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BUSINESS RESTRUCTURING REVIEW

THE YEAR IN BANKRUPTCY: 2022

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One year ago, we wrote that, in early 2021, it was widely anticipated that the unprecedented pressure the COVID-19 pandemic brought to bear on the U.S. economy would lead to a boom in corporate bankruptcy filings. That boom never materialized. Instead, business bankruptcy filings in the U.S. plummeted in 2021. That trend continued until the last quarter of 2022. At that time, the volume of business bankruptcies began to swell due to a maelstrom of factors, including the persistence of the pandemic (especially in China, where vaccination rates are low and the population has little resistance due to strict lockdown protocols); the highest inflation in 40 years; spiking interest rates that put an end to the most recent era of cheap financing and lenders' willingness to forbear or extend loan maturities; supply-chain disruptions; and high energy costs caused in part by the war in Ukraine. Predictions of yet another recession loomed large at the end of 2022.

In the corporate bankruptcy world, 2022 will be remembered for the "crypto winter" that descended in November with the spectacular collapse of FTX Trading Ltd., Alameda Research and approximately 130 other affiliated companies. In a domino effect, the FTX bankruptcy ignited the meltdown of many other platforms, exchanges, lenders and mining operations because they did business with FTX.

The year 2022 will also be remembered for the continuing controversy over the legitimacy of seeking bankruptcy protection as a way to deal with mass-tort liabilities in chapter 11 plans that release company owners and other insiders from liability as a quid pro quo for funding payments to creditors. Other memorable developments in 2022 included the right-sizing woes of the tech sector, including industry giants Amazon, Meta and Twitter, the increasing incidence of "creditor-on-creditor" litigation in bankruptcy, and the tax-driven year-end rush to liquidate special purpose acquisition companies (SPACs), effectively marking an end to the "blank-check" company gold rush that peaked in 2021.

BUSINESS BANKRUPTCY FILINGS

According to data provided by Epiq Bankruptcy, a leading provider of U.S. bankruptcy filing data, commercial bankruptcy filings declined in 2022 by five percent, from 22,561 in 2021 to 21,396 last year. Commercial chapter 11 filings, however, increased two percent to 3,816 in 2022 from the previous year's total of 3,726. By contrast, in 2020, there were 32,517 commercial bankruptcy filings, of which 7,129 were chapter 11 cases. Small business debtor

IN THIS ISSUE

1 The Year In Bankruptcy: 2022

2 Lawyer Spotlight: Genna Ghaul and Nicholas J. Morin

9 First Impressions: The Eleventh Circuit Examines 20-Day Administrative Expense Claims and the Subsequent New Value Preference Defense

14 *Sears Holding*: A Case Study in Valuing Collateral in Chapter 11

18 Appeal of Unstayed Order Approving Bankruptcy Sale of Real Property Free and Clear of Lease and Related Settlement Agreement Dismissed as Moot

22 Fifth Circuit: Bad Faith Does Not Overcome Deferential Business Judgment Standard Applied to Assumption or Rejection of Contracts in Bankruptcy

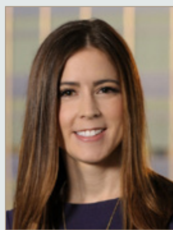
25 Default Under Assumed Lease Need Not Be Material or Ongoing to Trigger Landlord's Entitlement to Adequate Assurance of Future Performance

28 Acceleration Enforceable Under State Law Following Non-Monetary ControlCovenant Default Prevents Reinstatement of Loan Under Chapter 11 Plan

31 Newsworthy

LAWYER SPOTLIGHT: GENNA GHAUL AND NICHOLAS J. MORIN

Jones Day welcomed 45 new partners to the Firm in January 2023, including Genna Ghaul and Nicholas ("Nick") J. Morin, both members of the Business Restructuring & Reorganization Practice.

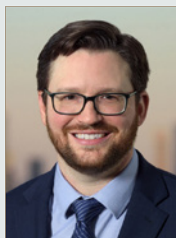

Genna Ghaul

Genna, a former Jones Day summer associate who joined the Firm's New York Office in 2014, represents clients in chapter 11 proceedings, out-of-court restructurings, section 363 sales and other distressed transactions, bankruptcy litigation, and mass tort matters. She has served clients in the retail, energy, automotive, mining, and telecom industries.

Genna currently represents Jefferies Finance LLC, as DIP agent, DIP lender, and stalking horse bidder, in the chapter 11 cases of cosmetics company Forma Brands before the Bankruptcy Court for the District of Delaware. Genna also represents LTL Management, a Johnson & Johnson affiliate, in its chapter 11 case before the Bankruptcy Court for the District of New Jersey. Her past and present debtor representations include SHL Liquidation Industries (f.k.a. Shiloh Industries), Aldrich Pump and Murray Boiler, DBMP, GUE Liquidation Companies (f.k.a. FTD Companies), American Apparel, M&G USA Corporation, Transtar Holding Company, and Nextel (NII Holdings). Past creditor representations include the purchaser of the assets of The Bon-Ton Department Stores, the 1.5 Lien Noteholders of Hexion, and the term loan lenders in rue21 and Seventy Seven Energy's chapter 11 cases.

Prior to joining the Firm, Genna was a law clerk to the Honorable Robert E. Gerber, U.S. Bankruptcy Court, Southern District of New York (2013–2014). According to Genna, "It was when I clerked for Judge Gerber following law school and experienced first-hand the role that bankruptcy plays in our legal system and in restructuring distressed companies that I knew I wanted to pursue a career in bankruptcy law. I was initially drawn to Jones Day as a summer associate to become an antitrust lawyer, but fortunately for me, the Firm also had a preeminent bankruptcy practice that welcomed me with open arms."

Genna maintains an active pro bono practice, representing clients in immigration matters, family court proceedings, and before the Bankruptcy Court for the Eastern District of New York.


Nicholas J. Morin

Nick, who joined the Firm's New York Office in 2015, has substantial experience in both transactional and litigation legal work, primarily representing financially distressed companies or their lenders.

He has represented numerous creditor groups in various restructurings, including creditors of: Intelsat (represented group of holders of secured and unsecured debt in restructuring of $15 billion of funded debt in two-year chapter 11 case); Syncreon (represented group of secured lenders in restructuring of $1 billion of funded debt in UK scheme proceeding and related chapter 15 case); Sungard AS (represented group of term loan lenders in restructuring of $1.2 billion of funded debt in a two-day chapter 11 case); David's Bridal (represented group of term loan lenders in restructuring of $800 million of funded debt); and Bon-Ton (represented group of second lien noteholders in $125 million credit bid to acquire rights in company's assets).

Nick also has represented many companies in distressed situations, including Peabody Energy (in restructuring more than $8 billion of funded debt through chapter 11 plan); M&G USA Corporation (in the sale of assets for more than $1 billion); and Rex Energy (in the sale of assets for more than $600 million).

In addition, Nick has been involved in high-stakes, insolvency-related litigation, including successfully obtaining the dismissal of fraudulent conveyance claims asserting $450 million in damages.

chapter 11 cases under subchapter V also increased in calendar year 2022—the 1,433 filings represented a 13 percent jump from the 1,263 filings recorded in 2021. Epiq also reported that total individual bankruptcy filings in 2022 were at their lowest level since 1985, suggesting that extensive government pandemic relief may have ameliorated financial distress for many individuals.

Data available on legal-research platform Westlaw show that 4,271 chapter 11 cases (business and non-business) were filed in 2022, compared to 4,143 in 2021, and 7,330 in 2020. According to data available from financial research company The Deal Pipeline, 112 companies with liabilities exceeding $50 million filed for chapter 7, 11 or 15 bankruptcy in 2022, compared to 114 in 2021. Chapter 11 filings by companies with at least $1 million in debt numbered 338 in 2022, compared to 378 in 2021.

Reorg, a global provider of credit intelligence, data, and analytics, reported that 2022 business chapter 11 filings in the industrials sector increased steeply (approximately 34% from 2021 levels), health care cases rose by 32%, and consumer staples filings doubled their 2021 levels. For cases with more than $100 million of liabilities, filings in the financials sector increased by 175%, with a wave of crypto bankruptcies in the latter part of the year. Reorg data also show that the sectors that fell the most from 2021 were consumer discretionary, communications, energy, real estate, and utilities.

The Deal Pipeline and Westlaw data indicate that chapter 15 petitions were filed in 2022 on behalf of 88 foreign debtors (including 19 businesses with at least $1 million in debt), compared to 165 foreign debtors (including four businesses with at least $1 million in debt) in 2021. Only two municipalities filed for chapter 9 protection in 2022, compared to three in 2021.

There were 18 billion-dollar (by debt) business chapter 11 filings in 2022, compared to 15 in 2021. Chapter 15 petitions were filed on behalf of seven foreign companies with liabilities of at least $1 billion in 2022.

2022 Some of the most notable business bankruptcy filings included:

- Cryptocurrency company FTX Trading Ltd., which filed for chapter 11 protection on November 11, 2022, following a loss of faith in the platform and a resulting liquidity crunch.
- Cineworld Group plc (d/b/a Regal Entertainment), the world's second-largest theater chain after AMC Theaters, which filed for chapter 11 protection on September 7, 2022, with more than $10 billion in both assets and debt, having failed to rebound from the pressure inflicted by the pandemic and a massive debt load.
- Core Scientific Inc., one of the largest U.S.-listed bitcoin miners, which filed for chapter 11 protection in the fall out from the FTX collapse on December 21, 2022, with $1.4 billion in assets and $1.3 billion in debt.
- American International Group Inc. subsidiary AIG Financial Products Corp., which filed for chapter 11 protection on December 14, 2022, with $152 million in assets and $37.9 billion in legacy liabilities stemming from the 2008-09 financial crisis.
- Financial services and consumer lending company Reverse Mortgage Investment Trust Inc., which filed for chapter 11 protection on November 30, 2022 with $10 billion in both assets and debt due to rising interest rates and overall volatility in the fixed-income and mortgage markets.
- Cryptocurrency lender BlockFi Inc., the first major bankruptcy spawned by the sudden collapse of FTX. BlockFi filed for chapter 11 protection on November 28, 2022, listing $1 billion in both assets and debt.
- Sports and energy-beverage provider Vital Pharmaceuticals Inc. (d/b/a VPX Sports), which filed for chapter 11 protection on November 10, 2022, after it was ordered to pay $293 million in damages to Monster Beverage Corp. for interfering with Monster's dealings with retailers and falsely advertising the mental and physical benefits of Bang Energy drinks.
- Medical imaging supply company Carestream Health Inc., which filed for chapter 11 protection on August 23, 2022, with $2.3 billion in assets and $1.5 billion in debt, to implement a pre-negotiated chapter 11 plan that wiped $470 million in debt from its balance sheet.
- Healthcare and pharmaceuticals company Endo International plc, which filed for chapter 11 protection on August 16, 2022, with $6.3 billion in assets and $9.5 billion in debt, to end a multiyear effort to resolve opioid liabilities.
- Cryptocurrency lender Celsius Network LLC, which filed for chapter 11 protection on July 13, 2022, with $10.7 billion in assets and $10.2 billion in debt, roughly a month after suspending customer withdrawals.
- Scandinavian air carrier SAS AB, which filed for chapter 11 protection on July 5, 2022, with $2.5 billion in assets and $3.5 billion in debt, to complete a restructuring in the wake of the Covid-19 pandemic.
- Cosmetics giant Revlon Inc., which filed for chapter 11 protection on June 15, 2022, with $2.3 billion in assets and $3.7 billion in debt, as it grappled with an onerous debt load and supply chain problems.
- Power plant owner Talen Energy Supply LLC, which filed for chapter 11 protection on May 5, 2022, with $4.1 billion in assets and $9.3 billion in debt, due to volatile weather patterns, commodity and fuel pricing challenges and unsupportable debt.

Notable bankruptcy exits in 2022 included Lehman Brothers Inc., whose liquidation proceeding under the Securities Investor Protection Act—the largest bankruptcy filing ever in U.S. history—finally came to a close 14 years after the 2008-09 financial crisis. On March 15, 2022, Puerto Rico ended its nearly five-year bankruptcy, as the commonwealth successfully restructured $22 billion of debt.

NOTABLE BUSINESS BANKRUPTCY DECISIONS IN 2022

Bankruptcy Asset Sales. Until 2022, only two federal courts of appeals had weighed in on whether real property may be sold in bankruptcy free and clear of a leasehold interest. In *Precision Industries, Inc. v. Qualitech Steel SBQ*, 327 F.3d 537 (7th Cir. 2003), the U.S. Court of Appeals for the Seventh Circuit held that a real property lease can be extinguished in a free-and-clear bankruptcy sale. In *In re Spanish Peaks Holding II, LLC*, 872 F.3d 892 (9th Cir. 2017), the U.S. Court of Appeals for the Ninth Circuit essentially endorsed this position, with certain caveats. The U.S. Court of Appeals for the Fifth Circuit was the latest circuit court to examine this issue, but in an oblique way. In *In re Royal Street Bistro, L.L.C.*, 26 F.4th 326 (5th Cir. 2022), the court denied certain tenants' motion for a writ of mandamus directing a district court to issue a stay pending appeal of a bankruptcy court order approving the sale of leased real property free and clear of the tenants' leasehold interests. However, the Fifth Circuit agreed with the result reached by the lower courts, but cautioned courts against "blithely accepting *Qualitech*'s reasoning and textual exegesis."

In *Archer-Daniels-Midland Co. v. Country Visions Cooperative*, 29 F.4th 956 (7th Cir. 2022), the U.S. Court of Appeals for the Seventh Circuit examined the scope of 363(m) of the Bankruptcy Code, which prohibits reversal or modification on appeal of an order approving a sale of assets in bankruptcy to a good-faith purchaser unless the party challenging the sale obtains a stay pending appeal. The Seventh Circuit affirmed lower court rulings denying a motion by a buyer of bankruptcy estate property to bar an entity holding a right of first refusal on the property purchased from the debtor "free and clear" of all interests pursuant to section 363(f) from continuing state court litigation seeking to enforce its right. According to the Seventh Circuit, because the buyer had actual and constructive knowledge of a right of first refusal held by a party who had not received notice of the bankruptcy, yet never informed the bankruptcy court, the buyer had not acted in good faith and was not entitled to the protections of section 363(m).

Bankruptcy Discharge. In *In re U.S. Pipe & Foundry Co.*, 32 F.4th 1324 (11th Cir. 2022), a divided three-judge panel of the U.S. Court of Appeals for the Eleventh Circuit ruled that certain debtors' alleged obligation to pay retiree health benefits mandated by the Coal Industry Retiree Health Benefit Act of 1992 were discharged in 1995 upon the confirmation of a chapter 11 plan, even though the payment obligation was not triggered until 2016. According to the majority, the payment obligation was a "claim" in 1995 and was therefore discharged upon confirmation of the debtors' plan.

Chapter 11 Plans. In *In re LATAM Airlines Grp. S.A.*, 2022 WL 2206829 (Bankr. S.D.N.Y. June 18, 2022) (unpublished opinion), *corrected*, 2022 WL 2541298 (Bankr. S.D.N.Y. July 7, 2022), *aff'd on other grounds*, 643 B.R. 741 (S.D.N.Y. 2022), *aff'd*, 2022 WL 17660057 (2d Cir. Dec. 14, 2022), the U.S. Bankruptcy Court for the Southern District of New York overruled an objection to confirmation of a chapter 11 plan based on, among other things, the debtors' alleged violation of the Bankruptcy Code's chapter 11 plan solicitation requirements by entering into agreements with certain creditors, prior to the court's approval of a disclosure statement, that obligated them to vote in favor of a plan in exchange for allowance of their claims. According to the court, even if those plan support agreements were improper, the only remedy for the violation was disallowance of the creditors' votes, which would not change the outcome of the voting process. Both the district court and the Second Circuit affirmed the decision on appeal, albeit on other grounds (discussed below).

Cross-Border Bankruptcy Cases. In *In re Black Gold S.A.R.L.*, 2022 WL 488438 (B.A.P. 9th Cir. Feb. 17, 2022), a Bankruptcy Appellate Panel for the Ninth Circuit (the "BAP") held that the judicially created "good faith" filing requirement for chapter 11 cases does not apply to a petition seeking recognition of a foreign bankruptcy under chapter 15 of the Bankruptcy Code. The BAP accordingly reversed a bankruptcy court order denying chapter 15 recognition of a Monaco bankruptcy proceeding. The bankruptcy court reasoned that the petition was inconsistent with the objectives of chapter 15 because the debtor acted in bad faith by filing a chapter 15 case as a ploy to evade payment of a judgment and shield its principals from tort liability. On appeal, according to the BAP, once the Bankruptcy Code's requirements for chapter 15 recognition are satisfied, recognition is mandatory unless it would be "manifestly contrary" to U.S. public policy—a threshold that is rarely met in chapter 15 cases.

In *In re Talal Qais Abdulmunem Al Zawawi*, 637 B.R. 663 (M.D. Fla. 2022), *appeal filed*, No 22-11024 (11th Cir. Mar. 31, 2022), the U.S. District Court for the Middle District of Florida affirmed a bankruptcy court ruling that chapter 15 has its own eligibility requirements, and that the eligibility requirements for debtors in cases under other chapters of the Bankruptcy Code do not apply in chapter 15 cases. In so ruling, the district court distanced itself from the Second Circuit's ruling in *In re Barnet*, 737 F.3d 238 (2d Cir. 2013), where the court of appeals held that the provision of the Bankruptcy Code requiring U.S. residency, assets, or a place of business applies in chapter 15 cases as well as cases filed under other chapters.

In *In re Modern Land (China) Co., Ltd.*, 641 B.R. 768 (Bankr. S.D.N.Y. 2022), the U.S. Bankruptcy Court for the Southern District of New York 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."

