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EIGHTH CIRCUIT RULES THAT BANKRUPTCY CODE'S CAP ON LEASE DAMAGE CLAIMS APPLIES TO FRAUDULENT TRANSFER JUDGMENT

Dan T. Moss ■ Mark G. Douglas

To prevent landlords under long-term real property leases from reaping a windfall for future rent claims at the expense of other creditors, section 502(b)(6) of the Bankruptcy Code caps the amount of a landlord's claims against a debtor-tenant for damages "resulting from the termination" of a real property lease. The U.S. Court of Appeals for the Eighth Circuit recently addressed the scope of this provision in an unusual case. In *Lariat Cos. v. Wigley (In re Wigley)*, 951 F.3d 967 (8th Cir. 2020), the court of appeals reversed a bankruptcy appellate panel decision and held that an individual debtor's joint liability with the guarantor of a real property lease for a fraudulent transfer judgment: (i) was not discharged as a result of the lease guarantor's prior bankruptcy discharge; but (ii) was nonetheless capped under section 502(b)(6). According to the Eighth Circuit, the fraudulent transfer judgment was "one step removed from the breach of the lease, but [the debtor's] liability results from the breach of the lease, so the cap applies."

STATUTORY CAP ON LANDLORD FUTURE RENT CLAIMS

Section 502(b)(6) of the Bankruptcy Code provides that, upon the filing of a timely objection, a claim filed in a bankruptcy case shall be disallowed to the extent that:

> if such claim is the claim of a lessor for damages resulting from the termination of a lease of real property, such claim exceeds—
>
> (A) the rent reserved by such lease, without acceleration, for the greater of one year, or 15 percent, not to exceed three years, of the remaining term of such lease, following the earlier of—
>
> (i) the date of the filing of the petition; and
> (ii) the date on which such lessor repossessed, or the lessee surrendered, the leased property; plus
>
> (B) any unpaid rent due under such lease, without acceleration, on the earlier of such dates. . . .

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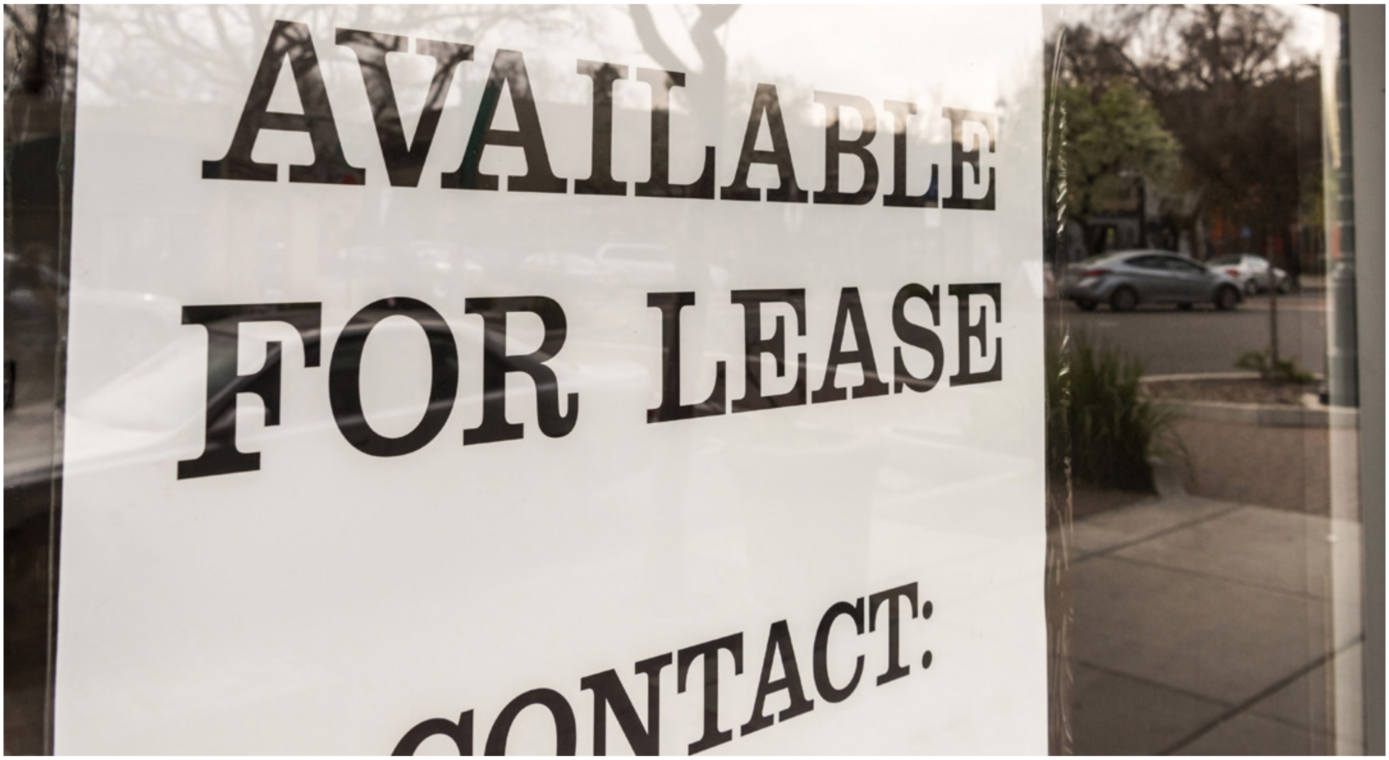

Section 502(b)(6) thus imposes a ceiling, or "cap," on the allowed amount of a landlord's claim for damages resulting from the termination of a lease of real property. The purpose of the rent cap is to balance the interests of landlords and other unsecured creditors by allowing a landlord "to receive compensation for losses suffered from a lease termination while not permitting a claim so large as to prevent general unsecured creditors from recovering from the estate." *Solow v. PPI Enterprises, Inc. (In re PPI Enterprises (U.S.), Inc.)*, 324 F.3d 197 (3d Cir. 2003); *see generally* COLLIER ON BANKRUPTCY ¶ 502.03(7)(a) (16th ed. 2020). Although section 502(b)(6) does not expressly refer to claims against guarantors of a lease, most courts that have considered the issue have ruled that the provision caps the future rent claims of a lessor against a debtor-guarantor of a lease. *See In re Ancona*, 2016 WL 828099, at *5 (Bankr. S.D.N.Y. Mar. 2, 2016) (citing cases and noting contrary authority representing the minority view).

In *Wigley*, the Eighth Circuit considered whether an individual debtor's joint liability with the guarantor of a lease for a fraudulent transfer judgment was capped under section 502(b)(6).

WIGLEY

Michael Wigley guaranteed a 10-year commercial lease between his restaurant company Baja Sol Cantina EP, LLC ("Baja Sol") and Lariat Companies, Inc. ("Lariat"). After Baja Sol defaulted on the lease in 2010, Lariat obtained a $2.2 million judgment against Mr. Wigley under the guaranty in Minnesota state court. The judgment included future rent payable under the lease.

In 2011, Lariat sued Mr. Wigley and his wife Barbara in state court pursuant to the Minnesota Uniform Fraudulent Transfer Act ("MUFTA") to avoid and recover $800,000 transferred by Mr. Wigley to Mrs. Wigley with the actual intent to hinder, delay, or defraud creditors (specifically, Lariat, in attempting to collect amounts due under the lease and guaranty). After a trial, the state court adjudged the defendants jointly and severally liable to Lariat for the $800,000 under the MUFTA.

Mr. Wigley filed for chapter 11 protection in February 2014 in the District of Minnesota. Lariat filed a proof of claim in the amount of approximately $1.7 million, consisting of unpaid rent and other fees due under the lease, future rent, interest, attorneys' fees, and the unpaid fraudulent transfer judgment. After disallowing certain elements of the claim, including the avoidance action liability, which it deemed duplicative of an earlier state court judgment awarding Lariat damages for Baja Sol's breach of the lease, the bankruptcy court applied the statutory cap in section 502(b)(6) and allowed Lariat's claim in an amount that was later stipulated to be approximately $310,000. The court later confirmed a chapter 11 plan over Lariat's objection under which Mr. Wigley paid Lariat's claim in the full capped amount and received a discharge. Lariat was deemed to accept the plan because its allowed claim was paid in full. Lariat appealed the confirmation order to an Eighth Circuit Bankruptcy Appellate Panel, which affirmed.

In 2014, the state court ruled that Mr. Wigley's bankruptcy discharge did not retroactively relieve Mrs. Wigley of her liability for the fraudulent transfer judgment. Thereafter, Mrs. Wigley filed her own bankruptcy case. Lariat filed a proof of claim in the case in the amount of approximately $1 million based on the fraudulent transfer judgment and related items. Mrs. Wigley objected to the claim, arguing that Lariat's acceptance of her husband's chapter 11 plan extinguished her fraudulent transfer judgment liability.

As a matter of apparent first impression, the bankruptcy judge ruled that, although Mr. Wigley's bankruptcy did not discharge his wife's joint and several fraudulent transfer debt, Lariat's claim should be capped by section 502(b)(6) at $310,000 because it "result[ed] from the termination of a lease of real property." Another Eighth Circuit Bankruptcy Appellate Panel ("BAP") reversed the ruling and disallowed Lariat's claim in its entirety, holding that the "predicate claim" had been satisfied by payment of the claim in Mr. Wigley's chapter 11 case, leaving the wife with no liability. Lariat appealed to the Eighth Circuit.

THE EIGHTH CIRCUIT'S RULING

A three-judge panel of the Eighth Circuit reversed the BAP. Writing for the panel, Circuit Judge Duane Benton explained that section 524(e) of the Bankruptcy Code provides that the "discharge of a debt of the debtor does not affect the liability of any other entity on . . . such debt." He accordingly agreed with the bankruptcy court's conclusion that Mrs. Wigley's liability for the state court fraudulent transfer judgment was not discharged when her husband's debt was discharged in his chapter 11 case. Judge Benton also cited a century-old decision of the U.S. Supreme Court for the proposition that "'discharge destroys the remedy, but not the indebtedness'" (quoting *Zavelo v. Reeves*, 227 U.S. 625, 629 (1913)).

Next, Judge Benton addressed whether the fraudulent transfer judgment against Mrs. Wigley was capped by section 502(b)(6). The judge rejected Lariat's argument that section 502(b)(6) did not apply because the judgment against Mrs. Wigley was based on the receipt of a fraudulent transfer, in contrast to her husband's capacity as a guarantor of the lease. According to Judge Benton, like courts in other jurisdictions, courts in the Eighth Circuit have held that section 502(b)(6) caps liability for guarantors and garnishees of leases. He reasoned that guarantors and garnishees are "analogous to fraudulent transferees because their liability is one step removed from the breach of lease."

Allowing Lariat's claim in an uncapped amount, Judge Benton explained, would violate the purpose of section 502(b)(6) because Lariat would receive a windfall at the expense of other creditors. "Lariat, as lessor," the judge wrote, "should not avoid the cap—and receive a windfall—because it is filing a claim based on a fraudulent-transfer judgment from a breach of the lease, instead of a claim based just on the breach."

According to Judge Benton, the fraudulent transfer judgment "is one step removed from the breach of the lease, but [Mrs. Wigley's] liability results from the breach of the lease, so the cap applies." Lariat's claim against her, he concluded, "result[ed] from the termination of a lease" within the meaning of section 502(b)(6). Moreover, applying the cap "complies with the statute's text, which focuses on the 'claim of a lessor'—not claim against a lessee."

The Eighth Circuit accordingly reversed the judgment of the BAP and remanded the case to the bankruptcy court for the purpose of entering an order allowing Lariat's claim in the amount of $310,000.

OUTLOOK

The Eighth Circuit's expansive reading of the scope of section 502(b)(6) in *Wigley* speaks to both the policy concerns underpinning the provision and the unusual circumstances involved. Section 502(b)(6) was enacted to prevent long-term commercial lease damage claims, which in many cases are readily subject to mitigation, from overwhelming the claims of a debtor's other creditors and thereby diluting creditor recoveries. Here, the court of appeals focused on the nexus between the guarantor's liability under the lease guaranty and the nature of the avoidance judgment—i.e., the guarantor fraudulently transferred funds to his wife with the intent to evade his guaranty obligations and defraud the landlord. The Eighth Circuit accordingly interpreted the phrase "resulting from the termination of a lease" in section 502(b)(6) broadly to include the fraudulent transfer judgment against the wife, even though she was not the tenant, the guarantor or in any other way obligated to pay amounts due under the lease.

The Eighth Circuit did leave room for a different outcome under a different factual circumstance, however. A seemingly key fact in *Wigley* was that Mrs. Wigley and Lariat stipulated that Mr. Wigley's payment did not cover all the money owed to Lariat. Had Mr. Wigley's payment satisfied all of Lariat's uncapped claim or had the unpaid amount been less than the calculated cap under section 502(b)(6), the result may have been different on appeal.

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OVERSECURED CREDITOR'S RIGHT TO CONTRACTUAL DEFAULT-RATE INTEREST ALLOWED UNDER STATE LAW

Stacey L. Corr-Irvine ▪ Mark G. Douglas

It is generally well understood that an "oversecured" creditor is entitled to interest and, to the extent provided for under a loan agreement, related fees and charges as part of its secured claim in a bankruptcy case. Although section 506(b) of the Bankruptcy Code provides that fees, costs or charges allowed as part of a secured claim must be "reasonable," the provision does not expressly impose any restrictions on the amount or nature of interest allowable as part of a secured claim. A Bankruptcy Appellate Panel for the Eighth Circuit recently considered whether a secured creditor is entitled to contractual default-rate interest under section 506(b).

