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BUSINESS RESTRUCTURING REVIEW

SECOND CIRCUIT GREEN LIGHTS PURDUE PHARMA CHAPTER 11 PLAN CONTAINING NONCONSENSUAL THIRD-PARTY RELEASES

Jane Rue Wittstein • Mark G. Douglas

There is longstanding controversy concerning the validity of third-party release provisions in non-asbestos trust chapter 11 plans that limit the potential exposure of various non-debtor parties involved in the process of negotiating, implementing and funding a plan. In the latest chapter of this debate, the U.S. Court of Appeals for the Second Circuit handed down a long-awaited ruling regarding the validity of nonconsensual third-party releases in the chapter 11 plan of pharmaceutical company Purdue Pharma, Inc. and its affiliated debtors (collectively, "Purdue"). In *In re Purdue Pharma L.P.*, 69 F.4th 45 (2d Cir. 2023), the Second Circuit reversed a district court decision finding that the bankruptcy court lacked the power to approve a plan provision releasing the founding Sackler family from liabilities arising from Purdue's sale of opioids and affirmed the bankruptcy court order confirming Purdue's chapter 11 plan.

CHAPTER 11 PLAN RELEASES

Section 524(e) of the Bankruptcy Code provides that, "[e]xcept as provided in subsection (a)(3) of this section [making the discharge injunction applicable to actions to collect against community property], discharge of a debt of the debtor does not affect the liability of any other entity on, or the property of any other entity for, such debt." Even so, chapter 11 plans confirmed by bankruptcy courts in certain circuits commonly include provisions that release various non-debtors from certain debtor liabilities.

Third-party releases can provide for the relinquishment of both prepetition and postpetition claims belonging to the debtor or non-debtor third parties (e.g., creditors) against various non-debtors. As such releases have become common features of chapter 11 plans, they also have become more controversial.

It is generally accepted that a chapter 11 plan can release non-debtors from claim s of other non-debtor third parties if the release is consensual. *See generally* COLLIER ON BANKRUPTCY ("COLLIER") ¶ 524.05 (16th ed. 2023) (citing cases). What constitutes consent, however, is sometimes disputed. COLLIER at ¶ 1141.02[5](b) (discussing various opt-out and opt-in mechanisms that have been attempted as a manifestation of consent for impaired and unimpaired creditors); Lisa M. Schweitzer, *Third-Party Releases in Chapter 11 Plans: Key Considerations and Recent Developments*, in Nuts and Bolts of Corporate Bankruptcy

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2021, at 323 (Practising Law Institute Commercial Law and Practice Course Handbook Series, PLI Order No. A-1043, 2021) (same).

In addition, a plan that establishes a trust under section 524(g) of the Bankruptcy Code to fund payments to asbestos claimants can enjoin litigation against certain third parties (e.g., entities related to the debtor or its insurers) alleged to be liable for the conduct of, claims against, or demands on the debtor. *See* 11 U.S.C. § 524(g)(4). Section 524(g) was added to the Bankruptcy Code in 1994 in the wake of the historic Johns-Manville and UNARCO Industries chapter 11 cases. It was enacted to provide explicit statutory authority for courts to issue channeling injunctions in respect of asbestos claims and demands, including those held by persons who have been exposed to asbestos but have not yet manifested any signs of illness.

The circuit courts of appeals are split as to whether a bankruptcy court has the authority, other than under section 524(g), to approve chapter 11 plan provisions that, over the objection of creditors or other stakeholders, release specified non-debtors from liability or enjoin dissenting stakeholders from asserting claims against such non-debtors. The minority view, held by the Fifth and Tenth Circuits—and until 2020, arguably the Ninth Circuit (see below)—bans such nonconsensual releases on the basis that they are prohibited by section 524(e) of the Bankruptcy Code. *See Bank of N.Y. Trust Co. v. Official Unsecured Creditors' Comm. (In re Pac. Lumber Co.)*, 584 F.3d 229 (5th Cir. 2009); *Resorts Int'l, Inc. v. Lowenschuss (In re Lowenschuss)*, 67 F.3d 1394 (9th Cir. 1995); *In re W. Real Estate Fund, Inc.*, 922 F.2d 592 (10th Cir. 1990); *see also Blixseth v. Credit Suisse*, 961 F.3d 1074, 1083-84 (9th Cir. 2020) (suggesting, contrary to *Lowenschuss* and other previous rulings, that section 524(e) does not preclude certain non-debtor plan releases of claims that are not based on the debt discharged by the plan), *cert. denied*, 141 S. Ct. 1394 (2021).

On the other hand, the majority of the circuits that have considered the issue have found such releases and injunctions permissible under certain circumstances. *See SE Prop. Holdings, LLC v. Seaside Eng'g & Surveying, Inc. (In re Seaside Eng'g & Surveying, Inc.)*, 780 F.3d 1070 (11th Cir. 2015); *In re Airadigm Commc'ns, Inc.*, 519 F.3d 640 (7th Cir. 2008); *In re Dow Corning Corp.*, 280 F.3d 648 (6th Cir. 2002); *In re Drexel Burnham Lambert Grp., Inc.*, 960 F.2d 285 (2d Cir. 1992); *In re A.H. Robins Co., Inc.*, 880 F.2d 694 (4th Cir. 1989). For authority, these courts generally rely on section 105(a) of the Bankruptcy Code, which authorizes courts to "issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of [the Bankruptcy Code]." Moreover, as the Seventh Circuit held in *Airadigm*, the majority view is that section 524(e) does not limit a bankruptcy court's authority to grant such releases. *Airadigm*, 519 F.3d at 656 ("If Congress meant to include such a limit, it would have used the mandatory terms 'shall' or 'will' rather than the definitional term 'does.' And it would have omitted the prepositional phrase 'on, or . . . for, such debt,' ensuring that the 'discharge of a debt of the debtor shall not affect the liability of another entity'—whether related to a debt or not.").

LAWYER SPOTLIGHT: TOM WEARSCH

Tom Wearsch brings a strong business acumen and creative approach to finding practical, efficient solutions for distressed and healthy companies, financial institutions, equity and hedge funds, bondholders, committees, boards, and management. He has served as counsel to numerous corporations involved in chapter 11 reorganizations, out-of-court restructurings, and distressed mergers and acquisitions for a range of industries, including automotive, aerospace, manufacturing, health care, energy, hospitality, securities, mining, media, and technology.

Tom's many out-of-court restructurings have allowed clients to continue their business operations without filing bankruptcy. He also has significant experience representing debtors and other constituencies in all aspects of complex chapter 11 proceedings. He has served as chapter 11 debtor's counsel in *Shiloh Industries*, *Peabody Energy*, and *Alpha Natural Resources* and as purchaser's counsel in *National Label*, *GigaMonster*, *Xchange Telecom*, *Bold Ocean*, and *Sakthi Automotive*. Prior to joining Jones Day, Tom served as company, trustee, or chapter 11 debtor's counsel in *Black Elk Offshore Energy*, *Swift-Cor Aerospace*, *Excello Engineered*, *VSV Group*, *Creative Polymer*, *Westgate Resorts*, *Bernard L. Madoff Investment Securities*, and *Globix*, and as purchaser's counsel in *Dune Energy*, *Cardinal Fastener*, and *Saberliner Aerospace*.

A partner in the New York and Cleveland offices, Tom serves on the boards of Shoes and Coats for Kids, Brookhaven Farms, and the Harvard Club of Northeast Ohio.

As authority for such involuntary releases, some courts have also relied on section 1123(a)(5) or 1123(b)(6) of the Bankruptcy Code. *See, e.g., Airadigm*, 519 F.3d at 657; *In re Scrub Island Dev. Grp. Ltd.*, 523 B.R. 862, 875 (Bankr. M.D. Fla. 2015). The former states that a chapter 11 plan "shall . . . provide adequate means for the plan's implementation," including a non-exclusive list of examples. The latter provides that a chapter 11 plan may "include any other appropriate provision not inconsistent with the applicable provisions of [the Bankruptcy Code]."

The First and D.C. Circuits have suggested that they agree with the "pro-release" majority, depending upon the specific circumstances. *See In re Monarch Life Ins. Co.*, 65 F.3d 973 (1st Cir. 1995) (a debtor's subsidiary was collaterally estopped by a plan confirmation order from belatedly challenging the jurisdiction of the bankruptcy court to permanently enjoin lawsuits against the debtor's attorneys and other non-debtors not contributing to the debtor's reorganization); *In re AOV Indus.*, 792 F.2d 1140 (D.C. Cir. 1986) (a plan provision releasing liabilities of non-debtors was unfair because the plan did not provide additional compensation to a creditor whose claim against the non-debtor was being released; adequate consideration must be provided to a creditor forced to release claims against non-debtors).

In *In re Millennium Lab Holdings II, LLC*, 945 F.3d 126 (3d Cir. 2019), the Third Circuit refrained from "broadly sanctioning the permissibility of nonconsensual third-party releases in bankruptcy reorganization plans," but, based on the "specific, exceptional facts" of the case, upheld a lower court decision confirming a chapter 11 plan containing nonconsensual third-party releases, finding that the order confirming the plan did not violate Article III of the U.S. Constitution.

Even courts in the majority camp acknowledge that nonconsensual plan releases should be approved only in rare or unusual cases. *See Seaside Eng'g*, 780 F.3d at 1078; *Nat'l Heritage Found., Inc. v. Highbourne Found.*, 760 F.3d 344, 347-50 (4th Cir. 2014); *Behrmann v. Nat'l Heritage Found.*, 663 F.3d 704, 712 (4th Cir. 2011); *In re Metromedia Fiber Network, Inc.*, 416 F.3d 136, 141-43 (2d Cir. 2005).

Recent lower court rulings also highlight the deep division among courts on this issue. *See, e.g., In re Boy Scouts of Am. & Delaware BSA, LLC,* 650 B.R. 87 (D. Del. 2023) (ruling that the bankruptcy court had "related to" jurisdiction to confirm a chapter 11 plan providing for nonconsensual third-party releases and a channeling injunction, which were permissible under sections 105(a), 1123(a)(5), and 1123(b)(6) and necessary to ensure an equitable process by which abuse survivors' claims would be administered and paid), *appeal filed*, No. 23-1668 (3d Cir. Apr. 11, 2023); *In re Mallinckrodt PLC*, 639 B.R. 837 (Bankr. D. Del. 2022) (concluding that bankruptcy courts have statutory and constitutional authority to approve chapter 11 plans containing nonconsensual third-party releases, albeit only in extraordinary cases, and holding that, given the extraordinary nature of the case, nonconsensual opioid releases in the plan of debtor-drug manufacturers were integral to the plan's success and would be approved as fair and reasonable), *stay pending appeal denied*, 2022 WL 1206489 (D. Del. Apr. 22, 2022); *Patterson v. Mahwah Bergen Retail Group, Inc.*, 636 B.R. 641 (E.D. Va. 2022) (vacating a bankruptcy court order confirming a retail group's chapter 11 plan and ruling that the plan impermissibly authorized nonconsensual third-party releases because the bankruptcy court lacked constitutional authority to adjudicate the released claims and failed to analyze whether the releases were justified under Fourth Circuit precedent).

Majority-view courts employ various tests to determine whether such releases are appropriate. Factors generally considered by courts evaluating third-party plan releases or injunctions include whether they are essential to the reorganization, whether the parties being released have made or are making a substantial financial contribution to the reorganization, and whether affected creditors overwhelmingly support the plan. *See Dow Corning*, 280 F.3d at 658 (listing factors).

PURDUE PHARMA

In September 2021, Purdue obtained confirmation of a chapter 11 plan that included nonconsensual releases of various non-debtors, including Purdue's founders the Sackler family, of liabilities associated with Purdue's sale of OxyContin, in exchange for the Sackler family's ownership interest in the companies and more than $4 billion to settle OxyContin litigation claims. At the time of Purdue's bankruptcy filing, Purdue and the Sacklers were defendants in 3,400 lawsuits seeking an estimated $40 trillion in damages, whereas the value of Purdue's assets was estimated at no more than $1.8 billion.

In December 2021, the U.S. District Court for the Southern District of New York vacated the plan confirmation order, ruling that the bankruptcy court did not have authority under the U.S. Constitution or the Bankruptcy Code to approve nonconsensual releases granted under the plan to the Sacklers. According to the district court, the released claims at issue were "non-core" under the U.S. Supreme Court's ruling in *Stern v. Marshall*, 564 U.S. 462 (2011), and the bankruptcy court could not constitutionally enter a final order that effectively finally adjudicated the released claims but, rather, should have issued proposed findings of fact and conclusions of law regarding such claims (and the releases thereof) to the district court. In addition, the district court wrote:

> Contrary to the bankruptcy judge's conclusion, Sections 105(a) and 1123(a)(5) & (b)(6) [of the Bankruptcy Code], whether read individually or together, do not provide a bankruptcy court with such authority; and there is no such thing as 'equitable authority' or 'residual authority' in a bankruptcy court untethered to some specific, substantive grant of authority in the Bankruptcy Code.

In re Purdue Pharma, L.P., 635 B.R. 26, 78 (S.D.N.Y. 2021), *rev'd and remanded*, 69 F.4th 45 (2d Cir. 2023).

On January 27, 2022, the Second Circuit granted the request of Purdue, various creditor and claimant groups, and several Sackler

family members for leave to appeal the district court's interlocutory order vacating the bankruptcy court's confirmation order.

In February 2022, the Sacklers agreed to add more than $1.6 billion to the $4.3 billion settlement that they would have paid under Purdue's original chapter 11 plan. Pending the Second Circuit's hearing and deliberations on the dispute, a court-appointed mediator explored a possible global settlement between Purdue and parties opposing the plan. As a result of these negotiations, many parties agreed to the terms of a revised plan, reflecting, among other things, the Sackler family's increased financial contribution. By the time the Second Circuit handed down its ruling on the appeal, the remaining appellees consisted of the U.S. Trustee, several Canadian municipalities and indigenous nations, and several individual *pro se* plaintiffs.

THE SECOND CIRCUIT'S RULING

Sixteen months after it agreed to hear Purdue's appeal, a three-judge panel of the Second Circuit reversed the district court's order holding that the Bankruptcy Code does not permit nonconsensual releases of third-party direct claims against non-debtors, affirmed the bankruptcy court's confirmation of Purdue's chapter 11 plan, and remanded the case below for further proceedings.

Writing for the panel, U.S. Circuit Court Judge Eunice C. Lee explained at the inception of the court's opinion that, "[w]hen a bankruptcy is the result of mass tort litigation against the debtor, the complexities [inherent in a process where no one is completely satisfied] are magnified because the debts owed are wide-ranging and the harm caused goes beyond the financial." *Purdue Pharma*, 69 F.4th at 56. Judge Lee acknowledged the important policy implications, including considerations of fairness, raised by the approval of a chapter 11 plan that includes nonconsensual non-debtor releases of parties from liability "for actions that cause great societal harm." *Id.* at 57. Even so, she wrote, "our role in this appeal does not require us to answer all of these serious and difficult questions." Instead, she explained, "we are tasked only with resolving two key questions: *First*, does the Bankruptcy Code permit non-consensual third-party releases of direct claims against non-debtors, and, *Second*, if so, were such releases proper here in light of all equitable considerations and the facts of this case." *Id.*

Addressing the first question, the Second Circuit panel concluded that the bankruptcy court had both jurisdiction and statutory authority to approve the third-party releases in Purdue's chapter 11 plan.

Initially, Judge Lee explained, a bankruptcy court's "ability to release claims at all derives from its power of discharge" under section 524(a), which provides that a bankruptcy discharge, among other things, releases a debtor from personal liability for any debt by enjoining creditors from attempting to collect on it. Although section 524(e) of the Bankruptcy Code provides that a debtor's discharge "does not affect the liability of any other entity on . . . such debt," Judge Lee emphasized that the releases in Purdue's chapter 11 plan "do not constitute a discharge of debt for the Sacklers because the releases neither offer umbrella protection against liability nor extinguish all claims." *Id.* at 70.

The Second Circuit panel agreed with the lower courts that the bankruptcy court had statutory jurisdiction to approve the releases "because it is conceivable, indeed likely, that the resolution of the released claims would directly impact" Purdue's bankruptcy estate even though many of the claims were asserted directly against the Sackler officers and directors, who were indemnified by Purdue for liabilities that did not arise from bad-faith conduct. *Id.* at 71.

The Second Circuit panel also concluded that nonconsensual third-party releases may be approved as part of a chapter 11 plan under sections 105(a) and 1123(b)(6) of the Bankruptcy Code. Although section 105(a) alone cannot provide authority to approve such releases, Judge Lee explained, section 1123(b)(6) fills the gap consistent with the Supreme Court's conclusion in *United States v. Energy Resources Co.*, 495 U.S. 545 (1990), that section 1123(b)(6)— "acting in tandem with § 105(a)—grants bankruptcy courts a 'residual authority' consistent with 'the traditional understanding that bankruptcy courts, as courts of equity, have broad authority to modify creditor-debtor relationships.'" *Id.* at 73 (quoting *Energy Resources*, 495 U.S. at 549). The Second Circuit panel found the Seventh Circuit's reasoning in *Airadigm* and the Sixth Circuit's rationale in *Dow Corning* to be convincing on this point.

The Second Circuit panel distanced itself from courts that have ruled that section 524(e) precludes such releases, emphasizing, as the Seventh Circuit explained in *Airadigm*, that the language of section 524(e) is not mandatory and does not expressly manifest lawmakers' intent to limit the bankruptcy court's power to release non-debtors. The panel also found ample Second Circuit precedent "support[ing] the approval of a plan containing non-consensual third-party releases" in non-asbestos liability cases, provided the bankruptcy court makes adequate factual findings and satisfies certain equitable considerations. *Id.* at 75-77 (citing *In re Metromedia Fiber Network, Inc.*, 416 F.3d 136 (2d Cir. 2005); *Drexel*, 960 F.2d at 293; *MacArthur Co. v. Johns-Manville Corp.*, 837 F.2d 89, 91 (2d Cir. 1988)).

