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BUSINESS RESTRUCTURING REVIEW

THE YEAR IN BANKRUPTCY: 2020

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One year ago, we wrote that the large business bankruptcy landscape in 2019 was generally shaped by economic, market, and leverage factors, with notable exceptions for disastrous wildfires, liabilities arising from the opioid crisis, price-fixing fallout, and corporate restructuring shenanigans.

The year 2020 was a different story altogether. The headline was COVID-19.

The pandemic may not have been responsible for every reversal of corporate fortune in 2020, but it weighed heavily on the scale, particularly for companies in the energy, retail, restaurant, entertainment, health care, travel, and hospitality industries. Mandatory shutdowns beginning in the spring of 2020 wreaked havoc on the bottom lines of thousands of companies confronting a precipitous drop in demand for their products and services. Some were able to weather the worst of the storm with packages of government assistance or by adapting their business models to meet the unique challenges of the pandemic. Others could not and either closed their doors or sought bankruptcy protection to attempt to restructure their balance sheets or sell their assets.

BUSINESS BANKRUPTCY FILINGS

According to data provided by Epiq AACER, there were 32,506 commercial bankruptcy filings in 2020, compared to 39,050 in 2019—a 26% decrease. By contrast, commercial chapter 11 filings increased by 29% in 2020 to 7,128, compared to 5,519 in 2019. The 2020 commercial chapter 11 filing total was the highest since the 7,789 filings registered in 2012. Recognition of a foreign bankruptcy proceeding under chapter 15 was sought on behalf of 221 commercial debtors in 2020, compared to 113 in 2019.

S&P Global Market Intelligence reported that U.S. corporate bankruptcies reached their highest levels in a decade in 2020 as the pandemic upended global industries and struggling companies faced their breaking points. A total of 630 public companies with either assets or liabilities valued at $2 million, or private companies with public debt and at least $10 million in assets or liabilities, declared bankruptcy in 2020, compared to 578 in 2019. This surpassed the number of such filings in every year since 2010, when there were 800. The top five sectors represented by the filings were consumer discretionary, industrials, energy, health care, and consumer staples.

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PUBLIC COMPANY BANKRUPTCIES

According to New Generation Research, Inc.'s BankruptcyData.com, bankruptcy filings for "public companies" (defined as companies with publicly traded stock or debt) reached the highest level in more than a decade in 2020. The number of public company bankruptcy filings in 202 was 110, compared to 64 in 2019. At the height of the Great Recession, 138 public companies filed for bankruptcy in 2008 and 211 in 2009.

The combined asset value of the 110 public companies that filed for bankruptcy in 2020 was $292.7 billion, compared to $150 billion in 2019. By contrast, the 138 public companies that filed for bankruptcy in 2008 had prepetition assets valued at $1.2 trillion in aggregate.

Companies in the oil and gas sector led the charge in public company bankruptcy filings in 2020, with 26% (29 cases) of the year's 110 public company bankruptcies. Thirteen of the 30 largest public company bankruptcy filings in 2020 came from the oil and gas sector. Other sectors with a significant number of public company filings in 2020 included retail (14 cases), health care (seven cases), pharmaceuticals (six cases), and entertainment, software, and airlines (four cases each).

The year 2020 added 51 public company names to the billion-dollar bankruptcy club (measured by value of assets), compared to 21 in 2019.

The largest public company bankruptcy filing of 2020—car rental company The Hertz Corporation, with $25.8 billion in assets—was the 24th largest public company bankruptcy case of all time. By asset value, the largest public company bankruptcy filings in 2020 also included air carrier LATAM Airlines Group S.A. ($21 billion in assets); specialty finance company Emergent Capital, Inc. ($17.5 billion in assets); telecommunications provider Frontier Communications Corporation ($17.4 billion in assets); natural gas production company Chesapeake Energy Corporation ($16.2 billion in assets); offshore drilling services company Valaris plc ($13 billion in assets); satellite services provider Intelsat S.A. ($11.6 billion in assets); pharmaceutical company Mallinckrodt plc ($9.6 billion in assets); and oilfield service company McDermott International, Inc. ($8.8 billion in assets).

Twenty-five public companies with assets valued at more than $1 billion obtained confirmation of chapter 11 plans or exited from bankruptcy in 2020. Continuing a trend begun in 2012, many more of those companies reorganized than were liquidated or sold.

More than half of the chapter 11 plans confirmed in 2020 by billion-dollar public companies were in prepackaged or prenegotiated bankruptcy cases. As in 2019, the "rapid-fire prepack" was in vogue in 2020. In 2019, women's plus-size retailer Fullbeauty Brands Inc. and information technology company Sungard Availability Services Capital Inc. established new records when they obtained bankruptcy court approval of prepackaged chapter 11 plans in 24 and 19 hours, respectively. In 2020, in-store music and interactive mobile marketing services provider Mood Media Corp. set a new record when it not only obtained confirmation of a plan in less than a day but emerged from bankruptcy in just 31 hours.

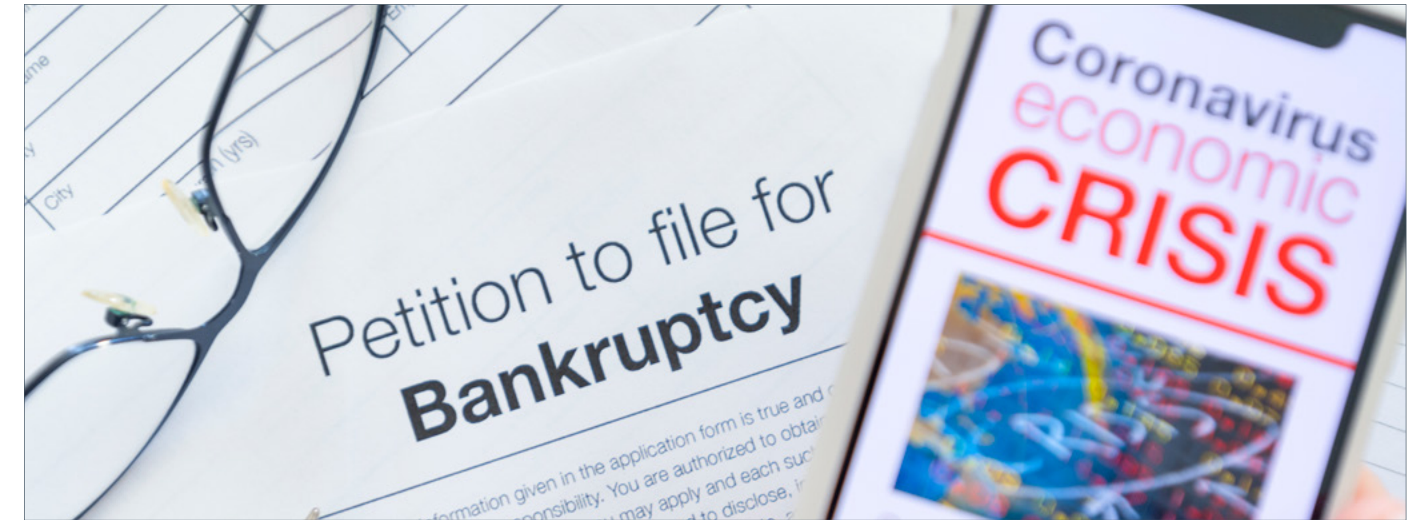
NOTABLE BANKRUPTCY RULINGS

Notable court rulings in 2020 examined: (i) the bankruptcy "safe harbor" protecting payments made as part of certain securities transactions from avoidance as fraudulent transfers; (ii) the payment of claims for "make-whole" premiums under a chapter 11 plan; (iii) the enforcement of contractual subordination agreements under a plan; (iv) debtor-in-possession financing; (v) rent relief during bankruptcy for commercial tenants due to the pandemic; and (vi) the rejection in bankruptcy of executory contracts regulated by the Federal Energy Regulatory Commission ("FERC").

Securities Transactions Safe Harbor. In 2019, the U.S. Court of Appeals for the Second Circuit made headlines when it ruled in *In re Tribune Co. Fraudulent Conveyance Litig.,* 946 F.3d 66 (2d Cir. 2019), *petition for cert. filed,* 2020 WL 3891501 (U.S. July 6, 2020), that creditors' state law fraudulent transfer claims arising from the 2007 leveraged buyout of Tribune Co. were preempted by the safe harbor for certain securities, commodity, or forward contract payments set forth 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 held in *Holliday v. K Road Power Management, LLC (In re Boston Generating LLC),* 617 B.R. 442 (Bankr. S.D.N.Y. 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 debtors as part of a pre-bankruptcy recapitalization transaction were protected from avoidance under section 546(e) because, for that section's purposes, the debtors were "financial institutions," as customers of banks that acted as their depositories and agents in connection with the transaction.

The U.S. District Court for the Southern District of New York joined the *Tribune* bandwagon in *In re Nine W. LBO Sec. Litig.,* 2020 WL 5049621 (S.D.N.Y. Aug. 27, 2020), *appeal filed,* No. 20-3290 (2d Cir. Sept. 25, 2020). The court dismissed $1.1 billion in fraudulent transfer and unjust enrichment claims brought by a chapter 11 plan litigation trustee and an indenture trustee against the debtor's shareholders, officers, and directors. Citing *Tribune*, the district court ruled that the payments were protected by the section 546(e) safe harbor because they were made by a bank



acting as Nine West's agent. According to the court, "[w]hen, as here, a bank is acting as an agent in connection with a securities contract, the customer qualifies as a financial institution with respect to that contract, and all payments in connection with that contract are therefore safe harbored under Section 546(e)."

In *SunEdison Litigation Trust v. Seller Note, LLC (In re SunEdison, Inc.),* 2020 WL 6395497 (Bankr. S.D.N.Y. Nov. 2, 2020), the U.S. Bankruptcy Court for the Southern District of New York invoked section 546(e) to dismiss a chapter 11 plan litigation trustee's complaint seeking to avoid and recover alleged constructive fraudulent transfers made by a subsidiary of renewable-energy development company SunEdison, Inc., in connection with the acquisition of a wind and solar power generation project. According to the court, even though the trustee sought to avoid part of a two-step transaction that did not involve an agent financial institution, the "overarching transfer" was made as part of an "integrated transaction" insulated from avoidance under the safe harbor.

In *Fairfield Sentry Limited (In Liquidation) v. Theodoor GGC Amsterdam (In re Fairfield Sentry Ltd.),* 2020 WL 7345988 (Bankr. S.D.N.Y. Dec. 14, 2020), the U.S. Bankruptcy Court for the Southern District of New York applied the *Tribune* rationale in a chapter 15 case to dismiss claims under British Virgin Islands ("BVI") law to recover "unfair preferences" and "undervalue transactions" asserted by the liquidators of foreign feeder funds that invested in Bernard L. Madoff Investment Securities LLC. According to the court, redemption payments made to investors in the funds were safe harbored under section 546(e) in accordance with *Merit* and *Tribune* because, among other things, the BVI law claims were constructive, rather than intentional, fraudulent transfer claims, and the funds were "financial institutions," as the customers of the banks that made the redemption payments as the funds' agent.

In *In re Greektown Holdings, LLC,* 2020 WL 6218655 (Bankr. E.D. Mich. Oct. 21, 2020), *reh'g denied*, 2020 WL 6701347 (Bankr. E.D. Mich. Nov. 13, 2020), the U.S. Bankruptcy Court for the Eastern District of Michigan ruled that a pre-bankruptcy recapitalization transaction involving the issuance of notes underwritten by a financial institution and payment of a portion of the proceeds to parties later sued in avoidance litigation fell outside the section 546(e) safe harbor because: (i) neither the transferor nor the transferees were financial institutions in their own right; (ii) the defendants failed to establish that the transaction was "for the benefit" of the underwriter financial institution by showing that it "received a direct, ascertainable, and quantifiable benefit corresponding in value to the payments"; and (iii) the evidence did not show that the underwriter was acting as either the transferor's agent or custodian in connection with the transaction, such that the transferor itself could be deemed a financial institution.

In *In re Lehman Bros. Holdings Inc.*, 2020 WL 4590247 (2d Cir. Aug. 11, 2020), the U.S. Court of Appeals for the Second Circuit held that section 560 of the Bankruptcy Code, which creates a safe harbor for the liquidation of swap agreements, prevented a debtor from recovering payments made to certain noteholders in accordance with a priority-altering "flip clause" in agreements governing a collateralized debt obligation transaction. According to the court, even if the provisions were "*ipso facto*" clauses that are generally invalid in bankruptcy in other contexts, section 560 creates an exception to this rule in connection with the liquidation of swap agreements.

Make-Whole Premiums and Postpetition Interest. In *In re Ultra Petroleum Corp.*, 2020 WL 6276712 (Bankr. S.D. Tex. Oct. 26, 2020), direct appeal certified, No. 16-32202 (Bankr. S.D. Tex. Dec. 1, 2020) [Docket No. 1897], the U.S. Bankruptcy Court for the Southern District of Texas issued a long-awaited ruling on whether Ultra Petroleum Corp. must pay a make-whole premium to noteholders under its confirmed chapter 11 plan and whether the noteholders were entitled to postpetition interest on their claims. The bankruptcy court held that: (i) the make-whole premium was not disallowed under section 502(b)(2) of the Bankruptcy Code as "unmatured interest" or its "economic equivalent" but represented liquidated damages enforceable under New York law; and (ii) the

noteholders were entitled to postpetition interest on their claims at the contractual default rate, rather than the federal judgment rate, in accordance with the "solvent-debtor exception."

Enforcement of Subordination Agreements in a Chapter 11 Plan. In *In re Tribune Co.*, 972 F.3d 228 (3d Cir. 2020), the U.S. Court of Appeals for the Third Circuit ruled that a debtor's confirmed chapter 11 plan did not unfairly discriminate against senior noteholders who contended that their distributions were reduced because the plan improperly failed to strictly enforce pre-bankruptcy subordination agreements. The court held that a nonconsensual chapter 11 plan that does not enforce a subordination agreement does not necessarily discriminate unfairly against a class of creditors that would otherwise benefit from subordination. The Third Circuit agreed with the lower courts that the "immaterial" reduction in the senior noteholders' recovery did not rise to the level of unfair discrimination.

Bankruptcy Financing. In *In re LATAM Airlines Grp. S.A.*, 2020 WL 5506407 (Bankr. S.D.N.Y. Sept. 10, 2020), the U.S. Bankruptcy Court for the Southern District of New York initially refused to approve a proposed debtor-in-possession financing agreement involving insider shareholders, finding that the agreement was a prohibited "*sub rosa*" chapter 11 plan because it provided that the debtor could elect to repay the shareholder loan with discounted stock in lieu of cash and effectively prevented confirmation of any plan other than the debtor's. However, after the parties modified the financing agreement to remove the equity election feature, the bankruptcy court approved it.

