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BUSINESS RESTRUCTURING REVIEW

U.S. SUPREME COURT RULES THAT BANKRUPTCY CODE PROVIDES ONLY LIMITED ABROGATION OF SOVEREIGN IMMUNITY TO AVOIDANCE ACTIONS

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Bankruptcy trustees and chapter 11 debtors-in-possession ("DIPs") frequently seek to avoid fraudulent transfers and obligations under section 544(b) of the Bankruptcy Code and state fraudulent transfer or other applicable non-bankruptcy laws because the statutory "look-back" period for avoidance under many non-bankruptcy laws exceeds the two-year period governing avoidance actions under section 548. "Governmental units" (defined below) sometimes argue that avoidance actions against them under non-bankruptcy law are precluded by the doctrine of sovereign immunity, even though section 106(a) of the Bankruptcy Code explicitly provides that sovereign immunity is abrogated "with respect to . . . [section] 544."

The federal circuit courts of appeals (and many lower courts) were split regarding whether the abrogation of sovereign immunity by governmental units with respect to avoidance actions commenced under section 544(b) also extends to the causes of action arising under applicable non-bankruptcy law that a "triggering" or "predicate" creditor would be precluded from asserting outside of bankruptcy due to sovereign immunity. In 2023, the U.S. Court of Appeals for the Eleventh Circuit aligned itself with the majority position among the circuits when it ruled in *U.S. v. Miller*, 71 F.4th 1247 (10th Cir. 2023), *rev'd*, No. 23-824, 2025 WL 906502 (U.S. Mar. 26, 2025), that the abrogation of sovereign immunity in section 106(a) permitted a chapter 7 trustee to sue the Internal Revenue Service ("IRS") to avoid and recover a fraudulent transfer under section 544(b)(1), even though an eligible existing creditor could not have sued the IRS outside of bankruptcy.

On March 26, 2025, the U.S. Supreme Court reversed the Eleventh Circuit's decision. The Court ruled that the abrogation of sovereign immunity in section 106(a) applies to avoidance claims under section 544(b), but not to state law claims that could otherwise be invoked by triggering creditors under applicable non-bankruptcy law. According to the 8–1 majority, section 106(a)'s text, context, and structure clearly indicate that the provision does not modify section 544(b)'s substantive requirements, which tie a bankruptcy trustee's rights to the rights of an actual creditor under "applicable law." In short, the Court concluded, if no creditor could assert a cause of action against the IRS under applicable non-bankruptcy law due to the government's sovereign immunity, a bankruptcy trustee is similarly constrained by that defense.

IN THIS ISSUE

ABROGATION OF SOVEREIGN IMMUNITY IN THE BANKRUPTCY CODE

Pursuant to the federal system created by the U.S. Constitution, each state is a sovereign entity. In addition, both federal and state governmental bodies have sovereign immunity from suit unless that immunity has been abrogated by Congress, waived by the governmental body, or eliminated by a specific provision of the Constitution itself. *See generally* COLLIER ON BANKRUPTCY ("COLLIER") ¶ 1.06.01 (6th ed. 2025).

Abrogation of sovereign immunity by Congress requires that: (i) Congress has "unequivocally expressed its intent to abrogate the immunity"; and (ii) lawmakers have acted "pursuant to a valid exercise of power." *Id.* (quoting *Seminole Tribe v. Florida*, 517 U.S. 44, 56 (1996); *In re LTV Steel Co., Inc.*, 264 B.R. 455, 464 (Bankr. N.D. Ohio 2001); *accord LAC du Flambeau Bank of Lake Superior Chippewa Indians v. Coughlin*, 143 S. Ct. 1689, 1695 (2023). The sovereign immunity of a litigant deprives a court of subject matter jurisdiction to adjudicate a dispute. *See FDIC v. Meyer*, 510 U.S. 471, 475 (1995) ("Sovereign immunity is jurisdictional in nature."). A waiver or abrogation of sovereign immunity acts as a "prerequisite for jurisdiction—[it does] not create any new substantive rights or alter any pre-existing ones." *U.S. v. Mitchell*, 463 U.S. 206, 212 (1983). Such a waiver of immunity must be strictly construed in favor of the sovereign, with any ambiguities resolved in favor of sovereign immunity. *See Orff v. U.S.*, 545 U.S. 596, 601–602 (2005).

