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BUSINESS RESTRUCTURING REVIEW

FIRST IMPRESSIONS: THIRD CIRCUIT SCUTTLES TRIANGULAR SETOFF IN BANKRUPTCY

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The ability of a creditor to exercise its contractual, common law or statutory rights under non-bankruptcy law to set off amounts owed to a debtor in bankruptcy against the debtor's obligations to the creditor gives offsetting creditors an important advantage. Unlike many other creditors, creditors with setoff rights can receive preferential treatment in the form of full payment on their claims up to the amount of the setoff. However, a limitation on the exercise of setoff rights in bankruptcy is the Bankruptcy Code's requirement that the debts involved must be "mutual," a concept that is not well understood and sometimes disputed in the courts. The U.S. Court of Appeals for the Third Circuit recently addressed the meaning of mutuality in this context as a matter of first impression. In *In re Orexigen Therapeutics, Inc.*, 990 F.3d 748 (3d Cir. 2021), the Third Circuit affirmed lower court rulings that a "triangular setoff" does not satisfy the Bankruptcy Code's mutuality requirement.

SETOFF IN BANKRUPTCY

Section 553 of the Bankruptcy Code provides, subject to certain exceptions, that the Bankruptcy Code "does not affect any right of a creditor to offset a mutual debt owing by such creditor to the debtor that arose before the commencement of the case under this title against a claim of such creditor against the debtor that arose before the commencement of the case." Section 553 does not create setoff rights—it merely preserves certain setoff rights that otherwise would exist under contract or applicable nonbankruptcy law. *See* Collier on Bankruptcy ("Collier") ¶ 553.04 (16th ed. 2021) (citing *Citizens Bank of Maryland v. Strumpf*, 516 U.S. 16 (1995)). As noted by the U.S. Supreme Court in *Studley v. Boylston Nat. Bank*, 229 U.S. 523, 528 (1913), setoff avoids the "absurdity of making A pay B when B owes A."

With certain exceptions for setoffs under "safe harbored" financial contracts, a creditor is precluded by the automatic stay from exercising its setoff rights without bankruptcy court approval. *See* 11 U.S.C. §§ 362(a)(7), (b)(6), (b)(7), (b)(17), (b)(27), and (o). However, if it applies, the automatic stay merely suspends the exercise of such a setoff pending an orderly examination of the respective rights of the debtor and the creditor by the court, which will generally permit the setoff if the requirements under applicable law are met, except under circumstances where it would be inequitable to do so. *See In re Ealy*, 392 B.R. 408 (Bankr. E.D. Ark. 2008).

IN THIS ISSUE

A creditor stayed from exercising a valid setoff right must be granted "adequate protection" (*see* 11 U.S.C. § 361) against any diminution in the value of its interest caused by the debtor's use of the creditor's property. *Ealy*, 392 B.R. at 414.

Setoff is expressly prohibited by section 553 if: (i) the creditor's claim against the debtor is disallowed; (ii) the creditor acquires its claim from an entity other than the debtor either after the bankruptcy filing date or after 90 days before the petition date while the debtor was insolvent (with certain exceptions); or (iii) the debt owed to the debtor was incurred by the creditor after 90 days before the petition date, while the debtor was insolvent, and for the purpose of asserting a right of setoff (with certain exceptions). *See* 11 U.S.C. § 553(a)(1)-(3).

Thus, for a creditor to be able to exercise a setoff right in bankruptcy, section 553 requires on its face that: (i) the creditor has a right of setoff under applicable non-bankruptcy law; (ii) the debt and the claim are "mutual"; (iii) both the debt and the claim arose *prepetition*; and (iv) the setoff does not fall within one of the three prohibited categories specified in the provision. 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).

Creditors typically rely on the remedy of setoff if the mutual debts arise from *separate transactions*, although the issue is murky. *See* COLLIER at ¶ 553.10. By contrast, if mutual 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); *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).

MUTUALITY AND TRIANGULAR SETOFFS

The Bankruptcy Code does not define the term "mutual debt." Debts are generally considered mutual when they are due to and from the same persons or entities in the same capacity, but there is some confusion among the courts on this point. *See generally* COLLIER at ¶ 553.03[3][a] (citing cases).

For example, an exception to this strict mutuality requirement may exist in cases involving "triangular setoff," the provenance of which is commonly traced (rightly or wrongly) to a 1964 ruling construing section 68(a) of the former Bankruptcy Act of 1898 by the Seventh Circuit Court of Appeals in *Inland Steel Co. v. Berger Steel Co. (In re Berger Steel Co.)*, 327 F.2d 401 (7th Cir. 1964). In such a situation, A might have a business relationship with B and C, where B and C are related parties. Triangular setoff occurs when A owes B, and A attempts to set off that amount against amounts C owes to A. The validity of triangular setoff in the bankruptcy context, as distinguished from under state contract or common law, is subject to debate.

In *In re SemCrude, L.P.*, 399 B.R. 388 (Bankr. D. Del. 2009), *aff'd*, 428 B.R. 590 (D. Del. 2010), Bankruptcy Judge Brendan L. Shannon of the Delaware bankruptcy court ruled that triangular setoff is not permitted in bankruptcy due to the absence of mutuality. According to the court, "mutuality cannot be supplied by a multi-party agreement contemplating a triangular setoff." The court rejected the contention that parties can contract around section 553's mutuality requirement. It also rejected *Berger Steel* as authority for the proposition that non-mutual setoff provisions in a contract can be enforced against a debtor.

In *In re Lehman Bros. Inc.*, 458 B.R. 134 (Bankr. S.D.N.Y. 2011), a New York bankruptcy court similarly ruled that triangular setoff does not satisfy the Bankruptcy Code's mutuality requirement and that the Bankruptcy Code's safe-harbor provisions for financial contracts (*see* 11 U.S.C. §§ 555-56, 559-62) do not eliminate that requirement in connection with setoffs under such contracts.

Consistent with the rulings in *SemCrude* and *Lehman*, a Delaware bankruptcy court held in *In re American Home Mortgage Holdings, Inc.*, 501 B.R. 44 (Bankr. D. Del. 2013), that: (i) parties cannot contract around section 553's mutuality requirement; (ii) the Bankruptcy Code's safe harbor provisions for financial contracts "cannot be interpreted as implicitly removing the mutuality requirement for setoff"; and (iii) without moving for relief from the stay, the nondebtor counterparty to a swap or repurchase agreement cannot exercise control over estate property by retaining funds via exercising alleged triangular-setoff rights.

Other courts have also concluded that triangular setoff does not involve the mutuality required for setoff in bankruptcy. *See, e.g., Ciber Global, LLC v. SAP Am., Inc.*, 2021 WL 1141661, *8 (E.D. Pa. Mar. 25, 2021); *In re Celebrity Contractors, Inc.*, 524 B.R. 95, 110 (Bankr. E.D. La. 2014); *In re Arcapita Bank B.S.C.*, 2014 WL 2109931, *3 (Bankr. S.D.N.Y. May 20, 2014).

Until recently, however, this issue had not been ruled upon at the court of appeals level. The Third Circuit considered this question in *Orexigen*.

OREXIGEN

In 2016, pharmaceutical company Orexigen Therapeutics, Inc. ("OTI") entered into a distribution agreement with McKesson Corporation ("McKesson") under which McKesson agreed to distribute weight management drugs manufactured by OTI to pharmacies. The distribution agreement included a "setoff provision" that allowed "each of [McKesson] and its affiliates … to setoff, recoup and apply any amounts owed by it to [OTI's] affiliates against any [and] all amounts owed by [OTI] or its affiliates to any of [McKesson] or its affiliates."

Later in 2016, OTI entered into a separate services agreement with McKesson subsidiary McKesson Patient Relationship Solutions ("MPRS") under which MPRS managed a customer loyalty program for OTI whereby patients would receive price discounts from pharmacies. MPRS advanced funds to pharmacies selling OTI's drugs, and OTI reimbursed MPRS for the advances. The distribution agreement and the services agreement did not reference, incorporate, or integrate one another.

OTI filed for chapter 11 protection on March 12, 2018, in the District of Delaware. At that time, OTI owed MPRS approximately $9.1 million under the services agreement, and McKesson owed OTI approximately $6.9 million under the distribution agreement. Had there been a setoff under the distribution agreement prior to the petition date, OTI would have owed MPRS approximately $2.2 million, and McKesson would have owed OTI nothing.