In *GPIF Aspen Club LLC v. Aspen Club Spa LLC (In re Aspen Club Spa LLC)*, 2020 WL 4251761 (B.A.P. 10th Cir. July 24, 2020), a Tenth Circuit bankruptcy appellate panel ruled that section 364(d)(1) of the Bankruptcy Code could not be used to approve chapter 11 plan exit financing that primed the liens of an existing secured lender, and it remanded the case to the bankruptcy court to determine whether the cram-down plan provided the primed lender with the "indubitable equivalent" of its secured claim.

Commercial Rent Relief During the Pandemic. In response to the devastating impact of the pandemic on restaurants, retailers, and other "nonessential" businesses forced to shutter or severely curtail their operations, many bankruptcy courts deployed their statutory and equitable powers during 2020 to defer or suspend timely payment of rent and other expenses that would otherwise be obligatory under the Bankruptcy Code. *See, e.g., In re Hitz Restaurant Group*, 616 B.R. 374, 379 (Bankr. N.D. Ill. June 3, 2020) (due to a *force majeure* clause in a lease, abating the debtor's rent payments "in proportion to its reduced ability to generate revenue due to the executive order"); *In re Bread & Butter Concepts, LLC*, No. 19-22400 (DLS) [Docket 219] (Bankr. D. Kan. May 15, 2020) (holding that "these unprecedented circumstances require flexible application of the Bankruptcy Code and exercise of the Court's equitable powers ... to grant further relief" such as deferring rent payments); *In re True Religion Apparel, Inc.*, No. 20-10941 (CSS) (Bankr. D. Del. May 12, June 22, and Aug. 7, 2020) [Docket Nos. 221; 367; 465] (extending time to perform rent obligations for four months by order extending for 60 days and two additional orders, each extending for additional 30-day increments); *In re Pier 1 Imports, Inc.*, 2020 WL 2374539 (Bankr. E.D. Va. May 10, 2020) (delaying debtors' payment of certain accrued but unpaid rent during a "limited operations period" when their stores were closed due to stay-at-home orders entered in connection with the pandemic); *In re CraftWorks Parent, LLC*, No. 20-10475 (BLS) (Bankr. D. Del. Mar. 30, 2020) [Docket No. 217] (temporarily suspending certain aspects of a chapter 11 case under section 105(a)); *In re Modell's Sporting Goods, Inc.*, No. 20-14179 (VFP) [Docket Nos. 166, 294, and 371] (Bankr. D.N.J. Mar. 27, Apr. 30 and June 5, 2020) (suspending a bankruptcy case under sections 105 and 305 and deferring payment of nonessential expenses, including rent obligations).

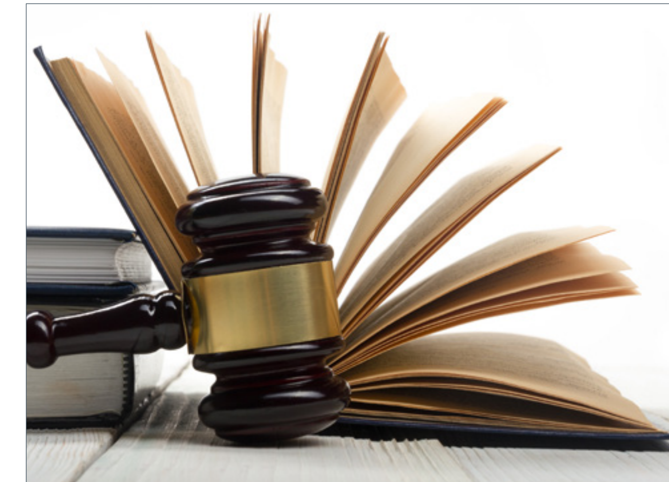
However, some courts concluded that their equitable powers could not be used to circumvent the express language of the Bankruptcy Code mandating the payment of rent. *See, e.g., In re CEC Entertainment Inc.*, 2020 WL 7356380 (Bankr. S.D. Tex. Dec. 14, 2020) (denying a chapter 11 debtor's motion for a further abatement of rent and holding that: (i) a court cannot use its equitable powers to override section 365(d)(3)'s unequivocal rent payment requirement; and (ii) *force majeure* clauses in the leases did not excuse timely payment of rent due to the pandemic or government shutdown orders).

Rejection of Natural Gas Agreements in Bankruptcy. In a leading precedent—*Sabine Oil & Gas Corp. v. Nordheim Eagle Ford Gathering, LLC (In re Sabine Oil & Gas Corp.)*, 734 Fed. Appx. 64 (2d Cir. May 25, 2018)—the U.S. Court of Appeals for the Second Circuit upheld rulings authorizing a chapter 11 debtor to reject certain natural gas gathering and handling agreements under section 365 of the Bankruptcy Code. According to the Second Circuit, the agreements could be rejected because, under Texas law, they contained neither real covenants "running with the land" nor equitable servitudes that would continue to burden the affected property even if the agreements were rejected.

In 2020, bankruptcy courts in Delaware and Texas joined the fray in the ongoing debate on this issue.

In *Extraction Oil & Gas, Inc. v. Platte River Midstream, LLC and DJ South Gathering, LLC (In re Extraction Oil & Gas, Inc.)*, 2020 WL 6694354 (Bankr. D. Del. Oct. 14, 2020), Chief Judge Christopher S. Sontchi of the U.S. Bankruptcy Court for the District of Delaware entered a declaratory judgment that certain gas transportation service agreements did not create covenants running with the land under Colorado law and could therefore be rejected in bankruptcy, because the agreements did not "touch and concern" the land but merely dealt with hydrocarbons after they were produced from the debtor's real property.

In *In re Extraction Oil & Gas, Inc.*, 2020 WL 6389252 (Bankr. D. Del. Nov. 2, 2020), *stay pending appeal denied*, No. 20-01532 (D. Del. Dec. 7, 2020), Judge Sontchi authorized the debtor to reject the gas transportation service agreements, ruling that: (i) even if the agreements created covenants that run with the land, the agreements could still be rejected, after which any covenants would be unenforceable against the debtor and its assigns; (ii) the "business judgment" test rather than "heightened scrutiny" should be applied to the debtor's request to reject the agreements; and (iii) there is "no prohibition on or limitation against rejecting a [FERC] approved contract" under section 365(a) of the Bankruptcy Code.



In *In re Chesapeake Energy Corp.*, 2020 WL 6325535 (Bankr. S.D. Tex. Oct. 28, 2020), the U.S. Bankruptcy Court for the Southern District of Texas authorized the debtor to reject a natural gas production agreement after concluding that the agreement did not create a covenant running with the land or an equitable servitude under Texas law because it expressly indicated that the debtor did not intend to create any such encumbrances or to convey a real property interest but merely conveyed an interest in produced gas.

In *Southland Royalty Company LLC, v. Wamsutter LLC (In re Southland Royalty Company LLC)*, 2020 WL 6685502 (Bankr. D. Del. Nov. 13, 2020), Judge Karen B. Owens of the U.S. Bankruptcy Court for the District of Delaware ruled that gas gathering agreements did not contain covenants running with the land or equitable servitudes under Wyoming law but were merely service contracts relating to the debtor's personal property (produced gas), and that, even if they did, the debtor could either reject the agreements or sell its assets free and clear of any associated covenants. Following rejection, the court noted, the contract counterparty would have a prepetition claim against the estate for damages resulting from the debtor's nonperformance.

In *In re Ultra Petroleum Corp.*, 2020 WL 4940240 (Bankr. S.D. Tex. Aug. 21, 2020), the U.S. Bankruptcy Court for the Southern District of Texas granted the debtors' motion to reject a FERC-regulated gas transportation agreement. Addressing the standard for rejection, the court held that a bankruptcy court should engage in a fact-intensive analysis of whether the rejection of the agreement would lead to direct harm to the public interest through an "interruption of supply to consumers" or a "readily identifiable threat to health and welfare," none of which was shown to exist in this case. The court wrote that it "is not authorized to graft a wholesale exception to § 365(a) of the Bankruptcy Code ... preventing rejection of FERC approved contracts." It further noted that, whether the rejection of such a contract is "good or bad public policy" must be decided by Congress and not by the court or FERC.

LEGISLATIVE DEVELOPMENTS

Much of the bankruptcy legislative activity during 2020 was understandably focused on alleviating the impact of the pandemic. Enacted legislation and executive orders included:

The Coronavirus Aid, Relief, and Economic Security ("CARES") Act. Signed into law on March 27, 2020, as an initial response to the economic fallout of the pandemic, the CARES Act created a $600 unemployment bonus that lasted until July 31, 2020, for those who lost their jobs as a result of the shutdowns due to COVID-19. The law also set up the Paycheck Protection Program ("PPP") to provide up to $659 billion to small businesses to pay up to eight weeks of payroll costs, mortgage interest, rent, and utilities. Originally set to expire on June 30, 2020, the PPP was extended to August 8, 2020, after which it lapsed. The CARES Act also provided temporary relief for federal student loan borrowers by deferring student loan payments for six months without penalty.

The Consolidated Appropriations Act, 2021 ("CAA"). Signed into law on December 27, 2020, the CAA was a $2.3 trillion spending bill that combined $900 billion in stimulus relief for the pandemic with a $1.4 trillion omnibus spending bill for the 2021 federal fiscal year. The CAA was one of the largest spending measures ever passed by Congress. It provided for $600 in direct payments to millions of Americans, as well as $300 per week in supplemental federal unemployment benefits for 11 weeks. It also included: (i) $284 billion to revive the lapsed PPP, along with additional small-business aid; (ii) $15 billion in payroll support to airlines; (iii) $25 billion in rental assistance and eviction moratoriums; and (iv) a ban on most surprise medical bills.

The CAA also included various bankruptcy-related provisions for both consumer and business debtors. The business bankruptcy provisions included:

- Amendment of sections 501 and 502 of the Bankruptcy Code, which govern the filing and allowance of claims, to implement a procedure for creditors to file proofs of claim for amounts lost due to forbearance periods mandated by the CARES Act.
- Amendment of section 365(d)(3), which obligates a debtor to continue performing its obligations under an unexpired lease of nonresidential real property, to provide that debtors in subchapter V small business chapter 11 bankruptcy cases may ask the court to provide an additional 60-day delay (120 days total) to pay rent if the debtor is experiencing a material financial hardship due to the pandemic. Landlord claims arising from an extension will be treated as administrative

expenses for purposes of confirming a subchapter V small business plan.

- Amendment of section 365(d)(4), which provides that an unexpired lease of nonresidential real property is deemed rejected unless assumed by the trustee or the chapter 11 debtor-in-possession ("DIP") within 120 days following the filing of the bankruptcy case, to increase the period to 210 days. Under the pre-amendment provision, the court already had the power to increase this period by 90 days. Thus, under the amendment, a trustee or DIP can have up to 300 days to decide whether to assume or reject a lease.
- Amendment of section 547 of the Bankruptcy Code, which governs the avoidance of pre-bankruptcy preferential transfers, to protect from avoidance certain deferred payments made by a debtor after March 13, 2020, to nonresidential real property landlords and suppliers of goods and services.

Amendments to the Small Business Reorganization Act of 2019 ("SBRA"). Even though the SBRA, which created a new subchapter V of chapter 11 of the Bankruptcy Code for small businesses, became effective on February 19, 2020, Congress amended the law shortly afterward to increase the eligibility threshold for businesses filing under the new subchapter so that it could be available to a greater number of small business debtors.

Other Bankruptcy Code Amendments Benefitting Individual Debtors. These included amendments to the Bankruptcy Code: (i) excluding coronavirus-related payments from the federal government from the definition of "income" for the purposes of determining eligibility to file for chapters 7 and 13; (ii) clarifying that the calculation of disposable income for the purpose of confirming a chapter 13 plan does not include coronavirus-related payments; and (iii) permitting chapter 13 debtors to seek payment plan modifications if they are experiencing a material financial hardship due to the pandemic.

Executive Orders. President Trump issued executive orders on August 8, 2020, to address some of the concerns related to the pandemic financial crisis. They included measures providing an additional $400 ($300 in federal funds, $100 contingent on state participation) in weekly unemployment benefits to replace the expired $600-per-week unemployment bonus, suspending certain student loan payments, protecting some renters from eviction, and deferring payroll taxes.

Several other pieces of bankruptcy legislation were introduced in the 116th Congress but were never enacted, although many of them are likely to be reintroduced in 2021. These included bills that would implement the most significant consumer bankruptcy reforms since 2005, make student loans dischargeable in bankruptcy, significantly increase the federal-scheme homestead exemption, and protect employees and retirees in business bankruptcy cases.

FOCUS ON HEALTH CARE PROVIDER BANKRUPTCIES

Mark A. Cody ■ Mark G. Douglas

After reaching a four-year high in 2018, the volume of heath care and medical industry bankruptcy filings in the United States continues to be significant. According to statistics provided by New Generation Research's bankruptcydata.com, as of the end of 2020, bankruptcies in health care and medical sector companies—including hospitals, physicians' offices and clinics, specialty outpatient facilities, assisted-living facilities, and other providers—numbered 752, of which 458 were chapter 11 filings, compared to 678 total filings (405 chapter 11 cases) in 2019, and 937 total filings (668 chapter 11 cases) in 2018. With the special challenges posed by the COVID-19 pandemic, other industries (i.e., real estate, restaurant, construction, oil and gas, and entertainment) led the way in the number of bankruptcy filings in 2020. Even so, health care provider bankruptcies still made up a large part of the total volume, in part because providers have been hit hard during the pandemic by plummeting revenue due to the curtailment of elective surgical procedures and physician visits. In addition, elder care facilities criticized for their substandard response to the crisis have faced litigation and increased government regulation.

Other than pandemic-driven issues, the financial woes of health care providers can be attributed to a number of factors, including continuing uncertainty concerning the possible collapse, replacement, or defunding of the Affordable Care Act; increased competition; the need for investment in additional personnel and technology; the erosion of profitability due to the evolution from a "fee for service" payment model to a "bundle of services" payment model; liquidity problems caused by government payment disputes; operational changes; and increased pharmaceutical costs. These and other factors have led an increasing number of financially distressed providers to consider bankruptcy as a vehicle for effectuating closures, consolidation, restructurings, and related transactions.

Even if a health care provider seeks bankruptcy protection, its ability to continue operating or consummate a sale of its assets is by no means assured. In part, this is because government authorities have routinely taken the position in the bankruptcy courts that: (i) Medicare and Medicaid provider agreements cannot be sold or assigned without payment of associated liabilities, such as overpayment claims; (ii) government withholding of Medicare and Medicaid payments after a provider files for bankruptcy to recover pre-bankruptcy overpayments is excepted from the automatic stay under the "police and regulatory powers" exception; and (iii) government authorities are not prohibited by the automatic stay from recouping pre-bankruptcy overpayment claims or other liabilities from post-bankruptcy Medicare or Medicaid program payments. Each of these issues has been addressed in recent court rulings.