In *In re Family Pharmacy, Inc.*, 614 B.R. 58 (B.A.P. 8th Cir. 2020), the panel reversed a bankruptcy court's order disallowing a secured creditor's claim for interest at the default rate under the parties' contract, using a penalty-type analysis generally applied to liquidated damages provisions. According to the panel, such an analysis cannot be applied to default interest provisions. The panel also held that the bankruptcy court erred when it held that the default interest rate was unenforceable based on "equitable considerations."

SECURED CREDITOR'S RIGHT TO INTEREST, FEES, COSTS, OR CHARGES

Whether a claim is secured or unsecured is determined in accordance with section 506(a) of the Bankruptcy Code, which provides that a creditor holds a secured claim to the extent of the value of the collateral securing its claim and an unsecured claim for any deficiency. If a creditor is "oversecured" because the creditor's collateral has a greater value than the face amount of the claim, section 506(b) provides that the creditor is entitled to receive, as part of its secured claim, "interest on [its] claim, and any reasonable fees, costs, or charges provided for under the agreement or State statute under which such claim arose." As noted by a leading commentator, "the entitlement provided by section 506(b) marks a significant exception to the general rule that claims are not entitled to accrue interest after the commencement of the [bankruptcy] case." COLLIER ON BANKRUPTCY ("COLLIER") ¶ 506.04 (16th ed. 2020).

In *United States v. Ron Pair Enterprises, Inc.*, 489 U.S. 235 (1989), the U.S. Supreme Court determined that section 506(b) applies to both consensual and nonconsensual liens and security interests. Prior to *Ron Pair*, some courts ruled that interest was not allowable under section 506(b) with respect to nonconsensual liens, reasoning that: (i) the reference to an "agreement" in the provision modified the entitlement to interest, suggesting that interest could be allowed only if there was an agreement providing for it; and (ii) because nonconsensual liens, such as tax liens, do not involve agreements, such liens must be excluded from the scope of section 506(b). *See generally* Collier at ¶ 506.04[a] (citing cases). According to the Court in *Ron Pair*, the reference to an "agreement" in section 506(b) modifies only the reference to "reasonable fees, costs, or charges," but not to "interest." An oversecured creditor has an "unqualified" right to such interest, the Court concluded, as long as it is entitled to such interest under a contract or applicable law.

Notably, the Court did not specify the rate of interest to which an oversecured creditor is entitled under section 506(b). Most lower courts have since concluded that the interest rate should be the rate provided in the contract, or other applicable law, under which the claim arose—i.e., the "contract rate" of interest. Collier at 506.04[b][i] (citing cases).

Although courts may disagree over the payment of contractual default-rate interest as part of an allowed secured claim, whether a claim based on another common contractual provision designed to compensate the non-defaulting party—a liquidated damages clause—is less controversial.

ENFORCEABILITY OF LIQUIDATED DAMAGES CLAIMS IN BANKRUPTCY

Section 502(b)(1) of the Bankruptcy Code provides that, if a party objects to a claim, the bankruptcy court shall allow it except to the extent that "such claim is unenforceable against the debtor and property of the debtor, under any agreement or applicable law for a reason other than because such claim is contingent or unmatured." Thus, state law generally determines whether a claim is enforceable in bankruptcy. *See Travelers Cas. & Sur. Co. of Am. v. Pac. Gas & Elec. Co.*, 549 U.S. 443, 452 (2007).

Under the laws of most states, a "liquidated damages" provision in a contract specifying the amount of damages payable upon default without proof of actual damages is enforceable unless it represents a penalty. *See, e.g., Breen v. Green,* 2019 WL 5855978, at *10 (D.R.I. Sept. 13, 2019) ("Rhode Island law distinguishes contractual penalties from liquidated damages and treats the former as unenforceable as a matter of public policy."); *In re John Q. Hammons Fall 2006, LLC,* 612 B.R. 779, 797 (Bankr. D. Kan. Jan. 3, 2020) (noting that, "in Missouri, liquidated damages provisions are 'valid and enforceable'; on the other hand, 'penalty clauses are not'"); *In re Madison 92nd St. Assocs. LLC*, 472 B.R. 189, 196 (Bankr. S.D.N.Y. 2012) ("A liquidated damages clause is valid under New York law if: (1) actual damages are difficult to determine, and (2) the sum is not 'plainly disproportionate' to the possible loss.").

In *Family Pharmacy*, the bankruptcy appellate panel considered whether a creditor was entitled to contractual default-rate interest as part of its secured claims under section 506(b).

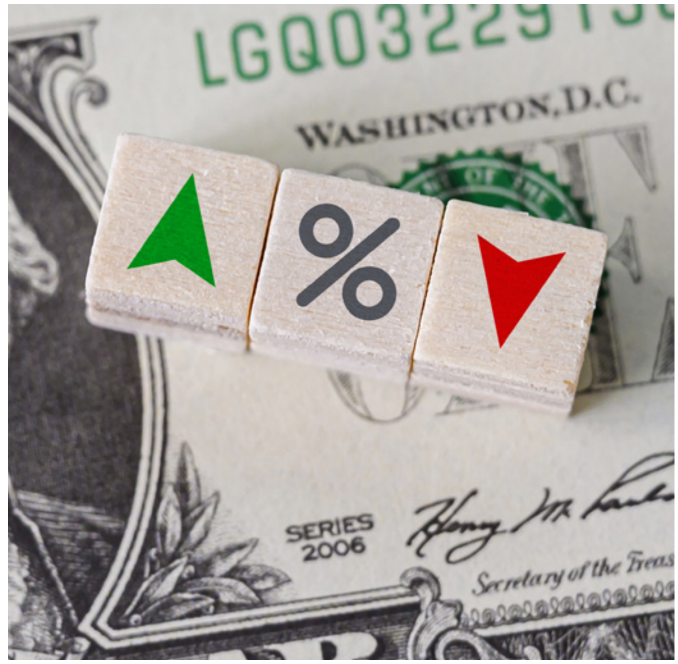
FAMILY PHARMACY

In April 2018, Family Pharmacy, Inc. and four affiliates (collectively, the "debtors") filed for chapter 11 protection in the Western District of Missouri. At the time of the filing, the debtors' secured creditors were, in order of priority, the Bank of Missouri ("BOM"), which was owed $11 million under a series of promissory notes; Cardinal Health ("Cardinal"), which was owed $1 million; and JM Smith Corporation and an affiliate (collectively, "Smith"), which were owed $18 million. The notes held by BOM bore various non-default interest rates ranging from 3.65% to 7.5% and provided that the rate of interest would increase to 18% upon default. The notes further provided that a default would be triggered when the "Borrower fails to make any payment when due."

The debtors undertook to sell their assets in bankruptcy. Although the initial stalking horse bid for the debtors' assets was only $8 million, after a marketing and auction process, the bankruptcy court approved a sale of substantially all of the debtors' assets to Smith for approximately $14 million. The sale proceeds were then disbursed to BOM and Cardinal, leaving excess proceeds of approximately $560,000. BOM received $11.3 million, which, pursuant to its proof of claim, included the outstanding principal amount of the promissory notes, interest at the respective non-default rates set forth in the notes, and certain related fees and expenses. BOM later filed a motion seeking allowance under section 506(b) of an additional approximately $18,000 in postpetition attorneys' fees, plus $443,000 in interest calculated at the 18% default rate specified in the notes. The debtors and Smith objected to the allowance of interest at the default rate as part of BOM's secured claim.

The bankruptcy court acknowledged that an 18% rate of interest was legal under Missouri law. Even so, it denied BOM's claim for default-rate interest for two reasons. First, reasoning that Missouri courts refuse to enforce liquidated damages clauses that are improper penalties, the bankruptcy court held that the default interest rate was unenforceable under "applicable law." In the alternative, the bankruptcy court held that the default interest rate could not be enforced on "equitable considerations." In so ruling, the court cited post-*Ron Pair* decisions representing the majority position that have applied "a presumption in favor of the contract rate subject to rebuttal based upon equitable considerations" (citing *In re Terry Ltd. P'ship*, 27 F.3d 241, 243 (7th Cir. 1994)). Those considerations included: (i) the spread between the 18% default rate and the non-default interest rates in the notes (ranging from 3.65% to 7.5%), which the court did not find to be a "reasonable prediction for any harm caused by a presumed default"; and (ii) BOM's failure to assert a claim for default interest until after the debtors' assets had fetched a higher price at auction than originally anticipated.

Prior to making its alternative rulings, the bankruptcy court addressed whether the default interest rate was triggered under the promissory notes. The debtors did not fail to make required payments under the notes until the day after they filed for



bankruptcy. They argued that they were excused from doing so in the absence of a court order and, because the notes were not in default, interest therefore did not begin to accrue at the default rate. The bankruptcy court noted that decisions addressing this issue are "murky" and declined to rule on the issue in light of its ruling disallowing BOM's claim for default-rate interest.

BOM appealed the bankruptcy court's ruling to a bankruptcy appellate panel.

THE BANKRUPTCY APPELLATE PANEL'S RULING

A three-judge bankruptcy appellate panel ("BAP") reversed the bankruptcy court's decision. Writing for the court, Chief Judge Thomas L. Saladino explained that "the concepts of default interest and liquidated damages are often conflated." A liquidated damages provision provides for a fixed amount of damages in the event of a breach, whereas a default interest provision results in the escalation of the interest rate payable upon default.

Citing decisions from bankruptcy courts outside of the Eighth Circuit, Judge Saladino found that the bankruptcy court's decision to subject the default interest provision to a liquidated damages analysis was inappropriate (citing *In re 3MBB, LLC*, 609 B.R. 841, 848 (Bankr. E.D. Cal. 2019) (addressing California law); *In re 785 Partners LLC*, 470 B.R. 126, 131 (Bankr. S.D.N.Y. 2012) (addressing New York law)). He also noted that, although the Eighth Circuit appeared to apply a liquidated damages analysis to a default interest rate under Minnesota law in *In re Bowles Sub Parcel A, LLC*, 792 F.3d 897 (8th Cir. 2015), a careful reading of the decision and the district court ruling below reveal that the Eighth Circuit did not decide the issue, but merely "addressed the issues as presented by the parties."

Judge Saladino noted that neither BOM nor the debtors cited a single case under Missouri law that "applied a liquidated damages analysis to a contractual interest rate set forth in a promissory note." Moreover, he wrote, such an analysis "brings into play 'reasonableness' factors that simply are not applicable to interest rates under 11 U.S.C. § 506(b)."

The BAP also determined that the bankruptcy court erred by disallowing BOM's claim for default-rate interest due to "equitable considerations." The court noted that such considerations "should be used sparingly and only in exceptional circumstances" that are not present when the plain meaning of a statute "provides the answer in a more straightforward and less time-consuming manner." "Simply put," the BAP found, "no section of the Bankruptcy Code gives the bankruptcy court authority, equitable or otherwise, to modify a contractual interest rate prior to plan confirmation." As an oversecured creditor, the court explained, BOM had an "unqualified right" to postpetition interest under section 506(b), "and that interest should be computed at the rate—default as well as non-default—provided in the parties' agreement, as long as those rates are allowed under state law."

The BAP accordingly reversed the bankruptcy court's ruling and remanded the case to the bankruptcy court to determine whether the default interest rate was triggered under the notes.

OUTLOOK

The BAP's decision in *Family Pharmacy* is consistent with *Ron Pair*'s ruling that the term "reasonable" in section 506(b) modifies the terms "reasonable fees, costs, or charges" but not "interest." If the rate of interest—default or otherwise—under a secured instrument is valid and enforceable under state law and the value of the collateral securing the loan exceeds the face amount of the debt, the secured creditor is entitled to interest at the contract rate as part of its allowed secured claim. According to the BAP in *Family Pharmacy*, neither the analysis traditionally applied to liquidated damages clauses nor equitable considerations should have any bearing on an oversecured creditor's entitlement to interest under section 506(b). That said, the issue of whether the default rate was triggered in this case remains to be determined by the bankruptcy court on remand.

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FORCE MAJEURE CLAUSE TRIGGERED BY PANDEMIC SHUTDOWN ORDER PARTIALLY RELIEVES CHAPTER 11 DEBTOR FROM TIMELY PAYING POSTPETITION RENT

Charles M. Oellermann ▪ Mark G. Douglas

With their doors closed by mandatory government shutdown orders in effect until most states started gradually reopening in May and June, many businesses have found it difficult or impossible to satisfy their lease obligations during the COVID-19 crisis. Businesses pushed into bankruptcy have increasingly looked to the courts for rent relief, even though the Bankruptcy Code expressly protect landlords' interests by requiring debtors to timely pay postpetition rent. However, in response to the extraordinary circumstances created by the pandemic, some courts are finding ways to provide at least partial relief to debtors in a way that attempts to protect landlord interests.

One example was the ruling handed down by an Illinois bankruptcy court in *In re Hitz Restaurant Group*, 2020 WL 2924523 (Bankr. N.D. Ill. June 3, 2020). In a matter of apparent first impression, the court addressed the impact of the pandemic on a "*force majeure*" clause in a contract, which clause generally relieves the parties from performing their obligations when certain circumstances beyond their control arise that render performance impracticable, illegal, inadvisable, or impossible. The bankruptcy court held that, because a government shutdown decree forced a restaurant to suspend on-premises dining, the *force majeure* clause in the restaurant's lease partially relieved the debtor from paying postpetition rent. However, because the debtor still generated income from takeout and delivery services during the shutdown period, the court concluded that the debtor was obligated to pay a portion (25%) of its obligations under the lease.