The Second Circuit panel stated seven factors that a bankruptcy court should consider in deciding whether to approve nonconsensual third-party releases as part of a chapter 11 plan:

(1) "whether there is an identity of interests between the debtors and released third parties, including indemnification relationships, 'such that a suit against the non-debtor is, in essence, a suit against the debtor or will deplete the assets of the estate.'"
(2) "whether claims against the debtor and non-debtor are factually and legally intertwined, including whether the debtors and the released parties share common defenses, insurance coverage, or levels of culpability."

(3) "whether the scope of the releases is appropriate."
(4) "whether the releases are essential to the reorganization, in that the debtor needs the claims to be settled in order for the *res* to be allocated, rather than because the released party is somehow manipulating the process to its own advantage."
(5) "whether the non-debtor contributed substantial assets to the reorganization."
(6) "whether the impacted class of creditors 'overwhelmingly' voted in support of the plan with the releases."
(7) "whether the plan provides for the fair payment of enjoined claims."

Id. at 78-79 (citations omitted). In applying these factors, Judge Lee cautioned, "[g]iven the potential for abuse, courts should exercise particular care when evaluating these types of releases." *Id.* at 79.

The Second Circuit panel found no error in the bankruptcy court's conclusion that the releases in Purdue's chapter 11 plan satisfied all of these factors (other than factor two, which the bankruptcy court did not list but considered in substance in discussing that releases limited to claims legally intertwined with Purdue's conduct were appropriately subject to settlement). *Id.* at 79-82.

The Second Circuit panel rejected the U.S. Trustee's argument that claimants impacted by the releases were denied procedural due process because the bankruptcy court failed to provide adequate notice of the plan confirmation hearing and the language of the releases was "dense." Judge Lee explained that the bankruptcy court made detailed findings that notice of the confirmation hearing was adequate and that the release language in the plan was "simple . . . plain English." *Id.* at 83.

The Second Circuit panel also rejected the U.S. Trustee's argument that a release, without any ability to opt out, cannot comply with due process "because it effectively denies claimants their day in court." According to Judge Lee, this argument ignores the due process findings by the bankruptcy court and "would essentially call into question all releases through bankruptcy, including bankruptcy discharges (which are one of the most important features of bankruptcy)," and the court accordingly "decline[d] to so undermine such a critical component of bankruptcy." *Id.* at 83.

In a concurring opinion, Circuit Judge Richard C. Wesley stated that the binding precedent in *Drexel* compelled the conclusion that a bankruptcy court has the power to approve nonconsensual third-party releases as part of a chapter 11 plan, but that "neither *Drexel*, nor our subsequent discussion of nonconsensual nondebtor releases in *Metromedia*, traces that power back to any provision of the Bankruptcy Code." *Id.* at 85. He also urged the U.S. Supreme Court to grant *certiorari* in any appeal of the ruling, given the lack of uniformity on this issue among the circuits.

OUTLOOK

Third-party releases in non-asbestos chapter 11 plans have long been controversial. Because such releases are commonly the linchpin of heavily negotiated chapter 11 plans involving tens of thousands of creditors, the Second Circuit's ruling in *Purdue Pharma* is a positive development for companies that file for chapter 11 protection in an effort to manage mass tort and other liabilities. The decision does not represent a sea change in the Second Circuit, which doubled down on its previous rulings that a bankruptcy court can approve such releases under appropriate circumstances. However, *Purdue Pharma* is notable because the Second Circuit unequivocally ruled that a bankruptcy court has both jurisdiction and statutory authority to approve such releases.

Purdue Pharma and other recent court rulings suggest that the controversy is far from being resolved. As the concurring opinion in *Purdue Pharma* portends, a *certiorari* petition seeking review of the Second Circuit ruling by the U.S. Supreme Court will almost certainly be sought (and potentially granted). On July 24, 2023, the Second Circuit denied a motion filed by the U.S. Trustee to stay the mandate of the Second Circuit's ruling pending the Supreme Court's consideration of a *certiorari* petition, which the U.S. Trustee intends to submit before the August 28, 2023, deadline. The U.S. Trustee argued that staying the decision could prevent equitable mootness arguments if Purdue quickly implements its chapter 11 plan. It also claimed that, if the ruling stands, it could set a precedent for abuse of the bankruptcy system to avoid mass tort liability.

There is also a chance that Congress addresses the issue, since various pieces of legislation have been introduced in recent years regarding third-party releases. For now, the *Purdue Pharma* decision brings needed clarity in the Second Circuit on the continued viability of the careful use of third-party releases to achieve a confirmable plan in complex chapter 11 cases.

ILLINOIS BANKRUPTCY COURT: WHETHER DISPUTE IS CORE OR NON-CORE NOT "BRIGHT LINE" IN DETERMINING ENFORCEABILITY OF ARBITRATION CLAUSE

Charles M. Oellermann • Mark G. Douglas

Whether a dispute that is subject to arbitration can or must be referred to arbitration after one of the parties to a prepetition arbitration agreement files for bankruptcy has long been a source of disagreement among bankruptcy and appellate courts due to a perceived conflict between the Federal Arbitration Act and the Bankruptcy Code. The U.S. Bankruptcy Court for the Northern District of Illinois recently provided some useful guidance regarding this issue.

In *Johnson v. S.A.I.L. LLC (In re Johnson)*, 649 B.R. 735 (Bankr. N.D. Ill. 2023), the court denied in part and granted in part a motion demanding that certain disputes between a chapter 13 debtor and her prepetition lender be referred to arbitration in accordance with the terms of an arbitration clause in a loan agreement. In so ruling, the court emphasized that, in determining whether a dispute should be arbitrated instead of adjudicated by a bankruptcy court, there is no "bright line" rule dependent on whether the dispute is within the court's "core" jurisdiction. Instead, the court must examine the nature of the dispute, including whether it is core or non-core, to determine whether arbitration would inherently conflict with the policies underlying the Bankruptcy Code. If such an inherent conflict exists, a demand to arbitrate the dispute should be denied.

ARBITRATION OF DISPUTES IN BANKRUPTCY

Whether a contractual arbitration clause will be enforced by the bankruptcy courts in accordance with the Federal Arbitration Act, 9 U.S.C. §§ 1 *et seq.* (the "FAA"), has been the focus of debate in bankruptcy and appellate courts for decades. The FAA provides that, with certain exceptions, arbitration agreements "shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract." FAA § 2. Pursuant to the FAA, arbitration agreements must generally be enforced in commercial disputes. *See Dean Witter Reynolds, Inc. v. Byrd*, 770 U.S. 213, 218 (1985) ("[I]nsofar as the language of the [FAA] guides our disposition of this case, we would conclude that agreements to arbitrate must be enforced, absent a ground for revocation of the contractual agreement.").

In *Shearson/Am. Exp. Inc. v. McMahon*, 482 U.S. 220, 226-27 (1987), the U.S. Supreme Court ruled that the FAA's mandate may be overridden if a party opposing arbitration can demonstrate that "Congress intended to preclude a waiver of judicial remedies for the statutory rights at issue." According to the Court, such congressional intent can be discerned in one of three ways: (i) the text of the statute; (ii) the statute's legislative history; or (iii) "an inherent conflict between arbitration and the statute's underlying purposes." The party opposing arbitration bears the burden of showing that "Congress intended to preclude a waiver of judicial remedies for the statutory rights at issue." *Id.* at 227; *accord Gilmer v. Interstate/Johnson Lane Corp.,* 500 U.S. 20, 26 (1991).

Guided by this mandate, in the past, the consensus among most courts addressing the issue has been that a bankruptcy court can adjudicate a dispute otherwise subject to binding arbitration if the dispute falls within the court's "core" jurisdiction, but in all other cases it must defer to arbitration. *See generally* COLLIER ON BANKRUPTCY ("COLLIER") ¶ 9019.05[2] (16th ed. 2023).

However, the approach adopted by most circuit courts that have considered the issue is more nuanced. Rulings from the Second, Third, Fourth, Fifth, Ninth, and Eleventh Circuits stand for the proposition that arbitration is the favored means of resolving disputes—even some that fall within the bankruptcy court's core jurisdiction. In these circuits, the focus of the inquiry has shifted from an analysis of core versus non-core to determining: (i) whether a dispute is core; and (ii) if so, whether referral of the dispute to arbitration would conflict with the underlying purposes of the Bankruptcy Code. *See Continental Ins. Co. v. Thorpe Insulation Co. (In re Thorpe Insulation Co.*), 671 F.3d 1011 (9th Cir. 2012); *Whiting-Turner Contracting Co. v. Elec. Mach. Enters., Inc. (In re Elec. Mach. Enters., Inc.)*, 479 F.3d 791 (11th Cir. 2007); *MBNA America Bank, N.A. v. Hill*, 436 F.3d 104 (2d Cir. 2006); *Mintze v. American General Financial Services, Inc. (In re Mintze)*, 434 F.3d 222 (3d Cir. 2006); *Phillips v. Congelton, L.L.C. (In re White Mountain Mining Co.)*, 403 F.3d 164 (4th Cir. 2005); *Ins. Co. of N. Am. v. NGC Settlement Trust & Asbestos Claims Mgmt. Corp. (In re Nat'l Gypsum Co.*), 118 F.3d 1056 (5th Cir. 1997).

Therefore, although once hostile to arbitration, bankruptcy courts have for the most part embraced the process as a means of resolving certain disputes. *See* COLLIER at ¶ 9019.05[2] ("All in all, the bankruptcy system seems to have, if not embraced arbitration, at least dropped the overall hostility that once characterized its view of that alternative dispute resolution device, and adopted theories recognizing its place in the bankruptcy world.").

CORE V. NON-CORE PROCEEDINGS

A matter falls within a bankruptcy court's "core" jurisdiction if it either invokes a substantive right created by federal bankruptcy law or could not exist outside a bankruptcy case. *See* 28 U.S.C. § 157(b)(2) (setting forth a non-exclusive list of "core" proceedings). In contrast, "non-core" matters generally involve disputes that have only a tenuous relationship to a bankruptcy case and would in all likelihood have been litigated elsewhere but for the debtor's bankruptcy filing. *See In re Seven Fields Dev. Corp.*, 505 F.3d 237, 256 (3d Cir. 2007) (claims or causes of action arising under state law are not "core proceedings" because they do not invoke "a substantive right provided by title 11 or a proceeding that, by its nature, could arise only in the context of a bankruptcy case").

A bankruptcy court may enter a final judgment in a core proceeding (a proceeding "arising under" or "arising in a case under" the Bankruptcy Code). 28 U.S.C. § 157(b)(1). The court "may also hear a proceeding that is not a core proceeding but that is otherwise related to" a bankruptcy case, but may not render a decision in such a proceeding without the consent of all the parties. 28 U.S.C. §§ 157(b)(1), (c). Unless all the parties consent to a bankruptcy court's final adjudication of a non-core related matter, the court must "submit proposed findings of fact and conclusions of law to the district court, and any final order or judgment shall be entered by the district judge after considering the bankruptcy judge's proposed findings and conclusions and after reviewing de novo those matters to which any party has timely and specifically objected." 28 U.S.C. § 157(c)(1).

The Judicial Code includes certain other jurisdictional and procedural rules pertaining to bankruptcies. A bankruptcy court may not try personal injury or wrongful death claims, which must be tried in the district court. 28 U.S.C. § 157(b)(5). If a party in a proceeding that may be heard by a bankruptcy court has a right to a jury trial, the bankruptcy court may conduct the jury trial if all the parties expressly consent and the court is "specially designated to exercise such jurisdiction by the district court." 28 U.S.C. § 157(e).

In addition to *statutory* authority, a bankruptcy judge must have *constitutional* authority to hear and determine a matter. *Stern v. Marshall*, 564 U.S. 462 (2011). Constitutional authority exists when a matter originates under the Bankruptcy Code or, in non-core matters, where the matter is either one that falls within the "public rights exception," (i.e., cases involving "public rights" that Congress could constitutionally assign to "legislative" courts for resolution), or where the parties have consented, either expressly or impliedly, to the bankruptcy court hearing and determining the matter. *See, e.g., Wellness Int'l Network, Ltd. v. Sharif*, 135 S. Ct. 1932 (2015) (parties may consent to a bankruptcy court's jurisdiction); *Richer v. Morehead*, 798 F.3d 487, 490 (7th Cir. 2015) (noting that "implied consent is good enough"). Thus, a proceeding might be statutorily, but not constitutionally, core, thus precluding the bankruptcy court from finally adjudicating the dispute. *See Stern*, 564 U.S. at 482 ("Although we conclude that § 157(b)(2(C) permits the Bankruptcy Court to enter final judgment on [a] counterclaim, Article III of the Constitution does not.").

If the parties in a bankruptcy case agree to arbitration of a dispute, Rule 9019(c) of the Federal Rules of Bankruptcy Procedure authorizes the bankruptcy court to order final and binding arbitration.

JOHNSON

Prior to filing a chapter 13 petition in August 2022 in the Northern District of Illinois, Joan Johnson (the "debtor") borrowed $4,000 from S.A.I.L. LLC ("SAIL"), a company whose affiliate made high-interest loans to Illinois residents from storefront locations. The loan agreement executed by the debtor included an arbitration clause providing that all claims and disputes related to the loan agreement "shall be resolved by binding arbitration pursuant to and under the [FAA]."

The debtor disputed the claim (in part secured and in part unsecured) SAIL filed in her bankruptcy case and commenced an adversary proceeding seeking disallowance of the claim and asserting counterclaims. The debtor's complaint stated three counts: (i) disallowance of SAIL's claim and the imposition of punitive damages and other amounts on the ground that the loan was unenforceable because it violated Illinois's Predatory Loan Prevention Act and the Illinois Consumer Fraud and Deceptive Practices Act (the "Consumer Fraud Act"); (ii) an award of damages for violation of the Illinois Interest Act (the "Interest Act") because the loan was usurious; and (iii) disallowance of SAIL's claim and the imposition of punitive damages and other amounts on account of deceptive and misleading representations under the Consumer Fraud Act.

Instead of answering the complaint, SAIL filed a motion to compel arbitration of the dispute, as provided for in the Loan Agreement. According to SAIL, because the debtor agreed to arbitrate all disputes regarding the loan, and the claims asserted by the debtor in the complaint were non-core, the bankruptcy court did not have discretion to deny the motion to compel arbitration. Alternatively, if the court were to determine any of the debtor's claims were core, SAIL asked the court to order

arbitration for any non-core claims. The debtor countered that her claim objection and counterclaims were core claims and that the court should deny the motion to compel arbitration of such claims. She also argued that resolution of the dispute was "material" to the confirmation of her chapter 13 plan, and that arbitration of her claims "would substantially interfere with her efforts to reorganize, and also would be inconsistent with the purposes of the Bankruptcy Code."

THE BANKRUPTCY COURT'S RULING

The bankruptcy court denied SAIL's motion to compel arbitration of two of the three counts stated in the debtor's complaint, but referred the remaining count to arbitration.

Initially, U.S. Bankruptcy Judge David D. Cleary noted that neither the U.S. Supreme Court nor the U.S. Court of Appeals for the Seventh Circuit has determined whether (or to what extent) arbitration agreements are enforceable in bankruptcy. However, he explained, in *McMahon*, the Supreme Court held that, as a general rule, an arbitration agreement may be disregarded only upon a showing that "Congress intended to make an exception to the Arbitration Act . . . [by] an intention discernible from the text, history, or purposes of the statute." *Johnson*, 649 B.R. at 740 (quoting *McMahon*, 482 U.S. at 227).

Next, because there was no dispute that the arbitration clause in the loan agreement was valid, Judge Cleary considered whether there was an inherent conflict between arbitration and the underlying purposes of the Bankruptcy Code regarding the dispute between SAIL and the debtor. If such a conflict existed, the judge explained, "it is not relevant whether the dispute is core or non-core" because both core and non-core matters can give rise to an inherent conflict. *Id.* at 747. Whether a dispute is core or non-core, he wrote, "should not be used as a bright line in determining the enforceability of arbitration clauses." *Id.*

Examining the three counts stated in the debtor's complaint, Judge Cleary found that two of the counts in the debtor's complaint were core, whereas one was not:

(i) Count one seeking disallowance of SAIL's claim was "statutorily core" under 28 U.S.C. § 157(b)(2)(B) (providing that the "allowance or disallowance of claims against the estate" is a core proceeding) and section 502(b) of the Bankruptcy Code (stating that the court shall disallow a claim against the estate to the extent "such claim is unenforceable against the debtor and property of the debtor, under any agreement or applicable law"), and the debtor's request in count one for punitive damages and attorneys' fees would be resolved in adjudicating the claim objection;
(ii) Count two seeking damages under the Interest Act for usury was non-core, insofar as it arose solely under state law and would not "impact" confirmation of the debtor's chapter 13 plan; and
(iii) Count three seeking disallowance of SAIL's claim under the Consumer Fraud Act was core because it involved disallowance of SAIL's claim.

Judge Cleary emphasized, however, that identifying the claims as core or non-core did not end the inquiry. In this case, he noted, declining to decide a claim objection and referring it to arbitration would conflict with the purposes of the Bankruptcy Code, one of which is to "centralize[] decision-making" in the bankruptcy court. *Id.* at 749. Many other bankruptcy and appellate courts, Judge Cleary explained, have similarly refused to enforce arbitration agreements when doing so would conflict with the purposes of the Bankruptcy Code.