For example, in some cases generating controversy, courts have held that health care debtors can sell provider agreements in bankruptcy "free and clear" of associated liabilities, but those rulings were later vacated due to settlement of the issues or abandonment of the sale transaction. *See, e.g., In re Verity Health Sys. of California, Inc.*, 606 B.R. 843 (Bankr. C.D. Cal. Sept. 26, 2019) (a provider agreement is a "statutory entitlement" that may be sold under section 363(f) of the Bankruptcy Code free and clear of the debtor provider's liabilities, including overpayments, rather than an executory contract that could be assumed and assigned only if such liabilities were cured), *vacated*, 2019 WL 7288754 (Bankr. C.D. Cal. Dec. 9, 2019); *In re Center City Healthcare, LLC*, No. 19-11466 (KG) (Bankr. D. Del. Sept. 10, 2019) (same), *appeal dismissed and order vacated sub nom. U.S.A. v. Center City Healthcare, LLC (In re Center City Healthcare, LLC)*, No. 19-01711 (D. Del. Mar. 17, 2020).

With respect to the second issue discussed above, a bankruptcy court rejected the government's position and held that government withholding of Medicare and Medicaid payments after a provider files for bankruptcy to recover pre-bankruptcy overpayments is not excepted from the automatic stay. *See True Health Diagnostics LLC v. Azar (In re THG Holdings LLC)*, 604 B.R. 154 (Bankr. D. Del. 2019) (ruling that the "police and regulatory powers" exception to the stay in section 362(b)(4) of the Bankruptcy Code did not apply where the evidence indicated that the government withheld the payments to protect its pecuniary interest over the interests of other unsecured creditors and nothing suggested that the government's actions were an effort to enforce public policy), *appeal dismissed*, 2020 WL 1493622 (D. Del. Mar. 27, 2020).

The third high-profile issue in health care bankruptcy cases noted above—whether government authorities are prohibited from offsetting or recouping overpayment claims or other liabilities against Medicare or Medicaid program payments—was the subject of a recent decision by the U.S. Court of Appeals for the Ninth Circuit in *In re Gardens Regional Hosp. and Medical Ctr., Inc.*, 975 F.3d 926 (9th Cir. 2020). The court reversed in part lower court rulings permitting the State of California to recoup certain fees owed by the debtor hospital from various payments that the state was obligated to make to the debtor under its Medicaid program.

RECOUPMENT AND SETOFF UNDER PROVIDER AGREEMENTS

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

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

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

42 U.S.C. § 1395g(a). The provider is legally obligated to return any overpayments.

If a provider files for bankruptcy before remitting overpayments to CMS or a regional agency, the automatic stay may or may not prevent actions by CMS or the agency to recover the overpayments. The answer to this question largely depends on whether the attempted recovery represents a "setoff" or a "recoupment." Both are equitable doctrines that predated the enactment of the Bankruptcy Code, but only setoff is expressly recognized in the statute. Section 553(a) provides that, subject to 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."

Thus, for a creditor to be able to exercise setoff rights in bankruptcy, section 553(a) requires on its face that: (i) the creditor has a right of setoff under applicable nonbankruptcy law; (ii) the debt and the claim are "mutual"; and (iii) both the debt and the claim arose prepetition. Although some courts have permitted the setoff of mutual *postpetition* debts (*see, e.g., 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)), the remedy 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).

The Bankruptcy Code does not define "mutual." However, debts are generally understood to be mutual when they are due to and from the same persons or entities in the same capacity. See COLLIER on Bankruptcy ("COLLIER") ¶ 553.03[3] (16th ed. 2020). With exceptions for certain kinds of financial contracts, post-bankruptcy setoff under section 553 of the Bankruptcy Code is subject to the automatic stay (see 11 U.S.C. §§ 362(a)(7), 362(b)(6), and 362(b)(7)), but the bankruptcy court will generally permit it 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).

Many courts have concluded that setoff applies only to debts arising from separate transactions, although the issue is murky. *See* COLLIER at ¶ 553.10. By contrast, if mutual prepetition debts arise from the *same* transaction, the creditor may have a right of "recoupment," which has been defined as "a deduction from a money claim through a process whereby cross demands arising out of the same transaction are allowed to compensate one another and the balance only to be recovered." *Westinghouse Credit Corp. v. D'Urso*, 278 F.3d 138, 146 (2d Cir. 2002); *accord Newbery Corp. v. Fireman's Fund Ins. Co.*, 95 F.3d 1392, 1399 (9th Cir. 1996) (recoupment is "the setting up of a demand arising from the same transaction as the plaintiff's claim or cause of action, strictly for the purpose of abatement or reduction of such claim"); *In re Matamoros*, 605 B.R. 600, 610 (Bankr. S.D.N.Y. 2019) ("recoupment is in the nature of a defense and arises only out of cross demands that stem from the same transaction"). Unlike setoff, recoupment is not subject to the automatic stay (see *In re Ditech Holding Corp.*, 606 B.R. 544, 600 (Bankr. S.D.N.Y. 2019)) and may involve both pre- and postpetition obligations. *See Sims v. U.S. Dep't of Health and Human Services (In re TLC Hosps., Inc.)*, 224 F.3d 1008, 1011 (9th Cir. 2000) (citing COLLIER at ¶ 553.10).

Courts disagree as to what constitutes the "same transaction" in distinguishing setoff from recoupment. See COLLIER at ¶ 553.10[1] ("Not surprisingly, in the absence of a common understanding of the requirement, courts do not always agree on what kinds of obligations qualify as arising out of the "same transaction."). They have generally applied one of two approaches to this question:

- The "logical relationship test" articulated by the U.S. Supreme Court in *Moore v. New York Cotton Exchange*, 270 U.S. 593, 610 (1926), where the Court stated that the concept of a "'[t]ransaction' is [one] of flexible meaning. It may comprehend a series of many occurrences, depending not so much upon the immediateness of their connection as upon their logical relationship." Under this standard, a court will allow "a variety of obligations to be recouped against each other, requiring only that the obligations be sufficiently interconnected so that it would be unjust to insist that one party fulfill its obligation without requiring the same of the other party." COLLIER at ¶ 553.10[1]. The Ninth Circuit adopted this approach in *Newbery*.
- The more restrictive "integrated transaction test," under which the obligations in question must "arise out of a single integrated transaction so that it would be inequitable for the debtor to enjoy the benefits of the transaction without also meeting its obligations." *In re Univ. Med. Ctr.*, 973 F.2d 1065, 1081 (3d Cir. 1992); *accord Malinowski v. New York State Dep't of Labor (In re Malinowski)*, 156 F.3d 131 (2d Cir. 1998).

Many courts have concluded that a provider's participation in the Medicare program involves a single, integrated, and ongoing transaction between the government and the provider, such that the government's recovery of overpayments is a recoupment rather than a setoff. *See, e.g., In re Slater Health Ctr., Inc.*, 398 F.3d 98 (1st Cir. 2005); *In re Holyoke Nursing Home, Inc.*, 372 F.3d 1 (1st Cir. 2004); *In re Doctors Hosp. of Hyde Park, Inc.*, 337 F.3d 951 (7th Cir. 2003); *Sims*, 224 F.3d at 1011; *United States v. Consumer Health Servs. of Am., Inc.*, 108 F.3d 390 (D.C. Cir. 1997). *But see Univ. Med. Ctr.*, 973 F.2d at 1081 (reasoning that because each government payment provides compensation for services performed in a set time span, each payment concerned different services rendered and thus constituted a separate transaction).

The Ninth Circuit examined recoupment and setoff with respect to Medicaid overpayments in *Gardens Regional Hospital*.

GARDENS REGIONAL HOSPITAL

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

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

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

By July 2016, the State had recovered all of the unpaid prepetition HQA fees as a result of its withholding. However, the State continued withholding because the debtor failed to pay postpetition HQA fees. During the case, the State withheld a total of approximately $4.3 million in HQA payments and Medi-Cal payments and applied the withheld funds to unpaid HQA fees. Even with the withholding, the debtor still owed more than $2.5 million in postpetition HQA fees.

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

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

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

> For recoupment purposes, a transaction may include a series of many occurrences, depending not so much upon the immediateness of their connection as upon their logical relationship, … provided that the "logical relationship" test is not applied so loosely that multiple occurrences in any one continuous commercial relationship would constitute one transaction.

The court found that a "logical relationship" existed between the HQA fees and the HQA payments because, without HQA fees, the State could not collect federal matching funds in an amount sufficient to make HQA payments. According to the bankruptcy court, even though different statutory formulas are used to calculate HQA fees and HQA payments, a "fundamental logical connection" exists between them.

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

THE NINTH CIRCUIT'S RULING

A three-judge panel of the Ninth Circuit affirmed in part, reversed in part, and remanded the case below.

Writing for the panel, Circuit Judge Daniel P. Collins explained that, after adopting the logical relationship test in *Newbery*, the Ninth Circuit in *Sims* expressly rejected "the Third Circuit's narrow definition of 'transaction'" in *Univ. Med. Ctr.* because it "improperly gave dispositive weight to the temporal immediacy of the countervailing claims rather than to their logical relationship." Moreover, quoting *Sims*, he wrote that, although the same transaction requirement has a "flexible meaning," the logical relationship test should not "be applied so loosely that multiple occurrences in any continuous commercial relationship would constitute one transaction."

The Ninth Circuit concluded that the State properly recouped the debtor's HQA fees from the HQA payments. According to Judge Collins:

> In view of the strong logical relationship among payment streams that is reflected in these unique features of the [HQA fee program], we conclude that this "distinctive … system" of continuously managing hospital payments into segregated funds against hospital payments out of those same funds is properly treated as "a single transaction" for purposes of recoupment.

However, the Ninth Circuit reached the opposite conclusion regarding the Medi-Cal payments, ruling that those deductions constituted a setoff barred by the automatic stay. Judge Collins explained that the legal and factual connections linking the HQA fees and the HQA payments were "simply not present" with respect to the Medi-Cal payments, which were not drawn from the same segregated fund as the HQA fees. According to him, "[t]o recognize a logical relationship between the [HQA fees] and the [Medi-Cal payments] would be to ignore *Sims*'s admonition that the "'logical relationship' concept is not to be applied so loosely that multiple occurrences in any continuous commercial relationship would constitute one transaction."

In so ruling, the Ninth Circuit rejected the State's argument that it was entitled to recoup everything owing to the debtor-hospital because state law and the provider agreement specifically allowed the State to deduct unpaid HQA fees owed by a hospital to the HQA fund from any Medi-Cal payments or other state payments owed to the hospital. "Were we to accept [the State's] contention that its statutory assertion of such a sweeping right of setoff alone establishes a sufficient logical relationship to warrant recoupment," Judge Collins wrote, "we would effectively obliterate the distinction between recoupment and setoff" and exempt the State from the Bankruptcy Code's restrictions on setoff.

The Ninth Circuit accordingly reversed the lower courts' determination that the State was permitted to recoup the HQA fees from the Medi-Cal payments and remanded the case below.

OUTLOOK

The Ninth Circuit's ruling in *Gardens Regional Hospital* is instructive regarding the distinction between the two most common approaches applied to the setoff/recoupment issue. Although the Ninth Circuit's "logical relationship" approach may be more flexible than the Third Circuit's bright-line "integrated transaction" test, *Gardens Regional Hospital* illustrates that it may be more difficult to apply, particularly in situations involving ongoing payments under Medicare and Medicaid provider agreements. This and other rulings are also emblematic of the aggressive strategy adopted by government authorities in many health care provider bankruptcy cases.

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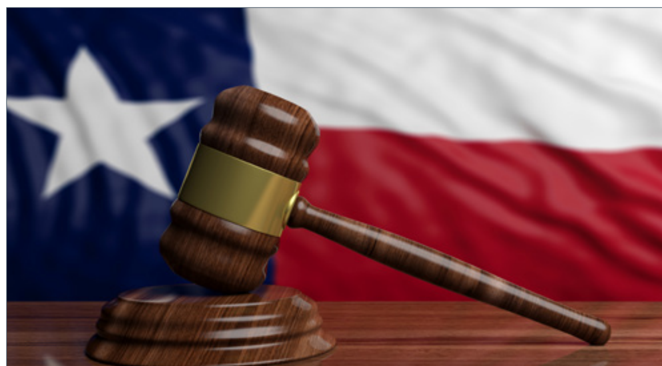

TEXAS BANKRUPTCY COURT ALLOWS MAKE-WHOLE PREMIUM AS LIQUIDATED DAMAGES AND REQUIRES SOLVENT CHAPTER 11 DEBTOR TO PAY POSTPETITION INTEREST

Brad B. Erens ▪ **Mark G. Douglas**

On October 26, 2020, the U.S. Bankruptcy Court for the Southern District of Texas issued a long-awaited ruling on whether natural gas exploration and production company Ultra Petroleum Corp. ("UPC") must pay a make-whole premium to noteholders under its confirmed chapter 11 plan and whether the noteholders are entitled to postpetition interest on their claims pursuant to the "solvent-debtor exception." On remand from the U.S. Court of Appeals for the Fifth Circuit, the bankruptcy court answered "yes" on both counts, adding yet another chapter to a debate that has long occupied bankruptcy and appellate courts in this and other chapter 11 cases. *See In re Ultra Petroleum Corp.*, 2020 WL 6276712 (Bankr. S.D. Tex. Oct. 26, 2020).

In particular, the bankruptcy court held that: (i) the contractual make-whole premium was not disallowed under section 502(b)(2) of the Bankruptcy Code as "unmatured interest" or its "economic equivalent" but, rather, represented liquidated damages enforceable under New York law; and (ii) the noteholders were entitled to interest on their claims at the contractual default rate, rather than the federal judgment rate, in accordance with the "solvent-debtor exception," which "has been widely recognized, both before and after adoption of the Bankruptcy Code" and is "rooted in the principle that the solvent debtor must pay its creditors in full before the debtor may recover a surplus."

ULTRA PETROLEUM

UPC issued approximately $1.5 billion in unsecured notes from 2008 to 2010. The note agreement, which was governed by New York law, provided that UPC had the right to prepay the notes at 100% of principal plus a make-whole amount. The make-whole amount was calculated by subtracting the accelerated principal from the discounted value of the future principal and interest payments. Events of default under the agreement included a bankruptcy filing by UPC. In that event, failure to pay the outstanding principal, any accrued interest, and the make-whole amount immediately triggered the obligation to pay interest at a higher default rate specified in the note agreement.

UPC filed for chapter 11 protection in April 2016. Improving business conditions during the course of the case allowed UPC to seek confirmation of a chapter 11 plan that provided for the payment in cash of all unsecured claims in full. The plan designated the noteholders' claims as "unimpaired" but did not provide for the payment of the make-whole amount and would pay postpetition interest on the notes at the federal-funds rate rather than the default rate. UPC contested the noteholders' right to receive the make-whole amount. The parties agreed that postpetition interest should be paid on the noteholders' claims, but they disagreed on the appropriate rate. The plan distributed new common stock in the reorganized entity to UPC's existing shareholders.