In *In re Global Cord Blood Corp.*, 2022 WL 17478530 (Bankr. S.D.N.Y. Dec. 5, 2022), the U.S. Bankruptcy Court for the Southern District of New York denied without prejudice a petition filed by the joint provisional liquidators for recognition of a proceeding commenced under the Cayman Islands Companies Act (the "Cayman CA") for the purpose of investigating allegations that a Cayman company's board and/or officers caused or allowed an improper expenditure of more than $600 million of corporate funds. According to the court, chapter 15 recognition was unwarranted because the Cayman proceeding was more akin to a corporate governance and fraud remediation effort rather than a collective proceeding for the purpose of dealing with insolvency, reorganization, or liquidation. To rule otherwise, the bankruptcy court wrote, "would be to invite recourse to U.S. bankruptcy courts whenever any foreign corporation sustains losses as a result of officer or director fraud or defalcation, so long as that corporation first commences proceedings in its home jurisdiction seeking to install new fiduciaries and right the wrong that the corporation has suffered." The court further explained that, although the Cayman CA generally establishes standards and procedures for the liquidation or winding up of insolvent companies, no such liquidation was underway when the liquidators filed their chapter 15 petition, which was "fatal" to their request for chapter 15 recognition.

Executory Contracts and Unexpired Leases. In *In re Ultra Petroleum Corp.*, 2022 WL 763836 (5th Cir. Mar. 14, 2022) ("*Ultra I*"), the U.S. Court of Appeals for the Fifth Circuit held that the bankruptcy court below properly authorized a debtor to reject a filed-rate gas transportation contract under its chapter 11 plan without obtaining the approval of the Federal Energy Regulatory Commission ("FERC") and that the debtor was not subject to a separate public-law obligation to continue performance under the rejected contract.

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 Natural Gas Act and the Federal Power Act can be rejected in bankruptcy without FERC's consent. Reaffirming its previous rulings in *In re Mirant Corp.*, 378 F.3d 511 (5th Cir. 2004), and *Ultra I* (see above), 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."

In *In re J.C. Penney Direct Marketing Services, L.L.C.*, 50 F.4th 532 (5th Cir. 2022), the U.S. Court of Appeals for the Fifth Circuit affirmed lower court rulings approving a chapter 11 debtor's decision, at the behest of the purchaser of its assets, to reject a commercial ground lease, even though an agent retained by the debtor to market its shopping center leases acted in bad faith in negotiations with a sublessee intent upon acquiring the ground lessor's interest. In so ruling, the Fifth Circuit rejected the sublessee's argument that the debtor's decision to reject the lease should not receive deference under the business judgment standard due to the agent's bad faith. According to the Fifth Circuit, in the absence of evidence that the decision to reject did not enhance the bankruptcy estate or was "clearly erroneous, too speculative, or contrary to the Bankruptcy Code," the presumption created by the business judgment rule could not be overcome. Nor, the court noted, did the sublessee demonstrate that the debtor's decision was "so manifestly unreasonable that it could not be based on sound business judgment, but only on bad faith, or whim or caprice."

In *In re Hawkeye Entertainment LLC*, 49 F.4th 1232 (9th Cir. 2022), the U.S. Court of Appeals for the Ninth Circuit ruled that, even though a default under an unexpired lease has been remedied prior to assumption or is immaterial, the landlord is nonetheless entitled to "adequate assurance of future performance." The Ninth Circuit concluded that a bankruptcy court erred in ruling otherwise, but that the error was harmless because the defaults either had been cured prior to the debtor's request to assume the lease or were "minor deviations" from the lease terms, and "any adequate assurance responsive to the alleged defaults would be little more than simple promises not to deviate from the contract terms again."

Make-Whole Premiums, Postpetition Interest on Unsecured Claims, and the Solvent-Debtor Exception. In *In re Ultra Petroleum Corp.*, 51 F.4th 138 (5th Cir. 2022) ("*Ultra II*"), the U.S. Court of Appeals for the Fifth Circuit ruled that debtors were obligated to pay a $201 million make-whole premium to noteholders under their confirmed chapter 11 plan and that the noteholders and certain other unsecured creditors were entitled to postpetition interest on their claims pursuant to the "solvent-debtor exception." In affirming a bankruptcy court's 2020 ruling, a divided three-judge panel of the Fifth Circuit held that the Bankruptcy Code disallowed 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 the case. Given the debtors' solvency, the Fifth Circuit majority also ruled that the debtors were obligated to pay postpetition interest to their noteholders and certain other unsecured creditors at the agreed-upon contractual default rate to render their claims unimpaired by the debtors' chapter 11 plan.

In *In re PG&E Corp.*, 46 F.4th 1047 (9th Cir. 2022), *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 three-judge panel of the U.S. Court of Appeals for the Ninth Circuit ruled that a solvent debtor's chapter 11 plan must pay postpetition 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 acknowledged the presumption that unimpaired creditors in a solvent chapter 11 case should receive postpetition 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).

In *In re Hertz Corp.*, Adv. Proc. No. 21-50995 (MFW) (Bankr. D. Del. Nov. 21, 2022), the U.S. Bankruptcy Court for the District of Delaware held that, examining the economic substance of a transaction rather than the formalistic labels given to it, a "redemption price" payable to unsecured noteholders upon default or early repayment must be disallowed as unmatured interest under section 502(b)(2). The court also declined to reconsider, in light of *PG&E* and *Ultra II*, its previous decision in *In re Hertz Corp.*, 637 B.R. 781 (Bankr. D. Del. 2021), that the solvent-debtor exception only partially survived enactment of the Bankruptcy Code. According to the court, the exception survives only if a secured creditor is oversecured, a chapter 7 debtor is solvent, or an impaired creditor does not accept a chapter 11 plan. In the same opinion, the court certified a direct appeal of its ruling to the Third Circuit.

In *In re LATAM Airlines Grp. S.A.*, 2022 WL 2206829 (Bankr. S.D.N.Y. June 18, 2022), *corrected*, 2022 WL 2541298 (Bankr. S.D.N.Y. July 7, 2022), *aff'd*, 643 B.R. 741 (S.D.N.Y. Aug. 31, 2022), *aff'd*, 2022 WL 17660057 (2d Cir. Dec. 14, 2022), the U.S. Bankruptcy Court for the Southern District of New York ruled that: (i) unsecured creditors were not impaired under a chapter 11 plan that did not provide for the payment of postpetition interest on their claims because section 502(b)(2) of the Bankruptcy Code (disallowing claims for unmatured interest), rather than the plan, altered their legal, equitable, or contractual rights under applicable bankruptcy law and their debt instruments; and (ii) the solvent-debtor exception survived the enactment of the Bankruptcy Code, but because the debtor was insolvent, unsecured creditors were not entitled to postpetition interest under the exception.

Both the district court and the Second Circuit affirmed the ruling on appeal. The district court noted 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. The Second Circuit similarly found no fault with the bankruptcy court's reasoning. Like the Third, Fifth, and Ninth Circuits, the Second Circuit ruled—as a matter of first impression—that postpetition interest is barred by the Bankruptcy Code itself and that creditors can claim impairment "only when the plan of reorganization, rather than the Code [here, section 502(b)(2)], alters the creditor's legal, equitable, or contractual rights." The Second Circuit also ruled as a matter of first impression that that the solvent-debtor exception survived the enactment of the Bankruptcy Code. It was the third circuit court of appeals to do so in 2022.

In *In re RGN-Grp. Holdings, LLC*, 2022 WL 494154 (Bankr. D. Del. Feb. 17, 2022), the U.S. Bankruptcy Court for the District of Delaware agreed with the rationale articulated in *Hertz* (discussed above), in ruling that the solvent-debtor exception survived the enactment of the Bankruptcy Code only to a limited extent. The court held that a landlord was entitled to postpetition interest on its allowed unsecured claim, but at the federal judgment rate rather than the contract rate.

In *In re Moore & Moore Trucking, LLC*, 2022 WL 120189 (Bankr. E.D. La. Jan. 12, 2022), the U.S. Bankruptcy Court for the Eastern District of Louisiana held 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.

Mass Tort Chapter 11 Cases. In *In re Imerys Talc America, Inc.*, 38 F.4th 361 (3d Cir. 2022), the U.S. Court of Appeals for the Third Circuit ruled as a matter of first impression that a future claims representative ("FCR") in an asbestos chapter 11 case must be more than merely a "disinterested person"—the standard applied to some professional retentions in bankruptcy. Instead, like the members of official creditors' committees, an FCR must be not only free of conflicts of interest but also fulfill fiduciary duties to future claimants, including duties of undivided loyalty and honesty.

In *In re LTL Mgmt., LLC*, 637 B.R. 396 (Bankr. D.N.J. 2022), *direct appeal certified*, No. 22-2003 (3d Cir. May 11, 2022) (oral argument on Sept. 19, 2022), the U.S. Bankruptcy Court for the District of New Jersey denied motions to dismiss the chapter 11 case of LTL Management LLC ("LTL"), an indirect subsidiary of Johnson & Johnson that filed for bankruptcy to manage thousands of claims against LTL's predecessor-in-interest alleging that Johnson's® Baby Powder caused ovarian cancer and/or mesothelioma. In denying the dismissal motions, the bankruptcy court: (i) determined that bankruptcy provides the optimal forum to resolve the mass tort liability at issue; and (ii) found that the implementation of a "Texas Two-Step" divisional merger prior to the bankruptcy filing did not harm talc claimants. Despite a series of objections by representatives for talc claimants, the bankruptcy court ruled that LTL filed its chapter 11 case in good faith—and not as an improper litigation tactic—and concluded that, as compared with the U.S. tort system, bankruptcy offers both present and future LTL talc claimants the best opportunity to obtain equitable and timely recoveries.

Jones Day represents LTL in its chapter 11 case.

Valuation. In *In re Sears Holding Corp.*, 51 F.4th 53 (2d Cir. 2022), the U.S. Court of Appeals for the Second Circuit examined collateral valuation in a chapter 11 case for the purpose of determining whether junior secured creditors were entitled to super-priority administrative claims to compensate them for alleged diminution in the value of their collateral during the period from the bankruptcy petition date until the bankruptcy court approved a sale of the debtors' business as a going concern. The Second Circuit held that, given the uncertainty surrounding the retail debtors' fate at the time they filed for bankruptcy, the bankruptcy court did not err in valuing inventory collateral at its "net orderly liquidation value," rather than book value, going-out-business sale value, or forced liquidation value. The Second Circuit also found no fault with the bankruptcy court's decision to value non-borrowing base inventory at zero and to ascribe full face value to undrawn letters of credit where, among other things, the junior lenders failed to meet their evidentiary burden of suggesting a reasonable alternative.

2022 U.S. Supreme Court Bankruptcy Roundup. In *Siegel v. Fitzgerald*, 142 S. Ct. 1770 (2022), the U.S. Supreme Court held unconstitutional certain aspects of a 2017 amendment to 28 U.S.C. § 1930(a)(6) (the "2017 amendment") that dramatically increased the quarterly fees charged by the United States Trustee ("UST") in chapter 11 cases. When Congress created the UST program in the mid-1980s, it established the program in only 88 of the 94 judicial districts across the country ("UST districts"). In the six judicial districts in North Carolina and Alabama ("BA districts"), however, Congress continued to allow bankruptcy cases to be administered by Bankruptcy Administrators ("BAs"), which comprise a department of the Judicial Branch and overseen by the Judicial Conference.

In 2017, Congress sought to address funding problems with the UST program by enacting the 2017 amendment, which raised the quarterly fees payable by large chapter 11 debtors in UST districts by more than 700%. In UST districts, the amended fee structure took effect in both new and pending chapter 11 cases on January 1, 2018. However, in the six BA districts, the fees did not take effect until the Judicial Conference adopted them in September 2018. And, even then, the Judicial Conference decided to apply the fees only prospectively for new chapter 11 cases filed after October 1, 2018. As a result, debtors whose cases were filed in a UST district prior to October 1, 2018, were required to pay significantly higher quarterly fees than they would have if their cases were pending in a BA district.

Several debtors in various UST districts challenged the 2017 amendment, arguing that, among other things, by making debtors in UST districts pay significantly higher fees than similarly situated debtors in BA districts, the 2017 amendment violated the Constitution's requirement that bankruptcy laws be geographically uniform throughout the country. The Fourth, Fifth, and Eleventh Circuits rejected the debtors' uniformity arguments, but the Second and Tenth Circuits agreed with the debtors and ordered a refund of fees. The Supreme Court granted certiorari in *Siegel* to resolve the circuit split.

In a 9–0 decision, the Supreme Court determined that the 2017 amendment violated Congress's constitutional authority under the "Bankruptcy Clause ... to establish 'uniform Laws on the subject of Bankruptcies throughout the United States.' U.S. Const., Art. I, § 8, cl. 4." The Court stated that, while "[t]he Bankruptcy Clause affords Congress flexibility to 'fashion legislation to resolve geographically isolated problems,' ... the Clause does not permit Congress to treat identical debtors differently based on an artificial funding distinction that Congress itself created."

The Supreme Court did not decide whether chapter 11 debtors were entitled as a remedy to refunds for overpayments of quarterly fees to the UST program. Even though the Court agreed to review appeals in several other cases addressing the issue, it remanded the cases below to decide the remedy.

Guided by *Siegel*, the U.S. Court of Appeals for the Tenth Circuit adhered to its original decision by holding in *In re John Q. Hammons Fall 2006 LLC*, 2022 WL 3354682 (10th Cir. Aug. 15, 2022), *petition for rehearing filed*, No. 20-3203 (10th Cir. Oct. 31, 2022), that the UST must pay a refund to a chapter 11 debtor based on what the debtor would have paid over the same time were its case in a BA district. The U.S. Court of Appeals for the Second Circuit came to the same conclusion shortly afterward in *In re Clinton Nurseries, Inc.*, 53 F.4th 15 (2d Cir. 2022). Other cases regarding the proper remedy are working their way through various bankruptcy and lower appellate courts. *See, e.g., Siegel v. U.S. Trustee Program (In re Circuit City Stores, Inc.)*, 2022 WL 17722849 (Bankr. E.D. Va. Dec. 15, 2022) (holding that the trustee of a chapter 11 liquidating trust is entitled to a refund for overpayment of unconstitutional UST fees).

In *Kirschner v. Fitzsimons*, 2022 WL 516021 (U.S. Feb. 22, 2022), the U.S. Supreme Court denied a petition seeking review of a 2021 ruling by the Second Circuit that largely upheld lower court dismissals of claims asserted by the chapter 11 liquidation trustee of media giant The Tribune Co. ("Tribune") against various shareholders, officers, directors, employees, and financial advisors for, among other things, avoidance and recovery of fraudulent and preferential transfers, breach of fiduciary duties, and professional malpractice in connection with Tribune's failed 2007 leveraged buy-out.

In *Citibank, N.A. v. Picard*, 142 S. Ct. 1209 (2022), the Court denied a petition seeking review of a 2021 ruling by the Second Circuit reviving litigation filed by the Securities Investor Protection Act trustee administering the assets of defunct investment firm Bernard L. Madoff Inv. Sec. LLC ("MIS"), seeking to recover hundreds of millions of dollars in allegedly fraudulent transfers made to former MIS customers and certain other defendants as part of the Madoff Ponzi scheme. The Second Circuit ruling vacated a 2019 bankruptcy court ruling, in which the bankruptcy court dismissed the trustee's claims against certain defendants because the trustee failed to allege that the defendants had not received the transferred funds in "good faith." The Second Circuit's ruling, which involved test cases for approximately 90 dismissed actions, breathed new life into avoidance litigation seeking recovery of $3.75 billion from global financial institutions, hedge funds, and other participants in the global financial markets.

In *Estate of Fontana v. ACFB Administração Judicial Ltda.-ME*, 142 S. Ct. 1229 (Mar. 7, 2022), the Court denied a petition seeking review of a 2021 decision by the U.S. Court of Appeals for the Eleventh Circuit regarding the finality of a discovery order in a chapter 15 case. The Eleventh Circuit held in a nonprecedential ruling that an order denying a request to quash a subpoena in the chapter 15 case of a Brazilian airline was not final and could not be appealed immediately because the order was "merely a preliminary step" in the context of a broader proceeding. In *dicta*, however, the Eleventh Circuit appeared to limit its ruling to the facts before it and noted that if the only purpose of the chapter 15 case is to obtain discovery, a discovery order may be final and immediately appealable because the discovery order is effectively the entire proceeding.

On June 6, 2022, the Court declined to review an Eleventh Circuit decision dismissing, under the doctrines of constitutional and equitable mootness, appeals of bankruptcy court orders disallowing through estimation a secured claim and confirming a chapter 11 plan. *See KK-PB Financial LLC v. 160 Royal Palm LLC*, 142 S.Ct. 2778 (2022).

On June 27, 2022, the Court granted a petition to review the Second Circuit's 2021 decision dismissing an appeal brought by Mall of America ("MOA") challenging the bankruptcy court's order approving the assignment of MOA's lease to the purchaser of bankrupt retailer Sears Holdings Corp.'s assets. *See In re Sears Holdings Corp.*, 2021 WL 5986997 (2d Cir. Dec. 17, 2021), *cert. granted*, 142 S. Ct. 2867 (2022). In its decision, the Second Circuit agreed with the district court below, which concluded that MOA's appeal was moot under section 363(m) of the Bankruptcy Code because it failed to obtain a stay of the bankruptcy court order approving the assignment. The Court heard argument in the case on December 5, 2022.

On October 11, 2022, the Court declined to hear an appeal seeking to reverse a January 2022 decision by the U.S. Court of Appeals for the Second Circuit reviving a racketeering suit in which Jay Alix ("Alix") accused McKinsey & Co. ("McKinsey") of intentionally failing to disclose disqualifying conflicts of interest in large bankruptcy cases. *See McKinsey & Co. v. Jay Alix*, 2022 WL 6572113 (U.S. Oct. 11, 2022). The Second Circuit reversed a lower court order that dismissed Alix's racketeering claims, finding that Alix had plausibly alleged that his firm lost business to McKinsey and was harmed by McKinsey's allegedly inadequate conflict-of-interest disclosures provided to bankruptcy courts.

