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TEXAS DISTRICT COURT: BANKRUPTCY SALE BREAK-UP FEE SATISFIED BOTH BUSINESS JUDGMENT TEST AND ADMINISTRATIVE EXPENSE STANDARD

Paul M. Green • Mark G. Douglas

Bankruptcy and appellate courts disagree over the standard that should apply to a request for payment of a break-up fee or expense reimbursement to the losing bidder in a sale of the debtor's assets outside the ordinary course of the debtor's business. Some apply a "business judgment" standard, while others require that the proposed payments satisfy the more rigorous standard applied to administrative expense claims. The U.S. District Court for the Southern District of Texas addressed this question in *In re Bouchard Transp. Co., Inc.*, 639 B.R. 697 (S.D. Tex. 2022). The court affirmed a bankruptcy court order approving a $3.3 million break-up fee and more than $885,000 in expense reimbursement to a disappointed "stalking-horse" bidder in an auction of the debtors' assets, finding that the payments satisfied both the business judgment test under section 363(b) of the Bankruptcy Code and the standard for approval of administrative expense claims under section 503(b).

STALKING HORSES AND BREAK-UP FEES

Section 363(b)(1) of the Bankruptcy Code authorizes a bankruptcy trustee or chapter 11 debtor-in-possession, "after notice and a hearing," to use, sell, or lease property of the estate outside the ordinary course of business. Most courts apply a "business judgment" standard to a proposed use, sale, or lease of property under section 363(b)(1) whereby "the bankruptcy court reviews the trustee's (or debtor-in-possession's) business judgment to determine independently whether the judgment is a reasonable one." COLLIER ON BANKRUPTCY ("COLLIER") ¶ 363.02[4] (16th ed. 2022) (citing and discussing cases).

A sale under section 363(b)(1) is most frequently undertaken by means of a public auction, in which assets are generally sold to the highest bidder, although the bankruptcy court may also approve a private sale entered into between the debtor and a purchaser. Generally speaking, the initial bidder in a public auction held under section 363—the "stalking-horse bidder"—sets the minimum price and other terms of the transaction. Because of the time and effort expended by the stalking-horse bidder in performing due diligence and engaging in the negotiations necessary to arrive at the initial bid, bankruptcy courts generally will allow reasonable bid protections for the stalking-horse bidder in the event the bidder does not prevail at the auction. Those bid protections, which are typically

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the subject of extensive negotiations, often include reimbursement of expenses incurred by the bidder in connection with the transaction, a break-up fee equal to a specified percentage of the bidder's purchase price, auction procedures, and certain other rights related to the stalking-horse bid.

Outside of bankruptcy, a seller's decision to give such protections are typically accorded deference under the "business judgment" rule. In the bankruptcy context, however, several different approaches have been applied by courts in assessing the propriety of bid protections. *See generally* COLLIER at ¶ 363.02[7]. Some courts apply a business judgment standard to the issue, which involves the highest degree of deference to the debtor's decision to commit to the bidding protections under scrutiny. *See, e.g., In re Diocese of Buffalo, N.Y.*, 637 B.R. 701, 704 (Bankr. W.D.N.Y. 2022); *In re JW Res., Inc.*, 536 B.R. 193, 197 (Bankr. E.D. Ky. 2015); *In re Genco Shipping & Trading Ltd.*, 509 B.R. 455, 465 (Bankr. S.D.N.Y. 2014). Other courts apply stricter scrutiny, requiring evidence that proposed bid protections are in the "best interests of the estate." COLLIER at ¶ 363.02[7] (citing cases).

Finally, some courts, and in particular the U.S. Court of Appeals for the Third Circuit, have generally allowed or disallowed bid protections, including break-up fees, according to the standard governing the allowance of administrative expenses under section 503(b). *See In re Reliant Energy Channelview LP,* 594 F.3d 200 (3d Cir. 2010); *Calpine Corp. v. O'Brien Envtl. Energy, Inc. (In re O'Brien Envtl. Energy, Inc.)*, 181 F.3d 527, 535 (3d Cir. 1999); *accord In re Acis Cap. Mgmt., L.P.,* 604 B.R. 484, 517 (N.D. Tex. 2019); *In re President Casinos, Inc.*, 314 B.R. 786, 788 (Bankr. E.D. Mo. 2004).

This standard for allowed administrative expenses is set forth in section 503(b)(1)(A) of the Bankruptcy Code, which provides in pertinent part that, "[a]fter notice and a hearing, there shall be allowed, administrative expenses, . . . including—(1)(A) the actual, necessary costs and expenses of preserving the estate." 11 U.S.C. § 503(b). According to the Third Circuit, for a claim to be entitled to administrative expense status under this provision, it must "arise from a [postpetition] transaction with the debtor-in-possession," and "be beneficial to the debtor-in-possession in the operation of the business." *O'Brien*, 181 F.3d at 532–33; *accord In re Philadelphia Newspapers, LLC*, 690 F.3d 161, 172–73 (3d Cir. 2012).

In *O'Brien*, the debtor sought court approval of a stalking-horse agreement prior to a planned auction of its assets. The bankruptcy court refused to approve the break-up fee and expense provisions, expressing concern that allowing such fees and expenses would chill or unnecessarily complicate the bidding process. After the auction, the losing stalking-horse bidder filed an application seeking allowance of more than $4 million in fees and expenses under section 503(b). The bankruptcy court denied the application, and the bidder appealed.

The Third Circuit ultimately affirmed. It concluded that there was no "compelling justification for treating an application for break-up fees under § 503(b) differently from other applications for administrative expenses under the same provision," meaning that the requesting party must "show that the fees were actually necessary to preserve the value of the estate." *O'Brien*, 181 F.3d at 535. The Third Circuit also determined that, although "the business judgment rule should not be applied as such in the bankruptcy context . . . , the considerations that underlie the debtor's judgment may be relevant to the Bankruptcy Court's determination on a request for break-up fees and expenses." *Id.*

In *Reliant*, Kelson Channelview LLC ("Kelson") submitted the highest bid in a private auction of the debtors' Texas power plant. Under the agreement with Kelson, the debtors were required to seek an order of the court either authorizing the sale without a public auction or approving bid protections for Kelson, including a $5 million minimum overbid threshold, a $15 million break-up fee, and reimbursement of up to $2 million in expenses.

Before the bankruptcy court could rule on the motion, a competing bidder—Fortistar, LLC ("Fortistar")—asserted that it was willing to enter a "higher and better" bid, but claimed that the $15 million break-up fee and the $2 million expense reimbursement would deter its competing bid. The court ruled that a public auction was necessary. It also refused to approve the $15 million

LAWYER SPOTLIGHT: GREGORY M. GORDON

Greg Gordon represents clients in complex, high-profile chapter 11 cases and corporate restructurings. His experience includes out-of-court restructurings, prepackaged bankruptcies, distressed M&A transactions, and cross-border insolvencies. He has assisted clients in achieving permanent resolutions of mass tort liabilities, including asbestos and talc liabilities. Recently, Greg successfully represented LTL Management, an affiliate of Johnson & Johnson, in a chapter 11 case it filed to resolve its talc liability. Greg is located in the Dallas Office and is a fellow in the American College of Bankruptcy.

break-up fee for Kelson, but approved both the $5 million overbid threshold and the expense reimbursement provision.

Fortistar's winning bid at the auction topped Kelson's previous bid by $32 million. The bankruptcy court approved the sale and authorized the debtors to pay Kelson approximately $1.2 million in expenses, but no break-up fee. After the district court affirmed on appeal, Kelson appealed to the Third Circuit.

The Third Circuit affirmed. Applying the *O'Brien* standard, the Third Circuit explained that there are two ways that a break-up fee can preserve the value of an estate: (i) by inducing the stalking-horse bidder to make an initial bid; and (ii) by inducing the bidder to adhere to its bid after the court orders an auction. According to the Third Circuit, the bankruptcy court correctly found that neither element was satisfied in this case. The Third Circuit also concluded that any benefit to the estates was outweighed by the potential harm to the estates that a break-up fee would cause by deterring other bidders.

Finally, the Third Circuit rejected Kelson's argument that, because no one objected to the break-up fee, the business judgment test was the proper standard to apply. According to the court, in accordance with *O'Brien*, the section 503(b) standard applies and is not satisfied merely because no objections are interposed.

The U.S. Court of Appeals for the Fifth Circuit adopted a more nuanced approach to the issue in *In re ASARCO, L.L.C.*, 650 F.3d 593 (5th Cir. 2011). In *ASARCO*, the bankruptcy court granted the debtor's request to reimburse all qualified bidders for their expenses prior to an auction. The Fifth Circuit was "not persuaded that *Reliant* and *O'Brien* [were] apt [when] . . . a debtor requests the authority to reimburse expense fees 'for second-round "qualified bidders" in a multiple stage auction for a very unique and very valuable but possibly worthless asset.'" *Bouchard*, 639 B.R. 697, 710 (quoting *ASARCO*, 650 F.3d at 602). Instead, because the bankruptcy court in *ASARCO* approved the expense reimbursement *before* any potential qualified bidders had incurred any due diligence and work fees, the Fifth Circuit "conclude[d] that the business judgment standard is the better fit for assessing ASARCO's reimbursement motion." *Id.*

Under the *ASARCO* approach, a request for approval of bid protections prior to an asset sale under section 363(b) should be examined under the business judgment standard, whereas a post-sale request for such protections not previously authorized by the bankruptcy court must be scrutinized under section 503(b).

BOUCHARD

In September 2020, ocean-going petroleum barge company Bouchard Transportation Company, Inc. and its affiliates (collectively, "BTC") filed for chapter 11 protection in the Southern District of Texas. BTC decided to sell substantially all of its assets (principally vessels) under section 363(b) of the Bankruptcy Code and sought court approval for a public auction and proposed bidding procedures. The bankruptcy court approved bidding procedures that allowed BTC to offer bid protections to an as-yet unnamed stalking-horse bidder, including a break-up fee not to exceed 3% of the cash purchase price and expense reimbursement in an amount to be agreed upon by BTC and the stalking-horse bidder. The order approving the procedures established deadlines for designation and court approval of a stalking-horse bidder and for the filing of any objections to either the stalking-horse bidder, the bid protections, or the auction process.

Because BTC failed to generate significant interest in its fleet, either as a whole or in part, those deadlines were extended several times with the consent of the unsecured creditors' committee (the "committee"). Ultimately, BTC's board considered bids from only two prospective purchasers—Hartree Partners, LP ("Hartree") and Centerline Logistics Corp. ("Centerline"). Centerline submitted a bid to purchase 31 vessels pledged as collateral to postpetition lender JMB Capital Partners Lending ("JMB") and 19 additional vessels securing BTC's prepetition revolving-credit facility. Hartree bid only for the vessels securing the JMB loan.

The board decided not to proceed with the Centerline bid because it was unclear whether Centerline could obtain the necessary financing. Instead, on July 18, 2021, it agreed to sign a stalking-horse sale agreement with Hartree in anticipation of the auction. The agreement provided for a $3.3 million break-up fee equal to 3% of Hartree's $110 million bid and expense reimbursement up to $1.5 million. The agreement also included a $500,000 overbid threshold. Thus, taking into account the overbid, the break-up fee and reimbursable expenses, the agreement established a floor overbid price of more than $115 million for the covered vessels.

BTC filed a notice of the selection of Hartree as the stalking-horse bidder and the terms of the stalking-horse agreement on July 18, 2021. BTC never obtained court approval of the agreement, and the auction took place the following day. No party objected prior to the auction.

At the auction, the 19 vessels pledged to secure BTC's prepetition credit facility sold for $130 million. JMB outbid Hartree for the remaining 31 vessels by submitting a bid in the amount of $115.3 million. During the auction, the committee stated that it did not support the bid protections in the stalking-horse agreement. Two days later, the committee filed an objection to Hartree's designation as the stalking horse and to the bid protections. The committee argued that the bid protection request should be evaluated and denied under section 503(b).

Chief U.S. Bankruptcy Judge David R. Jones approved the asset sale on August 5, 2021, but deferred any ruling on the bid protections. Acknowledging that it was unclear which standard should apply (i.e., section 503(b) or the business judgment rule), the bankruptcy court later ruled that the stalking-horse agreement, including the bid protections, satisfied either standard because the agreement "certainly" conferred a benefit on the estate and

BTC's decision to offer the bid protections to Hartree was "a knowing, intelligent, and thoughtful decision." The court allowed the break-up fee in full, but reduced the expense reimbursement cap to $1 million.

The committee appealed to the district court.

THE DISTRICT COURT'S RULING

The district court affirmed the ruling below and dismissed the appeal.

Chief U.S. District Court Judge Lee H. Rosenthal noted that courts disagree over the standard applicable to the approval of bid protections in a bankruptcy sale.

Judge Rosenthal distinguished the case before him from *O'Brien* and *Reliant*, where, after an auction, the losing stalking-horse bidders sought payment of fees and expenses that the bankruptcy court refused to approve prior to the auction. Instead, he noted, this case was more similar to *ASARCO*, the leading Fifth Circuit precedent on the issue.

However, Judge Rosenthal wrote, *ASARCO*, *O'Brien*, and *Reliant* all were relevant, "but materially different from the facts of this case." He explained that, because the bankruptcy court in this case never approved the final stalking-horse agreement before the auction, the court's rationale in *ASARCO* suggests that the section 503(b) standard should apply. However, Judge Rosenthal noted, the bankruptcy court did generally authorize BTC to provide bid protections within certain parameters prior to the auction, suggesting that the stalking-horse agreement should be reviewed under the business judgment test applied under section 363(b).

Given the "unusual facts of this case," the district court, like the bankruptcy court, ultimately declined to decide which standard should apply because it agreed with the bankruptcy court's determination that both standards were satisfied.

First, Judge Rosenthal explained that, although the bankruptcy court did not make detailed findings regarding the benefit the estate derived from the break-up fee and expense reimbursement, the record supported its conclusion that these bid protections satisfied the test for administrative expense status under section 503(b). Among other things, Judge Rosenthal determined that the stalking-horse agreement, although never approved by the bankruptcy court, "was a valid postpetition transaction" and that Hartree "provided [BTC] with a service—acting as the stalking-horse bidder—and then sought payment for providing that service in the form of the bid protections offered in the stalking-horse agreement." *Bouchard*, 639 B.R. at 715. In addition, Judge Rosenthal found that the bid protections were "actual and necessary expenses" given the difficulties encountered by BTC in finding prospective purchasers, the risks associated with a "naked auction" without a stalking-horse bidder, and evidence demonstrating that the bid protections were reasonable and necessary to induce Hartree to bid. *Id.* at 716-17. Finally, he noted, had there been no bidders at the auction, JMB would have foreclosed on its collateral, which would have led to "a host of other undesirable consequences," including the estate's administrative insolvency, conversion of the chapter 11 cases to chapter 7 liquidations, and "costly and uncertain litigation" among the parties. *Id.* at 718 n.3 (internal quotation marks omitted).

