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# BUSINESS RESTRUCTURING REVIEW

## FIFTH CIRCUIT RULES ON THE "SOLVENT-DEBTOR EXCEPTION" AND MAKE-WHOLE PREMIUMS

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On October 14, 2022, the U.S. Court of Appeals for the Fifth Circuit issued a long-awaited ruling on whether Ultra Petroleum Corp. ("UPC") must pay a $201 million make-whole premium to noteholders under its confirmed chapter 11 plan and whether the noteholders and certain other unsecured creditors are entitled to postpetition interest on their claims pursuant to the "solvent-debtor exception." In affirming the bankruptcy court's 2020 ruling, a divided three-judge panel of the Fifth Circuit held that the Bankruptcy Code disallows the make-whole premium "as the economic equivalent of unmatured interest," but held that "because Congress has not clearly abrogated the solvent-debtor exception," it applied to this case. Given UPC's solvency, the Fifth Circuit majority also ruled that UPC is obligated to pay postpetition interest to its noteholders and certain other unsecured creditors at the agreed-upon contractual default rate to render their claims unimpaired by UPC's plan. *See Ultra Petroleum Corp. v. Ad Hoc Comm. of OpCo Unsecured Creditors (In re Ultra Petroleum Corp.)*, 51 F.4th 138 (5th Cir. 2022) (*affirming In re Ultra Petroleum Corp.*, 624 B.R. 178 (Bankr. S.D. Tex. 2020)), *reh'g denied*, No. 21-20008 (5th Cir. Nov. 15, 2022).

### *ULTRA PETROLEUM*

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

UPC also had an approximately $1 billion unsecured revolving credit facility (the "RCF") that provided for the payment of post-default interest.

UPC filed for chapter 11 protection in April 2016. Improving business conditions during the course of the case allowed UPC to seek confirmation of a chapter 11 plan that provided for the payment in cash of all unsecured claims in full. The plan designated the noteholder claims and the RCF creditor claims as unimpaired but did not provide for the payment

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of the make-whole amount. Nor did the plan provide for the payment of postpetition interest at the default rate on the make-whole amount, the principal amount under the notes, or the principal amount under the RCF. UPC contested the noteholders' right to receive the make-whole amount. The parties agreed that postpetition interest should be paid on the noteholder and RCF creditor claims, but disagreed on the appropriate rate. The plan distributed new common stock in the reorganized entity to UPC's existing shareholders.

The bankruptcy court initially decided that, under New York law, the make-whole amount was an enforceable liquidated damages provision, rather than an unenforceable penalty. The court also held that UPC's chapter 11 plan impaired the noteholders' claims because the plan failed to provide for the payment of the make-whole amount and postpetition default-rate interest. The court rejected UPC's position that, because the make-whole amount represented "unmatured interest" and was not allowable under section 502(b)(2) of the Bankruptcy Code, the plan left the rights of the noteholders under the Bankruptcy Code unaltered, and the claims were therefore unimpaired under section 1124(1) of the Bankruptcy Code.

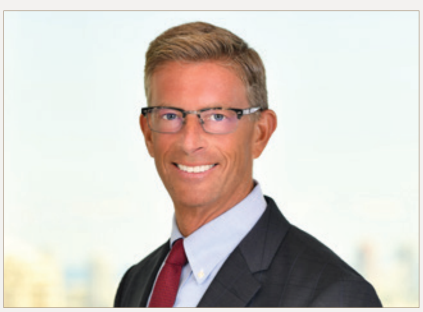
The ruling was appealed to the Fifth Circuit, which ultimately remanded the case to the bankruptcy court to determine: (i) whether the make-whole premium should be disallowed under section 502(b)(2) as unmatured interest; and (ii) whether UPC was required to pay postpetition interest to the noteholders and the RCF creditors under the solvent-debtor exception and, if so, at what rate.

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

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

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

According to the bankruptcy court, standing alone, neither section 105(a) of the Bankruptcy Code (giving the bankruptcy court broad equitable power), nor section 1129(a)(7) (the "best



## LAWYER SPOTLIGHT: GARY L. KAPLAN

**Gary Kaplan**, a partner in Jones Day's Business Restructuring & Reorganization Practice, first developed an interest in restructuring as a summer associate. With an interest in transactional work and litigation, he discovered that BRR presents a blend of both. It also allows him to represent all sides, from debtor and lender to sponsor, creditor, and more. "Restructuring lawyers see their knowledge widen with each cycle involving new and distinct industries," says Gary, who has represented clients in a wide array of business and industry sectors, including retail, casino operators, maritime/cargo shipping, real estate, automotive, pharmaceutical, aviation, media, health care, sports, and engineering. In addition to a national bankruptcy practice, he focuses on cross-border matters, including representing non-U.S. entities in obtaining chapter 15 relief.

Gary appreciates the depth and breadth of the BRR practice at Jones Day. "Very few, if any, firms have the same level of understanding and experience in debtor, creditor, mass tort, and municipal matters," he says. "That, combined with Jones Day's worldwide restructuring-focused litigation, M&A, finance, tax, and other lawyers really makes the practice well-positioned for the next restructuring cycle."

interests" test), nor section 1129(b)(1) (requiring a cram-down chapter 11 plan to be "fair and equitable" with respect to dissenting impaired classes of creditors) is a statutory source for the solvent debtor exception. Instead, the court wrote, "piecing these Bankruptcy Code provisions together," the solvent-debtor exception flows through section 1124(1), which provides that, to render a class of claims unimpaired, a plan must leave unaltered the claimants' "legal, equitable, and contractual rights." According to the court, "[b]ecause an unimpaired creditor has equitable rights to be treated no less favorably than an impaired creditor and to be paid in full before the debtor realizes a recovery, a plan denying post-petition interest in a solvent debtor case alters the equitable rights of an unimpaired creditor under §§ 1124(1)."

Finally, the bankruptcy court held that the default contract rate was the appropriate rate of interest rather than the federal judgment rate. Limiting the noteholder and RCF creditor class to interest at the federal judgment rate (then 0.54%), it noted, would contravene the purpose of the solvent-debtor exception, which dictates that when a debtor is solvent, "a bankruptcy court's role is merely to enforce the contractual rights of the parties."

UPC appealed the bankruptcy court's ruling directly to the Fifth Circuit.

## THE FIFTH CIRCUIT'S RULING

A divided three-judge panel of the Fifth Circuit affirmed.

Writing for the majority, U.S. Circuit Court Judge Jennifer Walker Elrod explained that "[b]ecause the Make-Whole Amount here is the 'economic equivalent' of a lender's 'unmatured interest,' the [Bankruptcy] Code—per our circuit's precedent—disallows it." *Ultra*, 51 F.4th at 146 (citing 11 U.S.C. § 501(b)(2); *In re Pengo Indus., Inc.*, 962 F.2d 543, 546 (5th Cir. 1992)).

The Fifth Circuit majority concluded that, regardless of the label applied to the payment, the make-whole amount was unmatured interest or its "economic equivalent" because "it compensates [the noteholders] for the future use of their money, albeit use that will never actually occur because of [UPC's] default." In so ruling, the majority rejected the noteholders' argument that the make-whole amount matured upon UPC's default when it filed for bankruptcy. Judge Elrod agreed with the bankruptcy court that the acceleration clause "was an ipso facto clause that is not to be considered in assessing whether the payment it triggered had matured." *Id.* at 147.

The Fifth Circuit majority also rejected as "untenable" the noteholders' argument that the make-whole amount was not the economic equivalent of unmatured interest but, rather, "liquidated damages," as some courts have held. "Liquidated damages certainly can compensate for anticipated transaction costs that are not unmatured interest," Judge Elrod wrote, "[b]ut the Make-Whole Amount … is both liquidated damages and the 'economic equivalent of unmatured interest'—indeed, that is its whole point." *Id.* at 149.

Next, the Fifth Circuit majority agreed with the bankruptcy court that the solvent-debtor exception, which was derived from English law and recognized under the former Bankruptcy Act, survived the enactment of the Bankruptcy Code in 1978. Nothing in the Bankruptcy Code, Judge Elrod explained, manifests clear Congressional intent to abrogate a legal principle that was universally recognized in cases involving solvent debtors before the Bankruptcy Code was enacted.

According to the majority, "Congress has not explicitly addressed claims for unmatured interest owed by solvent debtors" and "the text of § 502(b)(2) hardly constitutes an unambiguous—let alone explicit—change in bankruptcy practice." *Id.* at 156.

The Fifth Circuit majority held that "the solvent-debtor exception is alive and well" and that UPC is obligated to pay the make-whole amount "even though … it is indeed otherwise disallowed unmatured interest."

The majority rejected UPC's alternative argument that the make-whole amount should be disallowed as an unenforceable penalty under New York law. According to Judge Elrod, the make-whole amount constitutes enforceable liquidated damages under New York contract law—and the solvent-debtor exception continues to apply—because the make-whole amount is not "plainly or grossly disproportionate to the probable loss" incurred by the noteholders as a result of default. *Id.* at 157 (citation omitted).

Finally, the Fifth Circuit majority ruled that the appropriate rate of postpetition interest is the default contract rate rather than the federal judgment rate. Logic dictates, the majority explained, that unimpaired creditors cannot be treated less favorably under a chapter 11 plan than impaired creditors, who are entitled to "not less than" what they would have received in a chapter 7 liquidation under section 1129(a)(7)'s best interests test, which, in a solvent-debtor case, includes interest at "the legal rate" under section 726(a)(5). The majority acknowledged that most courts have construed "the legal rate" to mean the federal judgment rate. However, Judge Elrod explained, "the legal rate" specified in section 726(a)(5) "only sets a floor—not a ceiling—for what an impaired (and by implication, unimpaired) creditor is to receive in a cram-down scenario," and the "fair and equitable" test in section 1129(b) permits the payment of interest at a higher rate in an appropriate case.

"Creditors are entitled to what they bargained for," the Fifth Circuit majority concluded, "and the Code does not preclude the contractual interest rate." *Id.* at 160.

In a dissenting opinion, Circuit Judge Andrew S. Oldham agreed with the majority that the make-whole amount "is unmatured interest in disguise," but argued that it should be disallowed because the solvent-debtor exception did not survive enactment of the Bankruptcy Code. According to the dissent, it is "unmistakably clear that" section 502(b)(2) is "incompatible with the pre-existing solvent-debtor exception." *Id.* Judge Oldham explained that, unlike section 502(b)(2), the former Bankruptcy Act did not

preclude unmatured interest, and the majority misconstrued the relevant statutory provisions in concluding otherwise. He wrote that "[n]either the solvent-debtor exception's historical pedigree nor its policy underpinnings—no matter how compelling—can overcome Congress's clear, and clearer-than-ever, command on this point." *Id.* at 164.

**OUTLOOK**

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

On November 9, 2022—less than one month after the Fifth Circuit's ruling in *Ultra Petroleum*—the U.S. Bankruptcy Court for the District of Delaware held that a make-whole premium owed by reorganized debtor Hertz Global for redeeming $1.24 billion in unsecured notes prior to their stated maturity must be disallowed as unmatured interest. Mindful of the disagreement among various circuit courts on this issue, the bankruptcy court immediately certified the decision for a direct appeal to the Third Circuit, which will now have an opportunity to weigh in on the matter. The court also certified for direct appeal its denial of a motion to reconsider its previous decision awarding postpetition interest to unsecured noteholders of the solvent chapter 11 debtor at the federal judgment rate rather than the contract rate. *See In re Hertz Corp.*, Adv. Proc. No. 21-50995 (Bankr. D. Del. Nov. 9, 2022).

According to a leading commentator, prior to the Fifth Circuit's ruling in *Ultra Petroleum* and the bankruptcy court's decision in *Hertz*, a majority of lower courts had concluded that a make-whole premium is not unmatured interest, but "more akin to a charge or a fee, or to liquidated damages, than to interest not yet due." Collier on Bankruptcy ¶ 502.03 (16th ed. 2022) (citing cases). Whether these recent rulings portend a shift in the landscape on this issue remains to be seen.

The Fifth Circuit majority's conclusion in *Ultra Petroleum* that the solvent-debtor exception survived the enactment of the Bankruptcy Code and demands payment of postpetition interest at the contract rate is a significant development, but not unprecedented. Once-rare solvent-debtor bankruptcy cases have become more common in recent years, and the obligation to pay postpetition interest under a chapter 11 plan to render unsecured creditors' claims unimpaired (such that they are therefore deemed to accept the plan) can carry a hefty price tag. Most other recent court rulings involving solvent debtors—including the Ninth Circuit's decision (discussed here and elsewhere in this edition of the *Business Restructuring Review*) in *In re PG&E Corp.*, 46 F.4th 1047 (9th Cir. 2022) (holding that the solvent-debtor exception requires payment of postpetition interest, presumptively at the contract rate, but remanding the case for determination of the rate), *reh'g en banc denied*, No. 21-16043 (9th Cir. Oct. 5, 2022), *stayed pending petition for cert.*, No. 21-16043 (9th Cir. Oct. 27, 2022)—have likewise affirmed that the solvent-debtor exception is alive and well. However, it bears noting that the Ninth Circuit's decision, like the Fifth's, was accompanied by a vigorous dissent. Moreover, the Ninth Circuit's ruling has been stayed pending the disposition of a petition seeking Supreme Court review of the decision.

The conclusion of the Fifth and Ninth Circuits that postpetition interest must be paid at the contract rate, rather than the federal judgment rate, in a solvent-debtor case represents a potentially expensive approach to an issue that has divided courts. Before the Fifth and Ninth Circuit's recent decisions, many lower courts had ruled to the contrary. *See, e.g., In re RGN-Grp. Holdings, LLC*, 2022 WL 494154, at *6 (Bankr. D. Del. Feb. 17, 2022) (federal judgment rate); *In re Hertz Corp.*, 637 B.R. 781, 801 (Bankr. D. Del. 2021) (same), *reconsideration denied and direct appeal certified,* Adv. Proc. No. 21-50995 (Bankr. D. Del. Nov. 9, 2022); *In re Mullins*, 633 B.R. 1, 16 (Bankr. D. Mass. 2021) (same); *In re Cuker Interactive, LLC*, 622 B.R. 67, 71 (Bankr. S.D. Cal. 2020) (same). As noted, on November 9, 2022, the *Hertz* bankruptcy court certified a direct appeal of its ruling on the issue to the Third Circuit.

On November 15, 2022, the Fifth Circuit denied UPC's motion for an *en banc* rehearing of the court's decision in *Ultra Petroleum*.

# U.S. BANKRUPTCY COURT CAN ENFORCE FOREIGN RESTRUCTURING PLAN PROVIDING FOR CANCELLATION OF U.S. LAW-GOVERNED DEBT

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Isel M. Perez • Mark G. Douglas

Even before chapter 15 of the Bankruptcy Code was enacted in 2005 to govern cross-border bankruptcy proceedings, the enforceability of a foreign court order approving a restructuring plan that modified or discharged U.S. law-governed debt was well recognized under principles of international comity. The U.S. Bankruptcy Court for the Southern District of New York recently reaffirmed this concept in *In re Modern Land (China) Co., Ltd.*, 641 B.R. 768 (Bankr. S.D.N.Y. 2022). The court granted a petition seeking recognition of a debtor's Cayman Islands restructuring proceeding under chapter 15 for the purpose of enforcing a court-sanctioned scheme of arrangement that canceled New York law-governed notes in exchange for new notes (also governed by New York law).

Because the debtor conducted business through its subsidiaries in China before filing its Caymans restructuring proceeding, the U.S. Bankruptcy Court considered the possibility that the debtor might seek to enforce the scheme in Hong Kong, where a court recently suggested that chapter 15 recognition by a U.S. court of a foreign proceeding involving the cancellation of U.S. law-governed debt does not discharge the debt. The U.S. bankruptcy court explained that the Hong Kong court misconstrued U.S. law on this point, writing: "To be clear, in recognizing and enforcing the Scheme in this case, the Court concludes that the discharge of the Existing Notes and issuance of the replacement notes is binding and effective."

## RECOGNITION UNDER CHAPTER 15

Chapter 15 was enacted in 2005 to govern cross-border bankruptcy and insolvency proceedings. It is patterned on the 1997 UNCITRAL Model Law on Cross-Border Insolvency (the "Model Law"), which has been enacted in some form by more than 50 countries.