In OTI's bankruptcy, McKesson argued that it should be permitted to exercise the setoff but later agreed to pay the $6.9 million it owed to OTI, which amount was segregated pending resolution of the dispute by the bankruptcy court. Bankruptcy Judge Kevin Gross denied McKesson's request to exercise the setoff. He concluded that, although the setoff provision created an enforceable contractual right to effect a prepetition triangular setoff under state law, that relationship "does not supply the strict mutuality required in bankruptcy."

Relying on *SemCrude* and *Lehman*, Judge Gross reasoned that contracts cannot transform non-mutual debts into debts satisfying the mutuality requirement of section 553. He rejected McKesson's argument that mutuality merely "identifies the state-law right that is thereby preserved unaffected in bankruptcy." Judge Gross also rejected the argument that MPRS's alleged status as a third-party beneficiary of the distribution agreement created mutuality, characterizing those arguments as attempts to "contract around section 553(a)'s mutuality requirement."

The district court affirmed on appeal, and McKesson appealed to the Third Circuit.

THE THIRD CIRCUIT'S RULING

A three-judge panel of the Third Circuit also affirmed. Writing for the court, Circuit Judge Kent A. Jordan initially noted that "[t]he meaning of mutuality in [section 553] is a matter of first impression for us" and that, although "our sister circuits have opined on the importance of mutuality as a distinct limitation of § 553, they have not ruled on whether a contract can create an exception to the requirement of direct mutuality."

Citing *SemCrude* and *Lehman* with approval, Judge Jordan rejected McKesson's contention that both the general right to enforce a setoff and the required mutuality are defined by state law, and that section 553 imposes "no independent mutuality limitation." Specifically, McKesson argued that, because section 553 includes three enumerated federal exceptions to the right to enforce a setoff in sections 553(a)(1)-(3) (as described above), lawmakers would have included an enumerated exception addressing mutuality if they "had intended that concept to serve as a limitation under federal law rather than a term simply descriptive of state law." According to Judge Jordan, "McKesson's reading of the provision would render the term 'mutual' redundant, as the phrase 'any right … to offset' provides adequate definitional scope to § 553." Moreover, he explained, the text in section 553(a) immediately following the "mutuality" requirement—which limits setoff to prepetition debts—has consistently been "viewed as a distinct limitation on the ability to assert a setoff right, and there is no persuasive reason to treat the requirement of mutuality any differently."

Having determined that mutuality is a "distinct and limiting requirement of federal bankruptcy law," the Third Circuit panel determined that triangular setoffs do not satisfy the requirement. Judge Jordan noted that setoff is inconsistent with the fundamental bankruptcy policy of equality of distribution among similarly situated creditors. For this reason, he explained, lawmakers' intent to exclude contractual modifications purporting to establish mutuality for setoff purposes beyond simple, bilateral relationships is "not surprising." According to Judge Jordan, the reasoning on this point articulated in *SemCrude*, *Lehman* and other decisions rejecting triangular setoffs (including the lower courts in this case) was persuasive. In addition to serving the goal of the Bankruptcy Code to ensure that similarly situated creditors are treated fairly and enjoy equality of distribution absent compelling circumstances, he wrote, "a rule that excludes nonmutual debts from the setoff privilege of § 553 promotes predictability in credit transactions."

Finally, the Third Circuit panel rejected McKesson's argument that it actually asserted a direct claim against OTI under the setoff provision of the distribution agreement, noting that this position, which was also considered and rejected by the *SemCrude* court, "is nothing but a recasting of [McKesson's] failed effort to defeat the purpose and meaning of § 553" based on a flawed interpretation of the definition of "claim."

OUTLOOK

With *Orexigen*, a federal court of appeals has now apparently for the first time unequivocally concluded that, even though "triangular setoff" may be enforceable under state law, it is not permitted in bankruptcy. This means that cross-affiliate setoff without mutuality continues to be impermissible at least in the two most popular business bankruptcy jurisdictions in the United States—the Southern District of New York and the District of Delaware—and likely most other jurisdictions. However, the Third Circuit indicated in *dicta* that alternative structures to contractual triangular setoff provisions, such as cross-collateralization, joint and several liability, or perfected security interests in receivables owed by or to affiliates, might be enforceable in bankruptcy.

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SHOULD EQUITABLE MOOTNESS BAR APPEALS ONLY OF CHAPTER 11 PLAN CONFIRMATION ORDERS?

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The court-fashioned doctrine of "equitable mootness" has traditionally been invoked to bar appeals of orders confirming "substantially consummated" chapter 11 plans. Some appellate courts, however, have applied it to bar appeals of other kinds of bankruptcy court orders unrelated to plan confirmation. As demonstrated by a ruling recently handed down by the U.S. District Court for the Northern District of Texas, courts disagree on whether equitable mootness should apply outside of the plan context. In *Harden Healthcare LLC v. OLP Wyoming Springs LLC (In re Senior Care Centers, LLC)*, 2021 WL 632779 (N.D. Tex. Feb. 18, 2021), the district court affirmed a bankruptcy court order approving a settlement reached in connection with a sale transaction. In so ruling, the court held that the appeal was neither equitably nor statutorily moot, noting that, according to Fifth Circuit precedent, equitable mootness should not be expanded into such a "new frontier."

DISMISSAL OF APPEALS UNDER THE DOCTRINE OF MOOTNESS

"Mootness" is a doctrine that precludes a reviewing court from reaching the underlying merits of a controversy. An appeal can be either constitutionally, equitably, or statutorily moot. Constitutional mootness is derived from Article III of the U.S. Constitution, which limits the jurisdiction of federal courts to actual cases or controversies and, in furtherance of the goal of conserving judicial resources, precludes adjudication of cases that are hypothetical or merely advisory.

Equitable Mootness. The court-fashioned remedy of "equitable mootness" bars adjudication of an appeal when a comprehensive change of circumstances has occurred such that it would be inequitable for a reviewing court to address the merits of the appeal. In bankruptcy cases, appellees often invoke equitable mootness as a basis for precluding appellate review of an order confirming a chapter 11 plan.

The doctrine of equitable mootness is sometimes criticized as an abrogation of federal courts' "virtually unflagging obligation" to hear appeals within their jurisdiction. *In re One2One Commc'ns, LLC*, 805 F.3d 428, 433 (3d Cir. 2015); *In re Charter Commc'ns, Inc.*, 691 F.3d 476, 481 (2d Cir. 2012). According to this view, dismissing an appeal on equitable mootness grounds "should be the rare exception." *In re Tribune Media Co.*, 799 F.3d 272, 288 (3d

Cir. 2015); *accord In re Pac. Lumber Co.*, 584 F.3d 229, 240 (5th Cir. 2009) (equitable mootness should be applied "with a scalpel rather than an axe").

Substantially similar tests have been applied by most circuit courts of appeals in assessing whether an appeal of a chapter 11 confirmation order should be dismissed under the doctrine. Those tests generally focus on whether the appellate court can fashion effective and equitable relief. *See, e.g., PPUC Pa. Pub. Util. Comm'n v. Gangi*, 874 F.3d 33, 37 (1st Cir. 2017) (considering whether: (i) the appellant diligently pursued all available remedies to obtain a stay of the confirmation order; (ii) the challenged chapter 11 plan had progressed "to a point well beyond any practicable appellate annulment"; and (iii) providing relief would harm innocent third parties); *JPMCC 2007-C1 Grasslawn Lodging, LLC v. Transwest Resort Props., Inc. (In re Transwest Resort Props., Inc.)*, 801 F.3d 1161, 1167–68 (9th Cir. 2015) (applying a four-factor test, including whether the court "can fashion effective and equitable relief without completely knocking the props out from under the plan and thereby creating an uncontrollable situation for the bankruptcy court"); *Tribune*, 799 F.3d at 278 (considering "(1) whether a confirmed plan has been substantially consummated; and (2) if so, whether granting the relief requested in the appeal will (a) fatally scramble the plan and/or (b) significantly harm third parties who have justifiably relied on plan confirmation"); *Search Market Direct, Inc. v. Jubber (In re Paige)*, 584 F.3d 1327, 1339 (10th Cir. 2009) (applying a six-factor test, including the likely impact upon a successful reorganization of the debtor if the appellant's challenge is successful); *In re United Producers, Inc.*, 526 F.3d 942, 947–48 (6th Cir. 2008) (three-factor test); *TNB Fin., Inc. v. James F. Parker Interests (In re Grimland, Inc.)*, 243 F.3d 228, 231 (5th Cir. 2001) (same); *see also In re Fin. Oversight & Mgmt. Bd. for Puerto Rico*, 987 F.3d 173, 182 (1st Cir. 2021) (holding that the doctrine of equitable mootness was not abrogated by the U.S. Supreme Court's ruling in *Mission Product Holdings, Inc. v. Tempnology, LLC*, 139 S. Ct. 1652 (2019), and that the doctrine applied to dismiss an appeal of an order approving a plan in a proceeding under the Puerto Rico Oversight, Management and Economic Stability Act).