In its plan confirmation ruling, the bankruptcy court decided that under New York law, the make-whole amount was an enforceable liquidated damages provision, rather than an unenforceable penalty. The court rejected UPC's arguments that the make-whole amount was "conspicuously disproportionate to foreseeable losses at the time the parties entered" into the note agreement because it would result in a double recovery.

The court also held that UPC's chapter 11 plan impaired the noteholders' claims because the plan failed to provide for the payment of the make-whole amount and postpetition default-rate interest. The court rejected UPC's position that, because the make-whole amount represented "unmatured interest" and was not allowable under section 502(b)(2), the plan left the noteholders' rights under the Bankruptcy Code unaltered, and the noteholders' claims were therefore unimpaired under section 1124(1).

The bankruptcy court certified a direct appeal of its order to the Fifth Circuit, which agreed to hear the appeal.

In *In re Ultra Petroleum Corp.*, 913 F.3d 533 (5th Cir. 2019) ("*Ultra I*"), the Fifth Circuit ruled that the make-whole premium constituted "unmatured interest" disallowed by section 502(b)(2) and that, because the Bankruptcy Code, rather than UPC's chapter 11 plan itself, disallowed the noteholders' claim for a make-whole premium and postpetition interest at the contractual default rate, the noteholders' claims were not "impaired" for purposes of confirming the plan.

However, the Fifth Circuit acknowledged in *Ultra I* that the noteholders' claim for a make-whole premium might still be allowed because UPC was solvent. According to the court, "the creditors can recover the Make-Whole Amount if (but only if) the solvent-debtor exception survives Congress's enactment of § 502(b)(2)."

Prior to the enactment of the Bankruptcy Code, the Fifth Circuit explained, there existed a "solvent-debtor exception" to the disallowance of interest accruing after the filing of a bankruptcy petition derived from English law. The exception provided that

interest would continue to accrue on a debt after a bankruptcy filing if the creditor's contract expressly provided for it and that interest would be payable if the bankruptcy estate contained sufficient assets to pay it after satisfying other debts. According to the Fifth Circuit, in such cases the post-bankruptcy interest was treated as part of the underlying debt obligation, as distinguished from interest "on" a creditor's claim that might be allowed by the provisions of a bankruptcy statute.

The Fifth Circuit further explained that the Bankruptcy Code contains several exceptions to the general principal that upon a bankruptcy filing, unmatured interest is disallowed under section 502(b)(2). For example, section 506(b) provides that an oversecured creditor is entitled to interest during the bankruptcy case at the contract rate. Further, in a chapter 7 case, the distribution scheme set forth in section 726 designates as fifth in priority of payment interest on allowed unsecured claims "at the legal rate" (which has been interpreted to mean the federal statutory rate for interest on judgments set by 28 U.S.C. §1961). Thus, if the estate in a chapter 7 case is sufficient to pay claims of higher priority, creditors are entitled to postpetition interest before the debtor can recover any surplus.

In a chapter 11 case, the chapter 7 priority scheme can apply under section 1129(a)(7). Referred to as the "best interests" test, section 1129(a)(7) mandates that, unless each creditor in an impaired class accepts a chapter 11 plan, the creditor must receive at least as much under the plan as it would in a chapter 7 liquidation of the debtor.

The Fifth Circuit emphasized, however, that each of these provisions is a statutory grant of postpetition interest "on a claim," rather than an allowance of postpetition interest accruing as part of the claim itself. According to the court, disallowance of the latter type of interest is absolute pursuant to section 502(b)(2), unless the pre-Bankruptcy Code solvent-debtor exception allowing postpetition interest as part of a claim survived the enactment of section 502(b)(2).

The Fifth Circuit doubted that it survived. Even so, the court noted, the bankruptcy court's resolution of the Bankruptcy Code versus chapter 11 plan impairment question prevented it from considering whether "Congress chose not to codify the solvent-debtor rule as an absolute exception to § 502(b)(2)" or whether lawmakers' silence on that score in 1978 should be presumed as an indication that certain long-established bankruptcy principles should remain undisturbed. The Fifth Circuit accordingly remanded the case below to make that determination. It also remanded the case to the bankruptcy court for additional findings regarding the appropriate rate of postpetition interest.

After agreeing to rehear the case, the Fifth Circuit partially vacated its decision in *Ultra I*. *See In re Ultra Petroleum Corp.*, 943 F.3d 758 (5th Cir. 2019) ("*Ultra II*"). In *Ultra II*, the court reaffirmed its previous ruling regarding impairment but again remanded the case below to determine whether the make-whole premium was disallowed under section 502(b)(2) as unmatured interest, whether the noteholders were entitled to postpetition interest under the "solvent-debtor exception," and, if so, at what rate.

THE BANKRUPTCY COURT'S RULING ON REMAND

At the outset of its opinion on remand, the bankruptcy court framed the issues before it as: (i) "does the Bankruptcy Code disallow a contractual claim for [a make-whole premium] when an interest-bearing obligation is prepaid?"; and (ii) "does the Bankruptcy Code permit a solvent debtor to forego contractual obligations to an unimpaired class of unsecured creditors, but still pay a distribution to its shareholders?" The courts answered "no" on both counts.

The Make-Whole Premium Was Liquidated Damages Rather than Unmatured Interest. Addressing the first issue, the bankruptcy court explained that, because the Bankruptcy Code defines neither "interest" nor "unmatured interest" (as used in section 502(b)(2) or elsewhere), those terms must be defined according to their ordinary meanings under applicable nonbankruptcy law. According to the court, the ordinary meaning of "interest" is "*consideration for the use or forbearance of another's money accruing over time*," and "unmatured interest" means "*consideration for the use or forbearance of another's money, which has not accrued or been earned as of a reference date.*" In bankruptcy, the reference date is the date of entry of the order for relief (which is the petition date in voluntary cases).

The court rejected the noteholders' argument that the make-whole premium matured due to acceleration. In this case, the court explained, "whether interest is matured at the moment of filing is determined without reference to acceleration clauses triggered by a bankruptcy petition."

However, the bankruptcy court concluded that the make-whole premium was not interest because it did not compensate the noteholders for UPC's use or forbearance of the noteholders' money but, instead, "compensate[d] the [noteholders] for the cost of reinvesting in a less favorable market." It further explained that, in an unfavorable market, UPC's decision not to use the noteholders' money would cause them to suffer damages, which the make-whole premium liquidated. The court also wrote that "[t]he Make-Whole Amount is not unmatured interest simply because it could equal zero when reinvestment rates are high." Moreover, the make-whole premium did not accrue over time but, rather, "is a one-time charge which fixes the [noteholders'] damages when it is triggered."

Because the make-whole premium was not interest, the court wrote, "it is also not unmatured interest" or its "economic equivalent," which the court defined as "in economic reality, … the economic substance of unmatured interest," such as unamortized original issue discount on bonds. Instead, the bankruptcy court ruled that the make-whole premium was an enforceable liquidated damages clause under New York law, and accordingly, "it forms part of the [noteholders'] allowed claims."

The Solvent-Debtor Exception Survives. Next, the bankruptcy court held that, because UPC was solvent, it was obligated to pay postpetition interest to the noteholders. It wrote that, according to the legislative history, "Congress gave no indication that it intended to erode the solvent debtor exception" when it enacted the Bankruptcy Code. Moreover, "[e]quitable considerations" continue to support it, including the policy against allowing a windfall at the expense of creditors to any debtor that can afford to pay all of its debts.

According to the court, this conclusion is also supported by post-Bankruptcy Code court rulings involving solvent debtors as well as the removal from the Bankruptcy Code in 1994 of section 1124(3), which did not require the payment of postpetition interest on claims to render a class of creditors unimpaired under a chapter 11 plan, and therefore deemed to accept it, even though more junior classes would receive value under the plan. In short, the court wrote, there is a "'monolithic mountain of authority,' developed over nearly three hundred years in both English and American courts, holding that a solvent debtor must make its creditors whole" (quoting *Ultra II*, 943 F.3d at 760).

The court explained that, standing alone, neither section 105(a) of the Bankruptcy Code (giving the bankruptcy court broad equitable power), section 1129(a)(7) ("best interests" test), nor section 1129(b)(1) (requiring a cram-down chapter 11 plan to be "fair and equitable" with respect to dissenting impaired classes of creditors) is a statutory source for the solvent-debtor exception. Instead, the court wrote, "piecing these Bankruptcy Code provisions together," the solvent-debtor exception flows through section 1124(1), which provides that, to render a class of claims unimpaired, a plan must leave unaltered the claimants' "legal, equitable, and contractual rights." According to the court, "[b]ecause an unimpaired creditor has equitable rights to be treated no less favorably than an impaired creditor and to be paid in full before the debtor realizes a recovery, a plan denying post-petition interest in a solvent debtor case alters the equitable rights of an unimpaired creditor under § 1124(1)."

Finally, the bankruptcy court held that the default contract rate was the appropriate rate of interest, rather than the federal judgment rate. The court explained that the noteholders' right to postpetition interest was based on "two key equitable rights"—the right to receive no less favorable treatment than impaired creditors and the right to have their contractual rights fully enforced. According to the court, if the noteholder class were paid interest at the federal judgment rate, it would be worse off than if it were impaired under UPC's plan because "even though the [noteholders] would receive identical interest as a hypothetical impaired class, as an unimpaired class the Claimants were deprived of the right to vote for or against the plan." In addition, the court noted, limiting the noteholder class to interest at the federal judgment rate would contravene the purpose of the solvent-debtor exception, which dictates that when a debtor is solvent, "a bankruptcy court's role is merely to enforce the contractual rights of the parties."

OUTLOOK

The circuit courts of appeals have come to conflicting conclusions over the allowance of make-whole premiums in bankruptcy. The Third Circuit allowed a make-whole premium in *Delaware Trust Co. v. Energy Future Intermediate Holding Co. LLC (In re Energy Future Holdings Corp.)*, 842 F.3d 247 (3d Cir. 2016). The Second Circuit disallowed one in *BOKF NA v. Momentive Performance Materials Inc. (In re MPM Silicones LLC)*, 874 F.3d 787 (2d Cir. 2017), *cert. denied*, 138 S. Ct. 2653 (2018), but because the make-whole never became payable under the relevant terms of the notes. In *Ultra Petroleum*, the bankruptcy court noted that *MPM* is distinguishable because the Second Circuit "was not presented with the question of whether a make-whole is unmatured interest." Therefore, it wrote, to the extent the Second Circuit appeared to say that make-whole premiums are disallowed, it is *dicta*.

The bankruptcy court's ruling regarding the solvent-debtor exception is notable. However, whether it will be embraced by courts adhering to a "plain language" approach to the relevant provisions of the Bankruptcy Code is an open question. Moreover, given the relative rarity of solvent-debtor chapter 11 cases, the issue may not be subject to extensive scrutiny.

Finally, the court's determination that the unsecured creditors of a solvent debtor are entitled to interest at the contract rate, rather than the federal funds rate, is controversial. Several other courts have ruled to the contrary. *See In re Cardelucci*, 285 F.3d 1231 (9th Cir. 2002); *In re Beguelin*, 220 B.R. 94 (B.A.P. 9th Cir. 1998); *In re Cuker Interactive LLC*, 2020 WL 7086066 (Bankr. S.D. Cal. Dec. 3, 2020); *In re Pacific Gas & Electric Co.*, 610 B.R. 308 (Bankr. N.D. Cal. 2019).

The bankruptcy court certified a direct appeal of his ruling on remand to the Fifth Circuit on November 30, 2020. As such, the Fifth Circuit will have yet another opportunity to consider whether the make-whole premium in *Ultra Petroleum* should be allowed.

ENERGY SECTOR UPDATE: MORE BANKRUPTCY COURTS JOIN THE FRAY IN DISPUTE OVER REJECTION OF GAS GATHERING AGREEMENTS

Paul M. Green ■ Mark G. Douglas

In a leading precedent handed down in 2018—*Sabine Oil & Gas Corp. v. Nordheim Eagle Ford Gathering, LLC (In re Sabine Oil & Gas Corp.)*, 734 Fed. Appx. 64 (2d Cir. May 25, 2018)—the U.S. Court of Appeals for the Second Circuit upheld rulings authorizing a chapter 11 debtor to reject certain executory gas gathering and handling agreements under section 365 of the Bankruptcy Code. According to the Second Circuit, the lower courts did not err in finding that the agreements could be rejected because, under applicable nonbankruptcy law, the agreements contained neither real covenants "running with the land" nor equitable servitudes that would continue to burden the affected property even if the agreements were rejected.

Since then, bankruptcy courts in Colorado, Texas, and Delaware have joined the fray in the debate on this issue. As discussed in more detail below, their findings and conclusions on the real covenants question varied due to the facts of the cases and the applicable state law. However, in a notable development, some of these courts have ruled that the answer to this question does not matter for the purpose of determining whether a gathering agreement can be rejected in bankruptcy. Instead, those courts have held that a gathering agreement can be rejected (or sold free and clear) even if it creates a covenant that runs with the land under applicable law.

SABINE OIL

In *Sabine Oil*, the debtors filed a motion to reject three gas gathering and handling agreements governed by Texas law. The counterparties argued that the relevant hydrocarbon dedications in the agreements were covenants running with the land that would survive rejection. Under Texas law, at least four conditions must be met for a covenant to run with the land: (i) it "touches and concerns the land"; (ii) it relates to a thing in existence or specifically binds the parties and their assigns; (iii) the covenant is intended by the original parties to run with the land; and (iv) the successor to the burden has notice of the covenant. A covenant "touches and concerns" land if it: (i) reduces the promisor's legal relations or increases the promisee's legal relations with respect to the land; or (ii) affects the nature, quality, or value of the subject of the covenant or affects the mode of enjoying it. Some courts have held that a fifth requirement—"horizontal privity of estate," meaning a mutual or successive relationship to the same rights in property—is also required. The bankruptcy court approved rejection of the gathering agreement over the counterparties' objections.

On appeal, the Second Circuit ultimately concluded that it need not determine whether the gas gathering agreements at issue touched and concerned the land, "because we find that Texas still requires horizontal privity and that it was not satisfied in this case." The court rejected the argument that horizontal privity of estate is established through separate agreements conveying a pipeline easement and a separate parcel of land. The Second Circuit also rejected the argument that the agreements created equitable servitudes amounting to a property interest that could not be rejected under section 365 because there was no benefit to any real property owned by the non-debtor counterparties.