Both chapter 15 and the Model Law are premised upon the principle of international comity, or "the recognition which one nation allows within its territory to the legislative, executive or judicial acts of another nation, having due regard both to international duty and convenience, and to the rights of its own citizens or of other persons who are under the protection of its laws." *Hilton v. Guyot*, 159 U.S. 113, 164 (1895). Chapter 15's stated purpose is "to provide effective mechanisms for dealing with cases of cross-border insolvency" with the objective of, among other things, cooperation between U.S. and non-U.S. courts. 11 U.S.C. § 1501(a).

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

The basic requirements for recognition under chapter 15 are outlined in section 1517(a), namely: (i) the proceeding must be "a foreign main proceeding or foreign nonmain proceeding" within the meaning of section 1502; (ii) the "foreign representative" applying for recognition must be a "person or body"; and (iii) the petition must satisfy the requirements of section 1515, including that it be supported by the documentary evidence specified in section 1515(b).

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

> [A] collective judicial or administrative proceeding in a foreign country, including an interim proceeding, under a law relating to insolvency or adjustment of debt in which proceeding the assets and affairs of the debtor are subject to control or supervision by a foreign court, for the purpose of reorganization or liquidation.

More than one bankruptcy or insolvency proceeding may be pending with respect to the same foreign debtor in different countries. Chapter 15 therefore contemplates recognition in the United States of both a foreign "main" proceeding—a case pending in the country where the debtor's center of main interests ("COMI") is located (*see* 11 U.S.C. § 1502(4))—and foreign "nonmain" proceedings, which may be pending in countries where the debtor merely has an "establishment" (*see* 11 U.S.C. § 1502(5)). A debtor's COMI is presumed to be the location of the debtor's registered office, or habitual residence in the case of an individual. *See* 11 U.S.C. § 1516(c).

However, this presumption can be overcome. *See In re ABC Learning Centres Ltd.*, 445 B.R. 318, 328 (Bankr. D. Del. 2010) (stating that "the COMI presumption may be overcome particularly in the case of a 'letterbox' company not carrying out any business" in the country where its registered office is located), *aff'd*, 728 F.3d 301 (3d Cir. 2013).

Various factors have been deemed relevant by courts in determining a debtor's COMI, including the location of the debtor's headquarters, managers, employees, investors, primary assets, and creditors, as well as the jurisdiction whose law would apply to most of the debtor's disputes. *See In re SPhinX, Ltd.*, 351 B.R. 103 (Bankr. S.D.N.Y. 2006), *aff'd*, 371 B.R. 10 (S.D.N.Y. 2007). In addition, courts have considered any relevant activities, including liquidation activities and administrative functions. *See Morning*

*Mist Holdings Ltd. v. Krys (In re Fairfield Sentry Ltd.)*, 714 F.3d 127 (2d Cir. 2013). Courts may also consider the situs of the debtor's "nerve center," including the location from which the debtor's "activities are directed and controlled, in determining a debtor's COMI." *Id.* at 138. "[R]egularity and ascertainability" by creditors are also important factors in the COMI analysis. *Id.*; *In re British Am. Ins. Co.*, 425 B.R. 884, 912 (Bankr. S.D. Fla. 2010) ("The location of a debtor's COMI should be readily ascertainable by third parties."); *In re Betcorp Ltd.*, 400 B.R. 266, 289 (Bankr. D. Nev. 2009) (looking to the ascertainability of COMI by creditors). Creditors' expectations regarding the location of a debtor's COMI are also relevant. *See In re Serviços de Petróleo Constellation S.A.*, 613 B.R. 497 (Bankr. S.D.N.Y. 2019); *In re Oi Brasil Holdings Coöperatief U.A.*, 578 B.R. 169, 228 (Bankr. S.D.N.Y. 2017).

COMI can sometimes be found to have shifted, or "migrated," from a foreign debtor's original principal place of business or habitual residence to a new location. *See In re Pirogova,* 593 B.R. 402, 410 (Bankr. S.D.N.Y. 2018); *In re Creative Finance Ltd. (In Liquidation)*, 543 B.R. 498 (Bankr. S.D.N.Y. 2016). In *Fairfield Sentry*, the Second Circuit ruled that, due principally to the present verb tense of the language of section 1517, the relevant time for assessing COMI is the chapter 15 petition date, rather than the date a foreign insolvency proceeding is commenced with respect to the debtor. The Fifth Circuit previously reached the same conclusion in *In re Ran*, 607 F.3d 1017 (5th Cir. 2010), as did the bankruptcy court in *British American*.

In *Fairfield Sentry*, the Second Circuit also expressed concern about possible COMI "manipulation," ruling that a court "may look at the period between the commencement of the foreign proceeding and the filing of the Chapter 15 petition to ensure that a debtor has not manipulated its COMI in bad faith." *Fairfield Sentry*, 714 F.3d at 138; *see also In re O'Reilly*, 598 B.R. 784 (Bankr. W.D. Pa. 2019) (denying the petition of a foreign bankruptcy trustee for recognition under chapter 15 of a debtor's Bahamian bankruptcy and finding that, although the Bahamian bankruptcy was otherwise eligible for recognition, the debtor's COMI was no longer in the Bahamas when the Bahamian trustee filed the chapter 15 petition and the trustee failed to demonstrate that the debtor even had an "establishment" there); *In re Ocean Rig UDW Inc.*, 570 B.R. 687 (Bankr. S.D.N.Y. 2017) (ruling that scheme of adjustment proceedings pending in the Cayman Islands should be recognized as "foreign main proceedings" under chapter 15, even though the debtors' COMI had been shifted to the Caymans less than a year before the proceedings were commenced, because the country in which the debtors' COMI had previously been located did not have a law permitting corporate restructurings), *appeal dismissed*, 585 B.R. 31 (S.D.N.Y. 2018), *aff'd*, 2019 WL 1276205 (2d Cir. Mar. 19, 2019); *In re Suntech Power Holdings Co.*, 520 B.R. 399 (Bankr. S.D.N.Y. 2014) (the court-appointed liquidators of a Cayman Islands-incorporated debtor in a Cayman liquidation proceeding did not manipulate the debtor's COMI in bad faith where, although the debtor's COMI prior to filing its chapter 15 petition was in China, where the debtor was managed, and the debtor did not conduct any activities in the Caymans, the liquidators, after assuming control of the debtor's affairs, performed substantial liquidation activities in the Caymans such that its COMI legitimately shifted to the Caymans).

An "establishment" is defined by section 1502(2) as "any place of operations where the debtor carries out a nontransitory economic activity." Unlike with the determination of COMI, there is no statutory presumption regarding the determination of whether a foreign debtor has an establishment in any particular location. *See British American*, 425 B.R. at 915.

After recognition of a foreign proceeding, section 1521(a) authorizes the bankruptcy court, upon the request of the foreign representative, to grant a broad range of relief designed to preserve the foreign debtor's assets or otherwise provide assistance to the court or other entity presiding over the debtor's foreign proceeding. Such post-recognition relief "is largely discretionary and turns on subjective factors that embody principles of comity." *In re Bear Stearns High-Grade Structured Credit Strategies Master Fund, Ltd.*, 329 B.R. 325, 333 (S.D.N.Y. 2008).

However, section 1522 provides that the bankruptcy court may grant relief under section 1521 "only if the interests of the creditors and other interested entities, including the debtor, are sufficiently protected."

Similar to section 1521(a), section 1507 of the Bankruptcy Code states that, post-recognition, the court may provide "additional assistance" to a foreign representative under the Bankruptcy Code "or under other laws of the United States." In determining whether to provide such relief, the court must consider whether such assistance, "consistent with the principles of comity," will reasonably ensure, among other things: (i) just treatment of all creditors and interest holders; (ii) protection of U.S. creditors "against prejudice and inconvenience in the processing of claims in such foreign proceeding"; and (iii) "distribution of proceeds of the debtor's property substantially in accordance with the order prescribed" in the Bankruptcy Code.

Section 1506 of the Bankruptcy Code sets forth a public policy exception to the relief otherwise authorized in chapter 15, providing that "[n]othing in this chapter prevents the court from refusing to take an action governed by this chapter if the action would be manifestly contrary to the public policy of the United States."

Post-recognition relief under sections 1507 and/or 1521 commonly includes an order enforcing in the United States the terms of a restructuring plan approved by the foreign court overseeing the debtor's bankruptcy case. *See, e.g., In re Arctic Glacier Int'l, Inc.,* 901 F.3d 162 (3d Cir. 2018); *In re Condor Flugdienst GmbH*, 627 B.R. 366, 372 (Bankr. N.D. Ill. 2021); *In re Agrokor d.d.*, 591 B.R. 163 (Bankr. S.D.N.Y. 2018); *In re Oi S.A.*, 587 B.R. 253 (Bankr. S.D.N.Y. 2018); *In re Avanti Commc'ns Grp. PLC*, 582 B.R. 603 (Bankr. S.D.N.Y. 2018); *In re Cell C Proprietary Ltd.*, 571 B.R. 542 (Bankr. S.D.N.Y. 2017); *In re Rede Energia S.A.*, 515 B.R. 69 (Bankr. S.D.N.Y. 2014); *see also In re Lupatech S.A.*, 611 B.R. 496, 502 (Bankr. S.D.N.Y. 2020) ("Appropriate relief under section 1521 includes enforcing a foreign order confirming a debtor's plan.").


***MODERN LAND***

Incorporated in the Caymans, Modern Land (China) Co., Ltd ("MLC") is a Hong Kong stock exchange-listed holding company for a large group of real estate development businesses, most of which are incorporated in the Caymans or the British Virgin Islands ("BVI"), but that conduct business principally or exclusively in China. MLC's $4.32 billion in debt as of June 30, 2021, included $1.42 billion in notes (the "Old Notes") governed by New York law. MLC's $12.49 billion in consolidated assets were located in China or the United States.

Liquidity concerns arising during the pandemic caused MLC to default on its debt in 2021.

After defaulting on the Old Notes in 2021, MLC entered into a restructuring support agreement with the holders of 80.75% of the Old Notes (representing approximately $1.08 billion in principal).

In April 2022, MLC commenced a reorganization proceeding in a Cayman court under the Cayman Islands Companies Act (2022) (the "Cayman proceeding") seeking to confirm a scheme of arrangement (the "scheme") and asking the court to appoint a foreign representative for the company.

Under the proposed scheme, the claims based on the Old Notes would be released, and each holder of the Old Notes (the "Old Noteholders") would receive a pro rata share of: (i) approximately $22 million in cash; and (ii) new notes (the "Scheme Notes") governed by New York law. The scheme also provided for the cancellation of New York law-governed Old Note guarantees, the issuance of new guarantees governed by New York law, and releases by Old Noteholders of MLC and its affiliates. None of MLC's remaining debt would be restructured under the scheme.

The Old Noteholders overwhelmingly approved MLC's scheme, and the Cayman court approved it July 2022.

In anticipation of the Cayman court's approval, MLC's foreign representative filed a petition on June 3, 2022, in the U.S. Bankruptcy Court for the Southern District of New York seeking recognition of the Cayman proceeding under chapter 15 and enforcement of the scheme.

**THE BANKRUPTCY COURT'S RULING**

Before examining whether chapter 15 recognition of the Cayman proceeding was appropriate, U.S. Bankruptcy Judge Martin Glenn addressed a pair of decisions issued by a Hong Kong court suggesting that a U.S. court, after recognizing a foreign restructuring proceeding, could not enforce a scheme of arrangement sanctioned by a foreign court providing for the modification or discharge of debt governed by U.S. law.

In June 2022, a Hong Kong court issued a ruling in *In the Matter of Rare Earth Magnesium Technology Group Holdings Ltd.* [2022] HKCFI 1686, in which it stated in *dicta* that "recognition under Chapter 15 is limited in territorial effect and [the court thinks] it is reasonable to assume that the reason for this is that the procedure does not discharge the debt." In its opinion, the Hong Kong court relied on Judge Glenn's decision in *Agrokor*, where he stated that "Section 1520(a)(1) provides that the automatic stay will apply to all the debtor's property *that is located with the territorial jurisdiction of the United States*." The Hong Kong court read this pronouncement to mean that "[r]ecognition does not appear as a matter of United States' law to discharge the debt."

In a ruling in another case—*In the Matter of an application for recognition and assistance by the provisional liquidator of Global Brands Group Holding Limited (in liquidation)*, HCMP 644/2022, [2022] HKCFI 1789—the Hong Kong court stated that, in assessing whether it would recognize and enforce any future scheme sanctioned in the Caymans or BVI, the court would look to the debtor's COMI rather than its place of incorporation, as had been done in the past, to determine whether recognition and enforcement are warranted.

Judge Glenn explained that whether MLC's scheme could modify or discharge existing debt and guarantees governed by New York law, and provide for the issuance of new debt and guarantees governed by New York law, was "a critically important issue" in this and in "many other scheme or restructuring cases." *Modern Land*, 641 B.R. at 776.

"With great respect for the Hong Kong court," Judge Glenn further explained, the court misinterpreted his decision in *Agrokor*, "as well as many other decisions in the United States which have recognized and enforced foreign court sanctioned schemes or restructuring plans that have modified or discharged New York law governed debt." *Id.* Provided a foreign court properly exercises jurisdiction over a foreign debtor in an insolvency proceeding and the foreign court's procedures comport with "broadly accepted" principles of due process, he wrote, "a decision of the foreign court approving a scheme or plan that modifies or discharges New York governed debt is enforceable." According to Judge Glenn, this "unremarkable proposition" has been firmly established in the United States for more than a century. *Id.* (citing *Canada Southern Ry. Co. v. Gebhard*, 109 U.S. 527 (1883)).

In *Agrokor*, Judge Glenn explained, he enforced the modification of both English law- and New York law-governed debts pursuant to a settlement reached as part of a Croatian insolvency proceeding, even though, in doing so, the court refused to extend comity to the "*Gibbs* Rule," whereby courts in Commonwealth jurisdictions have refused since 1890 to recognize or enforce foreign court judgments or proceedings that discharge or compromise debts governed by English law. Based on *Agrokor*, Judge Glenn saw no impediment to recognizing the scheme in *Modern Land*, particularly as it was unlikely that a court in Hong Kong would be asked to consider whether the scheme was effective in Hong Kong (in which Commonwealth law has been generally applicable).

Having addressed this preliminary, albeit "critically important," issue, the bankruptcy court examined whether chapter 15 recognition of the Cayman proceeding as a foreign main proceeding was appropriate. Judge Glenn concluded that it was, noting that there were no objections to recognition and that the only open question was the location of MLC's COMI.

The bankruptcy court determined that MLC's COMI was in the Caymans. According to Judge Glenn, findings supporting that conclusion included:

- Recognition was consistent with creditor expectations. The Old Noteholders understood that MLC was a Cayman company, expected that that its debts would be restructured under Cayman law if a restructuring became necessary, and overwhelmingly voted to support the scheme.
- MLC's pre-scheme and restructuring activities supported a finding of COMI in the Caymans. Among other things, MLC publicly identified itself as a Cayman company, nearly half of its direct wholly owned subsidiaries were Cayman entities, MLC maintained its registered office and statutory registers in the Caymans, and MLC disclosed in the documentation of the Old Notes that any restructuring would take place in the Caymans. In addition, on the chapter 15 petition date, restructuring activities were MLC's primary business activity, and the vast majority of restructuring activities took place in the Caymans.
- None of the Old Noteholders objected to MLC's COMI as being located in the Caymans, and Old Noteholders holding more than half a billion dollars in Old Notes were domiciled in the Caymans and had urged MLC to restructure in the Caymans as "the most logical restructuring venue."
- Although the Old Notes were governed by New York law, Cayman law would apply to most disputes over corporate actions arising in connection with the Cayman proceeding. Other MLC debt governed by Hong Kong law, which might indicate a COMI in China, was not being restructured as part of MLC's scheme.
- Unlike in cases involving bad-faith COMI manipulation, MLC sought chapter 15 recognition in good faith.

The bankruptcy court separately determined that the Cayman proceeding was not a foreign nonmain proceeding. In reaching this conclusion, it determined that such recognition would be inconsistent with the goals of foreign nonmain proceedings, and that, because Modern Land did not engage in any non-transitory economic activity in the Caymans, it did not impact the local Cayman marketplace.