On November 21, 2022, the Court declined to hear an appeal by Puerto Rican teachers challenging the changes made to their pension benefits by the island territory's restructuring plan under the Puerto Rico Oversight, Management, and Economic Stability Act ("PROMESA"). *See Federación de Maestros de Puerto Rico, Inc. et al. v. Financial Oversight and Management Board for Puerto Rico*, 2022 WL 17085185 (U.S. Nov. 21, 2022). Under the prior pension plans, retirees were promised definite payments, while the new plan pledged only certain levels of contributions to employees' retirement accounts, much like 401(k) retirement plans. In April 2022, the U.S. Court of Appeals for the First Circuit held that Congress enabled the board pursuant to PROMESA to preempt Commonwealth laws calling for forward-going teachers' pension obligations under existing retirement regime.

BANKRUPTCY LEGISLATIVE AND REGULATORY DEVELOPMENTS IN 2022

On June 21, 2022, President Joe Biden signed into law the "Bankruptcy Threshold Adjustment and Technical Corrections Act" (S. 3823 and H.R. 7494), which, among other things, raised for

an additional two years the debt limit (now $7.5 million) for small businesses electing to file for bankruptcy under subchapter V of chapter 11.

Various amendments to the Federal Rules of Bankruptcy Procedure went into effect on December 1, 2022. A more detailed discussion of the changes is available here.

Several pieces of business bankruptcy legislation were proposed in 2022, but never enacted, including:

- The "Stop Looting American Pensions Act of 2022" or the "SLAP Act" (S. 5097), which would have amended the Bankruptcy Code to: (i) require an employer to continue satisfying the minimum pension plan funding requirement specified in the Employee Retirement Income Security Act of 1974 ("ERISA") during a bankruptcy case unless the Secretary of the Treasury waived the requirement; (ii) confer administrative expense priority on unpaid pension minimum funding obligations as well as pension plan withdrawal liability arising under ERISA; (iii) except from the automatic stay actions by the Pension Benefit Guaranty Corporation to enforce ERISA's minimum pension plan funding requirements; (iv) preclude bankruptcy asset sales unless either: (a) each class of creditors has approved the sale or is unimpaired; or (b) the sale does not discriminate unfairly and is fair and equitable with respect to each dissenting class of impaired creditors; (v) prohibit any sale of substantially all of a debtor employer's assets during the initial 60 days of a bankruptc y case unless, among other things, the bankruptcy court determines that there is a high likelihood that the value of the property will decrease significantly during that period; (vi) provide that the bankruptcy court, in deciding whether to approve any non-ordinary-course sale of assets, must consider the extent to which a bidder has offered to maintain existing jobs, preserve terms and conditions of employment, and assume or match pension and retiree health benefit obligations; (vii) increase the "look-back period" for the avoidance of intentional and constructive fraudulent transfers from two to six years; and (viii) impose additional restrictions on executive compensation enhancements provided during a bankruptcy case.
- The "No Bonuses for Executives Act of 2022" (H.R. 9155), which would have imposed an alternative minimum tax on state-regulated electric utilities in bankruptcy that make incentive-based payments, other than salary, to any of their 13 highest compensated employees, and that own or lease infrastructure other than climate-resilient infrastructure.
- The Lummis-Gillibrand Responsible Financial Innovation Act (S. 4356), which would have added "digital assets" and "digital asset exchanges" to various provisions of the Bankruptcy Code that deal with bankruptcies of commodity brokers and the rights of contract parties and customers.

FIRST IMPRESSIONS: THE ELEVENTH CIRCUIT EXAMINES 20-DAY ADMINISTRATIVE EXPENSE CLAIMS AND THE SUBSEQUENT NEW VALUE PREFERENCE DEFENSE

Nathan P. Yeary • Mark G. Douglas

The Bankruptcy Code confers "administrative expense" priority status on the claims of vendors for the value of goods that are shipped in the ordinary course of business and received by a debtor within 20 days of filing for bankruptcy. It also provides vendors and other creditors with various defenses to the avoidance of preferential payments received from the debtor during anywhere from 90 days to one year before filing for bankruptcy, depending upon whether the creditor is an "insider" of the debtor.

One of those defenses shields from avoidance as a preferential transfer any payment made to a creditor to the extent that the creditor subsequently gave "new value" to the debtor, as long as that new value is provided on an unsecured basis and the debtor does not thereafter make an "otherwise unavoidable" transfer to the creditor.

Because such prepetition unsecured "20-day claims" are granted administrative expense priority—a designation almost exclusively limited to claims against a debtor that arise after the bankruptcy petition date—courts sometimes disagree over whether a preference defendant can use the same value to assert a 20-day claim that it can use to offset its preference liability under the "subsequent new value" defense. The U.S. Court of Appeals for the Eleventh Circuit recently addressed this question as a matter of first impression in *Auriga Polymers Inc. v. PMCM2, LLC*, 40 F.4th 1273 (11th Cir. 2022). It held that a preference defendant may use the same value to assert a 20-day claim that it can use to offset its preference liability under the subsequent new value defense. In so ruling, the court determined that only prepetition transfers affect a creditor's subsequent new value defense.

ADMINISTRATIVE EXPENSE PRIORITY FOR 20-DAY CLAIMS

Section 503(b)(9) of the Bankruptcy Code provides that a creditor shall have an administrative expense claim for "the value of any goods received by the debtor within 20 days before the date of commencement of a [bankruptcy] case . . . in which the goods have been sold to the debtor in the ordinary course of such debtor's business." Unless the creditor agrees otherwise, a debtor cannot confirm a chapter 11 plan without paying administrative expense claims in full. *See* 11 U.S.C. § 1129(a)(9)(A). By contrast, vendor claims that do not meet the requirements of section 503(b)(9) typically are treated as general unsecured claims, entitling the holders to no more than their pro rata share of the estate's unencumbered assets.

Section 503(b)(9) was adopted to incentivize trade creditors to continue doing business with distressed companies. The provision "is a significant statutory departure from virtually all other parts of section 503(b), because it expressly affords administrative expense status to certain prepetition debts." COLLIER on BANKRUPTCY ("COLLIER") ¶ 503.16 (16th ed. 2022).

Section 503(b)(9) complements a seller's "reclamation" rights under applicable non-bankruptcy law. Section 546(c) of the Bankruptcy Code provides that, with certain exceptions, the avoidance powers of a bankruptcy trustee or chapter 11 debtor-in-possession ("DIP") are subject to the right of a vendor who sold goods to a debtor in the ordinary course of the vendor's business to "reclaim" those goods from the debtor, including by stopping shipment of or retrieving the goods, "if the debtor has received such goods while insolvent" and within 45 days before filing for bankruptcy, provided that the vendor timely gives notice of the reclamation. Section 546(c)(2) explicitly provides that a seller failing to timely give such notice may nonetheless "assert the rights contained in section 503(b)(9)." Section 503(b)(9) "'provides a supplemental remedy for those sellers who would be preferred reclamation sellers, but for a minor disqualification under section 546(a).'" *In re World Imports*, 516 B.R. 296, 297 (Bankr. E.D. Pa. 2014) (quoting *In re Momenta, Inc.*, 2012 WL 3765171, *4 (D.N.H. Aug. 29, 2012)); *accord In re O.W. Bunker Holding N. Am. Inc.*, 607 B.R. 32, 40 (Bankr. D. Conn. 2019).

THE SUBSEQUENT NEW VALUE DEFENSE TO PREFERENTIAL TRANSFER AVOIDANCE

Section 547(b) of the Bankruptcy Code provides that a trustee or DIP, "based on reasonable due diligence in the circumstances of the case and taking into account a party's known or reasonably knowable affirmative defenses under subsection (c)," may avoid "any transfer" made by an insolvent debtor within 90 days of a bankruptcy petition filing (or up to one year, if the transferee is an insider) to a creditor, if the creditor, by reason of the transfer, receives more than it would have received in a chapter 7 liquidation and the transfer had not been made. 11 U.S.C. § 547(b).

Section 547(c) sets forth nine defenses or exceptions to preference avoidance. One of those is the "subsequent new value" defense in section 547(c)(4), which provides as follows:

> The trustee may not avoid under this section a transfer . . . to or for the benefit of a creditor, to the extent that, after such transfer, such creditor gave new value to or for the benefit of the debtor—
>
> (A) not secured by an otherwise unavoidable security interest; and
>
> (B) on account of which new value the debtor *did not make an otherwise unavoidable transfer* to or for the benefit of such creditor[.]

11 U.S.C. § 547(c)(4) (emphasis added).

Under this section 547(c)(4) exception, even if a creditor receives a preferential transfer, any subsequent unsecured credit provided to the debtor by the creditor may be offset against the creditor's preference liability. The "subsequent new value defense," in turn, is reduced to the extent a debtor makes an "otherwise unavoidable transfer" to the creditor on account of the new value received.

The subsequent new value exception encourages trade creditors—who may fear nonpayment or payment clawback by distressed companies—to continue providing goods and services to such companies by narrowing the circumstances under which a trustee can avoid payment for those goods and services. *See Jones Truck Lines, Inc. v. Full Serv. Leasing Corp.*, 83 F.3d 253, 257 n.3 (8th Cir. 1996). "A subsequent advance is excepted because a creditor who contributes new value in return for payments from the incipient bankruptcy . . . should not later be deemed to have depleted the bankruptcy estate to the disadvantage of other creditors." *In re Jet Florida Sys., Inc.*, 841 F.2d 1082, 1083 (11th Cir. 1988) (*per curiam*); *accord In re Phoenix Rest. Grp., Inc.*, 317 B.R. 491, 495 (Bankr. M.D. Tenn. 2004).

New value is defined as "money or money's worth in goods, services, or new credit, or release by a transferee of property previously transferred to such transferee in a transaction that is neither void nor voidable by the debtor or the trustee under any applicable law, including proceeds of such property, but does not include an obligation substituted for an existing obligation." 11 U.S.C. § 547(a)(2).

A few areas of disagreement regarding the scope and application of section 547(c)(4) have emerged in the courts. First, some courts have concluded that any new value provided by a creditor must remain unpaid by the debtor for the creditor to benefit from the defense, whereas others have reasoned that the statutory language "otherwise unavoidable transfer" suggests that as long as the payment to a creditor that supplies the new value is avoidable, the "subsequent new value" defense is available. *Compare In re N.Y.C. Shoes Inc.*, 880 F.2d 679, 680 (3d Cir. 1989) (new value must remain unpaid); *In re Prescott*, 805 F.2d 719, 731 (7th Cir.

1986) (same), *with In re BFW Liquidation, LLC*, 899 F.3d 1178 (11th Cir. 2018) (joining the Fourth, Fifth, Eighth, and Ninth Circuits in ruling that section 547(c)(4) applies to all new value supplied by the creditor during the preference period and not merely to new value that remains unpaid on the bankruptcy petition date); *see generally* COLLIER at ¶¶ 547.04[4][c] and [e] (citing cases).

Second, courts sometimes disagree over the meaning of the phrase "otherwise unavoidable transfer." Most, however, have concluded that it means a transfer that is not avoidable pursuant to one of the other eight preference defenses or exceptions codified in section 547(c). *See, e.g., BFW Liquidation*, 899 F.3d at 1198-99 ("We read the phrase 'otherwise unavoidable transfer' in § 547(c)(4)(B) as referring to transfers that are unavoidable for reasons other than § 547(c)(4)'s subsequent-new-value defense.... Our interpretation is bolstered by the fact that § 547(c)(4) is only one exception to avoidability contained within a list of such exceptions.... Thus, a transfer that is rendered unavoidable by one of those other exceptions, such as § 547(c)(2)'s ordinary-course-of-business defense, can naturally be said to be 'otherwise unavoidable' for purposes of § 547(c)(4)(B)."); *accord Phoenix Rest. Grp.*, 317 B.R. at 499–500; *In re Check Reporting Servs., Inc.*, 140 B.R. 425, 431–32, 435–36 (Bankr. W.D. Mich. 1992).

Third, most, but not all, courts have concluded that only prepetition transfers by the debtor and creditor should be considered for purposes of the subsequent new value preference defense. *Compare In re Friedman's Inc*., 738 F.3d 547, 557 (3d Cir. 2013) (citing and discussing cases and ruling that a DIP's postpetition payment of prepetition wages did not affect the calculation of preference liability under section 547(c)(4)); *In re Bellanca Aircraft Corp.*, 850 F.2d 1275, 1284 (8th Cir. 1988) (postpetition goods or services provided to a DIP do not qualify as "new value" for purposes of § 547(c)(4): "'for the *benefit of the debtor*' ... impl[ies] that subsequent advances of new value are only those given pre-petition, because any post-petition advances are given to the debtor's estate, not to the debtor"); *Phoenix Rest. Grp.*, 317 B.R. at 496 ("The plain language of § 547 closes the preference window at the petition, limiting the § 547(c)(4) defense to new value supplied and payments made before the debtor crosses into bankruptcy."); *In re Slamdunk Enterprises, Inc.*, 2021 WL 389081, *29 (Bankr. E.D. Tex. Jan. 29, 2021) (postpetition payments do not qualify for the subsequent new value defense); *In re Dearborn Bancorp, Inc.*, 583 B.R. 395, 429 (Bankr. E.D. Mich. 2018) ("[A]ny new value from services that Defendants provided during the Post–Petition Period does not count as new value under Defendants' § 547(c)(4) defense."), *with In re Furr's Supermarkets, Inc.*, 485 B.R. 672, 734 (Bankr. D.N.M. 2012) (post-petition payments made under an employee benefits order can be used to limit the creditor's new value defense); *In re JKJ Chevrolet, Inc.*, 412 F.3d 545, 553 n.6 (4th Cir. 2005) ("While post-petition transfers [under a floor plan financing arrangement] may be considered under section 547(c)(4)(B), ... neither party has addressed whether the post-petition transfers that occurred in the instant case were unavoidable.").

Only a handful of courts have considered whether section 547(c)(4) provides a defense to preference liability where a creditor received postpetition administrative expense payments under section 503(b)(9) in exchange for the subsequent new value. Some bankruptcy courts have concluded that a vendor/creditor should be restricted to using the value of the goods supplied either as a "new value" defense to preference liability under section 547(c)(4) or as an administrative claim under section 503(b)(9), but not both, whereas others have ruled to the contrary. *Compare In re Commissary Operations, Inc.*, 421 B.R. 873, 878-89 (Bankr. M.D. Tenn. 2010) (holding that payment under section 503(b)(9) does not impact the subsequent new value defense), *with PMCM2, LLC v. Fabric Sources, Inc. (In re Beaulieu Grp., LLC)*, 616 B.R. 857, 878 (Bankr. N.D. Ga. 2020) ("*Fabric Sources*") ("[T]he Court concludes that there is no temporal requirement in § 547(c)(4) for the debtor's transfer on account of new value. Accordingly, when a creditor has a claim under § 503(b)(9) and a defense under § 547(c)(4) and when the debtor has established reserves to pay administrative claims in full, then that reserve constitutes an 'otherwise unavoidable transfer' by the debtor, and the new value represented by the § 503(b)(9) claim cannot be used to offset the creditor's preference liability."); *In re TI Acquisition, LLC*, 429 B.R. 377, 385 (Bankr. N.D. Ga. 2010) (ruling that payment under section 503(b)(9) reduces a creditor's new value defense); *In re Circuit City Stores, Inc.*, 515 B.R. 302, 314 (Bankr. E.D. Va. 2014) (same); *In re Circuit City Stores, Inc.*, 2010 WL 4956022, *9 (Bankr. E.D. Va. Dec. 1, 2010) (same); *see generally* COLLIER at ¶ 547.04[e] (citing cases).

These rulings hinge in part on whether the payment of a 20-day administrative expense claim under section 503(b)(9) is an "otherwise unavoidable transfer" within the meaning of section 547(c)(4), such that the amount in question cannot be used to offset the recipient's preference liability under the subsequent new value defense.

The Eleventh Circuit considered this question as a matter of first impression in *Auriga Polymers*.

AURIGA POLYMERS

Beaulieu Group, LLC (the "debtor") was a carpet manufacturer and distributer of residential and commercial flooring products. Following a downturn in the carpet industry, the debtor and its affiliates each filed a voluntary petition under chapter 11 of the Bankruptcy Code on July 16, 2017, in the Northern District of Georgia.

Prior to the bankruptcy filing, Auriga Polymers Inc. ("Auriga") sold materials used in a variety of products to the debtor. Auriga sold goods worth nearly $4.3 million to the debtor on credit for which it had not received payment as of the petition date. During the 90-day preference period (Auriga was not an insider), the debtor paid Auriga over $2.2 million in aggregate.

The debtor made its final $421,119 payment to Auriga during the preference period on June 23, 2017. After receiving that payment and within 20 days of the July 16 bankruptcy petition date, Auriga delivered $694,502 in goods to the debtor. Thus, the subsequent new value provided by Auriga during the 20 days preceding the petition date exceeded the June 23 payment by nearly $274,000.

During the bankruptcy case, Auriga filed: (i) a general unsecured claim in the amount of $3.596 million, representing the difference between the nearly $4.3 million total owed to Auriga and the $694,502 for which Auriga asserted a 20-day claim under section 503(b)(9); and (ii) a motion for payment of $694,502 as an administrative expense under section 503(b)(9).

The bankruptcy court subsequently confirmed a liquidating chapter 11 plan for the debtor pursuant to which all of its assets, including avoidance causes of action, were transferred to a liquidating trust. The liquidating trustee (the "Trustee") commenced an adversary proceeding to avoid the $2.2 million in transfers to Auriga as a preference under section 547(b) and to recover that amount from Auriga under section 550.