BADLANDS ENERGY

After filing for chapter 11 in 2017 in Colorado, Badlands Production Company ("Badlands") sought court authority to sell its oil and gas assets, including a gas gathering and processing agreement and a saltwater disposal agreement (collectively, "agreements") with Monarch Midstream, LLC ("Monarch"), free and clear of liens, claims, encumbrances, and interests under sections 363(b) and 363(f) of the Bankruptcy Code. The sale agreement with the proposed purchaser—Wapiti Utah, L.L.C. ("Wapiti")—provided that Wapiti would not assume the agreements or any other contracts with Monarch as part of the sale. Monarch responded by filing an adversary proceeding seeking a declaratory judgment that Wapiti could not purchase the assets free and clear of the agreements because the agreements were covenants that ran with the land.

The U.S. Bankruptcy Court for the District of Colorado ruled in favor of Monarch. Initially, the court noted that, despite a Colorado choice of law provision, Utah law governed whether the agreements constituted real covenants because the oil and gas assets were located in Utah. Under Utah law, a covenant runs with the land if: (i) the covenant "touches and concerns" the land; (ii) the parties intend the covenant to run with the land; (iii) there is "privity of estate"; and (iv) the covenant is in writing. *See Monarch Midstream, LLC v. Badlands Production Company (In re Badlands Energy Utah LLC)*, 608 B.R. 854 (Bankr. D. Colo. 2019).

The bankruptcy court found that the agreements "touched and concerned" the land under Utah law because Badlands's interests in the associated oil and gas leases were "diminished" by the agreements, and the burdens imposed by the agreements consequently impacted Badlands's use and enjoyment of its interests in the leases. In addition, both of the agreements expressly provided that the covered dedications and commitments were covenants running with the land and that any successors and assigns were bound by their terms.

The bankruptcy court distinguished *Sabine.* It explained that *Sabine* involved a "very different dedication"—the agreements in *Sabine* concerned personal property rather than real property under Texas law because they covered only minerals extracted from the ground (the dedication was for "all [gas and condensate] produced and saved … from wells … located within the dedicated area"). By contrast, the court noted, the dedicated reserves in the agreements were interests in real property under Utah law, not personalty, because they included "non-extracted minerals," even though one of the objectives of the agreements was the gathering, processing and disposal of "produced gas" and water, which are not real property interests under Utah law.

The court further concluded that vertical, mutual and horizontal privity of estate existed because: (i) Wapiti was the successor to the estate of the original entity burdened by the covenant; (ii) Badlands and Monarch held simultaneous ownership interests in the covered oil and gas leases; and (iii) the covenants in the agreements burdened Badlands' real property interests in connection with a simultaneous conveyance of real property interests to Monarch.

The bankruptcy court accordingly ruled that "the [a]greements are part of the bundle of sticks [Wapiti] acquired when it purchased the [oil and gas assets], and they are not subject to elimination utilizing Section 363(f)."

ALTA MESA

In 2015, upstream oil and gas producer Alta Mesa Holdings, LP ("AM") entered into oil and gas gathering agreements with Kingfisher Midstream, LLC ("Kingfisher") to construct a gathering system linking AM's Oklahoma wells to central collection points in exchange for fixed gathering fees. Under the agreements, AM conveyed to Kingfisher "any easement or rights-of-way for purposes of constructing, owning, operating, repairing, replacing and maintaining any portion" of the gathering system. In addition, the agreements provided that they were "covenants running with the land" that the parties were obligated to record, and that any assignee or transferee was bound by their terms.

After filing for chapter 11 protection in 2019 in Texas, AM sought a declaratory judgment that it could reject the gathering agreements. Kingfisher argued that the agreements could not be rejected because they were real property covenants rather than executory contracts.

Chief Judge Marvin Isgur of the U.S. Bankruptcy Court for the Southern District of Texas ruled in Kingfisher's favor, concluding that the agreements satisfied all of the requirements under Oklahoma law for the creation of real property covenants. *See Alta Mesa Holdings, LP v. Kingfisher Midstream, LLC (In re Alta Mesa Resources, Inc.)*, 613 B.R. 90 (Bankr. S.D. Tex. 2019). First, the gathering agreements "touched and concerned" the AM oil and gas leases because the benefits and burdens of the covenants were "logically connected to [AM's] leasehold interests in real property." Among other things, Judge Isgur found that: (i) the surface easement limited AM's possessory interest in its leases by restricting AM's use of the surface land for drilling or exploration and by restricting AM's use of its reserves; (ii) by dedicating nearly all of its production to Kingfisher, AM burdened its interest under the oil and gas leases because it restricted AM's right to seek a different gatherer or build its own gathering system; and (iii) the fixed fee arrangement burdened the leases because the oil and gas produced by AM would be less profitable than it might be on more favorable terms or in a less depressed oil and gas market. On this point, the bankruptcy court distinguished *Sabine*, where the court found that the surface easement did not touch and concern the mineral estate under Texas law because the surface and mineral estates were separate and the dedication was limited to post-extraction hydrocarbons. In this case, the *Alta Mesa* court wrote, "in the context of an oil and gas lease, the surface easement is integral to the lessee's ability to realize the value of its mineral reserves."

Second, the bankruptcy court found that privity of estate existed between AM and Kingfisher because: (i) the parties, which were the original signatories to the gathering agreements, did not dispute that vertical privity existed; and (ii) even if horizontal privity is required to create a real property covenant under Oklahoma law, the conveyance of a surface easement to Kingfisher to construct and maintain a gathering system was adequate to show the conveyance of an estate ("a property interest in [AM's] leasehold estates") necessary for a finding of horizontal privity.

Third, the *Alta Mesa* court found that, considering the express language of the gathering agreements and other evidence of the parties' course of dealing, AM and Kingfisher intended for the covenant to run with the land.

The bankruptcy court accordingly ruled that the gathering agreements were not executory and could not be rejected by AM.

EXTRACTION OIL & GAS

Extraction Oil & Gas, Inc. ("EOG") is a Colorado-based oil and gas producer. Prior to filing for chapter 11 protection on June 14, 2020, in Delaware, it entered into transportation service agreements ("Agreements") with various midstream counterparties, including Elevation Midstream, LLC, Platte River Midstream, LLC ("Platte"), DJ South Gathering, LLC, Grand Mesa Pipeline, LLC ("Mesa" and, collectively, the "counterparties"), to transport hydrocarbons directly to market in Oklahoma and dispose of wastewater generated by its operations. In connection with a proposed bankruptcy sale of substantially all of its assets, EOG sought court authority to reject the Agreements, and commenced adversary proceedings against the counterparties seeking declaratory judgments that the Agreements did not create covenants running with the land under Colorado law. EOG moved for summary judgment in each of the proceedings.

Chief Judge Christopher S. Sontchi of the U.S. Bankruptcy Court for the District of Delaware granted summary judgment to EOG. Initially, he noted that Colorado law "disfavors the creation of covenants running with the land as a derogation of the common law's preference for the free alienability of land." To create a covenant running with the land under Colorado law, he explained: (i) the parties must intend to create a covenant running with the land; (ii) the covenant must touch and concern the land with which it runs; and (iii) there must be privity of estate between the original covenanting parties at the time of the covenant's creation. *See Extraction Oil & Gas, Inc. v. Elevation Midstream, LLC (In re Extraction Oil & Gas, Inc.)*, Adv. Proc. No. 20-50839 (CSS) (Bankr. D. Del. Oct. 14, 2020); *Extraction Oil & Gas, Inc. v. Platte River Midstream, LLC and DJ South Gathering, LLC (In re Extraction Oil & Gas, Inc.)*, 2020 WL 6694354 (Bankr. D. Del. Oct. 14, 2020); *Extraction Oil & Gas, Inc. v. Grand Mesa Pipeline, LLC (In re Extraction Oil & Gas, Inc.)*, Adv. Proc. No. 20-50816 (CSS) (Bankr. D. Del. Oct. 14, 2020).

According to Judge Sontchi, although certain of the Agreements manifested an intent to create covenants running with the land, the "central issue" before the court was whether the dedications in the Agreements actually "touched and concerned" the relevant land. The court found that they did not. After examining the gathering services provided by the counterparties under the Agreements and the related dedications, the court concluded that the commodity produced by EOG and gathered under the Agreements did not constitute a real property interest in Extraction's mineral estate. Instead, the court found, it concerned only personal property and did not affect the physical use of real property or even closely relate to real property.

In so ruling, the court distanced itself from the courts in *Alta Mesa* and *Badlands*, which concluded that a gathering system can touch and concern land because it enhances the value of the relevant mineral interest. Instead, the *Extraction* court agreed with *Sabine* in finding that the primary effect of a dedication is on the use and enjoyment of personal property—i.e., the commodity produced—rather than real property.

In addition, the *Extraction* court determined that the dedications in the Agreements did not run with the land due to the absence of horizontal privity. In particular, the court found that the dedications were not created in conjunction with the conveyance of an independent real property interest in the relevant mineral estate. According to the court, even though EOG conveyed easements and other property rights to the counterparties, the rights were interests in a severed surface estate rather than EOG's mineral estates.

The bankruptcy court ultimately concluded that the Agreements did not satisfy Colorado's requirements for creating covenants running with the land and were therefore executory contracts that could be rejected by EOG in bankruptcy.

The court denied Mesa's request that it abstain from resolving the dispute in favor of a Colorado state court. It also denied Mesa's motion for relief from the automatic stay to commence a proceeding before the Federal Energy Regulatory Commission ("FERC") to determine whether rejection of the Agreements is consistent with the public interest and the Interstate Commerce Act. Both Mesa and FERC appealed that ruling.

On October 28, 2020, Mesa and the other counterparties appealed the bankruptcy court's decision regarding EOG's ability to reject the Agreements.

On November 2, 2020, the bankruptcy court granted EOG's motion to reject the Agreements with Mesa and Platte *nunc pro tunc* to the bankruptcy petition date. *See In re Extraction Oil & Gas, Inc.*, 2020 WL 6389252 (Bankr. D. Del. Nov. 2, 2020). Notably, in authorizing rejection, the court concluded that: (i) even if the agreements created covenants that run with the land (which they did not), they could be rejected and "any covenant running with the land still exists (as the contract still exists), but it is unenforceable against [EOG] and [its] assigns after the Rejection Counterparties' claims are satisfied as part of the reorganization process"; (ii) although "heightened scrutiny" above and beyond the "business judgment" test normally applied to rejection was unwarranted, after balancing the equities and considering the public interest, rejection was appropriate; (iii) any determination by FERC concerning the proposed rejection was unnecessary because "payment of claims through the plan and confirmation process is [not] an abrogation of FERC approved rates"; and (iv) there is "no prohibition on or limitation against rejecting a FERC approved contract" under section 365(a) of the Bankruptcy Code. FERC appealed the ruling.

CHESAPEAKE ENERGY

Chesapeake Energy Corp. and certain affiliates (collectively, "Chesapeake") filed for chapter 11 protection in June 2020 in Texas. In 2016, Chesapeake entered into a series of related agreements (collectively, "agreement") with ETC Texas Pipeline, Ltd. ("ETC") to sell natural gas produced from Chesapeake's wells. The dedication under the agreement stated that it "is a covenant running with the land." In the event of a breach, the agreement

provided that the "sole and exclusive remedy" of the parties was recovery of monetary damages. The agreement further provided that the agreement and all transactions contemplated by it "constitute 'forward contracts' and/or 'swap agreements' and [that] this Agreement constitutes a 'master netting agreement' as defined in section 101 of the Bankruptcy Code." In addition, it stated that the parties "are entitled to the rights under, and protections afforded by, sections 362, 546, 553, 556, 560, 561 and 562 of the Bankruptcy Code."

In bankruptcy, Chesapeake filed a motion to reject the agreement. ETC opposed the motion, arguing that the agreement was not executory because it contained a covenant running with the land under Texas law. Chesapeake countered that the agreement did not create such a covenant and that, even if it did, the existence of such a covenant did not prevent Chesapeake from rejecting it.

Judge David R. Jones of the U.S. Bankruptcy Court for the Southern District of Texas ruled in favor of Chesapeake. Initially, he noted that ETC cited no authority for the proposition that the agreement could not be an executory contract because it contained a covenant running with the land. *See In re Chesapeake Energy Corp.*, 2020 WL 6325535 (Bankr. S.D. Tex. Oct. 28, 2020). According to Judge Jones, ETC's reliance on *Alta Mesa* and *Badlands* was misplaced. Although the courts in those cases held that gathering agreements containing covenants running with the land could not be rejected, he agreed with those decisions because "[i]n each case, the debtors sought to remove the entirety of the burden from their real property interests." Moreover, Judge Jones noted, no party asserted in those cases that the agreements could be rejected "notwithstanding that a real property covenant would continue to burden the land post-rejection." However, the court determined that further analysis of this issue was moot in light of its conclusion that the agreement with ETC did not contain a covenant running with the land.

In this regard, among other things, the bankruptcy court found that:

- Despite the express language of the agreement, the parties did not intend for the obligation to sell certain quantities of gas to run with the land. The exclusive remedy for breach was an award of monetary damages, "a remedy ... inherently personal in nature and unrelated to any real property interest held by Chesapeake." This, together with the acknowledgment that the agreement was a two-party forward contract, "suggest[s] that the added language that 'the parties intended for the obligation to run with the land' was an ill-conceived attempt to portray the [agreement] as a horse of a different color."
- The dedication in the agreement did not "touch and concern" the land because Chesapeake did not assign a specific interest in the gas leases themselves, but only the gas produced at the wellhead, which is personal property under Texas law.

Finally, the bankruptcy court rejected ETC's argument that the agreement could not be rejected because it created an equitable servitude on Chesapeake's property interests. This argument, the court wrote, does not apply to the analysis of whether an alleged executory contract can be rejected and, "if applicable at all, would be raised in response to [Chesapeake's] request for authority to sell its property interests under 11 U.S.C. § 363."

The court accordingly granted Chesapeake's motion to reject the agreement. The parties agreed to certify a direct appeal of the ruling to the Fifth Circuit on November 20, 2020.

SOUTHLAND

Prior to filing for chapter 11 protection in January 2020 in Delaware, upstream energy company Southland Royalty Company LLC ("Southland") entered into two gas gathering agreements with midstream service provider Wamsutter LLC ("Wamsutter") pertaining to Southland's assets in Wyoming. In bankruptcy, Southland asked the bankruptcy court to determine whether, among other things, it could either sell its assets free and clear of any interest asserted by Wamsutter in the agreements or reject the agreements. Wamsutter argued that neither a free and clear sale nor rejection was permitted because the agreements contained covenants that ran with the land or equitable servitudes under Wyoming law.