## OUTLOOK

*Modern Land* is a significant ruling for at least two reasons. First, the bankruptcy court dispelled the notion that, unlike Commonwealth jurisdictions following the *Gibbs* Rule, U.S. courts will, under appropriate circumstances and as a matter of comity in accordance with chapter 15, enforce the terms of a foreign court-sanctioned restructuring plan that modifies or cancels U.S. law-governed debt. With such a definitive ruling from a prominent U.S. bankruptcy judge, borrowers and lenders in certain circumstances may look to restructure under a scheme in the United Kingdom, the Netherlands, or Singapore and utilize a chapter 15 proceeding to implement the restructuring in the United States. Arguably, in at least certain contexts, such a restructuring should be just as effective as a chapter 11 case.

Second, the decision reinforces the principle that a foreign debtor's COMI should be determined as of the chapter 15 petition date. As such, the fact that COMI may have migrated from one jurisdiction to another at some time prior to the chapter 15 petition date is not necessarily indicative of abuse or bad faith.

# FIFTH CIRCUIT EMBRACES FLEXIBLE APPROACH TO COUNTRYMAN TEST OF EXECUTORINESS IN BANKRUPTCIES INVOLVING MULTIPARTY CONTRACTS

Daniel B. Prieto • Mark G. Douglas

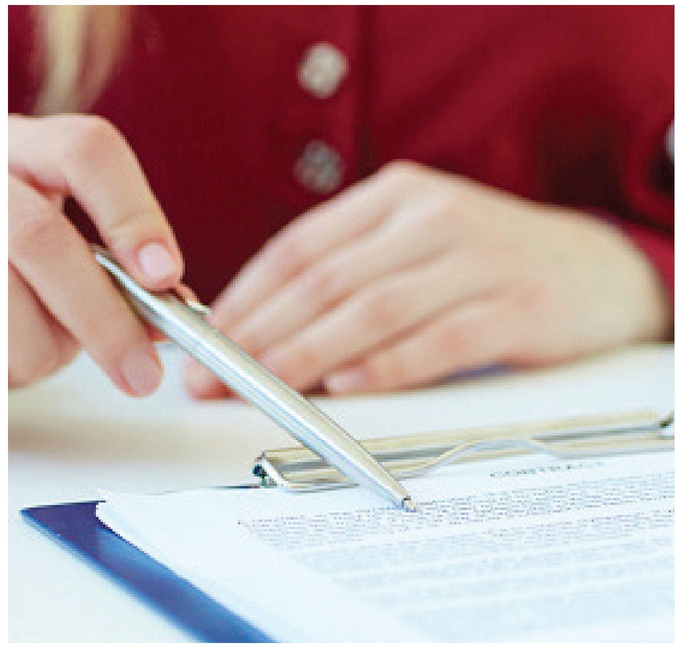
Whether a contract is "executory" such that it can be assumed, rejected, or assigned in bankruptcy is a question infrequently addressed by the circuit courts of appeals. The U.S. Court of Appeals for the Fifth Circuit provided some rare appellate court-level guidance on the question in *Matter of Falcon V, L.L.C.*, 44 F.4th 348 (5th Cir. 2022). The Fifth Circuit affirmed lower-court rulings determining that a surety contract was not executory because the surety had already posted irrevocable surety bonds and did not owe further performance to the debtors.

In so ruling, however, the Fifth Circuit adopted a flexible approach to the "Countryman test" for executoriness in cases involving multiparty contracts. According to the Fifth Circuit, courts "should apply the Countryman test to multiparty contracts in a flexible manner that accounts for the various obligations owed to all of the parties, rather than focusing exclusively on the flow of obligations between the debtor and the creditor."

### ASSUMPTION AND REJECTION OF EXECUTORY CONTRACTS AND UNEXPIRED LEASES

Section 365(a) of the Bankruptcy Code provides that, with certain exceptions delineated elsewhere in the statute, "the trustee, subject to the court's approval, may assume or reject any executory contract or unexpired lease of the debtor." The trustee's power to assume or reject is also conferred upon a chapter 11 debtor-in-possession ("DIP") under section 1107(a) of the Bankruptcy Code. Rejection results in a court-authorized breach of the contract, with any claim for damages treated as a prepetition claim against the estate on a par with the claims of other general unsecured creditors (unless the debtor has posted security with the non-debtor counterparty). 11 U.S.C. § 365(g). Assumption of a contract requires, among other things, that the trustee or DIP cure all existing monetary defaults and provide adequate assurance of future performance. 11 U.S.C. § 365(b).

A bankruptcy court will generally approve assumption or rejection of an executory contract if presented with evidence that either course of action is a good business decision. *See Mission Prod. Holdings, Inc. v. Tempnology, LLC*, 139 S. Ct. 1652, 1658 (2019) ("The bankruptcy court will generally approve [the] choice [to assume or reject], under the deferential 'business judgment' rule."). Upon assumption, most kinds of executory contracts may also be assigned by the trustee or DIP to third parties under the circumstances specified in sections 365(c) and 365(f). In chapter 11 cases, except with respect to certain kinds of contracts (such as nonresidential real property leases, aircraft lease agreements, and commitments to a federal depository institutions regulatory agency), the trustee or DIP may decide to assume or reject at any time up to confirmation of a chapter 11 plan. However, any nondebtor party to a contract may seek to compel the trustee or DIP to assume or reject the contract prior to confirmation, in which case the bankruptcy court must decide what period of time is reasonable to make the decision. 11 U.S.C. §§ 365(d)(2), (d)(4) and (o). Pending the decision to assume or reject, the trustee or DIP is generally obligated to keep current on most obligations that become due under the contract postpetition. 11 U.S.C. §§ 365(d)(3) and (d)(5).



### DEFINITION OF "EXECUTORY"

The Bankruptcy Code does not define "executory." Based on the legislative history of section 365, the U.S. Supreme Court concluded in a 1984 decision that "Congress intended the term to mean a contract 'on which performance is due to some extent on both sides.'" *NLRB v. Bildisco & Bildisco*, 465 U.S. 513, 522 n.6 (1984) (quoting H.R. Rep. No. 95-595, 347 (1977); S. Rep. No. 95-989, 58 (1978)).

However, because nearly all contracts involve some unperformed obligations on both sides as of the bankruptcy petition date, many courts have adopted the more restrictive definition proposed by Professor Vern Countryman, who in 1973 defined an "executory" contract as "[a] contract under which the obligations of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing performance of the other." *See* V. Countryman, *Executory Contracts in Bankruptcy: Part I*, 57 Minn. L. Rev. 439, 460 (1973); *see also* V. Countryman, *Executory Contracts in Bankruptcy: Part II*, 57 Minn. L. Rev. 479 (1974); *see generally* Collier on Bankruptcy ("Collier") ¶ 365.02 (16th ed. 2022) (citing cases).

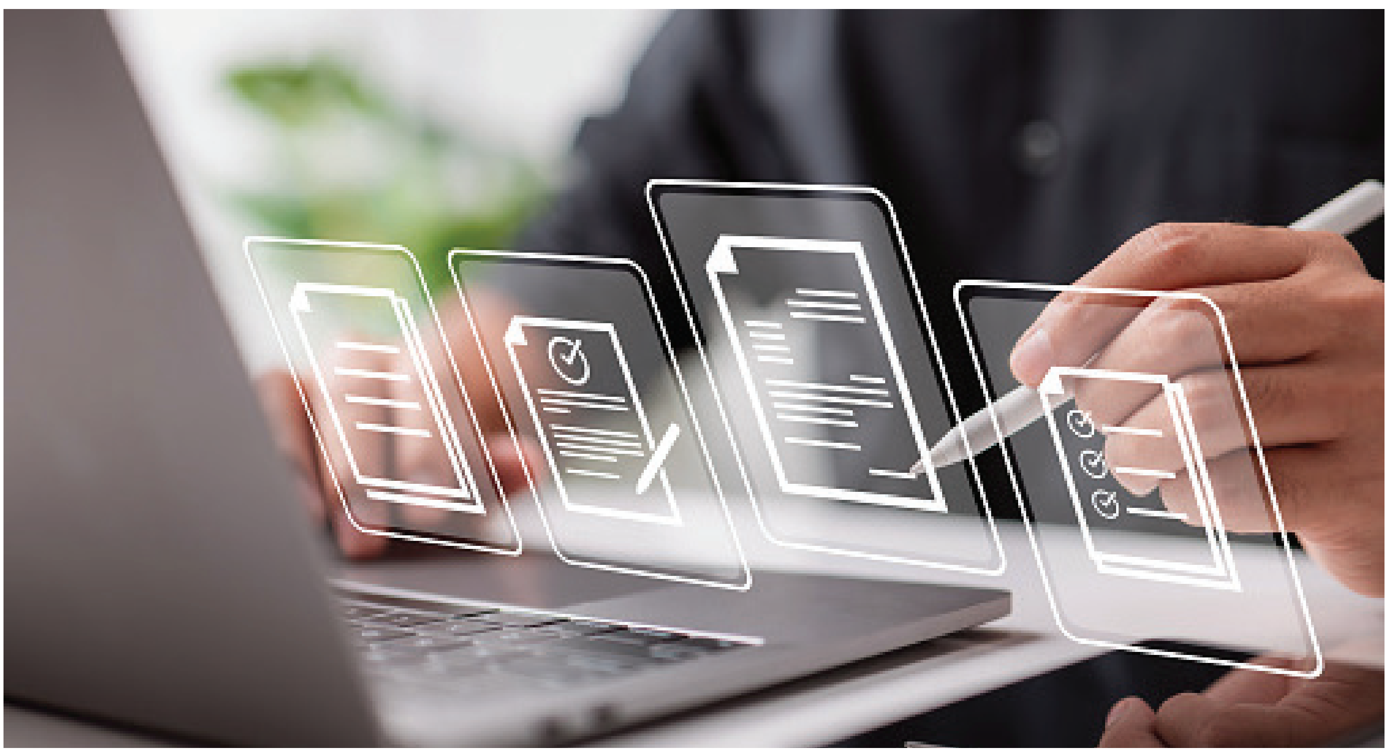
Thus, according to this approach, unless both parties have unperformed obligations as of the bankruptcy petition date that would constitute a material breach if not performed, the contract is not executory. *See In re Columbia Gas Sys. Inc.*, 50 F.3d 233, 239 (3d Cir. 1995); *accord In re Bennett Enterprises, Inc.*, 628 B.R. 481 (Bankr. D.N.J. 2021) (a contract for the sale of a debtor's liquor license did not remain executory after the purchaser obtained a state court order for specific performance because, under New Jersey law, neither party had any remaining material obligations to the other under the sale contract, and to the extent either party failed to fulfill its obligations under the state court order, the state court had authority to complete, or appoint a third party to complete, those obligations); *see also In re Brick House Properties LLC*, 633 B.R. 410, 421 (Bankr. D. Utah 2021) (noting that, in accordance with the Tenth Circuit's ruling in *In re Baird*, 567 F.3d 1207 (10th Cir. 2009), the Countryman definition applies, but with the caveat that the remaining obligations must be "significant").

The U.S. Court of Appeals for the Third Circuit recently explained the rationale of the Countryman approach as follows:

> To facilitate the debtor's rehabilitation, the Countryman test attempts to foolproof the debtor's choice to assume or reject contracts; thus, the debtor only has that flexibility for executory contracts—those contracts where there could be uncertainty about whether they are valuable or burdensome. A helpful perspective is to view executory contracts "as a combination of assets and liabilities to the bankruptcy estate; the performance the nonbankrupt owes the debtor constitutes an asset, and the performance the debtor owes the nonbankrupt is a liability." ... Under this framework, a contract where the debtor fully performed all material obligations, but the nonbankrupt counterparty has not, cannot be executory; that contract can be viewed as just an asset of the estate with no liability... . Treating it as an executory contract risks inadvertent rejection because the debtor would in effect be giving up an asset by rejecting it... . On the other extreme, where the counterparty performed but the debtor has not, the contract is also not executory because it is only a liability for the estate... . Treating it as an executory contract risks inadvertent assumption, for the debtor would effectively be agreeing to pay the liability in full when the counterparty should instead pursue the claim against the estate like other (typically unsecured) creditors... . Only where a contract has at least one material unperformed obligation on each side—that is, where there can be uncertainty if the contract is a net asset or liability for the debtor—do we invite the debtor's business judgment on whether the contract should be assumed or rejected.

*In re Weinstein Co. Holdings LLC*, 997 F.3d 497, 504–05 (3d Cir. 2021) (citations omitted).

State law determines what constitutes a material unperformed obligation. *Columbia Gas*, 50 F.3d at 239 n.10; *In re Houston*, 2009 WL 3762257, at *2 (Bankr. W.D. Ky. Nov. 9, 2009) ("Whether a party's nonperformance of the remaining obligations under a contract would constitute a material breach is a factual question resolved through application of state law.") (citing *In re Teligent, Inc.*, 268 B.R. 723, 730 (Bankr. S.D.N.Y. 2001)); *Seitz v. Paul T. Freund Corp.*, 2009 WL 1011617, at *2 (W.D.N.Y. Apr. 15, 2009) ("Determination of



whether a breach is material is a factual question resolved by resort to state law… . In New York, a material breach is one which substantially defeats the purpose of the contract, and if uncured, will operate to excuse the other party from further performance.”).

Some courts have eschewed the traditional Countryman test in favor of a result-oriented or “functional” approach examining whether the bankruptcy estate will benefit from assumption or rejection of the contract instead of looking at the mutuality of unperformed material obligations. *See In re Fin. Oversight & Mgmt. Bd. for Puerto Rico*, 631 B.R. 559, 566 (D.P.R. 2021) (noting that the functional approach works “‘backward from an examination of the purposes to be accomplished by rejection, and if they have already been accomplished then the contract cannot be executory’” (citation omitted), and ruling that a pre-bankruptcy settlement agreement was executory and could be assumed under either the Countryman or the functional test); *see generally* Collier at ¶ 365.02 (citing cases).

Yet another approach is a “modern contract analysis” proposed by Professor Jay L. Westbrook and Kelsi S. White in their article titled “The Demystification of Contracts in Bankruptcy,” 91 Am. Bankr. L.J. 481 (Summer 2017), which is premised on the notion that the Countryman test is outmoded and confusing. This approach would abolish the “material breach” rule that embodies executoriness as a prerequisite to application of section 365. Instead, the court would engage in the following analysis to determine whether a contract should be assumed or rejected:

(1) Determine under state contract law if the contract contains some obligations that remain to be performed; and if not, it cannot be assumed or rejected;
(2) If there is nothing remaining under the contract except obligations owed by the debtor (*e.g.*, payment), assumption or rejection is not necessary because there is nothing left to do except payment and discharge through the bankruptcy process;
(3) If some obligations remain other than mere payment, consider whether the net benefit to the estate from performance by both parties (assumption) exceeds the net benefit from the estate’s breach of the contract and payment of the breach (rejection) claim; and
(4) The court should approve the course of action resulting in net benefit to the estate, unless some other specific provision in section 365 requires a different conclusion.

*Id.* at 489.

If a contract or agreement is not executory, it may be neither assumed nor rejected. Instead, the contract may give rise to either an estate asset or a liability—in the latter case, a claim that may be asserted against the estate by the non-debtor party. Thus, for example, if the non-debtor party has fully performed under the contract and “the only remaining obligation is the [debtors’] duty to pay,” the contract is not executory. *Teligent*, 268 B.R. at 732; *accord Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc.*, 756 F.2d 1043, 1046 (4th Cir. 1985) (“It is true that a contract is not executory as to a party simply because the party is obligated to make payments of money to the other party.”).

However, like other assets of a bankruptcy estate, a contract that is not executory may be sold by the trustee or DIP as part of a chapter 11 plan or in a sale under section 363 of the Bankruptcy Code. In the event of a sale “free and clear” under section 363(f), the trustee or DIP need not cure any defaults under a non-executory contract and, unless the parties agree otherwise, the buyer would not assume any prepetition liabilities under the contract. *See In re Am. Home Mortg. Holdings, Inc.*, 402 B.R. 87, 94 (Bankr. D. Del. 2009) (“[S]ection 363 of the Bankruptcy Code permits a debtor to transfer its rights and obligations under a non-executory contract … [and] section 363(f)(5) permits the rights and obligations under one non-executory contract to be transferred free and clear of claims arising under other contracts.”); *accord In re Badlands Energy, Inc.*, 608 B.R. 854, 874 (Bankr. D. Colo. 2019).