According to Judge Cleary, the progress of the debtor's chapter 13 case—i.e., confirmation of a plan providing for the payment of creditor claims—was "stalled because SAIL would like to arbitrate the Claim *it filed in this case*." *Id.* at 752. Finding an inherent conflict between the Bankruptcy Code and the FAA with respect to counts one and three of the debtor's complaint, the bankruptcy court denied SAIL's arbitration demand concerning those counts and referred count two to arbitration. However, the court stayed the arbitration until resolution of the debtor's objection to SAIL's claim.

OUTLOOK

The enforceability of arbitration agreements in bankruptcy has long been a source of uncertainty and dispute among bankruptcy and appellate courts due to the apparent conflict between the Bankruptcy Code and the FAA. In *Johnson*, the bankruptcy court emphasized that there is no "bright line" rule hinging on the core or non-core nature of disputes that dictates whether an otherwise arbitrable dispute in bankruptcy should be referred to arbitration. Instead, a bankruptcy court must analyze the nature of the dispute, including whether it is core or non-core and, regardless of the answer to that question, consider whether referring the dispute to arbitration would inherently conflict with the policies underpinning the Bankruptcy Code.

On June 23, 2023, a 5–4 majority of the U.S. Supreme Court ruled in *Coinbase Inc. v. Bielski*, No. 22-105 (U.S. June 23, 2023), that a federal court's denial of a motion to compel arbitration automatically imposes a stay on the entire action in the trial court, pending the resolution of an appeal from the order denying arbitration (section 16(a) of the FAA authorizes an interlocutory appeal of an order denying a motion to compel arbitration). Although *Coinbase* did not involve an order denying a motion to compel arbitration in a bankruptcy case, it remains to be seen whether the ruling will be construed to mandate a stay in a bankruptcy case whenever such an order is on appeal and, if so, the scope of such a stay.

CALIFORNIA BANKRUPTCY COURT EXAMINES CHAPTER 15 DISCOVERY RULES

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In *In re Golden Sphinx Ltd.*, 2023 WL 2823391 (Bankr. C.D. Cal. Mar. 31, 2023), the U.S. Bankruptcy Court for the Central District of California denied a motion filed by a creditor of a chapter 15 debtor seeking discovery from a bank that had provided financing to one of the debtor's affiliates. The bankruptcy court concluded that: (i) litigation and discovery regarding a debtor's assets is best pursued in the foreign bankruptcy proceeding, rather than an ancillary case under chapter 15, because the "whole point of Chapter 15 is to avoid a multiplicity of international proceedings and instead focus most litigation in the foreign main proceeding"; and (ii) the discovery request was an overbroad and inappropriate "fishing expedition" under Rule 2004 of the Federal Rules of Bankruptcy Procedure (the "Bankruptcy Rules") and represented an effort to give the creditor an unfair advantage in non-bankruptcy litigation. However, in so ruling, the court held that Bankruptcy Rule 2004 applies in chapter 15 cases (as well as cases under other chapters of the Bankruptcy Code) and that, under appropriate circumstances, a party other than the debtor's foreign representative may obtain discovery in a chapter 15 case under Bankruptcy Rule 2004.

DISCOVERY IN BANKRUPTCY CASES

Bankruptcy Rule 2004 provides a broad-ranging discovery mechanism in bankruptcy cases. It states that "[o]n motion of any party in interest, the court may order the examination of any entity." Such an examination "may relate only to the acts, conduct, or property or to the liabilities and financial condition of the debtor, or to any matter which may affect the administration of the debtor's estate, or to the debtor's right to a discharge." In addition, in a non-railroad "reorganization case under chapter 11" (among other cases), the examination "may also relate to the operation of any business and the desirability of its continuance, the source of any money or property acquired or to be acquired by the debtor for purposes of consummating a plan and the consideration given or offered therefor, and any other matter relevant to the case or to the formulation of a plan."

Discovery may also be sought in "adversary proceedings" (*see* Bankruptcy Rule 7001 *et seq.*) or "contested matters" (*see* Bankruptcy Rule 9014) commenced during a bankruptcy case, and in certain other contexts, such as contested involuntary bankruptcy or chapter 15 petitions. Such discovery is governed by Bankruptcy Rules 7026–7037 and 9016, which incorporate many of the discovery procedures under the Federal Rules of Civil Procedure that apply to other kinds of federal litigation. These rules include specific procedures governing disclosure, witnesses, subpoenas, depositions, interrogatories, document production, physical and mental examinations, requests for admission, and other discovery-related matters.

DISCOVERY IN CHAPTER 15 CASES

In a chapter 15 case, section 1521(a) of the Bankruptcy Code provides that, upon recognition by a U.S. bankruptcy court of a "foreign main" or "foreign nonmain" proceeding, the court may, "at the request of the [debtor's] foreign representative," grant any appropriate relief, including "providing for the examination of witnesses, the taking of evidence or the delivery of information concerning the debtor's assets, affairs, rights, obligations or liabilities." 11 U.S.C. § 1521(a)(4). *See In re Millennium Glob. Emerging Credit Master Fund Ltd.*, 471 B.R. 342, 346 (Bankr. S.D.N.Y. 2012) (discovery under section 1521(a)(4) "enables a Foreign Representative to take broad discovery concerning the property and affairs of a [foreign] debtor").

Where discovery is requested, however, section 1522 provides that the court may grant such relief "only if the interests of the creditors and other interested entities, including the debtor, are sufficiently protected." *See In re AJW Offshore, Ltd.*, 488 B.R. 551, 561 (Bankr. E.D.N.Y. 2013) (discovery under section 1521(a)(4) "will only be permitted by motion on notice with an opportunity for hearing to the adverse parties and by making examination and production of documents . . ., with any discovery . . . allowed to be subject to [the] conditions imposed in accordance with § 1522").

Discovery under section 1521(a)(4) need not "concern the preservation or recovery of property in the United States" because chapter 15 "is not an independent in rem proceeding but an ancillary proceeding designed to assist a foreign representative in administering the foreign estate." *Millennium*, 471 B.R. at 347; *In re Fairfield Sentry Ltd. Lit.*, 458 B.R. 665, 679 n.5 (S.D.N.Y. 2011) (stating that section 1521(a)(4) "allows for discovery in the United States whether or not a debtor has assets here").

Chapter 15 discovery is not limited to documents located in the United States but also extends to documents in the possession, custody, or control of a party, including documents held by a

party's attorneys or agents. *See In re Markus*, 607 B.R. 379, 389 (Bankr. S.D.N.Y. 2019), *aff'd in part, vacated in part and remanded*, 615 B.R. 679 (S.D.N.Y. 2020). A subpoena issued under Fed. R. Civ. P. 45, which is made applicable to all bankruptcy cases by Bankruptcy Rule 9016, requires the production of documents responsive to the subpoena, wherever the documents may be located. *Sergeeva v. Tripleton Int'l Ltd.*, 834 F.3d 1194, 1200 (11th Cir. 2016); *In re Hulley Enters.*, 358 F. Supp. 3d 331, 345 (S.D.N.Y. 2019); *Marcus*, 607 B.R. at 391.

Most of the ordinary discovery mechanisms applying to adversary proceedings or contested matters expressly apply to contested recognition petitions in chapter 15 cases (*see* Bankruptcy Rule 1018). In addition, outside the contested recognition petition context, many courts have concluded that broad discovery under Bankruptcy Rule 2004 is available in chapter 15 cases as a form of "additional assistance" that can be granted in the court's discretion under section 1507(a) of the Bankruptcy Code, which provides that, upon chapter 15 recognition of a main or nonmain proceeding, the bankruptcy court may provide "additional assistance" to a foreign representative "under [the Bankruptcy Code] or under other laws of the United States." *See Millennium*, 471 B.R. at 346–47; *accord In re Platinum Partners Value Arbitrage Fund L.P.*, 583 B.R. 803, 810 (Bankr. S.D.N.Y. 2018) (noting that "[r]elief sought pursuant to Bankruptcy Rule 2004 may also be available pursuant to sections 1507, 1521(a)(4) or 1521(a)(7)"); *In re Petroforte Brasileiro de Petroleo Ltda.*, 542 B.R. 899, 911 (Bankr. S.D. Fla. 2015) (concluding that the scope of chapter 15 discovery was not solely controlled by section 1521; Bankruptcy Rule 2004 is also applicable); *see also In re Comair Ltd.*, 2021 WL 5312988, *9 and n.19 (Bankr. S.D.N.Y. Nov. 14, 2021) (citing decisions in which the courts have concluded that Bankruptcy Rule 2004 applies in chapter 15 cases, but noting that, "[s]ince the Foreign Representative can obtain the discovery he seeks pursuant to section 1521(a)(4), the discussion of the application of Rule 2004 in chapter 15 cases is academic"), *appeal dismissed*, 2023 WL 171892 (S.D.N.Y. Jan. 12, 2023). *But see In re Sibaham Ltd.*, 2020 WL 2731870, *4 (Bankr. W.D.N.C. May 4, 2020) ("Discovery in a Chapter 15 foreign main proceeding falls under § 1521(a)(4) . . . [and] Chapter 15 discovery, like all discretionary relief under § 1521, is one-sided, as it can only be granted 'at the request of the foreign representative.'").

As the court in *Millennium* noted, "one of the main purposes of chapter 15 is to assist a foreign representative in the administration of the foreign estate, . . . which would militate in favor of granting a foreign representative broad discovery rights using the full scope of Rule 2004." *Millenium*, 471 B.R. at 347.

Discovery in chapter 15 cases has also been sought by foreign representatives under section 542(e) of the Bankruptcy Code, which provides that, "[s]ubject to any applicable privilege, after notice and a hearing, the court may order an attorney, accountant, or other person that holds recorded information, including books, documents, records, and papers, relating to the debtor's property or financial affairs, to turn over or disclose such recorded information to the trustee." 11 U.S.C. § 542(e); *see, e.g., AJW*, 488 B.R. at 564.

Discovery in connection with foreign court proceedings is also authorized by 28 U.S.C. § 1782(a), which provides in relevant part that:

> The district court of the district in which a person resides or is found may order him to give his testimony or statement or to produce a document or other thing for use in a proceeding in a foreign or international tribunal, including criminal investigations conducted before formal accusation. The order may be made pursuant to a letter rogatory issued, or request made, by a foreign or international tribunal or upon the application of any interested person and may direct that the testimony or statement be given, or the document or other thing be produced, before a person appointed by the court.

Courts are uncertain as to whether chapter 15 recognition is a necessary "ticket to entry" to U.S. courts to seek discovery for use in a foreign bankruptcy court under 28 U.S.C. § 1782(a). *See In re Soundview Elite, Ltd.*, 503 B.R. 571, 592 n.56, 594 (Bankr. S.D.N.Y. 2014) (discussing the interplay between chapter 15 and 28 U.S.C. § 1782 and noting uncertainty among the courts as to whether chapter 15 recognition is necessary to seek discovery under 28 U.S.C. § 1782).

GOLDEN SPHINX

Golden Sphinx Limited (the "debtor") was a passive-investment holding company vehicle organized under the laws of the Bailiwick of Jersey and created for the ultimate benefit of Alexander Sabadash ("Sabadash"), a U.S. citizen and formerly an elected senator in Russia, and his family.

The debtor was owned by JTC Trust Company Limited, as trustee of a legacy trust also created for the benefit of the Sabadash family that held shares in the debtor indirectly through various affiliates of JTC plc, a global provider of fund management and other financial services.

In or around 2000, Sabadash hired Garry Itkin ("Itkin") to perform accounting services for various companies under Sabadash's ownership. Itkin was also hired to manage and oversee the finances of the debtor as a director, as well as the finances of several other Sabadash companies.

The debtor alleged that Itkin engaged in fraudulent, unauthorized, and self-dealing actions as a director. In November 2016, Itkin, who was then the debtor's sole director, responded to the allegations by suing the debtor and certain other defendants in a Jersey court. After Itkin refused to defend against the lawsuit on the debtor's behalf, the court entered a default judgment in Itkin's favor in the amount of more than £500,000.

Itkin later caused the debtor to transfer ownership to him personally of the debtor's ownership interest in a UK affiliate (the "UK affiliate") that owned a Beverly Hills, California, residence valued at approximately $45 million. The property collateralized

a $5 million loan provided to the UK affiliate by East West Bank ("EWB"). As sole director, Itkin had also previously caused the debtor to assign to him personally approximately £35 million of the debtor's intercompany receivables.

In 2017, the debtor, along with several other companies controlled by Sabadash, sued Itkin in California state court seeking damages arising from Itkin's conduct in causing the debtor to fraudulently transfer its stock in the UK affiliate. Itkin asserted various counterclaims in this state court litigation, arguing, among other things, that the share transfer was authorized under a partnership agreement between Itkin and Sabadash.

In April 2021, the Jersey court refused to set aside its £500,000 judgment, finding that although the debtor had a colorable defense, it waited too long to seek vacatur of the judgment. Shortly afterward, Itkin was removed as the debtor's director, and the debtor's new board voted to void the transfer of the UK affiliate's stock.

In June 2021, in an effort to collect on the Jersey court's judgment, Itkin filed a complaint seeking to enforce it in a California federal district court. The debtor asserted counterclaims in the litigation for setoff and unjust enrichment.

In April 2022, Itkin also sued the debtor in an English court seeking a determination that the UK affiliate's stock and the intercompany receivables were lawfully transferred to him.

In July 2022, the debtor commenced a "creditors' winding up process" under the Jersey Companies Law 1991 for the purpose of liquidating its assets, which it claimed consisted of 100% of the stock in the UK affiliate as well as the £35 million in intercompany receivables.

The Jersey court-appointed liquidators, as the debtor's "foreign representatives," filed a petition on August 9, 2022, in the U.S. Bankruptcy Court for the Central District of California, seeking chapter 15 recognition of the Jersey liquidation. Overruling Itkin's objections, the bankruptcy court issued an order in September 2022 granting the petition.

Later that month, Itkin sought relief from the automatic stay imposed as a result of chapter 15 recognition of the Jersey liquidation to continue with the California state and federal court litigation. The bankruptcy court denied the motions, without prejudice to their renewal once the foreign representatives were afforded an adequate "breathing spell."

In December 2022, Itkin filed a motion under Bankruptcy Rule 2004 seeking discovery from EWB. According to Itkin, documents from EWB "may shed light on the [UK affiliate], which the Debtor claims to own, and ... on the Debtor's financial condition," which could potentially uncover other assets belonging to the debtor. The foreign representatives opposed the discovery motion, claiming that Itkin was attempting to conduct a "fishing expedition" to assist his prospects in the California state and federal litigation.

THE BANKRUPTCY COURT'S RULING

The bankruptcy court denied Itkin's motion for discovery under Bankruptcy Rule 2004.

Initially, U.S. Bankruptcy Judge Neil W. Bason rejected the foreign representatives' argument that section 1521(a)(4) of the Bankruptcy Rule, as distinguished from Bankruptcy Rule 2004, is the sole vehicle for discovery in chapter 15 cases. Instead, he explained, chapter 15 discovery can also be obtained under Bankruptcy Rule 2004, which does not contain any language limiting its application to cases under other chapters of the Bankruptcy Code, but states in subsection (a) that "[o]n motion of any party in interest, the court may order the examination of any entity" concerning the matters specified in subsection (b). Judge Bason also noted that Bankruptcy Rule 1001 states that "[t]he Bankruptcy Rules and Forms govern procedure in cases under title 11 of the Unites States Code," including chapter 15. *Golden Sphinx*, 2023 WL 2823391, at *2.

According to Judge Bason, "the vast majority" of bankruptcy courts have either ruled or assumed that Bankruptcy Rule 2004 applies in chapter 15 cases, although those rulings have generally involved discovery sought by a foreign representative, rather than a creditor or other party in interest.

Next, Judge Bason determined that chapter 15 discovery is available to parties other than foreign representatives. He acknowledged that "discovery normally should take place in the foreign main proceeding, because Chapter 15 cases are intended to be ancillary proceedings that do not require bankruptcy courts to adjudicate claims or administer debtors' liquidations." However, Judge Bason wrote, "this Court can conceive of scenarios in which it might be appropriate for a creditor to seek discovery in this ancillary proceeding." *Id.* at *3. These scenarios might include: (i) if the foreign court overseeing the debtor's bankruptcy were to request that a U.S. bankruptcy court resolve a discovery dispute or enforce a discovery order; (ii) if discovery were "relevant to a pending contested matter involving the elements of the chapter 15 petition"; and (iii) if a creditor were defending against a motion or adversary proceeding brought by a foreign representative.

Judge Bason acknowledged that, in these scenarios, the discovery rules in part VII of the Bankruptcy Rules (Bankruptcy Rule 7001 *et seq.*) "probably would apply, rather than Rule 2004." Even so, he explained, a creditor could be authorized to pursue discovery under Bankruptcy Rule 2004 "if it would further this Court's assistance of the foreign main proceeding," such as where the creditor presented sufficient grounds to suspect the existence of fraudulent transfer claims that a foreign representative refused to prosecute. *Id.*

According to Judge Bason, none of these circumstances applied in the case before him. Instead, Itkin was attempting "to engage in the so-called Rule 2004 'fishing expedition,' notwithstanding that the whole point of Chapter 15 is to avoid a multiplicity of

international proceedings and instead focus most litigation in the foreign main proceeding." *Id.* Further, Itkin's request for discovery under Bankruptcy Rule 2004 was "overbroad" and could provide an unfair advantage to Itkin in the California state and federal litigation, and as such, the bankruptcy court denied the discovery motion without prejudice to its renewal if circumstances should change.