PAYMENT OF NON-RESIDENTIAL REAL PROPERTY LEASE OBLIGATIONS IN BANKRUPTCY PENDING ASSUMPTION OR REJECTION

Under section 365(a) of the Bankruptcy Code, a trustee or chapter 11 debtor-in-possession ("DIP") may, with court approval, assume or reject any of the debtor's executory contracts or unexpired leases. Pending assumption or rejection, section 365(d)(3) of the Bankruptcy Code obligates the trustee or DIP to "timely perform all the obligations of the debtor . . . arising from and after the order for relief under any unexpired lease of nonresidential real property, until such lease is assumed or rejected, notwithstanding section 503(b)(1) of [the Bankruptcy Code]."

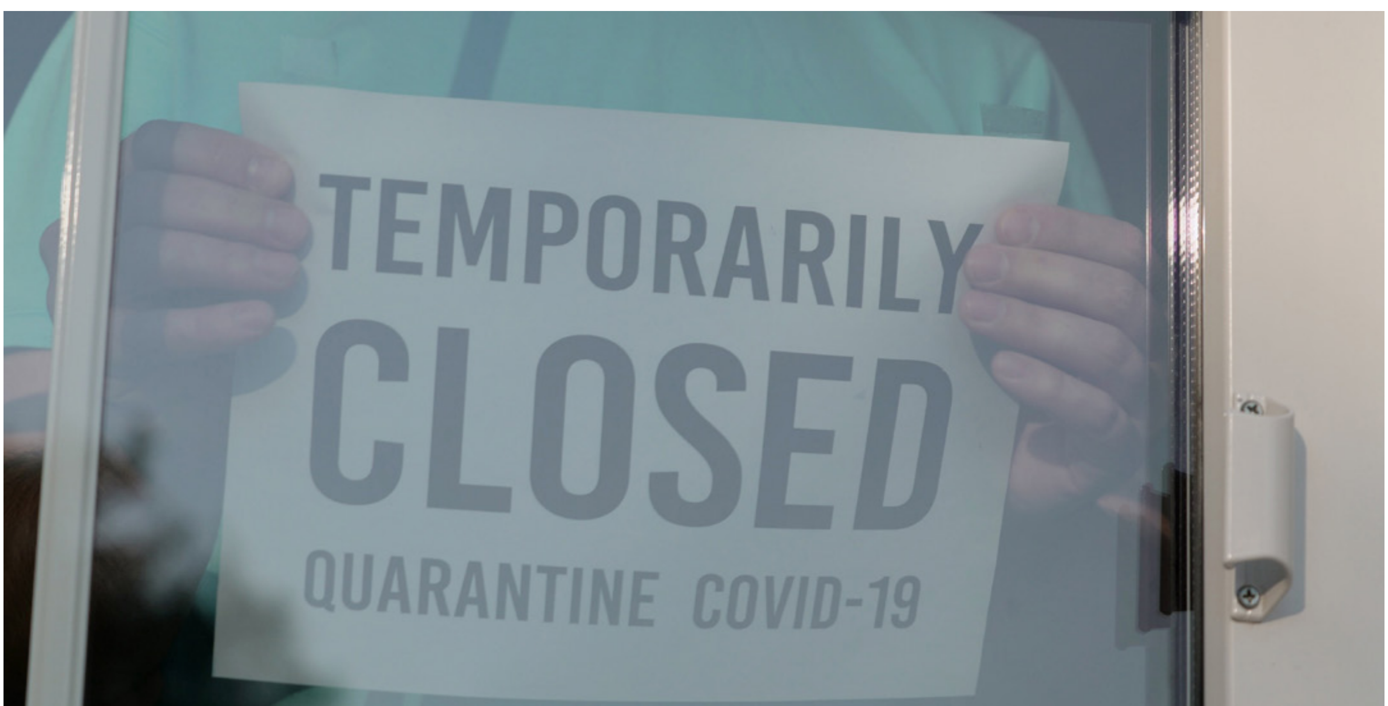
Added to the Bankruptcy Code in 1984, section 365(d)(3) was intended to ameliorate the immediate financial burden borne by commercial landlords pending the trustee's decision to assume or reject a lease. Prior to that time, landlords were routinely compelled to seek payment of rent and other amounts due under a lease by asking the bankruptcy court for an order designating those amounts as administrative expenses. The process was cumbersome and time-consuming. Moreover, landlords' efforts to get paid were hampered by the standards applied in determining what qualifies as a priority expense of administering a bankruptcy estate. *See generally* COLLIER ON BANKRUPTCY ("COLLIER") ¶ 365.04[1] (16th ed. 2020).

Section 503(b)(1) of the Bankruptcy Code provides that allowed administrative expenses include "the actual, necessary costs and expenses of preserving the estate." Rent payable under an unexpired commercial lease during a bankruptcy case falls into this category. *See JN Med. Corp. v. Auro Vaccines, LLC*, 597 B.R. 879, 898 (D. Neb. 2019). Even so, section 503(b)(1) has uniformly been interpreted to require that, in addition to being actual and necessary, an expense must benefit the bankruptcy estate to qualify for administrative priority. *See* Collier at ¶ 503.06. Prior to the enactment of section 365(d)(3), "benefit to the estate" in this context was determined on a case-by-case basis by calculating the value to the debtor of its "use and occupancy" of the premises, rather than looking to the rent stated in the lease. *See, e.g., In re Bob Grissett Golf Shoppes, Inc.*, 50 B.R. 598, 607 (Bankr. E.D. Va. 1985), *on reconsideration*, 76 B.R. 89 (Bankr. E.D. Va. 1987). Moreover, even if a landlord's claim for postpetition rent was conferred with administrative expense priority, the Bankruptcy Code did not specify when the claim had to be paid.

Section 365(d)(3) was designed to remedy this problem. It requires a trustee or DIP to remain current on lease obligations pending assumption or rejection of a lease. Nevertheless, courts have struggled with the precise meaning of the provision. For example, courts disagree over whether the phrase "all the obligations of the debtor ... arising from and after the order for relief" means: (i) all obligations that become due and payable upon or after the filing of a petition for bankruptcy; or (ii) obligations that "accrue" after filing the bankruptcy petition. The former approach is commonly referred to as the "performance" or "billing date" rule. Under the latter approach, which is sometimes referred to as the "proration" or "pro rata" approach, the portion of real estate taxes and other non-rent expenses that accrue prior to a bankruptcy filing but are payable postpetition need not be paid currently as administrative expenses pending a decision to assume or reject the lease. *See generally* Collier at ¶ 365.04[1].

Section 365(d)(3) has also been controversial in cases where the timing of a bankruptcy filing creates "stub rent." Stub rent is the rent that accrues during the period following the bankruptcy petition date until the next rent-payment date. For example, if a lease calls for the payment of rent on the first of each month, and the petition date falls on the 10th day of the month, assuming that rent was not paid prior to the petition date, the stub-rent period would be from the 10th day of the month through the end of the month. Because section 365(d)(3) requires current payment of obligations "arising from and after the order for relief," it could be argued that stub rent need not be paid under section 365(d)(3) because the payment was due prior to the petition date. Some courts have rejected this approach, ruling that section 365(d)(3) requires a debtor to pay stub rent on a prorated basis as part of its duty to "timely perform" its obligations arising under its unexpired leases. Other courts disagree, holding that stub rent need not be paid under section 365(d)(3). *See generally* Collier at ¶ 365.04[1][c].

Courts also disagree whether section 365(d)(3), rather than section 503(b)(1), is an appropriate basis for conferring administrative priority on (as distinguished from requiring performance of) a postpetition lease obligation. For example, in *In re Goody's Family Clothing Inc.*, 610 F.3d 812 (3d Cir. 2010), the U.S. Court of Appeals for the Third Circuit ruled that section 365(d)(3) does not supplant or preempt section 503(b)(1). The court concluded



that the DIP's use of the leased premises postpetition to produce income provided an "actual and necessary" benefit to the estate and that commercial landlords were thus entitled to stub rent as an administrative expense. Other courts have held that section 365(d)(3) provides authority to confer administrative status on a claim independent of section 503(b)(1). *See, e.g., In re The Leather Factory Inc.*, 475 B.R. 710 (Bankr. C.D. Cal. 2012).

HITZ RESTAURANT

Hitz Restaurant Group ("Hitz") operates Giglio's State Street Tavern, an Italian restaurant and bar in Chicago. It leases the premises from The South Loop Shops, LLC ("South Loop"), which retained Kass Management Services, Inc. as its leasing agent (together with South Loop, the "landlord"). The lease provides that rent, common area maintenance fees, real estate taxes, and late fees (collectively, "rent") in the aggregate amount of approximately $16,000 are due on the first day of each month. A *force majeure* clause in the lease provides that:

> Landlord and Tenant shall each be excused from performing its obligations or undertakings provided in this Lease, in the event, but only so long as the performance of any of its obligations are prevented or delayed, retarded or hindered by laws, governmental action or inaction, orders of government .... Lack of money shall not be grounds for Force Majeure.

Hitz had not paid the full amount of the rent since before July 2019. The landlord served a notice of termination of the lease in December 2019 and sued to evict Hitz from the premises in January 2020. Hitz forestalled eviction by filing for chapter 11 protection in the Northern District of Illinois on February 24, 2020.

On March 16, 2020, an executive order issued by Illinois's governor went into effect to address the pandemic. It provided in part as follows:

> Beginning March 16, 2020 at 9 p.m. through March 30, 2020 [later extended to April 30 and then May 29], all businesses in the State of Illinois that offer food or beverages for on-premises consumption—including restaurants, bars, grocery stores, and food halls—must suspend service for and may not permit on-premises consumption. Such businesses are permitted and encouraged to serve food and beverages so that they may be consumed off-premises, as currently permitted by law, through means such as in-house delivery, third-party delivery, drive-through, and curbside pick-up. In addition, customers may enter the premises to purchase food or beverages for carry-out[.] However, establishments offering food or beverages for carry-out, including food trucks, must ensure that they have an environment where patrons maintain adequate social distancing.

After Hitz failed to pay postpetition rent on the first of March and April, the landlord filed a motion on April 27, 2020, for relief from the automatic stay to evict Hitz from the premises unless Hitz immediately complied with section 365(d)(3) by paying past-due and future postpetition rent.

Hitz argued that its obligation to pay postpetition rent was excused by the *force majeure* clause triggered by the governor's executive order. The landlord countered that the clause did not apply because: (i) it was never triggered, as the order did not shut down the banking and postal systems, and Hitz was physically capable of writing and mailing rent checks; (ii) Hitz's failure to perform arose merely due to a "lack of money," which is expressly excluded from the scope of the clause; and (iii) Hitz could have paid the rent by obtaining a small business loan under the Paycheck Protection Program.

THE BANKRUPTCY COURT'S RULING

The bankruptcy court ruled that the *force majeure* clause was triggered by the governor's executive order but that Hitz was not totally relieved of its obligation under section 365(d)(3) to pay postpetition rent. In particular, the court explained, the order did not totally suspend all restaurant and bar operations but was limited to on-premises consumption. Like other restaurants, Hitz was still permitted to offer takeout, curbside pickup, and delivery service. For this reason, the court concluded that Hitz's obligation to pay postpetition rent under section 365(d)(3) should be reduced in proportion to the reduction of its ability to provide restaurant and bar services. Pending an evidentiary hearing on this issue, the court concluded preliminarily that, because approximately 75% of the leased restaurant space was rendered unusable by the executive order, Hitz's obligation to pay rent during the period that the order was in force should be correspondingly reduced.

The bankruptcy court rejected each of the landlord's arguments. Initially, it noted that contracts are enforced according to the terms under Illinois law, which provides that a *force majeure* clause will excuse performance only if the triggering event was in fact the proximate cause of nonperformance. The court characterized the landlord's contention that Hitz was physically capable of sending rent checks as a "specious argument ... that lacks any foundation in the actual language of the *force majeure* clause of the lease." According to the court, the governor's executive order was the proximate cause of Hitz's failure to pay rent, rather than "lack of money." Finally, the court wrote that "[n]othing in the [*force majeure* clause or court decisions] requires the party adversely affected by governmental actions or orders to borrow money to counteract their effects."

The bankruptcy court accordingly directed Hitz to pay 25% of its obligations under the lease for the months of April, May, and June 2020 no later than June 16, failing which the stay would be lifted because of Hitz's failure to adequately protect the landlord's interest in the leasehold.

OUTLOOK

In cases where an unexpired commercial real property lease contains a *force majeure* clause and the clause specifies "governmental action" as a triggering event, bankruptcy courts inclined to follow the approach adopted by the court in *Hitz Restaurant* may grant debtors some measure of relief (at least temporarily) during the pandemic from the obligation to make timely postpetition rent payments. It remains to be seen whether other courts will follow this approach, which may be essential to some debtors' prospects for reorganization.

Even in cases not involving a *force majeure* clause, bankruptcy courts have been willing to suspend, defer, or delay commercial rent payments due to COVID-19—generally exercising their broad equitable powers under section 105(a) of the Bankruptcy Code or in accordance with section 305(a), which allows the court to suspend all proceedings in a case. *See, e.g., In re J.C. Penney Co. Inc.*, No. 20-20182 (DRJ) (Bankr. S.D. Tex. June 11, 2020); *In re Craftworks Parent LLC*, No. 20-10475 (BLS) (Bankr. D. Del. May 21, 2020); *In re Bread & Butter Concepts, LLC*, No. 19-22400 (DLS) (Bankr. D. Kan. May 15, 2020); *In re Pier 1 Imports, Inc.*, 2020 WL 2374539 (Bankr. E.D. Va. May 10, 2020); *In re Modell's Sporting Goods, Inc.*, No. 20-14179 (VFP) (Bankr. D. N.J. Mar. 27, 2020). Until the pandemic abates, more rulings like this are likely.