Because the language of section 365(a) is permissive (“the trustee … may assume or reject”), it is possible that the trustee or DIP may take no action with respect to an executory contract or unexpired lease. When that happens in a chapter 11 case, contracts may “ride through” or “pass through” the bankruptcy case because a prepetition executory contract that is not assumed in a chapter 11 case is not “deemed rejected”—but not a lease of nonresidential real property, which is deemed rejected if not assumed within a specific time frame (*see* 11 U.S.C. §§ 365(d)(1) and 365(d)(4)). Thus, pursuant to the “ride-through” or “pass-through” doctrine, an executory contract that is neither assumed nor rejected during a chapter 11 case or in a chapter 11 plan will ride though the bankruptcy and continue to exist thereafter. *See generally* Collier at ¶ 365.03[6] (citing cases).

## PROHIBITION OF ASSUMPTION OR ASSIGNMENT OF CERTAIN TYPES OF CONTRACTS AND LEASES

A trustee or DIP may not assume or assign certain kinds of executory contracts or unexpired leases, whether or not the contract or lease prohibits or restricts an assignment of rights or a delegation of duties. *See* 11 U.S.C. § 365(c). These include: (i) contracts with respect to which applicable law excuses the non-debtor party from accepting performance from, or rendering performance to, an entity other than the debtor or the DIP (e.g., personal service contracts or patent licenses), and the non-debtor does not consent to assumption or assignment; (ii) contracts “to make a loan, or extend other debt financing or financial accommodations, to or for the benefit of the debtor, or to issue a security of the debtor”; and (iii) nonresidential real property leases that terminated under applicable non-bankruptcy law before the entry of an order for relief in the bankruptcy case. *See* 11 U.S.C. § 365(c)(1)-(3).

The scope of section 365(c)(2) is limited. It “applies only to extensions of credit that are ‘loans,’ ‘debt financing’ or ‘financial accommodations,’ and not to all contracts to extend credit.” Collier at ¶ 365.07[2] (citing cases). The purpose of the provision is to prevent a trustee or DIP from requiring new advances of money from a creditor. *See In re Jonesboro Tractor Sales, Inc.*, 619 B.R. 223, 233 (Bankr. E.D. Ark. 2020); *In re Cent. Illinois Energy, L.L.C.*, 482 B.R. 772, 787 (Bankr. C.D. Ill. 2012), *aff'd sub nom. Rafool v. Evans*, 497 B.R. 312 (C.D. Ill. 2013). The term "financial accommodation" is not defined in the Bankruptcy Code. However, it has been narrowly construed to mean an extension of money or credit to accommodate another. *See In re Thomas B. Hamilton Co., Inc.*, 969 F.2d 1013, 1018–19 (11th Cir. 1992); *In re Jonesboro Tractor Sales, Inc.*, 619 B.R. 223, 231 (Bankr. E.D. Ark. 2020).

### *FALCON*

Oil and gas exploration and development companies Falcon V, LLC and its affiliates (collectively, "Falcon V") entered into a "Surety Bond Program" with Argonaut Insurance Company ("Argonaut") whereby Argonaut posted four irrevocable performance bonds (the "Bonds") guaranteeing Falcon V's obligations to certain third parties related principally to the plugging, abandonment, and restoration of oil and gas wells. The Bonds provided that "regardless of the payment or nonpayment by [Falcon V] of any premiums owing with respect to this Bond, [Argonaut's] obligations under this Bond are continuing obligations and shall not be affected or discharged by any failure by [Falcon V] to pay any such premiums." In exchange, Falcon V pledged security for its payment obligations, agreed to pay premiums to Argonaut and agreed to indemnify Argonaut for any payments that Argonaut made under the Bonds (the "Indemnity Agreement").

In May 2019, Falcon V filed for chapter 11 protection in the Middle District of Louisiana. Argonaut filed a proof of claim in the case for the amount outstanding under the Bonds (approximately $10.5 million), $3.2 million of which was secured. Argonaut also asserted that the Surety Bond Program could not be assumed or assigned because it was a "financial accommodation." However, Argonaut reserved its rights to challenge any action taken by Falcon V with respect to the contracts if the court were later to find that they were executory.

The bankruptcy court confirmed Falcon V's chapter 11 plan in October 2019. The plan provided that Falcon V was "deemed to have assumed each executory contract … to which it is a party." In February 2020, Argonaut requested, in accordance with the terms of the Indemnity Agreement, that Falcon V provide $7.3 million in additional collateral to secure the Bonds. Asserting that the plan discharged Argonaut's claims, Falcon V refused.

Argonaut then asked the bankruptcy court to interpret and enforce the plan, arguing that Falcon V assumed the Surety Bond Program under the plan, and that even if the Surety Bond Program had not been assumed, it had "passed through" the bankruptcy unaffected.

The bankruptcy court ruled that the Surety Bond Program had not been assumed under the plan because it was not an executory contract. In applying the Countryman test, the court concluded that even though Falcon V had a continuing obligation to pay premiums to Argonaut and to indemnify Argonaut for any payments that it made under the Bonds, the Surety Bond Program did not satisfy the test's initial prong because Argonaut had already posted the Bonds and did not owe further performance to Falcon V. Thus, the parties' obligations flowed only in one direction, and the Surety Bond Program was not executory.

The bankruptcy court also held that Argonaut's unsecured claim against Falcon V must be disallowed under section 502(e)(1)(B) of the Bankruptcy Code as a co-obligor's contingent claim for reimbursement or contribution, but noted that Argonaut had an allowed secured claim for $3.2 million. The court did not address Argonaut's pass-through argument.

Argonaut appealed to the district court, which affirmed. In so ruling, the district court held that the bankruptcy court did not err in declining to address the pass-through argument because the doctrine applies exclusively to executory contracts. Argonaut appealed to the Fifth Circuit.

### THE FIFTH CIRCUIT'S RULING

A three-judge panel of the Fifth Circuit affirmed the district court's ruling.

Writing for the panel, U.S. Circuit Court Judge Stephen A. Higgenson explained that Falcon V did not assume the Surety Bond Program in its chapter 11 plan because the program was not an executory contract under the Countryman test, and therefore could not be rejected.

Judge Higgenson was unconvinced by Argonaut's argument that the Countryman test should be modified in the case of a surety contract to consider not only the obligations between the surety (Argonaut) and the principal (Falcon V), but also their obligations to the third-party obligees. According to Argonaut, because both it and Falcon V remained obligated to the various third parties for whose benefit the Bonds were issued, and because Falcon V had not fulfilled its indemnity obligation to Argonaut, the Surety Bond Program should qualify as an executory contract. Such a modification of the test, Judge Higgenson wrote, would simply elevate the rights of sureties over the rights of other creditors, rather than "further[ing] the test's goal of 'facilitat[ing] the debtor's rehabilitation' by giving debtors discretion to assume or reject those contracts 'where there can be uncertainty if the contract is a net asset or liability for the debtor.'" *Falcon*, 44 F.4th at 354 (citing *Weinstein*, 997 F.3d at 504-05).

Even so, the Fifth Circuit determined that courts "should apply the Countryman test to multiparty contracts in a flexible manner that accounts for the various obligations owed to *all* of the parties, rather than focusing exclusively on the flow of obligations between the debtor and the creditor." *Id.*

In the case before the Fifth Circuit, Judge Higgenson explained, even if the continuing obligations of the parties collectively under the Surety Bond Program satisfied the first prong of the Countryman test—continuing performance on both sides—the program did not satisfy the second prong, and was therefore not executory, because Falcon V's failure to perform its obligations under the Surety Bond Program would not excuse Argonaut from its "irrevocable" performance obligations to the obligees.

The Fifth Circuit also ruled that the Surety Bond Program did not ride through Falcon V's chapter 11 case because the doctrine applies only to executory contracts.

Finally, in light of its conclusion that the Surety Bond Program was not executory, the Fifth Circuit declined to address Argonaut's contention that the bankruptcy court erred in concluding that the program could not be assumed as a "financial accommodation."

### OUTLOOK

The Fifth Circuit's ruling in *Falcon* is significant for a number of reasons.

First, it embraces a nuanced and flexible approach to the Countryman test for executoriness that may expand the scope of what qualifies as an executory contract in cases involving multiparty contracts. Under this more flexible approach, for courts that apply the Countryman test, the absence of continuing obligations by one party to a contract may not preclude a determination that the contract is executory and can be rejected, assumed or assumed and assigned.

The Fifth Circuit acknowledged that, in other multiparty contract cases, it might make sense for courts to modify the Countryman test by, for example, applying the "functional approach."

Second, *Falcon* is the second decision in the last two years providing appellate-court guidance at the circuit level on the concept of executoriness in bankruptcy. In its 2021 ruling in *Weinstein*, the Third Circuit affirmed lower court rulings holding that a "work-made-for-hire" contract between a film company debtor and the producer of a motion picture was not an executory contract because the producer lacked any remaining "material obligations." In so ruling, the Third Circuit noted that the parties to a contract can override the Bankruptcy Code's intended protections for a debtor in connection with certain contracts, but only by clearly and unambiguously providing that continuing obligations are material in the text of the agreement and thereby ensuring to the maximum extent possible that the contract will be found to be executory.

It remains to be seen whether the Fifth Circuit's flexible approach to executoriness in *Falcon* will be applied by other courts.

## UNIMPAIRED UNSECURED CREDITORS IN SOLVENT-DEBTOR CHAPTER 11 CASE ENTITLED TO POSTPETITION INTEREST, PRESUMABLY AT CONTRACT OR DEFAULT RATE

Daniel J. Merrett • Mark G. Douglas

Perhaps given the relative rarity of solvent-debtor cases during the nearly 45 years since the Bankruptcy Code was enacted, a handful of recent high-profile court rulings have addressed whether a solvent chapter 11 debtor is obligated to pay postpetition, pre-effective date interest ("pendency interest") to unsecured creditors to render their claims "unimpaired" under a chapter 11 plan, and if so, at what rate. This question was recently addressed by two federal circuit courts of appeals. In *In re PG&E Corp.*, 46 F.4th 1047 (9th Cir. 2022) ("*Pacific Gas*"), *reh'g denied*, No. 21-16043 (9th Cir. Oct. 5, 2022), *stayed pending petition for cert.*, No. 21-16043 (9th Cir. Oct. 27, 2022), a divided panel of the U.S. Court of Appeals for the Ninth Circuit ruled that a solvent debtor's chapter 11 plan must pay pendency interest to unsecured creditors to render their claims unimpaired.

"We clarify today," the Ninth Circuit majority wrote, "that pursuant to the solvent-debtor exception, unsecured creditors possess an 'equitable right' to postpetition interest [under section 1124(1) of the Bankruptcy Code] when a debtor is solvent." The Ninth Circuit reversed a ruling below directing that pendency interest be paid to unsecured creditors only at the federal judgment rate, acknowledging the presumption that unimpaired creditors in a solvent chapter 11 case should receive pendency interest at the contractual or default rate absent contrary and compelling equitable considerations. However, finding that it lacked adequate evidence to balance the equities, the court of appeals remanded the case to the bankruptcy court for a determination of the appropriate interest rate (or rates).

On October 27, 2022, the Ninth Circuit issued an order staying the mandate on its ruling pending the filing of a petition for U.S. Supreme Court review. "If a timely petition for certiorari is filed, the mandate will issue immediately upon notice to this court that the Supreme Court has denied the petition," the order provides. "If certiorari is granted, the stay of the mandate will continue until the Supreme Court's final disposition."

Shortly after the Ninth Circuit handed down its decision in *Pacific Gas*, the Fifth Circuit issued a long-awaited ruling in *Ultra Petroleum Corp. v. Ad Hoc Comm. of OpCo Unsecured Creditors (In re Ultra Petroleum Corp.)*, 51 F.4th 138 (5th Cir. 2022) ("*Ultra II*"), *reh'g denied*, No. 21-20008 (5th Cir. Nov. 15, 2022). Like the Ninth Circuit, a divided Fifth Circuit panel concluded that "the solvent-debtor exception is alive and well." The Fifth Circuit majority accordingly held that a solvent chapter 11 debtor was obligated to pay a make-whole premium to unimpaired noteholders amount "even though … it is indeed otherwise disallowed unmatured interest." It also ruled that, because "[c]reditors are entitled to what they bargained for," the noteholders and certain other creditors were entitled to pendency interest at the default contract rate. A more detailed discussion of *Ultra II* appears elsewhere in this edition of the *Business Restructuring Review*.

## THE BANKRUPTCY CODE'S PRIORITY SCHEME

The Bankruptcy Code sets forth certain priority rules governing distributions to creditors in both chapter 7 and chapter 11 cases. Secured claims enjoy the highest priority under the Bankruptcy Code. *See generally* 11 U.S.C. § 506. The Bankruptcy Code then recognizes certain priority unsecured claims, including claims for administrative expenses, wages, and certain taxes. *See id.* § 507(a). General unsecured claims come next in the priority scheme, followed by any subordinated claims and the interests of equity holders.

In a chapter 7 case, the order of priority for the distribution of unencumbered assets is determined by section 726 of the Bankruptcy Code. The order of distribution ranges from payments on claims in the order of priority specified in section 507(a), which have the highest priority, to payment of any residual assets after satisfaction of all claims to the debtor, which has the lowest priority. Fifth priority in a chapter 7 liquidation is given to "interest at the legal rate from the date of the filing of the petition" on any claim with a higher liquidation priority, including unsecured claims. *See id.* § 726(a)(5).

Distributions in chapter 7 are made pro rata to parties of equal priority within each of the six categories specified in section 726. If claimants in a higher category of distribution do not receive full payment of their claims, no distributions can be made to parties in lower categories.

In a chapter 11 case, the chapter 11 plan determines the treatment of secured and unsecured claims (as well as equity interests), subject to the requirements of the Bankruptcy Code.

## IMPAIRMENT OF CLAIMS UNDER A CHAPTER 11 PLAN

Creditor claims and equity interests must be placed into classes in a chapter 11 plan and treated in accordance with the Bankruptcy Code's plan confirmation requirements. Such classes of claims or interests may be either "impaired" or "unimpaired" by a chapter 11 plan. The distinction is important because only impaired classes have the ability to vote to accept or reject a plan. Under section 1126(f) of the Bankruptcy Code, unimpaired classes of creditors and shareholders are conclusively presumed to have accepted a plan.

Section 1124 provides that a class of creditors is impaired under a plan unless the plan: (i) "leaves unaltered the legal, equitable, and contractual rights" to which each creditor in the class is entitled; or (ii) cures any defaults (with limited exceptions), reinstates the maturity and other terms of the obligation, and compensates each creditor in the class for resulting losses.

Section 1124 originally included a third option, then section 1124(3), for rendering a claim unimpaired—by providing the claimant with cash equal to the allowed amount of its claim. In *In re New Valley Corp.*, 168 B.R. 73 (Bankr. D.N.J. 1994), the court ruled that, in light of this third option, and because sections 726(a)(5) and 1129(a)(7) of the Bankruptcy Code (described below) apply in a chapter 11 case only to impaired creditors, a solvent debtor's chapter 11 plan that paid unsecured claims in full in cash, but without postpetition interest, did not impair the claims. The perceived unfairness of *New Valley* led Congress to remove this option from section 1124 of the Bankruptcy Code in 1994. Since then, most courts considering the issue have held that, if an unsecured claim is paid in full in cash with postpetition interest at an appropriate rate, the claim is unimpaired under section 1124. *See, e.g., In re PPI Enterprises (U.S.), Inc.*, 324 F.3d 197, 205–07 (3d Cir. 2003).

## CRAM-DOWN CONFIRMATION REQUIREMENTS

If a creditor class does not agree to impairment of the claims in the class under the plan and votes to reject it, the plan can be confirmed only under certain specified conditions. Among these "cram-down" conditions are requirements that: (i) each creditor in the class receive at least as much under the plan as it would receive in a chapter 7 liquidation (11 U.S.C. § 1129(a)(7)) (commonly referred to as the "best interests" test); and (ii) the plan be "fair and equitable" (*Id.* § 1129(b)(1)).

Therefore, by incorporating the minimum benchmark of the result of a chapter 7 liquidation, the bests interests of creditors test of section 1129(a)(7) requires that a chapter 11 debtor that can pay its creditors in full pay impaired unsecured creditors pendency interest on their allowed claims "at the legal rate" to confirm a plan. *See id.* § 726(a)(5).