Sovereign immunity has been applied in bankruptcy cases to shield state and federal governments from claims asserted against them by bankruptcy trustees or DIPs. However, the Bankruptcy Code provides for a broad-ranging abrogation of sovereign immunity. In particular, section 106(a) of the Bankruptcy Code provides that, "[n]otwithstanding an assertion of sovereign immunity, sovereign immunity is abrogated as to a governmental unit to the extent set forth in this section with respect to" 59 provisions of the Bankruptcy Code specified in section 106(a)(1), including actions to enforce the automatic stay, preference, and fraudulent transfer avoidance actions and proceedings seeking to establish the dischargeability of a debt.

The abrogation in section 106(a) expressly includes litigation brought against a "governmental unit" under section 544 of the Bankruptcy Code. Section 544(b)(1) empowers a bankruptcy trustee to step into the shoes of an actual creditor with an unsecured claim that could have sued to avoid a transfer outside of bankruptcy under applicable non-bankruptcy law (e.g., the Uniform Voidable Transfer Act (the "UVTA") enacted in many states or the Internal Revenue Code (the "IRC")). *See generally* COLLIER at ¶ 544.06.

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).

Section 106(a)(2) provides that "[t]he court may hear and determine any issue arising with respect to the application of the [the specified Bankruptcy Code provisions] to governmental units."

Other subsections of section 106 address a bankruptcy court's power to issue process, orders, or judgments against governmental units (sections 106(a)(3) and (a)(4)). Subsection 106(a)

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Fabienne has advised on significant debt restructuring cases, represented parties in prepackaged chapter 11 cases, and has served as investors' counsel on a broad range of asset deals. Her experience includes setting up strategic carve-out, reorganization, or restructurings of groups and assisting turnaround distressed funds in the sale, acquisition, or investment of distressed equity interests.

Chambers Europe noted that Fabienne has "strong technical expertise coupled with business sense." *Legal 500 EMEA* named her among the "Leading Individuals" in France, and described her as "totally dedicated to clients" and "a tough negotiator and very creative as she masters all the aspects of a restructuring case."

(5) provides that "[n]othing in [section 106] shall create any substantive claim for relief or cause of action not otherwise existing under this title, the Federal Rules of Bankruptcy Procedure, or nonbankruptcy law." In addition, other subsections address a governmental unit's deemed waiver of sovereign immunity with respect to certain counterclaims by filing a proof of claim (subsection 106(b)), and permitted setoffs, despite any assertion of sovereign immunity, of claims owned by the bankruptcy estate against claims asserted by governmental units (subsection 106(c)).

Enacted as part of the Bankruptcy Code in 1978, section 106 was amended in 1994 to clarify lawmakers' intent to abrogate sovereign immunity of governmental units with respect to actions for damages as well as declaratory and injunctive relief under the specified provisions of the Bankruptcy Code. The change was designed to overrule two U.S. Supreme Court decisions—*Hoffman v. Connecticut Department of Income Maintenance*, 492 U.S. 96 (1989), and *U.S. v. Nordic Village, Inc.*, 503 U.S. 30 (1992)—holding that section 106 did not state with sufficient clarity lawmakers' intent to abrogate the sovereign immunity of the states and the federal government in bankruptcy cases.

CONTROVERSY IN THE COURTS

Even though section 106(a)(1) expressly abrogates sovereign immunity with respect to section 544, courts have disagreed as to whether the abrogation of immunity extends to both an action brought by the trustee or DIP under section 544(b)(1) and the avoidance causes of action that, but for sovereign immunity, the triggering creditor could have brought under applicable non-bankruptcy law. Four federal circuit courts of appeals have addressed this question (three prior to *Miller*), with three of them (including the Tenth Circuit in *Miller*) concluding that section 106(a)'s abrogation of sovereign immunity extended to causes of action under state law that could be asserted by a trustee or DIP under section 544(b)(1).

In *In re Equip. Acquisition Res., Inc.*, 742 F.3d 743 (7th Cir. 2014) ("*EAR*"), the U.S. Court of Appeals for the Seventh Circuit ruled that section 106(a)(1) does not modify the triggering creditor requirement in section 544(b)(1). The court acknowledged that section 106(a)(1) abrogates a governmental unit's sovereign immunity with respect to avoidance litigation commenced by a DIP under section 544(b)(1) and Illinois fraudulent transfer law. However, applying a two-tiered approach, the Seventh Circuit concluded that because the governmental unit's sovereign immunity was not abrogated as to the underlying state law cause of action, the litigation under section 544(b) was barred.