Finally, as in *Hitz*, landlords may argue that their interest in leased premises occupied by a debtor during a bankruptcy case is entitled to some form of "adequate protection" under section 361 of the Bankruptcy Code, which typically takes the form of periodic cash payments, additional or replacement liens, or an administrative expense claim designed to compensate for any diminution in value of a creditor's interest in property. In this case, a debtor-tenant would bear the burden of demonstrating that something other than immediate cash payments of rent satisfies this requirement. *See, e.g.*, *Pier 1*, 2020 WL 2374539, **6-7 (to the extent that adequate protection was required in connection with the court's issuance of an order temporarily suspending the payment of commercial rent during the "limited operations period" when their stores were closed due to stay-at-home orders, the debtors' continued payment of related non-rent expenses and assurance of cure payments in the future was sufficient to protect the lessors against any perceived diminution in value).

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EXPANDING THE SCOPE OF THE BANKRUPTCY SAFE HARBOR FOR SECURITIES TRANSACTIONS

Charles M. Oellermann ■ Mark G. Douglas

In 2019, the U.S. Court of Appeals for the Second Circuit made headlines when it ruled that creditors' state law fraudulent transfer claims arising from the 2007 leveraged buyout ("LBO") of Tribune Co. ("Tribune") were preempted by the safe harbor for certain securities, commodity or forward contract payments contained in section 546(e) of the Bankruptcy Code. The Second Circuit concluded that a debtor may itself qualify as a "financial institution" covered by the safe harbor, and thus avoid the implications of the U.S. Supreme Court's decision in *Merit Mgmt. Grp., LP v. FTI Consulting, Inc.*, 138 S. Ct. 883 (2018), by retaining a bank or trust company as an agent to handle LBO payments, redemptions and cancellations.

Picking up where the Second Circuit left off, the U.S. Bankruptcy Court for the Southern District of New York recently held in *Holliday v. K Road Power Management, LLC (In re Boston Generating LLC)*, 2020 WL 3286207 (Bankr. S.D.N.Y. June 18, 2020), that: (i) section 546(e) preempts intentional fraudulent transfer claims under state law because the intentional fraud exception expressly included in section 546(e) applies only to intentional fraudulent transfer claims under federal law; and (ii) payments made to the members of limited liability company ("LLC") debtors as part of a pre-bankruptcy recapitalization transaction were protected from avoidance under section 546(e) because the debtors were "financial institutions," as customers of banks that acted as their depositories and agents in connection with the transaction.

THE SECTION 546(E) SAFE HARBOR

Section 546 of the Bankruptcy Code imposes a number of limitations on a bankruptcy trustee's avoidance powers, which include the power to avoid certain preferential and fraudulent transfers. Section 546(e) provides that the trustee may not avoid, among other things, a pre-bankruptcy transfer that is a settlement payment "made by or to (or for the benefit of) a . . . financial institution [or a] financial participant . . ., or that is a transfer made by or to (or for the benefit of)" any such entity in connection with a securities contract, "except under section 548(a)(1)(A) of the [Bankruptcy Code]." Thus, the section 546(e) "safe harbor" bars avoidance claims challenging a qualifying transfer unless the transfer was made with actual intent to hinder, delay, or defraud creditors under federal law, as distinguished from being constructively fraudulent because the debtor was insolvent at the time of the transfer (or became insolvent as a consequence) and received less than reasonably equivalent value in exchange.

Section 101(22) of the Bankruptcy Code defines the term "financial institution" to include:

> [A] Federal reserve bank, or an entity that is a commercial or savings bank, industrial savings bank, savings and loan

association, trust company, federally-insured credit union, or receiver, liquidating agent, or conservator for such entity and, *when any such Federal reserve bank, receiver, liquidating agent, conservator or entity is acting as agent or custodian for a customer (whether or not a "customer", as defined in section 741) in connection with a securities contract (as defined in section 741) such customer. . . .*

11 U.S.C. § 101(22) (*emphasis added*).

The purpose of section 546(e) is to prevent "the insolvency of one commodity or security firm from spreading to other firms and possibly threatening the collapse of the affected market." H.R. Rep. No. 97-420, at 1 (1982). The provision was "intended to minimize the displacement caused in the commodities and securities markets in the event of a major bankruptcy affecting those industries." *Id.*

In *Deutsche Bank Trust Co. Ams. v. Large Private Beneficial Owners (In re Tribune Co. Fraudulent Conveyance Litig.)*, 818 F.3d 98 (2d Cir. 2016) ("*Tribune 1*"), the U.S. Court of Appeals for the Second Circuit affirmed lower court decisions dismissing creditors' state law constructive fraudulent transfer claims arising from the 2007 LBO of Tribune. According to the Second Circuit, even though section 546(e) expressly provides that "the trustee" may not avoid certain payments under securities contracts unless such payments were made with the actual intent to defraud, section 546(e)'s language, its history, its purposes, and the policies embedded in the securities laws and elsewhere led to the conclusion that the safe harbor was intended to preempt constructive fraudulent transfer claims asserted by creditors under state law.

Prior to the Supreme Court's ruling in *Merit*, there was a split among the circuit courts of appeals concerning whether the section 546(e) safe harbor barred state law constructive fraud claims to avoid transactions in which the financial institution involved was merely a "conduit" for the transfer of funds from the debtor to the ultimate transferee. The Second Circuit ruled that the safe harbor applied under those circumstances in *In re Quebecor World (USA) Inc.*, 719 F.3d 94 (2d Cir. 2013). The Supreme Court resolved the circuit split in *Merit*.

In *Merit*, a unanimous Supreme Court held that section 546(e) does not protect transfers made through a "financial institution" to a third party, regardless of whether the financial institution had a beneficial interest in the transferred property. Instead, the relevant inquiry is whether the transferor or the transferee in the transaction sought to be avoided overall is itself a financial institution. Because the selling shareholder in the LBO transaction that was challenged as a constructive fraudulent transfer was not a financial institution (even though the conduit banks through which the payments were made met that definition), the Court ruled that the payments fell outside of the safe harbor.

In a footnote, the Court acknowledged that the Bankruptcy Code defines "financial institution" broadly to include not only entities traditionally viewed as financial institutions, but also the "customers" of those entities, when financial institutions act as agents or custodians in connection with a securities contract. The selling shareholder in *Merit* was a customer of one of the conduit banks, yet never raised the argument that it therefore also qualified as a financial institution for purposes of section 546(e). For this reason, the Court did not address the possible impact of the shareholder transferee's customer status on the scope of the safe harbor.

In April 2018, the Supreme Court issued an order that, in light of its ruling in *Merit*, the Court would defer consideration of a petition seeking review of *Tribune 1*. The Second Circuit later suspended the effectiveness of *Tribune 1* "in anticipation of further panel review." In a revised opinion issued in December 2019, *In re Tribune Co. Fraudulent Conveyance Litig.*, 946 F.3d 66 (2d Cir. 2019), *reh'g denied*, No. 13-3992 (L) (2d Cir. Feb. 6, 2020) ("*Tribune 2*"), the Second Circuit reaffirmed the court's previous decision that creditors' state law constructive fraudulent transfer claims were preempted by the section 546(e) safe harbor.

The Second Circuit acknowledged that one of the holdings in *Tribune 1* (as well as its previous ruling in *Quebecor*) was abrogated by *Merit*'s pronouncement that the section 546(e) safe harbor does not apply if a financial institution is a mere conduit. However, the court again concluded that section 546(e) barred the creditors' state law avoidance claims, but for a different reason.

The Second Circuit explained that, under *Merit*, the payments to Tribune's shareholders were shielded from avoidance under section 546(e) only if either Tribune, which made the payments, or the shareholders who received them, were "covered entities." It then concluded that Tribune was a "financial institution," as defined by section 101(22)(A) of the Bankruptcy Code, and "therefore a covered entity."

According to the Second Circuit, the entity Tribune retained to act as depository in connection with the LBO was a "financial institution" for purposes of section 546(e) because it was a trust company and a bank. Therefore, the court reasoned, Tribune was likewise a financial institution because, under the ordinary meaning of the term as defined by section 101(22), Tribune was the bank's "customer" with respect to the LBO payments, and the bank was Tribune's agent according to the common law definition of agency. "Section 546(e)'s language is broad enough under certain circumstances," the Second Circuit wrote, "to cover a bankrupt firm's LBO payments even where, as here, that firm's business was primarily commercial in nature."

BOSTON GENERATING

Boston Generating LLC ("BosGen"), its holding company EBG Holdings LLC ("EBG"), and their subsidiaries (collectively, "debtors") owned and operated electric power generating facilities near Boston. In November 2006, BosGen and EBG launched a leveraged recapitalization transaction whereby they borrowed approximately $2.1 billion from lenders, in part to fund a $925 million tender offer for EBG's member units and the distribution of $35 million in dividends to EBG's members. The Bank of New York ("BNY") acted as a depository and agent for both BosGen and EBG in connection with the tender offer.

The $2.1 billion cash infusion from the credit facilities was deposited into BosGen and EBG bank accounts at U.S. Bank National Association ("U.S. Bank") and later transferred to their accounts at BNY. In December 2006, as part of consummating the recapitalization transaction, EBG directed BNY to pay approximately $1 billion to EBG's members in the form of unit redemptions, warrant redemptions, and other distributions (collectively, "payments").

The debtors filed for chapter 11 protection in the Southern District of New York in August 2010. After authorizing the sale of substantially all of the debtors' assets, the bankruptcy court confirmed a liquidating chapter 11 plan for the debtors in August 2011. The plan created a liquidating trust to pursue claims on behalf of the debtors' general unsecured creditors. The liquidating trustee commenced an adversary proceeding seeking, among other things, to avoid and recover the payments as intentional and constructive fraudulent transfers under the New York Debtor & Creditor Law. The defendants moved to dismiss, arguing that the transfers were safe-harbored under section 546(e).

THE BANKRUPTCY COURT'S RULING

The bankruptcy court granted the motion to dismiss the liquidating trustee's fraudulent transfer claims. The court ruled that: (i) section 546(e) preempted the claims; and (ii) the payments were protected by the section 546(e) safe harbor because BosGen and EBG were "financial institutions," as customers of U.S. Bank and/or BNY.

Initially, the court acknowledged that, although neither *Tribune 1* nor *Tribune 2* addressed whether section 546(e) preempts *intentional* (as distinguished from constructive) fraudulent transfer claims under state law, the court saw "no reason why *Tribune*'s reasoning does not extend to intentional state law fraudulent transfer claims." Examining the plain language of section 546(e), the court declined to extend section 546(e)'s exception for *federal* intentional fraudulent transfer claims under section 548(a)(1)(A) to include state law intentional fraudulent transfer claims. According to the court:

> Congress may have specifically excluded state law intentional fraudulent transfer claims from section 546(e)'s exception having determined the need for stability in the securities markets overrode the potential danger of creditors escaping claims for intentional fraud based on a fear that inconsistent application of fifty (50) states' fraudulent transfer statutes would result in instability in the securities markets.

Looking at the series of transfers involving the payments as an "integrated transaction," the bankruptcy court determined that the payments satisfied the requirements for the safe harbor because: (i) "a transfer of cash to a financial institution made to repurchase and cancel securities—in other words, to complete a securities transaction—qualifies for the safe harbor as a settlement payment"; (ii) the LLC member units and warrants qualified as "securities" under the Bankruptcy Code's broad definition; (iii) the payments were made "in connection with a securities contract"—the tender offer; (iv) BosGen qualified as a "financial institution" by virtue of its relationship with U.S. Bank, which acted as the agent of its customers BosGen and EBG in connection with the tender offer; and (v) additionally, or in the alternative, both BosGen and EBG qualified as "financial institutions" as customers of BNY, which acted as their agent in connection with the tender offers.

Finally, the court also ruled that section 546(e) preempted the liquidating trustee's constructive fraudulent transfer claims under state law—an issue that was conceded by the trustee.

OUTLOOK

Merit potentially opened the door for state law constructive fraudulent transfer claims against selling equity holders in many LBOs or other recapitalization transactions. Such payments typically pass through financial intermediaries that would be considered "financial institutions" and, before *Merit*, were considered to be protected from such claims by the safe harbor in many circuits.

Post-*Merit* case law, however, appears to close the door, at least in the Second Circuit, on such fraudulent transfer claims. In handing down its ruling in *Boston Generating*, the bankruptcy court employed substantially the same reasoning articulated by the Second Circuit in *Tribune 2* and the U.S. District Court for the Southern District of New York in related litigation involving the Tribune litigation trustee's federal constructive fraudulent transfer claims. *See In re Tribune Co. Fraudulent Conveyance Litig.*, 2019 WL 1771786 (S.D.N.Y. Apr. 23, 2019). Each of these decisions suggests that the results of *Merit* might be avoided by structuring transactions so that the target or recapitalized entity is a "customer" of the financial intermediaries involved. *Boston Generating* adds an additional gloss to the analysis by concluding that state law intentional fraudulent transfer claims asserted on behalf of creditors are also preempted by section 546(e).

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ANOTHER BANKRUPTCY COURT JOINS THE MAJORITY CAMP ON POST-PLAN CONFIRMATION SETOFF

Marissa C. Alfano ■ Mark G. Douglas

In *In re Rogers Morris*, 2020 WL 1321894 (Bankr. N.D. Miss. Mar. 16, 2020), the U.S. Bankruptcy Court for the Northern District of Mississippi contributed to an existing split among the courts by joining the majority view in holding that a creditor may exercise setoff rights after the confirmation of a plan in a bankruptcy case. In a chapter 12 case, the court found that the creditor did not waive its setoff rights or engage in inequitable conduct justifying equitable subordination of its claim, and it granted the creditor's post-confirmation motion for relief from the automatic stay to offset mutual prepetition obligations.

