a significant reason why purportedly non-injunctive relief would have been treated differently than the express standard set out in Section 1519(e)." As an aside, the *Worldwide* court flagged that a different analysis may apply if a creditor is attempting *in rem* enforcement against property of the debtor's estate.

The *Worldwide* bankruptcy court did agree with one aspect of the court's ruling in *Pro-Fit*—namely, that an adversary proceeding is not required to obtain provisional relief under section 1519. The court acknowledged that a request for an injunction is normally designated an adversary proceeding under Bankruptcy Rule 7001. However, the court wrote that "a request for provisional relief under Section 1519 is ancillary to a petition for recognition of a foreign proceeding under Section 1515, which does not apparently require an adversary proceeding." As such, the court reasoned, a petition for recognition and any related requests for provisional relief under section 1519 should be treated as "contested matters" under Bankruptcy Rule 9014.

BEECHWOOD

Cayman Islands-domiciled reinsurance company Beechwood Re (the "debtor") was the subject of a winding-up proceeding in the Cayman Islands. The debtor was also a defendant in litigation pending before the U.S. District Court for the Southern District of New York involving allegations that Beechwood engaged in the unauthorized sale of reinsurance in the U.S. The plaintiffs in that litigation filed a motion to require the debtor to post $250 million in additional security.

In an effort to delay the district court's ruling on the bond motion, the debtor's Cayman Islands liquidator filed a petition in the U.S. Bankruptcy Court for the Southern District of New York seeking recognition of the Cayman Islands liquidation under chapter 15.

Pending the bankruptcy court's ruling on the recognition petition, the liquidator sought provisional relief under section 1519 in the form of an order declaring that the automatic stay precluded continuation of the district court litigation. Various parties to the district court litigation objected to the liquidator's motion, arguing that the district court should be permitted to issue its ruling on the bond motion, which had been fully briefed and submitted. The liquidator countered that the debtor could not post additional security, and that the district court would accordingly enter a default judgment against it.

The bankruptcy court denied the liquidator's motion for provisional relief. In so ruling, the court embraced the *Worldwide* court's approach to the standard for obtaining relief under section 1519 and rejected the contrary view articulated in *Pro-Fit*.

Applying the standard for a preliminary injunction, the bankruptcy court concluded that the Cayman Islands liquidator failed to show irreparable harm. According to the court, the district court might rule in the debtor's favor on the bond issue. Even if it did not, the bankruptcy court wrote, the debtor "would not suffer irreparable harm unless and until the district court proceed[ed] to enter a default judgment against [the debtor]." However, the bankruptcy court held that the liquidator could renew his motion for provisional relief if the district court issued its decision before the bankruptcy court ruled on the chapter 15 petition.

OUTLOOK

The *Pro-Fit* court's approach to the appropriate standard applicable to gap period relief in a chapter 15 case appears to be the minority view. Nonetheless, that court's criticism of the statutory language of section 1519(e) is not without merit. It is unlikely that lawmakers intended the forms of gap period relief available under section 1519 other than injunctive relief (*e.g.*, examination of witnesses) to be subject to the preliminary injunction standard and to require an adversary proceeding. However, given the majority view followed by *Beechwood*, parties seeking relief under section 1519 should be prepared to comply with the standards, procedures, and limitations—including the evidentiary burden—associated with a request for injunctive relief. This is particularly true when gap period relief may turn on events outside the bankruptcy case. Finally, litigants should be mindful of the U.S. Supreme Court's anticipated ruling in *Ritzen Group Inc. v. Jackson Masonry, LLC*, No. No. 18-938 (argued on Nov. 13, 2019), with respect to the finality of orders and whether denial of gap period relief requests constitutes a "final" order in a "proceeding" such that it is immediately appealable.

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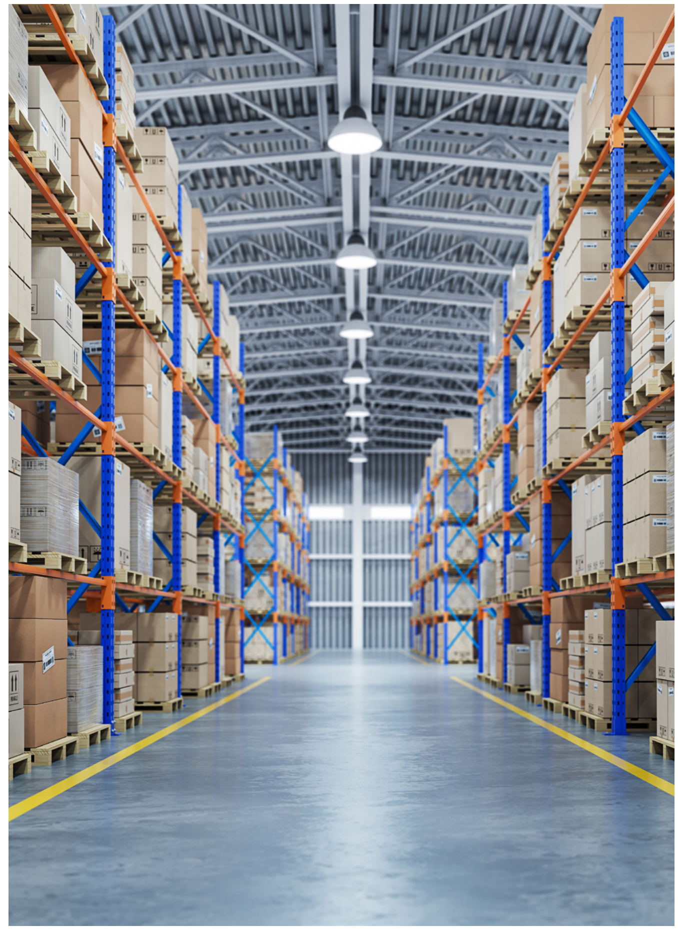