Second, Judge Rosenthal found no error in the bankruptcy court's conclusion that BTC's agreement to offer the bid protections satisfied the business judgment test under section 363(b). According to Judge Rosenthal, BTC's board reasonably

concluded that an auction was in the best interests of the estate, attempted to market BTC's assets, and once those marketing efforts generated little interest, made thoughtful and knowing decisions regarding the auction and the stalking-horse agreement, including the bid protections, after engaging in substantial negotiations. "The record is clear," the judge wrote, "that the board acted in good faith, that it acted in the best interests of the estates, and that it reasonable believed that a stalking-horse bid was necessary for a successful auction, given the demonstrated low interest in bidding." *Id.* at 721.

OUTLOOK

Bouchard is an unusual case. It does not fit neatly into the framework established by the Fifth Circuit's precedent in *ASARCO* that pre-sale proposed bid protections be judged under the business judgement standard, whereas post-sale requests for such protections must be subjected to more exacting scrutiny under the estate-benefit analysis demanded by section 503(b). As a consequence, the bankruptcy and district courts examined the bid protections under both standards, and concluded that both were satisfied.

Given BTC's failure to seek court approval of the stalking-horse agreement prior to the auction (as it was obligated to do by court order) and the single day between the committee's receipt of notification that the agreement had been signed and the auction, the committee's objections were understandable. Because BTC's secured creditors were undersecured, after the payment of a break-up fee and expenses to Hartree, unsecured creditors would receive little or nothing from BTC's estate. Even so, the committee was clearly aware that the court had already authorized bidding protection parameters for an as-yet unnamed stalking horse, and the protections granted to Hartree were generally consistent with those parameters.

In the end, the bankruptcy and district courts in *Bouchard* concluded that BTC and its board of directors made the best of a bad situation in a way that passed muster under either section 503(b) or the business judgment standard.

DENIAL OF CHAPTER 11 PLAN CONFIRMATION UNWARRANTED EVEN IF PLAN SUPPORT AGREEMENTS VIOLATED DISCLOSURE REQUIREMENTS

T. Daniel Reynolds • Nick Buchta • Mark G. Douglas

A bedrock principle underlying chapter 11 of the Bankruptcy Code is that creditors, shareholders, and other stakeholders should be provided with adequate information to make an informed decision to either accept or reject a chapter 11 plan. For this reason, the Bankruptcy Code provides that any "solicitation" of votes for or against a plan must be preceded or accompanied by stakeholders' receipt of a "disclosure statement" approved by the bankruptcy court that explains adequately the background of the case as well as the key provisions of the chapter 11 plan. The solicitation of votes of stakeholders outside of this process is deemed improper, and those votes accordingly may be disallowed.

However, to promote communication and negotiation among the debtor and other stakeholders throughout the course of a chapter 11 case, courts generally construe the term "solicitation"—and the remedies for improper solicitation—narrowly. The United States Bankruptcy Court for the Southern District of New York recently addressed this issue in *In re LATAM Airlines Grp. S.A.,* 2022 WL 2206829 (Bankr. S.D.N.Y. June 18, 2022) (unpublished opinion), *as amended*, 2022 WL 2541298 (Bankr. S.D.N.Y. July 7, 2022), *stay pending appeal denied*, No. 20-11254 (JLG) (Bankr. S.D.N.Y. July 7, 2022), *certification denied*, No. 20-11254 (JLG) (Bankr. S.D.N.Y. July 26, 2022), *aff'd*, 2022 WL 3910718 (S.D.N.Y. Aug. 31, 2022). In an unpublished opinion, the court overruled an objection to confirmation of a chapter 11 plan based on the debtors' alleged violation of the plan solicitation requirements by entering into agreements with certain creditors, prior to the court's approval of a disclosure statement, that obligated those creditors to vote in favor of a plan in exchange for allowance of their claims. According to the court, even if those plan support agreements were improper (and the court did not reach that question), the only remedy for the violation was disallowance of the creditors' votes, which would not change the outcome of the voting process.

SOLICITATION AND DISQUALIFICATION OF VOTES ON A CHAPTER 11 PLAN

Section 1125(b) of the Bankruptcy Code provides that votes in favor of a chapter 11 plan can be solicited postpetition only after the creditor or shareholder receives a court-approved disclosure document containing "adequate information," a concept defined in section 1125(a). The provision is "designed to 'discourage the undesirable practice of soliciting acceptance or rejection at a time when creditors and stockholders were too ill-informed to act capably in their own interests.'" *In re Heritage Org., LLC*, 376 B.R.

783, 794 (Bankr. N.D. Tex. 2007) (quoting *In re Clamp-All Corp.*, 233 B.R. 198, 208 (Bankr. D. Mass. 1999)).

In cases where section 1125(b) has been violated, section 1126(e) provides a remedy:

> On request of a party in interest, and after notice and a hearing, the court may designate any entity whose acceptance or rejection of such plan was not in good faith, *or was not solicited or procured in good faith or in accordance with the provisions of this title*.

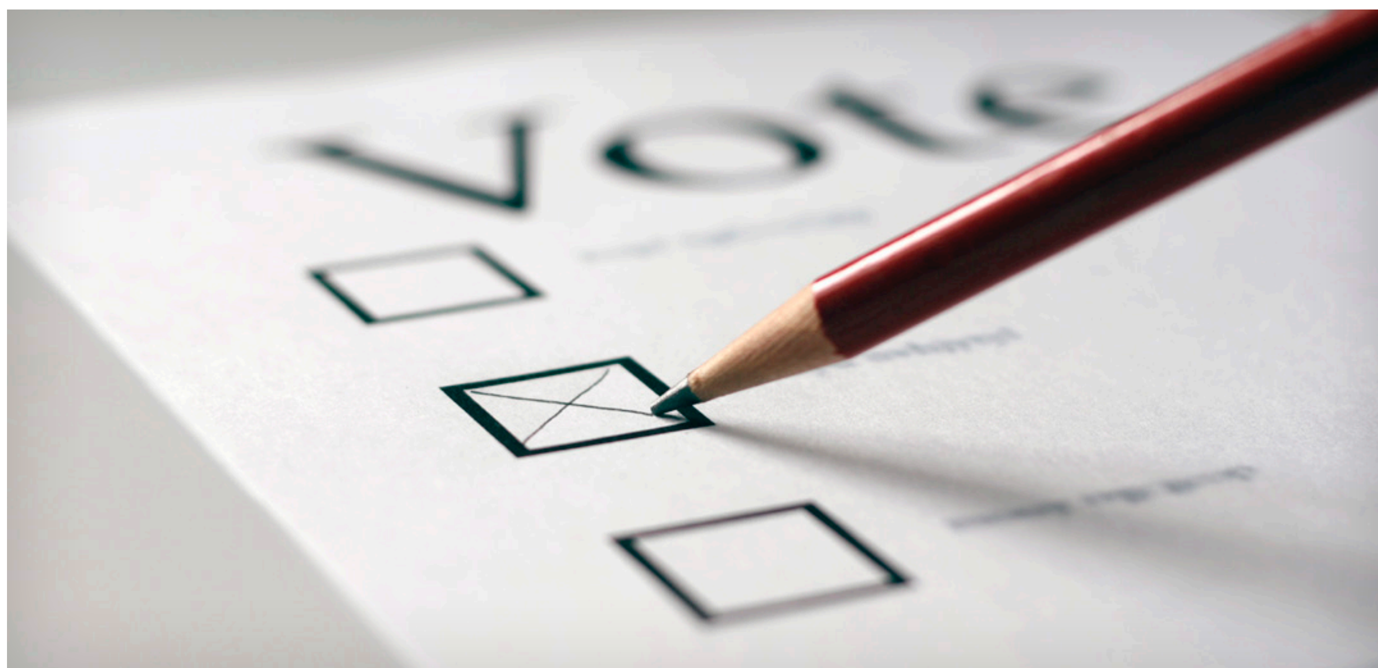
11 U.S.C. § 1126(e) (emphasis added). "Designation" of an entity under section 1126(e) means that it is disqualified from voting or its vote is disallowed. *See* Collier on Bankruptcy ¶ 1126.06 (16th ed. 2022). Votes cast by any creditor or interest holder designated under the provision are not counted for the purpose of determining whether the plan has been accepted by a class of creditors or interest holders under sections 1126(c) and 1126(d). *See In re DBSD N. Am., Inc.*, 634 F.3d 79, 106 (2d Cir. 2011).

Designation of a vote under section 1126(e) "is a drastic remedy, and, as a result, designation of votes is the exception, not the rule. The party seeking to have a ballot disallowed has a heavy burden of proof." *In re Adelphia Commc'ns Corp.*, 359 B.R. 54, 61 (Bankr. S.D.N.Y. 2006)).

What constitutes "solicitation" of a vote on a plan is unclear. Most courts agree that the term "must be read narrowly . . . because [a] broad reading of § 1125 can seriously inhibit free creditor negotiations." *Century Glove, Inc. v. First Am. Bank of New York*, 860 F.2d 94, 101 (3d Cir. 1988). Relevant case law suggests that the term "should relate to the formal polling process in which the ballot and disclosure statement are actually presented to creditors with respect to a specific plan, and the term should not be read so broadly as to chill the debtor's postpetition negotiations with its creditors." *In re Residential Capital, LLC*, 2013 WL 3286198, *19 (Bankr. S.D.N.Y. June 27, 2013) (quotations and citations omitted).

In keeping with a series of court decisions beginning with the bankruptcy court's ruling in *Trans World Airlines, Inc. v. Texaco, Inc. (In re Texaco, Inc.)*, 81 B.R. 813 (Bankr. S.D.N.Y. 1988), restructuring support agreements ("RSAs") or plan support agreements ("PSAs") have generally been deemed not to run afoul of the Bankruptcy Code's solicitation requirements. *See*, *e.g., Heritage Org.*, 376 B.R. at 792; *In re Kellogg Square Partnership*, 160 B.R. 336 (Bankr. D. Minn. 1993). Among other reasons, courts have noted that such agreements typically contain provisions allowing signatories to back out of their commitments where: (i) their fiduciary obligations require it; or (ii) the plan actually proposed by the debtor is materially different from what was agreed upon.

However, in a pair of unpublished bench rulings handed down in 2002, Delaware Bankruptcy Judge Mary F. Walrath held that postpetition "lock-up" agreements violate section 1125(b), and she consequently disallowed the votes of the signatories under section 1126(e). *See In re Station Holdings Company, Inc.*, No. 02-10882 (MFW) (Bankr. D. Del. Sept. 30, 2002) [document no. 177]; *In re NII Holdings, Inc.*, No. 02-11505 (MFW) (Bankr. D. Del. Oct. 22, 2002) [document no. 367]. Both cases involved prepackaged chapter 11 plans. However, certain supporting creditors signed lock-up agreements after the petition date but before the court approved a chapter 11 plan disclosure statement. The transcripts of the proceedings indicate that Judge Walrath placed particular emphasis on the absence of any provision in the lock-up agreements permitting the signatories to change their votes if the information contained in the disclosure statement turned out to be different from what they had received previously.



Another Delaware bankruptcy judge, Brendan L. Shannon, revisited this issue in *In re Indianapolis Downs, LLC*, 486 B.R. 286 (Bankr. D. Del. 2013). In that case, the court rejected arguments that a postpetition RSA was impermissible, adopting a narrow interpretation of "solicitation" in section 1125(b) in accordance with the Third Circuit's ruling in *Century Glove*. *Id.* at 294. The court rejected the argument that provisions in the RSA requiring the signatories to vote in favor of a conforming plan and providing for the remedy of specific performance amounted to solicitation. According to the court, the specific performance provision in the RSA was appropriate because the parties "were entitled to demand and rely upon assurances that accepting votes would be cast." *Id.* at 297.

Courts from other jurisdictions have similarly concluded that the negotiation of postpetition PSAs or RSAs prior to approval of a disclosure statement does not amount to improper solicitation under section 1125. *See In re Fin. Oversight & Mgmt. Bd. for Puerto Rico*, 637 B.R. 223, 284 (D.P.R. 2022) ("The process of negotiation and solicitation of assent to the plan support agreements prior to the approval and distribution of the disclosure statement did not constitute improper solicitation of votes with respect to the Plan."); *COMM 2013 CCRE12 Crossings Mall Rd., LLC v. Tara Retail Grp., LLC*, 591 B.R. 640, 651 (N.D.W. Va. 2018) (drawing the distinction between plan support agreements that permit a signatory to change its vote under appropriate circumstances and prohibited lock-up agreements that do not and therefore violate section 1125); *In re Residential Cap., LLC*, 2013 WL 3286198, *20 (Bankr. S.D.N.Y. June 27, 2013) (citing cases).

LATAM

In May 2020, LATAM Airlines Group S.A. and certain affiliates (collectively, "LATAM"), Latin America's leading airline group, filed for chapter 11 protection in the Southern District of New York after losing 95% of its passenger business due to travel restrictions imposed during the COVID-19 pandemic.

After months of negotiations and several rounds of mediation, LATAM and its principal creditor and shareholder constituencies ultimately agreed on an RSA that established the framework of a chapter 11 plan that would permit LATAM to emerge from bankruptcy with an appropriate level of capital and debt, as well as access to substantial liquidity.

Following the expiration of the claims bar date, LATAM and its advisors initiated a process to review and reconcile the many thousands of filed and scheduled claims. Part of this process involved contacting creditors to exchange supporting materials and address questions or seek resolutions regarding claims. In several dozen instances, LATAM and creditors reached agreement on the allowed claim amounts, and the parties entered into claim allowance agreements ("CAAs").

LATAM filed a proposed chapter 11 plan and disclosure statement on November 26, 2021.

Beginning in late December 2021—and prior to the court's March 2022 approval of the disclosure statement for LATAM's chapter 11 plan—LATAM began to insert the following "plan support provision" ("PSP") in CAAs with general unsecured creditors of the LATAM parent company (later designated as class 5 in LATAM's chapter 11 plan):

> Support of the Plan. Counterparty shall timely cast any and all votes in respect of the Claim to vote in favor of acceptance of the Plan. Counterparty shall not oppose or object to approval of the Disclosure Statement and confirmation of the Plan. To the extent the Counterparty sells or otherwise transfers any portion of its interest in the Claim, including the right to vote on the Plan, such sale or transfer agreement (or any similar agreement) shall include a provision binding the purchaser or transferee, and any subsequent purchasers or transferees, to this Agreement.

LATAM obtained at least 41 CAAs with the PSP from class 5 creditors covering 95 separate claims. LATAM did not seek court authorization to enter into the CAAs but filed separately executed claim allowance stipulations, which did not include or mention the PSPs, and then sought court approval of the stipulations.