SETOFF IN BANKRUPTCY

Section 553(a) of the Bankruptcy Code provides that, with certain exceptions, 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." With this language, the Bankruptcy Code preserves an otherwise existing right of setoff, but it does not create one. *Citizens Bank of Md. v. Strumpf*, 516 U.S. 16, 18 (1995); *accord In Feltman v. Noor Staffing Grp., LLC (In re Corp. Res. Servs. Inc.)*, 564 B.R. 196 (Bankr. S.D.N.Y. 2017) (section 553 does not create an independent federal right of setoff, but merely preserves any such right that exists under applicable nonbankruptcy law).

The Bankruptcy Code defines a "claim," in relevant part, as a "right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured," and it defines a "debt" as a "liability on a claim." 11 U.S.C. § 101 (5)(A), (12). Under bankruptcy case law, the term "contingent" means contingent as to liability. *See Grady v. A.H. Robins Co. (In re A.H. Robins Co.)*, 839 F.2d 198 (4th Cir.), *cert. dismissed*, 487 U.S. 1260 (1988). Although the Bankruptcy Code does not define "mutual debt," courts typically find that the mutuality requirement is satisfied when the debt and the claim are between the same parties acting in the same capacity. *See* Collier on Bankruptcy ¶ 553.03[3] (16th ed. 2020).

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

However, setoff is available in bankruptcy only "when the opposing obligations arise on the same side of the . . . bankruptcy petition date." *Pa. State Employees' Ret. Sys. v. Thomas (In re Thomas)*, 529 B.R. 628, 637 n.2 (Bankr. W.D. Pa. 2015). Thus, prepetition obligations may not be set off against postpetition debts and vice versa. *See In re Williams,* 2018 WL 3559098 (Bankr. D.N.M. July 23, 2018); *In re Enright*, 2015 WL 4875483 (Bankr. D.N.J. Aug. 13, 2015); *In re Passafiume*, 242 B.R. 630 (Bankr. W.D. Ky. 1999).

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

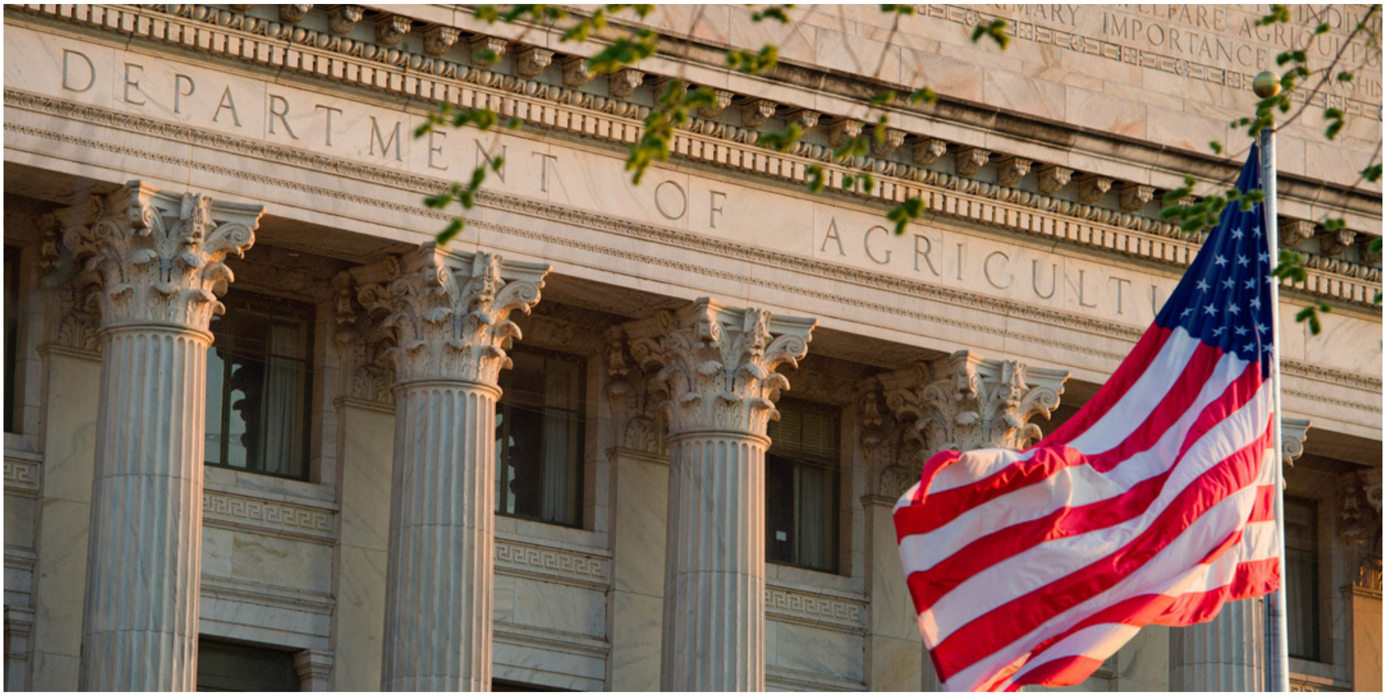
Courts disagree over whether setoff rights survive confirmation of a plan. The bankruptcy court weighed in on this issue in *Rogers Morris*.

ROGERS MORRIS

In March 2018, family farmer Rogers Morris ("Morris") filed a chapter 12 petition in the Northern District of Mississippi. Prior to filing for bankruptcy, Morris entered into a contract with the Commodity Credit Corporation ("CCC"), an agency within the U.S. Department of Agriculture ("USDA"), for risk and price loss crop coverage. The contract provided in part that "[o]ffsets for debts owed to agencies of the U.S. Government shall be made prior to making any payments to participants or their assignees."

The USDA was obligated under the contract to pay approximately $3,500 to Morris for the 2017 program year. The USDA duly issued a check, but withheld the payment because Morris had payments due under an outstanding prepetition secured debt to the CCC in the amount of approximately $31,000 and a partially secured debt in the amount of approximately $240,000 to the Farm Services Agency ("FSA"), also an agency within the USDA.

The U.S. government ("government") timely submitted proofs of claim on behalf of the CCC, the FSA, and the USDA in the bankruptcy court asserting a setoff right (expressly or by reference to attached documentation) under the contract and otherwise participated in the case. After resolving objections filed by the CCC, the FSA, and the USDA, among others, the bankruptcy court confirmed a chapter 12 plan for Morris in December 2018. The plan provided for reinstatement of the CCC, FSA, and certain other secured loans under altered terms, but provided for no



distribution to unsecured creditors. The plan was silent as to the effect of confirmation on setoff rights.

In October 2019—10 months after confirmation of Morris's chapter 12 plan—the government petitioned the bankruptcy court for relief from the automatic stay to exercise its setoff right. In opposing the setoff motion, Morris argued that: (i) a creditor may not assert a setoff right after confirmation of a plan; (ii) the government waived its setoff right by waiting 10 months after confirmation to file its setoff motion; and (iii) the government engaged in inequitable conduct warranting the equitable subordination of its claim by asserting its setoff right post-confirmation and thereby attempting to gain an unfair advantage over other creditors.

THE BANKRUPTCY COURT'S RULING

The bankruptcy court rejected Morris's arguments and granted the government's motion for relief from the automatic stay to exercise the right of setoff.

Initially, the court found that the government possessed a valid setoff right under the contract with Morris, that both obligations arose pre-bankruptcy, and that the mutuality requirement was satisfied.

Turning to the validity of post-confirmation setoff, the court acknowledged that no controlling Fifth Circuit precedent exists on this point. Looking to case law in other circuits, the bankruptcy court noted that the U.S. Court of Appeals for the Third Circuit and some lower courts in other circuits have concluded that setoff rights terminate upon plan confirmation (citing *In re Continental Airlines*, 134 F.3d 536, 540-42 (3d Cir. 1998) ("[T]he right of a creditor to set-off in a bankruptcy reorganization proceeding must be duly exercised in the bankruptcy court before the plan of reorganization is confirmed; the failure to do so extinguishes the claim" because section 553 is trumped by sections 1141(b) and 1141(c), which vest all property of the estate in the debtor free and clear of liens upon confirmation); *In re Lykes Bros. S.S. Co. Inc.*, 217 B.R. 304, 310 (M.D. Florida 1997) (once an order confirming a plan becomes final, the doctrine of *res judicata* precludes a creditor from asserting setoff rights post-confirmation)).

However, the bankruptcy court in *Rogers Morris* explained, this is the minority view. The majority rule, exemplified by the Ninth Circuit's decision in *In re De Laurentiis Entertainment Group, Inc.*, 963 F.2d 1269 (9th Cir. 1992), is that post-confirmation setoff is permitted in accordance with the plain language of section 553. In *De Laurentiis*, the Ninth Circuit wrote that:

> [A] contrary conclusion essentially would nullify section 553. Section 553 does not by itself create a right of setoff. Instead, it merely allows setoffs in bankruptcy to the same extent they are allowed under state law. If section 1141 were to take precedence over section 553, setoffs would be allowed under Chapter 11 only where they were written into a plan of reorganization. Section 553 would then be largely superfluous, since a setoff could be written into the reorganization plan even without section 553. A reading of section 553 which renders it meaningless should be highly suspect.

963 F.2d at 1277; *accord In re Davidovitch*, 901 F.2d 1533 (10th Cir. 1990); *In re BOUSA Inc.*, 2006 WL 2864964 (Bankr. S.D.N.Y. Sept. 29, 2006); *In re Ronnie Dowdy, Inc.*, 314 B.R. 182 (Bankr. E.D. Ark 2005); *In re Whitaker*, 173 B.R. 359 (Bankr. S.D. Ohio 1994).

The bankruptcy court in *Rogers Morris* was persuaded by this reasoning and opted for the *De Laurentiis* court's approach on this issue. The court echoed the Ninth Circuit's view that setoffs are usually favored, presumptively enforced, and essential to the equitable treatment of creditors—otherwise, a creditor would have to pay its full debt to the debtor while receiving only a portion of what the debtor owes to it.

The bankruptcy court rejected Morris's argument that the government waived its setoff right by waiting until after confirmation to assert the right. According to the court, by withholding the check and asserting the setoff right in its proofs of claim, the government never intentionally relinquished its right, and the confirmed chapter 12 plan did not address this issue. In addition, the court did not find that the government engaged in any misconduct or gained an unfair advantage that would warrant the equitable subordination of its claims. Finally, the court characterized as "absurd" Morris's argument that prohibiting the government from exercising its setoff right was consistent with section 553, given that the provision "expressly protects a creditor's setoff rights."

OUTLOOK

Setoff rights created by contract or applicable non-bankruptcy law are important creditor protections. The Bankruptcy Code preserves those rights and permits creditors to exercise them under appropriate circumstances. As illustrated by the ruling in *Rogers Morris*, however, courts disagree as to whether confirmation of a plan extinguishes setoff rights. Even though *Rogers Morris* involved a chapter 12 case, the court's reasoning should apply with equal force to post-confirmation setoffs in chapter 9, 11, and 13 cases.

However, it bears observation that, as noted in the chapter 11 context by the Third Circuit in *Continental Airlines*, chapters 11, 12, and 13 each provide that, unless provided otherwise in the plan or the confirmation order, confirmation of a plan vests all property of the estate in the debtor free and clear of any claim or interest of any creditor. *See* 11 U.S.C. §§ 1141, 1227, and 1327. The courts have disagreed regarding the impact of these provisions on post-confirmation setoff rights. Given the uncertain state of the law on this issue, creditors seeking to exercise setoff rights should be aware of the courts' views on the question in the jurisdiction of any debtor's bankruptcy filing and would be well-advised to assert setoff rights prior to plan confirmation or, in all events, at the earliest opportunity.

FROM THE TOP IN BRIEF: U.S. SUPREME COURT BANKRUPTCY ROUNDUP

Mark G. Douglas

APPOINTMENT OF PROMESA FINANCIAL OVERSIGHT BOARD WAS CONSTITUTIONAL

In *Financial Oversight and Management Board for Puerto Rico v. Aurelius Investment, LLC*, No. 18-1334, 590 U.S. _____ (June 1, 2020), the Supreme Court rejected a constitutional challenge to Congress's scheme for addressing Puerto Rico's fiscal crisis. In response to that crisis, Congress enacted the Puerto Rico Oversight, Management, and Economic Stability Act ("PROMESA"). PROMESA created a Financial Oversight and Management Board ("Board") with seven voting members. PROMESA permitted President Obama to appoint one member of the Board. He chose six more from a list of candidates provided by Congressional leaders.

The Appointments Clause of the U.S. Constitution (Art. II, § 2, cl. 2) provides that the President "shall nominate, and by and with the Advice and Consent of the Senate, shall appoint . . . all . . . Officers of the United States . . . ." Under PROMESA, Senate confirmation would have been required for any of the six additional members of the Board appointed by the President if they had not been on the list provided by Congressional leaders. Because they were on the list, the President appointed the entire Board without the advice and consent of the U.S. Senate.

In Article III of PROMESA, Congress authorized the Board to file debt-adjustment proceedings on behalf of Puerto Rico or its instrumentalities, to supervise and modify Puerto Rico's laws and budget, and to gather evidence and conduct investigations in support of these efforts. In May 2017, the Board filed debt-adjustment petitions in the U.S. District Court for the District of Puerto Rico on behalf of Puerto Rico and five of its instrumentalities. Both the district court and the Board had decided a number of matters in the cases when several creditors moved to dismiss on the ground that the Board members' selection violated the Appointments Clause's Senate confirmation requirements. The district court denied the motions, but the U.S. Court of Appeals for the First Circuit reversed. It ruled that the Board members' selection violated the Appointments Clause but concluded that any Board actions taken prior to its decision were valid under the "de facto officer" doctrine.