CROSS-BORDER RESTRUCTURING UPDATE: PROPOSED AMENDMENTS TO CHAPTER 15 OF THE BANKRUPTCY CODE

On August 20, 2018, the National Bankruptcy Conference (the "NBC"), a voluntary, nonpartisan, not-for-profit organization composed of approximately 60 of the nation's leading bankruptcy judges, professors, and practitioners, submitted a letter (the "Letter") to representatives of the House Subcommittee on Regulatory Reform and the House Committee on the Judiciary that proposed certain technical and substantive amendments to chapter 15 of the Bankruptcy Code. Chapter 15, which is patterned on the 1997 UNCITRAL Model Law on Cross-Border Insolvency (the "Model Law"), was enacted in 2005 and establishes procedures governing cross-border bankruptcy and insolvency proceedings. To date, the Model Law has been enacted by the U.S. and more than 40 countries and overseas territories.

In August 2019, the International Committee of the American College of Bankruptcy (the "ACB") issued its own report (the "ACB Report") responding to the NBC proposals.

THE PROPOSED NBC AMENDMENTS

A more detailed discussion of the amendments proposed by the NBC, most of which are not controversial, can be accessed here. The following is a summary of the proposals in the Letter that are controversial:

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

Date for Determining Center of Main Interests and Establishment. A growing number of courts have ruled that a foreign debtor's COMI or the existence of an "establishment" (necessary for recognition of a foreign nonmain proceeding) should be determined as of the date of the filing of its chapter 15 petition for recognition in the U.S., rather than the date upon which its foreign proceeding was commenced, as the U.S. Court of Appeals for the Second Circuit ruled in *In re Fairfield Sentry Ltd.*, 714 F.3d 127 (2d Cir. 2013), and most other U.S. courts have held. The NBC takes the position that this is contrary to the Model Law and a recent revision to the Model Law's Guide to Enactment, both of which measure COMI and the existence of an establishment as of the date of the commencement of the foreign proceeding. The Letter accordingly recommends that sections 1502(a)(4) and (5) and 1517(b) be amended to provide that COMI or the existence of an "establishment" is to be determined as of the date of commencement of the debtor's foreign proceeding rather than the date on which a chapter 15 petition is filed. If adopted, such a change would likely impede the ability of foreign provisional liquidators to effectuate "COMI shifting" or "COMI migration."

Venue of Cases Commenced Under Other Chapters. The Letter recommends that section 1511 of the Bankruptcy Code and 28 U.S.C. § 1408 (specifying venue requirements for bankruptcy cases) be amended to provide that, upon recognition of a foreign proceeding under chapter 15, the foreign representative may commence an involuntary case under chapter 303 or a voluntary case under section 301 or 302 in the court presiding over the foreign debtor's chapter 15 case. These provisions do not currently specify the venue for filing such cases under other chapters of the Bankruptcy Code.

THE ACB REPORT

The ACB Report states that the ACB does not endorse the NBC's proposals, as follows:

Abstention and Dismissal. The ACB Report states that NBC's proposed amendment to section 305(a) is "confusing, unnecessary, and perhaps unwise." The ACB Report notes that: (i) the more general language of the existing provision—"the interests of creditors and the debtor would be better served by such dismissal or suspension"—provides adequate authority for courts to abstain from abusive and otherwise inappropriate filings; and (ii) elevating the concept of COMI by introducing it into section 305—a standalone section that applies in cases under all chapters of the Bankruptcy Code—"could lead to unfortunate unanticipated consequences."

Date for Determining Center of Main Interests and Establishment. The ACB Report explains that UNCITRAL's assumption in enacting the Model Law in 1997 was that a substantial economic presence in the country of the foreign proceeding would be a prerequisite to recognition as a foreign main proceeding under chapter 15, and that UNCITRAL clarified its position in 2013 in favor of measuring COMI as of the date of the commencement of the foreign proceeding. It also acknowledges that "bankruptcy tourism" (shifting COMI or the location of an establishment to find a favorable venue) can be a problem. However, the ACB Report states that a degree of flexibility and discretion must be preserved for bankruptcy courts to deal with specific situations on their particular merits. Instead of fixing the date for determining COMI or the existence of an establishment on the commencement date of a foreign proceeding, the report states that the "better course in this dynamic environment in which the ground underlying the concepts of main and nonmain proceedings may be shifting" is to establish a statutory presumption modeled on the section 1516(c) presumption of COMI in favor of the registered office "in the absence of evidence to the contrary." New section 1516(d) would provide that: "In the absence of evidence to the contrary, it is presumed that the center of the debtor's main interests and the presence of an establishment should be determined as of the date of the commencement of the foreign proceeding."

Venue of Cases Commenced Under Other Chapters. The ACB Report states that amending the bankruptcy venue statute, 28 U.S.C. § 1408, to require that all cases commenced by a foreign representative be filed in the court that entered the chapter 15 recognition "is not necessary and likely to provoke controversy." According to the report, "A fact of life in Congress is that bankruptcy venue is a lightning rod for controversy for reasons not related to the merits of the NBC proposal," and amendment of the venue provision "does not appear to be necessary to accomplish the purposes of chapter 15."

Other restructuring professionals and organizations, including the International Insolvency Institute, have also weighed in on the NBC proposals. The National Conference of Bankruptcy Judges considered these proposals and recommendations at its annual meeting in Washington, D.C. from October 30 through November 2, 2019.