Auriga moved for summary judgment, claiming that its preference liability was eliminated pursuant to the subsequent new value defense under section 547(c)(4). It also argued that the value it provided during the 20 days prior to bankruptcy, for which it asserted a section 503(b)(9) claim, could also be used for its section 547(c)(4) defense. Pursuant to a stipulation between the parties, the trust distributed the undisputed amount of Auriga's section 503(b)(9) claim (approximately $274,000), and the Trustee set aside a $421,119 reserve to cover the balance pending resolution of the Trustee's adversary proceeding.

The Trustee and Auriga agreed that Auriga provided new value to the debtor in the entire $694,502 amount, but disagreed over whether the placement of funds in reserve to satisfy Auriga's section 503(b)(9) claim constituted an "otherwise unavoidable transfer" on account of the new value provided by Auriga, such that the value of the funds reserved could not offset Auriga's preference liability.

Noting that the issue had already been decided in another adversary proceeding filed by the Trustee against a different preference defendant in the debtor's chapter 11 case (*see Fabric Sources*, 616 B.R. at 878), the bankruptcy court held that Auriga could not use the same value to seek payment under section 503(b)(9) and to offset its preference liability under section 547(c)(4). Thus, the court held, Auriga was entitled to the full $694,502 under section 503(b)(9), but that amount could not be used to reduce its $2.2 million preference liability.

Relying on *BFW Liquidation* and the plain language of section 547(c)(4), the bankruptcy court summarized its ruling as follows:

> [P]ayment, or reserves for full payment, of a creditor's § 503(b)(9) administrative expense will offset that creditor's new value defense to a preference. Or, conversely, if the creditor successfully asserts a new value defense, it cannot receive payment of a § 503(b)(9) claim to the extent it is based on the same new value. . . . Under the plain language of the statute, payment of a § 503(b)(9) claim is an otherwise unavoidable transfer. It is a post-petition transfer that is authorized by the Bankruptcy Code; therefore, it is not avoidable under § 549. In addition, the plain language of the statute includes no requirement that the otherwise unavoidable transfer occur pre-petition. This interpretation is supported by the statutory history in that the predecessor to § 547(c)(4) included a temporal limitation on the payment of new value that was omitted from § 547(c)(4). The bankruptcy policies of encouraging creditors to continue doing business with financially distressed creditors and of equality of distribution also support this interpretation.

In re Beaulieu Grp., LLC, 2020 WL 7330537, *4 (Bankr. N.D. Ga. Mar. 20, 2020), *rev'd and remanded*, 40 F.4th 1273 (11th Cir. 2022).

Auriga appealed the ruling to the district court, which stayed the appeal pending the outcome of a direct appeal to the Eleventh Circuit.

THE ELEVENTH CIRCUIT'S RULING

A three-judge panel of the Eleventh Circuit reversed and remanded the case below.

Initially, the Eleventh Circuit rejected the Trustee's argument that its precedent in *BFW Liquidation* controlled the issue of whether funds held in reserve to pay Auriga's 20-day claim constituted an "otherwise unavoidable transfer" that would preclude its preference defense with respect to those funds.

In *BFW Liquidation*, the Eleventh Circuit held that new value need not remain unpaid in order to offset preference liability. Based on the plain language of section 547(c)(4), the court concluded that "otherwise unavoidable transfer" in section 547(c)(4)(B) means a transfer that is unavoidable for reasons *other than* those stated in section 547(c)(4).

The Trustee had argued that, in accordance with *BFW Liquidation*, section 547 does not on its face limit which unavoidable transfers affect a creditor's new value defense. The Eleventh Circuit disagreed, clarifying that *BFW Liquidation* did not address the timing of transfers with respect to a defendant's new value defense. The Eleventh Circuit accordingly found that *BFW Liquidation* was distinguishable because it did not address whether a defendant may assert both a section 503(b)(9) claim and reduce its preference liability under section 547(c)(4) based on the same underlying value.

Writing for the panel, U.S. Circuit Judge Barbara Lagoa noted that section 547(c)(4) does not specify whether an "otherwise unavoidable transfer" is a prepetition transfer or a postpetition transfer. However, based upon principles of statutory construction, the handful of decisions addressing the question in the context of section 503(b)(9), and other cases examining whether postpetition transfers can offset a transferee's preference liability under section 547(c)(4), the Eleventh Circuit ruled that an "otherwise unavoidable transfer" in the context of section 547(c)(4) refers to a *prepetition* transfer.

Examining the language and context of section 547, Judge Lagoa reasoned that the use of the word "transfer" in section 547(b) is instructive in ascertaining the meaning of the term in section 547(c)(4). According to Judge Lagoa, the phrase "otherwise avoidable transfer" in section 547(c)(4) must be interpreted in the context of the prepetition preference periods specified in section 547(b) because the meaning of words throughout a statute should be consistent. Moreover, she reasoned, section 547's title—"Preferences"—coupled with the fact that a separate provision (section 549) governs the avoidance of postpetition transfers, supports the conclusion that only prepetition transfers may be offset against a new value defense. Next, Judge Lagoa noted, most courts have concluded that value extended by a creditor after the petition date does not increase a creditor's new value defense, suggesting that postpetition payments do not affect preference liability.

In addition, the Eleventh Circuit explained that the statute of limitations for preference actions—which begins to run on the petition date or the appointment or election of a trustee (*see* 11 U.S.C. § 546(a)(1))—further supports the conclusion that "transfer" under section 547(c) means a prepetition transfer. Based on its statutory interpretation analysis, the Eleventh Circuit ruled that only prepetition amounts paid by a debtor reduce a preference defendant's new value defense.

This Eleventh Circuit downplayed the bankruptcy court's concerns that permitting a transferee to reduce its preference liability based on the same value supporting its section 503(b)(9) claim would amount to "double payment" or violate the bankruptcy principle of equality of distribution. It explained that there is no risk of double payment:

> [A]sserting a new value defense does not result in any payment to the creditor; it merely prevents disgorgement of monies previously paid. Before the Petition Date, Auriga delivered a substantial amount of goods to Beaulieu. Both Auriga's general unsecured claim and its § 503(b)(9) request only seek payment for unpaid invoices.

Auriga Polymers, 40 F.4th at 1288. "More importantly," Judge Lagoa explained, "equity of distribution does not mean equal distribution, as the bankruptcy code treats many kinds of creditors differently." *Id.* (citing 11 U.S.C. §§ 503, 503(b)(9), and 507).

According to the Eleventh Circuit panel, "[a]ll of these code provisions are themselves the result of independent policy choices made by Congress, all of which are entitled to judicial respect," and it is not a court's role to second guess how lawmakers have chosen to balance "the Bankruptcy Code's sometimes competing policies in different provisions." *Id.* (citations and internal quotation marks omitted).

OUTLOOK

Both the statutory priority afforded to 20-day claims under section 503(b)(9) and the subsequent new value preference defense under section 547(c)(4) protect creditors who do business with financially distressed companies that later file for bankruptcy protection. In *Auriga Polymers*, the Eleventh Circuit embraced what would previously have been characterized as the minority view on this issue, predicated largely on the court's reading of the plain meaning of section 547(c)(4), its statutory context, and lawmakers' perceived policy considerations in electing to give priority status to 20-day claims.

The Eleventh Circuit's rationale for dismissing the bankruptcy court's "double payment" concerns is not entirely satisfactory. In the case before it, the transferee creditor would receive full payment of its 20-day claim as a priority administrative expense, yet still could use the same value to offset its preference liability. This means that the bankruptcy estate will have less value to distribute to other unsecured creditors. That may result from the plain language adopted by Congress in enacting sections 503(b)(9) and 547(c)(4), but lawmakers' intent on this point is far from clear.

Finally, *Auriga Polymers* underscores that, in interpreting the text of provisions of the Bankruptcy Code, courts examine both: (i) the statutory context of the relevant provisions rather than considering them in isolation and (ii) the bankruptcy policies involved.

SEARS HOLDING: A CASE STUDY IN VALUING COLLATERAL IN CHAPTER 11

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

The U.S. Court of Appeals for the Second Circuit recently examined collateral valuation in a chapter 11 case for the purpose of determining whether junior secured creditors were entitled to super-priority administrative claims to compensate them for alleged diminution in the value of their collateral after the petition date and before the bankruptcy court approved a sale of the debtors' business as a going concern. In *ESL Investments, Inc. v. Sears Holdings Corp. (In re Sears Holdings Corp.)*, 51 F.4th 53 (2d Cir. 2022), the Second Circuit held that, given the uncertainty surrounding the retail debtors' fate at the time they filed for bankruptcy, the bankruptcy court did not err in valuing inventory collateral at its "net orderly liquidation value," rather than book value, going-out-of-business sale value, or forced liquidation value. The Second Circuit also found no fault with the bankruptcy court's decision to value non-borrowing base inventory at zero and to ascribe full face value to undrawn letters of credit where, among other things, the junior lenders failed to meet their evidentiary burden of suggesting a reasonable alternative.

VALUATION OF COLLATERAL IN BANKRUPTCY

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

The extent to which a claim is secured, therefore, turns on the valuation of the collateral. Section 506(a) is silent, however, as to the specific valuation method that a court should employ. As noted by the U.S. Court of Appeals for the Third Circuit in *In re Heritage Highgate, Inc.*, 679 F.3d 132 (3d Cir. 2012), the legislative history of section 506(a) suggests that Congress's silence on this point was intentional, to enable bankruptcy courts to "choose the standard that best fits the circumstances of a particular case." *Id.* at 141 (citing H.R. Rep. No. 95–595, at 356 (1977)). Even so, the court wrote, the valuation method should be chosen in light of the proposed disposition or use of the collateral, as set forth in section 506(a)(1) in language that is "of paramount importance to the valuation question." *Id.* (citation and internal quotation marks omitted).

In *Associates Commercial Corp. v. Rash*, 520 U.S. 953 (1997), the U.S. Supreme Court provided some guidance on this issue. In *Rash*, chapter 13 debtors proposed a plan under which they sought to retain the use of a vehicle encumbered by a lender's security interest instead of surrendering the vehicle to the creditor. Because the secured creditor did not consent to the proposed treatment of its secured claim, section 1325(a)(5) of the Bankruptcy Code obligated the debtors to make payments to the secured creditor under their chapter 13 plan equal to at least the present value of the amount of the creditor's secured claim. Thus, the value of the collateral had to be determined so that the debtors could confirm their cramdown plan and retain the use and possession of the vehicle.

The debtors argued that the lower foreclosure value (i.e., the amount the secured creditor would realize if it repossessed the truck and sold it at public auction) should apply, whereas the secured creditor argued for the higher replacement value—what it would cost the debtors to replace the vehicle in the open market. The bankruptcy court, the district court, and the Fifth Circuit (on rehearing *en banc*) sided with the debtors.

The Supreme Court reversed. The 8–1 majority explained that section 506(a) of the Bankruptcy Code mandates that the value of collateral "be determined in light of the purpose of the valuation and of *the proposed disposition or use of such property*." *Rash*, 520 U.S. at 961-62 (emphasis added). In this case, the Court noted, the proposed "disposition or use" of the collateral was the debtors' continued retention and use of the vehicle in order to generate an income stream. For this reason, the Court faulted the courts' conclusion below that the appropriate standard was foreclosure value:

> Of prime significance, the replacement-value standard accurately gauges the debtor's "use" of the property. It values "the creditor's interest in the collateral in light of the proposed [repayment plan] reality: no foreclosure sale and economic benefit for the debtor derived from the collateral equal to . . . its [replacement] value." . . . The debtor in this case elected to use the collateral to generate an income stream. That actual use, rather than a foreclosure sale that will not take place, is the proper guide under a prescription hinged to the property's "disposition or use."

Id. at 963.

Rash involved confirmation of a cramdown chapter 13 plan. The impact of *Rash* on collateral valuations in other contexts is unclear. Many, but not all, courts have concluded that its rationale

extends beyond chapter 13 to include valuations in chapter 11 cases. *See, e.g., Matter of Houston Reg'l Sports Network, L.P.*, 886 F.3d 523, 529 (5th Cir. 2018) ("Though the [*Rash*] court was considering whether foreclosure value or replacement value was appropriate in the Chapter 13 cram-down context, . . . the language provides guidance on the proper interpretation of § 506(a) as applied to plan-confirmation valuations when the debtor proposes to retain property [under a chapter 11 plan]."); *In re Nat'l Truck Funding LLC*, 588 B.R. 175, 180 (Bankr. S.D. Miss. 2018) ("Although *Rash* was decided in the context of chapter 13, its emphasis on 'actual use' of the property as the guide to valuation also applies in chapter 11."); *In re Motors Liquidation Co.*, 576 B.R. 325, 424 (Bankr. S.D.N.Y. 2017) ("Although *Rash* was decided in the context of a chapter 13 plan, the Court finds that the Supreme Court's emphasis on the actual disposition of the property, rather than a hypothetical outcome, applicable [for purposes of avoidance litigation requiring valuation of collateral]."); *In re Castleton Plaza, LP*, 2011 WL 4621123, *3 (Bankr. S.D. Ind. Sept. 30, 2011) ("Though *Rash* was not decided in the context of Chapter 11, it is routinely applied to cases arising under its provisions.") (citing *HSBC Bank USA v. UAL Corp.*, 351 B.R. 916 (Bankr. N.D. Ill. 2006)). *But see In re Sugarleaf Timber, LLC*, 529 B.R. 317, 329 n.14 (M.D. Fla. 2015) ("*Rash*'s narrow holding is inapplicable in the 'dirt-for-debt' context under Chapter 11, where the Debtor proposes to surrender property, not to retain it.").

THE AUTOMATIC STAY, ADEQUATE PROTECTION, AND SUPER-PRIORITY ADMINISTRATIVE EXPENSE CLAIMS

The filing of a bankruptcy petition triggers an automatic stay that precludes most actions against the debtor or its property to collect on prepetition debts. This includes "any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate." 11 U.S.C. § 362(a)(3). Because a lender is prevented by the automatic stay from foreclosing on its collateral after the borrower files for bankruptcy, the creditor is entitled to "adequate protection" of its interest in the collateral, which commonly takes the form of a cash payment or an additional or replacement lien to compensate the secured creditor for diminution in the value of its collateral during the bankruptcy case. 11 U.S.C. § 361(1)-(2).

If the adequate protection provided fails to preserve the value of the collateral during the bankruptcy case, the secured creditor is entitled as compensation to a "super-priority" administrative expense claim that must be paid before the payment from the bankruptcy estate of other administrative expense claims. 11 U.S.C. §§ 507(a)(2), (b); *In re Blackwood Assocs., L.P.*, 153 F.3d 61, 68 (2d Cir. 1998).

SEARS HOLDINGS

Iconic retailer Sears Holdings Corporation and its affiliates (collectively, "Sears") filed for chapter 11 protection in the Southern District of New York in October 2018.

When Sears filed for bankruptcy, its secured debt totaled approximately $2.68 billion, consisting of approximately $1.53 billion in first-lien debt secured by inventory, receivables, and certain other assets, and approximately $1.15 billion in second-lien debt secured on a junior basis by substantially the same collateral. The collateral securing both tranches of debt consisted of $2.39 billion in book value of borrowing-base inventory (referred to as "eligible" inventory), and approximately $300 million in book value of "non-borrowing-base" ("NBB") inventory that was excluded from the borrowing base against which asset-based lenders would loan money to Sears. The first-lien lenders had also issued $395 million in letters of credit ("LCs") guaranteeing various Sears obligations, such as workers' compensation claims. Although none of the LCs had been drawn on the petition date, approximately $9 million were drawn during the bankruptcy case.

Sears's largest secured creditor was ESL Investments, Inc. ("ESL"), a hedge fund owned by Edward Lampert, the CEO of Sears and chairman of its board of directors. ESL held approximately 79% of the second-lien debt.

As part of a debtor-in-possession financing package approved by the bankruptcy court early in Sears's chapter 11 case, the bankruptcy court granted adequate protection to both the first- and second-lien lenders for the use of their collateral in the form of replacement liens and super-priority claims under section 507(b) to compensate for any decline in the value of their collateral during the bankruptcy case.

At the time it filed for chapter 11, neither Sears nor its creditors knew whether Sears would be sold as a going concern or liquidated. In February 2019, after several rounds of failed negotiations, the bankruptcy court approved the sale of substantially all of Sears's assets for $5.2 billion to Transform Holdco LLC, an ESL affiliate controlled by Lampert and several other former Sears executives. The purchase price included more than $1.4 billion in cash, but consisted largely of non-cash consideration, including a $433.5 million credit bid organized by ESL, in which all of the second-lien lenders were obligated to participate under the terms of the credit documents.

The second-lien lenders claimed that the value of the collateral on the petition date was more than adequate to pay the first-lien and second-lien debt in full, but it had plummeted by the time of the sale due to Sears's use of its collateral by, among other things, selling the inventory to retail customers, collecting (and spending) old and new accounts receivable and cash, and funding the administrative costs of the chapter 11 case. This diminution, the second-lien lenders asserted, left them with $718 million in unpaid debt after the first-lien lenders were paid from the proceeds of the sale. The second-lien lenders also argued that, because the $433.5 million credit bid fell far short of the value of the collateral as of the petition date, they were entitled to section 507(b) super-priority claims to compensate for the diminution of the value of the collateral during the course of the bankruptcy case.

Thus, the bankruptcy court was asked to value the collateral as of the petition date and to determine whether that value had decreased by the time of the sale. To make that determination, the court had to calculate the petition-date value of the collateral and then subtract from that amount the obligations owed to the first-lien lenders on the petition date. The second-lien lenders would have viable section 507(b) super-priority claims only if that figure exceeded the $433.5 million credit bid the second-lien lenders had already recouped as part of the sale.