A common element of almost all of these tests is whether the chapter 11 plan has been substantially consummated. Section 1101(2) of the Bankruptcy Code provides that "substantial consummation" of a chapter 11 plan occurs when substantially all property transfers proposed by the plan have been completed, the debtor or its successor has assumed control of the debtor's business and property, and plan distributions have commenced.

Some courts, including the Third and Fifth Circuits, have taken the position that equitable mootness does not apply outside the context of appeals of chapter 11 plan confirmation orders. *See, e.g., In re LCI Holding Company, Inc.*, 802 F.3d 547, 554 (3d Cir. 2015) (stating that the doctrine "comes into play in bankruptcy (so far as we know, its only playground) after a plan of reorganization is approved" and ruling that equitable mootness would not cut off the authority to hear an appeal outside the plan context); *In re Sneed Shipbuilding, Inc.*, 916 F.3d 405, 409 (5th Cir. 2019) ("We recognize that some courts outside our circuit have employed equitable mootness when reviewing settlement agreements, not just plan confirmations, in particularly messy cases…. But that just highlights the second reason why equitable mootness should not apply to [an order approving a settlement]: this settlement and sale were not sufficiently complex. Equitable mootness is aimed at limiting review of complex plans whose implementation has substantial secondary effects.").

Other courts, including the Second, Fourth, Ninth, Tenth, and Eleventh Circuits, have been less constrained in relying on the doctrine to dismiss appeals. *See, e.g., In re Windstream Holdings, Inc.*, 838 F. App'x 634, 637 (2d Cir. 2021) (ruling that an appeal of a "critical vendor" order was equitably moot after confirmation of a chapter 11 plan and noting that: "Our precedent is clear that equitable mootness can be applied 'in a range of contexts,' including appeals involving all manner of bankruptcy court orders…. [A]n appeal does not need to directly challenge a reorganization plan to impact that plan."); *Myers v. Offit Kurman, P.A.*, 773 F. App'x 161, 162 (4th Cir. 2019) (finding that an appeal from a bankruptcy court order granting a chapter 7 trustee's motion for approval of a settlement agreement was equitably moot given that the agreement had been fully consummated and funds had been distributed accordingly); *Stokes v. Gardner*, 483 F. App'x 345, 346 (9th Cir. 2012) (finding that an appeal of an order approving a settlement agreement in a chapter 7 case was equitably moot); *Ordonez v. ABM Aviation, Inc.*, 787 F. App'x 533 (10th Cir. 2019) (appeals from a bankruptcy court order relating to a chapter 7 trustee's settlement of the debtor's employment discrimination claims were equitably moot, since the debtor did not diligently seek a stay, the settlement agreement had been fully consummated, the funds had been distributed, the estate had been fully administered, and the debtor's challenges were neither legally meritorious nor equitably compelling); *In re JMC Memphis, LLC*, 655 F. App'x 802 (11th Cir. 2016) (dismissing as equitably moot an appeal from an unstayed order approving a settlement between the chapter 7 trustee and the debtor's property insurer).

Statutory Mootness. An appeal can also be rendered moot (or otherwise foreclosed) by statute. For example, section 363(m) of the Bankruptcy Code provides that "[t]he reversal or modification on appeal of an authorization … of a sale or lease of property does not affect the validity of a sale or lease under such authorization to an entity that purchased or leased such property in good faith." Although courts disagree on the point, section 363(m) has been interpreted "to render statutorily moot any appellate challenge to a sale that is both to a good faith purchaser, and not stayed." *Mission Product Holdings, Inc. v. Old Cold, LLC (In re Old Cold, LLC)*, 879 F.3d 376, 383 (1st Cir. 2018).

Section 363(m) is a powerful protection for good-faith purchasers because it limits appellate review of a consummated sale irrespective of the legal merits of the appeal. *See Made in Detroit, Inc. v. Official Comm. of Unsecured Creditors of Made in Detroit, Inc. (In re Made in Detroit, Inc.)*, 414 F.3d 576 (6th Cir. 2005); *see also In re Palmer Equip., LLC*, 623 B.R. 804, 808 (Bankr. D. Utah 2020) (section 363(m)'s protection is vital to encouraging buyers to purchase the debtor's property and thus ensuring that adequate sources of financing remain available).

The circuits are split regarding whether section 363(m) automatically moots an appeal of an order approving a sale under all circumstances. Some circuits, including the First, Second, Fifth, Eleventh, and D.C. Circuits, have held that, in the absence of a stay of the sale order, the court must dismiss a pending appeal as moot unless the purchaser did not act in good faith. *Old Cold*, 879 F.3d at 383; *U.S. v. Salerno*, 932 F.2d 117 (2d Cir. 1991); *In re Sneed Shipbuilding, Inc.*, 916 F.3d 405 (5th Cir. 2019); *In re Steffen*, 552 F. App'x 946 (11th Cir. 2014); *In re Magwood*, 785 F.2d 1077 (D.C. Cir. 1986); *see also In re Pursuit Holdings (NY), LLC*, 2021 WL 864714 (2d Cir. Mar. 9, 2021) (the statutory mootness rule indisputably applies to challenges to any integral provision of an order approving a sale, such as a settlement); *In re Ern, LLC*, 124 F. App'x 151, 152 (4th Cir. 2005) (dismissing an appeal of a sale order as moot because the assets had been transferred and the party challenging the sale failed to obtain a stay pending appeal); *In re Trism, Inc.*, 328 F.3d 1003, 1007 (8th Cir. 2003) (mooting under section 363(m) "a challenge to a related provision of an order authorizing the sale of the debtor's assets" because the related provision was integral to the sale of the assets and reversing the provision would alter the parties' bargained-for exchange); *In re Rimoldi*, 172 F.3d 876, 1999 WL 132260, *1 (9th Cir. 1999) ("This court has recognized only two exceptions to section 363(m)'s rule of mootness. The first applies where real property is sold subject to a statutory right of redemption; the second applies where state law otherwise would permit the transaction to be set aside.").

Other circuits, including the Third, Sixth, and Tenth Circuits, have rejected the view that section 363(m) automatically moots an appeal. Instead, these courts have held that an appeal is not moot as long as it is possible to grant effective relief without impacting the validity of the sale. *See In re ICL Holding Co., Inc.*, 802 F.3d 547, 554 (3d Cir. 2015) (section 363(m) did not moot the government's appeal of the terms for distribution of escrowed funds for administrative expenses and settlement proceeds from the sale of substantially all of the debtors' assets since the court could order redistribution of the sale proceeds without disturbing the sale); *Brown v. Ellmann (In re Brown)*, 851 F.3d 619 (6th Cir. 2017) (finding that parties alleging statutory mootness under section 363(m) must prove that the reviewing court is unable to grant effective relief); *Osborn v. Duran Bank & Trust Co. (In re Osborn)*, 24 F.3d 1199 (10th Cir. 1994) (holding that an appeal of a sale order was not mooted by section 363(m) when under Texas state law a constructive trust could be imposed on the sale proceeds), *abrogated in part on other grounds by Eastman v. Union Pac. R.R.*, 493 F.3d 1151 (10th Cir. 2007); *In re C.W. Min. Co.*, 740 F.3d 548, 555 (10th Cir. 2014) (section 363(m) will moot appeals in cases where the only remedies available are those that affect the validity of the sale).

In *Trinity 83 Dev., LLC v. ColFin Midwest Funding, LLC*, 917 F.3d 599 (7th Cir. 2019), the Seventh Circuit held that section 363(m) did not moot an appeal involving a dispute over the proceeds of a sale of assets in bankruptcy. In concluding that section 363(m) did not moot such an appeal, but merely provided the purchaser with a defense in litigation challenging the sale, the Seventh Circuit overruled its prior decision strictly construing the scope of section 363(m) in *In re River West Plaza-Chicago, LLC*, 664 F.3d 668, 671-72 (7th Cir. 2011). According to the Seventh Circuit in *Trinity 83*, "We now hold that § 363(m) does not make any dispute moot or prevent a bankruptcy court from deciding what shall be done with the proceeds of a sale or lease." *Trinity 83*, 917 F.3d at 602.