Because the CAAs did not contain confidentiality provisions, LATAM's unsecured creditors' committee obtained a copy of one in January 2022. After learning of this disclosure, LATAM, without conceding any impropriety, took steps to disclaim any attempt to rely on or enforce the PSP, including: (i) adding language to its proposed disclosure statement committing not to enforce compliance with any provisions in the CAAs; (ii) notifying all counterparties to CAAs containing a PSP that LATAM expressly disclaimed the provisions; and (iii) submitting or resubmitting for court approval all claim allowance stipulations with language stating that the counterparties were not bound by a PSP.

The bankruptcy court approved LATAM's disclosure statement on March 21, 2022. It later approved procedures for the solicitation of votes on the plan.

The plan classified holders of claims and interests into 11 classes, of which class 1 (claims under a prepetition revolving credit facility), class 5 (general unsecured claims against the LATAM parent company), and class 7 (general unsecured claims against a single LATAM debtor affiliate) were classified as impaired and therefore entitled to vote.

The plan was overwhelmingly accepted by classes 1, 5, and 7. Fewer than half of the 95 class 5 claims originally subject to the PSPs were voted to accept the plan.

Several parties objected to confirmation of the plan. Among them, the U.S. Trustee argued that LATAM's negotiation of the CAAs constituted improper solicitation in violation of section 1125(b), and consequently, the plan was not confirmable because LATAM could not demonstrate that its actions comported with

section 1129(a)(2) of the Bankruptcy Code, which provides that a plan must "compl[y] with the applicable provisions of this title." The U.S. Trustee acknowledged that LATAM's negotiations with the class 5 creditors leading up to the execution of the CAAs did not touch upon matters relating to the development of a confirmable chapter 11 plan or the adequacy of the disclosure statement. Even so, it argued, LATAM "aggressively sought out" CAAs from the class 5 creditors "in an effort to ensure that they could satisfy the numerosity requirement under section 1126(c) of the Bankruptcy Code for Class 5's acceptance of the Plan."

According to the U.S. Trustee, the CAAs "were pre-drafted, with no room for negotiation with the creditors; all the creditors were required to sign it," and LATAM's actions qualified as "solicitation in substance," because "[i]f the creditor sign[ed] the agreement, it [was] legally bound to vote for the plan, as opposed to a tentative agreement or informal promise to vote for the plan."

LATAM countered that negotiating the CAAs did not amount to solicitation of votes and that the U.S. Trustee failed to demonstrate grounds for designating the votes of the class 5 creditors. LATAM likened the CAAs to postpetition PSAs that were "negotiated in good faith and at arm's length, between sophisticated commercial parties, and only after the Disclosure Statement and Plan had been filed." In addition, LATAM argued, even assuming it did violate section 1125(b), the remedy for such a violation is vote designation under section 1126(e), not denial of confirmation under section 1129(a)(2).

THE BANKRUPTCY COURT'S RULING

In an unpublished (nonprecedential) opinion, the bankruptcy court overruled the U.S. Trustee's objection (as well as all other objections) and confirmed LATAM's chapter 11 plan.

Judge James L. Garrity, Jr. rejected LATAM's contention that the CAAs were no different from postpetition PSAs, which, in other cases, have been deemed not to violate section 1125(b). He explained that the only "plan support" provision in the CAAs was the class 5 creditors' unconditional commitment to vote to accept the Plan. Moreover, Judge Garrity noted, whereas the PSAs cited by LATAM "were executed prior to approval of the disclosure statement and were executed in furtherance of a debtor formulating its plan—i.e., before the plan was filed in court—here that is clearly not the case." *LATAM*, 2022 WL 2206829, at *54.

Judge Garrity also explained that, although the CAAs did not include specific performance as a remedy for breach—an element that was deemed objectionable by Judge Walrath in *NII Holdings* and *Station Holdings*—each CAA was "an enforceable agreement obligating the counterparty Class 5 Claim Allowance Creditor to vote in favor of the Debtors' Plan, that was executed prior to the Court's approval of the Disclosure Statement." However, he noted, LATAM later disclaimed any right to enforce the plan support provisions and entered into new CAAs with the class 5 creditors without them. In addition, only 45 of the 95 claims involved were later voted to accept the plan.

According to Judge Garrity, even if LATAM violated section 1125(b) by entering into the CAAs, denying confirmation of the chapter 11 plan was "neither an equitable nor appropriate resolution" because "[b]y its terms, section 1126(e) provides the exclusive remedy for violations of section 1125(b)." *Id.* at *55 (citing *Texaco*, 81 B.R. at 816; *In re WorldCom, Inc.*, 2003 Bankr. LEXIS 2192, *35-36 (Bankr. S.D.N.Y. May 16, 2003)).

On the facts of this case, Judge Garrity explained, if the U.S. Trustee sought relief under section 1126(e) (which it did not), only the votes of the affected class 5 creditors who voted to accept the plan could be designated under section 1126(e), which would not alter the vote tabulation sufficiently to result in the rejection of the plan by that class of creditors.

Judge Garrity rejected the U.S. Trustee's argument that confirmation should be denied under section 1129(a)(2) because LATAM did not comply with section 1125(b)—an "applicable provision" of the Bankruptcy Code. Not only is section 1126(e) the exclusive remedy for a breach of section 1125(b), he wrote, but "section 1129(a)(2) does not provide for an affirmative grant of authority. It cannot provide any relief to remedy the Debtors' alleged breach of section 1125(b), let alone relief that is greater than the relief available under section 1126(e)." *LATAM*, 2022 WL 2206829, at *56.

On July 7, 2022, the bankruptcy court denied a motion filed by certain LATAM creditors for a stay of the plan confirmation order pending an appeal to the district court. On July 26, 2022, the court denied the creditors' request that it certify a direct appeal of the confirmation order to the U.S. Court of Appeals for the Second Circuit.

The U.S. District Court for the Southern District of New York affirmed the bankruptcy court's confirmation order on August 31, 2022. The district court's affirmance does not address the solicitation issue.

OUTLOOK

LATAM reinforces the principle that "solicitation" of votes on a chapter 11 plan should be narrowly construed to promote communication and negotiation among the debtor and other stakeholders in a chapter 11 case. Even so, the court did not conclusively weigh in on the propriety of the debtors' actions under section 1125(b). It was careful to note that the debtors failed to seek pre-approval of the claim allowance agreements, did not disclose the plan support provisions in the stipulations that the debtors did submit for court approval, and once the information came to light, disclaimed any intention of enforcing the plan support provisions.

Under different circumstances—i.e., where there were enough votes subject to designation to affect the outcome of the vote—the court may well have ruled to the contrary. Finally, *LATAM* reaffirms the notion that vote designation under section 1126(e) is the sole remedy for violating section 1125(b).

THIRD CIRCUIT SETS STANDARD FOR APPOINTMENT OF FUTURE CLAIMS REPRESENTATIVES IN ASBESTOS BANKRUPTCY CASES

Oliver S. Zeltner • Mark G. Douglas

Unlike professionals retained in a chapter 11 case by trustees, debtors, or official committees, the Bankruptcy Code provides little guidance regarding the appointment of a representative for "future claimants" in a chapter 11 case involving the establishment of a trust to pay the claims of asbestos creditors. Only a handful of court rulings have addressed this question, and until recently, no circuit court of appeals had weighed in on the issue.

The U.S. Court of Appeals for the Third Circuit considered the question as a matter of first impression in *In re Imerys Talc America, Inc.*, 38 F.4th 361 (3d Cir. 2022). The court ruled that a future claims representative ("FCR") in an asbestos case must be more than merely a "disinterested person"—the standard applied to some other professional retentions in bankruptcy. Instead, like the members of official creditors' committees, an FCR must be not only free of conflicts of interest, but also fulfill fiduciary duties to future claimants, including duties of undivided loyalty and honesty.

RETENTION OF PROFESSIONALS IN BANKRUPTCY CASES

Bankruptcy trustees or chapter 11 debtors-in-possession ("DIPs") are permitted to retain a wide variety of professionals, including lawyers, accountants, auctioneers, and investment bankers "that do not hold or represent an interest adverse to the estate, and that are disinterested persons" to represent them in connection with a bankruptcy case. 11 U.S.C. § 327(a). A professional is not disqualified from such employment solely because the professional has represented a creditor, unless another creditor or the U.S. Trustee objects to the retention, and the court concludes that the professional has an actual conflict of interest. *See* 11 U.S.C. § 327(c). Under section 327(e), a trustee or DIP may also retain a lawyer that has previously represented the debtor for a "special purpose" other than acting as general bankruptcy counsel (e.g., in connection with discrete litigation, real estate, or labor matters).

Section 101(14) provides that the term "disinterested person" means a person that—

(A) is not a creditor, an equity security holder, or an insider;
(B) is not and was not, within two years before the date of the filing of the petition, a director, officer, or employee of the debtor; and
(C) does not have an interest materiall y adverse to the interest of the estate or of any class of creditors or equity security holders, by reason of any direct or indirect relationship to, connection with, or interest in, the debtor, or for any other reason.

Under section 328(c), a court may deny compensation for services if, during a professional's employment by the estate, the professional "is not a disinterested person, or represents or holds an interest adverse to the interest of the estate with respect to the matter on which such professional person is employed."

Pursuant to section 1103(a) of the Bankruptcy Code, official committees appointed in a chapter 11 case may also, with court approval, retain professionals to perform services on their behalf. Any such professional may not represent any other entity having an interest adverse in connection with the bankruptcy case. However, representing one or more of the committees' constituent creditors does not *per se* represent an adverse interest. *See* 11 U.S.C. § 1103(b).

The Bankruptcy Code does not specify a standard to be applied to the retention of an FCR in a chapter 11 case involving the creation of a trust to pay present and future asbestos claims.

ASBESTOS TRUSTS IN BANKRUPTCY

Section 524(g) of the Bankruptcy Code establishes a procedure for dealing with future personal injury asbestos claims against a chapter 11 debtor. The provision was added to the Bankruptcy Code in 1994 in the wake of the historic *Johns-Manville* and *UNR Industries* chapter 11 cases, where the courts, relying on various Bankruptcy Code provisions, including a bankruptcy court's broad equitable powers under section 105(a), implemented procedures upon which section 524(g) was later patterned. *See In re Johns-Manville Corp.*, 36 B.R. 743 (Bankr. S.D.N.Y. 1984); *In re UNR Indus., Inc.*, 46 B.R. 671 (Bankr. N.D. Ill. 1985). The provision was enacted in response to lawmakers' concerns that a mechanism established in bankruptcy to pay asbestos claims could be depleted by the payment of present asbestos claims before future claimants manifest any signs of illness. Section 524(g) of the Bankruptcy Code, therefore, was designed to protect future claimants, while also recognizing that future asbestos claimants would be ill-served if asbestos companies are forced into liquidation.

Section 524(g) contemplates the creation of a trust under a chapter 11 plan to pay asbestos claims and the issuance of an injunction—sometimes referred to as a "channeling injunction"—to prevent asbestos claimants from suing the debtor and certain related parties, such as its insurance companies. All claims based upon asbestos-related injuries are channeled to the trust.

To safeguard the due process rights of future claimants, section 524(g)(4)(B) provides that the bankruptcy court must appoint "a legal representative for the purpose of protecting the rights of" future claimants in the chapter 11 case—i.e., an FCR. It further directs the court to determine that the terms of the injunction are "fair and equitable" with respect to future claimants in light of the benefits provided to the trust by the beneficiaries of the injunction. *See* 11 U.S.C. § 524(g)(4)(B)(i) and (ii).

However, unlike professionals retained by estate representatives under sections 327 and 1104, the Bankruptcy Code does not provide any guidance regarding the standard for selecting an FCR under section 524(g).

Some courts have used the "disinterested person" standard applied to professional retentions under sections 327(a) and 1104 in this context. *See, e.g.*, *In re Duro Dyne Nat'l Corp.*, 2019 WL 4745879, *7 (D.N.J. Sept. 30, 2019) (citing cases and adopting a disinterested person standard); *Fed. Ins. Co. v. Grace*, 2004 WL 5517843, *9 (D. Del. Nov. 22, 2004) (rejecting the "appearance of impropriety" disqualification standard in favor of the disinterested person standard).

Other courts have applied a more stringent "guardian *ad litem*" standard requiring a "legal representative" appointed under section 524(g) to be a fiduciary independent of the debtor and other parties in interest and able to act with undivided loyalty to future claimants. *See, e.g.*, *In re Fairbanks Co.*, 601 B.R. 831, 841 (Bankr. N.D. Ga. 2019) ("[An FCR] effectively undertakes the role of a guardian ad litem. Appointment of an FCR thus involves the same considerations as appointment of a guardian ad litem. . . . [T]he standard for appointing [an FCR] requires that the individual not only be disinterested and qualified; the [FCR] must also be capable of acting as an objective, independent, and effective advocate for the best interests of the future claimants. The Court must be satisfied that, like a guardian ad litem, an FCR will provide representation that is diligent, competent, and loyal.").

The Third Circuit addressed the question of which standard should apply to the appointment of an FCR as a matter of first impression in *Imerys Talc*.

IMERYS TALC

Imerys Talc America, Inc. and its affiliates (collectively, the "debtors") mined, processed, and distributed talc to third-party manufacturers for their products. The debtors had been sued by more than 14,000 claimants asserting asbestos-related talc exposure claims by the time they filed for chapter 11 protection in February 2019 in the District of Delaware.

In anticipation of the bankruptcy filing, the debtors retained James Patton ("Patton"), a partner at the law firm of Young Conaway Stargatt & Taylor ("Young Conaway"), to serve as a "Proposed FCR" in pre-bankruptcy negotiations. Patton, who had worked for decades in mass-tort bankruptcies and has served as FCR in many asbestos cases, hired Young Conaway as his counsel.

After filing for bankruptcy, the debtors sought court approval to retain Patton as FCR for the future claimant beneficiaries of a proposed section 524(g) trust that formed the cornerstone of their chapter 11 plan. In his retention papers, Patton disclosed that Young Conaway represented various insurers (the "insurers") that had issued policies to the debtors or their predecessors in coverage disputes related to environmental liabilities, including asbestos claims, "but unrelated to talc claims or the Debtors." In particular, Patton stated, Young Conaway represented two of the insurers—National Union Fire Insurance Company of Pittsburgh, PA ("National Union") and Continental Insurance Company ("Continental")—in a lawsuit filed in Delaware in 2010 involving coverage for asbestos-related injury claims (the "Delaware litigation"). Both National Union and Continental signed prospective conflict of interest waivers as part of Young Conaway's representation of them in the litigation.