OUTLOOK

Even though the facts in *Golden Sphinx* are somewhat complicated, key takeaways from the ruling include: (i) Bankruptcy Rule 2004 applies in chapter 15 cases as a complement to the discovery rules that apply in cases under other chapters of the Bankruptcy Code; (ii) under appropriate circumstances, a party other than a foreign representative can obtain discovery in a chapter 15 case; and (iii) absent certain unique scenarios, discovery concerning the foreign debtor's assets or operations should be conducted in the foreign main proceeding, not an ancillary chapter 15 case. Regardless of the bankruptcy court's determination in *Golden Sphinx* that Bankruptcy Rule 2004 discovery was not warranted under the facts of the case, the court's articulation of these general principles makes the decision noteworthy.

U.S. SUPREME COURT BANKRUPTCY ROUNDUP

Christopher DiPompeo • Mark G. Douglas

Since May 2023, the U.S. Supreme Court has issued three decisions addressing or potentially impacting issues of bankruptcy law. These included rulings concerning the abrogation of sovereign immunity for Native American tribes under the Bankruptcy Code, and for instrumentalities of Puerto Rico under a similar statute enacted in 2016 allowing the Commonwealth to restructure its debts. The Court also handed down an opinion concerning a homeowner's entitlement to the surplus proceeds of a real estate tax foreclosure sale. That ruling could conceivably impact fraudulent transfer litigation in bankruptcy cases arising from real property foreclosures. Finally, the Court denied petitions to review three decisions concerning the "solvent-debtor exception," which has been applied by some courts to require the payment of postpetition interest to unsecured creditors under a cramdown chapter 11 plan.

TRIBAL SOVEREIGN IMMUNITY

On June 15, 2023, the Court ruled in *Lac du Flambeau Band of Lake Superior Chippewa Indians v. Coughlin*, No. 22-227, 599 U.S. _____ (U.S. June 15, 2023), that section 106(a) of the Bankruptcy Code abrogates Native American tribal sovereign immunity because a Native American tribe satisfies the definition of a "governmental unit" in section 101(27).

Recognized Native American tribes generally have inherent authority to govern themselves without interference by federal or state governments. An important element of this "tribal sovereignty" is immunity from lawsuits in federal, state, and tribal courts, or "tribal sovereign immunity." Under this principle, a tribe may be sued only if the tribe consents to being sued or if Congress has clearly authorized such a suit.

Lac du Flambeau addresses the issue of whether the Bankruptcy Code provides such a clear congressional authorization. Bankruptcy Code Section 106(a) of the Bankruptcy Code abrogates the sovereign immunity of a "governmental unit" in connection with disputes relating to many provisions of the Bankruptcy Code, including actions to enforce the automatic stay, preference and fraudulent transfer avoidance actions, and proceedings seeking to establish the dischargeability of a debt.

Furthermore, pursuant to section 106(b) of the Bankruptcy Code, a governmental unit that files a proof of claim in a bankruptcy case "is deemed to have waived sovereign immunity with respect to a claim against such governmental unit that is property of the estate and that arose out of the same transaction or occurrence out of which the claim of such governmental unit arose."

Section 101(27) of the Bankruptcy Code defines the term "governmental unit" as:

> United States; State; Commonwealth; District; Territory; municipality; foreign state; department, agency, or instrumentality of the United States (but not a United States trustee while serving as a trustee in a case under this title), a State, a Commonwealth, a District, a Territory, a municipality, or a foreign state; ***or other foreign or domestic government***.

11 U.S.C. § 101(27) (emphasis added).

In July 2019, the debtor took out a payday loan from an indirect subsidiary of the Lac du Flambeau Band of Lake Superior Chippewa Indians (the "Band"). Later that year, the debtor filed a chapter 13 petition in the District of Massachusetts.

After the lender repeatedly contacted the debtor seeking repayment of the debt despite the automatic stay, the debtor sought an order from the bankruptcy court enforcing the automatic stay against both the lender and its corporate parents, including the Band. In response, the Band and its affiliates asserted tribal sovereign immunity and moved to dismiss the enforcement proceeding. The bankruptcy court agreed with the Band and granted the motion to dismiss. The First Circuit permitted a direct appeal from that decision.

A divided three-judge panel of the First Circuit reversed on appeal, concluding that Congress unequivocally abrogated the tribal sovereign immunity in section 106(a) of the Bankruptcy Code because a Native American tribe falls within the "catch-all" phrase concluding the definition of "governmental unit" in section 101(27). *See Coughlin v. Lac du Flambeau Band of Lake Superior Chippewa Indians (In re Coughlin)*, 33 F.4th 600 (1st Cir. 2022), *aff'd sub nom. Lac du Flambeau Band of Lake Superior Chippewa Indians v. Coughlin*, 22-227 (U.S. June 15, 2023), 599 U.S. _____, No. 22-227 (U.S. June 15, 2023)

In so ruling, the First Circuit deepened a split on this issue among the federal circuit courts of appeals. The First Circuit sided with the Ninth Circuit, which held in 2004 that section 106(a) abrogates tribal sovereign immunity. *See Krystal Energy Co. v. Navajo Nation*, 357 F.3d 1055, 1058 (9th Cir. 2004) ("[In sections 101(27) and 106(a),] Congress explicitly abrogated the immunity of any 'foreign or domestic government.' Indian tribes are domestic governments. Therefore, Congress expressly abrogated the immunity of Indian tribes."). The First Circuit rejected the contrary view expressed by the Sixth Circuit in *In re Greektown Holdings, LLC*, 917 F.3d 451, 460-61 (6th Cir. 2019) (Congress did not unequivocally express an intent to abrogate Indian tribes' sovereign immunity from bankruptcy avoidance litigation even though tribes might possess the characteristics of domestic governments), *cert. dismissed sub nom. Buchwald Cap. Advisors LLC v. Sault Ste. Marie Tribe*, 140 S. Ct. 2638 (2020).

The Supreme Court resolved the circuit split by affirming the First Circuit's ruling. Writing for an 8–1 majority, Justice Jackson viewed whether the Bankruptcy Code abrogates tribal sovereign immunity as "remarkably straightforward."

"We conclude," Justice Jackson wrote, "that the Bankruptcy Code unequivocally abrogates the sovereign immunity of any and every government that possesses the power to assert such immunity . . . [and] [f]ederally recognized tribes undeniably fit that description; therefore, the Code's abrogation provision plainly applies to them as well."

Explaining that a clear statement from lawmakers abrogating immunity "is not a magic-words requirement," the majority concluded that "Congress did not have to include a specific reference to federally recognized tribes in order to make clear that it intended for tribes to be covered by the abrogation provision." Instead, Justice Jackson reasoned, the "catchall phrase" included at the end of section 101(27) is expansive enough to

capture tribes within the definition of "governmental unit," as "domestic" and "foreign" were the two extremes, and tribes were, if not precisely either domestic or foreign governments, at least somewhere along that spectrum. She wrote that "[t]ribes are indisputably governments . . . [and] [t]herefore, § 106(a) unmistakably abrogates their sovereign immunity too."

Justice Thomas concurred in the judgment. He reasoned that the court's tribal sovereign immunity doctrine was overbroad and should simply be abandoned. However, because the case involved the tribe's off-reservation commercial conduct, Justice Thomas concurred, stating that the tribe lacked sovereign immunity regardless of section 106(a).

In a dissenting opinion, Justice Gorsuch stated, quoting the Sixth Circuit, that "[u]ntil today, there was 'not one example in all of history where [this] Court ha[d] found that Congress intended to abrogate tribal sovereign immunity without expressly mentioning Indian tribes somewhere in the statute.'" (citation omitted). According to Justice Gorsuch, the majority mistakenly concluded that the catch-all phrase in section 101(27) demonstrates that Congress "unequivocally express[ed]" its intention to vitiate tribal sovereign immunity under section 106(a) without expressly mentioning tribes in either provision. Although such an interpretation is "plausible," Judge Gorsuch wrote, "Respectfully, I do not think the language here does the trick."

WAIVER OF SOVEREIGN IMMUNITY UNDER PROMESA

On May 11, 2023, the Court handed down its ruling in *Fin. Oversight & Mgmt. Bd. for Puerto Rico v. Centro de Periodismo Investigativo, Inc.*, 598 U.S. ___, 143 S. Ct. 1176 (2023). An 8–1 majority ruled that Puerto Rico's Financial Oversight and Management Board (the "Board") need not provide discovery to journalist group Centro de Periodismo Investigativo ("CPI") in litigation concerning the finances of the bankrupt Puerto Rico Electric Power Authority because nothing in the Puerto Rico Oversight, Management, and Economic Stability Act ("PROMESA") makes "unmistakably clear" lawmakers' intent to abrogate the Board's sovereign immunity. In so ruling, the Court reversed a decision by the U.S. Court of Appeals for the First Circuit that PROMESA abrogated the Board's immunity.

Patterned on chapter 9, which provides for the "adjustment of debts of a municipality," PROMESA was enacted by Congress in 2016 to deal with a fiscal crisis in Puerto Rico brought about by soaring public debt. PROMESA established a system for overseeing Puerto Rico's finances and authorized the Commonwealth and its instrumentalities to file for bankruptcy protection similar to that available to debtors eligible to seek relief under the Bankruptcy Code (which Puerto Rico is not). PROMESA created the Board as an "entity within the territorial government" of Puerto Rico. The Board approves Puerto Rico's fiscal plans and budgets, supervises its borrowing, and represents Puerto Rico in judicial debt-restructuring proceedings under Title III of PROMESA.

Beginning in 2016, CPI asked the Board to release various documents relating to CPI's work as a nonprofit media organization reporting on Puerto Rico's fiscal crisis. Rebuffed, CPI sued the Board in federal district court, citing a provision of the Puerto Rican Constitution interpreted to guarantee a right of access to public records. The Board moved to dismiss on sovereign immunity grounds, but the district court rejected that defense. The First Circuit affirmed, holding that the jurisdictional provision in PROMESA clearly abrogated the Board's immunity.

The Supreme Court reversed. Writing for an 8–1 majority, Justice Elena Kagan noted that the First Circuit and the district court "simply assumed the Board's immunity before turning to the abrogation issue." Working from that assumption without deciding whether it was justified, the majority wrote that, "[u]nder long-settled law, Congress must use unmistakable language to abrogate sovereign immunity." In this case, Justice Kagan explained, nothing in PROMESA satisfies that "high bar" because the statute does not expressly strip the Board of immunity, it does not explicitly authorize the litigation of claims against the Board and its "judicial review provisions and liability protections are compatible with the Board's generally retaining sovereign immunity."

Justice Thomas filed a dissenting opinion in which he stated that both the majority and the lower courts assumed without deciding "the logically antecedent question" whether the Board enjoyed sovereign immunity "in the first place." Justice Thomas would have addressed this antecedent question to hold that the Board did not have any immunity.

ENTITLEMENT TO SURPLUS FROM REAL ESTATE TAX FORECLOSURES

On May 25, 2023, a unanimous Court ruled in *Tyler v. Hennepin County*, No. 22-166, 2023 WL 3632754 (U.S. May 25, 2023), that a real estate tax foreclosure proceeding in which a local taxing authority refused to pay the surplus realized from the sale to the homeowner violated the Takings Clause of the Fifth Amendment to the U.S. Constitution. In so ruling, the Court reversed a 2022 decision by the U.S. Court of Appeals for the Eighth Circuit that a real estate tax foreclosure proceeding in which a local taxing authority refused to pay the sale surplus to the homeowner does not violate the Takings Clause. *See Tyler v. Hennepin County*, 26 F.4th 789 (8th Cir. 2022), *rev'd*, No. 22-166, 2023 WL 3632754 (U.S. May 25, 2023).

A circuit split arose after the Eighth Circuit's decision, when the Sixth Circuit reached the opposite conclusion. *See Hall v. Meisner*, 51 F.4th 185 (6th Cir. 2022), *reh'g en banc denied*, 2023 WL 370649 (6th Cir. Jan. 4, 2023), *petition for cert. filed*, No. 22-996 (U.S. Apr. 13, 2023).

Although *Tyler* involved the Takings Clause, the ruling may shed light on a long-standing circuit split over whether a tax foreclosure can be challenged in bankruptcy as a fraudulent transfer. In

BFP v. Resolution Trust, 511 U.S. 531 (1994), the Court held that a regularly conducted real estate mortgage foreclosure cannot be a fraudulent transfer, regardless of how much equity the debtor forfeits in excess of the mortgage debt. The Fifth, Ninth, and Tenth Circuits later expanded the reach of *BFP* by ruling that a real estate tax foreclosure cannot be deemed a fraudulent transfer. The Second, Third, Sixth, and Seventh Circuits have ruled to the contrary. Because the Supreme Court held in *Tyler* that the Fifth Amendment prohibits a state from retaining the equity after a tax foreclosure, debtors may not need to resort to a fraudulent transfer action because they will have a direct Takings Clause claim against the taxing authority.

DISPOSITION OF NOTABLE PETITIONS FOR REVIEW

Pursuant to the "solvent-debtor exception" developed under English law and applied in cases under the former Bankruptcy Act, a solvent debtor is obligated to pay interest accruing during a bankruptcy case to unsecured creditors if the payment of such interest is required under a contract or applicable non-bankruptcy law. Because section 502(b)(2) of the Bankruptcy Code generally disallows claims for "unmatured" interest, courts disagree whether the solvent-debtor exception survived enactment of the Bankruptcy Code in 1978 to require a solvent debtor to pay postpetition interest to unsecured creditors under a chapter 11 plan to render their claims unimpaired (and deem the claimants to have accepted the plan).

Five federal circuit courts—including three in 2022 (two with vigorous dissents)—have ruled or suggested that the solvent-debtor exception survived. *See In re LATAM Airlines Grp. S.A.*, 55 F.4th 377 (2d Cir. 2022), *cert. denied*, No. 22-908 (U.S. June 12, 2023); *In re Ultra Petroleum Corp.*, 51 F.4th 138 (5th Cir. 2022), *cert. denied*, No. 22-772 (U.S. May 22, 2023); *In re PG&E Corp.*, 46 F.4th 1047 (9th Cir. 2022), *cert. denied*, No. 22-733 (U.S. May 22, 2023); *Gencarelli v. UPS Capital Bus. Credit*, 501 F.3d 1 (1st Cir. 2007); *In re Dow Corning Corp.*, 456 F.3d 668 (6th Cir. 2006). The Third Circuit is expected to weigh in on the issue sometime during 2023. *See In re The Hertz Corp.*, 637 B.R. 781 (Bankr. D. Del. 2021), *motion for reconsideration denied and direct appeal certified*, Adv. Pro. No. 21-50995 (MFW) (Bankr. D. Del. Nov. 9, 2022).

On May 22, 2023, the Supreme Court denied petitions for a writ of *certiorari* in the *PG&E* and *Ultra Petroleum* cases. On June 12, 2023, the Court also denied a petition for *certiorari* in the *LATAM* case.

OBJECTIONS TO BANKRUPTCY ASSET SALE DID NOT RISE TO LEVEL OF "ADVERSE INTEREST" DEFEATING BUYER'S GOOD-FAITH STATUS

Paul M. Green • Mark G. Douglas

The finality of asset sales and other transactions in bankruptcy is an indispensable feature of U.S. bankruptcy law designed to maximize the value of a bankruptcy estate as expeditiously as possible for the benefit of all stakeholders. To promote such finality, section 363(m) of the Bankruptcy Code prohibits reversal or modification on appeal of an order authorizing a sale or lease to a "good-faith" purchaser or lessee unless the party challenging the sale obtains a stay pending appeal. What constitutes "good faith" has sometimes been disputed by the courts.

The U.S. Court of Appeals for the Fifth Circuit recently revisited this issue in *SR Construction Inc. v. Hall Palm Springs LLC (In re RE Palm Springs II LLC)*, 65 F.4th 752 (5th Cir. 2023). The court reaffirmed its earlier decisions that a buyer's or lessee's good faith under section 363(m) is not defeated merely because it is aware of objections to the proposed sale or lease. Instead, the claims of the party challenging the sale or lease must rise to the level of an "adverse interest" in the ownership of the property. The Fifth Circuit also held that transparency in the sale or lease process is of paramount importance in establishing good faith.

MOOTNESS OF APPEALS UNDER SECTION 363(m)

"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."

An appeal can also be rendered moot (or otherwise foreclosed) by statute. For example, section 363(m) of the Bankruptcy Code provides as follows:

> The reversal or modification on appeal of an authorization [of a sale or lease of property in bankruptcy] 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, whether or not such entity knew of the pendency of the

appeal, unless such authorization and such sale or lease were stayed pending appeal.

11 U.S.C. § 363(m). Section 363(m) of the Bankruptcy Code 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 insuring that adequate sources of financing are available).

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., In re Pursuit Holdings (NY), LLC*, 845 Fed. App'x 60, 62-63 (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 seeking 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 (7th Cir. 1992) (holding that a collateral attack on 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 (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)).

Bankruptcy and appellate courts have long disagreed as to whether section 363(m) is jurisdictional—meaning that the issue can never be waived and an appellate court lacks jurisdiction to hear any appeal of an unstayed sale or lease authorization order other than on the ground that the purchaser or lessee did not act in good faith—or instead a defense that can be invoked by the proponents of the sale (e.g., the debtor, the bankruptcy trustee, or the purchaser) in connection with the appeal. The U.S. Supreme Court definitively settled this question in *MOAC Mall Holdings LLC v. Transform Holdco LLC*, 143 S. Ct. 927 (2023). A

unanimous Court held that section 363(m) is not jurisdictional and that an appeal of a bankruptcy court order approving the sale and assignment of a lease was not moot. The Court also expressed skepticism about mootness in general as a bar to appellate review of bankruptcy court decisions, despite the importance of finality in bankruptcy sales.