Judge Karen B. Owens of the U.S. Bankruptcy Court for the District of Delaware ruled that the agreements did not contain covenants that ran with the land or equitable servitudes and that even if they did, Southland could either reject the agreements or sell its assets free and clear of any associated covenants. *See Southland Royalty Company LLC, v. Wamsutter LLC (In re Southland Royalty Company LLC)*, 2020 WL 6685502 (Bankr. D. Del. Nov. 13, 2020). After examining the agreements, Wyoming law, and recent court rulings on the issues, Judge Owens concluded, "for many of the same reasons set forth by the courts in *Sabine* and *Extraction*," that the agreements contained no real covenants but were service contracts relating to Southland's personal property.

Nowhere in one of the agreements, she wrote, "do the parties unambiguously express an intention for all promises therein to run with the land." Moreover, although such an intention was expressed in the second gas gathering agreement, the dedication in that agreement did not "touch and concern the land" because it did "not alter Southland's legal rights in its real property" but merely affected produced gas, which is personal property under Wyoming law. Judge Owens also determined that privity of estate did not exist with respect to the second agreement because "the estate burdened by the various easements and other rights of access—Southland's surface lands—is not the same estate allegedly burdened by the [dedication in the agreement]—Southland's mineral interests." Because the dedication in the second agreement did not touch and concern the land, Judge Owens also ruled that it did not create an equitable servitude.

Judge Owens held that, even if the agreements had created covenants running with the land, they could be rejected. Agreeing with the court in *Extraction* on this point, she wrote that "Wamsutter will then have a prepetition claim against the estate for damages resulting from Southland's nonperformance."

Finally, Judge Owens ruled that, despite the existence of covenants running with the land, Southland could sell its assets free and clear of any interest asserted by Wamsutter under section 363(f) of the Bankruptcy Code because: (i) Wyoming law permitted a free and clear sale (by means of foreclosure); and (ii) Wamsutter could be compelled to accept a money satisfaction of its interest in a legal or equitable proceeding because both legal and equitable remedies are available under Wyoming law in covenant enforcement actions.

OUTLOOK

Considered together, these rulings illustrate that applicable nonbankruptcy law, the specific facts and circumstances of any given case, and the venue of a debtor's bankruptcy filing are crucial elements in assessing whether gas gathering and handling agreements can be rejected in bankruptcy. *Southland*, *Extraction*, and, to a lesser extent, *Chesapeake Energy* add a notable wrinkle to the analysis in indicating that, even if a gas gathering agreement does contain a covenant running with the land, the agreement can still be rejected.

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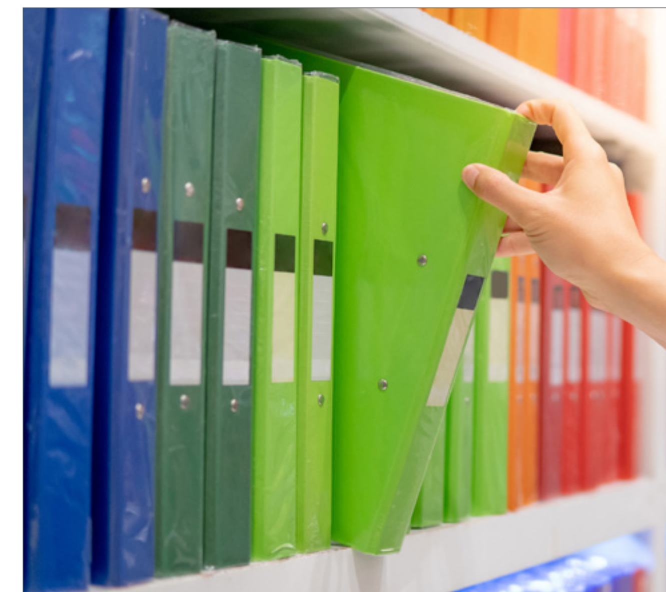


ANOTHER COURT ADOPTS MAJORITY VIEW IN APPROVING BANKRUPTCY TRUSTEE'S USE OF TAX CODE LOOK-BACK PERIOD IN AVOIDANCE ACTIONS

Daniel J. Merrett ▪ Mark G. Douglas

The ability of a bankruptcy trustee or chapter 11 debtor-in-possession ("DIP") to avoid fraudulent transfers is an important tool promoting the bankruptcy policies of equality of distribution among creditors and maximizing the property included in the estate. One limitation on this avoidance power is the statutory "look-back" period during which an allegedly fraudulent transfer can be avoided—two years for fraudulent transfer avoidance actions under section 548 of the Bankruptcy Code and, as generally understood, three to six years if the trustee or DIP seeks to avoid a fraudulent transfer under section 544(b) and state law by stepping into the shoes of a "triggering" creditor plaintiff.

The longer look-back periods governing avoidance actions under various state laws significantly expand the universe of transactions that may be subject to fraudulent transfer avoidance. Indeed, under a ruling recently handed down by the U.S. Bankruptcy Court for the Western District of North Carolina, the look-back period in avoidance actions under section 544(b) may be much longer—10 years—in bankruptcy cases where the Internal Revenue Service ("IRS") or another governmental entity is the triggering creditor. In *Mitchell v. Zagaroli (In re Zagaroli)*, 2020 WL 6495156 (Bankr. W.D.N.C. Nov. 3, 2020), the court, adopting the majority approach, held that a chapter 7 trustee could effectively circumvent North Carolina's four-year statute of limitations for fraudulent transfer actions by stepping into the shoes of the IRS, which is bound not by North Carolina law but by the 10-year statute of limitations for collecting taxes specified in the Internal Revenue Code ("IRC").

DERIVATIVE AVOIDANCE POWERS UNDER SECTION 544(B) OF THE BANKRUPTCY CODE

Section 544(b)(1) of the Bankruptcy Code provides in relevant part as follows:

> [T]he trustee may avoid any transfer of an interest of the debtor in property or any obligation incurred by the debtor that is voidable under applicable law by a creditor holding an unsecured claim that is allowable under section 502 of this title or that is not allowable only under section 502(e) of this title.

11 U.S.C. § 544(b). Thus, a trustee (or DIP pursuant to section 1107(a)) may seek to avoid transfers or obligations that are "voidable under applicable law," which is generally interpreted to mean state law. *See Ebner v. Kaiser (In re Kaiser)*, 525 B.R. 697, 709 (Bankr. N.D. Ill. 2014); *Wagner v. Ultima Holmes (In re Vaughan)*, 498 B.R. 297, 302 (Bankr. D.N.M. 2013).

The fraudulent transfer statutes of almost every state are versions of the Uniform Fraudulent Transfer Act ("UFTA"), which was recently amended and renamed the "Uniform Voidable Transactions Act" ("UVTA"). States that have adopted the UFTA or UVTA most commonly provide that avoidance actions are time-barred unless brought within four years of the time the transfer was made or the obligation was incurred. Notably, New York adopted the UVTA effective as of December 2019, reducing its look-back period to four years, from six under longstanding prior law.

LONGER LOOK-BACK PERIOD FOR CERTAIN GOVERNMENTAL ENTITIES

The federal government is generally not bound by state statutes of limitations, including those set forth in state fraudulent transfer laws. *Vaughan*, 498 B.R. at 304. Instead, various federal statutes or regulations specify the statute of limitations for enforcement actions. For example, the IRC provides that, with certain exceptions, an action to collect a tax must be commenced by the IRS no later than 10 years after the tax is assessed. *See* 26 U.S.C. § 6502(a). The rationale behind a longer federal statute of limitations is that public rights and interests that the federal government is charged with defending should not be forfeited due to public officials' negligence. *Vaughan*, 498 B.R. at 304.

On the basis of the plain meaning of section 544(b), nearly all of the courts that have considered the issue have concluded that a trustee or DIP bringing an avoidance action under that section may step into the shoes of the IRS (if it is a creditor in the case) to utilize the IRC's 10-year statute of limitations. *See, e.g., Murphy v. ACAS, LLC (In re New Eng. Confectionary Co.)*, 2019 Bankr. LEXIS 2281 (Bankr. D. Mass. July 19, 2019); *Viera v. Gaither (In re Gaither)*, 595 B.R. 201 (Bankr. D.S.C. 2018); *Hillen v. City of Many Trees, LLC (In re CVAH, Inc.)*, 570 B.R. 816 (Bankr. D. Idaho 2017); *Mukhamal v. Citibank, N.A. (In re Kipnis)*, 555 B.R. 877 (Bankr. S.D. Fla. 2016); *Kaiser,* 525 B.R. at 711–12.

Vaughan is apparently the only published decision to the contrary with respect to the IRS and the IRC. The *Vaughan* court reached its conclusion after considering policy and legislative intent. It noted that the IRS is not bound by state law statutes of limitations because it exercises sovereign powers and is therefore protected by the doctrine of *nullum tempus occurrit regi* ("no time runs against the king"). According to the court in *Vaughan*, Congress did not intend for section 544(b) to vest sovereign power in a bankruptcy trustee, and allowing a trustee to take advantage of the IRC's 10-year statute of limitations would be an overly broad interpretation.

In *MC Asset Recovery LLC v. Commerzbank A.G. (In re Mirant Corp.)*, 675 F.3d 530, 535 (5th Cir. 2012), the U.S. Court of Appeals for the Fifth Circuit rejected a line of cases holding that the Federal Debt Collection Practices Act ("FDCPA") can be "applicable law" for purposes of section 544(b), thereby affording the trustee use of the FDCPA statute of limitations, because the FDCPA expressly provides that "[t]his chapter shall not be construed to supersede or modify the operation of … title 11." *Id.* at 535 (quoting 28 U.S.C. § 3003(c)); *accord MC Asset Recovery, LLC v. Southern Co.*, 2008 WL 8832805 (N.D. Ga. July 7, 2008) ("[T]he FDCPA cannot be the 'applicable law' within the meaning of Section 544(b) of the Bankruptcy Code."). However, the IRC does not include comparable language.

The *Vaughan* minority approach has been rejected by almost all other courts. For example, in *Kipnis*, the court concluded that the meaning of section 544(b) is clear and does not limit the type of creditor from which a trustee can choose to derive rights. Moreover, because the court determined that its interpretation of the statute was not "absurd," the court did not deem it necessary to expand its inquiry beyond the express language of section 544(b) to consider legislative intent or policy concerns. *Kipnis*, 555 B.R. at 882 (citing *Lamie v. United States Trustee*, 540 U.S. 526, 534 (2004) ("It is well established that 'when the statute's language is plain, the sole function of the courts—at least where the disposition required by the text is not absurd—is to enforce it according to its terms.'")).

The court concluded that *Vaughan*'s *nullum tempus* argument was misplaced. Because section 544(b) is a derivative statute, the *Kipnis* court wrote, "the focus is not on whether the trustee is performing a public or private function, but rather, the focus is on whether the IRS, the creditor from whom the trustee is deriving her rights, would have been performing that public function if the IRS had pursued the avoidance actions."

However, the court agreed with *Vaughan* on one point—if applied in other cases, the court's ruling could result in a 10-year look-back period in many cases. According to the *Kipnis* court, because the IRS is a creditor in a significant number of cases, the paucity of decisions addressing the issue can more likely be attributed to the fact that trustees and DIPs have not realized that this "weapon is in their arsenal."

TRIGGERING CREDITOR MUST HAVE AN "ALLOWABLE CLAIM"

Avoidance under section 544(b) is permitted only if a transfer could be avoided under applicable law by a creditor holding an "allowable" unsecured claim. The term "allowable" is not defined in the Bankruptcy Code. However, section 502(a) provides that a claim for which the creditor files a proof of claim is deemed "allowed" unless a party in interest objects. Rule 3003(b) of the Federal Rules of Bankruptcy Procedure provides that, in a chapter 9 or chapter 11 case, a creditor need not file a proof of claim if the claim is listed on the debtor's schedules in the proper amount and is not designated as disputed, contingent, or unliquidated.

Thus, if an unsecured creditor has not filed a proof of claim and if, in a chapter 9 or chapter 11 case, its claim either is not scheduled in any amount or is scheduled as disputed, contingent, or unliquidated, a handful of courts have concluded that the claim is not "allowable" and the trustee or DIP may not step into the creditor's shoes to bring an avoidance action under section 544(b). *See In re Republic Windows & Doors*, 2011 WL 5975256, *11 (Bankr. N.D. Ill. Oct. 17, 2011) (a chapter 7 trustee could not take advantage of the IRC's 10-year statute of limitations because the IRS had not filed a proof of claim in the case); *Campbell v. Wellman (In re Wellman)*, 1998 WL 2016787, *3 (Bankr. D.S.C. June 2, 1998) ("[A]s Robert McKittrick was the only creditor of these three [creditors] to file a proof of claim, he is the only one with an allowable claim into whose shoes the [chapter 7] Trustee may step pursuant to § 544(b).").

However, the majority approach is otherwise. Most courts have held that the allowability of a claim for purposes of section 544(b) should be determined as of the petition date and, therefore, that the failure to file a proof of claim does not disqualify a creditor from being the triggering creditor. *See, e.g.*, *In re Tabor*, 2016 WL 3462100, at *2 (Bankr. S.D. Fla. June 17, 2016); *Whittaker v. Groves Venture, LLC (In re Bolon)*, 538 B.R. 391, 408 n.8 (Bankr. S.D. Ohio 2015); *Finkel v. Polichuk (In re Polichuk)*, 506 B.R. 405, 432 (Bankr. E.D. Pa. 2014); *In re Kopp*, 374 B.R. 842, 846 (Bankr. D. Kan. 2007).

In *Zagaroli*, the bankruptcy court considered whether a chapter 7 trustee could step into the shoes of the IRS for purposes of section 544(b).

ZAGAROLI

In 2018, Peter Zagaroli ("debtor") filed a chapter 7 case in North Carolina. The IRS filed a proof of claim in the case in the unsecured amount of approximately $4,000. In 2020, the chapter 7 trustee sued the debtor's parents, seeking to avoid 2010 and 2011 transfers of real property by the debtor to his parents as fraudulent transfers under the North Carolina UVTA, which has a four-year look-back period. *See* N.C. Gen. Stat. § 39-23.9. The defendants moved to dismiss, arguing that the challenged transfers occurred more than four years prior to the petition date. The trustee countered that he could utilize the IRC's 10-year look-back period because the IRS was a triggering creditor.

The bankruptcy court denied the motion to dismiss.

The defendants argued that, instead of focusing on the plain language of section 544(b), the court should consider the legislative history, the purpose of the provision, related provisions of the Bankruptcy Code, and other relevant statutes, such as the IRC, which requires specific authorization to bring any action thereunder. *See* 26 U.S.C. § 7401. According to the defendants, limiting consideration solely to the language of section 544(b) would lead to "absurd results or conflict with other statutory provisions."

The bankruptcy court rejected those arguments. When the language of a statute is unambiguous, the court explained, "'the court's task is simple: apply the plain language'" (citation omitted). Moreover, the court wrote, "the Defendants' position would result in leaving both the Trustee and the IRS without the right to avoid offending transfers" that occurred outside the look-back period under state law. The court concluded that "the applicable law that the Trustee seeks to invoke is the [North Carolina UVTA] and the IRC, both of which the IRS could have used to seek to avoid the transfers outside of bankruptcy."