None of the insurers objected to Patton's retention as FCR or to Patton's retention of Young Conaway on the basis of Young Conaway's involvement in the Delaware litigation. Instead, the insurers filed a limited objection to Patton's employment based on his pre-bankruptcy engagement as Proposed FCR, which they argued raised questions about his independence from the debtors.

The bankruptcy court, however, raised the Delaware litigation as a potential conflict of interest. In its initial May 2019 ruling approving Patton's retention as FCR, the court rejected the insurers' argument that Patton's prepetition employment as Proposed FCR undermined his independence, but expressed concerns about Patton's personal involvement in the Delaware litigation. The court directed Patton to provide additional information on that issue, and ultimately approved his retention as FCR, stating that "the standard for approval of a legal representative under section 524 is that he must be independent of the debtors and other parties-in-interest in the case and must be able to act with undivided loyalty to demand holders."

In his supplemental disclosure, Patton stated that National Union and Continental had signed prospective conflicts waivers for certain conflicts of interest that might arise out of Young Conaway's bankruptcy-related work. He also stated that he was not personally involved in the Delaware litigation and that Young Conaway had erected an "ethical wall" between Patton's FCR team and the firm's other insurance litigators.

Ten days after the bankruptcy court's initial ruling on Patton's retention application and two months after the objection deadline, the insurers filed an objection to Patton's appointment as

FCR on the basis of an alleged conflict of interest arising from the Delaware litigation.

The bankruptcy court overruled the objection on its merits, concluding that the conflicts waiver was valid and that Patton satisfied the appointment standard articulated in its initial ruling.

The district court affirmed and the insurers appealed to the Third Circuit.

THE THIRD CIRCUIT'S RULING

A three-judge panel of the Third Circuit affirmed.

Writing for the panel, U.S. Circuit Judge Cheryl Ann Krause explained that, as an initial matter, the insurers other than National Union and Continental lacked standing to appeal because they were not involved in the Delaware litigation and were therefore not "persons aggrieved" by the bankruptcy court's decision. She also noted that it appeared the insurers were interposing their objection in a tactical bid to delay confirmation of the debtors' chapter 11 plan, which was "just the sort of bad-faith tactic" that the Third Circuit had cautioned against in its previous ruling in *In re Congoleum Corp.*, 426 F.3d 675, 685–86 (3d Cir. 2005), where it addressed the "person aggrieved" standard in the context of an insurer's standing to object to the retention of special insurance counsel.

The Third Circuit panel also determined that the bankruptcy court correctly found that National Union and Continental waived their objections to Patton's retention. Even so, the court of appeals proceeded to address the merits of the appeal because, it said, the public interest would be better served by addressing arguments with "significant implications for bankruptcy law" and doing so would not prejudice the parties, who had fully briefed the issues before the bankruptcy court. *Imerys Talc*, 38 F.4th at 372.

The debtors and Patton argued that the "disinterested person" standard should apply to the retention of an FCR. The insurers advocated that the guardian *ad litem* test was more appropriate, but with the additional caveat that, in accordance with section 327(a), any actual conflict of interest should be *per se* disqualifying. In an amicus brief, the U.S. Trustee agreed with the bankruptcy court and the insurers that FCRs, like guardians *ad litem*, "should be held to the high standards applicable to fiduciaries who represent parties not before the Court." *Id.* at 374.

The Third Circuit ruled that "the FCR standard requires more than disinterestedness." According to Judge Krause, "[a]n FCR must be able to act in accordance with a duty of independence from the debtor and other parties in interest in the bankruptcy, a duty of undivided loyalty to the future claimants, and an ability to be an effective advocate for the best interests of the future claimants." *Id.* (footnote omitted).

The Third Circuit reached this conclusion after considering the text of the Bankruptcy Code and its legislative history, the standards traditionally applied to creditors' committees—which, the court explained, serve an analogous role in bankruptcy cases—and "the administrability of the fiduciary standard . . . in the bankruptcy context." *Id.*

First, the Third Circuit reasoned, Congress specifically chose to use the "disinterested person" standard in 11 other provisions of the Bankruptcy Code, yet omitted it from section 524(g). *Id.* at 375 (citing 11 U.S.C. §§ 327(a), 328(c), 332(a), 333(a)(2)(A), 701(a)(1), 703(c), 1104(b)(1), 1104(d), 1163, 1183(a), 1202(a) and 1302(a)). This is not surprising, Judge Krause wrote, because the provisions containing the "disinterested person" standard "relate to professionals whose duties run to the entire estate or to the court, requiring that they remain impartial" and do not represent any adverse interest, whereas the FCR is the "'legal representative' for just such an adverse interest, having been appointed specifically 'for the purpose of protecting the rights of' future asbestos claimants." *Id.* (quoting 11 U.S.C. § 524(g)(4)(B)(i)). The Third Circuit accordingly concluded that this statutory omission "counsels against" adopting the disinterested person standard for the purpose of FCR appointments.

Next, the Third Circuit reasoned that lawmakers' usage of the term "legal representative"—a term of art referring to someone owing fiduciary duties to absent constituents—in section 524(g) indicates they anticipated an FCR should "be able to fulfill the heightened duties owed by fiduciaries" rather than being merely disinterested. *Id.* at 376.

According to the Third Circuit, the legislative history of section 524(g), which does not address the issue, provides little support for applying the disinterested person standard to FCR appointments. The court acknowledged that the courts in *Johns-Manville* and *UNR* applied "something like" the disinterested

person standard in approving "proto-FCRs," and Congress amended section 524 three times after it was enacted without clarifying what the standard should be, even though some courts had already adopted the disinterested person standard.

The court noted that the *Johns-Manville* and *UNR* courts never explicitly applied the disinterested person standard, and the "legislative acquiescence argument . . . tells us nothing," particularly because the amendments to section 524 were "specific and targeted" rather than comprehensive. *Id.* at 377.

The Third Circuit looked for guidance to the standard governing the appointment of the members of a creditors' committee, "an analogous player in the bankruptcy process." Although section 1102(a)(2) of the Bankruptcy Code mandates only that a committee be "adequate[ly] representat[ive]" of its constituents, Judge Krause wrote, "courts have long required each committee member not only to be free of conflicts of interest but also to fulfill fiduciary duties to the committee's constituents, including duties of undivided loyalty and honesty." *Id.* (citing COLLIER ON BANKRUPTCY ¶ 1103.05[2] (16th ed. 2021)). Because an FCR effectively functions as a "creditors' committee of one," the Third Circuit reasoned, "that standard is equally appropriate . . . [and] that is the standard we adopt today." *Id.* at 378.

According to the Third Circuit, "that standard does not herald a categorical approach to an FCR's appointment." It further explained that, as in the context of creditors' committee appointments, whether a conflict exists in connection with the appointment of an FCR is less relevant than the nature of the conflict and its importance to the interests of future claimants. The Third Circuit also cautioned that "we do not today prescribe any particular process the bankruptcy court must follow in making that appointment." *Id.* at 379. Provided the bankruptcy court has adequate information to assess a proposed FCR's qualifications, the court wrote, "variations in the appointment process are otherwise within the discretion of the bankruptcy court." *Id.*

Having articulated the standard, the Third Circuit concluded that Patton satisfied it and was properly appointed as an FCR. The court emphasized that no one questioned Patton's qualifications, undivided loyalty, or ability to effectively advocate for future claimants. Instead, the insurers argued that Young Conaway's representation of National Union and Continental in the Delaware litigation was a direct conflict of interest that required disqualification and tainted Patton's independence and ability to be an effective advocate for future claimants.

The Third Circuit rejected these arguments. First, the court found that the bankruptcy court correctly ruled that National Union and Continental, as "sophisticated parties who were represented by both an agent and that agent's insurance counsel," waived this conflict with full knowledge "that there was a material risk that Young Conaway would be involved in the future in § 524(g) proceedings that would also involve insurance company creditors." *Id.* at 380. Second, the Third Circuit concluded that the insurers' argument that Patton could not be independent and an effective advocate because the Delaware litigation involved *issues* "substantially related" to the issues that might arise in the debtors' bankruptcy did not stand up to scrutiny. In a "typical conflicts analysis," Judge Krause explained, "substantially related" refers not to similar legal *issues* but to substantially related *transactions*, which was not the case here because there was not a "substantial risk" that Patton and Young Conaway would use any confidential information Young Conaway obtained during the Delaware litigation in the debtors' chapter 11 cases. *Id.* at 381.

OUTLOOK

The Third Circuit's ruling in *Imerys Talc* is notable for a number of reasons. First, the decision provides guidance at the appellate level on a question that is largely bereft of precedent from bankruptcy and appellate courts in published or unpublished opinions. Second, recognizing that many of the bankruptcy and district courts in the Third Circuit "had settled on the disinterested standard from which we now depart," the Third Circuit carefully explained why it found the standard it adopted to be the most appropriate one to govern the appointment of an FCR in an asbestos chapter 11 case. Finally, according to the Third Circuit, the "mere existence" of a potential conflict is not *per se* disqualifying, but requires a bankruptcy court to undertake a more detailed analysis in exercising its broad discretion.

In the Third Circuit, therefore, a higher standard than the "disinterested person" standard applies to the appointment of an FCR. It remains to be seen whether courts in other circuits will adopt this approach.

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SECOND CIRCUIT RULES THAT BANKRUPTCY COURTS MAY AWARD APPELLATE LEGAL FEES AS SANCTION FOR CONTEMPT

Charles M. Oellermann • Mark G. Douglas

Courts disagree whether a bankruptcy court, in exercising its broad equitable powers, has the authority to award appellate legal fees as a sanction for contempt. The U.S. Court of Appeals for the Second Circuit recently weighed in on this issue as an apparent matter of first impression. In *Law Offices of Francis J. Reilly, Esq. v. Selene Finance, L.P. (In re DiBattista)*, 33 F.4th 698 (2d Cir. 2022), the Second Circuit held that a bankruptcy court erroneously concluded that it did not have the power to award attorney fees incurred on appeal by a debtor seeking to enforce a contempt order for violations of a bankruptcy discharge order.

THE AMERICAN RULE AND FEE SHIFTING IN BANKRUPTCY

The general rule in the United States is that litigants are responsible for their own attorney fees, win or lose. This is referred to as the "American Rule," as distinguished from the "English Rule," whereby the prevailing party ordinarily recovers its own attorney fees from the loser. However, the American Rule is merely the general rule. It can be overridden under certain circumstances, such as by contract or statute—sometimes referred to as a "fee-shifting" statute.

The Bankruptcy Code contains many fee-shifting exceptions to the American Rule, including:

(1) Counsel to a bankruptcy trustee or a chapter 11 debtor-in-possession is compensated by the estate, and if the estate is insolvent, unsecured creditors bear the cost unless secured creditors agree to do so by means of a court-approved collateral "carve out";
(2) The estate is obligated to pay a secured creditor's attorney fees, either pursuant to section 506(b) of the Bankruptcy Code, to the extent the value of the secured creditor's collateral exceeds the face amount of its claim, or in accordance with an order authorizing postpetition financing and providing "adequate protection" to the secured creditor;
(3) Attorneys retained by official committees of unsecured creditors or shareholders are compensated by the estate;
(4) Attorney fees may be imposed as a sanction for violations of the automatic stay under section 362(k);
(5) Court-imposed sanctions under Rule 9011 of the Federal Rules of Bankruptcy Procedure ("Fed. R. Bankr. P.") for misrepresentations to the court may include the imposition of attorney fees;
(6) Creditors and certain other parties who, among other things, file an involuntary petition, make a "substantial contribution" in a chapter 9 or 11 case, recover property transferred or concealed by a debtor, or are involved in the prosecution of a criminal offense relating to the bankruptcy case or the debtor's business or property may be awarded a priority administrative expense claim for their attorney fees under section 503(b)(4);
(7) Expenses incurred by the bankruptcy estate for preserving collateral (including fees of estate professionals) may be surcharged against the collateral pursuant to section 506(c), thereby shifting the fees to the secured creditor; and
(8) A debtor may recover its attorney fees from petitioning creditors in a dismissed involuntary bankruptcy case under section 303(i).

See generally Daniel J. Bussel, *Fee-Shifting in Bankruptcy*, 95 AM. BANKR. L.J. 613, 629-31 (2021).

BANKRUPTCY COURT'S INHERENT POWER TO AWARD LEGAL FEES AS CONTEMPT SANCTION

In addition, it is well recognized that a bankruptcy court may award legal fees as a sanction for violations of its orders or the bankruptcy discharge in exercising its broad equitable powers under section 105(a) of the Bankruptcy Code, which authorizes the court to "issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of [the Bankruptcy Code.]" *See In re Stewart*, 634 B.R. 740, 748 (Bankr. E.D. Mich. 2021); *In re Jones*, 632 B.R. 138, 148 (Bankr. S.D. Ohio 2021).

Various courts have ruled that a bankruptcy court also has the power under section 105(a) to grant legal fees for the successful appellate defense of a contempt order. *See, e.g.*, *Liberis v. Craig*, 845 F.2d 326, 1988 WL 37450, **6-8 (6th Cir. 1988); *Hoti Enterprises, L.P. v. GECMC 2007 C-1 Burnett Street, LLC (In re Hoti Enterprises, L.P.)*, 2013 WL 1812197, **9, 20 (S.D.N.Y. 2013), *aff'd*, 562 Fed. App'x 1 (2d Cir. 2014); *In re Markus*, 619 B.R. 552, 575 (Bankr. S.D.N.Y. 2020); *Sprague v. Williams (In re Van Winkle)*, 598 B.R. 297, 301-02 (Bankr. D.N.M. 2019); *In re Rodriguez*, 517 B.R. 724, 738-39 (Bankr. S.D. Tex. 2014).

Other courts have ruled to the contrary. Some have reasoned that the only avenue for awarding legal fees incurred in defending a contempt order on appeal is Rule 38 of the Federal Rules of Appellate Procedure ("Fed. R. App. P.") or Fed. R. Bankr. P. 8020, both of which authorize an appellate court to award damages and costs, including legal fees, if it determines that an appeal was frivolous. *See, e.g., In re Del Mission Ltd.*, 98 F.3d 1147, 1153-54 (9th Cir. 1996); *DVI Receivables XIV, LLC v. Rosenberg*, 500 B.R. 174, 181-82 (S.D. Fla. 2013).

In *DiBattista*, the Second Circuit considered whether a bankruptcy court has the authority to award appellate legal fees as a sanction for contempt.

DIBATTISTA

Chapter 7 debtor Bret DiBattista received a bankruptcy discharge in 2009. Despite the discharge order, the servicer of the debtor's home mortgage (the "servicer") continued its attempts to collect on the delinquent mortgage.

In 2019, the bankruptcy court, upon the debtor's request, reopened the bankruptcy case and granted the debtor's motion for contempt sanctions against the servicer. The court awarded the debtor $17,500 in damages for willful and repeated violations of the discharge order as well as approximately $9,000 in legal fees.