GOOD FAITH

The Bankruptcy Code does not define "good faith." Courts have adopted various definitions, many of which are substantially similar. *See generally* COLLIER ON BANKRUPTCY ("COLLIER") ¶ 363.11 (16th ed. 2023). For example, the Fifth Circuit has defined a "good-faith purchaser" for purposes of section 363(m) as "'one who purchases the assets for value, in good faith, and without notice of adverse claims.'" *Hsin Chi Su v. C Whale Corp. (In re C Whale Corp.)*, 2022 WL 135125, *3 (5th Cir. Jan. 13, 2022) (quoting *In re TMT Procurement Corp.*, 764 F.3d 512, 521 (5th Cir. 2014)); *accord Licensing by Paolo, Inc. v. Sinatra (In re Gucci)*, 126 F.3d 380, 390 (2d Cir. 1997); *In re Mark Bell Furniture Warehouse, Inc.*, 992 F.2d 7, 8 (1st Cir. 1993). Lack of good faith is commonly manifested by "fraud, collusion between the purchaser and other bidders or the trustee, or an attempt to take grossly unfair advantage of the other bidders." *TMT Procurement*, 764 F.3d at 521; *accord In re Ewell*, 958 F.2d 276, 279 (9th Cir. 1992); *In re Abbotts Dairies, Inc.*, 788 F.2d 143, 147 (3d Cir. 1986); *Hoese Corp. v. Vetter Corp. (In re Vetter Corp.)*, 724 F.2d 52, 56 (7th Cir. 1983); *Badami v. Burgess (In re Burgess)*, 246 B.R. 352, 356 (B.A.P. 8th Cir. 2000); *In re General Motors Corp.*, 407 B.R. 463, 494 (Bankr S.D.N.Y. 2009).

Some courts—principally in the Third Circuit—require a finding of good faith at the time the bankruptcy court approves a sale or lease of property under section 363. *See Abbotts Dairies, Inc.*, 788 F.2d at 149–50; *In re Perona Bros., Inc.*, 186 B.R. 833, 839 (D.N.J. 1995); *In re Primel*, 629 B.R. 790, 799 (Bankr. W.D. Pa. 2021); *In re Hereford Biofuels, L.P.*, 466 B.R. 841, 860 (Bankr. N.D. Tex. 2012). Other courts do not. *See, e.g., In re Zinke*, 97 B.R. 155, 156 (E.D.N.Y. 1989) (declining to adopt the *Abbotts Dairies* rule); *In re M Cap. Corp.*, 290 B.R. 743, 748 (B.A.P. 9th Cir. 2003) ("Because findings of 'good faith' made at the time of the sale may be premature because they are made before the really interesting facts emerge, the Ninth Circuit does not require that a finding of 'good faith' be made at the time of sale and has rejected the Third Circuit's contrary rule.").

Courts also disagree as to whether any entity asserting a lien on, or other interest in, property to be sold free and clear under section 363(f) of the Bankruptcy Code must be provided with advance notice of the sale for the purchaser of the property to be entitled to the protection of section 363(m). *See generally* COLLIER at ¶ 363.11 ("The protection afforded by section 363(m) has been held [by some courts] not to protect even an otherwise good faith purchaser when no notice was given to the lienholder, resulting in the purchaser taking the property subject to the lien."). *Compare Archer-Daniels-Midland Co. v. Country Visions Cooperative*, 29 F.4th 956 (7th Cir. 2022) (affirming lower court rulings denying a motion to bar an entity holding a right of first refusal on property purchased from a debtor "free and clear" pursuant to section 363(f) from continuing state court litigation seeking to enforce its right and holding that, because the buyer had actual and constructive knowledge of the right of first refusal, 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)); *United States v. Moberg Trucking, Inc. (In re Moberg Trucking, Inc.)*, 112 B.R. 362 (B.A.P. 9th Cir. 1990) (section 363(m) requires that a sale be authorized under section 363(b), which specifically requires notice and a hearing; thus, section 363(m) mootness is not applicable when the appellant seeks to attack the section 363 sale of estate property on the grounds of improper notice), *with In re Edwards*, 962 F.2d 641 (7th Cir. 1992) (a purchaser at a section 363(b) sale took clear title even though the lienholder did not receive notice at the time of the sale); *In re Motors Liquidation Co.*, 529 B.R. 510 (Bankr. S.D.N.Y. 2015) (lack of notice will not invalidate a sale, unless party can show prejudice).

A purchaser or lessee bears the burden of establishing good faith under section 363(m). *TMT Procurement*, 764 F.3d at 520.

RE PALM SPRINGS

In November 2016, commercial real-estate developer Palm Springs, LLC ("Palm Springs") contracted with SR Construction, Inc. ("SR") to develop a hotel property located in Palm Springs, California. In 2017, Hall Palm Springs LLC ("Hall")—which was not a Palm Springs affiliate—agreed to provide Palm Springs with up to $50 million in construction financing secured by a deed of trust on the unfinished hotel. At the same time, SR entered into a subordination agreement with Hall in which SR agreed that Hall's loan would have priority of repayment over any claims asserted by SR in connection with the project.

Palm Springs terminated its construction contract with SR in October 2019, at the time owing SR more than $14 million for completed work. Shortly afterward, Palm Springs defaulted on the Hall loan, and Hall notified Palm Springs that it was accelerating the debt. On November 25, 2019, SR filed a mechanic's lien on the property to secure its $14 million claim.

In January 2020, SR sued Palm Springs, Hall, and various related parties in California state court seeking to foreclose on its mechanic's lien (the "state court action"), which SR alleged was superior in priority to Hall's deed of trust.

In February 2020, in lieu of foreclosure, Palm Springs agreed to convey the hotel property to a newly formed affiliate of Hall—RE Palm Springs II, L.L.C. (the "debtor")—under an agreement that would release Palm Springs from all liability for the loan and give Palm Springs a 50% interest in any net profits generated by the still-unfinished hotel property. After the beginning of the

COVID-19 pandemic derailed the debtor's plans to complete the hotel project, Hall and the debtor determined that they would attempt to find a strategic buyer for the property in bankruptcy.

As part of pre-bankruptcy planning, Hall retained an unrelated restructuring advisory firm—r2—to oversee the affiliate's restructuring. In an effort to ensure arm's-length objectivity, Hall conveyed ownership of the debtor to r2.

On July 22, 2020, the debtor filed for chapter 11 protection in the Northern District of Texas. It immediately sought court approval of debtor-in-possession ("DIP") financing to be provided by Hall, bidding and sale procedures, and the retention of r2 as a real estate agent to market the property. The bankruptcy court approved all the requested relief, finding that Hall's DIP loan "was the only game in town" and that r2 was well qualified and without any conflicts of interest.

The auction procedures required that the stalking-horse bidder for the property—an unrelated company named McWhinney Real Estate Services, Inc. ("McWhinney")—submit its bid as well as a nonrefundable $2.5 million deposit on or before August 28, 2020. Other bids were due no later than October 5, 2020, 11 days before the scheduled sale hearing.

The marketing of the property initially garnered substantial interest. Although McWhinney informally proposed a bid of $35,450,000 for the hotel, it ultimately declined to submit a bid or a deposit. The stalking horse having bowed out, Hall filed a motion seeking court approval to submit a credit bid for the property in the amount of its outstanding secured debt—$37,279,365.74—or nearly $2 million more than the amount of McWhinney's proposal. SR objected to the motion and commenced an adversary proceeding (the "adversary proceeding") against Hall, the debtor, and Palm Springs challenging Hall's lien and seeking a determination that the conveyance of the hotel property to the debtor was voidable.

In opposing the credit-bid sale, SR argued that it should not proceed because: (i) Hall (the intended purchaser) was aware of adverse claims to the property (i.e., the claims asserted in the state court action and the adversary proceeding); and (ii) Hall fraudulently manipulated the bankruptcy case by rigging the auction sale to acquire the hotel property free and clear of all interests, including SR's mechanic's lien.

In November 2020, with no other bidders expressing interest, the bankruptcy court entered orders approving the credit-bid sale of the hotel property to Hall free and clear of all interests under sections 363(b), 363(f), and 363(k) of the Bankruptcy Code. The bankruptcy court denied SR's motion for a stay pending its appeal of the sale order to the district court.

On appeal, the district court affirmed the bankruptcy court's orders, as well as the court's finding that Hall was a good-faith purchaser, and dismissed the appeal as moot under section 363(m). SR appealed to the Fifth Circuit.

THE FIFTH CIRCUIT'S RULING

A three-judge panel of the Fifth Circuit affirmed the rulings below.

Writing for the panel, U.S. Circuit Judge Patrick E. Higginbotham explained that the outcome of the appeal hinged on the Fifth Circuit's interpretation of the meaning of "good faith" under section 363(m) in *TMT*, where the court had previously defined the term in two ways: (i) a "notice-based definition," according to which a "good faith purchaser" is "one who purchases the assets for value, in good faith, and without notice of adverse claims"; and (ii) a "conduct-based definition," according to which a buyer or lessor acts in good faith unless it engages in misconduct, including fraud, collusion "or an attempt to take grossly unfair advantage of other bidders"). *RE Palm Springs*, 65 F.4th at 759 (footnotes and internal quotation marks omitted). According to Judge Higginbotham, although the Bankruptcy Code does not define the term "adverse claim" (section 101(5) does broadly define the term "claim"), the Fifth Circuit in *TMT* determined that such a claim "requires more" than simply "some creditor . . . objecting to the transaction and . . . trying to get the district court or the court of appeals to reverse the bankruptcy judge." *Id.* at 760 (quoting *TMT*, 764 F.3d at 522). Therefore, he noted, knowledge of an objection to a transaction is not bad faith by itself.

Instead, Judge Higginbotham concluded, *TMT* and other similar rulings, including the U.S. Supreme Court's long-standing precedent in *Boone v. Chiles*, 35 U.S. 177, 210 (1836), "make clear that, under the notice-definition of a good faith purchaser, the threshold for an 'adverse claim' is a dispute in ownership interest." *Id.* at 760-61. Because the lower courts found that the parties did not dispute the ownership of the hotel property—SR merely asserted a mechanic's lien, rather than an ownership interest—the Fifth Circuit held that SR's claims "do not rise to the level of an 'adverse claim' so as to vitiate the lender's status as a 'good faith purchaser.'" *Id.* at 761.

The Fifth Circuit rejected SR's argument that the state court action and the adversary proceeding alleging that the transfer of the property to the debtor was voidable and challenging the priority of SR's liens was an adverse claim. According to Judge Higginbotham, the contractual subordination agreement between SR and Hall "neuters [SR's] claim to equitable relief" in the state court action, and the adversary proceeding seeking a determination that the property transfer was voidable (as distinguished from void) passed the "notice-of-adverse claims test." *Id.* at 752.

The Fifth Circuit also rejected SR's argument that Hall was not entitled to good-faith purchaser status because it engaged in fraud and misconduct, including Hall's actions to control the bankruptcy case (by, among other things, controlling the real estate broker r2 and the stalking-horse bidder McWhinney) and obtain ownership of the hotel property at a depressed price free and clear of any competing interests (e.g., SR's mechanic's lien). According to Judge Higginbotham, Hall's actions in connection with the events surrounding Palm Springs's default on the construction loan and the transfer of a deed in lieu of foreclosure on

the hotel did not constitute misconduct, but instead "reflects a market actor responding to market forces and exercising its contractual rights." *Id.* at 763. Those market forces included the pandemic, the unfinished state of the hotel property, the absence of alternative sources of financing, and evidence that the property was a "wasting asset" with substantial monthly carrying costs.

Moreover, Judge Higginbotham explained, the other "data points" cited by SR as evidence of Hall's "fraud or misconduct" were disclosed by Hall to the bankruptcy court, which approved the auction sale transaction with full knowledge of the relevant facts. Disclosure, Judge Higginbotham wrote, "strongly favors a finding of good faith, as courts properly look to the transparency of the process as indicative of one's intent." *Id.* at 765.

Holding that the "lender did not engage in fraud and was a 'good faith purchaser,'" the Fifth Circuit affirmed the district court's judgment dismissing the appeal as moot.

OUTLOOK

There are several key takeaways from the Fifth Circuit's ruling in *RE Palm Springs*.

First, the Fifth Circuit reinforced its previous rulings that the finality of orders authorizing bankruptcy asset sales is an indispensable part of U.S. bankruptcy law, without which it would be far more difficult to monetize estate assets for the benefit of all stakeholders. Statutory mootness of unstayed sale or lease orders is the gatekeeper to finality and, at least in the Fifth Circuit, section 363(m) categorically bars appeals of such orders on any ground other than that the purchaser or lessee did not act in good faith. *See In re Walker County Hospital Corp.*, 3 F.4th 229, 236 (5th Cir. 2021).

Second, the good-faith status of a buyer or lessee of estate property in bankruptcy is not impugned merely because the buyer or lessee is aware of objections to the proposed sale or lease. Instead, such claims must rise to the level of an "adverse interest" in the ownership of the property to defeat good-faith status under section 363(m).

Third, a proposed buyer or lessee may generally exercise its legal and bargained-for contractual rights to safeguard its interests without jeopardizing its good-faith status under section 363(m). In *RE Palm Springs*, the courts appeared to be skeptical of the contractor's objections because it had expressly agreed to the subordination of its mechanic's lien and appeared to believe that the hotel property should have fetched significantly more at auction than it did.

Finally, *RE Palm Springs* illustrates the importance of transparency in establishing good faith in connection with a proposed asset sale or lease in bankruptcy. The bankruptcy court was made aware of all of the alleged conduct complained of by the contractor and had approved the auction procedures for the sale with full knowledge of the relevant facts.

DELAWARE BANKRUPTCY COURT RULES THAT DUE DILIGENCE IS ELEMENT OF PREFERENCE CLAIM RATHER THAN BASIS FOR AFFIRMATIVE DEFENSE

Daniel J. Merrett • Mark G. Douglas

A bankruptcy trustee's ability to avoid and recover pre-bankruptcy preferential transfers is essential to preserving or augmenting the estate for the benefit of all stakeholders. In 2019, however, the Bankruptcy Code was amended to add a due diligence requirement to the Bankruptcy Code's preference avoidance provision, apparently as a way to minimize the volume of speculative and coercive preference litigation. Neither the amendment nor its legislative history, however, clearly specifies the pleading rules or the allocation of the evidentiary burdens associated with the due diligence requirement, which has led to confusion among the courts.

The U.S. Bankruptcy Court for the District of Delaware recently addressed this issue in *In re Pinktoe Tarantula Ltd.*, 2023 WL 2960894 (Bankr. D. Del. Apr. 14, 2023). In dismissing a preference avoidance complaint without prejudice, the court concluded that the due diligence requirement in section 547(b) of the Bankruptcy Code is an element of a preference claim that must be proved by the preference plaintiff rather than the basis for an affirmative defense that must be proved by the defendant.

AVOIDANCE OF PREFERENTIAL TRANSFERS

Under section 547(b) of the Bankruptcy Code, a bankruptcy trustee (or a chapter 11 debtor in possession ("DIP") by operation of section 1107(a)) may, "*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 [section 547(c)],*" 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 or for the benefit of a creditor if such creditor, by reason of the transfer, receives more than it would have received in chapter 7 liquidation, if the transfer had not been made. 11 U.S.C. § 547(b) (emphasis added).

Section 547(c) contains nine defenses or exceptions to avoidance. These include, among other things, contemporaneous exchanges for new value, ordinary course business transfers, transfers involving purchase-money security interests, and transfers after which the transferor subsequently provides new value to the debtor.

Section 547(g) provides that the trustee or DIP "has the burden of proving the avoidability of a transfer" under section 547(b) and that "the creditor or party in interest against whom recovery or avoidance is sought has the burden" of establishing the existence of an affirmative defense under section 547(c).

The "reasonable due diligence" requirement was added to section 547(b) as part of the Small Business Reorganization Act of 2019 (the "SBRA"), which created a new subchapter V of chapter 11 of the Bankruptcy Code to provide a more expeditious path for small businesses to restructure successfully. *See In re Blue*, 630 B.R. 179, 186 (Bankr. M.D.N.C. 2021) (citing cases and H.R. Rep. No. 116-171, 1 (2019) (stating that subchapter V is meant to be a streamlined "process by which small business debtors reorganize and rehabilitate their financial affairs")).

The reasons for the addition of the due diligence requirement to section 547(b) are unclear. For example, the House Report accompanying the SBRA (cited above) gives no explanation for the change. As noted by a leading commentator:

> The most plausible explanation is that it seems to have been the practice for chapter 11 liquidating trusts to employ what are called, in the vernacular, "preference mills." The same practice may also be prevalent in larger chapter 7 cases. These entities pursue preference actions for the trustee and take a percentage of the recovery. Their business model is simple: they take the list from the debtor's statement of affairs of all payments the debtor made in the 90 days before bankruptcy and file preference actions against all the recipients without undertaking any investigation of the merits of the causes of action, such as whether the transfer was ordinary course, whether it was COD or otherwise a contemporaneous exchange, or any other defense. They file adversary proceedings in the home court (except for those under $13,650—the then preference venue cut-off—which probably aren't worth pursuing in any event). The defendants have to hire distant (often New York or Delaware) counsel to defend. It thus becomes very expensive to defend the action. It makes economic sense for defendants to settle for nuisance value or the cost of defense . . .. [T]he new language . . . seems to have been designed (1) to make it more expensive for the preference mills to pursue the adversary proceedings, and (2) to eliminate some of the suits when it is clear upon examination that the payments were ordinary course or substantially contemporaneous.