The best interests test, however, applies only to impaired classes of claims or interests. This was not always the case. When the Bankruptcy Code was enacted in 1978, the provision applied to all classes—impaired or not. Congress amended section 1129(a)(7) in 1984 so that it now applies only to impaired classes. *See* Bankruptcy Amendments and Federal Judgeship Act of 1984, 98 Stat. 333, Pub. L. 98-353 (1984), § 512(a)(7); *In re Wonder Corp. of Am.*, 70 B.R. 1018, 1024 (Bankr. D. Conn. 1987) ("[T]he 1984 Amendments also modified § 1129(a)(7) so that its provisions now only apply to 'each impaired class of claims or interests' rather than to 'each class of claims or interests.'").

Section 1129(b)(2)(B) of the Bankruptcy Code provides that a plan is "fair and equitable" with respect to a dissenting impaired class of unsecured claims if the creditors in the class receive or retain property of a value equal to the allowed amount of their claims or, failing that, if no creditor or equity holder of lesser priority receives any distribution under the plan. This is known as the "absolute priority rule."

**DISALLOWANCE OF CLAIMS FOR UNMATURED INTEREST**

Section 502(b)(2) of the Bankruptcy Code provides that a claim for interest that is "unmatured" as of the petition date shall be disallowed. *See generally* Collier on Bankruptcy ("Collier") ¶ 502.03 (16th ed. 2022) ("fixing the cutoff point for the accrual of interest as of the date of the filing of the petition is a rule of convenience providing for equity in distribution"). Charges that have been deemed to fall into this category include not only ordinary interest on a debt, but also items that have been deemed the equivalent of interest, such as original issue discount. *Id.* This means that, except where the Bankruptcy Code provides for an exception (or potentially allows for an exception, as described below), any claim for postpetition interest will be disallowed.

The bar on recovery by creditors of interest accruing after a bankruptcy filing predates the enactment of the Bankruptcy Code and is derived from English law. *Nicholas v. U.S.*, 384 U.S. 678, 682 (1966) (explaining that "[i]t is a well-settled principle of American bankruptcy law that in cases of ordinary bankruptcy, the accumulation of interest on claims against a bankruptcy estate is suspended as of the date the petition in bankruptcy is filed[, which rule is] grounded in historical considerations of equity and administrative convenience"); *Sexton v. Dreyfus*, 219 U.S. 339, 344 (1911) (recognizing the rule that interest ceases to accrue on unsecured debt upon commencement of bankruptcy proceedings is a fundamental principle of English bankruptcy law, which is the basis of the U.S. system). Section 63 of the Bankruptcy Act of 1898, as amended by the Chandler Act of 1938, expressly disallowed unmatured interest as part of a claim. Bankruptcy Act of 1938, ch. 575, § 63, 52 Stat. 840 (repealed 1978).

**THE SOLVENT-DEBTOR EXCEPTION**

English law contained notable exceptions to the unmatured-interest rule. One of those was the "solvent-debtor" exception, which provided that interest would continue to accrue on a debt after a bankruptcy filing if the creditor's contract expressly provided for it, and would be payable if the bankruptcy estate contained sufficient assets to do so after satisfying other debts. *See In re Ultra Petroleum Corp.*, 913 F.3d 533, 543-44 (5th Cir.) (citing treatises and cases), *opinion withdrawn and superseded on reh'g*, 943 F.3d 758 (5th Cir. 2019) ("*Ultra I*"). In such cases, the post-bankruptcy interest was viewed as "part of" the underlying debt obligation, as distinguished from interest "on" a creditor's claim. *Id.*

The fundamental principle barring creditors from recovering postpetition interest on their claims was incorporated into U.S. bankruptcy law—as were some of the exceptions, but arguably only in part.

In pre-Bankruptcy Code cases where the debtor possessed adequate assets to pay all claims in full with interest—meaning that the payment of interest to one creditor did not impact the recovery of other creditors—principles of equity dictated that creditors be paid interest to which they were otherwise entitled, most commonly at the rate determined by their contracts with the debtor. *See Am. Iron & Steel Mfg. Co. v. Seaboard Air Line Ry.*, 233 U.S. 261, 266–67 (1914) (concluding "in the rare instances where the assets ultimately proved sufficient for the purpose, that creditors were entitled to interest accruing after adjudication"); *Debentureholders Protective Comm. of Cont'l Inv. Corp. v. Cont'l Inv. Corp.*, 679 F.2d 264, 269 (1st Cir. 1982) (in refusing to confirm a plan under chapter X of the Bankruptcy Act because it did not pay postpetition interest on unsecured claims, noting that "[w]here the debtor is solvent, the bankruptcy rule is that where there is a contractual provision, valid under state law, providing for interest on unpaid [installments] of interest, the bankruptcy court will enforce the contractual provision with respect to both [installments] due before and [installments] due after the petition was filed"); *Ruskin v. Griffiths*, 269 F.2d 827, 832 (2d Cir. 1959) ("where there is no showing that the creditor entitled to the increased interest caused any unjust delay in the proceedings, it seems to us the opposite of equity to allow the debtor to escape the expressly bargained-for" contractual interest provision); *Sword Line, Inc. v. Indus. Comm'r of N.Y.*, 212 F.2d 865, 870 (2d Cir. 1954) (explaining that "interest ceases upon bankruptcy in the general and usual instances noted … unless the bankruptcy bar proves eventually nonexistent by reason of the actual solvency of the debtor"); *Johnson v. Norris*, 190 F. 459, 466 (5th Cir. 1911) (determining that debtors "should pay their debts in full, principal and interest to the time of payment whenever the assets of their estates are sufficient").

Even though section 502(b)(2) of the Bankruptcy Code provides that a claim for unmatured interest shall be disallowed, there are specific exceptions to the rule included elsewhere in the Bankruptcy Code. For example, section 506(b) of the Bankruptcy Code provides that an oversecured creditor is entitled to interest on its allowed secured claim.

In addition, as noted above, in a chapter 7 case, the distribution scheme set forth in section 726 of the Bankruptcy Code designates as fifth in priority of payment postpetition interest on an unsecured claim at "the legal rate."

Whether the solvent-debtor exception survived enactment of the Bankruptcy Code in 1978 is disputed. A handful of rulings from the federal circuit courts (including the Ninth Circuit's decisions in *Cardelucci* and *Pacific Gas*, as discussed below, as well as the Fifth Circuit's rulings in *Ultra I* and *Ultra II* (discussed elsewhere in this edition) have held or suggested that the exception survived. *See, e.g., Ultra II*, 51 F.4th at 156 ("We thus hold that the solvent-debtor exception is alive and well. The 1978 Code's disallowance of unmatured interest did not abrogate the exception with 'unmistakable' clarity."); *Ultra I*, 943 F.3d at 765–66 ("Our review of the record reveals no reason why the solvent debtor exception could not apply"); *Gencarelli v. UPS Capital Bus. Credit*, 501 F.3d 1, 7 (1st Cir. 2007) (holding that, in contrast to section 506(b)'s reasonableness limitation on oversecured creditors' claims for fees, costs and charges, section 502(b) does not disallow unreasonable prepayment penalties in a solvent-debtor case (so long as they are allowable under state law), and noting that "[t]his is a solvent debtor case and, as such, the equities strongly favor holding the debtor to his contractual obligations as long as those obligations are legally enforceable under applicable non-bankruptcy law"); *Official Comm. of Unsecured Creditors v. Dow Corning Corp. (In re Dow Corning Corp.)*, 456 F.3d 668, 678 (6th Cir. 2006) (noting that "[t]he legislative history of the Bankruptcy Code makes clear that equitable considerations operate differently when the debtor is solvent: '[C]ourts have held that where an estate is solvent, in order for a plan to be fair and equitable, unsecured and undersecured creditors' claims must be paid in full, including postpetition interest, before equity holders may participate in any recovery'" (quoting 140 Cong. Rec. H10,752–01, H10,768 (1994) (statement of Rep. Brooks, Chairman of the House Committee on the Judiciary and co-author of the Bankruptcy Reform Act of 1994)); *In re Cardelucci*, 285 F.3d 1231, 1234 (9th Cir. 2002) (because the chapter 11 debtor was solvent, an unsecured creditor was entitled to payment of pendency interest at the federal judgment rate prior to any distribution of remaining assets to the debtor).

Recent lower court rulings have generally recognized the continued vitality of the exception, but some courts disagree over to what extent it continues in force, including its statutory source of authority, and how it should be applied. Notable decisions include:

- *In re LATAM Airlines Grp. S.A.*, 2022 WL 2206829, *23 (Bankr. S.D.N.Y. June 18, 2022) (finding that the solvent-debtor exception survived the enactment of the Bankruptcy Code through section 1129(a)(7), not section 1124(1), and noting that the alternative outcomes—awarding no pendency interest or awarding pendency interest at the contract rate—"are simply untenable and illogical" because "the former would offend basic tenants of fairness and the purposes of the Bankruptcy Code by essentially allowing impaired creditors to be treated better than unimpaired creditors via an overly strict reading of section 1129(a)(7) that is contrary to Congressional intent"), *corrected*, 2022 WL 2541298 (Bankr. S.D.N.Y. July 7, 2022), *motion to certify appeal denied*, 2022 WL 2962948 (Bankr. S.D.N.Y. July 26, 2022), *aff'd*, 2022 WL 3910718, *6 n.2 (S.D.N.Y. Aug. 31, 2022) (noting that it was unnecessary to resolve the debate over whether the solvent-debtor exception survived the enactment of the Bankruptcy Code because the bankruptcy court's finding that the debtor was insolvent was not clearly erroneous).
- *In re RGN-Grp. Holdings, LLC*, 2022 WL 494154, *6 (Bankr. D. Del. Feb. 17, 2022) (agreeing with the rationale articulated *In re The Hertz Corp.*, 637 B.R. 781 (Bankr. D. Del. 2021), *reconsideration denied and direct appeal certified*, Adv. Pro. No. 21-50995 (MFW) (Bankr. D. Del. Nov. 9, 2022), where the court ruled that the solvent-debtor exception survived the enactment of the Bankruptcy Code only to a limited extent, and concluding that a landlord was entitled to interest on its allowed unsecured claim at the federal judgment rate rather than the contract rate).
- *In re Moore & Moore Trucking, LLC*, 2022 WL 120189, *10 (Bankr. E.D. La. Jan. 12, 2022) (ruling that the solvent-debtor exception remains in force but cannot prevent a solvent debtor from extending the maturity date of a prepetition promissory note under a chapter 11 plan).
- *Hertz*, 637 B.R. at 800 (noting that "the solvent debtor exception survived passage of the Bankruptcy Code only to a limited extent" and applies only in section 506(b) as to oversecured creditors and to impaired classes of unsecured creditors in a chapter 11 case pursuant to sections 1129(a)(7) and 726(a)(5); when Congress amended the Bankruptcy Code in 1984 to limit the scope of section 1129(a)(7) to impaired classes (which was not previously the case), "it was motivated by the desire to require voting only by impaired creditors, rather than by a desire to assure that unimpaired creditors get their contract rate of interest").
- *In re Mullins*, 633 B.R. 1, 10-11 (Bankr. D. Mass. 2021) (reasoning that lawmakers' use of the phrase "fair and equitable" in sections 1129(b)(1) and 1129(b)(2) "was intended to codify at least a century of bankruptcy jurisprudence … and grounded the solvent debtor exception as it related to impaired creditors in that provision" and explaining that the legislative history of the provision does not suggest that "Congress intended to abrogate the solvent debtor exception").
- *In re Ultra Petroleum Corp.*, 624 B.R. 178, 198 (Bankr. S.D. Tex. 2020) ("*UPC*") (on remand from *Ultra I*, ruling that, based on the legislative history, "Congress gave no indication that it intended to erode the solvent debtor exception" when it enacted the Bankruptcy Code and noting that "[e]quitable considerations" continue to support it, including the policy against allowing a windfall at the expense of creditors to any debtor that can afford to pay all of its debts"), *aff'd*, 51 F.4th 138 (5th Cir. 2022), *reh'g denied*, No. 21-20008 (5th Cir. Nov. 15, 2022).

- *In re Cuker Interactive, LLC*, 622 B.R. 67, 69 (Bankr. S.D. Cal. 2020) (in accordance with Ninth Circuit precedent, a solvent debtor must pay pendency interest to general unsecured creditors "at the legal rate").
- *In re PG&E Corp.*, 610 B.R. 308, 312–13 (Bankr. N.D. Cal. 2019) (based on the Ninth Circuit's precedent in *Cardelucci*, "unsecured creditors of a solvent debtor will be paid the Federal Interest Rate whether their prepetition contracts call for higher or lower rates, or applicable state law judgment rates are higher, or there are no other applicable rates to consider. Nor is that rule limited to impaired claims"), *aff'd*, 2021 WL 2007145 (N.D. Cal. May 20, 2021), *rev'd and remanded*, 46 F.4th 1047 (9th Cir. 2022).

## APPROPRIATE RATE OF INTEREST ON UNSECURED CLAIMS IN A SOLVENT-DEBTOR CASE

In cases where interest on an unsecured claim is required, the statutory language and court decisions on the rate of interest payable are unclear. As noted, section 726(a)(5) refers to interest at "the legal rate," which could mean the contract rate, the post-judgment rate, the federal statutory rate specified in 28 U.S.C. § 1961, or some other rate. Courts disagree on the appropriate rate. Before the Fifth and Ninth Circuit rulings in *Ultra II* (discussed elsewhere in this edition) and *PG&E* (discussed below) concluding that the contract rate is (at least presumptively) the appropriate rate of interest in a solvent-debtor case, the Ninth Circuit had previously held in *Cardelucci* that the federal judgment rate was the appropriate rate of interest. *See Cardelucci*, 285 F.3d at 1234.

Many lower courts agreed with this approach. *See, e.g.*, *RGN-Group*, 2022 WL 494154, at *6 (federal judgment rate); *Hertz*, 637 B.R. at 801 (federal judgment rate); *Cuker*, 622 B.R. at 71 (quoting *UPC*, 624 B.R. at 195) (because construing the solvent debtor-exception to require the payment of contract-rate interest might be problematic in cases with a significant number of creditors where several interest rates might apply, leading to an administrative morass and different treatment of creditors in the same class, pendency interest must be paid at the federal judgment rate); *Mullins*, 633 B.R. at 16 (to satisfy the "best interests" test, which incorporates section 726(a)(5)'s dictate that interest be paid at "the legal rate" in a case involving sufficient assets, pendency interest must be paid at the federal judgment rate); *see also In re Energy Future Holdings Corp.*, 540 B.R. 109, 118 (Bankr. D. Del. 2015) ("[T]he plain meaning of section 1129(b)(2) does not require payment to unsecured creditors of post-petition interest when a junior class is receiving a distribution for a plan to be fair and equitable. Rather, the Court has the discretion to exercise its equitable power to require, among other things, the payment of post-petition interest, which may be at the contract rate or such other rate as the Court deems appropriate. Finally, the plan in this case need not provide for the payment in cash on the effective date of post-petition interest at the contract rate for the PIK Noteholders to be unimpaired. Indeed, the plan need not provide for any payment of interest, even at the Federal judgement rate. But in order for the PIK Noteholders to be unimpaired the plan must provide that the Court may award post-petition interest at an appropriate rate if it determines to do so under its equitable power.").

The Ninth Circuit considered the solvent-debtor exception and the appropriate rate of pendency interest in *Pacific Gas.*

### *PACIFIC GAS*

PG&E Corp. and its Pacific Gas & Electric Co. utility subsidiary (collectively, "PG&E") filed for chapter 11 protection in the Northern District of California in January 2019. With listed assets of $71.4 billion and debts of $51.7 billion, PG&E was solvent on a balance sheet basis at the time it filed for bankruptcy to the tune of approximately $20 billion. The filing was precipitated by potential liabilities exceeding $30 billion arising from the alleged role of PG&E's equipment in sparking the largest and most deadly wildfires in California history.

PG&E's chapter 11 plan proposed to pay the claims of non-wildfire unsecured creditors in full together with pendency interest at the federal judgment rate (then 2.59%). The plan provided that the non-wildfire claim unsecured creditor class was unimpaired and that the class was therefore deemed to accept the plan. Certain unsecured creditors (collectively, the "plaintiffs") objected, arguing that they should be entitled to pendency interest at the significantly higher rates specified either in their contracts or under state law, which would increase total interest payments by as much as $200 million. According to the plaintiffs, because PG&E was solvent, they were entitled to interest at the contractual or default state law rates, failing which their claims would be impaired.