LANDMARK SYNCREON CROSS-BORDER RESTRUCTURING COMPLETED

On September 19, 2019, the Ontario Superior Court of Justice added the final chapter to a landmark cross-border restructuring when it entered an order recognizing the restructuring of syncreon Group Holdings B.V. ("syncreon") and its subsidiaries (collectively, the "debtors") under the Canadian Companies' Creditors Arrangement Act (the "CCAA"). Recognition of the restructuring in Canada followed the English High Court's approval on September 10, 2019 of schemes of arrangement for syncreon's Dutch and English subsidiaries, and recognition on September 11, 2019 of the schemes under chapter 15 of the Bankruptcy Code by the U.S. Bankruptcy Court for the District of Delaware. The debtors' reorganization is widely considered to be the first-ever use of an English scheme of arrangement to restructure debt issued by a U.S.-based global enterprise. It also appears to be the first time that an English scheme has been recognized under the CCAA.

The debtors are global providers of specialized logistics and supply chain solutions to multinational automotive and technology sector companies. Prior to the restructuring, the debtors had approximately $1.1 billion of debt under a secured credit facility, senior notes, liquidity loan facilities and an asset-based lending facility. A substantial number of obligors on the debt were organized in jurisdictions where chapter 11 or other "U.S.-based" options were not possible or could not provide the relief necessary to implement a comprehensive restructuring. For these reason, the debtors amended the agreements governing the credit facility and the notes to change the governing law from New York law to English law.

Pursuant to the restructuring, the debtors: (i) reduced their funded debt by approximately $690 million; (ii) repaid their existing asset-based lending facility; (iii) gained access to $125.5 million in additional liquidity from a group of ad hoc lenders; and (iv) entered into a new $135 million asset-based lending facility.

The restructuring was implemented by means of English schemes of arrangement for syncreon's Dutch subsidiary, syncreon Group BV, and its English subsidiary, syncreon Automotive (UK) Ltd., followed by recognition of the schemes under chapter 15 of the Bankruptcy Code and the CCAA. Pursuant to the terms of the schemes: (i) the $225 million secured credit facility was reinstated, and the lenders (the "senior lenders") received 80% of the equity (the "new equity") in a newly-established Dutch holding company; and (ii) noteholders received a 4.5% interest in, and warrants for, the new equity. In addition, senior lenders and noteholders that timely entered into a restructuring support agreement with the debtors received a lock-up payment equal to an additional 5.5% and 2.5% of the new equity, respectively. Anticipated recoveries from the schemes have been estimated to be as much as 72% for the senior lenders and as much as 10% for noteholders.

In addition, although not part of the schemes: (i) lenders under the new $125.5 million liquidity facility received 2.5% of the new equity; and (ii) lenders that agreed to backstop the new liquidity facility received 5% of the new equity.

The schemes were overwhelmingly supported by the senior lenders and the noteholders at a meeting of creditors convened in London on September 3, 2019. As noted, the English High Court sanctioned the schemes on September 10, 2019. Notably, the English court concluded that amendment of the law governing the senior credit facility and the notes to English law created a sufficient connection with England to confer the court with jurisdiction. The court also noted that, by entering into the restructuring support agreement, more than 95% of both the senior lender and noteholder classes had submitted to the jurisdiction of the English court. *See Syncreon Group BV, Re* [2019] EWHC 2412 (Ch) (September 10, 2019) at ¶ 29. Finally, the court wrote that "use of the English jurisdiction and the scheme process is regarded as the only viable route for restructuring the scheme companies on a going concern basis." *Id.*

The debtors' global footprint and the presence of guarantors in jurisdictions other than the U.K. meant that judicial recognition of the schemes in certain key jurisdictions was a crucial part of the restructuring. With recognition of the schemes in the U.S. and Canada, the restructuring has been successfully completed. The landmark restructuring is a testament to the importance of comity and cooperation among the courts of various nations in connection with cross-border restructurings and bankruptcies.

Jones Day represented an ad hoc group of secured term loan and revolver lenders in the global restructuring of syncreon.

NEWSWORTHY

Jones Day earned the best ranking of all of the top performing law firms, based on comparative ranks by BTI Consulting in its inaugural "Peak Performer" report, which covers each of the client-facing activities across all of BTI's published research. BTI said only 16 law firms met "this brutal test by earning a place in the elite group in each of the five BTI reports for 2019." Those surveys included the BTI Client Service A-Team, BTI Brand Elite, BTI Industry Power Rankings, BTI Legal Innovation and Technology Outlook, and BTI Client Service All-Stars for Law Firms. Jones Day was one of only two firms to rank in the Top 10 in each of those surveys.

Dan T. Moss (Washington) has been named the USA Co-Chair of the INSOL G36 Committee. The Group of Thirty-Six is the principal vehicle for activities serving the goals of INSOL InternationalTM, "a world-wide federation of national associations of accountants and lawyers who specialise in turnaround and insolvency."

Jasper Berkenbosch (Amsterdam), ***Fabienne Beuzit (Paris)***, ***Roger Dobson (Sydney)***, ***Ben Larkin (London)***, and ***Heather Lennox (Cleveland and New York)*** were recognized as "highly regarded" in the Restructuring category in the IFLR1000 2020.

Ben Larkin (London) and ***Sion Richards (London)*** were named "Leaders in Their Field" for Restructuring/Insolvency by Chambers UK 2020.

On November 4, 2019, ***Heather Lennox (Cleveland and New York)*** sat on a panel discussion titled "Preparing the Debtor" at the ABI Mid-Level Professional Development Program in New York City.