OUTLOOK

Zagaroli does not break new ground on the power of a bankruptcy trustee or DIP to bring avoidance actions under section 544(b) of the Bankruptcy Code. Nevertheless, the court's endorsement of the majority approach on the availability of a longer look-back period in cases in which the IRS is a creditor is notable. Widespread adoption of this approach could significantly augment estate avoidance action recoveries.

Furthermore, the IRS is not the only potential triggering creditor under section 544(b) with a longer look-back period. Other federal and state governmental entities may also provide that additional tool to a trustee or DIP. *See, e.g., In re 160 Royal Palm, LLC*, 2020 WL 4805478 (Bankr. S.D. Fla. July 1, 2020) (permitting a debtor under section 544(b) to take advantage of the Securities and Exchange Commission's six-year statute of limitations for fraudulent transfer claims under 28 U.S.C. §§ 2415(a) and 2416); *Alberts v. HCA Inc. (In re Greater Southeast Cmty. Hosp. Corp. I)*, 365 B.R. 293, 304 (Bankr. D.D.C. 2006) (the trustee of a liquidating trust created by a chapter 11 plan could step into the shoes of the IRS as well as the U.S. Department of Health and Human Services (six-year statute of limitations for actions to collect Medicare overpayments under 28 U.S.C. § 2415) for the purpose of bringing an avoidance action under section 544(b) and the Illinois UFTA); *G-I Holdings, Inc.*, 313 B.R. at 636 (the asbestos claimants' committee in a chapter 11 case could step into the shoes of the New Jersey Department of Environmental Protection (10-year statute of limitations for enforcement action) for purposes of section 544(b)). In addition, despite the Fifth Circuit's rejection of the FDCPA as "applicable law" for purposes of § 544(b), other courts have ruled to the contrary. *See, e.g., Gaither*, 595 B.R. at 214; *In re Alpha Protective Servs., Inc.*, 531 B.R. 889, 905 (Bankr. M.D. Ga. 2015) (citing cases). Thus, understanding the approach adopted in a particular jurisdiction is paramount for this purpose.

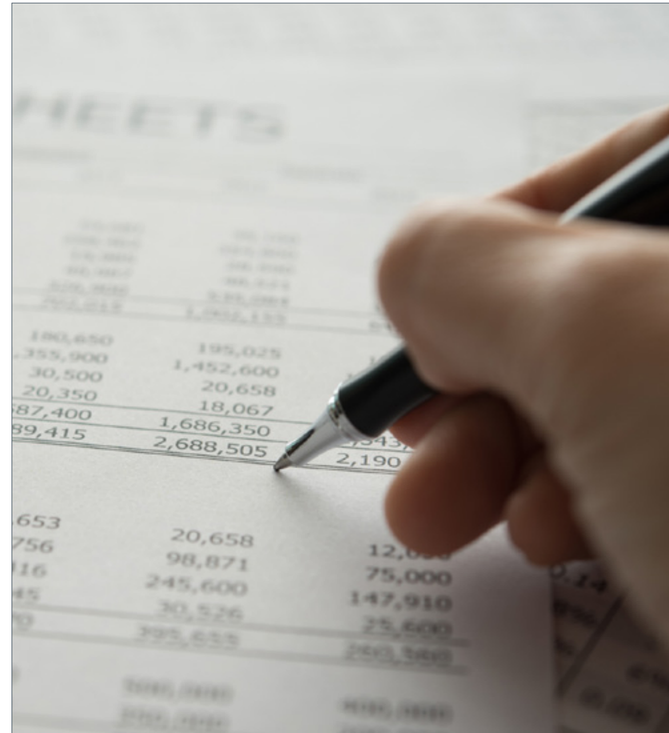
RESTORATION OF CROWN PREFERENCE AND EROSION OF THE ENGLISH FLOATING CHARGE

Kay V. Morley ▪ Anthony J. Whall ▪ Stanzi J. Rosenthal

With effect from December 1, 2020, Her Majesty's Revenue and Customs ("HMRC") ranks ahead of floating charge holders and unsecured creditors with respect to recovering certain pre-insolvency taxes from an insolvent business ("Crown preference"). Directors can also now incur personal liability for the unpaid taxes of an insolvent company where they are involved in tax avoidance, evasion, or phoenixism.

As a consequence of these changes, funds available to floating charge and unsecured creditors could be significantly reduced. The tax evasion measures could make unpaid taxes a personal liability for directors in certain circumstances.

Looking ahead, lenders will need to consider carefully the nature of their security and their likely recovery in the event of insolvency, given the increased leakage from floating charge realizations. As a consequence, the cost of lending could increase, particularly in respect of those business sectors that largely comprise floating charge assets.



PRIORITY OF CERTAIN TAXES IN INSOLVENCY

The Finance Act 2020, which received Royal Assent on July 22, 2020, has established that with effect from December 1, 2020, HMRC benefits from ranking ahead of floating charge holders and unsecured creditors with respect to recovering certain pre-insolvency taxes from an insolvent business. These changes have reinstated, in part, Crown preference, which was previously abolished pursuant to the Enterprise Act 2002.

The reforms apply only to taxes collected and held by businesses on behalf of their employees and customers, namely value-added tax ("VAT"), pay-as-you-earn ("PAYE") income tax, employee National Insurance contributions ("NICs"), Construction Industry Scheme ("CIS") deductions, and student loan repayments. The rationale is that these taxes should be used to fund public services rather than form part of funds available to floating charge and unsecured creditors (including HMRC), as was previously the case.

The rules remain unchanged for taxes owed by the insolvent business itself, such as corporation tax and employer NICs. Creditors with fixed charges over assets are also unaffected to the extent their claims can be settled in full by proceeds from the sale of assets subject to fixed charge security. This is because a fixed charge still ranks ahead of any Crown preference. However, in circumstances where a lender's security comprises largely floating charge assets, the impact of the reforms could be material, particularly in light of HMRC's additional COVID-19 support and deferrals.

It will be interesting to observe if the reinstatement of Crown preference has any impact on HMRC's appetite to issue winding up petitions (COVID-19 restrictions permitting) or otherwise to participate in company restructurings in the event of arrears, or to support a restructuring where a large part of a company's debt will likely be paid in any event. Although the recent amendments are likely to result in modest collective value, many will be concerned that the government will look to extend the scope of the Crown preference in the future at the cost of floating charge holders and unsecured creditors.

The above reforms follow the government's introduction with effect from April 6, 2020, of an increase in the cap on funds available to pay the "prescribed part" (the part of the proceeds from realizing assets covered by a floating charge set aside to satisfy unsecured debts) from £600,000 to £800,000 and the introduction of a new statutory moratorium available to companies in financial distress pursuant to the Corporate Insolvency and Governance Act 2020.

Costs and expenses incurred by the company during the new statutory moratorium will be payable on a super-priority basis out of floating charge realizations. In these circumstances, suppliers of goods and services (who are also no longer entitled to terminate contracts on the basis of insolvency) will be paid in priority out of floating charge realizations together with: (i) any other unpaid costs incurred by the company during the relevant moratorium period; and (ii) the fees of the insolvency practitioner appointed as monitor to oversee the business of the debtor for the duration of the statutory moratorium.

Critics of the reforms argue that the changes are likely to increase the costs of lending and potentially lead to more insolvencies. It certainly is the case that lenders will need to consider the nature of their security and, in the event of insolvency, consider the potential additional leakage from floating charge realizations.

INSOLVENCY AND PHOENIXISM RISKS

The Finance Act 2020 includes provisions aimed at tackling the situation where directors repeatedly place companies into an insolvency proceeding, leaving arrears outstanding to HMRC. In such circumstances, directors typically either acquire the business and assets out of an insolvency proceeding or continue trading successor businesses where the cycle begins again.

HMRC now has the power to make directors, shadow directors, and officers of a company who regularly abuse the insolvency regime in an effort to avoid or evade tax jointly and severally liable for a company's unpaid tax liabilities. It is hoped that the potential for personal liability will promote more responsible behavior and reduce the perceived abuse of insolvency proceedings by directors. Personal liability for directors in the case of tax avoidance, evasion, or phoenixism was proposed by the government prior to the outbreak of COVID-19.

In a post-COVID world where we are likely to see more businesses being restructured using phoenix structures, directors and other company officers entering into these transactions in good faith and without the intention of avoiding or evading unpaid tax liabilities will need to ensure that they take appropriate legal and financial advice in order to minimize the risk of personal liability.

THREE KEY TAKEAWAYS

1. With effect from December 1, 2020, when a company enters into an insolvency proceeding, HMRC benefits from a Crown preference in relation to certain pre-insolvency taxes collected by a company on behalf of employees and customers (VAT, PAYE income tax, employee NIC, CIS deductions, and student loan repayments).
2. Funds available to floating charge and unsecured creditors could be significantly reduced by such Crown preference, but fixed charge holders should be unaffected.
3. Measures have also been introduced to tackle tax evasion, avoidance, and phoenixism, making directors and company officers jointly and severally liable for a company's unpaid tax liabilities if there is a risk that the company may deliberately enter insolvency.

SECOND CIRCUIT: MADOFF PONZI SCHEME CUSTOMERS DID NOT RECEIVE FICTITIOUS PROFIT PAYMENTS "FOR VALUE"

Dan T. Moss ▪ Mark G. Douglas

In the latest chapter of more than a decade of litigation involving efforts to recover fictitious profits paid to certain customers of Bernard Madoff's defunct brokerage firm as part of the largest Ponzi scheme in history, the U.S. Court of Appeals for the Second Circuit held in *In re Bernard L. Madoff Investment Securities LLC*, 976 F.3d 184 (2d Cir. 2020) ("*Madoff*"), that the customers did not have a defense to avoidance and recovery because they received the payments "for value." The Second Circuit also ruled that the trustee overseeing the brokerage firm's liquidation properly determined the amount subject to recovery despite calculating the defendants' liability by netting the amounts they received against what they invested since the firm's inception.

GOOD-FAITH DEFENSE TO AVOIDANCE OF FRAUDULENT TRANSFERS

Section 548(a)(1) of the Bankruptcy Code authorizes a bankruptcy trustee to avoid any transfer of an interest of the debtor in property or any obligation incurred by the debtor "on or within 2 years before the date of the filing of the petition" if: (i) the transfer was made, or the obligation was incurred, "with actual intent to hinder, delay, or defraud" any creditor; or (ii) the debtor received "less than a reasonably equivalent value in exchange for such transfer or obligation" and was, among other things, insolvent, undercapitalized, or unable to pay its debts as such debts matured.

Section 548(c) provides a defense to avoidance of a fraudulent transfer for a "good faith" transferee or obligee who gives "value" in exchange for a transfer or obligation:

> Except to the extent that a transfer or obligation voidable under this section is voidable under section 544, 545, or 547 of this title [dealing with a trustee's power to avoid, respectively, transfers that are voidable under state law, statutory liens, and preferential transfers], a transferee or obligee of such a transfer or obligation that takes for value and in good faith has a lien on or may retain any interest transferred or may enforce any obligation incurred, as the case may be, to the extent that such transferee or obligee gave value to the debtor in exchange for such transfer or obligation.

11 U.S.C. § 548(c).

Section 548(d)(2)(A) states that "value" for the purposes of section 548 "means property, or satisfaction or securing of a present or antecedent debt of the debtor, but does not include an unperformed promise to furnish support to the debtor or to a relative of the debtor."

"Good faith" is not defined by the Bankruptcy Code. In determining whether it exists, some courts have applied a two-part analysis, examining: (i) whether the transferee was on inquiry notice of suspicious facts amounting to "red flags"; and (ii) if so, whether the transferee reasonably followed up with due diligence to determine whether a transaction may not have been bona fide. *See, e.g., Horton v. O'Cheskey (In re Am. Hous. Found.)*, 544 Fed. Appx. 516 (5th Cir. 2013); *Christian Bros. High School Endowment v. Bayou No Leverage Fund LLC (In re Bayou Group, LLC)*, 439 B.R. 284 (S.D.N.Y. 2010).

STOCKBROKER LIQUIDATIONS UNDER SIPA

Congress enacted the Securities Investor Protection Act, 15 U.S.C. §§ 78aaa *et seq.* ("SIPA"), in 1970 to deal with a crisis in customer and investor confidence and the prospect that capital markets might fail altogether after overexpansion in the securities brokerage industry led to a wave of failed brokers. The law was substantially revamped in 1978 in conjunction with the enactment of the Bankruptcy Code.

A SIPA proceeding is commenced when the Securities Investor Protection Corporation ("SIPC") files an application for a protective decree regarding one of its member broker-dealers in a federal district court. If the district court issues the decree, it appoints a trustee to oversee the broker-dealer's liquidation and refers the case to the bankruptcy court.

SIPA affords limited financial protection to the customers of registered broker-dealers. A "customer" is any person who has a claim:

> on account of securities received, acquired, or held by the debtor in the ordinary course of its business as a broker or dealer from or for the securities accounts of such person for safekeeping, with a view to sale, to cover consummated sales, pursuant to purchases, as collateral security, or for purposes of effecting transfer.

SIPA § 78lll(2). The term also includes "any person who has deposited cash with the debtor for the purpose of purchasing securities."

SIPA liquidations generally involve customer claims and the claims of general unsecured creditors, such as vendors or judgment creditors. Customer claims are satisfied out of a customer estate (a fund consisting of customer-related assets, such as securities and cash on deposit), while general unsecured claims are paid from the general estate (any remaining assets). The value of a customer's account, or its "net equity," is the measure of its SIPA customer claim. SIPA § 78fff-2(c)(1)(B). "Net equity" is the total value of cash and securities owed to the customer as of the petition date, less the total value of cash and securities owed by the customer to the debtor as of the petition date. SIPA § 78lll(11).

SIPC, a nonprofit membership corporation funded by its member securities broker-dealers, advances funds to the trustee as necessary to satisfy customer claims but limits them to $500,000 per customer, of which no more than $250,000 may be based on a customer claim for cash. SIPC is subrogated to customer claims paid to the extent of such advances. Those advances are repaid from funds in the general estate prior to payments on account of general unsecured claims.

If property in the customer estate is not sufficient to pay customer net equity claims in full, "the [SIPA] trustee may recover any property transferred by the debtor which, except for such transfer, would have been customer property if and to the extent that such transfer is voidable or void under the provisions of [the Bankruptcy Code]." SIPA § 78fff-2(c)(3).

As noted, the bankruptcy court presides over a SIPA case, and the case proceeds very much like a chapter 7 liquidation, with certain exceptions. SIPA expressly provides that "*[t]o the extent consistent with the provisions of this chapter*, a liquidation proceeding shall be conducted in accordance with, and as though it were being conducted under chapters 1, 3, and 5 and subchapters I and II of chapter 7 of title 11." SIPA § 78fff(b) (emphasis added).