The bankruptcy court held that, in accordance with *Cardelucci*, all unsecured creditors of a solvent chapter 11 debtor—whether or not impaired—are entitled to pendency interest, but at the federal judgment rate. In the alternative, the court ruled, even if *Cardelucci* did not control, the Bankruptcy Code itself limits unsecured creditors of a solvent debtor to interest at the federal judgment rate, and the plaintiffs' claims were therefore unimpaired by the plan (as distinguished from the statute).

The bankruptcy court later confirmed PG&E's chapter 11 plan. The plaintiffs appealed the confirmation order and the pendency interest order, but the district court affirmed for the same reasons articulated by the bankruptcy court. The plaintiffs appealed to the Ninth Circuit.

### THE NINTH CIRCUIT'S RULING

A divided three-judge panel of the Ninth Circuit reversed the ruling and remanded the case below for additional determinations.

Writing for the majority, U.S. Circuit Court Judge Carlos F. Lucero (sitting by designation from the Tenth Circuit) noted that the rate of pendency interest payable to unimpaired unsecured creditors in a solvent-debtor case was a matter of first impression among the federal circuit courts of appeals.

According to the majority, the lower courts erred in holding that, as unimpaired creditors, the plaintiffs were entitled to pendency interest, but only at the federal judgment rate. Under the solvent-debtor exception, Judge Lucero wrote, the plaintiffs "possess an equitable right to receive postpetition interest at the contractual or default state law rate, subject to any other equitable considerations, before PG&E collects surplus value from the bankruptcy estate." *Pacific Gas*, 46 F.4th at 1053. *Cardelucci*, the majority explained, "does not hold otherwise," and the lower courts erred in concluding that the decision settled the issue.

Judge Lucero explained that the litigants in *Cardelucci* agreed that unsecured creditors in a chapter 11 case (whose claims were impaired under a plan, although the court does not state as much) were entitled to pendency interest because the debtor was solvent, but disputed the rate of interest. Although, under the circumstances, the *Cardelucci* court made no distinction between unimpaired and impaired claims (and "did not refer to impairment status at all"), the court held merely that the phrase "interest at the legal rate" in section 726(a)(5) means the federal judgment rate. According to the majority in *Pacific Gas*, because section 726(a)(5) applies only to *impaired* claims in chapter 11 via the best interests test, "*Cardelucci* therefore does not tell us what rate of postpetition interest must be paid on plaintiffs' *unimpaired* claims." *Id.* at 1056.

The majority rejected PG&E's argument that the solvent-debtor exception was abrogated by the enactment of the Bankruptcy Code. According to PG&E, the combination of section 502(b)(2)—the general rule prohibiting postpetition interest on unsecured claims—and section 726(a)(5) (an exception to the unmatured interest prohibition applying only to impaired creditors in a solvent debtor chapter 11 case)—"reflects Congressional intent to establish a uniform rate of postpetition interest for all unsecured claims when a debtor is solvent."

"To the contrary," Judge Lucero wrote, for the plaintiffs' claims to be unimpaired, "the Code required PG&E's plan to leave 'unaltered' all of plaintiffs' 'legal, equitable, and contractual rights,'—§ 1124(1)—including their equitable right to receive the bargained-for postpetition interest under the solvent-debtor exception." *Id.*

According to the majority, the solvent-debtor exception derived from English law was well established in cases under the Bankruptcy Act and "[n]o Code provisions—alone or together—unambiguously displace the long-established solvent debtor exception or preclude supposedly unimpaired creditors from asserting an equitable right to contractual postpetition interest." *Id.* at 1058. Echoing the courts in *Mullins*, *UPC*, and *Energy Future*, Judge Lucero explained that section 502(b)(2) can plausibly be read to prohibit postpetition interest as "part of" a claim, but not interest "on" a claim, which may be required to render the claim

unimpaired. Nor does section 726(a)(5) abrogate the equitable solvent-debtor exception because it applies only to impaired chapter 11 creditors via the best interests test. According to the majority, if lawmakers had intended "to limit all unsecured, chapter 11 creditors to interest at the federal judgment rate, it could have done so directly," yet did not.

In addition, the majority noted, the removal of section 1124(3) from the Bankruptcy Code in 1994 to foreclose, as interpreted by the vast majority of courts, the designation of unsecured claims paid in their "allowed amount" without postpetition interest as unimpaired by a chapter 11 plan "confirm[s] that creditors of a solvent debtor who are designated as unimpaired *must* receive postpetition interest on their claim[s]—notwithstanding § 502(b)(2), or the fact that no Code provision expressly entitles such creditors to unaccrued interest." *Pacific Gas*, 46 F.4th at 1060. According to Judge Lucero, absent creditors' retention of "equitable rights" required by section 1124(1) to render their claims unimpaired, "creditors whose claims were paid in full and designated as unimpaired would not be entitled to any postpetition interest—the exact result Congress sought to preclude by repealing § 1124(3).") *Id.* (citing *Energy Future*, 540 B.R. at 123, where the court explained that unimpaired creditors' equitable right to interest "resolves a conflict between" section 502(b)(2) and the repeal of section 1124(3)).

This interpretation of the relevant Bankruptcy Code provisions, the majority stated, is supported by the plain meaning of the text and "equitable principles that persist under the modern bankruptcy regime." By contrast, it wrote, PG&E's reading of the Bankruptcy Code would permit it to "end-run [creditors'] statutory rights while reaping a windfall of hundreds of millions of dollars." *Id.*

Turning to the appropriate rate of interest, the majority noted that "absent compelling equitable considerations," a bankruptcy court should defer to the presumption that creditors in a solvent chapter 11 case should receive contractual or default-rate postpetition interest. However, because the "record before us is limited" (e.g., there was no evidence of the extent to which PG&E was solvent and could therefore pay pendency interest at any rate), the majority remanded this issue to the bankruptcy court. It accordingly reversed the district court's ruling and remanded the question of the appropriate interest rate below.

### DISSENT

In a lengthy dissent, Circuit Judge Sandra Ikuta adopted a strict textualist approach, reasoning that: (i) pursuant to section 502(b)(2), "a claim stops accruing interest at the time the petition in bankruptcy is filed," and any claim for postpetition interest must be disallowed unless such a claim is expressly authorized somewhere else in the Bankruptcy Code; and (ii) the Bankruptcy Code does not explicitly authorize or require payment of postpetition interest to unimpaired creditors.

According to Judge Ikuta, Congress knew how to draft the kind of statutory language that would create an exception to section 502(b)(2)'s prohibition of postpetition interest on unimpaired claims as well as impaired claims (via the best interests test and section 726(a)(5)), but elected not to do so. She wrote that "the sole function of the courts is to enforce [the Code's plain language] according to its terms … even if that 'may produce inequitable results for trustees and creditors.'" *Id.* at 1075 (citations omitted). Moreover, Judge Ikuta noted, "even if policy considerations were relevant, Congress could have chosen to give impaired creditors greater protections than unimpaired creditors, because impaired creditors (such as classes of wildfire victims here) may not receive payment of their claims in full." *Id.*

### OUTLOOK

The recent surge in solvent-debtor chapter 11 cases may be an aberration. Whether or not that is the case, we now have a wealth of judicial guidance at the bankruptcy and appellate level addressing the exception itself as well as the appropriate rate of pendency interest on unsecured claims.

*Pacific Gas* is consistent with the vast majority of decisions (including the Fifth Circuit's recent ruling in *Ultra II*) regarding the continued vitality of the solvent-debtor exception in cases under the Bankruptcy Code. Courts differ over the source of authority for the exception, but they generally agree that it survived the enactment of the Bankruptcy Code.

Both *Pacific Gas* and *Ultra II* are notable in rejecting the federal judgment rate as the appropriate rate of interest that must be paid to unsecured creditors to render their claims unimpaired by a chapter 11 plan. Based on these rulings, plan proponents in other chapter 11 cases must consider the impact—strategic and financial—of designating unsecured claims as unimpaired.

On October 5, 2022, the Ninth Circuit denied PG&E's petition for a rehearing *en banc* of the case. However, on October 27, 2022, the Ninth Circuit issued an order staying the mandate on its ruling pending the filing of a petition for U.S. Supreme Court review.

*Jones Day represented certain utility company shareholders owning a substantial portion of the outstanding common equity of PG&E in a series of regulatory proceedings before the California Public Utilities Commission.*

# DELAWARE DISTRICT COURT: USING CONTRACT RIGHTS TO STRATEGIC ADVANTAGE NOT GROUNDS FOR EQUITABLE SUBORDINATION IN BANKRUPTCY

Oliver S. Zeltner • Mark G. Douglas

When lenders use an aggressive strategy to deal with a financially troubled borrower that ultimately files for bankruptcy protection, stakeholders in the case, including chapter 11 debtors, trustees, committees, and even individual creditors or shareholders, frequently pursue causes of action against the lenders in an effort to augment or create recoveries. The incidence of lender liability-type claims in bankruptcy in the guise of litigation seeking, among other things, to equitably subordinate lender claims or to recharacterize such claims as equity has led some lenders to second-guess how aggressively they can enforce their rights under a loan agreement, including the extent to which they can take an active role in the affairs of a borrower.

The U.S. District Court for the District of Delaware recently handed down a ruling that should be welcome news to lenders facing equitable subordination claims in this context. In *Tilton v. MBIA Inc. (In re Zohar III, Corp.)*, 2022 WL 3278836 (D. Del. Aug. 11, 2022), *appeal dismissed*, No. 22-2695 (3d Cir. Nov. 10, 2022), the district court affirmed a bankruptcy court's dismissal of an adversary proceeding (the "Adversary Proceeding") filed by entities affiliated with chapter 11 debtors seeking to equitably subordinate the claims of the debtors' senior secured creditor and certain other defendants. According to the plaintiffs, these creditors had seized control and, ultimately, ownership of the debtors' assets through deception and misinformation that caused the debtors to default on their obligations and file for bankruptcy. "There is nothing inequitable," the district court wrote, "about using contractual rights to a strategic advantage."

### EQUITABLE SUBORDINATION

Equitable subordination is a remedy that was developed under common law prior to the enactment of the Bankruptcy Code to remedy misconduct by a creditor or equityholder of the debtor that results in injury to other creditors or shareholders. Where a creditor is shown to have engaged in such misconduct, the bankruptcy court has authority to subordinate the creditor's claim to the claim of a particular creditor injured by the misconduct, to the claims of an injured class of creditors, or to all other claims, depending on the circumstances.

Equitable subordination is expressly recognized in section 510(c) of the Bankruptcy Code, which provides that the bankruptcy court may, "under principles of equitable subordination, subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim or all or part of an allowed interest to all or part of another allowed interest." However, the Bankruptcy Code does not elaborate on the "principles of equitable subordination" referred to in section 510(c) or set forth a particular standard for courts to apply when evaluating an equitable subordination claim.

In *In re Mobile Steel Co.*, 563 F.2d 692 (5th Cir. 1977), the U.S. Court of Appeals for the Fifth Circuit articulated what has become the most commonly accepted standard for equitable subordination of a claim. Under this standard, a claim can be subordinated if the claimant engaged in inequitable conduct that resulted in injury to creditors (or conferred an unfair advantage on the claimant) and if equitable subordination of the claim is consistent with the provisions of the Bankruptcy Code. *Id.* at 700. Courts have refined the test to account for special circumstances. For example, many courts make a distinction between insiders (e.g., corporate fiduciaries) and non-insiders in assessing the level of misconduct necessary to warrant subordination. *See In re Alternate Fuels, Inc.*, 789 F.3d 1139, 1155 (10th Cir. 2015) ("If a claimant is an 'insider' or a 'fiduciary' of the debtor, our analysis is less stringent. '[T]he party seeking subordination need only show some unfair conduct, and a degree of culpability, on the part of the insider.'" (quoting *In re Hedged–Investments Assocs., Inc.*, 380 F.3d 1292, 1301 (10th Cir. 2004)); *In re Winstar Commc'ns, Inc.*, 554 F.3d 382, 412 (3d Cir. 2009). For non-insiders, equitable subordination generally requires a finding of gross or egregious misconduct, whereas insider claims or interests may be subordinated upon demonstration of a lesser degree of unfair conduct. *See In re AutoStyle Plastics, Inc.*, 269 F.3d 726, 744 (6th Cir. 2001); *In re Mid-Am. Waste Sys., Inc.*, 284 B.R. 53, 70 (D. Del. 2002).

### *ZOHAR*

Three investment vehicles—Zohar I, Corp. ("Zohar I"), Zohar II, Corp. ("Zohar II") and Zohar III, Corp. ("Zohar III" and, collectively, the "Funds")—created by Patriarch Partners, LLC (together with its affiliates, "Patriarch") founder Lynn G. Tilton used collateral from investors to make loans to distressed companies (the "Portfolio Companies") in exchange for repayment obligations and equity in the Portfolio Companies. The Funds issued collateralized interest-bearing notes to investors with various priorities and maturities. Through an affiliate, Tilton was the Funds' preferred shareholder, and as such, she was entitled to any excess value generated by them. She also allegedly indirectly owned and controlled the equity of the Portfolio Companies.

As a "credit enhancer," insurer MBIA Insurance Corp. ("MBIA") guaranteed senior notes issued by Zohar I and Zohar II. The insurance guarantee agreements provided that, upon the event of default by Zohar I or Zohar II, MBIA would, by way of subrogation, become those funds' senior secured creditor. MBIA also had the right to liquidate investor collateral held by Zohar I and Zohar II to recoup any insurance payouts.

With Zohar I at risk of defaulting on its notes, Tilton and MBIA engaged in discussions during the period from 2012 to 2014 regarding an extension of maturities and a global restructuring of the insured notes. Plaintiffs in the Adversary Proceeding—including Tilton and Patriarch (collectively, the "Plaintiffs")—alleged that, during this time, MBIA provided confidential, nonpublic information and misinformation regarding the Portfolio Companies to the U.S. Securities and Exchange Commission ("SEC") in connection with an SEC fraud investigation into the affairs of Tilton and Patriarch. The SEC investigation was eventually resolved in the favor of Tilton and Patriarch.

Restructuring talks for the Funds continued throughout 2015 without success. Zohar I defaulted on its senior insured notes in November 2015. In connection with the Zohar I default (and subsequent defaults by Zohar II and Zohar III), MBIA paid a total of approximately $919 million to the insured noteholders. According to the Plaintiffs, although MBIA supported an extension of the maturity date of the Zohar I notes and a global restructuring of the Funds' note obligations throughout the three years of

discussions, MBIA later refused to agree to either option, ultimately "causing" the Zohar I default in an effort to take control of the Funds.

On November 22, 2015, Tilton filed an involuntary bankruptcy case against Zohar I. After discussions among the parties in this initial bankruptcy case, Tilton caused the collateral managers of the Funds to resign beginning in 2015, and the bankruptcy case was dismissed. Tilton alleged that, although she was assured by MBIA that she could then appoint new Fund collateral managers, MBIA and certain Zohar III noteholders unilaterally appointed a new collateral manager for the Funds.

In June 2016, MBIA instructed the trustee bank under the Funds' note indentures to conduct an auction of the investor collateral held by Zohar I. The Plaintiffs sued in state court to enjoin the auction, arguing that the sale was a commercially unreasonable "sham" auction because it included equity in more than 20 Portfolio Companies allegedly owned by the Plaintiffs.

After the action was removed to federal district court, the district court rejected the Plaintiffs' claims that the proposed sale was commercially unreasonable and ruled that the auction could proceed. At the auction, MBIA prevailed with an approximately $150 million credit bid. Although Tilton had the right to match that bid under the Funds' organizational documents, she elected not to do so.

The new collateral manager for the Funds commenced litigation on the Funds' behalf in Delaware Chancery Court alleging that the prior collateral managers violated their contractual obligation to turn over certain Fund books and records. It also filed a separate action on the Funds' behalf in the same court seeking a determination that the Funds, and not Tilton, who had been removed from the portfolio companies' boards of directors at MBIA's direction, owned the equity in the portfolio companies. The court ruled in favor of the Funds in both cases.

In addition, the new collateral manager sued the Plaintiffs in a New York federal district court alleging violations of the civil RICO statute and New York common law (together with the Delaware Chancery Court actions, the "Zohar Litigation"). The district court ultimately dismissed with prejudice the RICO complaint as well as a third-party complaint filed in the action by the Plaintiffs alleging that MBIA and the new collateral manager breached their contractual and fiduciary duties.