SENIOR CARE

Senior Care Centers LLC and PM Management-Round Rock AL LLC (collectively, "debtors") operated skilled-nursing and assisted-living facilities throughout the United States, including the Wyoming Springs Assisted Living and Memory Care ("Wyoming Springs") in Texas. The debtors leased the Wyoming Springs facility from OLP Wyoming Springs LLC ("OLP"). Harden Healthcare LLC "(Harden") guaranteed the debtors' obligations under the lease.

The debtors filed for chapter 11 protection in December 2018 in the Northern District of Texas. Shortly afterward, the bankruptcy court authorized them to reject the Wyoming Springs lease because the facility was unprofitable. OLP had opposed rejection as well as other relief sought by the debtors in their chapter 11 cases. However, the debtors and OLP resolved those disputes in a settlement agreement whereby, among other things, the parties agreed on the amount of OLP's claims against the debtors and OLP agreed to support confirmation of the debtors' proposed chapter 11 plan.

The debtors also sought court approval of an agreement ("OTA") to sell the Wyoming Springs operation and certain related assets to a new operator, which would sign a new lease for the premises with OLP. The bankruptcy court approved the settlement agreement and the OTA in orders entered on October 11, 2019, and October 25, 2019, respectively. It confirmed the debtors' joint chapter 11 plan on December 13, 2019.

Harden appealed the order approving the settlement agreement but did not seek a stay of the order pending appeal. Harden argued that the bankruptcy court erred in approving the settlement agreement on an inappropriately expedited basis without adequate information. The debtors disputed that assertion but also argued that the appeal was equitably and statutorily moot because Harden failed to obtain a stay pending appeal, the debtors' chapter 11 plan had been substantially consummated, and all of the transactions contemplated by the "inextricably intertwined" settlement agreement and OTA "ha[d] occurred and cannot be unwound."

THE DISTRICT COURT'S RULING

District Judge Jane J. Boyle affirmed the order approving the settlement agreement. However, she rejected the debtors' argument that the appeal should be dismissed as being equitably or statutorily moot.

Harden, Judge Boyle explained, did not appeal the order confirming the debtors' plan but the order approving the settlement. She further noted that the Fifth Circuit has declined "to expand equitable mootness into … [a] new frontier" involving "settlement agreements, not just plan confirmations, in particularly messy cases," as courts have done in other circuits.

Thus, Judge Boyle found no reason or authority for applying the doctrine to an order approving a settlement agreement, especially because the case before the court was not a "particularly messy case." According to her, it was unclear whether the sale had been consummated. Moreover, Judge Boyle wrote, "unwinding it would simply involve transferring ownership of the nursing home back to the estate." It would not substantially impact the confirmed plan or prejudice third parties.

Judge Boyle also concluded that Harden's appeal was not statutorily moot under section 363(m). She reiterated that, contrary to the debtors' assertions, it was unclear whether the OTA sale transaction had actually closed. In addition, because the order approving the settlement agreement was on appeal, Judge Boyle noted that the agreement was not effective in accordance with its terms, which conditioned effectiveness on the existence of a "final, nonappealable order." "[G]iven the lack of certainty as to whether the sale at issue has closed," she wrote, "the Court declines to find this appeal statutorily moot."

Turning to the merits of the appeal, Judge Boyle determined that the bankruptcy court did not abuse its discretion in approving the settlement according to the standards established by Fifth Circuit precedent. She accordingly dismissed Harden's appeal.

OUTLOOK

As illustrated by *Senior Care*, in addition to construing the doctrine of equitable mootness narrowly in all cases, appellate courts in the Fifth Circuit have declined to expand the doctrine's application to appeals of orders other than plan confirmation orders. This is in contrast to other courts, which have endorsed application of equitable mootness in other contexts, generally under circumstances where the transaction authorized by an appealed order has been fully consummated and it would be both prejudicial and inequitable to undo the relief granted.

Interestingly, because the court found that it was unclear whether the sale transaction in *Senior Care* had closed, the court did not examine whether the absence of a stay pending appeal or the buyer's good faith would have mooted the appeal under section 363(m).

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DEBATE INTENSIFIES ON SUBSTANTIAL CONTRIBUTION CLAIMS IN CHAPTER 7 CASES

Daniel J. Merrett ■ Mark G. Douglas

To encourage creditors, equity interest holders, indenture trustees, and unofficial committees to take actions that benefit a chapter 9 or chapter 11 estate, the Bankruptcy Code confers administrative expense status on claims for expenses incurred by them in making a "substantial contribution" in such cases. Administrative expense status is also given to claims for reimbursement of reasonable professional fees incurred by such entities in making a substantial contribution.

Courts disagree over whether substantial contribution claims can also be allowed in cases under chapter 7 of the Bankruptcy Code. The U.S. Bankruptcy Court for the Northern District of Illinois examined this thorny issue in *In re Concepts Am., Inc.*, 625 B.R. 881 (Bankr. N.D. Ill. 2021). The court ruled that "[t]he plain and unambiguous language of § 503(b)(3)(D) is conclusive—substantial contribution claims are allowed as administrative expenses only in Chapters 9 and 11, not in Chapter 7."

ADMINISTRATIVE EXPENSE PRIORITY FOR MAKING A "SUBSTANTIAL CONTRIBUTION"

Section 503(b) of the Bankruptcy Code provides that, after notice and a hearing, the bankruptcy court shall allow as administrative expenses certain costs and expenses, "including" nine categories of claims, such as postpetition employee wages, postpetition taxes, professional compensation claims, and certain prepetition vendor claims. One of those categories is for "actual, necessary expenses" incurred by certain individual creditors, including creditors that file involuntary bankruptcy petitions (section 503(b)(3)(A)), creditors that recover estate property transferred or concealed by the debtor (section 503(b)(3)(B)), and creditors involved in the prosecution of criminal offenses relating to a bankruptcy case or to a debtor's business or property (section 503(b)(3)(C)).

Additionally, pursuant to section 503(b)(3)(D), administrative expense claims include the actual, necessary expenses incurred by "a creditor [or certain other parties-in-interest] in making a substantial contribution in a case under chapter 9 or 11 of this title." Relatedly, section 503(b)(4) grants administrative-expense priority for "reasonable compensation for professional services rendered by an attorney or an accountant of an entity whose expense is allowable under" section 503(b)(3)(D) and "reimbursement for actual, necessary expenses incurred by such attorney or accountant."

These provisions are an "accommodation between the two objectives of encouraging meaningful creditor participation in the reorganization process and keeping administrative expenses and fees at a minimum to maximize the estate for creditors." *In re AmFin Fin. Corp.*, 468 B.R. 827, 831 (Bankr. N.D. Ohio 2012).

The Bankruptcy Code neither defines "substantial contribution" nor sets forth criteria to be used in determining whether a creditor or other qualified entity has made a substantial contribution in a chapter 9 or chapter 11 case. The legislative history of the provisions similarly provides little clarity. The issue, therefore, of whether a creditor has made a "substantial contribution" is a question of fact, with the moving party bearing the burden of proof. Most courts narrowly construe what constitutes a "substantial contribution," and most have taken the position that substantial contribution claims, like other section 503(b) claims, should be strictly limited. *See generally* COLLIER ON BANKRUPTCY ("COLLIER") ¶ 503.10[5][a] (16th ed. 2021).

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

For example, in the Third and Tenth Circuits, actions motivated solely by self-interest are generally not compensable under section 503(b)(3)(D). *See Lebron v. Mechem Financial, Inc.*, 27 F.3d 937 (3d Cir. 1994); *In re Lister*, 846 F.2d 55 (10th Cir. 1988).

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

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

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

SUBSTANTIAL CONTRIBUTION CLAIMS IN CHAPTER 7 CASES?

Although section 503(b)(3)(D) expressly refers to expenses incurred in making a substantial contribution in a "chapter 9 or 11" case, some courts have held that substantial contribution claims may be allowed in chapter 7 cases. Most prominent among them is the only circuit court of appeals that has directly addressed the issue to date.