The second-lien lenders urged the bankruptcy court to apply a book value or replacement value standard in valuing the inventory collateral as of the petition date, which approach, they argued, was mandated by the Supreme Court's decision in *Rash*. The debtors argued that, as of the petition date, the inventory collateral was worth significantly less than its book value in light of the uncertainty regarding whether Sears would be sold or liquidated in chapter 11.

After holding a hearing and considering expert testimony, the bankruptcy court found that neither of the methodologies proposed by the second-lien lenders and the debtors appropriately measured the value of the collateral as of the petition date. Rather, the bankruptcy court determined that it would value the bulk of the collateral at its "net orderly liquidation value" ("NOLV")—the value Sears could have realized on the petition date for its assets in an orderly, company-wide going-out-of-business ("GOB") sale. This metric resulted in a valuation that was higher than the assets' liquidation value, but less than the full retail price of the inventory collateral. The bankruptcy court determined that a NOLV analysis, rather than full retail price or a depressed GOB sale or liquidation price, was appropriate because, although the Sears assets ultimately were sold as a going concern, that outcome was far from certain as of the petition date, when a material risk of liquidation still existed.

Applying the NOLV approach, the bankruptcy court found that the NOLV of the inventory collateral—after subtracting estimated overhead costs and legal fees, was 87.4% of its $2.69 billion book value, or $2.147 billion. It valued Sears's NBB inventory at zero because the second-lien lenders failed to offer a reasonable valuation method for those assets. Finally, the bankruptcy court decided that, because the LCs were undrawn as of the petition date, but at that time reasonably could have been expected to be drawn due to the exigent circumstances of the case, the full $395 million face value of the LCs should be deducted from the petition-date value of the collateral. In so ruling, the court rejected the second-lien lenders' argument that the LCs should be valued in accordance with how they were subsequently drawn during the case (to the extent of $9 million) and noted that the second-lien lenders failed to offer any reasonable method of discounting the value of the LCs as of the petition date.

After subtracting the first-lien lenders' $1.96 billion in claims from the $2.147 billion value of the collateral, the bankruptcy court determined that $187 million in collateral value remained for the second-lien lenders. However, because the second-lien lenders had already realized a greater amount from their $433.5 million credit bid, the court held that they were not entitled to any additional recovery in the form of section 507(b) super-priority claims.

The district court affirmed on appeal, and the second-lien lenders appealed to the Second Circuit.

THE SECOND CIRCUIT'S RULING

A three-judge panel of the Second Circuit affirmed.

Writing for the panel, U.S. Circuit Judge Richard J. Sullivan explained that "[t]he key question in this case is the value of the second-lien holders' collateral on the Petition Date, which, as the second-lien holders agree, is the value that controls for purposes of adequate protection and section 507(b) administrative super-priority claims." *Sears Holdings*, 51 F.4th at 61.

According to the Second Circuit, the bankruptcy court did not err in valuing Sears's inventory at NOLV, rather than book or replacement value. In *Rash*, Judge Sullivan noted, the Supreme Court never had to address whether the sale of collateral is properly characterized as a "disposition or use" within the meaning of section 506(a). *Id.* at 62. Even so, he concluded that, in accordance with the ordinary meaning of the word "disposition," a sale of inventory is properly characterized as a disposition. *Id.*

Looking to *Rash* for guidance, the Second Circuit observed that "*Rash* contemplated that one *particular* use or disposition must be proposed, and that this proposal must guide the valuation exercise." *Id.* at 63. According to Judge Sullivan, because neither Sears nor the second-lien lenders knew exactly how the collateral would be sold when Sears filed for bankruptcy, "the

bankruptcy court reasonably decided to assess the value of the second-lien holders' collateral in light of what the Debtors would likely be able to recoup from the collateral somewhere between a forced liquidation and its full retail price." *Id.*

The Second Circuit rejected the second-lien lenders' argument that the bankruptcy court should have valued the collateral at its retail value, instead of NOLV, because Sears did not ultimately liquidate but continued operating for several months before selling its business as a going concern. "[T]he valuation process in this case," Judge Sullivan wrote, "turned on the value of the collateral on the Petition Date, without inquiring into how the collateral was ultimately used." *Id.*

Next, the Second Circuit found no error in the bankruptcy court's NOLV analysis, noting that "a distressed-asset sale was regarded as a reasonably high-probability outcome" as of the petition date. The bankruptcy court's decision to use NOLV, Judge Sullivan wrote, "was consistent with section 506(a), *Rash*, and the facts of this case." *Id.* at 65.

In addition, given the second-lien lenders' "unsatisfactory" argument that that the NBB inventory should be valued in the same manner as the rest of the inventory collateral, the Second Circuit agreed with the bankruptcy court that the second-lien lenders failed to satisfy their evidentiary burden "to present the bankruptcy court with a credible method to value their [NBB] collateral as of the Petition Date." Observing that "the bankruptcy court was not obliged to manufacture an alternative valuation method for them," the Second Circuit found no fault with the bankruptcy court's decision to value the NBB inventory at zero. *Id.* at 66.

Finally the Second Circuit found no error in the bankruptcy court's decision to assign no value to the LCs as of the petition date. According to Judge Sullivan, the bankruptcy court acknowledged that it could value the LCs "based on a probabilistic formula, discounting their face value by some probability that they would actually be drawn," but the second-lien lenders never offered any such analysis below (or on appeal). Thus, he explained, the bankruptcy court, in assessing the value of those contingent liabilities, reasonably rejected the second-lien lenders' argument that the LCs should be valued at either: (i) zero as of the petition date, because it "ignored the 'realistic context of this case,' including 'the very real backdrop of a potential liquidation,' and the resulting need to tap available sources of capital"; or (ii) $9 million, because this "after-the-fact valuation methodology" was irrelevant in assessing the "likelihood of the contingency *on the Petition Date*." *Id.* at 67.

OUTLOOK

There are several key takeaways from the Second Circuit's ruling in *Sears Holding*.

First, valuation in bankruptcy is a fact-specific inquiry, and the selection of an appropriate valuation method, guided by section 506(a), is committed to the sound discretion of the Bankruptcy Court. The Second Circuit concluded that, based on the circumstances of the case, the bankruptcy court reasonably determined that the second-lien lenders' collateral should be valued at net orderly liquidation value in examining whether it had decreased in value after the petition date. In another context—e.g., determining whether the second-lien lenders' claims could be crammed down under a chapter 11 plan—the court likely would have chosen a different valuation method recognizing what actually happened during the course of the bankruptcy case.

Second, *Sears Holding* is a testament to the consequences of failing to satisfy evidentiary burdens. The Second Circuit found no error in the bankruptcy court's decision to ascribe no value to NBB inventory and to discount to zero the full face value of undrawn letters of credit because the second-lien lenders had the burden of proposing a reasonable alternative but repeatedly failed to do so.

Third, the Second Circuit reaffirmed in *Sears Holding* that *Rash* casts a wider net than the specific facts in that case. In *Sears Holding*, the Second Circuit interpreted *Rash* to require a bankruptcy court in a chapter 11 case to be guided in its valuation by the use or disposition likely for the subject collateral, rather than some hypothetical use or disposition.

Because *Sears Holdings* was heavily fact-dependent, it remains to be seen what impact the decision will have on valuations in other chapter 11 cases.

APPEAL OF UNSTAYED ORDER APPROVING BANKRUPTCY SALE OF REAL PROPERTY FREE AND CLEAR OF LEASE AND RELATED SETTLEMENT AGREEMENT DISMISSED AS MOOT

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To promote the finality of bankruptcy asset sales, section 363(m) of the Bankruptcy Code "moots" an appeal of an order approving a sale to a good-faith purchaser unless the party challenging the sale obtains a stay pending appeal. Courts, however, sometimes disagree over the scope of section 363(m) and whether it also bars appeals of orders approving transactions that are related to a sale, such as settlements.

The U.S. District Court for the Eastern District of Louisiana recently addressed this question in *In re Royal Street Bistro LLC*, 2022 WL 6308294 (E.D. La. Sept. 23, 2022) ("*Royal Street II*"), *appeal filed*, No. 22-30629 (5th Cir. Oct. 5, 2022). The district court affirmed bankruptcy court orders approving an auction sale of properties free and clear of a tenant's leasehold interest as well as a related settlement agreement because both appeals were mooted by section 363(m)—the sale, by the express terms of section 363(m), and the settlement, because it was an integral part of the sale.

The ruling reinforces the principle that property can be sold free and clear of a tenant's leasehold interest, despite protections of such interests elsewhere in the Bankruptcy Code. It is also emblematic of the broad interpretation in the Fifth Circuit of statutory mootness under section 363(m).

DISMISSAL OF APPEALS UNDER THE DOCTRINE OF MOOTNESS

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

The court-fashioned remedy of "equitable mootness" bars adjudication of an appeal when a comprehensive change of circumstances has occurred such that it would be inequitable for a reviewing court to address the merits of the appeal. In bankruptcy cases, appellees often invoke equitable mootness as a basis for precluding appellate review of an order confirming a chapter 11 plan that has been "substantially consummated." *See* COLLIER ¶1129.09 (16th ed. 2022).

An appeal can also be rendered moot (or otherwise foreclosed) by statute. For example, section 363(m) of the Bankruptcy Code provides that, absent a stay pending appeal, "[t]he reversal or modification on appeal of an authorization . . . of a sale or lease of property does not affect the validity of a sale or lease under such authorization to an entity that purchased or leased such property in good faith."

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

The circuits are split regarding whether section 363(m) automatically moots an appeal of an order approving an unstayed sale under all circumstances. Some circuits, including the First, Second, Fifth, Eleventh, and D.C. Circuits, have held that, in the absence of a stay of the sale order, the court must dismiss a pending appeal as moot unless the purchaser did not act in good faith. *See Mission Product Holdings, Inc. v. Old Cold, LLC (In re Old Cold, LLC)*, 879 F.3d 376, 383 (1st Cir. 2018); *U.S. v. Salerno*, 932 F.2d 117, 123 (2d Cir. 1991); *In re Walker County Hospital Corp.*, 3 F.4th 229, 236 (5th Cir. 2021); *In re Steffen*, 552 F. App'x 946, 949-50 (11th Cir. 2014); *In re Magwood*, 785 F.2d 1077, 1081 (D.C. Cir. 1986); *see also Reynolds v. ServisFirst Bank (In re Stanford)*, 17 F.4th 116, 122 (11th Cir. 2021) (although statutory mootness precludes review of an unstayed order approving a sale to a good-faith purchaser, mootness under section 363(m) is not jurisdictional, but acts as a defense); *In re Ern, LLC*, 124 F. App'x 151, 152 (4th Cir. 2005) (dismissing an appeal of a sale order as moot because the assets had been transferred and the party challenging the sale failed to obtain a stay pending appeal); *In re Rimoldi*, 172 F.3d 876, 1999 WL 132260, *1 (9th Cir. 1999) ("This court has recognized only two exceptions to section 363(m)'s rule of mootness. The first applies where real property is sold subject to a statutory right of redemption; the second applies where state law otherwise would permit the transaction to be set aside.").

Other circuits, including the Third, Sixth, and Tenth Circuits, have rejected the view that section 363(m) automatically moots an appeal. Instead, those courts have held that an appeal is not moot as long as it is possible to grant effective relief without impacting the validity of the sale. *See In re ICL Holding Co., Inc.*, 802 F.3d 547, 554 (3d Cir. 2015) (section 363(m) did not moot the government's appeal of the terms for the ordered distribution of escrowed funds for administrative expenses and settlement proceeds from the sale of substantially all of the debtors' assets since the court could order redistribution of the sale proceeds without disturbing the sale); *Brown v. Ellmann (In re Brown)*, 851 F.3d 619 (6th Cir. 2017) (holding that parties alleging statutory mootness under section 363(m) must prove that the reviewing court is unable to grant effective relief); *Osborn v. Duran Bank & Trust Co. (In re Osborn)*, 24 F.3d 1199 (10th Cir. 1994) (holding that an appeal of a sale order was not mooted by section 363(m) when under Texas state law a constructive trust could be imposed on the sale proceeds), *abrogated in part on other grounds by Eastman v. Union Pac. R.R.*, 493 F.3d 1151 (10th Cir. 2007); *In re C.W. Min. Co.*, 740 F.3d 548, 555 (10th Cir. 2014) (section 363(m) will moot appeals in cases where the only remedies available are those that affect the validity of the sale); *see also In re 388 Route 22 Readington Holdings, LLC*, 2021 WL 4811409, *2 (3d Cir. Oct. 15, 2021) ("Put simply, § 363(m) moots a challenge to a sale when '(1) the underlying sale or lease was not stayed pending the appeal, and (2) the court, if reversing or modifying the authorization to sell or lease, would be affecting the validity of such a sale or lease.'") (citations omitted), *cert. denied*, 142 S. Ct. 1674 (U.S. 2022); *In re K & D Indus. Servs. Holding Co., Inc.*, 850 F. App'x 966, 968-69 (6th Cir. 2021) ("Because § 363(m) 'limits appellate review of a consummated sale . . . regardless of the merits of legal arguments raised against it,' and because we cannot grant effective relief without disturbing the sales, the appeals to the district court are moot.") (citation omitted).

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

Statutory mootness under section 363(m) can preclude appellate review not only of an unstayed sale order but also orders approving transactions that are an integral part of the sale. *See, e.g., MOAC Mall Holdings LLC v. Transform Holdco LLC (In re Sears Holdings Corp.),* 2021 WL 5986997, *3 (2d Cir. Dec. 17, 2021) (in a nonprecedential summary order, affirming a district court order dismissing an appeal of an order approving an assignment of a lease that was "integral" to a sale transaction and noting that "[w]e have held in no ambiguous terms that section 363(m) is a limit on our jurisdiction and that, absent an entry of a stay of the Sale Order, we only retain authority to review challenges to the 'good faith' aspect of the sale" (internal quotation marks and citations omitted)), *cert. granted*, 142 S. Ct. 2867 (2022); *In re Pursuit Holdings (NY), LLC*, 845 Fed. App'x 60 (2d Cir. 2021) (the statutory mootness rule indisputably applies to challenges to any integral provision of an order approving a sale, such as a settlement); *In re Trism, Inc.*, 328 F.3d 1003, 1007 (8th Cir. 2003) (mooting under section 363(m) "a challenge to a related provision of an order authorizing the sale of the debtor's assets" because the related provision was integral to the sale of the assets and reversing the provision would alter the parties' bargained-for exchange); *see also Matter of Alabama-Mississippi Farm, Inc.*, 791 F. App'x 466, 470 (5th Cir. 2019) (section 363(m) does not preclude an appeal asserting a security interest in sale proceeds because, "nothing in the record suggests that the sale . . . was dependent on how the proceeds of that sale were to be distributed").

Section 363(m) has also been read to go further than simply limiting appellate review and to protect broadly the interests of any good-faith purchaser by subjecting any collateral attack made against a section 363 sale to a good-faith purchaser to the requirements of Rule 60(b) of the Federal Rules of Civil Procedure, which governs motions for reconsideration of or relief from prior court judgments or orders. *See In re Edwards*, 962 F.2d 641, 643 (7th Cir. 1992) (holding that a collateral attack on a sale to a good-faith purchaser must be made pursuant to Fed. R. Civ. Proc. 60(b)); *In re Veg Liquidation, Inc.*, 572 B.R. 725, 737 (Bankr. W.D. Ark. 2017) ("To the extent the trustee is alleging that fraud was involved, his remedy is under Rule 60, not [section] 363(m)."), *aff'd*, 583 B.R. 203 (B.A.P. 8th Cir. 2018), *aff'd*, 931 F.3d 730 (8th Cir. 2019); *see also In re Alan Gable Oil Dev. Co.*, 978 F.2d 1254, 1992 WL 329419, *4 (4th Cir. 1992) ("[T]hough section 363(m) does not in the strictest sense apply to [a movant›s] 60(b) motion, the policy favoring protection of good faith purchasers of estate property does. Not only does [the movant] bear the burden of establishing that the district court abused its discretion, he must do so in light of the strong policy favoring good faith purchasers of bankruptcy assets."); *In re Nilhan Devs., LLC*, 631 B.R. 507, 534 (Bankr. N.D. Ga. 2021) ("Sale orders in bankruptcy cases are accorded a high level of finality and, accordingly 'collateral attacks on sale orders should generally be prohibited.'") (*quoting In re CHC Indus., Inc*., 389 B.R. 767, 774 (Bankr. M.D. Fla. 2007)).

SCOPE OF FREE-AND-CLEAR SALES

The ability of a trustee or chapter 11 debtor-in-possession ("DIP") to sell bankruptcy estate assets "free and clear" of competing interests in the property has long been recognized as one of the most important advantages of a bankruptcy filing as a vehicle for restructuring a debtor's balance sheet and generating value. Still, section 363(f) of the Bankruptcy Code, which delineates the circumstances under which an asset can be sold free and clear of "any interest in such property," has generated a fair amount of controversy. This is so in part because the statute itself does not define "interest."

Although section 363(f) is generally acknowledged to encompass liens and security interests, some courts, taking into account both the language of the provision and its underlying purpose, have interpreted it much more broadly to encompass other obligations that may flow from ownership of property, including, for example, successor liability claims. *See, e.g., In re Trans World Airlines, Inc.*, 322 F.3d 283 (3d Cir. 2003); *In re Norrenberns Foods, Inc.*, 642 B.R. 825 (Bankr. S.D. Ill. 2022). Broadly applied, however, section 363(f) arguably conflicts with certain other provisions of the Bankruptcy Code.