Bruce Bennett (Los Angeles and New York), ***Jeffrey B. Ellman (Atlanta)***, ***Brad B. Erens (Chicago)***, ***Dan T. Moss (Washington)***, ***Kay V. Morley (London)***, ***Gregory M. Gordon (Dallas)***, and ***Juan Ferré (Madrid)*** were designated "Notable practitioners" in the Restructuring category in the IFLR1000 2020.

Ben Larkin (London) was recognized as a "Leading Lawyer" in the 2020 edition of The Legal 500 United Kingdom in the area of "Finance: Corporate restructuring and insolvency."

An article written by ***Carl E. Black (Cleveland)*** titled "An Overview of the Fiduciary Duties of Directors and Officers of Financially Distressed Corporations" was published in the November/December 2019 issue of Pratt's Journal of Bankruptcy Law. ***Jonathan Noble Edel (Cleveland)*** assisted in preparing the article.

An article written by ***Dan T. Moss (Washington)*** and ***Mark G. Douglas (New York)*** titled "Key Issues To Consider In Foreign Bankruptcy Proceedings" was recently posted on Lexis Practice Advisor and was published in the September 20, 2019, edition of Law360.

CLAIMS TO DIVIDENDS ORIGINATING FROM STOCK TRUST SUBORDINATED UNDER SECTION 510(B) OF THE BANKRUPTCY CODE

Charles M. Oellermann
Mark G. Douglas

Section 510(b) of the Bankruptcy Code provides a mechanism designed to preserve the creditor/shareholder risk allocation paradigm by categorically subordinating most types of claims asserted against a debtor by equity holders. However, courts do not always agree on the scope of the provision in attempting to implement its underlying policy objectives. The U.S. Court of Appeals for the Fifth Circuit recently examined the broad reach of section 510(b) in *In re Linn Energy*, 936 F.3d 334 (5th Cir. 2019). The court ruled that, even though the beneficiary of a stock trust did "not fit perfectly in the investor box," his claims should be subordinated under section 510(b) because his entitlement to "deemed dividends" originally arising from the trust "was certainly more like an investor's interest than a creditor's interest."

SUBORDINATION IN BANKRUPTCY

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

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

Section 510(b) generally subordinates claims arising from the purchase or sale of a security of the debtor or an affiliate of the debtor to all claims that are senior or equal to the claim or interest represented by the security.

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

SUBORDINATION OF SHAREHOLDER CLAIMS UNDER SECTION 510(B)

Section 510(b) provides as follows:

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

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

Shareholders have resorted to a wide array of devices and/or legal arguments in an effort to overcome this basic legal premise, including contractual provisions purporting to entitle them to damages upon the issuer's breach of a stock purchase agreement and alternative theories of recovery, such as unjust enrichment and constructive trust. *See generally Stucki v. Orwig*, 2013 WL 1499377 (N.D. Tex. Apr. 12, 2013) (discussing case law).

Some courts have decided cases under section 510(b) by reviewing the traditional allocation of risk between a company's shareholders and its creditors. Under this policy-based analysis, shareholders are deemed to undertake more risk in exchange for the potential to participate in the profits of the company, whereas creditors can expect only repayment of their fixed debts. Accordingly, shareholders, and not creditors, assume the risk of a wrongful or unlawful purchase or sale of securities. This risk allocation model is sometimes referred to as the "Slain/Kripke theory of risk allocation," as described in a 1973 law review article written by Professors John J. Slain and Homer Kripke entitled *The Interface Between Securities Regulation and Bankruptcy—Allocating the Risk of Illegal Securities Issuance Between Securityholders and the Issuer's Creditors*, 48 N.Y.U. L.

Rev. 261 (1973). *See In re SeaQuest Diving LP*, 579 F.3d 411, 420 (5th Cir. 2009); *In re Betacom of Phoenix, Inc.*, 240 F.3d 823, 829 (9th Cir. 2001); *In re Granite Partners, L.P.*, 208 B.R. 332, 336 (Bankr. S.D.N.Y. 1997).

Because of the parties' differing expectations for risk and return, it is perceived as unfair to allow a shareholder to recover from the limited assets of a debtor as a creditor by "converting" its equity stake into a claim through the prosecution of a successful securities lawsuit. The method by which such a conversion is thwarted is subordination of the shareholder's claim under section 510(b).

Many courts have found the language of section 510(b) to be ambiguous. *See SeaQuest*, 579 F.3d at 421. In *In re Am. Hous. Found.*, 785 F.3d 143 (5th Cir. 2015), the Fifth Circuit concluded that a claim should be subordinated under section 510(b) if: (i) the claim is for "damages"; (ii) the claim involves "securities"; and (iii) the claim "arise[s] from" a "purchase or sale." With respect to the third element, the court explained, "[f]or a claim to 'arise from' the purchase or sale of a security, there must be some nexus or causal relationship between the claim and the sale." *Id.* at 156 (quoting *SeaQuest*, 579 F.3d at 421) (internal quotation marks omitted). The Second Circuit applied a slightly different formulation of the test in *In re Lehman Bros. Holdings Inc.*, 855 F.3d 459, 472-78 (2d Cir. 2017), where it examined whether: (1) the claimant owns a security; (2) the claimant acquired the security by means of a purchase or sale; and (3) the claimant's damages arose from the purchase or sale of the security or the rescission of such a purchase or sale.

Section 101(49) of the Bankruptcy Code defines the term "security" broadly to "include" notes, stock, treasury stock, bonds, debentures and an extensive catalogue of other investments. In addition, the definition contains a broad residual clause providing that a security also includes "any other claim or interest commonly known as [a] '"security."' The scope of the residual clause is broad. *See SeaQuest*, 579 F.3d at 418.