After Zohar II and Zohar III also defaulted on their obligations to pay the insured notes, the Funds filed for chapter 11 protection in March 2018 in the District of Delaware. In 2019, the Plaintiffs filed the Adversary Proceeding in the bankruptcy court, seeking to equitably subordinate the claims of MBIA, the trustee bank, the new collateral manager and various Fund investors (collectively, the "Defendants") to the Plaintiffs' claims against the Funds. According to the Plaintiffs, MBIA, with the assistance of the other Defendants, wrested control of the Funds from the Plaintiffs and perpetrated a decade-long scheme to deprive the Plaintiffs of more than one billion dollars of their equity holdings in the Portfolio Companies by means of "sham" litigation. The Plaintiffs also alleged that MBIA's behavior was motivated by the need to rescue itself from the brink of financial ruin caused by an overwhelming amount of insurance guaranty obligations that arose as a result of the 2008 financial crisis.

The bankruptcy court dismissed the complaint, ruling that the Plaintiffs failed to allege facts sufficient to raise a plausible inference of inequitable conduct. It also held that the Plaintiffs were collaterally estopped from arguing that the Zohar Litigation and MBIA's inducement of the old collateral managers to resign was inequitable for purposes of equitable subordination, because the federal district court dismissed similar claims brought by the Plaintiffs against MBIA and the new collateral manager in the federal district court RICO litigation.

The Plaintiffs appealed to the district court.

### THE DISTRICT COURT'S RULING

The district court affirmed the bankruptcy court's dismissal of the Adversary Proceeding complaint.

Initially, U.S. Circuit Judge Thomas L. Ambro (sitting by designation from the U.S. Court of Appeals for the Third Circuit) noted that the litigants did not challenge the bankruptcy court's designation of MBIA, the new collateral manager and certain Fund investors as insiders, and the trustee bank as a non-insider. Instead, he explained, the Plaintiffs argued that the bankruptcy court erred in concluding that: (i) MBIA's conduct in connection with the Zohar I restructuring negotiations, its alleged communications with the SEC, and its conduct (together with the trustee bank) in connection with the Zohar I auction sale were not plausibly inequitable; and (ii) the Plaintiffs were collaterally estopped from alleging that the Zohar Litigation and the inducement of the old collateral managers' resignations were inequitable.

First, Judge Ambro noted that the Plaintiffs' complaint contained no allegations suggesting that MBIA ever committed to an extension of maturity or a restructuring of Zohar I, nor did it contain factual allegations to support a claim that MBIA engaged in a protracted scheme "to string [the Plaintiffs] along because it had an interest in ensuring Tilton continued to manage the Funds during that period and increase their value." *Zohar*, 2022 WL 3278836, at *4. "There is nothing inequitable," he wrote, "about using contractual rights to a strategic advantage, nor does such a strategy support the inference that MBIA was deliberately misleading Plaintiffs for years about its willingness to negotiate a maturity extension." *Id.*

Second, Judge Ambro emphasized that the Plaintiffs' allegations regarding a secret misinformation scheme between MBIA and the SEC was not supported by any evidence of even a single piece of actual misinformation given to the SEC by MBIA, and the Plaintiffs acknowledged in the complaint that the information-sharing agreement between MBIA and the SEC was not secret, but in fact permitted the SEC to give Tilton notice of any disclosures.

Third, the district court found no error in the bankruptcy court's collateral estoppel ruling. According to Judge Ambro, the issues raised by the Plaintiffs (and dismissed by the court) in the RICO litigation regarding the Defendants' conduct in connection with the former collateral managers' resignation and the Zohar Litigation were sufficiently identical and necessarily decided, such that the bankruptcy court properly concluded that such claims could not be relitigated in the context of the Plaintiffs' equitable subordination complaint.

Finally, the district court rejected the Plaintiffs' argument that MBIA and the trustee bank acted inequitably in connection with the Zohar I auction. The record, Judge Ambro explained, reflected that the auction was regularly conducted under court supervision, and the Plaintiffs failed to provide any factual allegations to support an inference that MBIA's winning credit bid was a "windfall," particularly because Tilton had the right to match the offer yet chose not to do so.

## OUTLOOK

The district court's decision in *Zohar* has been welcomed by lenders. It provides some level of comfort that they can enforce contractual rights negotiated at arm's length while minimizing exposure to equitable subordination claims (and potentially other lender liability claims) in a borrower's bankruptcy case. Lenders should still be wary of conduct that could be viewed as overreaching, but unless they qualify as insiders of the borrower-debtor, the bar for equitable subordination remains relatively high.

With the consent of the litigants, the Third Circuit dismissed the Plaintiffs' appeal of the district court's ruling on November 10, 2022.

In many respects, *Zohar* is reminiscent of another decision issued by a Delaware district court in 2016 addressing lender liability claims in bankruptcy, including equitable subordination, equitable disallowance, and breach of the covenant of good faith and fair dealing. In *In re Hercules Offshore, Inc.*, 565 B.R. 732 (Bankr. D. Del. 2016), the court overruled the objections of a committee of equity security holders to a chapter 11 plan that included releases of prepetition lenders, including a hedge fund that acquired 40% of secured debt refinanced as part of a previous chapter 11 filing. The court rejected the committee's argument that the releases were inappropriate given the existence of colorable claims against the lenders for misconduct in enforcing their rights under a prepetition credit agreement.

The equity committee claimed that the first-lien lenders had breached the implied covenant of good faith and fair dealing by asserting "baseless" events of default under the first-lien credit agreement, declining to extend the deadline for compliance with certain covenants in the credit agreement, and forcing the debtor to enter into certain forbearance agreements.

U.S. Bankruptcy Judge Kevin J. Carey rejected those arguments. He explained that the debtors did not dispute that they had breached covenants under the first-lien credit agreement. Similarly, the court determined that withholding consent to an extension of time for the debtors to comply with covenants "was arguably unfortunate, but not inappropriate." According to Judge Carey, although the first-lien lenders "were strategic in their actions, lenders are free to enforce contract rights and negotiate hard against borrowers at [arm's length], particularly those that are in distress, as here." *Id.* at 762.

In *Hercules Offshore*, Judge Carey noted that the debtors characterized the first-lien lenders, "sardonically, as 'aggressive,' 'vocal,' 'persistent,' and at times 'annoying.'" However, he wrote, "there is no evidence that they acted unlawfully and no evidence that the Debtors were damaged by any alleged lender misconduct." Evidence was lacking, he explained, that the first-lien lenders had interfered with the debtors' business or had somehow been implicitly bound to grant extensions of time to satisfy covenants. Nor was any evidence introduced to establish that the lenders had caused or contributed to the debtors' inability to timely satisfy covenants. Instead, the record showed that the first-lien lenders "acted within the boundaries of their contractual rights." *Id.* at 763.

# DEBTOR CAN SELL ASSETS FREE AND CLEAR OF SUCCESSOR LIABILITY CLAIMS ASSERTED BY UNION PENSION FUNDS

T. Daniel Reynolds • Mark G. Douglas

The ability of a bankruptcy trustee or chapter 11 debtor-in-possession to sell assets of the bankruptcy estate "free and clear" of "any interest in property" asserted by a non-debtor is an important tool designed to maximize the value of the estate for the benefit of all stakeholders. The U.S. Bankruptcy Court for the Southern District of Illinois recently examined whether such interests include "successor liability" claims that might otherwise be asserted against the purchaser of a debtor's assets. In *In re Norrenberns Foods, Inc.*, 642 B.R. 825 (Bankr. S.D. Ill. 2022), *appeal dismissed*, No. 22-1460 (S.D. Ill. Aug. 5, 2022), the court granted a debtor-in-possession's motion to sell substantially all of its assets free and clear of claims asserted by a union pension fund against the debtor and the purchaser for withdrawal liability under the Employment Retirement Income Security Act ("ERISA"). In so ruling, the bankruptcy court "follow[ed] the majority trend to interpret the term 'interest' broadly," finding that "successor liability claims are an 'interest' for purposes of Section 363(f) of the Bankruptcy Code."

## FREE AND CLEAR BANKRUPTCY SALES

Section 363(b)(1) of the Bankruptcy Code provides in relevant part that a bankruptcy trustee or chapter 11 debtor-in-possession, "after notice and a hearing, may use, sell, or lease, other than in the ordinary course of business, property of the estate." Courts generally apply some form of a business judgment test in determining whether to approve a proposed use, sale, or lease of estate property under section 363(b)(1). *See ASARCO, Inc. v. Elliott Mgmt. (In re ASARCO, L.L.C.)*, 650 F.3d 593, 601 (5th Cir. 2011); *In re Stearns Holdings, LLC*, 607 B.R. 781, 792 (Bankr. S.D.N.Y. 2019); *In re Friedman's, Inc.*, 336 B.R. 891, 895 (Bankr. S.D. Ga. 2005); *see generally* Collier on Bankruptcy ("Collier") ¶ 363.02[4] (16th ed. 2022).

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

Section 363(f) of the Bankruptcy Code authorizes a trustee or debtor-in-possession to sell estate property "free and clear of any interest in such property of an entity other than the estate," but only if:

(1) applicable nonbankruptcy law permits sale of such property free and clear of such interest;
(2) such entity consents;
(3) such interest is a lien and the price at which such property is to be sold is greater than the aggregate value of all liens on such property;
(4) such interest is in bona fide dispute; or

(5) such entity could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest.

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

Courts have sometimes struggled to identify the outer limits of the term "interest," which is not defined in the Bankruptcy Code or its accompanying legislative history. Most courts reject the narrow approach under which the reach of section 363(f) is limited to *in rem* property interests (such as liens or security interests) or only those claims that have already been asserted at the time the property is sold. *See* Collier at ¶ 363.06[1] (noting that «[o]bviously there must be situations in which the interest is something other than a lien; otherwise, section 363(f)(3) would not need to deal explicitly with the case in which the interest is a lien").

Instead, the majority of courts have construed the term broadly to encompass other obligations that may flow from ownership of property, such as leasehold interests. *See Pinnacle Rest. at Big Sky, LLC v. CH SP Acquisitions, LLC (In re Spanish Peaks Holding II, LLC),* 872 F.3d 892, 900 (9th Cir. 2017) (notwithstanding the tenant protections set forth in section 365(h)(1), real property can be sold by a debtor-lessor free and clear of a leasehold interest under section 363(f)); *Precision Indus., Inc. v. Qualitech Steel SBQ, LLC,* 327 F.3d 537, 545 (7th Cir. 2003) (same)).

Many courts have concluded that "successor liability" claims are also included within the scope of interests under section 363(f). *See Ind. State Police Pension Trust v. Chrysler LLC (In re Chrysler LLC)*, 576 F.3d 108, 124 (2d Cir. 2009) (a sale of assets to a newly formed acquisition entity free and clear of the debtor's liability for certain vehicle defects), *vacated on other grounds*, 558 U.S. 1087 (2009); *In re Trans World Airlines, Inc.*, 322 F.3d 283, 290 (3d Cir. 2003) (section 363 sale free and clear of employment discrimination claims arising from conduct prior to the sale and travel vouchers settling same); *UMWA 1992 Benefit Plan v. Leckie Smokeless Coal Co. (In re Leckie Smokeless Coal Co.)*, 99 F.3d 573, 586 (4th Cir. 1996) (debtor coal operators could sell their assets free of successor liability that would otherwise arise under the Coal Industry Retiree Health Benefit Act of 1992); *In re Catalina Sea Ranch, LLC*, 2020 WL 1900308, *13 (Bankr. C.D. Cal. Apr. 13, 2020) (a chapter 11 debtor could sell assets to an insider affiliate and secured creditor under section 363(f) free and clear of wrongful death successor liability claims); *In re K & D Indus. Servs. Holding Co., Inc.*, 602 B.R. 16 (Bankr. E.D. Mich. 2019) (sale of chapter 11 debtors' assets free and clear of successor liability claims for ERISA withdrawal liability).

### *NORRENBERNS FOODS*

Norrenberns Foods, Inc. (the "Debtor") operated a retail grocery store in Illinois. Before filing for chapter 11 protection on December 7, 2021, in the Southern District of Illinois, the Debtor also owned other grocery stores throughout the southern part of the state, but those stores were closed due to competition from larger grocery store chains.

The Debtor's retail food employees were represented by a union under a collective bargaining agreement ("CBA"). They were also the beneficiaries of a multi-employer pension fund (the "Fund") that provided retirement, disability, and death benefits to retail food employees in the Midwest who were covered by CBAs between their employees and various unions affiliated with the United Food and Commercial Workers International Union, AFL-CIO.

After the Debtor's other stores closed, the Debtor's remaining location became liable under ERISA for the pension withdrawal liabilities associated with the shuttered locations. As of the chapter 11 petition date, the Fund asserted an unsecured claim against the debtor for approximately $4.8 million, most of which was for ERISA pension plan withdrawal liability (the "Fund Claim").

In April 2022, the Debtor sought court authority to sell substantially all its grocery business assets to Norrenberns Properties, LLC and Betty Ann Market's Inc. (collectively, the "purchaser") free and clear of all liens, claims, interests, and encumbrances. The purchaser, which was created for the purpose of acquiring the debtor, was owned by the nephew of the Debtor's owners and the nephew's spouse. The nephew had been involved in the grocery store business for many years, but neither the nephew nor his spouse had ever worked for the Debtor. Under the proposed sale agreement, the Debtor's former owners would neither be employed by, nor have any interest in, the purchaser after the sale. The sale price was negotiated among the purchaser, the Debtor, and the Debtor's first-priority secured lender. The Debtor's owners would receive none of the sale proceeds. There were no other prospective purchasers.

The Fund objected to the sale, arguing that the bankruptcy court lacked jurisdiction to enjoin any successor liability claims against the purchaser and that the sale of the debtor's assets under section 363(f) could not extinguish the Fund Claim.

## THE BANKRUPTCY COURT'S RULING

The bankruptcy court approved the sale free and clear of the Fund Claim.

U.S. Bankruptcy Judge Laura K. Grandy explained that, in accordance with section 363(f)(5), the Fund Claim was an "interest" for which the Fund could be compelled to accept a money satisfaction, as evidenced by the proof of claim filed by the Fund indicating the claim's monetary value. She further noted that many courts, including the Third, Fourth, and Seventh Circuits, have expansively interpreted the term "interest" in section 363(f) to include possessory leasehold interests, employment-related claims, and pension plan withdrawal liability. *Norrenberns Foods*, 642 B.R. at 829 (citing *Precision Industries*, 327 F.3d at 545 (a possessory interest in a lease); *Trans World Airlines*, 322 F.3d at 289-90 (employment discrimination claims); *Leckie*, 99 F.3d at 575-77 (future premium payment obligations to retirement benefit plans); *K&D*, 602 B.R. at 28-29 (successor liability claims, including pension plan withdrawal liability claims); *Faulkner v. Bethlehem Steel/Int'l Steel Group*, 2005 WL 1172748, *3 (N.D. Ind. Apr. 27, 2005) (employment discrimination claims)).

According to Judge Grandy, the broad definition of "interest" has been adopted by many courts "with good reason" because lawmakers would have used the term "lien" instead of "interest" had it intended to restrict the scope of section 363(f) to liens, and they included the term "lien" in section 363(f)(3), suggesting that liens are a "subcategory of 'interest.'" *Id.* at 830. She reasoned that the Fund Claim is an "interest in such property" within the meaning of section 363(f) because it "arises from the very grocery store being sold" and would not have arisen "but for the sale of the assets and operation of the assets by the buyer."

The bankruptcy court found that the Fund put misplaced reliance on the Seventh Circuit's rulings in *Zerand-Bernal Grp., Inc. v. Cox*, 23 F.3d 159, 161 (7th Cir. 1994), and *Chicago Truck Drivers, Helpers & Warehouse Workers Union (Indep.) Pension Fund v. Tasemkin, Inc.*, 59 F.3d 48 (7th Cir. 1995), to support its argument that a bankruptcy court lacks jurisdiction to enjoin successor liability actions following a section 363 sale. According to Judge Grandy, *Zerand* is distinguishable because the case dealt not with section 363(f), but instead, an unknown future product-liability tort creditor whose claim had not arisen at the time of the sale of the debtor's assets. In that case, the Seventh Circuit never discussed the term "interest" in section 363(f) or "the possibility that such term included successor liability claims." *Norrenberns Foods*, 642 B.R. at 832. Moreover, the *Zerand* court explicitly stated that "'a cleansing of the assets in a bankruptcy sale' of all liens and other encumbrances 'is a valid power of the bankruptcy court.'" *Id.* (quoting *Zerand*, 23 F.3d at 163).