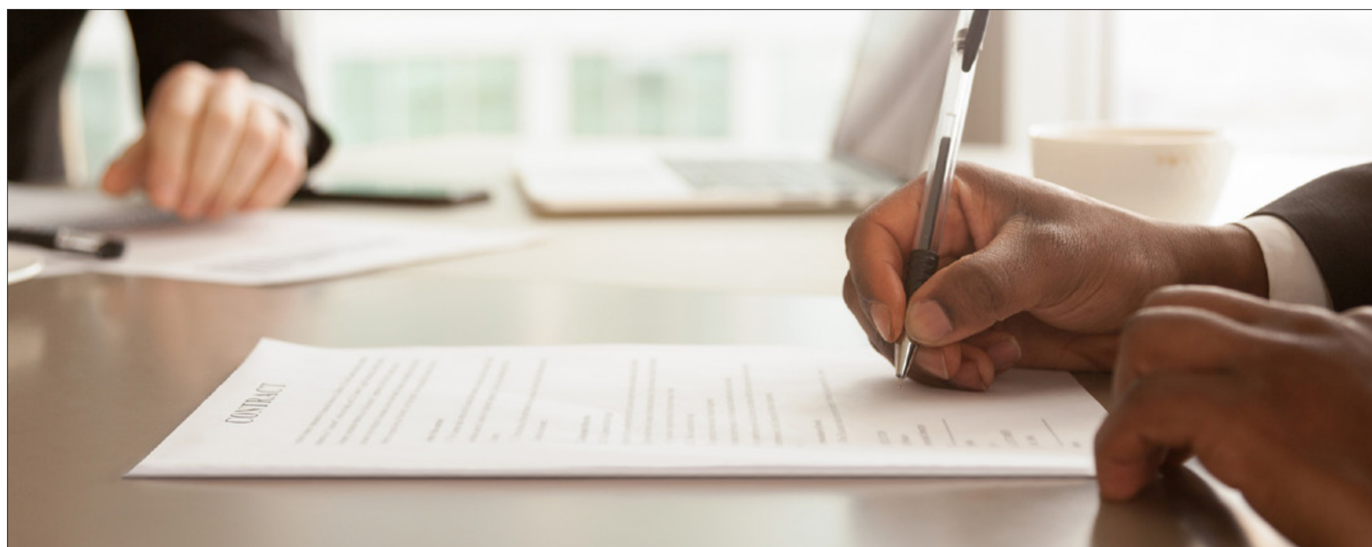
One of those provisions is section 365(h)(1), which specifically protects the interests of lessees and sublessees under unexpired real property leases. It provides that, if the trustee or DIP rejects an unexpired real property lease under which the debtor is the lessor, the non-debtor lessee (and any permitted successor or assign), pursuant to subsection (h)(1)(D)) has the option to either: (i) treat the lease as terminated and file a claim for breach; or (ii) retain its rights under the lease for the balance of the lease term (including any renewal or extension periods) "to the extent that such rights are enforceable under applicable non-bankruptcy law."

Courts disagree whether the rights of a lessee (or sublessee) under section 365(h)(1) are effectively extinguished where the debtor does not reject the lease, but the leased real property is sold free and clear under section 363(f). *See generally* COLLIER at ¶¶ 363.06[1] and 365.11[5] (noting that efforts to sell real property free and clear of leasehold interests protected by section 365(h)(1) "have met with mixed results," but that "[t]he apparent majority view is that section 365(h) trumps section 363(f)").

Until 2022, only two federal courts of appeals had weighed in on this question, both staking out what was considered to be the minority view. In *Precision Industries, Inc. v. Qualitech Steel SBQ*, 327 F.3d 537 (7th Cir. 2003), the Seventh Circuit disagreed with several lower courts and held that a real property lease can be extinguished in a free-and-clear sale of the property under section 363(f), at least where the lease has not been formally rejected. In *Pinnacle Rest. at Big Sky, LLC v. CH SP Acquisitions, LLC (In re Spanish Peaks Holding II, LLC)*, 872 F.3d 892 (9th Cir. 2017), the Ninth Circuit essentially endorsed this position, with certain caveats.

The Fifth Circuit recently examined this issue, but in an oblique way. In *In re Royal Street Bistro, L.L.C.*, 26 F.4th 326 (5th Cir. 2022) ("*Royal Street I*"), the court denied certain tenants' motion for a writ of mandamus directing a district court to issue a stay pending appeal of a bankruptcy court order approving the sale of leased real property free and clear of the tenants' leasehold interests. However, instead of issuing a summary order without explanation, the Fifth Circuit issued a brief *per curiam* opinion in which it agreed with the result reached by the lower courts but signaled disagreement with the holdings in *Qualitech* and *Spanish Peaks*, and cautioned courts against "blithely accepting *Qualitech*'s reasoning and textual exegesis."

Section 363(e) of the Bankruptcy Code provides protection to parties that have "interests" in property proposed to be sold free and clear under section 365(f). That subsection provides that, upon the request of an entity that has an "interest" in property proposed to be sold by the trustee or DIP, the court "shall prohibit or condition" the sale "as is necessary to provide adequate protection of such interest." *See Qualitech*, 327 F.3d at 547-48 ("Because a leasehold qualifies as an 'interest' in property for purposes of section 363(f), a lessee of property being sold pursuant to subsection (f) would have the right to insist that its interest be protected. 'Adequate protection' does not necessarily guarantee a lessee's continued possession of the property, but it does demand, in the alternative, that the lessee be compensated for the value of its leasehold—typically from the proceeds of the sale."); *Dishi & Sons v. Bay Condos LLC*, 510 B.R. 696, 698–99, 707–12 (S.D.N.Y. 2014) (real property may be sold pursuant to section 363(f) free and clear of a lessee's interest in the real property in limited circumstances, but that interest is entitled to adequate protection under section 363(e)).



ROYAL STREET

Royal Alice Properties, LLC ("RAP") owned three properties in New Orleans. RAP's sole equity holder was Susan Hoffman ("Hoffman"). The properties were leased to Hoffman as her personal residence and to commercial tenants Royal Street Bistro, L.L.C. ("RSB") and Picture Pro, LLC ("Picture Pro" and, collectively with RSB and Hoffman, the "Tenants").

In August 2019, RAP filed for chapter 11 protection in the Eastern District of Louisiana. Shortly afterward, it commenced an adversary proceeding against AMAG Inc. ("AMAG"), the mortgagee of the properties, seeking a determination of the validity, extent, and priority of disputed liens AMAG had asserted against the properties.

While the adversary proceeding was pending, the court appointed a chapter 11 trustee. The court then granted summary judgment in favor of AMAG in the adversary proceeding. In July 2021, the trustee sought court approval of a settlement with AMAG and authority to sell the properties free and clear of AMAG's liens and the Tenants' leasehold interests

The Tenants responded by filing a motion for adequate protection of their leasehold interests under section 363(e) in the form of retained possession of the leased premises through the end of their purported 20-year leases. They also asked the court to require the trustee to assume or reject the leases, arguing that rejection would trigger the protections set forth in section 365(h).

The bankruptcy court entered an order approving the settlement and the sale on November 30, 2021 (the "Nov. 30 order"), but denied the Tenants' motion for adequate protection and an order compelling the trustee to assume or reject the leases. According to the bankruptcy court: (i) because AMAG could have foreclosed on its mortgages under state law and thereby extinguished the tenants' leasehold interests, the properties could be sold free and clear of those interests under section 363(f)(1), which permits a sale free and clear if "applicable bankruptcy law permits sale of such property free and clear of such interest"; and (ii) because Picture Pro had not paid any rent for several months and was therefore in default of its lease, the property could be sold free and clear of the lease under section 363(f)(4), which permits a sale free and clear if "such interest is in bona fide dispute." *See In re Royal Alice Props.*, 637 B.R. 465, 481-82 (Bankr. E.D. La. 2021).

The Tenants appealed the Nov. 30 order to the district court and simultaneously sought an emergency stay of the bankruptcy court's order pending the appeal. The district court denied the motion for a stay. Both the bankruptcy court and the district court relied on *Qualitech* and *Spanish Peaks* in denying the Tenants' requested relief.

The Tenants then filed a petition with the Fifth Circuit for a writ of mandamus compelling the district court to issue a stay pending appeal. In its summary opinion denial of the petition, the Fifth Circuit agreed with the result reached by the lower courts, but signaled disagreement with the holdings in *Qualitech* and *Spanish Peaks*, and cautioned courts against "blithely accepting *Qualitech*'s reasoning and textual exegesis." *See Royal Street I*, 26 F.4th at 328.

On January 10, 2022, the bankruptcy court entered a final order (the "Jan. 10 order") approving the settlement and bidding procedures for the sale of the properties at auction in February 2022.

The Tenants appealed the Jan. 10 order as well, and the district court consolidated that appeal with the appeal of the Nov. 30 order.

At the auction, AMAG purchased one of the properties, and third parties bought the other two. The Tenants subsequently settled their dispute with AMAG and dismissed their consolidated appeal with respect to AMAG.

The trustee then moved to dismiss the appeal, arguing that any challenge to either the sale or the related settlement was rendered moot by section 363(m) because the purchasers acted in good faith and the sale was not stayed pending appeal. The trustee also argued that the appeal was moot due to the dismissal of AMAG from the litigation. According to the trustee, the Tenants could not overturn only the provisions of the settlement agreement that distributed the sales proceeds to the trustee, while leaving undisturbed the provisions awarding the remaining proceeds to AMAG.

The Tenants countered that they did not challenge the sale itself, but only the disposition of sale proceeds to the trustee under the settlement agreement. According to the Tenants, in the settlement agreement, they expressly relinquished any challenge to the sale or the distribution of sale proceeds to AMAG, but were seeking to reverse the settlement between the trustee and AMAG, but only as to the trustee, which was beyond the scope of section 363(m).

THE DISTRICT COURT'S RULING

The district court ruled that the appeal was moot under section 363(m).

U.S. District Judge Sarah S. Vance explained that, in accordance with Fifth Circuit precedent, "'fatal means fatal: challenges to authorized bankruptcy sales are dismissed when the party challenging the sale' fails to obtain a stay." *Royal Street II*, 2022 WL 6308294, at *3 (quoting *Walker County*, 3 F.4th at 234). She rejected the Tenants' argument, based on out-of-circuit precedent, that challenges to settlement agreements are outside the scope of section 363(m), noting that those courts "construe section 363(m) more narrowly that the Fifth Circuit." *Id.* at *4 (citing *In re X-Treme Bullets, Inc.*, 2020 WL 4455582, *7 (D. Nev. Aug. 3, 2020) (collecting cases and describing the Seventh and Ninth Circuits as adopting "the narrower view" of mootness under section 363(m)).

Instead, Judge Vance emphasized, the Fifth Circuit "considers how closely linked a challenged settlement provision is to a sale itself in order to determine the applicability of section 363(m) to an appeal." *Id.* She explained that, in this case, the terms of the settlement governing distribution of the sales proceeds "were part and parcel of the sale—they ensured that the sale would accomplish its purpose, the satisfaction of AMAG's claim, while allocating to the Trustee sufficient funds to effectuate the sale and to administer the estate." *Id.* at *5. The district court accordingly found that the terms of the settlement agreement governing the disposition of sales proceeds were "'necessary to facilitate the transaction' and are thus integrally linked to the underlying sale." *Id.* (quoting *In re Sneed Shipbuilding Inc.*, 916 F.3d 405, 407 (5th Cir. 2019), and citing *Alabama-Mississippi*, 791 F. App'x at 470).

The district court was critical of the Tenants' effort to cherry-pick which provisions of the settlement agreement could be enforced and against whom. "Both [the trustee and AMAG] performed as agreed under the settlement agreement," Judge Vance wrote, "and the sales are final." The district court accordingly dismissed the appeal as moot under section 363(m).

OUTLOOK

Royal Street II is consistent with the Fifth Circuit's broad interpretation of the scope of section 363(m) as applying not only to unstayed sale orders but also to orders approving transactions, such as settlements, that are integral to a sale. The decision also reinforces the importance of finality in bankruptcy sale transactions.

The Tenants appealed the district court's ruling to the Fifth Circuit on October 5, 2022.

The *Royal Street II* district court was not asked to decide whether section 363(m) acts as a jurisdictional bar to any appeal, as distinguished from a limitation on remedies. This issue, however, is squarely before the U.S. Supreme Court in *Sears Holdings*. *See MOAC Mall Holdings LLC v Transform Holdco LLC*, No. 21-1270 (U.S.). The Court heard oral argument on December 5, 2022, and its decision may provide guidance on both the jurisdictional question as well as the proper scope of section 363(m).

FIFTH CIRCUIT: BAD FAITH DOES NOT OVERCOME DEFERENTIAL BUSINESS JUDGMENT STANDARD APPLIED TO ASSUMPTION OR REJECTION OF CONTRACTS IN BANKRUPTCY

Mark A. Cody • Mark G. Douglas

The ability of a bankruptcy trustee or chapter 11 debtor-in-possession ("DIP") to assume, assume and assign, or reject executory contracts and unexpired leases is an important tool designed to promote a "fresh start" for debtors and to maximize the value of the bankruptcy estate for the benefit of all stakeholders. Bankruptcy courts generally apply a deferential "business judgment" standard to the decision of a trustee or DIP to assume or reject an executory contract or an unexpired lease.

In *In re J.C. Penney Direct Marketing Services, L.L.C.*, 50 F.4th 532 (5th Cir. 2022), the U.S. Court of Appeals for the Fifth Circuit affirmed lower court rulings approving a DIP's decision, at the behest of the purchaser of its assets, to reject a commercial ground lease, even though an agent retained by the DIP to market its shopping center leases acted in bad faith in negotiations with a sublessee intent upon acquiring the ground lessor's interest. In so ruling, the Fifth Circuit rejected the sublessee's argument that the DIP's decision to reject the lease should not receive deference under the business judgment standard due to the agent's bad faith. According to the Fifth Circuit, in the absence of evidence that the decision to reject did not enhance the bankruptcy estate or was "clearly erroneous, too speculative, or contrary to the Bankruptcy Code," the presumption created by the business judgment rule could not be overcome. Nor, the court noted, did the sublessee demonstrate that the DIP's decision was "so manifestly unreasonable that it could not be based on sound business judgment, but only on bad faith, or whim or caprice."

ASSUMPTION AND REJECTION OF EXECUTORY CONTRACTS AND UNEXPIRED LEASES IN BANKRUPTCY

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 contracts and leases (among other powers) is conferred upon a 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). 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). The cure obligations set forth in section 365(b)(1) do not apply to defaults triggered by the debtor's financial condition

(including its bankruptcy filing) and certain other breaches. *See* 11 U.S.C. § 365(b)(2).

The Bankruptcy Code does not define the term "executory." Many courts have adopted the test for executoriness articulated 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 ¶ 365.02 (16th ed. 2022) (citing cases). If a contract or lease 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.

The trustee or DIP may not assume or assign any executory contract or unexpired lease, whether or not such contract or lease prohibits or restricts an assignment of rights or delegation of duties, if: (i) applicable law excuses the non-debtor party from accepting performance from or rendering performance to an entity other than the debtor or the DIP, and the non-debtor party does not consent to assumption or assignment; (ii) the contract is one "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"; or (iii) the lease is a nonresidential real property lease that was terminated under applicable non-bankruptcy law prior to entry of the order for relief. 11 U.S.C. § 365(c).

Bankruptcy courts generally will approve a proposed assumption or rejection of a contract or lease 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."); *Richmond Leasing Co. v. Cap. Bank, N.A.*, 762 F.2d 1303, 1309 (5th Cir. 1985) ("as long as assumption of a lease appears to enhance a debtor's estate," a bankruptcy court should withhold approval only when "the debtor's judgment is clearly erroneous, too speculative, or contrary to the provisions of the Bankruptcy Code"); *see generally* COLLIER at ¶ 365.03[2] (citing cases and noting that "[u]nder the Code, most courts have applied a 'business judgment' test to trustees' decisions to assume or reject contracts or leases").

Some courts have concluded that a bankruptcy court should summarily affirm a DIP or trustee's decision to assume or reject a contract or lease unless it is "so manifestly unreasonable that it could not be based on sound business judgment, but only on bad faith, or whim, or caprice." *Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc.*, 756 F.2d 1043, 1047 (4th Cir. 1985); *accord In re Mallinckrodt PLC*, 2022 WL 906458, *6 (D. Del. Mar. 28, 2022); *In re Fin. Oversight & Mgmt. Bd. for Puerto Rico*, 631 B.R. 559, 569 (D.P.R. 2021); *In re Trans World Airlines, Inc.*, 261 B.R. 103, 121 (Bankr. D. Del. 2001); *In re Wheeling-Pittsburgh Steel Corp.*, 72 B.R. 845, 850 (Bankr. W.D. Pa. 1987).

Upon assumption, most kinds of executory contracts also may be assigned by the trustee or DIP to third parties under the circumstances specified in sections 365(c) and 365(f). Pending the decision to assume or reject, the trustee or DIP generally is obligated to keep current on most obligations that become due under the contract postpetition. 11 U.S.C. §§ 365(d)(3) and (d)(5).

J.C. PENNEY

In 1971, J.C. Penney Properties, Inc. ("JCP") leased commercial real estate in Illinois at below-market rent from a ground lessor for 30 years with an option to extend the lease for an additional 70 years. In 1981, JCP subleased the shopping center property, which was then unprofitable, to a bank trustee, thereby rendering JCP a pass-through entity because the ground lease and the ground sublease provided for identical rental payments. Thereafter, JCP had no ongoing operations associated with the property. In a separate agreement, the bank trustee purchased the existing improvements on the parcel from JCP for approximately $4 million. The bank then assigned its interest in the ground sublease to Klairmont Korners, L.L.C. ("Klairmont"). In later years, Klairmont unsuccessfully attempted to obtain a non-disturbance agreement from the ground lessor and to purchase both the property and JCP's interest in the ground lease.

In 2020, JCP filed for chapter 11 protection in the Southern District of Texas for the purpose of selling substantially all of its assets as a going concern under a chapter 11 plan. JCP ultimately negotiated a multibillion-dollar transaction to sell its business under an asset purchase agreement (the "APA") with

Copper Retail JV LLC and an affiliate (collectively, "OpCo") that would be the cornerstone of a chapter 11 plan. The court confirmed that plan in December 2020, after which JCP began to liquidate its remaining assets. Under the plan, rejected leases would be terminated and the non-debtor parties thereto would have an unsecured claim for any damages, and assumed leases would be sold or assigned to OpCo. The final decision whether to assume or reject leases (the "designation rights") would be made by OpCo pursuant to the terms of the APA.