The statutory definition also expressly excludes a number of items, including, among other things, currency, checks, drafts, bills of exchange, bank letters of credit, commodity futures contracts, forward contracts, options and warrants.

Section 101(16) of the Bankruptcy Code defines an "equity security" to mean shares in a corporation or any "similar security," limited partnership interests, and certain warrants or rights.

In *Lehman Brothers*, the Second Circuit noted that "some interests will not perfectly match any of the specific examples in [the Bankruptcy Code's definition of security]," and that, should this be the case, it is of "most significance" that a claimant "ha[s] the same risk and benefit expectations as shareholders." *Lehman Brothers*, 855 F.3d at 473-74; *accord In re WorldCom, Inc.*, 2006 WL 3782712, at*6 (Bankr. S.D.N.Y. Dec. 21, 2006) ("The form in which the equity interest is held is ultimately irrelevant. So long as the claimant's interest enabled him to participate in the success of the enterprise and the distribution of profits, the claim will be subordinated pursuant to section 510(b).").

The Bankruptcy Code does not define "damages." However, many courts have reasoned that "the concept of damages under Section 510(b) has the connotation of some recovery *other than* the simple recovery of an unpaid debt due on an instrument." *American Housing*, 785 F.3d at 153-54 (citing cases and ruling that claims seeking compensation for fraud or breach of fiduciary duty are claims for damages under section 510(b) as well as claims "predicated on post-issuance conduct," including breach of contract claims).

LINN ENERGY

Under a trust created in 1931, Clarence Bennett ("Bennett"): (i) had an interest in income paid as dividends on shares of stock in Berry Holding Company ("BHC"); and (ii) owned certain BHC stock outright. Bennett received regular dividend payments until 1986, when BHC merged with Berry Petroleum Company ("BPC"). BPC later proposed to retire what was formerly the BHC stock, but this would have eliminated the interests of Bennett and the other trust beneficiaries in the dividend income of the stock. However, Bennett would receive shares in BPC upon retirement of the BHC stock.

To overcome the objections of the trust beneficiaries, BPC created a "victory trust" that would continue to pay the original trust beneficiaries what would have been their interests in the BHC stock dividends. However, because the BHC stock was being retired, the payments were only "deemed dividends" akin to settlement payments. Moreover, the trust required BPC to pay Bennett and the other beneficiaries income only when dividends were issued on BPC stock—if no dividends were declared, the beneficiaries were not entitled to any payments.

In 2013, BPC merged with Linn Energy and an affiliate (collectively, "Linn") to become Berry Petroleum Company, LLC ("Berry"). At that time, Bennett was the only surviving beneficiary of the victory trust. To get Bennett's approval for the merger, Linn agreed to continue paying him the deemed dividends under the trust.

In 2014, Linn sued Bennett in federal district court seeking a declaration that it owed Bennett nothing. Bennett (and later his estate) countersued Linn and added Berry as a defendant, alleging breach of contract, tortious conduct, misrepresentation, elder abuse and breach of fiduciary duty.

In May 2016, Linn, Berry and various affiliates (collectively, the "debtors") filed for chapter 11 protection in the Southern District of Texas. Bennett filed proofs of claim for approximately $10 million in unpaid dividends. The debtors objected to the claims, arguing that they should be expunged or subordinated under section 510(b). The bankruptcy court subordinated Bennett's claims in whole or in part in two separate rulings, the first of which the district court affirmed, after which Bennett appealed to the Fifth Circuit. The bankruptcy court certified a direct appeal of its second subordination ruling to the Fifth Circuit, which consolidated the appeals.

THE FIFTH CIRCUIT'S RULING

The Fifth Circuit affirmed the bankruptcy court's rulings subordinating Bennett's claims under section 510(b).

Judge Edith Brown Clement began by examining the policy rationale underpinning section 510(b). She wrote that "[t]he most important question is this: Does the nature of [Bennett's] interest make [Bennett] more like an investor or a creditor?"

She noted that all parties agreed that Bennett was seeking "damages," within the meaning of section 510(b), which she found "surprising" because a theme throughout Bennett's submissions was that his interest under the victory trust was "more akin to a creditor's contractual right to payment than the equity interest of an investor." Bennett argued, however, that the damages did not arise from the purchase or sale of a security.

Consistent with the Fifth Circuit's previous ruling in *SeaQuest* that the residual clause of section 101(49) is broad in scope, Judge Clement concluded that the deemed dividend interest owned by Bennett was a security interest under the residual clause:

Bennett held greater financial expectations than that of a creditor during his lifetime. The upside of his deemed dividend payments was theoretically limitless, as it tracked the value of the corporation. Further, because he risked receiving nothing at all if the corporation went bankrupt or if the corporation chose not to issue dividends, Bennett faced many of the same risks as a traditional shareholder. True, Bennett did not have the right to vote or participate in corporate management, or to sell or bequeath his deemed dividend payments to someone else. But even traditional shareholders do not always enjoy all these rights. . . . The most fundamental consideration is whether Bennett had "the same risk and benefit expectations as shareholders." *Lehman Bros.*, 855 F.3d at 475. The deemed dividends plainly gave him such expectations. Treating them as securities comports with the broad reading courts have given Section 510(b). *Id.* at 474 ("Several courts have similarly defined 'security' in section 510(b) in terms of an interest tied to a firm's overall success.").

Judge Clement rejected Bennett's argument that his interest was more akin to a profit-sharing agreement, which is expressly excluded from the definition of "security." She wrote that "nothing guaranteed Bennett a share of the profits." Instead, Bennett was entitled to payments of deemed dividends only when other shareholders were paid dividends.