The servicer appealed the ruling to the district court, which vacated the ruling and remanded the case below for clarification of whether the bankruptcy court's award was for "actual" or "punitive" damages. After the bankruptcy court issued a second order clarifying that the $17,500 award was for compensatory damages, the debtor's counsel sought additional fees totaling approximately $28,000 for services provided in connection with the appeal.

The bankruptcy court denied the motion. It reasoned that:

> Appeal is a legal avenue for any losing party to pursue, and it's not a violation of the discharge order. And a party is not in contempt for choosing to take an appeal. If [the debtor's attorney] wanted fees, [it] needed to ask [the district court] for fees for that proceeding.

The district court affirmed on appeal, writing that a "bankruptcy judge has simply not been empowered by Congress to award legal fees incurred in connection with an appeal to the district court."

The debtor's attorney appealed to the Second Circuit.

THE SECOND CIRCUIT'S RULING

A three-judge panel of the Second Circuit vacated the district court's ruling and remanded the case below. Writing for the panel, U.S. Circuit Court Judge Richard J. Sullivan explained that it is well settled that a bankruptcy court, exercising its broad equitable powers under section 105(a), "may compensate a debtor for a creditor's violation of [a] discharge order" entered under section 524(a). These provisions, Judge Sullivan wrote, which "'bring with them the old soil that has long governed how courts enforce injunctions,'" authorize a court to impose civil contempt sanctions to coerce compliance with an injunction or to compensate a complainant for losses arising from noncompliance. *DiBattista*, 33 F.4th at 702 (quoting *Taggart v. Lorenzen*, 139 S. Ct. 1795 (2019)).

Judge Sullivan was guided by *Weitzman v. Stein*, 98 F.3d 717 (2d Cir. 1996)—a non-bankruptcy case—where the Second Circuit reversed a district court's denial of legal fees incurred in defending a contempt ruling on appeal, reasoning that the appellate costs were caused by the contemnor's misconduct because "'none of this [litigation] would have been necessary' if the contemnor had simply obeyed the district court's order." *DiBattista*, 33 F.4th at 703 (quoting *Weitzman*, 98 F.3d at 720). As in *Weitzman*, Judge Sullivan concluded, the debtor's appellate fees were "caused by" the servicer's contempt. He also wrote that, given the "old soil that has long governed how courts enforce injunctions . . . it is immaterial that this case involves a bankruptcy court's, rather than a district court's, contempt order." *Id.* Thus, Judge Sullivan found, the bankruptcy court's rationale that an appeal is not a violation of the discharge order was erroneous.

The Second Circuit also faulted the bankruptcy court's determination that only the district court could award appellate litigation costs. "[I]n line with long-established practice," Judge Sullivan explained, a bankruptcy court's contempt power includes the authority to compensate a party for damages arising from noncompliance with an injunction, "even if those losses take the form of appellate litigation fees." *Id.*

According to Judge Sullivan, the district court was never asked to award appellate legal fees to the debtor, and the bankruptcy court was "in no way prohibited" from doing so. Moreover, he wrote, the "frivolous appeal" sanctioning rules—Fed. R. Bankr. P. 8020(a) and Fed. R. App. Proc. 38—do not "prevent a lower court from assessing fees against a willful contemnor who has flouted the lower court's injunction order, even where the contemnor's appeal is non-frivolous." *Id.* at 704.

Finally, the Second Circuit rejected the servicer's argument that the American Rule precludes an award of appellate fees "absent explicit statutory authority." According to Judge Sullivan, an exception to the American Rule has long been recognized that permits a court to award legal fees for willful disobedience of an order entered as part of a fine levied on a contemnor.

SEVENTH CIRCUIT: SECURED CREDITOR THAT PARTICIPATED IN CHAPTER 11 CASE BOUND BY TERMS OF CONFIRMED PLAN THAT EXTINGUISHED LIEN

Dan B. Prieto • Mark G. Douglas

A hornbook principle of U.S. bankruptcy jurisprudence is that valid liens pass through bankruptcy unaffected. This long-standing principle, however, arguably conflicts with section 1141(c) of the Bankruptcy Code, which provides that, under certain circumstances, "the property dealt with by [a chapter 11] plan is free and clear of all claims and interests of creditors," except as otherwise provided in the plan or the order confirming the plan. Several courts have attempted to reconcile the pass-through principle with the statute by requiring the creditor to "participate in the reorganization" as a prerequisite to the application of section 1141(c). This judicial gloss raises the question of whether the terms of a chapter 11 plan providing for the treatment of secured creditor claims are binding on nonparticipating secured creditors.

The U.S. Court of Appeals for the Seventh Circuit recently addressed the participation question in *In re Aguirre*, 37 F.4th 427 (7th Cir. 2022). The court affirmed a lower court ruling that, because a tax lien creditor was "a party in the bankruptcy case," the creditor's tax lien did not pass through bankruptcy unaffected by the terms of a confirmed chapter 11 plan that extinguished the lien in exchange for an agreement to pay the creditor's secured claim in full in cash. The court also vacated an order directing a state court to vacate a tax deed issued to the creditor.

SECTION 1141(C)

Section 1141(c) states:

> Except as provided in subsections (d)(2) [debts of individual debtors that are excepted from discharge under section 523] and (d)(3) [denial of discharge for, among others, liquidating corporations] of this section and except as otherwise provided in the plan or in the order confirming the plan, after confirmation of a plan, the property dealt with by the plan is free and clear of all claims and interests of creditors, equity security holders, and of general partners in the debtor.

With respect to liens and security interests, section 1141(c) means that "unless the plan of reorganization, or the order confirming the plan, says that a lien is preserved, it is extinguished by the confirmation." *In re Penrod*, 50 F.3d 459, 463 (7th Cir. 1995); *accord JCB, Inc. v. Union Planters Bank, NA*, 539 F.3d 862 (8th Cir. 2008). *But see Bowen v. United States (In re Bowen)*, 174 B.R. 840 (S.D. Ga. 1994) (holding that a "lien" is not an "interest" within the meaning of section 1141(c); any release of a lien must rely on section 506(d)).

Concern regarding the impact of lien-stripping has led a number of (principally appellate) courts to add a judicial gloss to section 1141(c) requiring the secured creditor to have "participated in the reorganization" before its lien will be deemed extinguished. *See generally* COLLIER ON BANKRUPTCY ¶ 1141.04[1] (16th ed. 2022) (discussing cases).

In *Penrod*—apparently, the first decision to add the participation gloss to section 1141(c)—the debtor's chapter 11 plan made provision for payment of a secured claim, but neither the plan nor the order confirming it stated whether the lien would be extinguished. The Seventh Circuit, acknowledging the "old saw" that liens pass through bankruptcy unaffected, nevertheless concluded that "when lienholders participate in a bankruptcy proceeding, and especially in a reorganization, they know that their liens are likely to be affected, and indeed altered." *Penrod*, 50 F.3d at 462. It ruled that liens are "interests" covered by section 1141(c) and that "unless the plan of reorganization, or the order confirming the plan, says that a lien is preserved, it is extinguished by the confirmation . . . provided, we emphasize, that the holder of the lien participated in the reorganization." *Id.* at 463.

In *Elixir Indus., Inc. v. City Bank & Trust Co. (In re Ahern Enters., Inc.)*, 507 F.3d 817 (5th Cir. 2007), the Fifth Circuit held that four conditions must be met for a lien to be voided under section 1141(c): (i) the plan must be confirmed; (ii) the collateral must be dealt with by the plan; (iii) the lienholder must participate in the reorganization; and (iv) the lien must not be preserved under the plan.

In *City of Concord, N.H. v. Northern New England Telephone Operations LLC (In re Northern New England Telephone Operations LLC)*, 795 F.3d 343 (2d Cir. 2015), *cert. denied*, 577 U.S. 1009 (Nov. 30, 2015), the Second Circuit adopted a similar test, ruling that a lien is extinguished by a chapter 11 plan if: (i) the text of the plan does not preserve the lien; (ii) the plan is confirmed; (iii) the property encumbered by the lien is "dealt with" by the plan; and (iv) the secured creditor participated in the bankruptcy case.

The *New England Telephone* court explained that section 1141(c) provides a caveat to the long-standing "background" rule that "liens pass through bankruptcy unaffected." *Id.* at 346 (citing *Dewsnup v. Timm*, 502 U.S. 410, 417 (1992); *Penrod*, 50 F.3d at 461). The court also stated that the phrase "interests of creditors" in section 1141(c) includes liens and that, despite the absence of any express reference to lien extinguishment in section 1141(c), courts have uniformly held that confirmation of a chapter 11 plan can act to extinguish liens. *Id.* at 346-47 (citing *In re Chrysler LLC*, 576 F.3d 108, 126 (2d Cir.) (citing cases), *vacated as moot sub nom. Ind. State Police Pension Tr. v. Chrysler LLC*, 558 U.S. 1087 (2009)).

The Second Circuit concluded that a requirement of lienholder participation "is located squarely within" section 1141(c). It explained that "[t]he text of the Code allows a plan to extinguish a lien only if the underlying property is 'dealt with,' and that condition cannot be fairly satisfied in the absence of the interested parties, including the security holder." *Id.* at 348.

According to the Second Circuit, this conclusion is reinforced by the interaction between section 1141(c), which permits certain liens to be extinguished, and section 506(d), which preserves certain liens. Section 506(d) provides in relevant part:

> To the extent that a lien secures a claim against the debtor that is not an allowed secured claim, such lien is void unless . . . (2) such claim is not an allowed secured claim due only to the failure of any entity to file a proof of such claim under section 501 of this title.

Thus, the Second Circuit observed:

> Section 506(d)(2) . . . preserves liens of *non-participating lienholders* whose liens would otherwise be extinguished *solely as a result of their non-participation*. If extinguishment under § 1141(c) is consistent with this provision (as we must and do assume), then § 1141(c) must apply only to liens located outside of § 506(d)(2)'s safe harbor. Reading the "dealt with" limitation in § 1141(c) to include only *participating lienholders* harmonizes these provisions.

Id. at 348 (citing 8 COLLIER ON BANKRUPTCY ¶ 1141.04[1] (16th ed. 2013)).

Other circuit courts have similarly required secured creditor participation in the case as a condition to lien extinguishment under section 1141(c). *See, e.g., In re Barton Indus., Inc.*, 104 F.3d 1241, 1245 (10th Cir. 1997); *FDIC v. Union Entities (In re Be-Mac Transport Co.)*, 83 F.3d 1020, 1025-26 (8th Cir. 1996); *see also Airadigm Communications, Inc. v. FCC (In re Airadigm Communications, Inc.)*, 519 F.3d 640, 648 (7th Cir. 2008) (reaffirming the *Penrod* approach).

Although the four-part *Ahern* test has been adopted in one form or another by many other courts, relatively few have examined what constitutes "participation" for purposes of the test. *See, e.g.*, *In re Vitro Asset Corp.,* 656 F. App'x 717, 724 (5th Cir. 2016) (a late-filed amended proof of a tax lien claim amounted to participation); *New England Telephone*, 795 F.3d at 350 (a municipality filed several proofs of claims "closely related" to tax lien claims, thereby assuring that "the procedural safeguards embedded in the 'dealt with' language of §1141(c) [were] satisfied"); *Acceptance Loan Co., Inc. v. S. White Transp., Inc. (In re S. White Transp., Inc.)*, 725 F.3d 494, 498 (5th Cir. 2013) (the level of participation necessary to trigger extinguishment of a lien under section 1141(c) "requires more than mere passive receipt of effective notice" of the chapter 11 case; instead, participation "connotes activity, and not mere nonfeasance"); *Ahern*, 507 F.3d at 823 (filing a proof of claim as an unsecured priority creditor constitutes participation); *In re Regional Bldg. Systems, Inc.*, 254 F.3d 528 (4th Cir. 2001) (participation is found where the creditor sat on the

unsecured creditors' committee and filed a proof of unsecured claim, yet failed to object to confirmation of the plan after the estate realized settlement proceeds that would have rendered the creditor's claim partially secured); *Greater Am. Land Res., Inc. v. Town of Brick*, 2012 WL 1831563 (D.N.J. May 17, 2012) (no participation where the creditor taxing authority did not file a proof of claim and the plan neither listed nor treated the tax claim); *In re Omega Optical, Inc.,* 476 B.R. 157, 165 (Bankr. E.D. Pa. 2012) (to the extent participation is required by section 1141(c), filing a proof of claim, then entering a notice of appearance of counsel, constitutes participation); *In re WorldCom, Inc.*, 382 B.R. 610 (Bankr. S.D.N.Y. 2008) (the secured creditor participated by filing a proof of claim).

The Seventh Circuit revisited the question of secured creditor "participation" for purposes of section 1141(c) in *Aguirre*.

AGUIRRE

Ramon and Bertha Aguirre (the "debtors") owned a restaurant property in Illinois. The property acted as collateral for a $1.3 million loan provided by a commercial bank (the "lender").

After the debtors failed to pay their 2010 real estate taxes on the property, the county sold the tax lien debt to Wheeler Financial, Inc. ("Wheeler"). Wheeler continued to pay the property taxes in subsequent years.

The debtors filed for chapter 11 protection in the Northern District of Illinois on June 30, 2014. They did not list either the county or Wheeler as a creditor. In August, at the lender's request, the bankruptcy court issued an order directing the debtors to pay 2013 real estate taxes on the property—a debt that was not purchased by Wheeler. In connection with its motion, the lender informed the court that the debtors had not paid taxes on the property in years and attached an exhibit to its court submissions identifying Wheeler as the holder of the tax debt.

Wheeler did not file a claim in the chapter 11 cases.

The debtors filed a chapter 11 plan in November 2014. The plan classified the county's tax lien claim, but not in any detail. The plan did not mention Wheeler.

Wheeler filed a petition for a tax deed in state court on December 2014. Although served with the summons, the debtors did not file an appearance in the case and defaulted. Wheeler did not serve the lender with a summons.

Also in December 2014, the debtors filed an amended chapter 11 plan that listed the county and Wheeler as the holders of a secured tax lien debt in the amount of $40,000. The debtors did not provide notice of filing of the plan or the bankruptcy to Wheeler. The debtors also listed Wheeler as a creditor in a second amended plan filed in February 2015, but never notified Wheeler.

In late February 2015, the debtors filed a notice with the bankruptcy court indicating that plan ballots had been provided to Wheeler and the county. Wheeler later informed the court that it received a ballot and certain other notices "on or about" March 1, 2015. However, Wheeler never voted on the plan.

In April 2015, the bankruptcy court confirmed the chapter 11 plan, as amended at Wheeler's request to require the debtors to pay the tax lien debt to Wheeler within six months. The debtors defaulted on the plan by failing to make the payment when due.