The court authorized JCP to retain a real estate agent to market JCP's 800 unexpired leases. The agent repeatedly provided false information to Klairmont for the purpose of starting what became a messy bidding war for the ground lease. During those negotiations, Klairmont made several offers (ranging from $1.25 million to $3 million) to induce JCP to assume the ground lease and to assign it to Klairmont. Meanwhile, the ground lessor engaged in negotiations to extract itself from this below-market lease. Aided by the agent's disclosure of confidential information, the ground lessor and an investor first offered $1.5 million to induce JCP to reject the ground lease and then raised the offer to $1.7 million.

Even though the consideration offered by Klairmont was greater, JCP and OpCo decided that the ground lessor's offer was preferrable, largely due to litigation costs associated with the Klairmont offer arising from an anticipated dispute over the amount of adequate assurance payments required to assume and assign the ground lease. In March 2021, JCP, at OpCo's direction, sought court authority to reject both the ground lease and ground sublease, but subsequently withdrew its motion to reject the ground sublease.

The bankruptcy court expressed dismay regarding the events surrounding the negotiations and the bidding process, including the outright lies told by the agent and the mistreatment of Klairmont. The bankruptcy court noted that the dispute concerning the ground lease—which involved at most approximately $2 million to $3 million—risked unraveling a multibillion-dollar sale transaction involving far more than the ground lease.

The bankruptcy court authorized JCP to reject the ground lease. In doing so, it found that: (i) JCP sold the designation rights to OpCo under the APA; (ii) the tainted bidding process between the ground lessor/investor and Klairmont was not relevant to the question of JCP's exercise of sound business judgment; (iii) the decision to reject the ground lease was the result of an exercise of prudent business judgment; and (iv) although Klairmont was treated unfairly, the unfair treatment had no bearing on JCP's decision.

Klairmont appealed to the district court, arguing that JCP's process for arriving at the decision to reject the ground lease was "outside the bounds of business judgment" and that JCP's decision to reject the ground lease was not timely in accordance with the terms of the APA. The district court affirmed the bankruptcy court's ruling. In addition to finding that the ground lease was timely rejected, the district court concluded that JCP's decision to abide by OpCo's direction to reject the ground lease reflected sound business judgment.

In so ruling, the district court noted as follows:

> Any consequences to JCP of OpCo's decision [to reject the ground lease] paled in comparison to JCP's duties under the APA to honor OpCo's choice. So even if the offer accepted did not yield the highest amount of money or there was some defect in the process, such as the alleged passing of deadlines, it was within JCP's business judgment whether to stand or fall on a challenge to OpCo's decision—whether as a substantive or procedural matter. Given the competing concerns, which involved much more than the $3 million Klairmont offered, the Court cannot conclude that the Bankruptcy Court abused its discretion or clearly erred as a matter of fact in finding that JCP's decision was within the bounds of appropriate business judgment.

Klairmont Korners, LLC, 2022 WL 2136902, at *15 (S.D. Tex. June 10, 2022), *aff'd sub nom. Matter of J. C. Penney Direct Mktg. Servs., L.L.C.*, 50 F.4th 532 (5th Cir. 2022).

Klairmont appealed to the Fifth Circuit.

THE FIFTH CIRCUIT'S RULING

The Fifth Circuit affirmed the district court's ruling in a *per curiam* opinion.

Initially, the Fifth Circuit noted that the business judgment standard applied to JCP's decision to reject the ground lease. It declined to adopt the "bad faith, whim, or caprice" standard, but ruled that Klairmont's appeal failed under both standards.

According to the Fifth Circuit, "Klairmont misapprehends the lens through which courts view the business judgment rule." "The question," it wrote, "is not whether the debtor's decision reasonably protects the interests of other parties, but rather whether the decision 'appears to enhance a debtor's estate.'" *J.C. Penney*, 50 F.4th at 534 (quoting *Richmond Leasing*, 762 F.2d at 1309).

The Fifth Circuit explained that Klairmont's challenge to rejection of the ground lease foundered because it failed to argue that JCP's decision to reject the ground lease did not enhance the bankruptcy estate, nor did it contend that JCP's action on the estate's behalf was "clearly erroneous, too speculative, or contrary to the Bankruptcy Code." *Id.* Moreover, the Fifth Circuit noted, even under the "bad faith, whim, or caprice" standard, Klairmont's position was untenable because that standard does not require disapproval of a debtor's decision to assume or reject a lease upon any showing of bad faith. Instead, it hinges on "'whether the decision of the debtor *that rejection will be advantageous* is so manifestly unreasonable that it could not be based on sound business judgment, but only on bad faith, or whim or caprice.'" *Id.* at 535 (quoting *Lubrizol*, 756 F.2d at 1047) (emphasis added). According to the Fifth Circuit, that standard

also "revolves around benefit to the debtor, not bad faith affecting third parties." *Id.*

The Fifth Circuit acknowledged that bad-faith dealing prejudiced Klairmont in its negotiations with JCP's agent regarding assumption of the sublease. Even so, it wrote, "Klairmont will not find relief . . . in asserting that JCP's decision deserves no deference under the business judgment rule." *Id.*

OUTLOOK

In *J.C. Penney*, the Fifth Circuit reaffirmed that the business judgment standard applies to the decision to assume or reject an executory contract or an unexpired lease. Although the court declined to adopt the "bad faith, whim, or caprice" test used by some courts, the Fifth Circuit clarified that, under either standard, the bankruptcy court's inquiry should be directed at whether the decision to assume or reject benefits the bankruptcy estate, rather than any bad faith impacting third parties. Thus, the Fifth Circuit concluded that, under the circumstances, the DIP's decision to reject the ground lease was an exercise of sound business judgment, even though its agent acted in bad faith during the course of negotiations concerning the fate of the ground lease. Although the agent's bad faith in dealing with the sublessee was not a basis for denying deference to the DIP's business judgment in rejecting the ground lease, the sublessee might have other avenues of redress, such as an action against the agent for damages.

J.C. Penney represents the fourth time in 2022 that the Fifth Circuit has provided what traditionally has been rare appellate guidance on executory contracts. 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." *Id.* at 354.

In *In re Ultra Petroleum Corp.*, 28 F.4th 629 (5th Cir. 2022), the Fifth Circuit held that, although a bankruptcy court faced with a motion to reject a filed-rate contract regulated under the Federal Power Act (the "FPA") or the Natural Gas Act (the "NGA") must invite the Federal Energy Regulatory Commission ("FERC") to participate in the bankruptcy case, there is no requirement that FERC be allowed to conduct a hearing before the court can decide on rejection. In addition, in *Gulfport Energy Corp. v. FERC*, 41 F.4th 667 (5th Cir. 2022), the Fifth Circuit tripled down on its nearly two-decades-long view that filed-rate contracts regulated under the FPA and the NGA can be rejected in bankruptcy without FERC's consent.

DEFAULT UNDER ASSUMED LEASE NEED NOT BE MATERIAL OR ONGOING TO TRIGGER LANDLORD'S ENTITLEMENT TO ADEQUATE ASSURANCE OF FUTURE PERFORMANCE

Brad B. Erens • Mark G. Douglas

The ability of a bankruptcy trustee or chapter 11 debtor-in-possession ("DIP") to assume, assume and assign, or reject executory contracts and unexpired leases is an important tool designed to promote a "fresh start" for debtors and to maximize the value of the bankruptcy estate for the benefit of all stakeholders. However, the Bankruptcy Code establishes strict requirements for the assumption or assignment of contracts and leases. Among them are the requirements that, if the debtor has defaulted under an executory contract or unexpired lease, the default must be "cured" upon assumption of the contract or lease by the trustee or DIP and that the non-debtor party must be provided with "adequate assurance of future performance."

The adequate assurance requirement was recently examined by the U.S. Court of Appeals for the Ninth Circuit. In *Smart Capital Investments I LLC v. Hawkeye Entertainment LLC (In re Hawkeye Entertainment LLC)*, 49 F.4th 1232 (9th Cir. 2022), the Ninth Circuit ruled that, even though a default under an unexpired lease already had been remedied prior to assumption or was immaterial, the landlord is nonetheless entitled to adequate assurance of future performance. The Ninth Circuit concluded that a bankruptcy court erred in ruling otherwise, but that the error was harmless because the defaults either had been cured prior to the debtor's request to assume the lease or were "minor deviations" from the lease terms, and "any adequate assurance responsive to the alleged defaults would be little more than simple promises not to deviate from the contract terms again."

ASSUMPTION, ASSUMPTION AND ASSIGNMENT, AND REJECTION OF EXECUTORY CONTRACTS AND UNEXPIRED LEASES IN BANKRUPTCY

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 contracts or leases (among other powers) is conferred upon a 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). 11 U.S.C. § 365(g). Assumption of a contract requires, among other things, that if there have been defaults under the contract, the trustee or DIP cure all existing monetary defaults and provide "adequate assurance of future performance."

In particular, section 365(b)(1) provides as follows:

(1) If there has been a default in an executory contract or unexpired lease of the debtor, the trustee may not assume such contract or lease unless, at the time of assumption of such contract or lease, the trustee—
  (A) cures, or provides adequate assurance that the trustee will promptly cure, such default other than a default that is a breach of a provision relating to the satisfaction of any provision (other than a penalty rate or penalty provision) relating to a default arising from any failure to perform non-monetary obligations under an unexpired lease of real property, if it is impossible for the trustee to cure such default by performing non-monetary acts at and after the time of assumption, except that if such default arises from a failure to operate in accordance with a nonresidential real property lease, then such default shall be cured by performance at and after the time of assumption in accordance with such lease, and pecuniary losses resulting from such default shall be compensated in accordance with the provisions of this paragraph;
  (B) compensates, or provides adequate assurance that the trustee will promptly compensate, a party other than the debtor to such contract or lease, for any actual pecuniary loss to such party resulting from such default; and
  (C) provides adequate assurance of future performance under such contract or lease.

11 U.S.C. § 365(b)(1).

The cure obligations set forth in section 365(b)(1) do not apply to defaults triggered by the debtor's financial condition (including its bankruptcy filing) and certain other breaches. *See* 11 U.S.C. § 365(b)(2).

Special rules govern what constitutes adequate assurance of future performance under shopping center leases. *See* 11 U.S.C. § 365(b)(3). However, for other kinds of contracts and leases, the Bankruptcy Code does not specify what constitutes "adequate assurance of future performance." Courts have considered various factors in examining the issue, including the debtor's payment history, the existence of a guarantee or a security deposit, evidence of profitability, a chapter 11 plan earmarking money exclusively for the landlord, the general outlook in the debtor's industry, and whether an unexpired lease is at or below market. *See* COLLIER ¶ 365.06[3][a] (16th ed. 2022) (citing cases and noting that courts apply the adequate assurance requirement "based upon the facts and circumstances of each case").

The trustee or DIP may not assume or assign any executory contract or unexpired lease, whether or not such contract or lease prohibits or restricts an assignment of rights or delegation of duties, if: (i) applicable law excuses the non-debtor party from accepting performance from or rendering performance to an entity other than the debtor or the DIP, and the non-debtor party does not consent to assumption or assignment; (ii) the contract is one "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"; or (iii) the lease is a nonresidential real property lease that was terminated under applicable non-bankruptcy law prior to entry of the order for relief. 11 U.S.C. § 365(c).

Bankruptcy courts will generally approve a proposed assumption or rejection of a contract or lease 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 non-debtor 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). 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).

In *Hawkeye*, the Ninth Circuit considered the "adequate assurance of future performance" requirement in section 365(b)(1).

HAWKEYE

In 2014, Smart Capital Investments I, LLC and its affiliates (collectively, the "landlord") leased several floors of an office building in

Los Angeles to Hawkeye Entertainment, LLC (the "debtor") under a significantly below-market-rate lease. The debtor sublet a portion of the premises to its affiliate, WERM Investments, LLC. After the relationship between the landlord and the debtor soured, the landlord asked the debtor to sign estoppel certificates to assist in refinancing the landlord's mortgage on the property. However, the debtor refused, claiming that there were problems with the premises giving rise to claims against the landlord under the lease.

In August 2019, the landlord notified the debtor that it had defaulted under several non-monetary default provisions in the lease by, among other things, failing to provide adequate emergency infrastructure, violating a conditional use permit for the premises, improperly subletting a portion of the premises, failing to provide estoppel certificates, and refusing to subordinate its leasehold interest to any future mortgage. The landlord later notified the debtor that it would take steps to terminate the lease. The debtor, however, filed for chapter 11 protection in the Central District of California in August 2019 before the termination was effected.

The debtor moved to assume the lease and the sublease in October 2019. It also asked the bankruptcy court to defer rent payments under the lease for two months in light of Los Angeles's April 2020 COVID rent moratorium. The court denied the motion, concluding that the moratorium did not apply. The debtor did not timely pay its April 2020 rent (but ultimately paid such rent) and timely paid the rent due after April 2020. The late April rent triggered a late-fee penalty under the lease, which the debtor paid in October 2020.

Shortly afterward, the bankruptcy court granted the debtor's motion to assume the lease and the sublease. Among other things, the court found that: (i) a sound business rationale existed for the debtor's decision to assume the lease and the sublease; (ii) assumption of the lease and the sublease was in the best interests of the estate; and (iii) many of the debtor's alleged breaches of the lease had been ongoing for years and appeared to be "manufactured, and minor, and made-up, sometimes."

Addressing section 365(b)(1)'s adequate assurance of future performance requirement in cases where "there has been a default" under an unexpired lease, the bankruptcy court concluded that a "default" must be something that is "material" in that it would warrant forfeiture or termination of the lease under applicable non-bankruptcy law (here, California law). Because the landlord failed to demonstrate that the alleged non-monetary breaches of the lease were either ongoing or material, the court held that "the Debtor was not required to make a showing of cure or adequate assurance of prompt cure, compensation or adequate assurance of prompt compensation, or adequate assurance of future performance as a condition of assumption of the Lease and Sublease pursuant to Bankruptcy Code § 365(b)(1)(A), (B) and (C)." *In re Hawkeye Entertainment, LLC*, No. 1:19-bk-12102-MT (Bankr. C.D. Cal. Oct. 27, 2020) (unpublished order) p. 3 [Doc. No. 230]. According to the bankruptcy court, the adequate assurance requirement in section 365(b)(1) is not triggered by minor, immaterial, or previously cured defaults.

The district court affirmed, and the landlord appealed to the Ninth Circuit.

THE NINTH CIRCUIT'S RULING

A three-judge panel of the Ninth Circuit ruled that the bankruptcy court erred in concluding that section 365(b)(1) did not apply, but that the error was harmless.

Writing for the panel, U.S. Circuit Judge Danielle Jo Forrest explained that, if there has been no default under an unexpired lease, "section 365(b)(1)'s requirements—cure, compensation, and adequate assurances of future performance—are not triggered." *Hawkeye*, 49 F.4th at 1236.

However, she noted, the plain language of section 365(b)—"[i]f there *has been* a default"—indicates that lawmakers intended for the provision to be triggered upon the occurrence of a default prior to assumption, "regardless of whether that default has been resolved or is ongoing." *Id.* at 1237 (emphasis added). Although "a debtor that has previously cured a default need not provide *cure* as a condition of assumption under section 365(b)(1)(A)," Judge Forrest wrote, "the other two requirements—compensation for pecuniary loss and adequate assurances of future performance—may nonetheless still apply, depending on the circumstances." *Id.* (citing COLLIER at ¶ 365.06[2] (stating that a landlord is "entitled to insist that any defaults, *whenever they may have occurred*, be cured, that appropriate compensation be provided, *and that, a past default having occurred, adequate assurance of future performance is available*") (emphasis added)).

Therefore, the Ninth Circuit reasoned that the bankruptcy court's finding that there was no active default when it granted the debtors' motion to assume the lease "did not render section 365(b)(1)'s curative requirements inapplicable." *Id.*

Next, the Ninth Circuit determined that the bankruptcy court erred by narrowly construing "default" to mean only "defaults that are sufficiently material to warrant forfeiture of the lease under California law because there is nothing in section 365(b)(1) to support this interpretation." *Id.* at 1239. According to Judge Forrest, section 365(b)(1), unlike several other provisions of the Bankruptcy Code, does not explicitly require that a default be material, suggesting that Congress did not intend a materiality analysis in connection with the unexpired lease cure and adequate assurance requirements. *Id.* (citing 11 U.S.C. § 1112(b)(4)(N) (cause for conversion or dismissal of a chapter 11 case includes "material default by the debtor with respect to a confirmed plan"); § 1208(c)(6) (substantially the same for chapter 12); § 1307(c)(6) (substantially the same for chapter 13). Moreover, Judge

Forrest explained, "section 365(b)(2) specifically exempts certain types of defaults involving ipso facto and forfeiture clauses; non-material defaults are not one of the exempted categories." *Id.*

Despite its determination that the bankruptcy court had erred, the Ninth Circuit concluded that the bankruptcy court's failure properly to analyze section 365(b)(1)'s "curative requirements" was harmless error under Fed. R. Civ. P. 61, which provides that "the court must disregard all errors and defects that do not affect any party's substantial rights" (made applicable to bankruptcy cases by Fed. R. Bankr. P. 9005).

According to Judge Forrest, the only outstanding issue was the landlord's alleged right to "adequate protection of future performance" under section 365(b)(1)(C), because any existing breaches had been cured or had been found by the bankruptcy court to be "only minor deviations from the contract terms." Therefore, she wrote, "any adequate assurance responsive to the alleged defaults would be little more than simple promises not to deviate from the contract terms again." Furthermore, Judge Forrest noted, the landlord "has not explained how any additional assurance of future performance would have substantively impacted its right to full performance of the lease terms." *Id.* at 1240.