In *In re Connolly N. Am., LLC*, 802 F.3d 810 (6th Cir. 2015), a divided panel of the Sixth Circuit reversed lower court rulings denying a substantial contribution claim asserted by three unsecured creditors in a chapter 7 case that successfully prevailed in litigation to remove the chapter 7 trustee for misfeasance. The Sixth Circuit majority concluded that, despite the language of section 503(b)(3)(D), a bankruptcy court can confer administrative expense priority upon expenses not specifically mentioned in the provision using its broad equitable authority.

The majority reasoned that, because the term "including" in the introductory paragraph of section 503(b) "is not limiting," lawmakers did not intend to confine the scope of allowable expenses to the nine categories expressly enumerated in the provision but anticipated that "bankruptcy courts would encounter a variety of administrative expenses and circumstances warranting reimbursement, which [they] could then evaluate on a case-by-case basis." *Id.* at 816. According to the majority, "[i]t makes good sense that in providing" examples of common administrative expenses in section 503(b), "Congress would expressly mention Chapter 9 and 11 in the context of creditor activity making a 'substantial contribution,' but not Chapter 7 … [because] in all but the most atypical Chapter 7 case," the Office of the U.S. Trustee ("UST") devotes resources to benefit the estate as the "watchdog[]" to prevent fraud, dishonesty, and overreaching in bankruptcy. *Id.* at 817.

In a dissenting opinion, Circuit Judge Kathleen O'Malley faulted the majority approach under principles of statutory construction:

> Under the majority's interpretation of § 503(b), § 503(b)(3)(D) would be superfluous. If substantial contributions in a Chapter 7 proceeding can be considered an administrative expense under the broad "including" provision of § 503(b), then there is no reason why substantial contributions in Chapter 9 and 11 proceedings could not also have been considered administrative expenses under that same language, making § 503(b)(3)(D) unnecessary.

Id. at 821 (dissent). Judge O'Malley also stated that "[a]lthough the majority reads much into Congress's use of 'including' in § 503(b), Congress's failure to include Chapter 7 in § 503(b)(3)(D) seems to be far more indicative of its intent, especially where Congress used the term 'including' in § 503(b)(1)(A) and did not do so in § 503(b)(3)." *Id.* at 824. She also noted that a previous panel of the Sixth Circuit recognized (albeit in *dicta*) that substantial contribution claims are limited to chapter 9 and 11 cases in *In re Trailer Source, Inc.*, 555 F.3d 231 (6th Cir. 2009), and the vast majority of district and bankruptcy courts have expressly held that substantial contributions in a chapter 7 case are not administrative expenses.

Other courts have followed *Connolly*, but this represents the minority view. *See, e.g., In re Thacker*, 2020 WL 4000864 (Bankr. N.D. Fla. May 28, 2020); *In re Javed*, 592 B.R. 615 (Bankr. D. Md. 2018); *In re Maust Transp., Inc.*, 589 B.R. 887 (Bankr. W.D. Wash. 2018); *In re Maqsoudi*, 566 B.R. 40 (Bankr. C.D. Cal. 2017); *see generally* COLLIER at ¶ 503.10 (noting that *Connolly* is the minority view and citing cases).

Courts have also held that substantial contribution claims under section 503(b)(3)(D) may not be allowed in chapter 12 and 13 cases. *See In re Peterson*, 152 B.R. 612 (D.S.D. 1993) (chapter 12); *In re Chavez*, 2006 WL 3832858 (Bankr. E.D. Cal. Dec. 27, 2006) (chapter 13); *In re Rakosi*, 99 B.R. 47 (Bankr. S.D. Cal. 1989) (same).

CONCEPTS AMERICA

In May 2011, an affiliate of Concepts America, Inc. ("CA"), an Illinois-based restaurant management company, leased restaurant premises from Galleria Mall Investors LP ("Galleria"). After the affiliate breached the lease, Galleria sued, and a Texas state court entered a judgment against the affiliate and CA, which had guaranteed the lease.

Stymied in its efforts to collect on the judgment, Galleria joined with two other creditors in 2014 to file an involuntary chapter 7 petition against CA in the Northern District of Illinois. After CA consented to the entry of an order for relief, the chapter 7 trustee retained special counsel to investigate fraudulent transfer claims against CA and its affiliates. The trustee later sued more than 20 defendants based on those claims.

Galleria asserted that it "did the important work of unearthing" the facts and documents that gave rise to the claims asserted by the trustee. It accordingly sought allowance of an administrative expense claim under section 503(b)(3)(A), 503(b)(3)(D), and 503(b)(4) in the amount of more than $240,000, arguing, among other things, that Galleria made a substantial contribution in the bankruptcy case.

THE BANKRUPTCY COURT'S RULING

The bankruptcy court denied Galleria's substantial contribution claim because it concluded that such claims are not permitted in a chapter 7 case.

Applying well-established principles of statutory construction, Bankruptcy Judge David. D. Cleary reasoned as follows:

- The language of section 503(b)(3)(D) clearly and unambiguously limits such claims to chapter 9 and chapter 11 cases, and applying the plain meaning of the provision would not be absurd or "produce a result demonstrably at odds" with lawmakers' intent.
- The purpose of allowing substantial contribution claims is "to recognize that the creditor 'substantially contributed[d] to the reorganization efforts during the pendency of a chapter 11 case'" (citation omitted), and because there is no reorganization in chapter 7, "it is not absurd to read § 503(b)(3)(D) as applying only to Chapters 9 and 11."
- Following the provision's plain language comports with the "American Rule" that each litigant should bear its own attorneys' fees, regardless of the outcome, unless a statute or contract provides otherwise, which is not the case here.
- Other subsections of section 503(b)(3) are not expressly limited to cases under certain chapters, indicating that lawmakers knew what they were doing when limiting substantial contribution claims to chapter 9 and 11 cases, and necessarily meant to exclude such claims in cases under other chapters.
- The specific limitations stated in 503(b)(3)(D) (limiting such claims to chapter 9 and 11 cases) take precedence over the "general permission" given in section 503(b), which states that the nine listed categories of administrative expense claims are not exclusive.

In addition, Judge Cleary noted that the majority of courts that have considered the issue have limited substantial contribution claims to chapter 9 and 11 cases.

He faulted the Sixth Circuit's holding in *Connolly* as "a flawed interpretation of 'including' in section 503(b)." Judge Cleary acknowledged that, in section 503(b)(1)(A) (conferring administrative expense priority on the "actual, necessary costs and expenses of preserving the estate"), "including" is not limited to the listed examples "but could extend to a variety of other items."

However, he explained, only one of the other eight categories in section 503(b)—section 503(b)(8), which confers administrative expense status on certain health care business closure costs and expenses—contains the word "including." "The other seven do not," Judge Cleary wrote, and "are therefore limited to the situations described," which is "also true for the six subcategories of actual, necessary expenses in § 503(b)(3)." According to Judge Cleary, lawmakers would not have specifically provided for substantial contribution claims in chapter 9 and 11 cases "if they could simply be swept into a new category of actual, necessary expenses."

Judge Cleary also noted that there are other remedies for creditors who provide benefits in chapter 7 cases, including: (i) section 543(c)(1) of the Bankruptcy Code, which requires the court to "protect all entities to which a custodian has become obligated"; and (ii) the ability to have their attorneys retained and compensated directly by the chapter 7 estate.

Finally, Judge Cleary emphasized that a bankruptcy court's equitable powers can be exercised only within the confines of the Bankruptcy Code, which in this case prohibits substantial contribution claims in cases other than chapter 9 or 11 cases. He also wrote that "the power to correct a statute—if correction is needed—lies with the legislature alone."

OUTLOOK

Concepts America does not stake out any new ground in the debate over substantial contribution claims in cases other than chapter 9 or 11 cases. Even so, the decision contains a careful and detailed analysis of the issue based on accepted rules of statutory construction and bankruptcy policy considerations. It therefore provides useful guidance regarding a conflict that is likely to continue absent additional appellate precedent or legislative action.

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BANKRUPTCY COURT RECHARACTERIZES PURPORTED LOAN AS EQUITY

Paul M. Green ■ Mark G. Douglas

It is generally recognized that a bankruptcy court has the power—either equitable or statutory—to recharacterize a purported debt as equity if the substance of the transaction belies the labels the parties have given it. A ruling handed down by the U.S. Bankruptcy Court for the Southern District of New York provides a textbook example of such a recharacterization. In *In re Live Primary, LLC*, 2021 WL 772248 (Bankr. S.D.N.Y. Mar. 1, 2021), the court held that a purported loan made to a startup limited liability company by one of its members should be treated as a capital contribution because, among other things, the company was inadequately capitalized and the unsecured "loan" was not properly documented, bore a *de minimis* interest rate, and was repayable only upon the occurrence of a stock offering or a change of control.