Finally, Judge Clement concluded that Bennett's claims arose from the purchase or sale of the debtor's securities. Adopting a broad "but for causation standard," Judge Clement explained that, but for the 1931 stock bequest in the original trust, the 1986 victory trust, or the 2013 deemed dividend agreement, Bennett would not have a right to demand the deemed dividends in the bankruptcy cases. Accordingly, the judge wrote, "[e]ach of those transactions counts as a purchase or sale—or, in the case of the 1986 transaction—the rescission of a purchase or sale—of securities of the Debtors."

However, Judge Clement focused on the 2013 deemed dividend agreement because it was nearest in time and "the transaction most directly responsible for [Bennett's] claims." Quoting *Lehman Brothers*, Judge Clement explained that a claim, regardless of how it is characterized by the claimant, arises from a securities transaction "so long as the transaction is part of the causal link leading to the alleged injury" (quoting *Lehman Brothers*, 855 F.3d at 478). Because the 2013 deemed dividend agreement was "part of the causal link leading to [Bennett's] alleged injuries," Judge Clement ruled that Bennett's claims arose from the purchase or sale of the debtors' securities and must be subordinated under section 510(b).

According to Judge Clement, the policies underlying section 510(b) supported subordination of Bennett's claims. First, the interest held by Bennett in BHC, BPC and then in Linn or Berry "was certainly more like an investor's interest than a creditor's interest." Second, permitting Bennett's claims to be treated *pari passu* with the claims of creditors "would upset the equity cushion those creditors relied on when extending credit," in addition to undermining the absolute priority rule.

OUTLOOK

Linn Energy reinforces the broad scope of section 510(b), consistent with its underlying policy objective of preventing interest holders from transforming their rights as shareholders to claims with priority on a par with the claims of creditors. The ruling illustrates that, regardless of how a particular claim is characterized by the claimant, the court will closely examine the nature of the asserted claim and the relationship between the claimant and the debtor to ascertain whether the claimant is truly a creditor rather or an investor.

FIRST IMPRESSIONS: 9TH CIRCUIT RULES THAT NOTICE OF PROPOSED SUBSTANTIVE CONSOLIDATION MUST BE GIVEN TO CREDITORS OF NON-DEBTOR

Daniel J. Merrett
Mark G. Douglas

In *Leslie v. Mihranian (In re Mihranian)*, 937 F.3d 1214 (9th Cir. 2019), the U.S. Court of Appeals for the Ninth Circuit considered whether the creditors of a non-debtor must be given advance notice of a motion to substantively consolidate the non-debtor with the bankruptcy estate of a debtor. In an apparent matter of first impression among the circuits, the Ninth Circuit ruled that such notice is required.

SUBSTANTIVE CONSOLIDATION

Substantive consolidation is an equitable remedy pursuant to which a bankruptcy court may order that the assets and liabilities (for ease of reference, the "estates") of separate entities be treated as if they belonged to a single, combined entity.

The Bankruptcy Code does not expressly authorize substantive consolidation, but it recognizes that a chapter 11 plan may provide for the "merger or consolidation of the debtor with one or more persons" as a means of implementation. *See* 11 U.S.C. § 1123(a)(5)(C). In addition, Fed. R. Bankr. P. 1015(b) provides that a bankruptcy court may direct that cases involving affiliated debtors be jointly administered, but the rule is silent regarding substantive consolidation.

A majority of courts have concluded that bankruptcy courts have the power to substantively consolidate debtor entities under section 105(a) of the Bankruptcy Code, which provides that a court "may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions" of the Bankruptcy Code. Forcing the creditors of one entity to share equally with those of another, however, "is considered 'a rough justice remedy that should be rare and, in any event, one of last resort after considering and rejecting other remedies.'" *Audette v. Kasemir (In re Concepts America, Inc.)*, 2018 WL 2085615, *3 (Bankr. N.D. Ill. May 3, 2018) (quoting *In re Owens Corning*, 419 F.3d 195, 211 (3d Cir. 2005)).

Different standards have been employed by courts to determine the propriety of substantive consolidation. For example, in *Eastgroup Properties v. Southern Motel Assoc., Ltd.*, 935 F.2d 245 (11th Cir. 1991), the Eleventh Circuit adopted a modified version of the standard articulated by the District of Columbia Circuit in *Drabkin v. Midland Ross Corp. (In re Auto-Train Corp., Inc.)*, 810 F.2d 270, 276 (D.C. Cir. 1987). According to this standard: (i) the proponent of consolidation must demonstrate that there is substantial identity between the entities to be consolidated and that consolidation is necessary to avoid some harm or to realize some benefit; and (ii) a creditor may object on the grounds that it relied on the entities' separate credit and will be prejudiced by consolidation, in which case the court can order consolidation only if it determines that the benefits of consolidation "heavily" outweigh the harm.

The Second Circuit established a somewhat different two-part disjunctive standard for gauging the propriety of substantive consolidation in *Union Savings Bank v. Augie/Restivo Baking Co., Ltd. (In re Augie/Restivo Baking Co., Ltd.)*, 860 F.2d 515, 518 (2d Cir. 1988). There, the court concluded that the factual elements considered by the courts are "merely variants on two critical factors: (i) whether creditors dealt with the entities as a single economic unit and did not rely on their separate identity in extending credit, … or (ii) whether the affairs of the debtors are so entangled that consolidation will benefit all creditors."