The Seventh Circuit ultimately concluded in *Zerand* that the bankruptcy court lacked jurisdiction to enjoin the products liability claim, noting that the plaintiff in the products liability litigation was not a party to the bankruptcy case and the incident that gave rise to the claim occurred long after the bankruptcy case was closed. Unlike in *Zerand*, Judge Grandy wrote in *Norrenberns Foods*, "the Fund holds existing claims against the Debtor at the time of the sale, and the successor liability claims constitute interests in the Debtor's property." *Id.*

The bankruptcy court also distinguished *Chicago Truck Drivers* because it "does not involve a Section 363(f) sale at all." *Id.*

It accordingly ruled that the debtor was "authorized to sell its assets free and clear of the Fund's successor liability claims."

## OUTLOOK

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

The bankruptcy court's conclusion that a debtor may sell its assets free and clear of "successor liability" claims is slightly more nuanced than the opinion would suggest. The ruling has two components. First, the court held that the debtor could sell its assets under section 363(f) free and clear of the pension fund's claims for withdrawal liability under ERISA. Second, although it does not state as much, the court implies that the pension fund is barred from asserting claims under a theory of successor liability against the purchaser, even though the purchaser, and not the Debtor, is the only party against whom the Fund could ever have asserted successor liability claims. According to the court, unlike in *Zerand*, there was no jurisdictional infirmity to granting the second part of this relief because the pension fund was a party to the bankruptcy case and the claim existed at the time of the sale.

On August 5, 2022, the U.S. District Court for the Southern District of Illinois, with the consent of the parties, dismissed an appeal filed by the Fund of the order approving the sale.

# FIFTH CIRCUIT TRIPLES DOWN: FILED-RATE NATURAL GAS AND POWER CONTRACTS CAN BE REJECTED IN BANKRUPTCY WITHOUT FERC APPROVAL

Paul M. Green • Mark G. Douglas

In *Gulfport Energy Corp. v. FERC*, 41 F.4th 667 (5th Cir. 2022), the U.S. Court of Appeals for the Fifth Circuit tripled down on its nearly two-decades-long view that filed-rate contracts regulated under the National Gas Act (the "NGA") and the Federal Power Act (the "FPA") can be rejected in bankruptcy without the consent of the Federal Energy Regulatory Commission ("FERC"). Reaffirming its previous rulings in *In re Mirant Corp.*, 378 F.3d 511 (5th Cir. 2004), and *In re Ultra Petroleum Corp.*, 28 F.4th 629 (5th Cir. 2022), the Fifth Circuit was highly critical of FERC's "bizarre view" that the consequences of rejection of filed-rate contracts should be viewed differently than the consequences of rejection of other types of executory contracts in bankruptcy. According to the court, as in its previous rulings, it rejected FERC's argument because it "patently contradicts the [Bankruptcy] Code's text and established interpretation."

The Fifth Circuit summarized its decision as follows:

> FERC can decide whether *actual* modification or abrogation of a filed-rate contract would serve the public interest. It even may do so before a bankruptcy filing. But rejection is just a breach; it does not modify or abrogate the filed rate, which is used to calculate the counterparty's damage. So FERC cannot prevent rejection. It cannot bind a debtor to continue paying the filed rate after rejection. And it cannot usurp the bankruptcy court's power to decide [the debtor's] rejection motions.

*Gulfport*, 41 F.4th at 685. With its third such ruling in the last 18 years, the Fifth Circuit has unequivocally staked out its view on this issue, which is aligned with the position adopted by the only other court of appeals that has addressed it—the Sixth Circuit, in *In re FirstEnergy Solutions Corp.*, 945 F.3d 431 (6th Cir. 2019), *reh'g denied*, No. 18-3787 (6th Cir. Mar. 13, 2020).

More detailed descriptions of the long-running dispute between FERC and the bankruptcy courts regarding the rejection of filed-rate contracts in bankruptcy are available here and here.

### *MIRANT*

In *Mirant*, the Fifth Circuit ruled that the FPA does not prevent a bankruptcy court from ruling on a motion to reject a FERC-regulated rate-setting agreement as long as the proposed rejection does not represent a challenge to the agreement's filed rate.

The Fifth Circuit noted that, although the Bankruptcy Code places numerous limitations on a debtor's right to reject contracts, "including exceptions prohibiting rejection of certain obligations


imposed by regulatory authorities," there is no exception that prohibits a debtor's rejection of wholesale electricity contracts that are subject to FERC's jurisdiction. Concluding that "Congress intended § 365(a) to apply to contracts subject to FERC regulation," the Fifth Circuit held that the bankruptcy court's power to authorize rejection of the agreement did not conflict with the authority conferred upon FERC to regulate rates for the interstate sale of electricity.

The Fifth Circuit, however, imposed a higher standard for rejection of such agreements. It concluded that, in determining whether a debtor should be permitted to reject a wholesale power contract, "the business-judgment standard would be inappropriate … because it would not account for the public interest inherent in the transmission and sale of electricity." Instead, a "more rigorous standard" might be appropriate, including consideration of not only whether the contract burdens the estate, but also whether the equities balance in favor of rejection, rejection would promote a successful reorganization, and rejection would serve the public interest. Such a balancing exercise, the Fifth Circuit noted, could be undertaken with FERC's input.

### *ULTRA*

In *Ultra*, the Fifth Circuit held that, in accordance with its previous ruling in *Mirant*, a bankruptcy court properly authorized chapter 11 debtor Ultra Resources, Inc. ("UPC") to reject an NGA-governed natural gas transportation agreement as part of its chapter 11 plan without obtaining FERC's approval. It also ruled that UPC was not subject to a separate public-law obligation to continue performance under the rejected contract, and that the Bankruptcy Code does not require a bankruptcy court to seek FERC approval before confirming a chapter 11 plan providing for rejection of the contract.

In *Ultra*, the Fifth Circuit explained that the binding precedent in *Mirant* "balances the interests of the bankruptcy courts (which are ultimately in charge of the rejection decision) and FERC (by requiring that rejection of a filed-rate contract is considered under a higher standard that considers the public interest and by allowing FERC to participate in the bankruptcy proceedings)."

Noting that the Sixth Circuit came to the same conclusion in *FirstEnergy*, the Fifth Circuit ruled that the bankruptcy court properly authorized the rejection of the filed-rate contract under the *Mirant* standard based on the bankruptcy court's findings that: (i) rejection did not collaterally attack the rate filed with FERC because that rate was used to calculate the damage award after rejection and UPC did not seek to reject the contract because the rate were excessive, but because it did not need the capacity; and (ii) the bankruptcy court did not apply the normal business judgment standard in deciding whether to authorize rejection, but the higher standard that involves consideration of the public interest.

The Fifth Circuit rejected FERC's argument that it must be permitted to comment on the public-interest ramifications of a proposed rejection in a formal proceeding before rejection can be authorized. *Mirant*, it noted, does not "include such a requirement," and the bankruptcy court, which was obligated to weigh the public interest in deciding whether to authorize rejection of a filed-rate contract, specifically sought FERC's input on the impact of rejection.

Finally, the Fifth Circuit rejected FERC's argument that the bankruptcy court erred because rejection of the contract amounted to a rate change and the inclusion of a provision in UPC's chapter 11 plan authorizing rejection violated section 1129(a)(6) of the Bankruptcy Code. According to the court, "Since the bankruptcy court did not change the actual rate and used it to calculate the damages claim that would result from rejection of the contract, the confirmation of the plan did not violate [section 1129(a)(6)]."

### *GULFPORT ENERGY*

Natural gas producer Gulfport Energy Corporation ("GEC") and Rover Pipeline L.L.C. ("Rover") entered into transportation service agreements ("TSAs") whereby Rover agreed to transport GEC's gas through its pipelines.

After the onset of the COVID-19 pandemic crushed demand for energy, GEC disclosed in public filings that its financial outlook was grim. Concerned that GEC might file for bankruptcy and reject its TSAs, Rover petitioned FERC in September 2020 for a declaratory judgment that FERC had exclusive jurisdiction over the TSAs and that GEC would need FERC's approval before rejecting the contracts in bankruptcy. Rover also asked FERC to hold an expedited hearing to determine whether nonperformance of the TSAs would "harm the public interest."

FERC granted Rover's petition for declaratory relief in October 2020. In its order, FERC noted that it asserted "parallel, exclusive jurisdiction" over the filed-rate TSAs. It also stated that rejection of a filed-rate contract in bankruptcy "alters the essential terms and conditions" of that contract. In addition, the order provided that, because "[FERC's] approval is required to modify or abrogate [a] filed rate," GEC could not reject any TSAs with Rover in bankruptcy without FERC's approval. Finally, the order stated that the bankruptcy court could not confirm any chapter 11 plan that rejected a TSA "unless and until [FERC] agrees, or the plan … is made contingent on [FERC] approval."

In November 2020, FERC issued another order in which it found "that the public interest does not presently require the modification or abrogation of the [GEC] TSAs," because the rates "currently on file and in effect remain just and reasonable" under the *Mobile–Sierra* doctrine, which creates a rebuttable presumption that a rate set by a freely negotiated wholesale-energy contract meets the "just and reasonable" requirement of the NGA and the FPA. FERC also directed GEC to continue performing under the TSAs.

FERC later denied GEC's request for reconsideration of both orders.

On November 13, 2020, GEC filed for chapter 11 protection in the Southern District of Texas. It then filed a motion to reject the TSAs with Rover.

In January 2021, GEC appealed FERC's orders to the Fifth Circuit. *See* 15 U.S.C. § 717r(b) (permitting the federal circuit court in the circuit where a natural-gas company is located or has its principal place of business to hear an appeal of a FERC order).

In the meantime, GEC pursued its rejection motion in the bankruptcy court. Rover argued that the bankruptcy court "lacked exclusive subject matter jurisdiction over [Gulfport's] rejection request" because FERC had already asserted jurisdiction. It also moved to withdraw the reference of the rejection motion to the district court for an initial decision.

The bankruptcy court blasted Rover for "obtaining an advisory order from FERC" to obstruct and "avoid the Court's proper exercise of its jurisdiction over [the] pure bankruptcy matter" of rejection. "Th[at] tactic and associated arguments," the bankruptcy court wrote, "have been repeatedly rejected and are contrary to established Fifth Circuit precedent."

The district court withdrew the reference of the rejection motion in January 2021.

The bankruptcy court confirmed GEC's chapter 11 plan over Rover's objections in April 2021, and the company emerged from bankruptcy the following month.

Nearly a year later, the Fifth Circuit handed down its ruling in *Ultra*.

In July 2022, the *Gulfport Energy* district court returned GEC's motion to reject the Rover TSAs to the bankruptcy court, stating that "the bankruptcy court has authority [under *Mirant* and *Ultra*] to reject [the TSAs] without conflicting with FERC's authority to regulate filed rates."

### THE FIFTH CIRCUIT'S RULING IN GULFPORT ENERGY

The Fifth Circuit first determined that it had jurisdiction to hear GEC's January 2021 appeal of FERC's orders.

The Fifth Circuit then ruled that, although "FERC did have authority to issue the orders" because it "gave rational reasons for finding that its orders would remove uncertainty," the orders must be vacated because they "rested on an inexplicable misunderstanding of rejection" and were therefore "unlawful."

The Fifth Circuit explained that FERC's "ambitious" orders concluding that rejection could not be authorized without FERC's consent and directing GEC to continue performing under the Rover TSAs were "wrong" because they "assume[d] that rejecting a contract changes or cancels the obligations under that contract." That assumption, the Fifth Circuit wrote, "flouts the Bankruptcy Code, Supreme Court precedent, and the caselaw of every federal circuit."

The Fifth Circuit explained that, in accordance with section 365(g) of the Bankruptcy Code and the U.S. Supreme Court's ruling in *Mission Product Holdings, Inc. v. Tempnology, LLC*, 139 S. Ct. 1652 (2019), the rejection of a contract does not change or rescind it, but results in a breach excusing the debtor's performance and entitling the counterparty to a claim for damages. As such, the breach of the TSAs resulting from GEC's rejection of the contracts would entitle Rover to a claim for damages valued at the filed rate, but did not "change the contracts' terms or the filed rate itself."

According to the Fifth Circuit, "we have twice rejected" FERC's "bizarre view" that the consequences of rejection of filed-rate contracts should be viewed differently than the consequences rejection of other executory contracts, "and we reject it again today" because it "patently contradicts the [Bankruptcy] Code's text and established interpretation.

The Fifth Circuit also rejected Rover's arguments that: (i) *Mirant* and *Ultra* do not apply because the court was reviewing FERC, rather than bankruptcy court, orders; (ii) FERC's orders should remain undisturbed because the commission completed its administrative process before GEC filed for bankruptcy; and (iii) the Supreme Court overruled *Mirant* and *Ultra* in *Mission Product* because the *Mirant* court premised its conclusion that rejecting a filed-rate contract merely breaches the contract upon the "negative inference" that provisions of the Bankruptcy Code governing the rejection of an executory contract do not require the input of regulatory commissions like FERC.

According to the Fifth Circuit, the distinction between FERC and bankruptcy court orders was meaningless given FERC's "powerlessness to require continued performance of a rejected contract." For the same reason, it noted, the timing of FERC's orders was irrelevant. Finally, the court explained, Rover misconstrued *Mission Product*, which confirmed the rationale in *Mirant* and *Ultra* by dismissing a different "negative inference"—that lawmakers, by enumerating exceptions in the Bankruptcy Code to the rule that rejection results in breach rather than abrogation or modification of a contract, abandoned the rule.

Because FERC's action was "not in accordance with law," the Fifth Circuit stated, it vacated all of its orders.

## NEWSWORTHY

***Jones Day*** has been ranked among the "Fearsome Foursome"—the law firms that clients would least like to see as opposing counsel—in the BTI Litigation Outlook 2023 report, published in October 2022 by the BTI Consulting Group, Inc. This is the ninth time and third consecutive year that Jones Day has been named to the elite list. The report is based on feedback from senior in-house legal decision-makers.

***Carl E. Black*** ***(Cleveland)*** has been selected to become a Fellow in the American College of Bankruptcy. The induction ceremony will take place in March 2023 in Washington, D.C.

***Ben Larkin*** ***(London)*** was ranked among the premier lawyers in Britain in the field of Restructuring/Insolvency in the 2023 edition of *Chambers UK: A Client's Guide to the UK Legal Profession*.

On October 26, 2022, ***Jones Day*** announced that ***Amanda S. Rush*** **(Dallas)**, ***Nicholas J. Morin*** **(New York)**, ***Daniel B. Prieto*** ***(Dallas)***, and ***Genna Ghaul*** ***(New York)*** will be admitted as of January 1, 2023, to the partnership in the Firm's Business Restructuring & Reorganization practice.

On November 7, 2022, ***Jones Day*** welcomed Gary L. Kaplan to the Firm as a partner in the Business Restructuring & Reorganization Practice, resident in the New York Office.

An article written by ***Jane Rue Wittstein*** ***(New York)*** and ***Mark G. Douglas*** ***(New York)*** titled "Fifth Circuit: District Court Improperly Referred Bankruptcy Appeal to Magistrate Judge for Final Determination" was posted in September 2022 on *Lexis Practical Guidance*.

An article written by ***Oliver S. Zeltner*** ***(Cleveland)*** and ***Mark G. Douglas*** ***(New York)*** titled "Third Circuit Sets Standard for Appointment of Future Claims Representatives in Asbestos Bankruptcy Cases" was posted in September 2022 on *Lexis Practical Guidance*.

An article written by ***Brad B. Erens*** ***(Chicago)*** and ***Mark G. Douglas*** ***(New York)*** titled "Delaware Supreme Court: No 'Common Law Insolvency Exception'" was posted in September 2022 on *Lexis Practical Guidance*.

An article written by ***Daniel B. Prieto*** ***(Dallas)*** and ***Mark G. Douglas*** ***(New York)*** titled "Seventh Circuit: Secured Creditor that Participated in Chapter 11 Case Bound by Terms of Confirmed Plan that Extinguished Lien" was posted in September 2022 on *Lexis Practical Guidance*.

An article written by ***Corinne Ball*** ***(New York)*** titled "Court Defers to Debtor's Business Judgment on Lease Rejection, Even When Rejection Occurs at the Direction of the Purchaser of Its Assets" was published on October 26, 2022, in *New York Law Journal*.


## BUSINESS RESTRUCTURING REVIEW

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