RECHARACTERIZATION

Source of Power to Recharacterize Debt as Equity. The power to treat a debt as if it were actually an equity interest is derived from principles of equity. It emanates from the bankruptcy court's power to ignore the form of a transaction and give effect to its substance. *See Pepper v. Litton*, 308 U.S. 295, 305 (1939). However, because the Bankruptcy Code does not expressly empower a bankruptcy court to recharacterize debt as equity, some courts disagree as to whether they have the authority to do so and, if so, the source of such authority.

Every circuit court of appeals that has considered the issue has upheld the power of a bankruptcy court to recharacterize a claim as equity, notwithstanding the parties' characterization of a prepetition advance as a "debt." *See generally* COLLIER ON BANKRUPTCY ("COLLIER") ¶ 510.02 (16th ed. 2021) (citing cases). Some circuits have held that a bankruptcy court's power to recharacterize derives from the broad equitable powers set forth in section 105(a) of the Bankruptcy Code, which provides that "[t]he court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of [the Bankruptcy Code]." *See In re Dornier Aviation (N. Am.), Inc.*, 453 F.3d 225 (4th Cir. 2006); *In re SubMicron Sys. Corp.*, 432 F.3d 448 (3d Cir. 2006); *In re Hedged-Invs. Assocs., Inc.*, 380 F.3d 1292 (10th Cir. 2004); *In re AutoStyle Plastics, Inc.*, 269 F.3d 726 (6th Cir. 2001). In *Hedged Investments*, the Tenth Circuit explained that, if courts were bound by the parties' own characterization of a transaction, "controlling equity owners of a troubled corporation could jump the line of the bankruptcy process and thwart the company's outside creditors' and investors' priority rights." *Hedged Investments*, 380 F.3d at 1298.

The Fifth and Ninth Circuits have taken a different approach, holding instead that section 502(b)(1) of the Bankruptcy Code, which provides in relevant part that "the court … shall allow [a] claim … except to the extent that … such claim is unenforceable against the debtor and property of the debtor, under any agreement or applicable law," is the proper statutory authority for recharacterization. *See In re Lothian Oil Inc.*, 650 F.3d 539 (5th Cir. 2011); *In re Fitness Holdings Int'l, Inc.*, 714 F.3d 1141 (9th Cir. 2013).

The Eleventh Circuit has also recognized the legitimacy of the remedy, but without specifying the source of the court's power to exercise it. *See In re N & D Props., Inc.*, 799 F.2d 726, 733 (11th Cir. 1986) (noting that shareholder loans may be deemed capital contributions "where the trustee proves initial under-capitalization or where the trustee proves that the loans were made when no other disinterested lender would have extended credit").

In *In re Airadigm Communs., Inc.*, 616 F.3d 642, 653 (7th Cir. 2010), the Seventh Circuit declined to decide whether recharacterization of a debt was appropriate (although the bankruptcy court concluded below that it does not have the power to do so), but noted that the "overwhelming weight of authority" supports the authority of bankruptcy courts to recharacterize loans as equity.

Standard for Recharacterization. In *AutoStyle*, the Sixth Circuit applied an 11-factor test derived for recharacterization from federal tax law. Among the enumerated factors are the labels given to the alleged debt; the presence or absence of a fixed maturity date, interest rate, and schedule of payments; whether the borrower is adequately capitalized; any identity of interest between the creditor and the stockholders; whether the loan is secured; and the corporation's ability to obtain financing from outside lending institutions. This and similar tests have been adopted by many other courts. *See, e.g., Dornier Aviation*, 453 F.3d at 233 (applying *AutoStyle* factors); *SubMicron Sys. Corp.*, 432 F.3d 448 (seven-factor test); *Hedged Investments*, 380 F.3d at 1298 (13-factor test); *N & D Props.*, 799 F.2d at 733 (two-factor test); *In re Transcare Corp.*, 2020 WL 8021060, *37 (Bankr. S.D.N.Y. July 6, 2020) (noting that "[c]ourts in this District have adopted the eleven-factor analysis set forth in *AutoStyle*"). Under the *AutoStyle* test, no single factor is controlling. Instead, each factor is to be considered in light of the particular circumstances of the case.

In *Lothian Oil* and *Fitness Holdings*, the Fifth and Ninth Circuits ruled that state law should determine whether a debt should be recharacterized as equity. *Lothian Oil*, 650 F.3d at 543-44; *Fitness Holdings*, 714 F.3d at 1148.

As explained by the court in *In re Adelphia Commc'ns Corp.*, 365 B.R. 24, 74 (Bankr. S.D.N.Y. 2007), the "paradigmatic" recharacterization case involves a situation where "the same individuals or entities (or affiliates of such) control both the transferor and the transferee, and inferences can be drawn that funds were put into an enterprise with little or no expectation that they would be paid back along with other creditor claims."

Distinction Between Recharacterization and Equitable Subordination. A related but distinct remedy is "equitable subordination," which was developed under common law prior to

the enactment of the current Bankruptcy Code to remedy misconduct that results in injury to creditors or shareholders. It is expressly recognized in section 510(c) of the Bankruptcy Code, which provides that the bankruptcy court may, "under principles of equitable subordination, subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim or all or part of an allowed interest to all or part of another allowed interest."

In *In re Mobile Steel Co.*, 563 F.2d 692 (5th Cir. 1977), the Fifth Circuit articulated what has become the most commonly accepted standard for equitable subordination of a claim. Under this standard, a claim can be subordinated if the claimant engaged in some type of inequitable conduct that resulted in injury to creditors (or conferred an unfair advantage on the claimant) and if equitable subordination of the claim is consistent with the provisions of the Bankruptcy Code.

Courts have refined the *Mobile Steel* test to account for special circumstances. For example, many courts make a distinction between insiders (e.g., corporate fiduciaries) and non-insiders in assessing the level of misconduct necessary to warrant subordination. *See generally* COLLIER at ¶ 510.05[3].

As explained by the court in *Adelphia*, "[t]he recharacterization analyses focus on the substance of the *transaction*, whereas equitable subordination analyses focus on the creditor's *behavior*." *Adelphia*, 365 B.R. at 74.

LIVE PRIMARY

Live Primary, LLC ("debtor") was a shared office space company based in New York. Created in 2015, its members were Lisa Skye Hain ("Hain"), Primary Member, LLC ("PM"), and Daniel Orenstein ("Orenstein"). PM was controlled by Joel Schreiber ("Schreiber"), who was also the founder of real estate investment firm Waterbridge Capital ("Waterbridge").

Pursuant to the Delaware law-governed limited liability company agreement ("LLC Agreement"), the startup was to be funded by a $6 million "loan" from PM. Each tranche of the loan was to be evidenced by a promissory note and memorialized in a loan agreement. However, no loan agreement or promissory notes were ever executed.

The $6 million loan had no maturity date but was payable with accrued interest at the rate of 1% per annum upon the occurrence of a "liquidity event" (e.g., a merger, consolidation, or sale of the debtor) or an initial public offering ("IPO") of the debtor's stock.

The LLC agreement provided that, if PM failed to make any required disbursement of the loan proceeds, PM was obligated to pay the debtor a nonrefundable default fee, PM's membership share would be diluted, and the debtor was entitled to seek an alternative source of senior priority bridge financing. The PM loan was to be repaid in full before any distribution to other members.

Although PM was the nominal lender for the $6 million loan, the advances were actually made by Waterbridge. The debtor's books and records reflected that the loan was owed to either PM or Waterbridge.

The LLC agreement was later amended to create Class A Units—held equally by Hain, now the debtor's sole manager after Orenstein resigned, and PM—and Class B units, held by Orenstein. The amended agreement provided that all transactions between the debtor (managed by Hain) and any member or executive required the unanimous consent of the Class A members (Hain and PM).

In 2019, an investor group led by David Kirshenbaum ("Kirshenbaum") loaned the debtor $2.65 million. The provision in the LLC agreement governing member and executive transactions was then amended to require the unanimous consent of the Class A members and Kirshenbaum.

The debtor filed for chapter 11 protection in the Southern District of New York on July 12, 2020. PM filed a proof of claim in the case asserting a debt in the amount of approximately $6.4 million based on: (i) the initial $6 million loan plus additional advances and accrued interest; and (ii) 14 "other loans," the outstanding principal, and interest of which amounted to approximately $81,000. According to PM, those other loans were discussed orally, but not formally documented. Instead, they were evidenced by email correspondence among Hain, Schreiber, and Waterbridge.