In November 2015, Wheeler filed a motion for relief from the automatic stay to pursue its state court litigation, arguing that the debtors' post-confirmation payment default under their chapter 11 plan was "cause" for such relief. In connection with the motion, Wheeler's attorney acknowledged that Wheeler was a party in the bankruptcy case, but was uncertain how and when it became a party. However, Wheeler's attorney argued that Wheeler's tax lien passed through the bankruptcy unaffected and that it was not bound by the terms of the confirmed plan. Wheeler filed several other pleadings in the bankruptcy and district courts thereafter.

In December 2015, the debtors filed a motion to modify the plan to extend the due date for their payment to Wheeler by six months and to provide a guaranty of such payment by the lender. At a January 2016 hearing, the debtors and the lender offered to pay Wheeler $50,000 immediately, rather than within the proposed six-month extension. Nonetheless, in April 2016, the bankruptcy court granted the motion to lift the stay and denied the motion to modify the plan.

In May 2016, the lender appealed the stay relief order. However, the state court issued a tax deed to Wheeler before the appeal could be heard.

In January 2017, the district court on appeal held that after the plan was confirmed, "Wheeler no longer had a lien on the Debtors' restaurant property." *In re Aguirre*, 565 B.R. 646, 654 (N.D. Ill. 2017). Accordingly, the district court wrote, "it was an abuse of discretion for the bankruptcy court to lift the stay and permit Wheeler to pursue legal action in the state court." *Id.* The district court vacated the bankruptcy court's order modifying the automatic stay and remanded the case below. It also vacated the bankruptcy court's order denying the debtors' motion to modify the plan without discussing the merits of that denial.

Wheeler appealed the district court's decision to the Seventh Circuit, which ultimately dismissed the appeal for lack of appellate jurisdiction after determining that the district court's decision was not a final and appealable order.

On remand, the lender filed a motion in the bankruptcy court for an order directing the state court to vacate the tax deed. The bankruptcy court, retroactively imposing the automatic stay, granted the motion, and the state court later vacated the tax

deed. The debtors then filed a motion to modify their chapter 11 plan to provide for payment in full of Wheeler's tax debt within seven days. The court granted that motion as well as a motion to stay Wheeler from renewing its state court litigation seeking a tax deed on the restaurant property. Wheeler appealed all of the bankruptcy court's orders.

The district court affirmed the stay order and the plan modification order, but vacated the tax deed order. Among other things, the district court held that it would not disturb the lower court's determination that Wheeler no longer had a lien on the property after confirmation of the plan. *See In re Aguirre*, 2021 WL 3674612, at *4 (N.D. Ill. Aug. 19, 2021). The district court vacated the tax deed order because it was based on an erroneous legal conclusion (i.e., that a tax deed granted while a stay was not in effect, but was later granted retroactively, is void *ab initio*).

Wheeler appealed the district court's order regarding the extinguishment of its tax lien to the Seventh Circuit. The lender appealed vacatur of the tax deed order.

THE SEVENTH CIRCUIT'S RULING

A three-judge panel of the Seventh Circuit affirmed.

Writing for the panel, U.S. Circuit Judge Frank H. Easterbrook noted at the outset of his opinion that "[l]itigants' indifference to procedures has made a mess of this bankruptcy proceeding."

Judge Easterbrook explained that, if Wheeler was not bound by the plan, its lien would pass through bankruptcy, and the plan would need to be revised "to eliminate all Wheeler-specific causes." *Aguirre*, 37 F.4th at 429. Moreover, he noted, if this were so, the bankruptcy case would not be over, and the appeal would have to be dismissed for lack of jurisdiction because the district court's order would not be final and appealable.

However, Judge Easterbrook concluded that Wheeler was bound by the terms of the confirmed chapter 11 plan because it was a party in the bankruptcy case, "even though Wheeler did not become a party through the means normally employed for that purpose." According to the judge, although Wheeler did not vote on the plan, "it negotiated for better terms, got the terms it sought, accepted the plan's confirmation as a *fait accompli*, and claimed rights under it." Those steps, he wrote, "effectively consent[ed] to have the lien replaced by a cash payment and waive[d] any entitlement to better or earlier notice." *Id.* Judge Easterbrook further noted that "[t]he confirmed plan knocks out any entitlement that Wheeler may once have had to obtain a tax deed and foreclose on its lien," provided Wheeler receives the payment it is entitled to under the plan. *Id.* at 431.

OUTLOOK

Aguirre is consistent with the Seventh Circuit's earlier rulings in *Penrod* and *Airadigm* that, if it participates in a chapter 11 case, a secured creditor will be bound by the terms of a confirmed plan in that case. In *Aguirre*, the confirmed plan extinguished the secured creditor's lien in exchange for a cash payment. Although the court does not mention section 1141(c) in its ruling, it assumes that participation in the case (or, in its parlance, "becoming a party") is necessary before the confirmed plan can be binding on the secured creditor.

The problem with this approach is that section 1141(c) does not expressly include a case participation requirement. Reading the provision to mandate such a requirement means that a secured creditor cannot be stripped of its lien under section 1141(c), even if it receives notice of the chapter 11 plan and deliberately ignores it, unless the creditor actively participates in the case by, among other things, filing a proof of claim or, as in this case, negotiating for better treatment of its claim under a plan.

Thus, absent active participation by the secured creditor, a plan proponent may not be permitted to modify or avoid the creditor's lien solely through the plan confirmation process, but instead may be required to object affirmatively to the secured claim or initiate an adversary proceeding to challenge the lien. Given this, the participation requirement means that a secured creditor can opt to "wait in the wings" during the bankruptcy case and then proceed to exercise its remedies in a more favorable forum after confirmation of a plan, without regard for the plan's terms.

As suggested in an article written shortly after the Second Circuit issued its ruling in *New England Telephone*, "[t]wo possible solutions to this problem are evident." *See* Dan B. Prieto, "Problems in the Code: Power to Lien-Strip Through a Plan," 34 Am. Bankr. Inst. J. 26 (Mar. 2015). First, courts could follow the Supreme Court's rationale in *United States Aid Funds v. Espinosa*, 559 U.S. 260 (2010), and allow lien-stripping under a chapter 11 plan, so long as notice to the secured creditor satisfies due process. The creditor's rights would be safeguarded because it could object to a plan that impermissibly treats its secured claim. However, "if the creditor does not object, the terms of a chapter 11 plan would be binding and, pursuant to the plain language of § 1141(c), liens would be extinguished." Second, lawmakers could solve the problem by amending section 1141(c) "to clarify that a specified degree of secured creditor participation in a chapter 11 case is or is not a precondition to lien-stripping under a confirmed plan."

However, courts have persisted in imposing a participation requirement, and Congress has to date declined to amend section 1141(c).

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ELEVENTH CIRCUIT RULES THAT COAL ACT PAYMENT OBLIGATIONS ARISING IN 2016 WERE DISCHARGED BY 1995 CHAPTER 11 PLAN

Daniel J. Merrett • Mark G. Douglas

Whether claims have been discharged in bankruptcy is a frequently litigated issue. This is particularly so in chapter 11 cases involving mass tort claims that may have technically "arisen" when the debtor manufactured or sold products before filing for bankruptcy, but where claimants may not become aware of their injuries until long after confirmation of a chapter 11 plan discharging pre-bankruptcy claims. The scope of a bankruptcy discharge also arises in chapter 11 cases where a debtor's payment obligation under a pre-bankruptcy or a pre-plan confirmation contract is not triggered until after confirmation of a chapter 11 plan.

The U.S. Court of Appeals for the Eleventh Circuit recently examined this question in *U.S. Pipe & Foundry Co. v. Holland (In re U.S. Pipe & Foundry Co.)*, 32 F.4th 1324 (11th Cir. 2022). A divided panel of the Eleventh Circuit ruled that certain debtors' alleged obligation to pay retiree health benefits mandated by the Coal Industry Retiree Health Benefit Act of 1992, 26 U.S.C. §§ 9701 *et seq.* (the "Coal Act"), were discharged in 1995 upon the confirmation of a chapter 11 plan, even though the payment obligation was not triggered until 2016. According to the majority, the payment obligation was a "claim" in 1995 and was therefore discharged upon confirmation of the debtors' plan.

DISCHARGE OF CLAIMS IN BANKRUPTCY

By design, the Bankruptcy Code is intended to deal with as many of a debtor's pre-bankruptcy obligations as possible in keeping with its core principles of affording the debtor with a "fresh start" and promoting equality of distribution among similarly situated creditors. This mandate is facilitated in part by the Bankruptcy Code's broad definition of "claim" to include nearly every conceivable pre-bankruptcy debt or obligation.

A non-liquidating corporate debtor generally will be discharged from every "claim" that existed as of the bankruptcy petition date (and some that arose during the bankruptcy case) upon the confirmation of its chapter 11 plan of reorganization (or the completion of payments under the plan, in the case of a small business reorganization). *See* 11 U.S.C. §§ 1141, 1192. In particular, section 1141(d)(1) of the Bankruptcy Code provides that, with certain exceptions, the confirmation of a chapter 11 plan "discharges the debtor from any debt that arose before the date of such confirmation," and certain debts that are deemed to have arisen prepetition (e.g., prepetition lease and financial contract rejection claims), whether or not a proof of claim has been filed or deemed filed with respect to such debt, such claim has been "allowed," or the claimant has accepted the chapter 11 plan.

Section 101(12) defines "debt" as a "liability on a claim."

Section 101(5) defines "claim" as a:

(A) Right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured; or

(B) Right to an equitable remedy for breach of performance if such breach gives rise to a right to payment, whether or not such right to an equitable remedy is reduced to judgment, fixed, contingent, matured, unmatured, disputed, undisputed, secured, or unsecured.

The term "claim" is therefore "coextensive" with the term "debt" (*see Pennsylvania Department of Public Welfare v. Davenport*, 495 U.S. 552, 558 (1990)), and "[b]y fashioning a single definition of 'claim' in the Code, Congress intended to adopt the broadest available definition of that term." *See* COLLIER ON BANKRUPTCY ¶ 101.05 (16th ed. 2022) (citing *In re Udell*, 18 F.3d 403 (7th Cir. 1994)).

A "claim" may also include "a cause of action or a right to payment that has not yet accrued or become cognizable." *Id.* (citing and discussing cases). Even so, the Bankruptcy Code's broad definition of "claim" is not limitless. For example, someone injured in the future due to a chapter 11 debtor's prepetition conduct does not have a prepetition "claim" unless the person had a prepetition relationship with the debtor or its products. *Id.* In addition, "even if a claim exists, due process principles may prevent the claim from being discharged, or rendered unenforceable" under certain circumstances. *Id.*

THE COAL ACT

Congress enacted the Coal Act in 1992 in response to the underfunding of United Mine Workers of America ("UMWA") health plans and the threatened vitality of health care benefit funds provided by coal companies to their employees. The Coal Act established obligations for coal companies that were or had been parties to collectively bargained coal wage agreements as of the year of enactment.

The Coal Act requires such "signatory companies" to continue to fund individual employer retiree health plans ("IEPs"). 26 U.S.C. §§ 9704(a), 9711(a), 9712(d)(1), (3). In addition, the Coal Act created two funds—the "Combined Fund" and the "1992 Fund" (collectively, the "Coal Act funds")—to provide health benefits to employees not covered by IEPs who retired before October 1994. *Id.* §§ 9702 and 9712. Pre-existing UMWA health benefit funds were absorbed into the Combined Fund. The 1992 Fund was created as a "back-stop" for retirees who were not covered by other funds, as well as retirees who might later be "orphaned" when a coal company's IEP was terminated.

Each of the Coal Act funds is financed by premiums assessed against "assigned operators" or their "related persons," which is defined broadly to include companies under common control and companies that are a "member of [a] controlled group

of corporations." Such operators and their related persons are jointly and severally liable for all Coal Act obligations. *Id.* §§ 9701(c)(2)(A), 9704(a), 9711(c)(1), and 9712(d)(4). Whether an entity is a related person under the Coal Act was fixed on July 20, 1992. Therefore, entities that were related persons in 1992 but are no longer related persons are still related persons, and entities that are now related to a coal company, but were not in 1992, are not. *Id.* § 9701(c)(2)(B).

When a covered coal company and all related persons are no longer in business, the premium amount is reduced to zero. An entity remains in business so long as it "conducts . . . any business activity" or "derives revenue from any business activity, whether or not in the coal industry." *Id.* § 9701(c)(7).

U.S. PIPE

In 1989, Walter Industries, Inc., a holding company that owned home building, natural resources development, and industrial manufacturing companies, and its subsidiaries (collectively, the "Jim Walter companies") filed for chapter 11 protection in the Middle District of Florida. In 1992, with bankruptcy court approval, the Jim Walter companies created a benefit plan for certain employees (the "1992 Plan") under section 9712 of the Coal Act. The 1992 Plan provides benefits to miners who are owed, but are not receiving, benefits under section 9711 of the Coal Act. Covered entities that failed to provide health care benefits to their eligible retirees in an IEP under section 9711 of the Coal Act were required by section 9712 to pay monthly premiums to the 1992 Plan.

At the time the 1992 Plan was established, the Jim Walter companies included United States Pipe and Foundry Company, LLC ("USP"), JW Aluminum Company, and JW Window Components LLC (collectively, the "Appellants"), as well as coal miner and methane gas extractor Jim Walter Resources, Inc. ("JW Resources"). Because of their common ownership, the Appellants and JW Resources were "related persons" under the Coal Act.

In 1995, the bankruptcy court confirmed a chapter 11 plan for the Jim Walter companies (among other entities), including the Appellants and JW Resources. The trustees of the 1992 Plan did not file a proof of claim for future Coal Act obligations and did not object to confirmation of the plan. However, the trustees did file a proof of claim in the JW Resources bankruptcy for past-due payments owed under certain wage agreements and postpetition Coal Act fund premiums allegedly entitled to administrative priority.

The chapter 11 plan discharged all "[c]laims" against the companies that "arose at any time before the [e]ffective [d]ate" unless those claims were dealt with by the plan. The Jim Walter companies—known post-bankruptcy as Walter Energy, Inc. ("Walter Energy")—expressly assumed the obligations to fund retiree health benefits, and the plan confirmation order "authorized and directed" Walter Energy "to fund retiree health benefits."

Several years after the bankruptcy court confirmed the plan, the Appellants ceased their affiliation with Walter Energy and exited the coal industry.

In 2015, Walter Energy again filed for chapter 11 protection, this time in the Northern District of Alabama. Walter Energy then sought court approval of a sale of substantially all of its assets, which the court granted. In connection with the sale, the court entered an order terminating Walter Energy's obligations to provide benefits to retirees under the 1992 Plan and to pay premiums to the Coal Act funds. Walter Energy stopped providing benefits and paying premiums in April 2016.