The Supreme Court reversed unanimously. Writing for the Court, Justice Breyer acknowledged that the Appointments Clause governs the appointment of all officers "of the United States," including such officers located in Puerto Rico. However, he noted, two provisions of the Constitution—Art. I, § 8, cl. 17 and Art. IV, § 3, cl. 2—"empower Congress to create local offices for the District of Columbia and for Puerto Rico and the Territories." According to Justice Breyer, these provisions "give Congress the power to legislate for those localities in ways 'that would exceed its powers, or at least would be very unusual' in other contexts."

In addition, Justice Breyer noted that the term "Officers of the United States" in the Appointments Clause has "never been understood to cover those whose powers and duties are primarily local in nature and derive from these two constitutional provisions." In this case, he explained, the Board's statutory responsibilities "consist of primarily local duties, namely, representing Puerto Rico in bankruptcy proceedings and supervising aspects of Puerto Rico's fiscal and budgetary policies." The court rulings relied upon by the court of appeals, in contrast, were inapposite because "[e]ach of the cases considered an Appointments Clause problem concerning the importance or significance of duties that were indisputably *federal* or national in nature."

The Court ultimately concluded that, although the "Appointments Clause applies to the appointment of officers of the United States with powers and duties in and in relation to Puerto Rico," the members of the Board "are not 'Officers of the United States.'" As a consequence, "the Appointments Clause does not dictate how the Board's members must be selected," and "the congressionally mandated process for selecting members of the [Board] does not violate that Clause."

Justice Thomas and Justice Sotomayor issued separate opinions concurring in the judgment.

NOTABLE DENIALS OF CERTIORARI

On May 26, 2020, the Court declined to review a ruling by the U.S. Court of Appeals for the Third Circuit in *Opt-Out Lenders v. Millennium Lab Holdings II LLC (In re Millennium Lab Holdings II LLC)*, 945 F.3d 126 (3d Cir. Dec. 19, 2019), *cert. denied sub nom. ISL Loan Trust v. Millennium Lab Holdings*, No. 19-1152, 2020 WL 2621797 (U.S. May 26, 2020). In *Millennium*, the Third Circuit upheld a lower court decision confirming a chapter 11 plan including nonconsensual third-party releases. Although the Third Circuit did not give such releases its wholesale approval, it ruled that the bankruptcy court's order confirming the plan did not violate Article III of the U.S. Constitution. The Third Circuit also affirmed the lower courts' ruling that the appeal was "equitably moot" because, among other things, granting the requested relief would "scramble the plan," and any attempt to unwind the plan would likely be impossible. The circuits are split on the validity of nonconsensual third-party releases in chapter 11 plans. By contrast, every circuit that has considered the question has concluded that an appeal of a substantially consummated chapter 11 plan can be dismissed under the doctrine of equitable mootness.

On June 1, 2020, the Court denied a petition seeking review of a ruling by the U.S. Court of Appeals for the Second Circuit in *In re Picard, Trustee for the Liquidation of Bernard L. Madoff Investment Securities LLC*, 917 F.3d 85 (2d Cir. 2019), *cert. denied sub nom. HSBC Holdings v. Picard*, No. 19-277, 2020 WL 2814770 (U.S. June 1, 2020). In *Madoff*, the Second Circuit vacated a bankruptcy court order dismissing a trustee's litigation against various non-U.S. defendants to recover payments by a U.S. debtor that were allegedly avoidable because they were made with the intent to defraud creditors.

The bankruptcy court had ruled that the claims against these subsequent foreign transferees must be dismissed because section 550(a)(2) of the Bankruptcy Code, which provides for the recovery of avoided fraudulent transfers from subsequent transferees, does not apply extraterritorially, and because principles of international comity limited the provision's scope. In vacating the dismissal, the Second Circuit held that neither the "presumption against extraterritoriality" nor the doctrine of comity barred recovery because: (i) section 550(a)(2) works in tandem with section 548, which "focuses on the debtor's initial transfer of property"; (ii) the initial transfer occurred within the U.S., meaning that the case involved domestic, rather than foreign, application of section 550(a); and (iii) comity did not warrant dismissal of the recovery actions because the interest of the U.S. in applying the Bankruptcy Code's avoidance and recovery provisions "outweighs the interest of any foreign state."

Notably, however, because the Second Circuit found that the case involved a domestic application of section 550(a), it "express[ed] no opinion on whether § 550(a) clearly indicates its extraterritorial application." Thus, the ruling did not resolve the dispute (even among courts in the Second Circuit) over whether Congress intended the avoidance provisions of the Bankruptcy Code, including section 550(a), to apply extraterritorially.

ASSETS MAY BE SOLD IN BANKRUPTCY FREE AND CLEAR OF SUCCESSOR LIABILITY

Timothy W. Hoffmann ■ Mark G. Douglas

The ability of a bankruptcy trustee or chapter 11 debtor-in-possession ("DIP") to sell assets of the bankruptcy estate "free and clear" of "any interest" in the property asserted by a non-debtor is an important tool designed to maximize the value of the estate for the benefit of all stakeholders. The U.S. Bankruptcy Court for the Central District of California recently examined whether such interests include "successor liability" claims that might otherwise be asserted against the purchaser of a debtor's assets. In *In re Catalina Sea Ranch, LLC*, 2020 WL 1900308 (Bankr. C.D. Cal. Apr. 13, 2020), the court joined the majority of courts in holding that assets can be sold to an insider of a debtor free and clear of successor liability claims within the plain meaning of section 363(f) of the Bankruptcy Code.

FREE AND CLEAR BANKRUPTCY SALES

Section 363(b)(1) of the Bankruptcy Code provides in relevant part that "[t]he trustee, after notice and a hearing, may use, sell, or lease, other than in the ordinary course of business, property of the estate." Courts generally apply some form of a business judgment test in determining whether to approve a proposed use, sale, or lease of estate property under section 363(b)(1). *See ASARCO, Inc. v. Elliott Mgmt. (In re ASARCO, L.L.C.)*, 650 F.3d 593, 601 (5th Cir. 2011); *In re Stearns Holdings, LLC*, 607 B.R. 781, 792 (Bankr. S.D.N.Y. 2019); *In re Friedman's, Inc.*, 336 B.R. 891, 895 (Bankr. S.D. Ga. 2005); *see generally* COLLIER ON BANKRUPTCY ("COLLIER") ¶ 363.02 (16th ed. 2020).

Under this deferential standard, a bankruptcy court will generally approve a reasoned decision by a trustee or DIP to use, sell, or lease estate property outside the ordinary course of business. *See In re Alpha Nat. Res., Inc.*, 546 B.R. 348, 356 (Bankr. E.D. Va.), *aff'd*, 553 B.R. 556 (E.D. Va. 2016). However, when a transaction involves an "insider," courts apply heightened scrutiny to ensure that the transaction does not improperly benefit the insider at the expense of other stakeholders. *See In re Alaska Fishing Adventure, LLC*, 594 B.R. 883, 887 (Bankr. D. Alaska 2018); *In re Family Christian, LLC*, 533 B.R. 600, 622, 627 (Bankr. W.D. Mich. 2015).

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," but only if:

1. applicable nonbankruptcy law permits sale of such property free and clear of such interest;
2. such entity consents;
3. such interest is a lien and the price at which such property is to be sold is greater than the aggregate value of all liens on such property;
4. such interest is in bona fide dispute; or
5. such entity could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest.

11 U.S.C. § 363(f). A bankruptcy court's power to order sales free and clear of a competing interest without the consent of the party asserting the interest has been recognized for more than a century. *See Ray v. Norseworthy*, 90 U.S. 128, 131–32 (1875). It promotes the expeditious liquidation of estate assets by avoiding delay caused by sorting out disputes concerning the validity and extent of competing interests, which can later be resolved in a centralized forum. It also facilitates the estate's realization of the maximum value possible from an asset. A prospective buyer would discount its offer significantly if it faced the prospect of protracted litigation to obtain clear title to an asset. *See In re WBQ P'ship*, 189 B.R. 97, 108 (Bankr. E.D. Va. 1995); *accord In re Realia, Inc.*, 2012 WL 833372, at *10 (B.A.P. 9th Cir. Mar. 13, 2012) (noting that that "the purpose of the 'free and clear' language is to allow the debtor to obtain a maximum recovery on its assets in the marketplace"), *aff'd*, 569 F. App'x 544 (9th Cir. 2014).

Holders of such competing "interests" are provided with protections by the Bankruptcy Code. Pending the bankruptcy court's resolution of any disputes, the interest holder is entitled to "adequate protection" of its interest. This most commonly takes the form of a replacement lien on the proceeds of the sale. *See generally* Collier at ¶ 363.06[9].

Courts 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 (such as liens or security interests) or only those claims that have already been asserted at the time the property is sold. *Id.* at ¶ 363.06[1] (noting that "[o]bviously there must be situations in which the interest is something other than a lien; otherwise, section 363(f)(3) would not need to deal explicitly with the case in which the interest is a lien").

Instead, the majority of courts have construed the term broadly to encompass other obligations that may flow from ownership of property, such as leasehold interests. *See 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)); *Precision Indus., Inc. v. Qualitech Steel SBQ, LLC,* 327 F.3d 537 (7th Cir. 2003) (same)).

Many courts have concluded that "successor liability" claims are also included within the scope of section 363(f). *See Ind. State Police Pension Trust v. Chrysler LLC (In re Chrysler LLC)*, 576 F.3d 108 (2d Cir.) (sale of assets to newly formed acquisition entity free and clear of debtor's liability for certain vehicle defects), *vacated on other grounds*, 558 U.S. 1087 (2009); *In re Trans World Airlines, Inc.*, 322 F.3d 283 (3d Cir. 2003) ("*TWA*") (employment discrimination claims arising from conduct prior to a section 363 sale and travel vouchers settling same); *UMWA 1992 Benefit Plan*

v. Leckie Smokeless Coal Co. (In re Leckie Smokeless Coal Co.)*, 99 F.3d 573 (4th Cir. 1996) (debtor coal operators could sell their assets free of successor liability that would otherwise arise under the Coal Industry Retiree Health Benefit Act of 1992); *In re K & D Indus. Servs. Holding Co., Inc.*, 602 B.R. 16 (Bankr. E.D. Mich. 2019) (sale of chapter 11 debtors' assets free and clear of successor liability claims for ERISA withdrawal liability); *In re White Motor Credit Corp.*, 75 B.R. 944, 948, 951 (Bankr. N.D. Ohio 1987) (declining to impose successor liability on an asset purchaser because "[t]he successor liability specter would chill and deleteriously affect sales of corporate assets, forcing debtors to accept less on sales to compensate for this potential liability"); *see also Elliott v. Gen. Motors LLC (In re Motors Liquidation Co.)*, 829 F.3d 135 (2d Cir. 2016) (agreeing that successor liability claims can be "interests" when they flow from a debtor's ownership of transferred assets, but ruling that certain claims were not barred because they had not yet arisen at the time a section 363(f) sale closed and certain other claimants received inadequate notice of the sale); *Olson v. Frederico (In re Grumman Olson Indus., Inc.)*, 445 B.R. 243 (Bankr. S.D.N.Y. 2011) (a section 363 sale order cannot exonerate purchasers from successor liability claims by claimants who, at the time of the sale, had not yet been injured and had no contact or relationship with the debtor or its products).

In *Catalina Sea Ranch*, the bankruptcy court considered whether a chapter 11 debtor could sell substantially all of its assets to an affiliated company free and clear of successor liability claims arising from a boating accident allegedly caused by one of the debtor's fishing vessels.

CATALINA SEA RANCH

Catalina Sea Ranch LLC ("CSR") was a seafood supplier specializing in mussels. After CSR failed to sell its assets by means of an assignment for the benefit of creditors, certain creditors filed an involuntary chapter 7 case against the company, which the bankruptcy court converted to chapter 11 after transferring venue of the case to the Central District of California.

CSR filed a motion to sell substantially all of its assets at auction to Pacific Mariculture, LLC ("Mariculture"), an insider affiliate and a secured creditor, pursuant to sections 363(b) and 363(f). CSR's largest unsecured creditors were the estates of various members of the Poynter family ("Poynters"). They asserted a $10 million wrongful death claim arising from a prepetition shipping accident involving one of CSR's vessels and objected to the sale. They argued that CSR did not provide a sufficient business justification for the sale to an insider at a "bargain basement price" and that the sale should not be free and clear of a "successor liability" claim they intended to pursue against Mariculture.

THE BANKRUPTCY COURT'S RULING

Initially, the bankruptcy court found that, even though CSR's unsecured creditors would not receive any distribution from the estate if the proposed sale to Mariculture were approved, there

was no evidence of favoritism, bad faith, or inadequate consideration in connection with the sale.

Next, the bankruptcy court noted that neither Mariculture nor any other non-debtor (including CSR's insurers and directors) would be released or discharged from any liability under applicable non-bankruptcy law if the sale were approved. Rather, the court wrote, "[t]he only issue presently before the Court is whether the proposed sale of assets will be free and clear of successor liability." 2020 WL 1900308, at *11.

The bankruptcy court explained that, under applicable non-bankruptcy law (California law), the general rule is that a company that acquires the assets of another company does not assume the selling company's liabilities unless:

> (1) there is an express or implied agreement of assumption, (2) the transaction amounts to a consolidation or merger of the two corporations, (3) the purchasing corporation is a mere continuation of the seller, or (4) the transfer of assets to the purchaser is for the fraudulent purpose of escaping liability for the seller's debts.

Id. (quoting *Fisher v. Allis-Chalmers Corp. Prod. Liab. Tr.*, 95 Cal. App. 4th 1182, 1188 (Cal. Ct. App. 2002)). Factors that may be relevant in assessing whether a purchaser is a "mere continuation" of the seller include whether there is inadequate consideration paid or the buyer and the seller have common officers, directors, or stockholders. *Id.* (citing *Ray v. Alad Corp.*, 560 P.2d 3, 7 (Cal. 1977)).