The debtor and certain of its noteholders objected to PM's claim, arguing that: (i) the claim lacked *prima facie* validity because it was not supported by any written documentation evidencing the loans; (ii) the purported $6 million loan was in fact equity and should be recharacterized as such in accordance with *AutoStyle*; (iii) the "other loans," which were disputed by the debtor, were unauthorized loans made by Waterbridge, which did not file a proof of claim; (iv) PM was not a creditor because all payments on the "other loans" were made to Waterbridge; and (v) PM's claim should be disallowed under section 502(d) of the Bankruptcy Code because it received avoidable preferential transfers.

THE BANKRUPTCY COURT'S RULING

Initially, Bankruptcy Judge Martin Glenn ruled that, even though PM's claim was not memorialized in a loan agreement or promissory notes, the LLC agreement, the debtor's books and records, the parties' conduct, and other extrinsic evidence provided *prima facie* evidence of the purported loans. The court also held that PM had standing as a creditor to assert the claim for the loans because, among other things, the debtor treated PM and Waterbridge interchangeably. In addition, Judge Glenn concluded that an adversary proceeding was not required to seek recharacterization because the remedy does not fall under one of the 10 exclusive categories identified in Rule 7001 of the Rules of Bankruptcy Procedure (such as subordination of a claim or interest) and the debtor also proposed to recharacterize PM's claim as equity under its chapter 11 plan.

Turning to recharacterization, Judge Glenn explained that the "'ultimate exercise' in evaluating any recharacterization claim 'is to ascertain the intent of the parties'" (quoting *In re Lyondell Chem. Co.*, 544 B.R. 75, 102 (Bankr. S.D.N.Y. 2016)). He rejected PM's argument that, under Delaware law, the intent of the parties should be determined by reference to the terms of the LLC agreement, which clearly stated that the advances made by PM were loans. Instead, Judge Glenn wrote, "it is the meticulous application of the eleven *AutoStyle* Factors that reveals the actual intent of the Parties."

Examining those factors, Judge Glenn noted that each of them supported a finding that the purported $6 million loan was in fact equity:

- Although the LLC operating agreement and the debtor's books dispositive, and the absence of any instruments evidencing a loan, such as a master promissory note, suggested otherwise.
- The purported $6 million loan did not have a fixed maturity date.
- The loan bore a *de minimis* interest rate, which accrued rather than being payable periodically.
- The only source of repayment of principal and accrued interest was the proceeds of an IPO or a "liquidity event."
- Initial capital contributions under the LLC operating agreement amounted to only $1,000, which was "massively inadequate" because the debtor was a startup in its early stages of formation.
- PM was both a member of the debtor and the purported creditor, and the "structure of contributions with money from PM and contributions of sweat equity from Orenstein and [Hain] are indicative of equity." Under the LLC operating agreement, PM's membership interest would be reduced in proportion to the amount of the loan it failed to fund.
- The purported $6 million loan was unsecured.
- As a startup, the debtor could not have obtained loans from other lenders that were remotely similar to the PM advances.
- The purported $6 million loan was effectively subordinated to the claims of other creditors unless and until either an IPO or a liquidity event occurred.
- The proceeds of the purported loan were used to acquire capital assets rather than to satisfy the debtor's daily operating needs.
- There was no "sinking fund"—a fund holding regular deposits that are accumulated with interest to pay off long-term debt—to provide for repayment of the purported loan.

Judge Glenn also held that PM's claim based on the "other loans" should not be disallowed as "unauthorized" loans because, among other things, the Class A members approved the loans in writing, as required by the LLC operating agreement. However, he ruled that PM's claim based on the other loans must be disallowed under section 502(d) because PM received (and had not repaid) a $40,000 avoidable transfer within 90 days of the bankruptcy petition date.

OUTLOOK

In many respects, *Live Primary* is a textbook example of the circumstances under which a bankruptcy court will conclude that a purported loan should be treated as equity. The court found that *every one* of the 11 *AutoStyle* factors weighed in favor of recharacterizing the series of advances at issue as equity infusions. Many other cases are not so black and white, and thus require that the court weigh various factors supporting recharacterization against those that do not in deciding whether the remedy is appropriate.

Some of the key takeaways from *Live Primary* include: (i) the bankruptcy court's power to disregard the labels given to a transaction and to ascertain its substance in keeping with the priority scheme underlying federal bankruptcy law; and (ii) the fact-intensive analysis required to determine whether recharacterization of a debt as equity is warranted.

IN BRIEF: "FAILING" DELAWARE CORPORATION CAN TRANSFER ASSETS TO CREDITORS IN LIEU OF FORECLOSURE WITHOUT SHAREHOLDER CONSENT

Carl E. Black ▪ Mark G. Douglas

In *Stream TV Networks, Inc. v. SeeCubic, Inc.*, 2020 WL 7230419 (Del. Ch. Dec. 8, 2020), the Delaware Court of Chancery held that the assets of Stream TV Networks, Inc. ("Stream"), an insolvent Delaware-incorporated 3-D television technology company, could be transferred to an affiliate of two of Stream's secured creditors in lieu of foreclosure without seeking the approval of Stream's shareholders under section 271 of the General Corporation Law of Delaware ("DGCL") or Stream's certificate of incorporation.

In February 2020, Stream defaulted on more than $50 million in debt secured by all of its assets. At that time, it also owed $16 million to trade creditors, could not pay its bills or operating expenses, including payroll, and was insolvent.

In March 2020, Stream's controlling shareholders and directors, Mathus and Raja Rajan ("Rajans"), at the behest of the secured creditors, expanded the board of directors for the purpose of creating a committee to negotiate a resolution with the secured creditors and Stream's investors. In May 2020, Stream, its two secured creditors, and 52 Stream investors entered into an agreement ("Omnibus Agreement") under which, in lieu of foreclosure by the secured creditors, Stream would transfer all of its assets to SeeCubic, Inc. ("SeeCubic"), a newly formed entity controlled by its secured creditors. The secured creditors agreed to release their claims against Stream upon completion of the transfer of its assets to SeeCubic. The Rajans did not vote to approve the Omnibus Agreement and immediately tried to undermine it.

If Stream's secured creditors had foreclosed on Stream's assets, Stream's stockholders would have received no recovery. However, the Omnibus Agreement provided Stream's minority shareholders with the right to exchange their stock in Stream for shares in SeeCubic. The Omnibus Agreement also provided for the issuance of one million shares in SeeCubic to Stream.

Stream and the Rajans later sought an injunction preventing the effectiveness of the Omnibus Agreement. They contended that the agreement was invalid because: (i) the outside directors who approved it were never validly appointed; and (ii) the agreement was ineffective because it required majority stockholder approval under section 271 of the DGCL and the "class vote provision" in Stream's certificate of incorporation.

The Delaware Chancery Court ruled that the outside directors were validly appointed and that, even if they were not, they acted as *de facto* directors with the power to bind Stream to the terms of the Omnibus Agreement.

Writing for the court, Vice Chancellor ("VC") J. Travis Laster explained that section 271 of the DGCL requires *majority* stockholder approval to "sell, lease or exchange all or substantially all of [the company's] property and assets" (a relative rarity outside of bankruptcy compared to what he characterized as the "current dominance of the merger as the transactional vehicle for selling a corporation"). This is a modification of the general rule under common law "that the directors [had] no power or authority to sell out the entire property of a corporation and terminate its business" but had to obtain *unanimous* stockholder approval for such a transaction. However, VC Laster wrote, "A widely recognized exception to the rule applied to insolvent or failing firms." This "failing business" exception to the common-law rule continues in force today.

In addition, VC Laster noted, the legislative history of section 271 and its "position in the broader context of the statute" indicate that the transaction contemplated by the Omnibus Agreement did not qualify as a transaction to "sell, lease or exchange" all or substantially all of Stream's assets. Instead, he wrote, "These sources demonstrate that Section 271 does not apply to a transaction like the one contemplated by the Omnibus Agreement, in which an insolvent and failing firm transfers its assets to its secured creditors in lieu of a formal foreclosure proceeding."