Factors that may be relevant in satisfying these requirements include the following:

(1) Fraud or other complete domination of the corporation that harms a third party;

(2) The absence of corporate formalities;

(3) Inadequate capitalization of the corporation;

(4) Whether funds are put in and taken out of the corporation for personal rather than corporate purposes;

(5) Overlap in ownership and management of affiliated corporations;

(6) Whether affiliated corporations have dealt with one another at arm's length;

(7) The payment or guarantee of debts of the dominated corporation by other affiliated corporations;

(8) The commingling of affiliated corporations' funds; and

(9) The inability to separate affiliated corporations' assets and liabilities.

Id. at 518–19. The *Augie/Restivo* test was adopted by the Ninth Circuit in *Bonham v. Compton (In re Bonham)*, 229 F.3d 750 (9th Cir. 2000). Many other circuit and lower courts have adopted tests similar to the *Augie/Restivo* and *Eastgroup* standards. In *Owens Corning*, 419 F.3d at 210, however, the Third Circuit opted for an "open-ended, equitable inquiry" rather than a factor-based analysis, as employed by many courts, in reversing lower court rulings approving "deemed" consolidation of 18 debtors and three nondebtor subsidiaries under a plan.

SUBSTANTIVE CONSOLIDATION OF DEBTORS AND NON-DEBTORS

Although most courts have held that the substantive consolidation of debtor entities is permitted under appropriate circumstances, they disagree as to whether the substantive consolidation of debtors and non-debtors should ever be allowed. Some courts have concluded that such substantive consolidation is appropriate on the basis of: (i) section 105's broad grant of authority; (ii) a bankruptcy court's ability to assert personal and subject matter jurisdiction over nondebtors; and/or (iii) a bankruptcy court's mandate to ensure the equitable treatment of all creditors. *See, e.g.*, *Bonham*, 229 F.3d at 769–71; *In re Stewart*, 603 B.R. 138, 150 (Bankr. W.D. Okla. 2019); *In re Falls Event Ctr. LLC*, 600 B.R. 857, 868 (Bankr. D. Utah 2019); *In re AAA Bronze Statues & Antiques, Inc.*, 598 B.R. 27, 32 (Bankr. N.D. Fla. 2019); *Lassman v. Cameron Constr. LLC (In re Cameron Constr. & Roofing Co.)*, 565 B.R. 1, 10 (Bankr. D. Mass. 2016); *Simon v. ASIMCO Techs., Inc. (In re Am. Camshaft Specialties, Inc.)*, 410 B.R. 765, 786 (Bankr. E.D. Mich. 2009); *Walls v. Centurion Asset Mgmt., Inc. (In re Bolze)*, 2009 BL 157145, *4 (Bankr. E.D. Tenn. July 23, 2009); *Dominion Fin. Corp. v. Morfesis (In re Morfesis)*, 270 B.R. 28, 31 (Bankr. D.N.J. 2001); *see also Clark's Crystal Springs Ranch, LLC v. Gugino (In re Clark)*, 692 Fed. Appx. 946, 2017 BL 240043 (9th Cir. July 12, 2017) (because the Bankruptcy Code does not expressly forbid the substantive consolidation of debtors and nondebtors, the U.S. Supreme Court's decision in *Law v. Siegel*, 571 U.S. 415 (2014), does not bar bankruptcy courts from ordering the remedy).

Other courts have held that the substantive consolidation of debtors and non-debtors is inappropriate because, among other things, it circumvents the procedures concerning involuntary bankruptcies set forth in section 303 of the Bankruptcy Code. *See, e.g.*, *In re Archdiocese of Saint Paul & Minneapolis*, 888 F.3d 944, 951 (8th Cir. 2018) (involving non-profit non-debtors, against which an involuntary petition may not be filed); *Concepts America,* 2018 WL 2085615, *6; *In re Pearlman*, 462 B.R. 849, 854 (Bankr. M.D. Fla. 2012); *Helena Chem. Co. v. Circle Land & Cattle Corp. (In re Circle Land & Cattle Corp.)*, 213 B.R. 870, 877 (Bankr. D. Kan. 1997); *In re Hamilton*, 186 B.R. 991, 993 (Bankr. D. Colo. 1995).

NOTICE TO NON-DEBTOR'S CREDITORS REQUIRED?

Courts disagree over whether the creditors of a non-debtor must be given notice of a motion to substantively consolidate the non-debtor with a debtor's bankruptcy estate. The majority view is that such notice is required in the interests of fairness to all creditors whose substantive rights will be seriously impacted. *See, e.g.*, *Fid. & Deposit Co. of Md. v. U.S. Bank N.A. (In re Kimball Hill, Inc.)*, 2014 WL 5615650, at *4 (N.D. Ill. Nov. 4, 2014); *SE Prop. Holdings, LLC v. Stewart (In re Stewart)*, 571 B.R. 460, 473 (Bankr. W.D. Okla. 2017); *Mukamal v. Ark Capital Grp., LLC (In re Kodsi)*, 2015 WL 222493, at *2 (Bankr. S.D. Fla. Jan. 14, 2015); *Kapila v. S&G Fin. Servs, LLC (In re S&G Fin. Servs. of S. Fla., Inc.)*, 451 B.R. 573, 585 (Bankr. S.D. Fla. 2011); *cf. Concepts America*, 2018 WL 2085615, at *7 (even if substantive consolidation of debtors with non-debtors were permitted, notice to the non-debtor's creditors would be required).