In July 2016, the 1992 Plan trustees notified the Appellants that they were liable for premiums owed to the Coal Act funds and for retiree benefits under IEPs as "related persons." The Appellants refused to pay, and the trustees sued them in federal district court seeking, among other things, a declaratory judgment that the Appellants were liable under the Coal Act.

The Appellants responded by reopening their 1989 Florida bankruptcy cases and filing an adversary proceeding asserting that the Coal Act claims were discharged in 1995 and that the trustees' claims were therefore barred. One of the Appellants—USP—moved for partial summary judgment in that litigation. The Florida bankruptcy court, however, granted summary judgment to the trustees. It reasoned that the premiums must be either a "contingent claim or a tax." According to the bankruptcy court, if the premiums were a contingent claim in 1995, that claim would have been discharged under the 1995 chapter 11 plan. However, the court noted, if the premiums were a tax, claims for those premiums would have arisen only when the premiums were assessed, so they would not have been discharged.

The bankruptcy court concluded that the Coal Act premiums were "unquestionably a tax"—and "because they are taxes assessed on a periodic basis (either annually or monthly), each

period gives rise to a new liability," and the premiums therefore were not discharged. It did not address the trustees' request to compel the Appellants to provide health care benefits directly to retirees under section 9711 via IEPs.

The district court affirmed on appeal. It agreed with the bankruptcy court that, because Coal Act premiums are taxes, claims for the premiums arose only when the premiums were assessed. The district court also addressed the trustees' claim under section 9711, concluding that only debts can be discharged in bankruptcy, and not "obligations giving rise to [ ] debts" like the requirement to provide benefits.

The Appellants appealed to the Eleventh Circuit.

THE ELEVENTH CIRCUIT'S RULING

A divided three-judge panel of the Eleventh Circuit reversed.

Writing for the majority, Chief U.S. Circuit Court Judge William H. Pryor explained that the outcome of the appeal hinged on whether there was a "claim" against the Appellants in 1995. If so, he reasoned, the claim was discharged when the bankruptcy court confirmed the Jim Walter companies' chapter 11 plan. He divided his discussion into two parts. First, Judge Pryor explained why the trustees' claim for premiums to the Coal Act funds was discharged in 1995. Second, he explained why the trustees' claim under section 9711 of the Coal Act and for premiums to the 1992 Plan was discharged in 1995.

Noting that the definition of "claim" in section 101(5) of the Bankruptcy Code is given the broadest meaning, Judge Pryor concluded that whether the Appellants' "liability on a claim" based on their pre-plan confirmation conduct was discharged depended on whether they had a relationship with the Coal Act funds prior to confirmation. He ruled that they did. According to Judge Pryor:

> The Trustees held "claims" for future [Coal Act fund] premiums in 1995 because their right to payment was based on the [Appellants'] pre-confirmation conduct. In 1995, the [Appellants'] liability to the retirees had already been fixed; only the amount owed was uncertain.

U.S. Pipe, 32 F.4th at 1330.

Judge Pryor acknowledged that the amount of the eventual claim in 1995 was "uncertain," but reasoned that the uncertain amount meant merely that the claim was "unliquidated" and "unmatured" or "contingent," and such claims are discharged upon the confirmation of a chapter 11 plan. Moreover, he noted, the trustees were clearly aware of the existence of their claims because: (i) the Coal Act was enacted nearly three years before the effective date of the Jim Walter companies' chapter 11 plan: (ii) the Appellants' joint and several liability to pay premiums began nearly two-and-a-half years before that date; and (iii) the trustees were aware of the Appellants' Coal Act liability because the trustees filed a proof of claim for such liabilities in the bankruptcy case of JW Resources.

The majority determined that the trustees misplaced their reliance on the Second Circuit's decision in *LTV Steel Co. v. Shalala (In re Chateaugay II)*, 53 F.3d 478 (2d Cir. 1995). According to Judge Pryor, although the Second Circuit held that "Coal Act liability" for post-confirmation premiums "was not dischargeable in bankruptcy," the court "failed to provide any rationale for its holding." *U.S. Pipe*, 32 F.4th at 1332. The trustees attempted to connect the dots, arguing that the Second Circuit's holding must have been based upon its separate conclusion that that Coal Act premiums are "taxes" that "accru[e]" when they are assessed and become due (meaning that postpetition, pre-confirmation premiums were entitled to administrative priority). *Id.* Nevertheless, Judge Pryor held that the obligation to pay such premiums, whether or not they are taxes, and whether or not accrued or cognizable, gives rise to a dischargeable claim because the Appellants' liability turned on their pre-confirmation conduct. *Id.* at 1333. In support of the majority's holding, Judge Pryor distinguished those laws—like state unemployment tax laws or anti-discrimination laws—that "continue to impose obligations on a debtor after bankruptcy proceedings because the basis of an entity's liability is not pre-confirmation conduct." *Id.* at 1331. "By contrast," he wrote, "an entity's liability under the Coal Act to pay premiums to the Combined Fund turns solely on the companies' pre-confirmation conduct. The Coal Act imposed liability on the companies on July 20, 1992 . . . ." *Id.* Thus, according to Judge Pryor, *Chateaugay II* "has no bearing on when claims for those premiums arise." *Id.*

Similarly, the majority held that the trustees' claims under section 9711 of the Coal Act arising from the Appellants' obligation as "related persons" to provide health care benefits directly to retirees under IEPs and the trustees' claims for premiums due under the 1992 Plan were also discharged in 1995. According to Judge Pryor, the trustees' alleged right under section 9711 was a "claim" because, under section 9711 and the terms of the 1992 Plan, the trustees, in the event of a breach of the 1992 Plan, had a "right to an equitable remedy for breach of performance if such breach gives rise to a right to payment." Such a breach occurred prior to 1995, Judge Pryor explained, and the trustees' asserted right to the equitable remedy of specific performance is a "claim" that was discharged in 1995. "Like with the claim for Combined Fund premiums," he wrote, "the Trustees and the [Appellants] had the requisite relationship, and the [Appellants'] liability under section 9711 is based solely on the companies' pre-confirmation conduct and was fixed in 1992." *Id.* at 1333.

Finally, the majority ruled that the claim asserted by the trustees for 1992 Plan premiums was a "claim" discharged in 1995 even though at that time it was unliquidated and required estimation. In so ruling, Judge Pryor explained, "we join the many courts that have treated future Combined Fund and 1992 Plan premiums as similarly dischargeable in bankruptcy." *Id.* at 1336 (citing *Holland v. Westmoreland Coal Co. (In re Westmoreland Coal Co.)*, 968 F.3d 526, 531, 536, 544 (5th Cir. 2020); *In re Walter Energy, Inc.*,

911 F.3d 1121, 1157 (11th Cir. 2018); *In re Alpha Nat. Res., Inc.*, 552 B.R. 314, 326–28 (Bankr. E.D. Va. 2016); *In re Horizon Nat. Res. Co.*, 316 B.R. 268, 274–79 (Bankr. E.D. Ky. 2004); *In re Bethlehem Steel Corp.*, 2004 WL 601656, at *2 (Bankr. S.D.N.Y. Feb. 9, 2004)).

The majority accordingly reversed the district court's judgment and remanded the case for further proceedings.

Circuit Judge R. Lanier Anderson III concurred in part and dissented in part. Judge Anderson agreed with the majority that the Appellants' liability for the Combined Fund premiums was discharged in 1995. However, he did not agree that the Appellants' obligation to fund an IEP under section 9711 or to pay premiums to the 1992 Plan under section 9712 were discharged because they did not arise until 2016.

Judge Anderson explained that, under section 101(5)(B), a claim exists only if an equitable remedy gives rise to a right to payment. He reasoned that a creditor can have no such right before there is a breach of performance by the debtor, which did not occur in this case until 2016.

Judge Anderson viewed the majority's opinion as being "in tension with the established law that a bankruptcy confirmation plan does not discharge claims that arise on account of post-confirmation conduct of the debtor." *Id.* at 1342.

OUTLOOK

The majority and dissenting opinions in *U.S. Pipe* provide a detailed explanation of the scope of a bankruptcy discharge and the Bankruptcy Code's definition of a "claim" subject to discharge. Consistent with the Bankruptcy Code's broad definition of that term, the Eleventh Circuit majority concluded that Coal Act obligations were discharged by the Appellants' 1995 chapter 11 plan even though the payments did not become due and payable until more than two decades later.

With its ruling in *U.S. Pipe*, the Eleventh Circuit appears to have split with the Second Circuit regarding the dischargeability of pre-confirmation Coal Act obligations. Significantly, the majority in *U.S. Pipe* noted that the Coal Act fund trustees asserting the claims were well aware of the existence of the Appellants' payment obligations in 1995, yet did not assert those claims in their bankruptcy. Thus, the due process considerations present in some other cases (such as mass tort cases with unknown future claimants) were not a factor.

DELAWARE SUPREME COURT: NO "COMMON LAW INSOLVENCY EXCEPTION" PERMITTING DELAWARE CORPORATION TO TRANSFER ASSETS TO CREDITORS IN LIEU OF FORECLOSURE WITHOUT SHAREHOLDER CONSENT

Brad B. Erens • Mark G. Douglas

In *Stream TV Networks, Inc. v. SeeCubic, Inc.*, 2022 WL 2149437 (Del. June 15, 2022), the Delaware Supreme Court vacated and reversed a 2020 ruling by the Delaware Court of Chancery 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. *See Stream TV Networks, Inc. v. SeeCubic, Inc.*, 250 A.3d 1016 (Del. Ch. 2020).

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 (the "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 (the "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.

If Stream's secured creditors had foreclosed on Stream's assets, Stream and its 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 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 the "current dominance of the merger as the transactional vehicle for selling a corporation." This requirement 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 Lasker 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 Lasker 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 "sale, lease or exchange" of all or substantially all of Stream's assets. Instead, he wrote, "[t]hese 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 Lasker concluded that it "warrant[ed] the same interpretation." The Chancery Court thus ruled that the Omnibus Agreement did not require the approval of Steam's shareholders. It accordingly denied Stream's motion for a preliminary injunction to prevent the agreement's effectiveness and granted SeeCubic's motion for an injunction enforcing the Agreement.

The Chancery Court later: (i) granted in part SeeCubic's motion for summary judgment and for a permanent injunction (*Stream TV Networks, Inc. v. SeeCubic, Inc.*, 2021 WL 4352732 (Del. Ch. Sept. 23, 2021)); (ii) granted Stream's motion to have the summary judgment order entered as a partial final judgment (*Stream TV Networks, Inc. v. SeeCubic, Inc.*, 2021 WL 5240591 (Del. Ch. Nov. 10, 2021)); and (iii) denied Stream's motion to modify or stay the permanent injunction pending appeal (*Stream TV Networks, Inc. v. SeeCubic, Inc.*, 2021 WL 5816820 (Del. Ch. Dec. 8, 2021)).

Stream appealed the summary judgment and injunction rulings to the Delaware Supreme Court.

THE DELAWARE SUPREME COURT'S RULING

The Delaware Supreme Court vacated in part, reversed in part, and remanded the case below.

Writing for the *en banc* court, Delaware Supreme Court Justice Karen L. Valihura held "that a common law insolvency exception, if one existed in Delaware, did not survive the enactment of Section 271 and its predecessor." *Stream TV*, 2022 WL 2149437, at *11. Therefore, she wrote, "there is no Delaware common law 'board only' insolvency exception under Section 271." *Id.*

Justice Valihura noted that, in concluding otherwise based upon corporate law in states throughout the United States, the Chancery Court relied on treatises and case law issued between 1926 and 1948, "with no case cited after 1948 upholding such an exception." Moreover, she explained, although 15 states recognized the board-only insolvency exception "from the late 1800's to the early 1900's . . . no Delaware case expressly addresses or adopts the board-only insolvency exception." *Id.* at **20-21.

According to Justice Valihura, her reasoning was supported by "the plain language of Section 271, which contains no exceptions and is not ambiguous." In addition, she noted, this conclusion is "consistent with our policy of seeking to promote stability and predictability in our corporate laws, and with recognition that Delaware is a contractarian state." *Id.* at *25.

The Delaware Supreme Court accordingly vacated the injunction, reversed the declaratory judgment, and remanded the case to the Chancery Court for further proceedings.

OUTLOOK

The Delaware Supreme Court's ruling in *Stream TV* clarifies that a "failing" Delaware corporation may not give a deed in lieu of foreclosure to a secured creditor involving all or substantially all of the corporation's assets without shareholder approval, nor can it sell, lease, or exchange substantially all of its assets in an assignment for the benefit of creditors without obtaining such approval. As such, under this precedent, a bankruptcy filing and an asset sale under section 363(b) of the Bankruptcy Code or pursuant to a chapter 11 plan may be necessary where majority shareholder approval cannot be obtained.

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FIFTH CIRCUIT: DISTRICT COURT IMPROPERLY REFERRED BANKRUPTCY APPEAL TO MAGISTRATE JUDGE FOR FINAL DETERMINATION

Jane Rue Wittstein • Mark G. Douglas

Federal district courts, with the consent of the parties, are authorized by statute to refer "civil matter[s]" to magistrate judges for the purpose of conducting all proceedings and entering a judgment in the litigation. In the case of an appeal to a district court from a bankruptcy court, however, this statutory authority arguably conflicts with another statutory provision dictating that appeals from a bankruptcy court order or judgment be heard by a "district court" or a "bankruptcy appellate panel." This apparent conflict was recently addressed by the U.S. Court of the Appeals for the Fifth Circuit in *In re South Central Houston Action Council*, 38 F.4th 471 (5th Cir. 2022). The Fifth Circuit vacated a magistrate judge's ruling on appeal from a bankruptcy court judgment, ruling that the district court improperly referred the appeal to the magistrate judge for a final disposition, rather than a recommendation subject to review and adoption by the district court.

BANKRUPTCY COURT JURISDICTION

Article III, Section 1 of the U.S. Constitution provides that "[t]he judicial Power of the United States, shall be vested in one supreme Court, and in such inferior Courts as the Congress may from time to time ordain and establish." It further states that such judges "shall hold their Offices during good Behaviour, and shall, at stated Times, receive for their Services, a Compensation, which shall not be diminished during their Continuance in Office."

The exercise of the "judicial Power of the United States" is vested in judges appointed pursuant to Article III of the Constitution, i.e., Article III judges. Bankruptcy judges, however, are not Article III judges. They do not have life tenure—bankruptcy judges are appointed for a 14-year term (subject to reappointment) by the circuit courts of appeals under 28 U.S.C. § 152—and their salaries are subject to diminution. Bankruptcy judges are technically authorized under Article I, which governs the legislative branch and authorizes the establishment of a uniform system of federal bankruptcy laws. U.S. Const. Art. I § 8 cl. 4. Under principles of separation of powers, bankruptcy judges cannot exercise the judicial power reserved for Article III judges.