The bankruptcy court concluded that any liability that would otherwise follow assets sold in bankruptcy is an "interest" in the assets within the meaning of section 363(f), in accordance with the dictionary definition of the term, which includes a "legal share in something" and a "claim, share [or] stake." Because successor liability involves a challenge to the sale of estate property free of a claim, the court reasoned, it fits within the common understanding of an "interest," and a bankruptcy sale can be free and clear of successor liability "under the plain meaning of § 363(f)."

According to the bankruptcy court, this conclusion is consistent with other parts of section 363, which indicate that Congress did not intend to limit the scope of "interests" in section 363(f) to ownership interests, liens, or other "narrow types of 'interests'" *Id.* at *12 (citing sections 363(f)(3), 363(g) and 363(h)). It also comports with the rulings of numerous courts, including the Fourth Circuit in *Leckie* and the Third Circuit in *TWA*, where the court stated that "[t]o allow the claimants to assert successor liability claims against [the purchaser] while limiting other creditors' recourse to the proceeds of the asset sale would be inconsistent with the Bankruptcy Code's priority scheme." *TWA*, 322 F.3d at 292.

Finally, the bankruptcy court in *Catalina Sea Ranch* explained, the conclusion that "any interest" within the meaning of section 363(f) includes successor liability is consistent with the broad policy of the Bankruptcy Code to maximize the value of the estate's assets for the benefit of all stakeholders and the important policy considerations underpinning "free and clear" asset sales in bankruptcy. "For all of these reasons," the court wrote, "a sale free and clear of all interests in [a debtor's] property means a sale free and clear of successor liability."

The bankruptcy court accordingly approved the sale to Mariculture under: (i) section 363(f)(1), because California law permitted the sale free and clear of the Poynters' successor liability claim; and (ii) section 363(f)(5), because the claim was "subject to monetary valuation" and the Poynters could be compelled "to accept a money satisfaction" of their claim.

OUTLOOK

The bankruptcy court's rationale in *Catalina Sea Ranch* regarding the applicability of section 363(f) to successor liability claims aligns with the approach taken by the majority of courts that have considered the issue. To maximize the value of the bankruptcy estate for all stakeholders, the scope of "interests" that can be extinguished (albeit subject to provision of adequate protection) by means of free and clear asset sales under section 363(f) has been broadly construed.

BOLSTERING THE MAJORITY RULE: BANKRUPTCY COURT HOLDS THAT ADJUDICATION OF AVOIDANCE LIABILITY IS PREREQUISITE TO DISALLOWANCE OF TRANSFEREE'S CLAIM UNDER SECTION 502(D)

Daniel J. Merrett ■ Mark G. Douglas

The U.S. Bankruptcy Court for the Eastern District of North Carolina recently added some weight to the majority rule on an issue that has long divided bankruptcy and appellate courts. In *In re Southern Produce Distributors, Inc.*, 2020 WL 1228719 (Bankr. E.D.N.C. Mar. 11, 2020), the bankruptcy court held that the claim of a recipient of an avoidable transfer cannot be disallowed under section 502(d) of the Bankruptcy Code, which disallows such claims unless the transferee returns the transferred assets to the estate, until the transferee's avoidance liability has been finally adjudicated.

DISALLOWANCE OF CLAIMS OF AVOIDABLE TRANSFER RECIPIENTS

Section 502(d) of the Bankruptcy Code creates a mechanism to deal with creditors who have possession of estate property on the bankruptcy petition date or are the recipients of pre- or post-bankruptcy asset transfers that can be avoided because they are fraudulent, preferential, unauthorized, or otherwise subject to forfeiture by operation of a bankruptcy trustee's avoidance powers. Section 502(d) provides as follows:

> Notwithstanding subsections (a) and (b) of this section, the court shall disallow any claim of any entity from which property is recoverable under section 542, 543, 550, or 553 of this title or that is a transferee of a transfer avoidable under section 522(f), 522(h), 544, 545, 547, 548, 549, or 724(a) of this title, unless such entity or transferee has paid the amount, or turned over any such property, for which such entity or transferee is liable under section 522(i), 542, 543, 550, or 553 of this title.

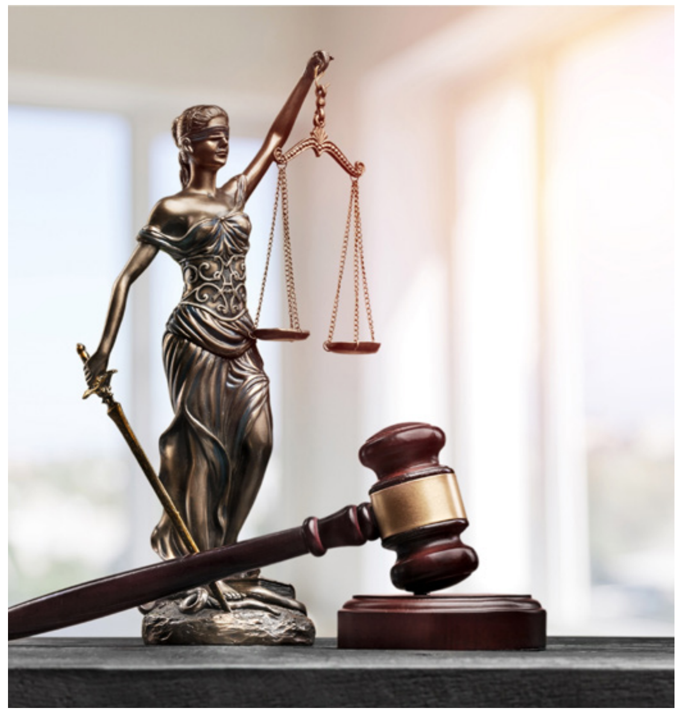
As noted by the U.S. Court of Appeals for the Fifth Circuit in *In re Davis*, 889 F.2d 658, 661 (5th Cir. 1989), "[t]he legislative history and policy behind Section 502(d) illustrates that the section is intended to have the coercive effect of insuring compliance with judicial orders." *See also* H.R. Rep. No. 95-595, at 354 (1978); S. Rep. No. 95-989, at 64 (1978); *accord In re Odom Antennas, Inc.*, 340 F.3d 705, 708 (8th Cir. 2003). The provision "is designed to foster the 'restoration' of assets to a debtor's estate, thereby assuring 'equality of distribution' . . . by precluding anyone who has received a voidable transfer from sharing in any distribution . . . unless he first pays back any preference that he has received." *In re Chase & Sanborn Corp.*, 124 B.R. 368, 371 (Bankr. S.D. Fla. 1991) (citations omitted). Section 502(d) was "not [intended] to punish, but to give creditors an option to keep their transfers (and hope for no action by the trustee) or to surrender their transfers and their advantages and share equally with other creditors." *In re Enron Corp.*, 379 B.R. 425, 435 (S.D.N.Y. 2007) (citations and internal quotation marks omitted).

Much of the controversy in recent years concerning section 502(d) has focused on whether a claim sold or assigned by the recipient of an avoidable transfer is still subject to disallowance in the hands of a "blameless" assignee or acquirer. *Compare In re Arctic Glacier Int'l, Inc.*, 901 F.3d 162, 168 (3d Cir. 2018) (when a claim is transferred, "the transferee assumes the same limitations as the transferor. . . . Otherwise, buyers could revive disallowed claims, laundering them to receive better treatment in new hands."); *In re KB Toys Inc.*, 736 F.3d 247, 252 (3d Cir. 2013) ("because § 502(d) permits the disallowance of a claim that was originally owned by a person or entity who received a voidable preference that remains unreturned, the cloud on the claim continues until the preference payment is returned, regardless of whether the person or entity holding the claim received the preference payment"); *In re Firestar Diamond, Inc.*, 615 B.R. 161 (Bankr. S.D.N.Y. 2020) (agreeing with *KB Toys* and other courts holding that claim disallowance under section 502(d) rests on the claim and not the claim holder) *with Enron Corp. v. Springfield Associates, L.L.C. (In re Enron Corp.)*, 379 B.R. 425, 439 (S.D.N.Y. 2007) (absent a pure assignment or other basis for the transferee to step into the shoes of the transferor, as distinguished from a sale of a claim, "the claim in the hands of the transferee is not subject to equitable subordination or disallowance based solely on the conduct of the transferor").

However, courts also disagree over whether a claim may be disallowed under section 502(d) prior to a final adjudication of the claimant's avoidance liability. Most courts take the approach that the underlying avoidance claims must be adjudicated fully before a claim can be disallowed under section 502(d). *See, e.g., In re Odom Antennas, Inc.*, 340 F.3d 705, 708 (8th Cir. 2003) (the language of section 502(d) indicates that the provision "should be used to disallow a claim after the entity is first adjudged liable; otherwise, the court could not determine if the exception applies"); *accord In re Atlantic Computer Sys.*, 173 B.R. 858, 862 (S.D.N.Y. 1994); *In re Damon's Int'l, Inc.*, 500 B.R. 729, 739 (Bankr. W.D. Pa. 2013); *In re West*, 474 B.R. 191, 201 (Bankr. N.D. Miss. 2012); *In re Metiom, Inc.*, 301 B.R. 634, 641-42 (Bankr. S.D.N.Y. 2003); *In re Lids Corp.*, 260 B.R. 680, 684 (Bankr. D. Del. 2001); *see generally* COLLIER ON BANKRUPTCY ¶ 502.05 (16th ed. 2020).

Some courts, noting that the statute refers to property that is "recoverable" or a transfer that is "avoidable," find that colorable allegations to that effect are sufficient to trigger temporary disallowance for certain purposes (e.g., voting on a plan of reorganization or to receive distributions of estate property), subject to later reconsideration. *See, e.g., Thaler v. Korn*, 2014 WL 1154059, at *8 (E.D.N.Y. Mar. 19, 2014); *In re Circuit City Stores, Inc.*, 426 B.R. 560, 571 (Bankr. E.D. Va. 2010); *In re Enron Corp.*, 340 B.R. 180, 192-93 (Bankr. S.D.N.Y. 2006), *vacated on other grounds,* 379 B.R. 425 (S.D.N.Y. 2007); *see also Ames Dep't Stores, Inc. v. ASM Capital LP (In re Ames Dep't Stores)*, 06 Civ. 0471 (LAK) (S.D.N.Y. Mar. 9, 2006) (unpublished order dismissing appeal of interlocutory order of bankruptcy court providing for temporary disallowance of claims under section 502(d) pending either adjudication of underlying avoidance claims or surrender of property transferred); *In re Miller,* 2019 WL 1112335, at *9 (Bankr. N.D. Ga. Mar. 8, 2019) ("section 502(d) merely requires an objecting party to make a *prima facie* showing the claimant received an unauthorized transfer and, once an avoidable transfer is shown, the court is required to disallow the claim even though the transfer could not be challenged due to the statute of limitations").

The bankruptcy court weighed in on this debate in *Southern Produce*.



SOUTHERN PRODUCE

In April 2018, potato grower, packer, and shipper Southern Produce Distributors, Inc. ("SPD") filed for chapter 11 protection in the Eastern District of North Carolina. Both before and after filing for bankruptcy, SPD did business with other potato growers (collectively, "Growers"), some of which filed claims against SPD for amounts due under prepetition contracts.

Alleging that the Growers failed to satisfy their obligations under postpetition contracts, SPD commenced adversary proceedings against the Growers seeking, among other things, an order pursuant to section 542 of the Bankruptcy Code directing the defendants to turn over estate property in the form of postpetition payments improperly applied to satisfy a portion of the Growers' prepetition claims. SPD also objected to the Growers' claims and sought an order under section 502(d) disallowing the claims. The Growers argued that disallowance was premature because section 502(d) requires, as a prerequisite to disallowance, a ruling that they are subject to turnover liability under section 542.

THE BANKRUPTCY COURT'S RULING

Judge Stephani W. Humrickhouse of the U.S. Bankruptcy Court for the Eastern District of North Carolina ruled that SPD's objections to the Growers' claims under section 502(d) "shall be held in abeyance pending final adjudication of the adversary proceedings." In so ruling, she adopted the majority position on the disallowance of claims under section 502(d).

The court acknowledged the split of authority on this issue but concluded that the minority approach is "not consistent with the spirit of the rule," which is "to foster the 'restoration' of assets to a debtor's estate, thereby assuring 'equality of distribution'" by precluding the recipients of avoidable transfers to share in estate distributions until they return transferred assets to the estate (citations omitted). Considering the intended coercive effect of section 502(d), the court reasoned that the provision "cannot be invoked to ensure the Grower Defendants comply with a judicial order to turn over property to the bankruptcy estate where there has been no such order entered." Thus, because there had been no adjudication of the Growers' liability under section 542, the court continued, "denying the Growers' claims against the debtor's estate is premature."

OUTLOOK

Southern Produce adds to the majority position against pre-adjudication disallowance of claims under section 502(d). This approach is consistent with the purpose of the provision to compel creditors who wish to share in the distribution of bankruptcy estate assets to disgorge any avoided transfers they received as a condition to receiving any recovery on their claims.

SECURED CREDITOR'S "NET ECONOMIC DAMAGES" ESTIMATE OF DISPUTED CLAIMS "PLAINLY INSUFFICIENT" TO ESTABLISH COLLATERAL VALUE

Paul M. Green ■ Mark G. Douglas

Valuation is a critical and indispensable part of the bankruptcy process. How collateral and other estate assets (and even creditor claims) are valued will determine a wide range of issues, from a secured creditor's right to adequate protection, postpetition interest, or relief from the automatic stay to a proposed chapter 11 plan's satisfaction of the "best interests" test or whether a "cram-down" plan can be confirmed despite the objections of dissenting creditors. Depending on the context, bankruptcy courts rely on a wide variety of standards to value estate assets, including retail, wholesale, liquidation, forced-sale, going-concern, or reorganization value.