COLLIER ON BANKRUPTCY *(*"COLLIER"*)* ¶ 547.02A (16th ed. 2023)*; see also In re Art Inst. of Philadelphia LLC,* 2022 WL 18401591, *20 (Bankr. D. Del. Jan. 12, 2022) ("The 2019 amendment to section 547 appears to be a response to [the preference mills], imposing an obligation on trustees (not typically borne by plaintiffs) to assess the availability of an affirmative defense before filing suit."); *In re Reagor-Dykes Motors, LP*, 2021 WL 2546664, *2 (Bankr. N.D. Tex. June 21, 2021) ("The language added to § 547(b) under the Small Business Reorganization Act of 2019 is meant to deter the filing of abusive preferential transfer suits."); *see generally* David S. Forsh *et al.*, *New Bankruptcy Amendments Lower the Burdens of Preference Actions on Defendants*, 16 Pratt's Journal of Bankruptcy Law 1, 3 (2021) (explaining that this new requirement is likely to discourage the practice of filing preference actions against every entity that received a prebankruptcy transfer); Brook E. Gotberg, *Poking at Preference Actions: SBRA Amendments Signal the Need for Change*, 28 Am. Bankr. Inst. L. Rev. 285, 295 (2020) (describing how the reasonable due diligence requirement should operate to prevent trustees from filing preference actions with only nuisance value).

In addition, neither section 547(b) nor its legislative history specifies how proof of compliance with the due diligence requirement is to be established, or what even constitutes "reasonable due diligence."

In the absence of statutory or Congressional guidance, court rulings addressing the due diligence requirement—including whether it is an element of a preference claim that must be pleaded by the DIP or trustee, as distinguished from an affirmative defense, proof of which must be established by a preference defendant—have been inconsistent and confusing. *See generally* COLLIER at ¶ 547.02A (discussing cases).

Most courts have avoided deciding this question. *See, e.g., In re Ctr. City Healthcare, LLC*, 641 B.R. 793, 802 (Bankr. D. Del. 2022) (finding it unnecessary to resolve the issue because the plaintiff alleged that the debtors conducted an analysis of transfers made in the avoidance period, including defenses, sent demand letters to defendants inviting an exchange of information regarding defenses, and received no responses); *Art Inst. of Phila. LLC*, 2022 WL 18401591, at * 20 (finding it unnecessary to resolve the issue because the court was dismissing the complaint on other grounds); *In re Randolph Hosp., Inc.*, 644 B.R. 446, 462 (Bankr. M.D.N.C. 2022) (concluding that due diligence was adequately pled when the plaintiff alleged that he reviewed books and records, evaluated reasonably knowable defenses, attached to the complaint documentary evidence of the transfers, and described the contractual relationship between the debtor and defendant); *In re Insys Therapeutics, Inc.*, 2021 WL 5016127, *3 (Bankr. D. Del. Oct 28, 2021) (declining to decide the issue because the preference complaint generally met the pleading standard of Fed. R. Civ. P. 8, the liquidating trustee alleged he sent a letter to the defendant demanding return of the transfers and inviting the defendant to advise of any defenses, which were reviewed if presented, and the trustee alleged he reviewed the debtors' books and records); *Reagor-Dykes Motors,* 2021 WL 2546664, at *5 (finding it unnecessary to resolve the issue, but noting that if due diligence was performed, it was not reflected in the complaint because of the lack of context surrounding the transfers); *In re Trailhead Engineering LLC*, 2020 WL 7501938, *7 (Bankr. S.D. Tex. Dec. 21, 2020) (concluding that any pleading requirement was satisfied because the complaint indicated that the chapter 7 trustee reviewed the debtor's books and records, invoices relating to the specific transfer, correspondence between the parties and the underlying contract, and related relationships between the debtor and the defendant transferee).

Other courts have concluded that a complaint cannot merely recite the language of section 547(b) to satisfy the provision, but must include facts to support due diligence. *See, e.g.*, *In re Arete Healthcare, LLC*, 2022 WL 362924, *11 (Bankr. W.D. Tex. Feb. 7, 2022) (dismissing a preference claim on other grounds, but

stating that "[i]f due diligence is an element, merely paraphrasing the element will not satisfy [Fed. R. Civ. P. 8]"); *see also Randolph Hosp.*, 644 B.R. at 462 (acknowledging that the plaintiff in preference avoidance litigation did "more than recite the introductory sentence of § 547(b)").

In *In re ECS Ref., Inc.*, 625 B.R. 425 (Bankr. E.D. Cal. 2020), the bankruptcy court tackled the question head-on in ruling on a motion to dismiss a chapter 7 trustee's complaint seeking, among other things, to avoid prepetition payments by the debtor to an insider creditor. The court concluded that, as amended by the SBRA, section 547(b) now includes a "condition precedent" with "three discrete subparts" that the party seeking avoidance must satisfy before commencing preference litigation:

> (1) reasonable due diligence under "the circumstances of the case"; (2) consideration as to whether a prima facie case for a preference action may be stated; and (3) review of the known or "reasonably knowable" affirmative defenses that the prospective defendant may interpose.

Id. at 453. Guided by U.S. Supreme Court precedent, the bankruptcy court in *ECS* also determined that this condition precedent is an *element* of a preference plaintiff's prima facie case—and may therefore defeat jurisdiction if not adequately pleaded—rather than an *affirmative defense* that the defendant must plead in opposing avoidance. *Id.* at 454 (discussing *Jones v. Bock*, 549 U.S. 199, 212-217 (2007) (interpreting the Prison Litigation Reform Act, which like amended section 547(b), is silent on whether satisfaction of a condition precedent is an element or an affirmative defense and on whether satisfaction of the condition is a pleading requirement)). According to the court, this conclusion is supported by several factors:

(i) "§ 547 expressly requires that the trustee affirmatively prove due diligence" and, in most instances, if the plaintiff bears the burden of proof of establishing a fact at trial, it is an element, whereas, if the defendant bears the burden of proof, it is an affirmative defense;
(ii) section 547(b) "defines" avoidable preferences, including the element of due diligence, whereas section 547(c) offers preference defendants nine affirmative defenses;
(iii) section 547(f) expressly "allocate[s] the burden of proof on the issue of due diligence under § 547(b) to the trustee"; and
(iv) treating the due diligence requirement as an element falls within the "plain meaning rule" because literally applying it would not "produce a result demonstrably at odds with the intentions of its drafters," but in fact is consistent with Congressional intent.

Id. at 457 (quoting *United States v. Ron Pair Enterprises, Inc.*, 489 U.S. 235, 242 (1989)). Stated differently, the *ECS* court reasoned that the due diligence requirement would have been included in section 547(c), rather than section 547(b), if lawmakers had intended that the absence of due diligence was an affirmative defense instead of an element of a preference claim.

TARANTULA

Women's clothing retailer Pinktoe Tarantula Limited ("Pinktoe") and its U.S. affiliates (collectively, the "debtors") were founded by Charlotte Olympia Dellal ("Dellal") in 2013 as the U.S. outlet for the Charlotte Olympia brand of women's apparel. Dellal served as an officer and a director of the debtors until 2018. She was also on the board of certain non-debtor affiliates located in the United Kingdom.

Sometime after 2013, Pinktoe signed a lease agreement with L&M 65th Madison LLC (the "landlord") for a retail store in New York City. Dellal personally guaranteed Pinktoe's obligations under the lease. Neither the New York store nor the debtors' other U.S. locations ever turned a profit. From February 2017 through January 2018, Pinktoe paid the landlord nearly $450,000 in rent for the New York store.

On February 17, 2018, the debtors filed for chapter 11 protection in the District of Delaware. The bankruptcy court confirmed a liquidating chapter 11 plan for the debtors approximately one year later. The plan created a liquidating trust for the purpose of prosecuting estate causes of action.

The liquidating trust commenced an adversary proceeding seeking: (i) in count one, avoidance and recovery under sections 547 and 550 of the nearly $450,000 in rent paid to the landlord during the year preceding the debtors' bankruptcy filing, which payments the trust alleged were transferred "for the benefit of" the "insider" guarantor Dellal and allowed Dellal to receive more

than she would have received if the debtors had been liquidated in chapter 7; and (ii) in count two, damages for Dellal's breach of fiduciary duty in, among other things, failing to close the unprofitable New York store (the rental payments for which reduced her guarantee liability), inadequately capitalizing the debtors, refusing to take steps that could have improved the debtors' financial viability, and bolstering her own brand (and the brands of the UK affiliates) at the expense of the debtors and their creditors.

Dellal moved to dismiss the complaint. She argued in part that the trust failed to plead a preference claim properly because the trust did not allege in the complaint that it undertook any due diligence into the merits of its claims or any potential affirmative defenses.

The trust argued that the due diligence requirement was an affirmative defense, which it was "not required to plead around." Alternatively, the trust contended that it did consider potential section 547(c) defenses but concluded that they were not applicable under the circumstances, and that "its diligence is evident on the face of the Complaint."

THE BANKRUPTCY COURT'S RULING

The bankruptcy court dismissed both counts of the complaint, but without prejudice and with leave to amend.

U.S. Bankruptcy Judge Laurie Selber Silverstein rejected the trust's arguments. First, she explained, although the amendment to section 547(b) as part of the SBRA took effect approximately three months before the trust filed its adversary proceeding, the complaint did not include any explicit allegations responsive to the new due diligence requirement.

Next, agreeing with the *ECS* court's reasoning, Judge Silverstein concluded that section 547(b)'s due diligence requirement is an element of a preference claim rather than an affirmative defense based on the structure and language of sections 547(b) (setting out the elements of a preference), 547(c) (setting forth affirmative defenses), and 547(g) (allocating the burden of proof in connection with both). According to Judge Silverstein, "[b]ecause the due diligence requirement appears in subsection (b), not (c), I conclude that the due diligence requirement is an element of the claim, or something that must be proven by the trust[]."

She also determined that the due diligence requirement in section 547(b) is a condition precedent, the pleading of which is governed not by the general pleading requirements stated in Fed. R. Civ. P. 8, but by Fed. R. Civ. P. 9(c) (made applicable in bankruptcy adversary proceedings by Fed. R. Bankr. P. 7009), which provides as follows:

> In pleading conditions precedent, it suffices to allege generally that all conditions precedent have occurred or been performed. But when denying that a condition precedent has occurred or been performed, a party must do so with particularity.

Fed. R. Civ. P. 9(c).

Judge Silverstein determined that the complaint failed this pleading standard because the trust did not allege, generally or otherwise, that it performed any due diligence. She accordingly dismissed the preference claim stated in the complaint (count one). However, because the effective date of the amendment to section 547(b) took effect shortly before the trust filed its complaint, the bankruptcy court gave the trust leave to amend the complaint to remedy the defect. The court also dismissed (without prejudice and with leave to amend) the breach of fiduciary duty claim (count two) because, among other reasons, the complaint did not adequately plead a claim for breach of the duty of care or allege that the debtors were insolvent at all relevant times.

OUTLOOK

Tarantula provides welcome guidance regarding the evidentiary burdens borne by plaintiffs and defendants in preference avoidance litigation. This question was muddied by the 2019 amendment to section 547(b) as part of the SBRA and has created considerable confusion in the bankruptcy courts. According to the *Tarantula* bankruptcy court's reasoning, the due diligence requirement is an element of a preference claim rather than a condition precedent. It remains to be seen whether other courts will embrace this approach.

"STRAIGHT" DISMISSAL OF CHAPTER 11 CASE DID NOT VIOLATE *JEVIC*'S PROHIBITION OF "STRUCTURED DISMISSALS" THAT DO NOT CONFORM WITH BANKRUPTCY CODE'S PRIORITY SCHEME

Oliver S. Zeltner • Mark G. Douglas

In *Czyzewski v. Jevic Holding Corp.*, 137 S. Ct. 973 (2017), the U.S. Supreme Court held that the Bankruptcy Code does not allow bankruptcy courts to approve distributions to creditors in a "structured dismissal" of a chapter 11 case that violate the Bankruptcy Code's ordinary priority rules without the consent of creditors. However, because the Court declined to express any "view about the legality of structured dismissals in general," many open questions remain regarding the structured dismissal mechanism.

A bankruptcy appellate panel for the Ninth Circuit ("BAP") recently addressed structured dismissals in *In re Pourteymour*, 2023 WL 2929323 (B.A.P. 9th Cir. Apr. 12, 2023). The BAP affirmed a bankruptcy court order granting a "straight dismissal" of a chapter 11 case, finding that, notwithstanding the debtor's pledge on the record to pay some, but not all, unsecured creditors after dismissal of his bankruptcy case, the court's dismissal order complied with all applicable provisions of the Bankruptcy Code.

STRUCTURED DISMISSALS

In a typical chapter 11 case, a plan of reorganization or liquidation is proposed; the plan is confirmed by the bankruptcy court; the plan becomes effective; and, after the plan has been substantially consummated and the case has been fully administered, the court enters a final decree closing the case. Because chapter 11 cases can be prolonged and costly, prepackaged or prenegotiated plans and expedited asset sales under section 363(b) of the Bankruptcy Code have been increasingly used as methods to short-circuit the process, minimize expenses, and maximize creditor recoveries. In chapter 11 cases primarily involving one, or just a few, real estate assets, bankruptcy courts also sometimes authorize nonjudicial foreclosure, enabling a creditor to take title to an estate asset outside of a chapter 11 plan.

After a bankruptcy court approves the sale of substantially all of a chapter 11 debtor's assets under section 363(b) of the Bankruptcy Code (or a nonjudicial foreclosure of real estate assets outside of a chapter 11 plan), three options are generally available to deal with the debtor's vestigial property and claims against the bankruptcy estate, and to wind up the bankruptcy case. Namely, the debtor can propose and seek confirmation of a liquidating chapter 11 plan, the case can be converted to a chapter 7 liquidation, or the case can be dismissed. The first two options commonly require significant time and administrative costs.

Yet outright dismissal of a chapter 11 case may not be the best course of action either, for several reasons. Section 349(b) of the Bankruptcy Code provides that, "[u]nless the court, for cause, orders otherwise," the dismissal of a bankruptcy case generally reinstates the status quo ante by, among other things, reinstating any pre-bankruptcy custodianship, vacating any bankruptcy court order avoiding a transfer or lien, and revesting property of the estate in the debtor. Dismissal of a case is intended to "undo the Bankruptcy case, as far as practicable, and to restore all property rights to the position in which they were found at the commencement of the case." H.R. Rep. No. 95-595, 338 (1977).

However, because conditions may have changed such that a complete restoration of the status quo is difficult or impossible, section 349(b) of the Bankruptcy Code permits the bankruptcy court, "for cause," to modify the ordinary "restorative consequences" of unconditional dismissal of the chapter 11 case. *Jevic*, 137 S. Ct. at 979. This power is particularly relevant in cases where the debtor's assets have been sold in a section 363(b) sale or foreclosed upon by a creditor. *See* H.R. Rep. No. 95-595, 338 (1977) (the intent "to undo the bankruptcy case, as far as practicable, and to restore all property rights to the position in which they were found at the commencement of the case . . . does not necessarily encompass undoing sales of property from the estate to a good faith purchaser").

Such a conditional dismissal—or "dismissal with strings"—is commonly referred to as a "structured dismissal," which has been defined as:

> a hybrid dismissal and confirmation order in that it typically dismisses the case while, among other things, approving certain distributions to creditors, granting certain third party-releases, enjoining certain conduct by creditors, and not necessarily vacating orders or unwinding transactions undertaken during the case. These additional provisions—often deemed "bells and whistles"—are usually the result of a negotiated and detailed settlement arrangement between the debtor and key stakeholders in the case.

Final Report and Recommendations of the American Bankruptcy Institute Commission to Study the Reform of Chapter 11 (2014), p. 270.

TYPICAL TERMS

Among the provisions commonly included in bankruptcy court orders approving structured dismissals are:

- Expedited procedures to resolve claims objections;
- Provisions specifying the manner and amount of distributions to creditors;
- Releases and exculpation provisions that might ordinarily be approved as part of a confirmed chapter 11 plan;

- Senior creditor carve-outs and "gifting" provisions, whereby, as a *quid pro quo* for a consensual structured dismissal, a senior secured lender or creditor group agrees to carve out a portion of its collateral from the sale proceeds and then "gift" it to unsecured creditors; and
- Provisions that, notwithstanding section 349(b) of the Bankruptcy Code, prior bankruptcy court orders survive dismissal and the court retains jurisdiction to implement the structured dismissal order, resolve certain disputes, and adjudicate certain matters, such as professional fee applications.

SOURCES OF AUTHORITY

The Bankruptcy Code does not expressly authorize or contemplate structured dismissals. Even so, sections 105(a), 305(a)(1), 349(b), and 1112(b) of the Bankruptcy Code are commonly cited as authority for the remedy. *See, e.g., In re Olympic 1401 Elm Assocs., LLC*, 2016 WL 4530602 (Bankr. N.D. Tex. Aug. 29, 2016); *In re Naartjie Custom Kids, Inc.*, 534 B.R. 416 (Bankr. D. Utah 2015); *see generally* Amir Shachmurove, *Another Way Out: Structured Dismissals in* Jevic's *Wake*, Norton Bankr. L. Adviser (Nov. 2015) (referencing sections 105, 305, 349, and 1112 of the Bankruptcy Code as authority for structured dismissals).

Section 1112(b)(1) of the Bankruptcy Code directs a bankruptcy court, on request of a party in interest and after notice and a hearing, to convert a chapter 11 case to a chapter 7 liquidation or to dismiss the chapter 11 case, "whichever is in the best interests of creditors and the estate, for cause." "Cause" is defined in a non-exclusive manner in section 1112(b)(4) to include, among other things, "substantial or continuing loss to or diminution of the estate and the absence of a reasonable likelihood of rehabilitation" and "inability to effectuate substantial consummation of a confirmed plan."