Because the class vote provision in Stream's charter substantially tracked the language of section 271, VC Laster concluded that that it "warrant[ed] the same interpretation." The Chancery Court ruled that the Omnibus Agreement did not require the approval of Stream's shareholders. It accordingly denied Stream's motion for a preliminary injunction and granted SeeCubic's motion for an injunction enforcing the Agreement.

U.S. SUPREME COURT DECLINES REVIEW OF LANDMARK *TRIBUNE* SAFE HARBOR RULING

Brad B. Erens ▪ Mark G. Douglas

On April 19, 2021, the U.S. Supreme Court declined to hear the appeal of a landmark 2019 decision issued by the U.S. Court of Appeals for the Second Circuit regarding the applicability of the Bankruptcy Code's safe harbor for certain securities, commodity, or forward contract payments to prevent the avoidance in bankruptcy of $8.3 billion in payments made to the shareholders of Tribune Co. as part of its 2007 leveraged buyout ("LBO").

In its 2019 ruling, the Second Circuit reaffirmed an earlier decision that creditors' state law fraudulent transfer claims arising from the LBO were preempted by the safe harbor set forth in section 546(e) of the Bankruptcy Code. *See In re Tribune Co. Fraudulent Conveyance Litig.*, 946 F.3d 66 (2d Cir. 2019), *cert. denied sub nom. Deutsche Bank Trust Co. Americas v. Robert R. McCormick Foundation*, No. 20-8 (U.S. Apr. 19, 2021). However, the Second Circuit also concluded that a debtor may itself qualify as a "financial institution" covered by the safe harbor, as implied in 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. Certain Tribune Co. noteholders and pensioners asked the Supreme Court to review the decision on July 6, 2020.

In *Merit*, the Supreme Court held that, because the selling shareholder in the LBO challenged as a constructive fraudulent transfer was not a financial institution (even though the conduit banks through which the payments were made met that definition), the payments fell outside of the section 546(e) safe harbor. In a footnote, however, the Court acknowledged that the Bankruptcy Code defines "financial institution" broadly to include not only entities traditionally viewed as financial institutions, but also the "customers" of those entities, when financial institutions act as agents or custodians in connection with a securities contract. The selling shareholder in *Merit* was a customer of one of the conduit banks yet never raised the argument that it therefore also qualified as a financial institution for purposes of section 546(e). For this reason, the Court did not address the possible impact of the shareholder transferee's customer status on the scope of the safe harbor.

The Second Circuit addressed this possibility directly in its 2019 ruling in *Tribune*.

In the aftermath of *Tribune*, several courts, principally in the Southern District of New York, but also elsewhere, relied on the decision in ruling that various transactions were shielded from avoidance by the safe harbor because the debtor involved met the Bankruptcy Code's definition of a "financial institution" due to its use of an agent bank to effectuate a transaction.

These rulings included:

- *In re Boston Generating LLC*, 617 B.R. 442 (Bankr. S.D.N.Y. 2020) (payments made to the members of limited liability company debtors as part of a recapitalization transaction were protected from avoidance under section 546(e) because the debtors were "financial institutions" as customers of banks that acted as their depositories and agents in connection with the transaction).
- *In re Nine W. LBO Sec. Litig.*, 482 F. Supp. 3d 187, 206 (S.D.N.Y. 2020), *appeal filed*, 20-3290 (2d Cir. Sept. 25, 2020) ("When, 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).")
- *Kelley v. Safe Harbor Managed Acct. 101, Ltd.*, 2020 WL 5913523, *4 (D. Minn. Oct. 6, 2020) (transfers to a subsequent transferee were protected from avoidance by the safe harbor because the transferor qualified as a financial institution by effecting the transfers through an agent bank).
- *SunEdison Litigation Trust v. Seller Note, LLC (In re SunEdison, Inc.)*, 620 B.R. 505, 517 (Bankr. S.D.N.Y. Nov. 2, 2020) (because an integrated two-step transaction involved a financial institution as the debtor's agent, the entire transaction was protected from avoidance under section 546(e)).
- *Fairfield Sentry Limited (In Liquidation) v. Theodoor GGC Amsterdam (In re Fairfield Sentry Ltd.)*, 2020 WL 7345988, *7 (Bankr. S.D.N.Y. Dec. 14, 2020) (ruling in a chapter 15 case that redemption payments made to investors in foreign funds were safe-harbored because the funds were "financial institutions," as the customers of the banks that made the redemption payments as the funds' agent).
- *In re Samson Res. Corp.*, 625 B.R. 291, 301 (Bankr. D. Del. 2020) (noting that "the plain text and structure of the Code's definition of financial participant does not exclude debtors," but ruling that issues of material fact as to whether the debtor had agreements or transactions in the requisite amount to meet the definition precluded entry of summary judgment on constructive fraudulent transfer avoidance claims asserted by the trustee as allegedly barred by the safe harbor).

However, at least one court rejected the *Tribune* "workaround." *See, e.g., In re Greektown Holdings, LLC*, 621 B.R. 797, 821-22 (Bankr. E.D. Mich. Oct. 21, 2020) (payments made in connection with a pre-bankruptcy recapitalization transaction that involved the issuance of unsecured notes underwritten by a financial institution were not safe-harbored by section 546(e) because the underwriter did not act as either the transferor's agent or custodian in connection with the transaction, such that the transferor itself was not a financial institution).

By its denial of *certiorari* in *Tribune*, the Supreme Court ended speculation, at least for now, that it might weigh in on the *Tribune* workaround and the controversy created by its provenance in the Court's *dicta* in *Merit*. The absence of any split in the circuits on the issue may have prompted the Court's decision not to review the case.

Justice Samuel Alito took no part in the consideration or decision of the *Tribune* petition for *certiorari*.

NEWSWORTHY

Jones Day was ranked #1 in The BTI Consulting Group's 2021 Client Service A-Team report for the fifth consecutive year and the 13th time since BTI has been publishing its results, based on independent research.

Bruce Bennett ***(Los Angeles and New York)*** was featured in the new book *The Caesars Palace Coup: How a Billionaire Brawl Over the Famous Casino Exposed the Power and Greed of Wall Street* (Diversion Books, March 2021) for his role representing second-lien bondholders in the 2016 bankruptcy cases of gaming and hotel giant Caesars Entertainment.

Corinne Ball ***(New York)*** was interviewed in a March 17, 2021, Turnaround Management Association podcast titled "Interview with a Turnaround Legend: Past, Present and Future of Bankruptcy Law."

Bruce Bennett ***(Los Angeles and New York)***, ***Heather Lennox*** ***(Cleveland and New York)***, and ***Ben Larkin*** ***(London)*** were ranked in the practice areas of Bankruptcy/Restructuring or Restructuring/Insolvency in *Chambers Global 2021*.

An article written by ***Corinne Ball*** ***(New York)*** titled "The 'Two Hats' Doctrine for Shared Directors and Officers Falters When Assessing Waiver of Attorney-Client Privilege Suggesting Caution on Sharing Legal Advice" was published in the April 21, 2021, issue of *The New York Law Journal*.

An article written by ***Bruce Bennett*** ***(Los Angeles and New York)***, ***Heather Lennox*** ***(Cleveland and New York)***, ***Christopher DiPompeo*** ***(Washington)***, and ***Dan. T. Moss (Washington)*** titled "Supreme Court: Mere Retention of Property Does Not Violate Automatic Stay" was published on April 9, 2021, in the *International Law Office Newsletter*.

Corinne Ball ***(New York)*** was among the "Senior Statespeople" recognized in the field of Bankruptcy/Restructuring in *Chambers Global 2021*.

An article written by ***Dan T. Moss*** ***(Washington)*** and ***Mark G. Douglas*** ***(New York)*** titled "Second Circuit: Madoff Ponzi Scheme Customers Did Not Receive Fictitious Profit Payments 'For Value'" was published in the March 2021 issue of *The Wall Street Lawyer*.

Roger Dobson ***(Sydney)***, **Katie Higgins** ***(Sydney)***, **Tim L'Estrange** ***(Melbourne)***, and **Lucas Wilk** ***(Perth)*** were recognized in the field of Insolvency and Reorganization Law in the 2022 edition of *The Best Lawyers in Australia*.™ *Roger Dobson (Sydney)* was also named a "lawyer of the year" for 2022 in the practice area of Distressed Investing and Debt Trading.

An article written by ***Charles M. Oellermann*** ***(Columbus)*** and ***Mark G. Douglas*** ***(New York)*** titled "The Year in Bankruptcy: 2020" was published on March 12, 2021, in the *International Law Office Newsletter*.

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