However, some courts, representing the minority view, have granted substantive consolidation without requiring notice to the putative consolidated entity's creditors. *See, e.g., Farmers & Traders State Bank of Meredosia v. Magill (In re Meredosia Harbor & Fleeting Serv., Inc.)*, 545 F.2d 583, 589 (7th Cir. 1976) (in a case under the former Bankruptcy Act, ruling that post-consolidation notice to a debtor subsidiary's creditors of consolidation with the debtor-parent was sufficient as a matter of due process); *Simon v. New Ctr. Hosp. (In re New Ctr. Hosp.)*, 187 B.R. 560, 566 (E.D. Mich. 1995) (ruling that the bankruptcy court did not err when it ordered substantive consolidation without affording notice to the non-debtor's creditors because the debtor and the non-debtor were alter egos "and the business dealings of the non-debtor Appellants and Debtor were so inextricably intertwined that no entity that had extended credit to the alter egos of the Debtor could reasonably be said to be without notice."); *In re Baker & Getty Fin. Servs., Inc.*, 78 B.R. 139, 143 (N.D. Ohio 1987) (noting that "[t]he possibility of prejudice to other personal creditors" of the individual debtors to be substantively consolidated with the corporate debtor "is more problematical," but concluding that, after consolidation, "both notice and the opportunity for hearing can be accorded these creditors in the context of the consolidated proceeding."); *see also S&G Financial*, 451 B.R. at 585 n.14 (noting that this approach is the "minority view").

MIHRANIAN

Medical doctor Mardiros Mihranian (the "debtor") filed a chapter 7 case in the Central District of California in December 2013. In 2015, the chapter 7 trustee commenced adversary proceedings in the bankruptcy court seeking to avoid more than $2 million in fraudulent transfers allegedly made by the debtor to his ex-wife, their two sons, the debtor's medical business and his long-time office manager (collectively, the "non-debtors"), none of which were in bankruptcy. In an effort to achieve the same result by other means, the trustee also filed a motion in 2016 seeking to substantively consolidate the debtor's estate with the estates of the non-debtors.

The bankruptcy court dismissed the adversary proceedings because the trustee failed to establish that the debtor was the initial transferor of the funds. A bankruptcy appellate panel affirmed those rulings on appeal.

The bankruptcy court also denied the trustee's substantive consolidation motion. The court found that: (i) the trustee had not proven that the debtor's assets were entangled with the non-debtors' assets to such an extent that substantive consolidation was warranted; and (ii) the trustee failed to notify the non-debtors' creditors of the substantive consolidation motion. A bankruptcy appellate panel affirmed this ruling as well on the ground of lack of notice. The trustee appealed to the Ninth Circuit.

THE NINTH CIRCUIT'S RULING

The Ninth Circuit affirmed.

Writing for the court, Judge Watson (sitting by designation) explained that, although the Ninth Circuit "permit[s] substantive consolidation of both debtor and non-debtor entities," the court has not yet determined whether notice to the non-debtors' creditors is required.

Judge Watson determined that several considerations supported a notice requirement:

(i) Ninth Circuit case law regarding consolidation of two or more debtors' estates "supports extending a notice requirement to a putative consolidated non-debtor's creditors, who should be afforded just as much—if not more—notice as a putative consolidated debtor's creditors";

(ii) The majority of courts considering the issue in other circuits have ruled that a non-debtor's creditors must be notified in advance;

(iii) If substantive consolidation is an equitable remedy the "sole aim" of which is "fairness to creditors," notice and an opportunity to be heard must be given to a non-debtor's creditors and not just to the non-debtors themselves;

(iv) The requirement that notice be provided "to the actual parties whose substantive rights will be 'seriously affected'" is logical so that they can have an opportunity to be heard; and

(v) The test for substantive consolidation adopted by the Ninth Circuit in *Bonham* "essentially requires notice to the putative consolidated parties' creditors" because it places the burden on an objecting creditor "to overcome the presumption that it did not rely on the separate credit of the putative consolidated entities."

Judge Watson rejected the trustee's argument that he provided notice to the same extent that notice was given in *Bonham*. In *Bonham*, Judge Watson explained, the putative consolidated parties' creditors were notified of the substantive consolidation motion, whereas the trustee in *Mihranian* notified the non-debtors, but not their creditors.

OUTLOOK

With *Mihranian*, the Ninth Circuit joined the majority camp in the dispute over notice to a non-debtor's creditors of a motion to substantively consolidate the non-debtor's estate with a debtor's bankruptcy estate. This approach comports with the principle that substantive consolidation must be fair to all creditors, but it places an added burden on the party seeking consolidation to identify the non-debtor's creditors. As noted by the Ninth Circuit in *Mihranian*, however, this information can readily be obtained through discovery.

Although the Ninth Circuit's decision is for all intents and purposes a matter of first impression among the circuits, the Ninth Circuit cites a Seventh Circuit decision—*Meredosia*—among the minority approach rulings that do not require notice to a non-debtor's creditors of proposed substantive consolidation. In *Meredosia*, a parent and its subsidiary each filed a case under chapter XI of the former Bankruptcy Act and asked the court to consolidate their cases.

The court granted the motion on the petition date. Notice of the bankruptcy case as well as the consolidation was given to all creditors of both debtors two weeks later. A lender to the subsidiary that was a defendant in preference and lien avoidance litigation argued that: (i) because only the parent was "adjudicated bankrupt," the subsidiary was not a "debtor" to which the avoidance laws applied; and (ii) no notice of the consolidation was given to the subsidiary's creditors. The Seventh Circuit rejected these arguments, finding that consolidation was requested by both debtors and that the subsidiary's creditors were given notice of the consolidation (albeit after the fact). Because the Seventh Circuit addressed the notice issue only tangentially in *Meredosia*, the Ninth Circuit's ruling in *Mihranian* can fairly be characterized as a matter of first impression.

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