Section 305(a)(1) of the Bankruptcy Code provides that a bankruptcy court may dismiss or suspend all proceedings in a bankruptcy case under any chapter if "the interests of creditors and the debtor would be better served by such dismissal or suspension." Section 305(a)(1) has traditionally been used to dismiss involuntary cases where recalcitrant creditors involved in an out-of-court restructuring file an involuntary bankruptcy petition to extract more favorable treatment from the debtor. However, the provision has also been applied to dismiss voluntary cases, albeit on a more limited basis. Because an order dismissing a case under section 305(a) may be reviewed on appeal only by a district court or a bankruptcy appellate panel, rather than by a court of appeals or the U.S. Supreme Court (*see* 11 U.S.C. § 305(c)), section 305(a) dismissal is an "extraordinary remedy." *See In re Kennedy*, 504 B.R. 815, 828 (Bankr. S.D. Miss. 2014). Section 305(a) has been cited as authority for approving a structured dismissal. *See, e.g., Olympic 1401*, 2016 WL 4530602, at *3; *Naartjie*, 534 B.R. at 425-26.

As noted above, section 349(b) authorizes a bankruptcy court to alter the ordinary consequences of dismissal "for cause." *See In re Johnson*, 565 B.R. 417, 425 (Bankr. C.D. Cal. 2017) ("Although not explicitly authorized by the Bankruptcy Code, structured dismissals (under § 1112(b) and/or § 305(a)) have been found to be implicitly authorized under § 349(b)".).

Section 105(a) of the Bankruptcy Code provides that a bankruptcy court "may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions" of the Bankruptcy Code. However, section 105(a) "'does not allow the bankruptcy court to override explicit mandates of other sections of the Bankruptcy Code.'" *Law v. Siegel*, 134 S. Ct. 1188, 1194 (2014) (quoting Collier on Bankruptcy ¶ 105.01[2] (16th ed. 2013)).

THE BANKRUPTCY CODE'S PRIORITY SCHEME

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

In a chapter 11 case, the chapter 11 plan usually determines the treatment of secured and unsecured claims (as well as equity interests), subject to the requirements of the Bankruptcy Code. Under section 1129(a)(7) of the Bankruptcy Code, each creditor must receive at least as much under the plan as it would receive in a chapter 7 liquidation. Additionally, if a creditor does not agree to "impairment" of its claim under the plan—such as by agreeing to receive less than payment in full—and votes to reject the plan, the plan can be confirmed only under certain specified conditions. Among these conditions is the requirement that the plan must be "fair and equitable" (11 U.S.C. § 1129(b)(1)).

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

The Bankruptcy Code does not expressly state whether these priority rules apply to structured dismissals, and until *Jevic*, precedent concerning this issue was sparse and inconsistent.

JEVIC

In *Jevic*, the U.S. Supreme Court held that bankruptcy courts may not deviate from the Bankruptcy Code's priority scheme when approving structured dismissals absent the consent of affected creditors—without, however, offering any "view about the legality of structured dismissals in general." *Jevic*, 137 S. Ct. at 985.

The Court distinguished *Jevic* from cases in which courts have approved interim settlements resulting in distributions of estate

assets in violation of the priority rules, such as *In re Iridium Operating LLC*, 478 F.3d 452 (2d Cir. 2007). The 6–2 *Jevic* majority found that *Iridium* "does not state or suggest that the Code authorizes nonconsensual departures from ordinary priority rules in the context of a dismissal—which is a final distribution of estate value—and in the absence of any further unresolved bankruptcy issues." *Jevic*, 137 S. Ct. at 985. In this sense, the majority explained, the situation in *Iridium* was similar to certain "first-day" orders, where courts have allowed for, among other things, payments ahead of secured and certain priority creditors to employees for prepetition wages or to critical vendors on account of their prepetition invoices. *Id.*

The Court further explained that "in such instances one can generally find significant Code-related objectives that the priority-violating distributions serve." *Id.* By contrast, it noted, the structured dismissal in *Jevic* served no such objectives (e.g., it did not benefit disfavored creditors by preserving the debtor as a going concern and enabling the debtor to confirm a plan of reorganization and emerge from bankruptcy). Rather, the distributions at issue "more closely resemble[d] proposed transactions that lower courts have refused to allow on the ground that they circumvent the Code's procedural safeguards" (citing, among others, certain section 363 asset sales). *Id.* at 986.

JEVIC'S IMPACT

Based on *Jevic*, many courts have refused to approve structured dismissals, settlements, and related transactions that appeared to fit within the scope of *Jevic*'s prohibition of nonconsensual final distributions to creditors that violate the Bankruptcy Code's distribution scheme. *See, e.g.*, *In re S-Tek 1, LLC*, 2023 WL 2529729, *11 (Bankr. D.N.M. Mar. 15, 2023) (denying a chapter 11 debtor's request for a structured dismissal whereby the lender's collateral would be sold free and clear of liens under section 363(f), the debtor would obtain financing and continue to operate its business, and stating that "the Court has not found any caselaw in which a court authorized a structured dismissal through the sale of a debtor's assets, where the intended purpose of the structured dismissal is to allow the debtor to reorganize and continue business operations"); *In re E. Coast Diesel, LLC*, 2022 WL 19078763, *4 (Bankr. M.D.N.C. Dec. 29, 2022) (denying structured dismissal of chapter 11 case where priority wage claims were not to be paid in full); *In re California Palms Addiction Recovery Campus, Inc.*, 2022 WL 2116643, *17 (Bankr. N.D. Ohio June 10, 2022) (noting that the chapter 11 debtor's structured dismissal proposal "failed to consider that priority-defying distributions do not comply with *Jevic*'s holding, and cannot be approved"); *In re Micron Devices, LLC*, 2021 WL 2021468, *10 (Bankr. S.D. Fla. May 20, 2021) (in approving a proposed settlement agreement, noting that "the 'structured dismissals' the Debtor has asked for, first directly and then indirectly—would not pass muster" under *Jevic* because, among other things, administrative claimants would not be paid in full); *In re Bluefield Women's Ctr., P.C.*, 2021 WL 1245949, *5 (Bankr. S.D. W. Va. Mar. 30, 2021) ("[Certain unsecured creditors] plead, in the alternative, that the 'cause' provision of § 349(b) would allow this Court to approve the structured dismissal. . . . This Court does not agree. Harkening back to the Supreme Court's decision in *Jevic*, 'cause' is too slender a reed for this Court to approve disbursement of funds in contravention to the Code's priority scheme."); *In re Fleetstar LLC*, 614 B.R. 767, 786–87 (Bankr. E.D. La. 2020) ("[T]o the extent the proposed 'dismissal with terms' provides for distributions that disturb the absolute priority rule designated in the Bankruptcy Code without the consent of all affected creditors, this Court is prohibited by the Supreme Court's holding in *Jevic* from approving such proposal.").

However, other courts have approved such dismissals or transactions by reading *Jevic* as strictly limited to its facts or by finding that the relief sought fell within one of the permitted exceptions articulated by the *Jevic* Court. *See, e.g.*, *In re Veg Liquidation, Inc.*, 931 F.3d 730, 739 (8th Cir. 2019) (unequal distribution of the proceeds from a section 363 sale to unsecured creditors with equal priority was not prohibited by *Jevic*); *In re Old Cold LLC*, 879 F.3d 376, 388 (1st Cir. 2018) (refusing to apply *Jevic* to disturb an asset sale under section 363(b) and ruling that section 363(m) rendered statutorily moot an appellate challenge to a sale to a good-faith purchaser); *In re KG Winddown, LLC*, 628 B.R. 739, 741 (Bankr. S.D.N.Y. 2021) (approving structured dismissals that did not violate the Bankruptcy Code's priority scheme and stating that "[*Jevic*] left the door open where such dismissals do not violate the absolute priority rule and otherwise comply with the applicable provisions of the Bankruptcy Code . . . [and] [h]ere, the Debtors' request for structured dismissals fits neatly through that open door"); *In re Atlantic & Pacific Tea Co. Inc.*, No. 15-23007 (RDD) (Bankr. S.D.N.Y. May 15, 2021) (noting that the structured dismissal of the debtor's chapter 11 case in accordance with the Bankruptcy Code's priority scheme did not violate *Jevic* because, among other things, the provisions governing the wind-down of the debtor's remaining business and assets did not constitute "plan relief" or an end-run around the Bankruptcy Code's creditor protections); *In re Goodrich Quality Theaters, Inc.*, 616 B.R. 514, 521 (Bankr. W.D. Mich. 2020) (relying on the "competing bankruptcy principles" identified in *Jevic*, namely preservation of going-concern value and prospects for reorganization, to approve critical vendor payments), *as supplemented*, 2020 WL 1180534 (Bankr. W.D. Mich. Mar. 9, 2020); *In re Claar Cellars, LLC*, 2020 WL 1238924, *7 (Bankr. E.D. Wash. Mar. 13, 2020) (holding

that the debtor's use of cash collateral to pay in part a prepetition, allegedly secured debt owed to an affiliated debtor did not violate *Jevic*); *In re ACI Concrete Placement of Kansas, LLC*, 604 B.R. 400, 407 (Bankr. D. Kan. 2019) (holding that enforcing a "carve out" from a secured creditor's collateral for payment of professional fees did not violate *Jevic*); *In re Daily Gazette Co.*, 584 B.R. 540, 546 (Bankr. S.D. W. Va. 2018) (a proposed disbursement following a section 363 sale that would result in an orderly payment of administrative claims, such as attorneys' fees and U.S. Trustee fees, followed by payment to an undisputed secured creditor whose claim exceeded amount of the net sale proceeds, "neither runs afoul of *Jevic* nor the Code generally").

POURTEYMOUR

In November 2020, real estate investor Ramin Pourteymour (the "debtor") filed for chapter 11 protection in the Southern District of California to prevent foreclosure on three parcels of real property encumbered by mortgages securing loans provided by a bank (the "lender") exceeding $10 million. The properties were later valued at approximately $9.7 million.

The lender filed secured claims in the chapter 11 case in the amount of approximately $10.2 million and an unsecured claim in the amount of approximately $1.4 million based on the debtor's personal guaranty of the loans. In July 2021, the bankruptcy court granted the lender relief from the automatic stay to foreclose on one of the properties, which it then acquired by means of a credit bid in foreclosure.

After the lender foreclosed, the debtor filed a motion to dismiss his chapter 11 case under section 1112(b) of the Bankruptcy Code, arguing that the loss of the foreclosed property (and in particular, its rental income) was "cause" for dismissal because it was a "material change of circumstances" that prevented him from confirming a chapter 11 plan. The debtor also argued that: (i) dismissal was in the best interests of creditors because it would avoid further expense, and if the case were dismissed, he would pay creditors over time; and (ii) liquidation of his remaining assets under chapter 7 would result in increased tax liability. The debtor proposed that any order dismissing the case should include language obligating him, as a condition to dismissal, to use unencumbered estate assets deposited in various accounts to pay property taxes, administrative fees. and prepetition arrearages on the remaining mortgage debt.

The Office of the United States Trustee opposed the motion, contending that conversion of the chapter 11 case to a chapter 7 liquidation would better serve creditors because it would permit a neutral chapter 7 trustee to evaluate and possibly settle potential litigation against the lender, thereby realizing the true value of the estate's assets. The lender also opposed the motion to dismiss. It argued that creditors would be better served by an orderly liquidation of the debtor's assets, and that the debtor's proposed structured dismissal would violate *Jevic*.

According to the debtor, the proposed structured dismissal of his chapter 11 case would provide for the payment of all arrearages, administrative claims, and unsecured claims, other than the lender's unsecured guaranty claim, which the debtor disputed. Such a dismissal, he argued, would not violate *Jevic* because the disputed lender claim "was within the same class as other unsecured creditors," and therefore "no claims would be paid out of priority." Alternatively, the debtor proposed to reserve the lender's pro rata share of amounts to be distributed to other unsecured creditors—anticipated to result in an 89% recovery—pending the resolution of the debtor's objection to the lender's unsecured claim.

The bankruptcy court ruled that there was cause to dismiss or convert the chapter 11 case based in part on the material change in circumstances caused by the foreclosure sale of one of the properties. However, the court found that the best interests of creditors would not be best served by conversion of the case to chapter 7.

Moreover, the bankruptcy court concluded that both of the structured dismissal alternatives proposed by the debtor "would violate either the holding or the spirit of *Jevic*." Applying a balancing test to decide whether to convert or dismiss the case under section 1112(b) of the Bankruptcy Code, the court determined that a "straight" dismissal of the debtor's chapter 11 case—rather than a structured dismissal—would best serve the interests of creditors and the estate. Accordingly, the court's dismissal order simply provided that, upon dismissal, property of the estate would revest in the debtor pursuant to section 349 of the Bankruptcy Code. The bankruptcy court expressly took no position on the debtor's proposal to pay creditors from unencumbered assets post-dismissal.

The lender appealed to the BAP.

THE BANKRUPTCY APPELLATE PANEL'S RULING

The BAP affirmed the ruling below, concluding that the: (i) bankruptcy court's dismissal order did not violate *Jevic* because it provided for a "straight dismissal" rather than a structured dismissal of the debtor's chapter 11 case; and (ii) the bankruptcy court did not abuse its discretion in concluding that dismissal of the chapter 11 case was in the best interests of creditors and the estate.

The BAP rejected the lender's argument that the dismissal order violated *Jevic* by not requiring payment of the lender's unsecured claim upon dismissal because the absolute priority rule would preclude the debtor from retaining substantial assets without paying the lender's claim under a chapter 11 plan. According to the BAP, "[t]he Bankruptcy Code does not impose the same burdens and requirements on dismissal as confirmation." *Pourteymour*, 2023 WL 2929323, at *6. It also noted that, upon dismissal of the debtor's chapter 11 case, "[the lender] retained its rights and remedies under state law and dismissal merely returned the parties to the prepetition financial status quo." *Id.*

The BAP also rejected the lender's argument that the dismissal order "provided for an implied structured dismissal because Debtor confirmed that he would pay some unsecured creditors even if the Dismissal Order was unconditional." According to the BAP, the debtor's statements about paying creditors did not alter the effect of the dismissal order, "which plainly provides for a straight dismissal." *Id.* Moreover, the BAP explained, the bankruptcy court handled the dismissal dispute "commendably" and did not improperly rely on the debtor's pledge to pay unsecured creditors in concluding that straight dismissal of the chapter 11 case was warranted in the best interest of creditors and the estate. In that regard, the BAP noted that the bankruptcy court's written dismissal order governed the terms of dismissal, not statements made by the court or the parties during argument on the dismissal motion.

In conclusion, the BAP held that "[t]he Dismissal Order does not violate the holding of *Jevic* because it provides for a straight dismissal in accordance with § 349, and it neither expressly nor impliedly conditions dismissal on payments to creditors." *Id.* at *7.

OUTLOOK

The Supreme Court's ruling in *Jevic* does not categorically prohibit structured dismissals of chapter 11 cases, but it does prohibit structured dismissals conditioned on distributions to creditors that violate the Bankruptcy Code's priority scheme where there are no "significant Code-related objectives that the priority-violating distributions serve." Consequently, bankruptcy courts continue to approve structured dismissals that do not violate *Jevic*'s mandate. They will likely continue to do so because there are circumstances in which a structured dismissal, rather than a straight dismissal or conversion of a chapter 11 case to chapter 7, appears to better serve the interests of creditors and the estate.

Pourteymour does not fit neatly into this category of such cases because, despite the debtor's pledge to pay unsecured creditors upon dismissal, the bankruptcy court's order dismissing the chapter 11 case was not a structured dismissal. It was not expressly conditioned on the payment of creditors (either in accordance with statutory priorities or otherwise) and was therefore consistent with section 349 of the Bankruptcy Code. Nevertheless, the bankruptcy court's unpublished (and therefore nonprecedential) ruling provides useful guidance regarding structured dismissals. It also demonstrates the pitfalls of relying on representations made by the parties on the record rather than the express language of a court order or judgment.

LIQUIDATING CHAPTER 11 PLAN CONFIRMED DESPITE PROVISION TEMPORARILY ENJOINING LITIGATION AGAINST CORPORATE DEBTORS

Charles M. Oellermann • Mark G. Douglas

To prevent "trafficking in corporate shells," the Bankruptcy Code prohibits any discharge of corporate or partnership debts if the debtor is not an "individual" and, in a chapter 11 case, if the debtor proposes a liquidating chapter 11 plan contemplating the cessation of the debtor's business following confirmation.

The U.S. Bankruptcy Court for the District of Delaware recently addressed this prohibition in *In re Kabbage Inc.*, No. 22-10951 (Bankr. D. Del. Mar. 15, 2023). In an unpublished letter ruling, the court concluded that a plan provision permanently enjoining third parties from suing the debtors, their estates, or a court-appointed "wind-down officer" following confirmation could not be confirmed because it was tantamount to a prohibited discharge of the debts of a liquidating corporation. However, instead of simply denying confirmation, the court exercised its broad equitable powers to confirm the plan, as amended to provide for merely temporary injunctive relief until such time that the debtors' assets had been liquidated.

PROHIBITION OF BANKRUPTCY DISCHARGE FOR LIQUIDATING CORPORATIONS AND PARTNERSHIPS

Section 1141(d)(1) of the Bankruptcy Code provides that, except as otherwise provided in section 1141(d), a chapter 11 plan, or a plan confirmation order, the confirmation of a chapter 11 plan by the bankruptcy court discharges the debtor from any claim or debt that arose before the confirmation date, including claims arising from the rejection of executory contracts or unexpired leases, certain claims arising from the recovery of property by the estate, and certain tax claims. *See* 11 U.S.C. § 1141(d)(1).

However, pursuant to section 1141(d)(3), the confirmation of a chapter 11 plan does not discharge a debtor if:

> (A) the plan provides for the liquidation of all or substantially all of the property of the estate;
> (B) the debtor does not engage in business after consummation of the plan; ***and***
> (C) the debtor would be denied a discharge under section 727(a) . . . if the case were a case under chapter 7 of [the Bankruptcy Code].