In *Northern Pipeline Constr. Co. v. Marathon Pipe Line Co.*, 458 U.S. 50 (1982), the U.S. Supreme Court struck down the Bankruptcy Act of 1978 because it conferred Article III judicial power upon bankruptcy judges who lacked life tenure and protection against salary diminution. Two years later, Congress enacted the Bankruptcy Amendments and Federal Judgeship Act of 1984 to fix the *Marathon* issue. The 1984 jurisdictional scheme for bankruptcy courts continues in force today. That scheme vests bankruptcy jurisdiction in the first instance in the U.S. federal district courts.

Federal district courts have "original and exclusive jurisdiction" of all "cases" under the Bankruptcy Code. 28 U.S.C. § 1334(a). District courts also have "original but not exclusive jurisdiction of all civil proceedings arising under" the Bankruptcy Code, "or arising in or related to cases under" the Bankruptcy Code. 28 U.S.C. § 1334(b).

District courts may and routinely do, however, refer these cases and proceedings by standing orders of reference to the bankruptcy courts in their districts, which are constituted as "units" of the district courts. 28 U.S.C. §§ 151 and 157(a). That reference may be withdrawn by the district court "for cause shown," and must be withdrawn "if the [district] court determines that resolution of the proceeding requires consideration of both [the Bankruptcy Code] and other laws of the United States regulating organizations or activities effecting interstate commerce." 28 U.S.C. § 157(d).

Under 28 U.S.C. § 152(a)(1), "Bankruptcy judges shall serve as judicial officers of the United States district court established under Article III of the Constitution."

A bankruptcy court may enter a "final" judgment in "all core proceedings arising under the [Bankruptcy Code] or arising in a case under [the Bankruptcy Code]." 28 U.S.C. § 157(b)(1). Core proceedings include, but are not limited to, among other things, matters concerning the administration of the estate; the allowance or disallowance of claims; orders authorizing postpetition financing; proceedings to avoid and recover preferential or fraudulent transfers; determinations as to the dischargeability of debts; motions to modify the automatic stay; the recognition of foreign bankruptcy proceedings under chapter 15 of the Bankruptcy Code; and "other proceedings affecting the liquidation of the assets of the estate or the adjustment of the debtor-creditor or the equity security holder relationship, except personal injury tort or wrongful death claims." 28 U.S.C. § 157(b)(2).

The bankruptcy court may also hear non-core "related" matters, but may not decide them without the consent of the parties. 28 U.S.C. §§ 157(c). Unless the parties consent to a bankruptcy court's final adjudication of a non-core related matter, the court must "submit proposed findings of fact and conclusions of law to the district court, and any final order or judgment shall be entered by the district judge after considering the bankruptcy judge's proposed findings and conclusions and after reviewing de novo those matters to which any party has timely and specifically objected." 28 U.S.C. § 157(c)(1). A bankruptcy court may not try personal injury or wrongful death claims, which must be tried in the district court. 28 U.S.C. § 157(b)(5). If a party in a proceeding that may be heard by a bankruptcy court has a right to a jury trial, the bankruptcy court may conduct the jury trial if the parties expressly consent and the court is "specially designated to exercise such jurisdiction by the district court." 28 U.S.C. § 157(e).

In addition to statutory authority, a bankruptcy judge must have *constitutional* authority to hear and determine a matter. *See Stern v. Marshall*, 564 U.S. 462 (2011). Constitutional authority exists when a matter originates under the Bankruptcy Code or, in non-core matters, where the matter is either one that falls within the "public rights exception," (i.e., cases involving "public rights" that Congress could constitutionally assign to "legislative" courts for resolution) or where the parties have consented, either expressly or impliedly, to the bankruptcy court hearing and determining the matter. *See, e.g., Wellness Int'l Network, Ltd. v. Sharif*, 135 S. Ct. 1932 (2015) (parties may consent to a bankruptcy court's jurisdiction); *Richer v. Morehead*, 798 F.3d 487, 490 (7th Cir. 2015) (noting that "implied consent is good enough").

APPEALS OF BANKRUPTCY COURT ORDERS

Sections 158, 1291, and 1292 of title 28 of the U.S. Code determine whether federal appellate courts other than the U.S. Supreme Court have jurisdiction to hear appeals of orders or judgments issued by lower courts. That determination ordinarily hinges on whether the order or judgment is "final" or merely "interlocutory."

In ordinary civil litigation, a final order or judgment "ends litigation on the merits and leaves nothing for the . . . court to do but execute the judgment." *Hooker v. Cont'l Life Ins. Co.*, 965 F.2d 903, 904 (10th Cir. 1992). Therefore, an interlocutory order is an order that does not constitute a final judgment on the merits. See BLACK'S LAW DICTIONARY (11th ed. 2019) (defining "interlocutory" as "interim or temporary; not constituting a final resolution of the whole controversy").

A bankruptcy case differs from ordinary civil litigation because it is a framework within which the court resolves a wide variety of disputes that precede the closure of the bankruptcy case after confirmation of a plan, discharge of the debtor following administration of its nonexempt assets, or dismissal.

Thus, the rules governing appeals of orders or judgments in bankruptcy cases are somewhat different than those in other civil litigation. *See Ritzen Grp., Inc. v. Jackson Masonry, LLC,* 140 S. Ct. 582, 586 (2020) ("The ordinary understanding of 'final decision' is not attuned to the distinctive character of bankruptcy litigation."); *Matter of Forty-Eight Insulations, Inc.*, 115 F.3d 1294, 1299 (7th Cir. 1997) (finality is applied with a "relaxed eye" in the bankruptcy context); *In re Dow Corning Corp.*, 86 F.3d 482, 488 (6th Cir. 1996) (the finality requirement in bankruptcy "is considered in a more pragmatic and less technical way in bankruptcy cases than in other situations").

Twenty-eight U.S.C. § 158(a) reflects this by providing that "[t]he district courts of the United States shall have jurisdiction to hear appeals": (i) from final bankruptcy court judgments, orders, and decrees; (ii) from interlocutory orders and decrees increasing or reducing a debtor's exclusive right to propose and seek acceptances for a chapter 11 plan; and (iii) "with leave of the court, from other interlocutory orders or decrees."

Appeals from the same types of bankruptcy court orders may instead be heard with the consent of the litigants by three-judge "bankruptcy appellate panels" under the circumstances specified in section 158(b).

Twenty-eight U.S.C. § 158(d)(1) provides that federal circuit courts of appeals shall have jurisdiction over appeals from "all final decisions, judgments, orders, and decrees entered [by district courts or bankruptcy appellate panels] under subsections (a) and (b)."

Twenty-eight U.S.C. § 1291 similarly provides that, with certain exceptions, the federal circuit courts of appeals "shall have jurisdiction of appeals from all final decisions of the district courts of the United States." Section 1292 gives the courts of appeals jurisdiction over certain interlocutory appeals.

Finally, section 158(d)(2) provides that a circuit court of appeals, in its discretion, shall have jurisdiction to hear an appeal from a final judgment, order, or decree if the bankruptcy court, district court, or bankruptcy appellate panel involved certifies, or the litigants jointly certify, that the judgment, order, or decree: (i) involves a question of law as to which there is no controlling circuit court or U.S. Supreme Court precedent or "involves a matter of public importance"; (ii) involves a question of law requiring the resolution of conflicting rulings; or (iii) if immediately appealed, "may materially advance the progress of the case or proceeding in which the appeal is taken."

MAGISTRATE JUDGES

Magistrate judges are judicial officers of the U.S. district courts appointed by the district judges for a renewable term of eight years (four years for part-time magistrates) to handle a variety of judicial proceedings. The U.S. magistrates system was established by the Federal Magistrates Act of 1968. Pub. L. No. 90-578, 82 Stat. 1107 (1968) (codified as amended at 28 U.S.C. §§ 604, 631-639 and 18 U.S.C. §§ 3060, 3401-3402). Thus, like bankruptcy judges, magistrate judges are Article I, rather than Article III, judges.

The jurisdiction and powers of magistrate judges are set forth in 28 U.S.C. § 636. Those powers include, among other things, "all powers and duties conferred or imposed upon United States commissioners" by law or by the Federal Rules of Criminal Procedure, the authority to issue warrants, conduct preliminary proceedings in criminal cases, and hear cases involving petty offenses committed on federal lands.

Pursuant to 28 U.S.C. § 636(c), with the consent of the parties, a magistrate judge "may conduct any or all proceedings in a jury or nonjury civil matter and order the entry of judgment in the case, when specially designated to exercise such jurisdiction by the district court or courts he serves."

HOUSTON ACTION COUNSEL

A church that owned a large commercial building in Houston (the "landlord") leased space to a health care services company (the "debtor") for a low-cost medical clinic. Due to a rent dispute, the landlord terminated the lease and obtained a judgment entitling it to possession of the premises. However, before it was evicted, the debtor filed for chapter 11 protection in the Southern District of Texas in January 2019.

In April 2019, the debtor sued the landlord in a Texas state court for breach of contract and unjust enrichment. In November of that year, the landlord removed the state court action to the bankruptcy court as an adversary proceeding. In June 2020, the bankruptcy court entered summary judgment in favor of the landlord in the litigation and later denied the debtor's motion for reconsideration.

The debtor appealed to the district court, which with the consent of the parties reassigned the appeal to a magistrate judge pursuant to 28 U.S.C. § 636(c). The magistrate judge affirmed the bankruptcy court's rulings and dismissed the appeal. The debtor then appealed to the Fifth Circuit.

THE FIFTH CIRCUIT'S RULING

A three-judge panel of the Fifth Circuit vacated the magistrate judge's ruling and remanded the case below, but not on the merits of the appeal.

Writing for the Fifth Circuit panel, U.S. Circuit Court Judge Edith H. Jones emphasized that the court of appeals has an obligation to examine the district court's jurisdiction before addressing the merits of a dispute. She concluded that the district court's judgment must be vacated "because the district court improperly authorized referral of the appeal from a bankruptcy court decision to a magistrate judge," and that was inconsistent with the Fifth Circuit's previous ruling in *Minerex Erdoel, Inc. v. Sina, Inc.*, 838 F.2d 781 (5th Cir. 1988).

In *Minerex*, Judge Jones explained, a previous Fifth Circuit panel held that, despite the "broad latitude" for referring matters to magistrate judges under 28 U.S.C. § 636(c), the statute governing appeals from bankruptcy court decisions—28 U.S.C. § 158—"plainly and solely" permits appeals to be taken either to a district court or a bankruptcy appellate panel. *Houston Action Counsel*, 38 F.4th at 472 (citing *Minerex*, 838 F.2d at 786). The *Minerex* court also stated that "[i]t is reasonable to conclude that had Congress meant for its appeals scheme to include the potential for reference to a magistrate, Congress would have expressly so provided . . . [yet] did not do so." *Minerex*, 838 F.2d at 786. Judge Jones noted that a district court may refer bankruptcy appeals to a magistrate judge for a report and recommendation, but the district court can adopt the magistrate's findings and conclusions only after engaging in independent consideration of the issues. *Houston Action Counsel*, 38 F.4th at 472 n.1.

The Fifth Circuit accordingly vacated the magistrate judge's judgment and remanded the case to the district court for further proceedings.

OUTLOOK

The Fifth Circuit's ruling in *Houston Action Counsel* resolves the conflict between the two statutes at issue—28 U.S.C. §§ 158 and 636(c)—in keeping with a well-recognized principle of statutory construction. In particular, specific statutory provisions targeting a particular issue apply instead of provisions more generally covering the issue. *See RadLAX Gateway Hotel, LLC v. Amalgamated Bank*, 566 U.S. 639, 645 (2012). Thus, because section 158 expressly states that district courts or bankruptcy appellate panels "shall" have jurisdiction to hear appeals from bankruptcy court orders and judgments, that provision trumps the more general (and permissive) jurisdictional reference of "civil matters" to magistrate judges in section 636(c).

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NEWSWORTHY

For the third consecutive year, *Law360* has named ***Jones Day*** a "Ceiling Smasher" for having one of the top percentages of women partners in law firms with more than 600 lawyers.

Jones Day recently ranked "Best of the Best" in 12 categories in the first-of-its-kind report "Associate Satisfaction A-Listers 2022: BTI Survey of Law Firms Where Associates are Happiest." The BTI Consulting Group notes that ***Jones Day***'s results surpassed the "majority of the other 650 firms competing for business at large companies whose associates responded to the survey."

Bruce Bennett ***(Los Angeles)*** was named to the *Daily Journal*'s 2022 list of Top Bankruptcy Lawyers.

The 2023 edition of *The Best Lawyers in Germany*™, in cooperation with *Handelsblatt*, one of Germany's leading business publications, recognized ***Dr. Olaf Benning*** ***(Frankfurt)*** in the field of Restructuring and Insolvency Law.

The 2022 edition of *The Legal 500 EMEA* guide named ***Fabienne Beuzit*** ***(Paris)*** as a "Next Generation Partner" in the field of Insolvency.

On September 6, 2022, ***Corinne Ball*** ***(New York)*** gave a presentation regarding cross-border bankruptcy cases under chapter 15 of the Bankruptcy Code at the International Insolvency Institute's 22nd Annual Conference in Toronto, Canada.

Jeffrey B. Ellman ***(Atlanta)***, ***Kevyn D. Orr*** ***(Washington)***, ***Thomas M. Wearsch*** ***(Cleveland)***, ***Caitlin K. Cahow*** ***(Chicago)***, ***Anna Kordas*** ***(New York)***, ***James O. Johnston*** ***(Los Angeles)***, ***Aldo L. LaFiandra*** ***(Atlanta and New York)***, ***Heather Lennox*** ***(Cleveland and New York)***, ***Gregory M. Gordon*** ***(Dallas)***, ***Corinne Ball*** ***(New York)***, ***Carl E. Black*** ***(Cleveland)***, ***Bruce Bennett*** ***(Los Angeles)***, ***Brad B. Erens*** ***(Chicago)***, ***Genna Ghaul*** ***(New York)***, and ***Nicholas J. Morin*** ***(New York)*** were recognized in *The Best Lawyers in America* (2023) in the fields of Bankruptcy and Creditor Debtor Rights/Insolvency and Reorganization Law and/or Litigation—Bankruptcy.

On August 25, 2022, an article written by ***Corinne Ball*** ***(New York)*** titled "Scheme Proceeding Commenced by Cayman Holding Company to Restructure Its New York Governed Debt Incurred to Support Chinese Real Estate Operations Obtains Recognition under Chapter 15 in '*Modern Land*'" was published in the *New York Law Journal*.

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