This means, for example, that the automatic stay precludes the continuation of most collection efforts against the debtor or its property but not the exercise of the contractual rights of a qualifying entity (e.g., a stockbroker or a financial participant) under a financial or securities contract or a repurchase agreement. See 11 U.S.C. §§ 362(b)(6) and (7)). Similarly, the SIPA trustee has substantially all of a bankruptcy trustee's powers, including the avoidance powers. However, neither a SIPA trustee nor a bankruptcy trustee may avoid certain transfers made by, to, or for the benefit of stockbrokers, repurchase agreement participants,

swap agreement participants, and certain other entities, unless the transfer was made with actual intent to hinder, delay, or defraud creditors in accordance with section 548(a)(1)(A). See 11 U.S.C. §§ 546(e), (f) and (g).

MADOFF

Bernard L. Madoff Investment Securities LLC ("MIS") was the brokerage firm that carried out Bernard Madoff's infamous Ponzi scheme by collecting customer funds that it never invested and making distributions of principal and fictitious "profits" to old customers with funds it received from new customers. After the scheme collapsed in December 2008, the U.S. District Court for the Southern District of New York issued a protective decree for MIS under SIPA.

Because the customer property held by MIS was inadequate to pay customer net equity claims, the SIPA trustee sought to recover funds that would have been customer property had MIS not transferred them to others. Certain customers had net equity claims, because they had withdrawn less than the full amount of their investments from their MIS accounts before entry of the protective decree. Other customers had no net equity claims, because they withdrew more money from their accounts than they had deposited. These customers (collectively, "Madoff Defendants") received not only a return of their principal investment but also the fictitious "profits" that were actually other customers' money.

In 2010, the SIPA trustee sued the Madoff Defendants in the bankruptcy court seeking to avoid and recover the profits as actual and constructive fraudulent transfers under sections 548(a)(1)(A) and 548(a)(1)(B) of the Bankruptcy Code. The Madoff Defendants did not dispute that MIS made the payments with actual intent to hinder, delay, or defraud creditors. Instead, they argued that the trustee could not recover the transfers because: (i) they were protected from avoidance under section 546(e) as settlement payments or transfers made in connection with a securities contract; and (ii) the Madoff Defendants had a defense to avoidance under section 548(c) because they received the payments in exchange "for value."

That litigation and hundreds of similar actions were later consolidated in the U.S. District Court for the Southern District of New York. Largely adopting the reasoning in a case involving MIS and other customers who received fictitious profits (*SIPC v. Bernard L. Madoff Inv. Sec. LLC*, 476 B.R. 715 (S.D.N.Y. 2012), *aff'd*, 773 F.3d 411 (2d Cir. 2014) ("*Greiff*")), the district court in *Madoff* held that: (i) the customer agreements between MIS and the Madoff Defendants qualified as securities contracts, and the payments were therefore safe harbored from avoidance as constructive fraudulent transfers by section 546(e) as "settlement payments," even though MIS did not actually complete the securities transactions because it never invested the funds; and (ii) the Madoff Defendants did not have a section 548(c) defense to the trustee's actual fraudulent transfer claims because they did not take the transfers in exchange "for value." The court also held that section 548(a)(1) did not prohibit the trustee from considering transfers made more than two years prior to the SIPA petition date in calculating the amount of money subject to recovery.

In *Greiff*, a different district court rejected customers' argument that the fictitious positions listed on their account statements evidenced "securities entitlements" under applicable law (the New York Uniform Commercial Code ("NYUCC")) or any other "right to payment" that would qualify as "value." According to the court, the section 548(c) defense applies only when there is a "commensurability of consideration"—i.e., where payments to an investor contesting avoidance are "offset by an equivalent benefit to the estate." 476 B.R. at 724. It also noted that "every circuit court to address this issue has concluded that an investor's profits from a Ponzi scheme, whether paper profits or actual transfers, are not 'for value.'" *Id.* at 725.

The *Greiff* district court also rejected the customers' argument that they were entitled to retain the transfers because they were creditors rather than equity investors. It concluded that "the general rule that investors in a Ponzi scheme d[o] not receive their profits 'for value'" also applies to "this unusual kind of 'creditor,' whose claims to profits depend upon enforcing fraudulent representations." *Id.* at 726-27. Finally, the *Greiff* district court reasoned that, even if the customers had enforceable claims for the amounts reported on their brokerage statements, a conclusion that satisfaction of those debts gave "value" to MIS would conflict with SIPA's priority scheme "by equating net equity and general creditor claims."

After denying the Madoff Defendants' motion for an interlocutory appeal, the *Madoff* district court remanded the case to the bankruptcy court, where both MIS and the Madoff Defendants sought summary judgment. In its report, the bankruptcy court recommended to the district court that summary judgment be entered in favor of the trustee.

The Madoff Defendants objected to the recommendation. They reiterated their original arguments regarding section 548(c), stating that a supervening Second Circuit ruling in *Picard v. Ida Fishman Revocable Trust*, 773 F.3d 411 (2d Cir. 2014) ("*Fishman*"), compelled the conclusion that the transfers were "for value." The Madoff Defendants also argued that the U.S. Supreme Court's ruling in *Cal. Publ. Employees' Retirement Sys. v. ANZ Securities, Inc.*, 137 S. Ct. 2042 (2017) ("*ANZ*"), clarified that permitting the trustee to recover the transfers would violate section 548(a)(1)'s two-year limitation period.

In *Fishman*, the Second Circuit affirmed the district court's ruling in *Greiff* dismissing the trustee's constructive fraudulent transfer claims. According to the Madoff Defendants, *Fishman* established a new rule—i.e., that courts must rely on the Bankruptcy Code alone, as distinguished from SIPA, to determine whether transfers are shielded from recovery by an affirmative defense. The *Madoff* district court rejected this argument, concluding that *Fishman*, which addressed whether the transfers were settlement payments for purposes of section 546(e), did not decide what

constitutes "for value" under section 548(c) and the two concepts are distinct.

In *ANZ*, the Supreme Court held that a statutory provision limiting claims under federal securities laws to those brought within three years of the securities offering is a "statute of repose," rather than a statute of limitation, meaning that the three-year period cannot be equitably tolled. According to the *Madoff* district court, *ANZ* did not require it to reconsider its earlier conclusion that the trustee's actual fraudulent transfer claims did not violate the two-year limitation in section 548(a)(1) because its previous decision approving the trustee's calculation of the amount that could be recovered from the Madoff Defendants "did not turn on whether § 548(a) was a statute of repose or a statute of limitation" and contained "no discussion of equitable tolling."

The district court adopted the bankruptcy court's recommendation and granted summary judgment in favor of the trustee. The Madoff Defendants appealed to the Second Circuit.

THE SECOND CIRCUIT'S RULING

The Second Circuit affirmed the district court's ruling.

The Madoff Defendants argued that they received the transfers "for value" because: (i) the transfers satisfied a property right to payment of "profits" created when MIS fabricated account statements that appeared to show customers' investments were profitable; and (ii) the transfers discharged MIS's liability on claims based on the Madoff Defendants' contract rights. Writing for the three-judge panel, Circuit Judge Robert D. Sack rejected these arguments.

According to Judge Sack, the Second Circuit did not hold in *Fishman* that customer account statements created property rights in the form of "securities entitlements" under the NYUCC but, instead, that transfers to customers qualified for the section 546(e) safe harbor as settlement payments. Even if the account statements created such entitlements under the NYUCC, Judge Sack explained, they did not give the Madoff Defendants property rights to fictitious profits from fictitious trading.

The Second Circuit also rejected the Madoff Defendants' argument that they gave value for the transfers in the form of a discharge of their contract rights under federal securities laws, which allow an innocent party to a securities contract procured by fraud to either void or enforce the contract. A finding that the transfers were "for value," Judge Sack noted, would conflict with SIPA, which prioritizes customers over general creditors and only selectively incorporates the Bankruptcy Code to the extent not inconsistent with SIPA's provisions.

A SIPA trustee can invoke the Bankruptcy Code's avoidance provisions to recover customer property, Judge Sack wrote, "[b]ut whether a transferee can invoke the 'for value' defense—exactly as that defense applies in bankruptcy, i.e., to transfers that satisfy debt or discharge liability on a claim—depends upon whether the defense would operate in a manner consistent with SIPA and its priority system." Under SIPA, he explained, customers may assert claims for a return of principal or net equity, but not fictitious profits "in excess of principal that depleted the resources of the customer property fund without an offsetting satisfaction of a debt or liability of that fund."

Next, the Second Circuit rejected the Madoff Defendants' argument that the trustee could not recover the transfers because the "underlying obligation" that gave rise to them arose more than two years prior to the SIPA petition date. According to Judge Sack, when the Madoff Defendants and MIS entered into a securities contract, "no right to the transfers at issue arose." Because MIS never generated any legitimate profits from trading, he wrote, the Madoff Defendants "had no rights to the transfers let alone rights that arose prior to the two-year limitation period."

Finally, the Second Circuit was unpersuaded by the Madoff Defendants' contention that both fraudulent transfer claims and the trustee's authority to compute amounts subject to recovery are subject to two-year limitation period, and that the trustee improperly "reach[ed] back" to dates prior to the beginning of the two-year period in calculating the recoverable amount. Judge Sack stated that "[t]here is no such limitation on a trustee's 'legal authority' to compute exposure under the fraudulent transfer provisions." According to the judge, unlike section 548(a), section 548(c) does not impose a two-year limitation on assessing whether a transfer was given "for value." Judge Sack agreed with the *Greiff* district court that "'[t]he concept of harm or benefit to the estate is separate from the concept of the reach-back period … [and] there is no reason why a line should be drawn at the beginning of the reach-back period in determining whether a transfer was for value.'"

OUTLOOK

Madoff is the latest installment in a decade-long saga involving hundreds of lawsuits dealing with the SIPA trustee's efforts to recover fictitious profits paid as part of the Madoff Ponzi scheme. The decision appears to foreclose definitively the defense that the recipient customers gave value in exchange for the payments in the form of discharged contract rights or "entitlements." It is possible that the Madoff Defendants will seek Supreme Court review of the ruling, but given the absence of a circuit split and the unique issues raised in *Madoff*, it appears unlikely that the Supreme Court would grant certiorari.

Madoff also reinforces the principle that, although the two statutory schemes are similar, SIPA and the Bankruptcy Code differ when it comes to prioritizing the claims of stakeholders: In keeping with its purpose, SIPA prioritizes "customers" ahead of general creditors, whereas the Bankruptcy Code does not except in certain limited circumstances (e.g., certain priority consumer deposit claims).

ADMINISTRATION SALES TO BE SUBJECT TO FURTHER SCRUTINY IN THE UNITED KINGDOM

Ben Larkin ▪ Kay Morley ▪ David Harding

Pre-pack sales have long been criticized by certain stakeholders for allowing the phoenix to rise from the ashes having shed its liabilities. However, they remain a popular restructuring tool, and given the current economic climate, we are likely to see an increased number of pre-pack insolvency sales in the next few years. In brief, a pre-pack sale involves the marketing of a business prior to its insolvency and the sale of the business and assets of the company by an insolvency practitioner immediately following his or her appointment. Pre-packs are particularly controversial where the business and assets of a company are sold to connected parties (e.g., directors, officers, shareholders, and affiliates). The Graham Review led to the creation of the pre-pack pool, an independent body that offers an opinion on pre-pack purchases. As submissions are voluntary, there has never been a strong take-up. In 2019, submissions dwindled to just 8% of all eligible transactions, leading the pre-pack pool to question its own future viability. In response, the Secretary of State has published draft regulations aimed at improving the scrutiny of sales by administrators to connected persons.

The regulations apply on a disposal by a company in administration of all or a substantial part of its business or assets to a connected person within the first eight weeks of the company's administration. An administrator is prohibited from making such a disposal unless either: (i) he or she obtains the approval of the company's creditors; or (ii) the buyer obtains a report from an evaluator who states whether he or she is satisfied that the consideration and the grounds for the disposal are reasonable in the circumstances.

The evaluator must be independent and qualified, meaning that the evaluator must self-certify that he or she has the requisite knowledge and experience to provide the report. The administrator must have no reason to dispute this.

The regulations permit the buyer to obtain more than one report, but all reports must be disclosed to the company's creditors. If none of the reports is favorable, the administrator must explain his or her reasons for proceeding with the disposal.

The regulations seek to instill confidence that the process is fair and transparent and achieves the best outcome for creditors. However, given the nature of administration sales, in most circumstances there is unlikely to be sufficient time to seek creditor approval. Absent creditor approval, while the requirement to obtain an independent report will add credibility to the pre-pack process, in the current economic climate, the time required to obtain such a report could be prohibitive; some businesses with inadequate liquidity to satisfy liabilities while a report is being prepared may fall into liquidation and not be rescued on a going concern basis. This would be an unwelcome result, but it highlights the difficult balance required, given the goal of ensuring that, if pre-pack sales in their current form are to continue, they must be credible and stand up to scrutiny in the best interests of all stakeholders.

NEWSWORTHY

Christopher DiPompeo (Washington) was honored among the *American Bankruptcy Institute*'s "40 under 40" for 2020.

Heather Lennox (Cleveland and New York) was named a "Midwest Trailblazer" for 2021 by *Law.com* and *The American Lawyer*.

An article written by **Mark A. Cody (Chicago)** and **Mark G. Douglas (New York)** titled *"Bankruptcy Blocking Right in Debtor's Corporate Charter Violates Federal Public Policy"* was published in the November 13, 2020, edition of the *International Law Office Newsletter*.

An article written by **Brad B. Erens (Chicago)** and **Mark G. Douglas (New York)** titled *"Cram-Down Chapter 11 Plan Need Not Strictly Enforce Subordination Agreement"* was published on November 26, 2020, in *Lexis Practical Guidance*.

An article written by **Daniel J. Merrett (Atlanta)** and **Mark G. Douglas (New York)** titled *"First Impressions: 10th Circuit BAP Rules that Section 364 of the Bankruptcy Code Does Not Apply to Chapter 11 Exit Financing"* was published on December 1, 2020, in *Lexis Practical Guidance*.

An article written by **Charles M. Oellermann (Columbus)** and **Mark G. Douglas (New York)** titled *"New York District Court Expands the Scope of the Bankruptcy Safe Harbor for LBO Payments"* was published on December 1, 2020, in *Lexis Practical Guidance*.

An article written by **Stacey L. Corr-Irvine** and **Mark G. Douglas (New York)** titled *"DIP Financing Agreement Initially Rejected As Sub Rosa Chapter 11 Plan"* was published on November 26, 2020, in *Lexis Practical Guidance*.

Juan Ferré (Madrid) was selected for inclusion in the 2021 edition of *The Best Lawyers in Spain* for his work in Insolvency and Reorganization Law.

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