11 U.S.C. § 1141(d)(3) (emphasis added).

Section 727(a)(1) of the Bankruptcy Code provides that "[t]he court shall grant the debtor a discharge [in a chapter 7 case], unless . . . the debtor is not an individual." The term "individual" is not defined by the Bankruptcy Code. However, it has been construed to include only "natural persons," as distinguished from

corporations, partnerships, and other entities. *See, e.g., Friedman v. C.I.R.*, 216 F.3d 537, 548 n.7 (6th Cir. 2000) (a corporate debtor is not an individual entitled to a chapter 7 discharge); *Yamaha Motor Corporation v. Shadco, Inc.*, 762 F.2d 668, 670 (8th Cir. 1985) ("Congress clearly did not intend the term 'corporate debtor' to be used interchangeably with the term 'individual debtor,' as such a construction would render meaningless employment by Congress of the term 'individual.'" (citations and internal quotation marks omitted)); *Consolidated Rail Corp. v. Gallatin State Bank*, 173 B.R. 146, 147 (N.D. Ill 1992) ("Although the Bankruptcy Code nowhere explicitly defines the word 'individual' it leaves no doubt that a corporation is not an individual."); *In re Automatic Plating of Bridgeport, Inc.*, 202 B.R. 540, 542 (Bankr. D. Conn. 1996) ("Although 'individual' is not specifically defined under the code, it is apparent from the separate enumeration of individual and corporation in § 101(41) that those entities were intended to be treated separately under the code.").

Section 1141(d)(3) is designed to prevent trafficking in corporate shells and bankrupt partnerships. *See* H.R. Rep. No. 95-595, 384 (1977); S. Rep. No. 95-989, 130 (1978); *Borsdorf v. Fairchild Aircraft Corp. (In re Fairchild Aircraft Corp.)*, 128 B.R. 976, 982 (Bankr. W.D. Tex. 1991) (stating that "by freighting the [corporate] shell with all the claims, so that any claims or portions of claims not paid by the liquidation will attach to the shell . . . [the corporate shell becomes] much less attractive for use in starting up another enterprise"); *Diego v. Zamost (In re Zamost)*, 7 B.R. 859 (Bankr. S.D. Cal. 1980) (explaining that, once a corporation's assets are liquidated, it is not necessary to provide it with a discharge); *accord In re AB Liquidation Corp.*, 2006 WL 6810956, *6 (B.A.P. 9th Cir. Dec. 22, 2006). The prohibition of a discharge for liquidating business entities was not the rule under the former Bankruptcy Act of 1898, as amended. *See* Collier on Bankruptcy ("Collier") ¶ 727(a)(1)[3] (16th ed. 2023) (citing H.R. Rep. No. 95-595, 384 (1977) («[Section 727(a)(1)] is a change from present law, under which corporations and partnerships may be discharged in liquidation cases, though they rarely are»); S. Rep. No. 95-989, 130 (1978)).

Following liquidation, any dissolution of a corporation or partnership must be effected under applicable state law. *See China Nat. Bldg. Material Inv. Co. v. BNK Int'l, LLC,* 2015 WL 363275, *8 (W.D. Tex. Jan. 27, 2015)*; In re Townside Constr., Inc.*, 582 B.R. 407, 416 (Bankr. W.D. Va. 2018); *see generally* Collier at ¶ 727.01[3] ("Under the Code, a corporation or partnership in a chapter 7 case is liquidated only and never receives a discharge. After liquidation, any dissolution of the corporation or partnership that the parties desire must be effectuated under state law, since the Code does not provide for dissolution of corporations or partnerships.").

Taken together, sections 1141(d)(3) and 727(a)(1) prevent non-individual liquidating debtors "from avoiding the operation of section 727(a)(1) through the use of a liquidating plan under chapter 11 instead of a chapter 7 liquidation." Collier at ¶¶ 727.01[3] and 1141.05[4].

Because section 1141(d)(3) is written in the conjunctive, "if any one provision does not apply, confirmation of a plan results in the discharge of debt." *In re River Capital Corp.*, 155 B.R. 382, 387 (Bankr. E.D. Va. 1991). Thus, if a corporate debtor's chapter 11 plan does not provide for the liquidation of all or substantially all of the debtor's assets and the debtor continues to operate after its plan is confirmed, the debtor is entitled to a discharge. *See In re T-H New Orleans Ltd. P'ship*, 188 B.R. 799, 804 (E.D. La. 1995) ("While the debtor would arguably be denied a discharge under § 727(a)(1), the other conjunctive requirements are not met. The court below ably noted that [section 1141(d)(3)(A)] is not satisfied by the facts of this case. The plan does not necessarily provide for liquidation of all property because the debtor has the option of refinancing and paying the creditor in full."), *aff'd sub nom. Matter of T-H New Orleans Ltd. P'ship*, 116 F.3d 790 (5th Cir. 1997)*; In re Glob. Water Techs., Inc.*, 311 B.R. 896, 901 (Bankr. D. Colo. 2004) ("The Court finds that, even though Debtor's Plan contains language that is tantamount to granting of a discharge of pre-petition debts, because the Debtor will resume its business operations post-confirmation, its Plan does not violate § 1141(d)(3)."); *accord Broussard v. First Am. Health Care of Ga., Inc. (In re First Am. Health Care of Ga., Inc.)*, 220 B.R. 720, 725–26 (Bankr. S.D. Ga. 1998); *In re Ocean Downs Racing Assoc. Inc.*, 164 B.R. 245, 247 (Bankr. D. Md. 1993).

KABBAGE

Online small business loan and Paycheck Protection Program loan servicing company Kabbage Inc. and its affiliates (collectively, the "debtors") filed for chapter 11 protection in the District of Delaware in December 2022 for the purpose of liquidating their remaining assets after much of the debtors' business was sold in 2020.

The debtors proposed a chapter 11 plan under which the debtors would be liquidated. The plan provided in part as follows: "[A]ll Entities who have held, hold, or may hold Claims against or Interests in the Debtors . . . are permanently enjoined, on and after the Effective Date [from, among other things,] commencing, conducting, or continuing . . . any suit . . . of any kind . . . against or affecting the Debtors, the Wind Down Estates, or the Wind Down Officer, as applicable."

The Office of the U.S. Trustee (the "UST") objected to confirmation of the plan, arguing that the liquidating debtors were not eligible for a discharge and that the plan language tracked the discharge language in section 524(a) of the Bankruptcy Code.

THE BANKRUPTCY COURT'S RULING

The bankruptcy court agreed with the UST.

In an unpublished letter ruling (the "Letter Ruling"), U.S. Bankruptcy Judge Craig T. Goldblatt rejected the debtors' argument that the injunction language in the plan was permissible even though it amounted to a "de facto discharge." Judge Goldblatt stated as follows:

> This Court has serious concerns about the propriety of granting relief that is the functional equivalent of a discharge to a debtor that is ineligible for a discharge on the ground that the parties affixed a different label to it. The heart of the equitable authority of bankruptcy courts, Justice Douglas taught in *Pepper v. Litton*, is "that substance will not give way to form." Otherwise put, bankruptcy law will treat as a duck that which quacks like a duck.

Letter Ruling at pp. 2-3 (footnote omitted). However, instead of denying confirmation of the debtor's plan, the court concluded that "this was a problem to which there was a ready solution that would avoid doing any violence to bankruptcy principles." *Id.* at p. 3.

Judge Goldblatt explained that the debtors in the case before him did not need the protection of an injunction once they no longer had any assets. Rather, the debtors' sole concern was preventing creditors from acting against the post-effective date entities, including the debtors, their estates, and the court-appointed wind-down officer, while the debtors still had assets. The debtors, Judge Goldblatt emphasized, had no intention of "trafficking in corporate shells," and once they had "distributed their assets in accordance with the plan, and [were] reduced to corporate shells, there is no longer any need to protect them." *Id.*

According to the bankruptcy court, "the readily available solution, therefore, is to afford those entities not *permanent* injunctive relief, but rather *temporary* injunctive relief that will remain in effect only as long as those entities hold assets." *Id.* (emphasis added). Because the injunctive relief would expire upon the distribution of the debtors' assets, Judge Goldblatt concluded, such relief was "not the functional equivalent of a discharge, and the granting of such relief would not run afoul of § 1141(d)(3) or the purposes it serves." *Id.* This solution, the judge reasoned, operated to "carry out" the provisions of the Bankruptcy Code and was therefore a legitimate exercise of the court's equitable authority under section 105(a) of the Bankruptcy Code, which provides that "[t]he court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of [the Bankruptcy Code]."

Finally, the bankruptcy court noted that its ruling comported with the U.S. Supreme Court's rulings limiting the exercise of a bankruptcy court's equitable powers under section 105(a), including: (i) *Law v. Siegel*, 571 U.S. 415, 421 (2014), where the court cautioned that section 105(a) may not be used to "contravene specific statutory provisions"; and (ii) *Czyzewski v. Jevic Holding Corp.*, 580 U.S. 451, 464-69 (2017), in which the Court elaborated that a bankruptcy court's equitable discretion is limited not only by the express language of the Bankruptcy Code but also by any reasonable inferences that can be made based upon that language regarding lawmakers' intent.

The bankruptcy court accordingly confirmed the debtors' chapter 11 plan, as revised.

OUTLOOK

There are two key takeaways from the bankruptcy court's letter ruling in *Kabbage*.

First, strong policy considerations underpin the prohibition in the Bankruptcy Code of a discharge for liquidating corporations and partnerships. As a consequence, courts view with skepticism attempts to skirt that prohibition by characterizing a de facto liquidating corporate or partnership discharge as something else. *See, e.g., In re New Towne Dev., LLC*, 410 B.R. 225, 232 (Bankr. M.D. La. 2009) (under Fifth Circuit precedent, a liquidating chapter 11 plan for a corporate debtor improperly included third-party releases and permanent injunctions—effectively a discharge—where the liquidating debtor itself could not receive a discharge under sections 1141(d)(3) and 727(a)(1)).

Second, *Kabbage* illustrates the broad scope of a bankruptcy court's equitable authority within the constraints established by the U.S. Supreme Court.

NEWSWORTHY

Bruce Bennett ***(Los Angeles)*** received a Band 1 Ranking in the field of Bankruptcy/Restructuring in the 2023 edition of *Chambers Global: The World's Leading Lawyers for Business*. He also received a Band 1 Ranking in the field of Bankruptcy/Restructuring in the 2023 edition of *Chambers USA*.

Corinne Ball ***(New York)*** *and* ***Bruce Bennett*** ***(Los Angeles)*** were designated "Hall of Fame" attorneys in the field Restructuring (Including Bankruptcy): Corporate in the 2023 edition of *Legal500 United States*. ***Heather Lennox*** ***(Cleveland and New York)*** received a "Leading Lawyer" designation, and ***Brad B. Erens*** ***(Chicago)***, ***Carl E. Black*** ***(Cleveland)***, ***Dan B. Prieto*** ***(Dallas)***, ***Gregory M. Gordon*** ***(Dallas)***, and ***Matthew Kairis*** ***(Dallas and Houston; Business & Tort Litigation*** *and* ***Business Restructuring & Reorganization)*** were named "Other Key Lawyers."

For the second consecutive year, ***Jones Day*** topped the list of BTI Client Service All-Stars with 13 attorneys—more than any other law firm in the report. BTI bases the rankings on interviews with top legal decision-makers at large organizations with more than $700 million in annual revenue. Among the 13 Jones Day attorneys were ***Bruce Bennett*** ***(Los Angeles)*** and ***Jane Rue Wittstein*** ***(New York)***.

Corinne Ball ***(New York)*** was among the "Senior Statespeople" named in the 2023 edition of *Chambers USA* in the field of Bankruptcy/Restructuring.

Heather Lennox ***(Cleveland and New York)***, ***Bruce Bennett*** ***(Los Angeles)***, ***Kevyn D. Orr*** ***(Washington)***, ***Gregory M. Gordon*** ***(Dallas)***, ***Paul M. Green*** ***(Houston)***, ***Carl E. Black*** ***(Cleveland)***, ***Daniel J. Merrett*** ***(Atlanta)***, ***Robert W. Hamilton*** ***(Columbus)***, ***Corinne Ball*** ***(New York)***, ***Gary L. Kaplan*** ***(Miami)***, ***Thomas M. Wearsch*** ***(New York and Cleveland)***, ***Brad B. Erens*** ***(Chicago)***, ***Jeffrey B. Ellman*** ***(Atlanta)***, and ***Dan T. Moss*** ***(Washington)*** were recognized in the area of Bankruptcy/Restructuring in the 2023 edition of *Chambers USA*.

Genna Ghaul ***(New York)*** was named a "Rising Star" for 2023 in the practice area Bankruptcy by *Law360*.

Lawyers of Color named ***Kevyn D. Orr*** ***(Washington)*** to its 2023 Power List. The annual Power List recognizes the most influential minority attorneys and allies in the United States.

Fabienne Beuzit ***(Paris)*** was designated a "Leading Individual" in the practice area of Insolvency in the 2023 edition of *The Legal 500 EMEA*. She was also recognized in the field of Restructuring/Insolvency in *Chambers Europe* 2023.

Roger Dobson ***(Sydney)*** and ***Katie Higgins*** ***(Sydney)*** were recognized in the practice area of Insolvency and Reorganisation Law in the 2024 edition *of Best Lawyers in Australia*. Roger was also named to the Hall of Fame in the 2023 edition of *The Legal 500 Asia Pacific* in the practice area Australia Restructuring and Insolvency.

Ben Larkin ***(London)*** and ***Sion Richards*** ***(London)*** were recognized in the practice area Insolvency & Restructuring Law in the 2024 edition of *The Best Lawyers in the United Kingdom*.™

Fabienne Beuzit ***(Paris)***, ***Elodie Fabre*** ***(Paris)***, and ***Rodolphe Carrière*** ***(Paris)*** were recognized in the practice area Insolvency & Restructuring Law in the 2024 edition in *The Best Lawyers in France*™.

Dr. Olaf Benning ***(Frankfurt)*** was recognized in the practice area Restructuring and Insolvency Law in the 2024 edition of *The Best Lawyers in Germany*.™

Juan Ferré ***(Madrid)*** was designated a "Leading Individual" in the practice area Restructuring and Insolvency in the 2023 edition of *The Legal 500 EMEA*.

Corinne Ball ***(New York)***, ***Bruce Bennett*** ***(Los Angeles)***, ***Carl E. Black*** ***(Cleveland)***, ***Jeffrey B. Ellman*** ***(Atlanta)***, ***Brad B. Erens*** ***(Chicago)***, ***Gregory M. Gordon*** ***(Dallas)***, ***Heather Lennox*** ***(Cleveland and New York)***, ***Joshua M. Mester*** ***(Los Angeles)***, ***Charles M. Oellermann*** ***(Columbus)***, and ***Kevyn D. Orr*** ***(Washington)*** were included in the 2023 *Lawdragon 500 Leading Bankruptcy and Restructuring Lawyers*.

Amanda Johnson ***(Chicago)*** was one of three Jones Day associates selected for two different Leadership Council on Legal Diversity programs. The Leadership Council on Legal Diversity is an organization of more than 400 corporate chief legal officers and law firm managing partners who have pledged themselves to creating a truly diverse U.S. legal profession.

Sid Pepels ***(Amsterdam)*** was nominated to Class XII of the III NextGen Leadership Program for 2023. The Program is sanctioned under the leadership of the International Insolvency Institute and is intended to recognize the most prominent younger "Rising Stars" in the international insolvency area, while creating a venue for scholarship and networking for members of this program.

An article written by ***Oliver S. Zeltner*** ***(Cleveland)*** and ***Mark G. Douglas*** ***(New York)*** titled "Sears Holding: A Case Study in Valuing Collateral in Chapter 11" was published on May 9, 2023, in the *Harvard Law School Bankruptcy Roundtable*.

An article written by ***Dan B. Prieto*** ***(Dallas)*** and ***Mark G. Douglas*** ***(New York)*** titled "Texas District Court: Equitable Mootness Doctrine Does Not Preclude Appellate Review of Chapter 11 Plan Exculpation Clause" was published on June 5, 2023, in *Lexis Practical Guidance*.

An article written by ***Brad B. Erens*** ***(Chicago)*** and ***Mark G. Douglas*** ***(New York)*** titled "Massachusetts Bankruptcy Court Adopts 'Per Plan' Approach to Impaired Class Acceptance Requirement for Confirmation of Joint Chapter 11 Plan" was published on June 2, 2023, in *Lexis Practical Guidance*.

An article written by ***Oliver S. Zeltner*** ***(Cleveland)*** and ***Mark G. Douglas*** ***(New York)*** titled "U.S. Supreme Court Rules that Bankruptcy Code's Protection of Unstayed Asset Sale Orders to Good-Faith Purchasers Is Not Jurisdictional" was published on June 2, 2023, in *Lexis Practical Guidance*.

An article written by ***Dan B. Prieto*** ***(Dallas)*** and ***Mark G. Douglas*** ***(New York)*** titled "Second Circuit Weighs In on Bankruptcy Code v. Chapter 11 Plan Impairment and the Solvent-Debtor Exception" was published on June 13, 2023, in the *Harvard Law School Bankruptcy Roundtable*.

An article written by ***Daniel J. Merrett*** ***(Atlanta)*** and ***Mark G. Douglas*** ***(New York)*** titled "New York Bankruptcy Court Breaks from Precedent in Ruling that Time Approach Should Be Used to Calculate Landlord's Claim for Lease Termination Damages" was published on June 5, 2023, in *Lexis Practical Guidance*.

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