Certain assets, however, may be especially difficult to value because valuation depends on factors that may be difficult to quantify, such as the likelihood of success in litigating estate causes of action. The U.S. Court of Appeals for the First Circuit recently addressed this issue in *In re Montreal, Maine & Atlantic Railway, Ltd.*, 956 F.3d 1 (1st Cir. 2020) ("*MMA Railway*"). The First Circuit affirmed a ruling that a secured creditor failed to satisfy its burden of establishing that collateral in the form of indemnification claims settled by the estate had any value entitled to adequate protection. According to the court, a showing of possible damages with respect to a disputed claim is not enough. Instead, the creditor must establish the likely validity of the claim and the likelihood of recovery.

VALUATION OF COLLATERAL IN BANKRUPTCY

The Bankruptcy Code classifies a debtor's obligations in terms of "claims" rather than "debts." This means that a creditor who is owed money on the basis of a prebankruptcy transaction is generally treated under the Bankruptcy Code as the holder of either an unsecured prepetition claim or a secured prepetition claim, or sometimes both.

Whether a claim is secured or unsecured is determined in accordance with section 506(a) of the Bankruptcy Code. Section 506(a)(1) provides that a secured creditor's claim is "a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property . . . and is an unsecured claim to the extent that the value of such creditor's interest . . . is less than the amount of such allowed claim." The provision goes on to mandate that "[s]uch value shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property."

The extent to which a claim is secured, therefore, turns on the valuation of the collateral. Section 506(a) is silent, however, as to the valuation method that a court should employ. As noted by the U.S. Court of Appeals for the Third Circuit in *In re Heritage Highgate, Inc.*, 679 F.3d 132 (3d Cir. 2012), the legislative history of section 506(a) suggests that Congress's silence on this point was intentional, to enable bankruptcy courts to "choose the standard that best fits the circumstances of a particular case." *Id.* at 141 (citing H.R. Rep. No. 95–595, at 356 (1977)). Even so, the court wrote, the valuation method should be employed in light of the proposed disposition or use of the collateral, language that is "of paramount importance to the valuation question." *Id.* (citation and internal quotation marks omitted).

Neither section 506(a) nor the Federal Rules of Bankruptcy Procedure allocate the burden of proof as to the value of secured claims. In the absence of any express direction, courts have developed divergent approaches to the issue. *See, e.g.*, *In re SW Bos. Hotel Venture, LLC*, 748 F.3d 393, 408 (1st Cir. 2014) (a secured creditor must demonstrate the value of its collateral under section 506(a) by a preponderance of the evidence); *Heritage Highgate*, 679 F.3d at 139-40 (acknowledging a three-way split of authority regarding the burden of proof as to the value of secured claims under section 506(a), but adopting a "burden-shifting framework" whereby: (i) once a secured creditor has established the validity and amount of its claim, the party challenging the amount of the secured claim bears the initial burden of proof with regard to valuation; and (ii) if the challenger establishes that the secured claim is overvalued because the collateral is of insufficient value, the burden then shifts to the creditor to prove the value of the collateral securing its claim by a preponderance of the evidence); *see generally* COLLIER ON BANKRUPTCY ¶ 506.03[9] (16th ed. 2020).

In *MMA Railway*, the First Circuit considered whether a creditor satisfied its burden of proving the value of certain disputed contractual and regulatory indemnification claims allegedly securing the debtor's obligations.

MMA RAILWAY

In the aftermath of the July 2013 train accident and massive crude oil fire that engulfed Lac-Mégantic, Quebec, killing 48 people, the Montreal, Maine & Atlantic Railway Ltd. ("debtor") filed a chapter 11 petition in the District of Maine as well as an ancillary insolvency proceeding in Quebec for the purpose of liquidating its assets. At the time of the bankruptcy filings, the debtor's secured creditors included Wheeling & Lake Erie Railway Co. ("Wheeling"), which extended a $6 million secured line of credit to the debtor in 2009. Wheeling's collateral included the debtor's "[a]ccounts and other rights to payment (including Payment Intangibles)," which extended to any non-tort claims belonging to the debtor.

Recognizing the likelihood that the estate would face significant liability arising from the train derailment, a chapter 11 trustee appointed for the debtor sued various entities, including Western Petroleum Company ("Western"), the shipper of the crude oil, in an effort to establish a fund for the derailment victims. In a January 2014 adversary proceeding, the trustee alleged that Western negligently mislabeled the crude oil as less volatile than it actually was, causing the debtor to implement inadequate safety measures. The complaint did not state any contract or regulatory claims.

Western and the trustee settled the litigation. As part of the settlement: (i) Western agreed to pay $110 million for the benefit of the derailment victims; (ii) Western and the trustee agreed to release all claims and counterclaims against each other arising from the derailment; and (iii) Western agreed to assign to the debtor's estate any claims it had against other carriers involved in transporting the crude oil. The settlement was conditioned on U.S. and Canadian court approval of the debtor's plan of liquidation.

Wheeling objected to the settlement, claiming that it released the debtor's non-tort claims against Western, including contract and regulatory claims based on indemnification obligations under the bills of lading, and that those claims constituted part of Wheeling's collateral. According to Wheeling, it was entitled to compensation for the release of the non-tort claims as a form of "adequate protection." The bankruptcy court approved the settlement and confirmed the debtor's liquidating chapter 11 plan in 2015. However, the plan and confirmation order reserved Wheeling's right to contest whether its collateral included the released claims.

During a trial of the issue, the parties stipulated that, assuming the contract claims against Western existed: (i) the train derailment caused the debtor to suffer "economic damages" in an amount no less than $25 million; and (ii) had the trustee pursued the claims, the net "economic damages" for breach of contract by Western would not have been less than $10 million after subtracting attorneys' fees and expenses. The stipulation did not address the likelihood that the trustee would prevail on the claims or his ability to collect on any judgment. Wheeling did not offer expert testimony at trial concerning the value of the claims, but instead relied on the stipulation to show that the value of the claims exceeded the face value of its claim against the debtor under the line of credit.

The bankruptcy court ultimately ruled in favor of the trustee. It concluded that the trustee did not use Wheeling's collateral when he agreed to release Western as part of the settlement because the estate did not have any cognizable non-tort claims against Western. Alternatively, the court ruled that Wheeling failed to satisfy its burden of proving the value of the claims.

The district court affirmed on appeal. Wheeling appealed to the First Circuit.

THE FIRST CIRCUIT'S RULING

A three-judge panel of the First Circuit affirmed.

Writing for the panel, Circuit Judge Bruce M. Selya declined to decide "arcane and unsettled" questions of law governing the transport of goods or secured transactions, or to address Wheeling's argument that it was entitled to adequate protection under section 363(e) of the Bankruptcy Code due to the estate's use of Wheeling's non-tort claim collateral. Instead, even assuming that the estate possessed cognizable non-tort claims against Western and that the trustee used Wheeling's collateral when he released the claims as part of the settlement, Judge Selya found "no clear error in the bankruptcy court's finding that Wheeling failed to carry its burden of proving the value of the non-tort claims."

According to Judge Selya, Wheeling's argument was based on the "erroneous premise that the value of a claim is the amount of damages suffered by the claimant, net of prosecution costs." "Valuing a claim, at least for settlement purposes," he wrote, "is not so simple."

To prove damages arising from a disputed claim, Judge Selya explained, the creditor must demonstrate, among other things, the probability of recovery, which depends on "a gallimaufry of factors," including the strength of the evidence, the viability of any defenses, the ability of the defendant to satisfy a judgment, the cost of litigation, and the parties' staying power, relative desire to avoid litigation and bargaining leverage. As such, Judge Selya wrote, "even a claim alleging a substantial figure for damages may have no settlement value at all if the cost, difficulty, or uncertainty of litigation makes it not worthwhile to pursue."

Judge Selya explained that, in this case, "recovery was far from certain" because, if there had been no settlement, Western would have faced significant tort liability based on wrongful death claims, likely leaving it with insufficient assets to satisfy all monetary judgments. According to Judge Selya, Wheeling's stipulated "net economic damages" estimate was "plainly insufficient" to satisfy its burden of proving the value of its collateral. He wrote that Wheeling "offered no evidence that would have allowed the bankruptcy court either to assess [the likelihood of recovery] or to gauge any of the relevant factors other than the estate's potential recovery that may have affected the settlement value of the non-tort claims." Nor did Wheeling offer any expert testimony concerning a range of value for the settlement of non-tort claims.

The First Circuit panel accordingly affirmed the ruling below.

OUTLOOK

MMA Railway is a cautionary tale for secured creditors. Creditors bear the ultimate burden of proof in establishing the value of their collateral under section 506(a) of the Bankruptcy Code—a determination that has important consequences in many contexts in a bankruptcy case. The First Circuit's ruling highlights the importance of building a strong evidentiary record to support valuation. It also indicates that certain types of collateral (e.g., disputed litigation claims) are more difficult to value than others.

Interestingly, Wheeling's decision to pursue its appeal for more than five years after the bankruptcy court confirmed the debtor's liquidating chapter 11 plan in 2015 is curious. The plan provided that Wheeling's secured claim would be paid in full (and was therefore unimpaired) from the proceeds of the sale of its collateral. Although it is not evident from the district court and First Circuit opinions, the proceeds of the sale of Wheeling's collateral other than the contractual and regulatory indemnification claims must not have been sufficient to satisfy Wheeling's $6 million secured claim in full.

NEWSWORTHY

Corinne Ball ***(New York)*** received the 2020 Lifetime Achievement Award from the *New York Law Journal* ("*NYLJ*") for making "an impact on the legal community and the practice of law over an entire career." The *NYLJ* announced its 2020 awards on June 30, will feature the recipients in its upcoming *Professional Excellence Magazine*, and will honor them at the New York Legal Awards on October 27, 2020. Ms. Ball has nearly 40 years of experience in business finance and restructuring, with a focus on c omplex corporate reorganizations and distressed acquisitions. She co-leads the New York Office of Jones Day's Business Restructuring & Reorganization Practice and leads the Firm's European Distress Investing and Alternative Capital Initiatives. She also leads the Firm's distressed M&A efforts and is the featured "Distress M&A" columnist for the *NYLJ*.

Fabienne Beuzit ***(Paris)*** and ***Isabelle Maury*** ***(Paris)*** were recognized in the 2021 edition of *The Best Lawyers in France*™ in the field of Insolvency and Reorganization Law.

Heather Lennox ***(Cleveland and New York)*** and ***Corinne Ball*** ***(New York)*** were named "Leading Lawyers" in the field of "Finance—Restructuring (including bankruptcy): corporate" in *The Legal 500 United States* 2020.

Dr. Olaf Benning ***(Frankfurt)*** was recognized in the 2021 edition of *The Best Lawyers in Germany*™ in the field of Restructuring and Insolvency Law.

Bruce Bennett ***(Los Angeles and New York)*** was named a "Leading Lawyer" in the fields of "Finance—Restructuring (including bankruptcy): corporate" and "Finance—Restructuring (including bankruptcy): municipal" in *The Legal 500 United States* 2020.

An article written by ***Brett P. Barragate*** ***(New York)*** and ***Kay V. Morley*** ***(London)*** titled "Cross-Border Restructurings Case Study: syncreon" was the "feature story" in the May 2020 issue of *The Secured Lender*.

Joshua K. Brody ***(New York)*** was named a "Next Generation Partner" in the field of "Finance: Restructuring (including bankruptcy): corporate" in *The Legal 500 United States* 2020.

On April 28, 2020, ***Thomas M. Wearsch*** ***(Cleveland)*** gave a presentation titled "Anatomy of a Distressed Supplier Situation" to the Legal Issues Council of the Association of Original Equipment Suppliers at its annual meeting. On June 24, 2020, he gave a presentation regarding "Navigating the Minefield of Emerging Corporate Governance Issues in Complex Restructurings" at the Association of Insolvency and Restructuring Advisors' annual conference.

An article written by ***Carl E. Black*** ***(Cleveland)***, ***Mark J. Andreini*** ***(Cleveland)***, and ***Jonathan Noble Edel*** ***(Cleveland)*** titled "Creditors at the Gate: How Good Are Your Indemnities and D&O Insurance?" was published in the June 2020 issue of *Pratt's Journal of Bankruptcy Law*.

An article written by ***Charles M. Oellermann*** ***(Columbus)*** and ***Mark G. Douglas*** ***(New York)*** titled "Use of Cash Collateral to Pay Prepetition Debt Not Prohibited by *Jevic*" was published in the June 26, 2020, issue of the International Law Office's *Insolvency and Restructuring Newsletter*.

An article written by ***Dan T. Moss*** ***(Washington)*** and ***Heather Lennox*** ***(Cleveland and New York)*** titled "Temporary Suspension of Bankruptcy Cases During Pandemic" appeared in the May 1, 2020, edition of *Bloomberg Law*.

An article written by ***Corinne Ball*** ***(New York)*** titled "Release and Waiver by an LLC Debtor of Its Affiliated Lenders Bars Subsequent Suit" was published in the June 24, 2020, edition of the *NYLJ*.

An article written by ***Dan T. Moss*** ***(Washington)*** and ***Mark G. Douglas*** ***(New York)*** titled "Post-*Taggart*, Ninth Circuit BAP Holds that No Fair Ground of Doubt Standard Applies to Automatic Stay Violations" was published on May 12, 2020, in *Lexis Practice Advisor*.

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