The Ninth Circuit ultimately ruled that any error committed by the bankruptcy court was "harmless." Noting the below-market nature of the lease, Judge Forrest wrote that the landlord "made the deal" and "is not entitled to use section 365(b)(1) as a means to get out of a bad deal so that it can make a better one." *Id.* at 1240-41.

OUTLOOK

The key takeaway from the Ninth Circuit's decision in *Hawkeye* is that a default under an executory contract or an unexpired lease need not be material or ongoing to trigger the obligation of the DIP or trustee to provide adequate assurance of future performance to the non-debtor counterparty as a condition to assumption of the contract or lease. The materiality of any breach may, however, impact the court's determination as to the extent of adequate assurance required to assume a contract or lease.

In *Hawkeye*, for example, because the payment default under the lease had been cured prior to assumption and the remaining alleged lease defaults were viewed as immaterial, the Ninth Circuit concluded that the bankruptcy court's imposition of a materiality trigger on the adequate assurance obligation was harmless error and that little or no adequate assurance was necessary. The court also perceived that the landlord was objecting to assumption on the basis of lack of adequate assurance in a ploy to get out of a bad lease. On different facts, the court might have ruled otherwise.

ACCELERATION ENFORCEABLE UNDER STATE LAW FOLLOWING NON-MONETARY CONTROLCOVENANT DEFAULT PREVENTS REINSTATEMENT OF LOAN UNDER CHAPTER 11 PLAN

Daniel J. Merrett • Mark G. Douglas

Chapter 11 debtors commonly use plans of reorganization to decelerate defaulted loans and reinstate the obligations according to their original terms as a means of locking in favorable terms in an unfavorable market. In order to do so, the Bankruptcy Code requires that the trustee or chapter 11 debtor-in-possession ("DIP") "cure" any defaults under the loan agreement, other than defaults related to a debtor's financial condition ("*ipso facto* provisions") or penalties payable due to the debtor's breach of certain non-monetary obligations.

The U.S. Bankruptcy Court for the Eastern District of New York addressed the cure obligation incident to reinstatement of a prepetition loan under a plan in *In re 975 Walton Bronx LLC*, 2022 WL 5265041 (Bankr. E.D.N.Y. Oct. 6, 2022). After finding that acceleration of the loan was not subject to state law equitable exceptions to enforcement, the court ruled that the DIP could not reinstate the loan without curing a default arising from a change in control of the debtor without the lender's consent.

REINSTATEMENT OF OBLIGATIONS UNDER A CHAPTER 11 PLAN

Confirmation of chapter 11 plans involving reinstatement of an objecting secured creditor's claim hinges on the Bankruptcy Code's definition of "impairment." Classes of claims or interests may be either "impaired" or "unimpaired" by a plan. The distinction is important because only creditors holding claims in impaired classes have the right 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 defines impairment, providing as follows:

> Except as provided in section 1123(a)(4) of this title [permitting the holder of a claim or interest to agree to less-favorable treatment of its claim or interest than the class], a class of claims or interests is impaired under a plan unless, with respect to each claim or interest of such class, the plan—
>
> (1) leaves u naltered the legal, equitable, and contractual rights to which such claim or interest entitles the holder of such claim or interest; or
> (2) notwithstanding any contractual provision or applicable law that entitles the holder of such claim or interest to demand or receive accelerated payment of such claim or interest after the occurrence of a default—

(A) *cures any such default that occurred before or after the commencement of the case under this title, other than a default of a kind specified in section 365(b)(2) of this title or of a kind that section 365(b)(2) expressly does not require to be cured*;

(B) reinstates the maturity of such claim or interest as such maturity existed before such default;

(C) compensates the holder of such claim or interest for any damages incurred as a result of any reasonable reliance by such holder on such contractual provision or such applicable law;

(D) *if such claim or such interest arises from any failure to perform a non-monetary obligation, other than a default arising from failure to operate a nonresidential real property lease subject to section 365(b)(1)(A), compensates the holder of such claim or such interest (other than the debtor or an insider) for any actual pecuniary loss incurred by such holder as a result of such failure*; and

(E) does not otherwise alter the legal, equitable, or contractual rights to which such claim or interest entitles the holder of such claim or interest.

11 U.S.C. § 1124 (emphasis added).

Section 365(b)(2) provides that a debtor's obligation to cure defaults under an executory contract or an unexpired lease prior to assumption does not include *ipso facto* clauses—provisions relating to the debtor's insolvency or financial condition, the bankruptcy filing, or the appointment of a trustee or custodian—or provisions relating to "the satisfaction of any penalty rate or penalty provision relating to a default arising from any failure by the debtor to perform non-monetary obligations under the executory contract or unexpired lease."

Pursuant to section 365(b)(1)(A), an executory contract or unexpired lease under which the debtor has defaulted can be assumed only if the trustee or DIP cures the default, or provides adequate assurance of its prompt cure, other than with respect to "a default that is a breach of a provision relating to the satisfaction of any provision (other than a penalty rate or penalty provision) relating to a default arising from any failure to perform non-monetary obligations under an unexpired lease of real property," with certain caveats. Although the language of section 365(b)(1)(A) is confusing, even after it was supposedly clarified by Congress in 2005 (*see* Pub. L. No. 109–8, § 328(a)(1)(A) (2005)), it has been suggested that "the reference to non-monetary obligations and the impossibility of cure by subsequent performance means that the provision relates to continuous operation provisions and other provisions that are similar in that they involve non-monetary obligations and cannot be retroactively cured." COLLIER ¶ 365.06 (16th ed. 2022).

By reinstating an obligation and curing defaults under section 1124(2), a plan effectively can "roll back the clock to the time before the default existed." *MW Post Portfolio Fund Ltd. v. Norwest Bank Minn., N.A. (In re Onco Inv. Co.)*, 316 B.R. 163, 167 (Bankr. D. Del. 2004); *see also* 11 U.S.C. § 1123(a)(5)(G) (providing that a plan shall provide adequate means for its implementation, such as "curing or waiving of any default"). However, this does not mean that reinstatement relieves the debtor of the obligation to pay postpetition interest at the default rate specified in a loan agreement or applicable non-bankruptcy law. *See In re New Investments, Inc.*, 840 F.3d 1137 (9th Cir. 2016); *In re Sagamore Partners, Ltd.*, 620 Fed. App'x. 864 (11th Cir. 2015); *In re Moshe*, 567 B.R. 438 (Bankr. E.D.N.Y. 2017).

For a chapter 11 debtor, reinstatement of a loan may be the preferable strategy if the loan bears an interest rate lower than the prevailing market rate and is otherwise subject to terms (including covenants) that are favorable to the debtor. Reinstatement may also allow the debtor to lock in a loan under favorable terms until post-reorganization financing becomes more available or attractive.

975 WALTON

975 Walton Bronx LLC (the "debtor") owned a mixed-use building with retail and residential units in the Bronx, New York. The property secured a mortgage loan in the amount of $22.5 million from Investors Bank ("IB"). The 2015 loan agreement contained a change-in-control restriction (the "control covenant") limiting ownership of the debtor to its sole managing member, 15-21 Crooke LLC ("Crooke"), until the loan was repaid. Crooke's sole managing member was Benzion Kohn ("Kohn").

The loan agreement provided, however, that IB could consent to a change in the legal or equitable ownership of the debtor and assumption of the mortgage provided that, among other things: (i) no event of default under the loan agreement had occurred and remained uncured at the time of the loan assumption; (ii) the proposed transferee had delivered an assumption agreement to IB with specified terms; and (iii) IB had received a "transfer processing fee" equal to 1% of the outstanding principal amount of the loan plus any costs and expenses incurred by IB in connection with the transfer.

Events of default under the loan agreement included any change in ownership of the building or the equity ownership of the debtor without IB's prior written consent.

In January 2018, Crooke transferred 49.99% of its ownership interest in the debtor to the J Partners Group ("J Partners") without IB's consent. Thereafter, J Partners managed the property. The debtor further defaulted on the loan in April 2020 by, among other things, failing to make debt service payments and failing to provide financial information required by the loan agreement to IB. IB delivered notice of the defaults and its intention to accelerate the loan in August 2020.

In October 2020, IB assigned the loan to Walton Improvement Group LLC ("Walton"). In February 2021, Walton commenced an action in state court to foreclose on the property. Its complaint listed the payment defaults but omitted the control covenant default.

The foreclosure action was stayed when the debtor filed for chapter 11 protection in the Eastern District of New York on February 25, 2021. Walton filed a proof of secured claim in the case for approximately $24 million.

The debtor's chapter 11 plan proposed to reinstate the loan according to its original terms (with one exception) and to cure all prepetition payment defaults with interest at the default contract rate (approximately $1.6 million). Walton objected to confirmation of the plan, arguing that the loan could not be cured and reinstated due to the control covenant default.

During the plan confirmation hearing, the bankruptcy court ruled that Walton did not waive the default arising from breach of the control covenant and was not estopped from enforcing it. In addition, this non-monetary default was incurable without Walton's consent, which Walton was authorized to withhold retrospectively for any reason or no reason at all. Notwithstanding the default, however, the court held that the loan would be unimpaired, and thus susceptible to reinstatement, if the debtor could show that acceleration was inappropriate due to the existence of certain equitable factors under New York law, as outlined in *In re 53 Stanhope LLC*, 625 B.R. 573 (Bankr. S.D.N.Y. 2021). It accordingly ordered the parties to brief this issue.

THE BANKRUPTCY COURT'S RULING

After briefing and a trial, the bankruptcy court held that the debtor could not reinstate the loan under its chapter 11 plan without curing the non-monetary controlcovenant default, which required Walton's consent.

Initially, U.S. Bankruptcy Judge Jil Mazer-Marino explained that, under New York law, a mortgagee is entitled to enforce an acceleration clause in a mortgage absent some element of fraud, exploitative overreaching, or unconscionable conduct. *975 Walton*, 2022 WL 5265041, at *4 (citing *Fifty States Mgmt. Corp. v. Pioneer Auto Parks, Inc.*, 46 N.Y.2d 573, 575 (N.Y. 1979); *Graf v. Hope Bldg. Corp.*, 254 N.Y. 1 (N.Y. 1930)). Even so, she noted, "'equity will often intervene to prevent a substantial forfeiture occasioned by a trivial or technical breach'" or "'to prevent unconscionable overreaching where a good faith mistake has been promptly cured and there is no prejudice to the non-defaulting party.'" *Id.* at *5 (quoting *Fifty States*, 46 N.Y.2d at 576-77).

Next, the bankruptcy court reasoned that, under New York law, a court exercising its equitable powers can prevent the enforcement of a mortgage acceleration clause triggered by a *non-monetary* default. In *Stanhope*, Judge Mazer-Marino explained, the bankruptcy court acknowledged that acceleration clauses are strictly enforced under New York law upon a *monetary* default, but noted that, in deciding whether to enforce an acceleration clause triggered by a *non-monetary* default, New York courts consider whether the mortgagee suffered actual damages as a result of the default, whether the default impaired the lender's security, whether the default makes future payment of principal and interest less likely, and whether the default was inadvertent or insignificant. *Id.* at *6 (citing *Stanhope*, 625 B.R. at 584).

Judge Mazer-Marino concluded that, under either the *Stanhope* standard or the *Fifty States* standard, Walton was within its rights to accelerate the mortgage loan based on the debtor's default under the control covenant. In so ruling, the bankruptcy court rejected the debtor's argument that Walton purchased the loan for the sole purpose of foreclosing on the property and therefore engaged in the kind of "fraudulent, exploitative, overreaching, or unconscionable conduct" described in *Fifty States*. Even if it were aware of the control-covenant default when it bought the loan, Judge Mazer-Marino wrote, Walton's acquisition of the debt to accelerate the loan and foreclose was "a legitimate exercise of a mortgage assignee's rights." *Id.* at *7.

The bankruptcy court also rejected the debtor's argument that IB engaged in inequitable conduct by failing to grant the debtor a forbearance. According to Judge Mazer-Marino, IB was not obligated to offer a forbearance or to negotiate a sale of the loan to the debtor, and the debtor admitted that, at the time it was seeking a forbearance, it had defaulted on the control covenant and its payment obligations.

Addressing the *Stanhope* standard, the bankruptcy court found, among other things, that: (i) Walton suffered actual damages due to the control-covenant default because J Partners failed to pay debt service, real estate taxes, and water bills with respect to the property, evidencing "J Partners' lack of care or dubious business judgment," and failed to escrow certain fire insurance proceeds; (ii) the control-covenant default made the future payment of principal and interest on the loan less likely because the debtor paid insider loans that "more closely resemble[d] contributions to equity as opposed to short-term loans," instead of servicing the mortgage debt, and Walton was prejudiced because, unlike Kohn, neither J Partners nor its investors had executed a "bad-boy" guarantee of the debt to deter them from approving actions detrimental to the mortgagee; and (iii) the debtor intentionally defaulted on the control covenant and J Partners made a

business decision to purchase its 49.9% interest even though it knew that it would violate the covenant.

"The equitable principles articulated in *Graf* and *Stanhope*," Judge Mazer-Marino wrote, "have no application here." The bankruptcy court accordingly ruled that the debtor's chapter 11 plan could not be confirmed to the extent that it provided for reinstatement of the Walton loan without curing the change-in-control covenant default.

OUTLOOK

The bankruptcy court's examination in *975 Walton* of equitable limitations under New York law on the ability of a lender to enforce its acceleration and foreclosure rights is instructive, but arguably unnecessary given the context.

Section 1124(2) expressly states that, to reinstate an obligation, any and every default must be cured "other than a default of a kind specified in section 365(b)(2) of this title or of a kind that section 365(b)(2) expressly does not require to be cured." Section 365(b)(2), in turn, excuses from cure only obligations relating to breaches of *ipso facto* provisions or to the payment of penalties incurred due to the debtor's failure to perform non-monetary obligations under an executory contract or unexpired lease.

Neither section 1124(2) nor section 365(b)(2) includes an exception to the requirement to cure defaults—non-monetary or otherwise—that are technical, minor, or caused by a lender's inequitable conduct. To be sure, section 1124(2)(d) *does* relieve the trustee or DIP *from compensating a lessor for pecuniary losses* arising from the breach of non-monetary obligations under a nonresidential real property lease subject to section 365(b)(1)(A), but that provision has no relevance to the facts in *975 Walton*. None of these section 1124(2) exceptions excuses cure of defaults, monetary or non-monetary, under a loan agreement that is to be reinstated in a chapter 11 plan.

NEWSWORTHY

In December 2022, ***Jones Day*** was awarded a "Most Recommended" law firm status by BTI Consulting Group for the 20th consecutive year. The honor is based on unprompted responses from in-depth interviews with more than 340 top legal decision makers conducted by BTI Consulting Group for its annual survey, "The Firms Top Legal Decision Makers Recommend Above All Others."

Jones Day received a National Tier 1 Ranking in the fields of Litigation-Bankruptcy and Bankruptcy and Creditor Debtor Rights/Insolvency and Reorganization Law in the 2023 *U.S. News—Best Lawyers*® "Best Law Firms" list published jointly by *U.S. News and World Report* and *Best Lawyers*®.

Corinne Ball ***(New York)*** was recognized by Who's Who Legal ("WWL") as a "Global Elite" Thought Leader for 2023. The lawyers designated as Global Elite obtained the highest number of nominations from peers, corporate counsel, and other market sources in WWL's most recent research cycle.

Carl E. Black ***(Cleveland)*** has been named a Fellow of The American College of Bankruptcy, an honorary public service association of professionals who are invited to join as Fellows "based on a proven record of the highest standards of expertise, leadership, integrity, professionalism, scholarship, and service to the bankruptcy and insolvency practice and to their communities." He will be formally inducted at the American College of Bankruptcy's Annual Meeting in March 2023 in Washington, D.C.

Juan Ferré ***(Madrid)*** was recognized in the 2023 edition of *The Best Lawyers in Spain*™ in the field of Insolvency and Reorganization Law.

An article written by ***Corinne Ball*** ***(New York)***, ***Dan T. Moss*** ***(Washington)***, ***Michael C. Schneidereit*** ***(New York)***, ***Isel M. Perez*** ***(Miami)***, and ***Mark G. Douglas*** ***(New York)*** titled "U.S. Bankruptcy Court Can Enforce Foreign Restructuring Plan Providing for Cancellation of U.S. Law-Governed Debt" was published in *Lexis Practical Guidance* on November 28, 2022.

An article written by ***Charles M. Oellermann*** ***(Columbus)*** and ***Mark G. Douglas*** ***(New York)*** titled "Second Circuit Rules that Bankruptcy Courts May Award Appellate Legal Fees as Sanction for Contempt" was posted on the *Harvard Law School Bankruptcy Roundtable* on November 29, 2022.

An article written by ***Corinne Ball*** ***(New York)*** titled "Second Circuit Weighs In on Whether the Bankruptcy Code Requires Payment of Post-Petition Interest on Unsecured Claims" was published in the December 21, 2022 issue of the *New York Law Journal*.

An article written by ***Daniel J. Merrett*** ***(Atlanta)*** and ***Mark G. Douglas*** ***(New York)*** titled "Unimpaired Unsecured Creditors in Solvent-Debtor Chapter 11 Case Entitled to Postpetition Interest, Presumably at Contract or Default Rate" was published in *Lexis Practical Guidance* on November 28, 2022.

An article written by ***Oliver S. Zeltner*** ***(Cleveland)*** and ***Mark G. Douglas*** ***(New York)*** titled "Delaware District Court: Using Contract Rights to Strategic Advantage Not Grounds for Equitable Subordination in Bankruptcy" was published in *Lexis Practical Guidance* on November 28, 2022.

BUSINESS RESTRUCTURING REVIEW

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