The Ninth and Fourth Circuits staked out a different approach. In *In re DBSI, Inc.*, 869 F.3d 1004 (9th Cir. 2017), the Ninth Circuit held that "[s]ection 106(a)(1)'s abrogation of sovereign immunity is absolute with respect to Section 544(b)(1) and thus necessarily includes the derivative state law claim on which a Section 544(b)(1) claim is based." *Id.* at 1010. Examining the language of section 106(a) in the framework of the Bankruptcy Code as a whole, the Ninth Circuit concluded that "we cannot read the plain text of Section 544(b)(1)—i.e., the triggering creditor requirement—devoid of the declaration in Section 106(a)(1) that 'sovereign immunity is abrogated as to a governmental unit . . . with respect to [Section 544].'" *Id.*

The Ninth Circuit also explained that Congress enacted section 106(a)(1) (in its current form) after section 544(b)(1) and that lawmakers understood that the latter provision codified a trustee's power to invoke state law when they "waived sovereign immunity with respect to Section 544." *Id.* at 1011. Finally, the Ninth Circuit emphasized that the Seventh Circuit's approach would preclude any action against a governmental unit under section 544(b)(1) to avoid a transfer without an additional waiver or abrogation of sovereign immunity by Congress or a state legislature with respect to the underlying state law cause of action. *Id.* at 1011–12 (stating that "the interpretation offered by the government would essentially nullify Section 106(a)(1)'s effect on Section 544(b)(1), an interpretation we should avoid").

The Fourth Circuit agreed with this approach in *In re Yahweh Ctr., Inc.*, 27 F.4th 960 (4th Cir. 2022), where it held that sovereign immunity did not bar litigation against the IRS by a chapter 11 plan trustee seeking, under section 544(b)(1) and the North Carolina UVTA, to avoid tax penalty payments made by the debtor. According to the Fourth Circuit, even if the IRS had not waived sovereign immunity by filing a proof of claim in the chapter 11 case (triggering a waiver under section 106(b)), section 106(a) expressly abrogated sovereign immunity with respect to the avoidance provision invoked by the trustee and as to "any issue arising with respect to" applying that provision against the IRS, which encompassed the North Carolina UVTA. *Id.* at 966.

Lower courts have also disagreed on the impact of section 106(a) on state fraudulent transfer claims asserted by a trustee or DIP under section 544(b). *Compare In re Affiliated Physicians & Emps. Master Tr.*, 2022 WL 16953555 (Bankr. D.N.J. Nov. 15, 2022) (ruling that avoidance litigation commenced by a DIP against the IRS under section 544(b) and New Jersey law was barred because the IRS had sovereign immunity from suit under New Jersey law, which is not abrogated under section 106(a)(1)), *with In re Lewiston*, 528 B.R. 387, 395 (Bankr. E.D. Mich. 2015) (agreeing with *DBSI* that "§ 106(a)(1) accomplishes the elimination of sovereign immunity for all purposes with respect to § 544, and requires no additional waiver as to any specific non-bankruptcy law causes of action that a trustee may bring under § 544(b)(1)").

MILLER

Utah-based transportation company All Resort Group. Inc. (the "debtor") filed for chapter 11 protection in 2017 in the District of Utah. After the case was converted to chapter 7, the bankruptcy trustee commenced an adversary proceeding against the IRS under section 544(b) and the Utah UVTA, to avoid approximately $145,000 in payments made by the debtor to the IRS in 2014 to satisfy its principals' personal tax debts.

The IRS did not dispute that all of the elements for avoidance were satisfied. Instead, it argued that, because any suit by the triggering creditor under the Utah UVTA was barred by sovereign immunity, the trustee could not satisfy section 544(b)(1)'s triggering creditor requirement. The trustee countered that the abrogation of sovereign immunity in section 106(a) extended to both the trustee's adversary proceeding under section 544(b)(1) and the underlying state law cause of action. Both parties moved for summary judgment.

The bankruptcy court ruled in favor of the trustee, concluding that "§ 106(a)(1) unequivocally waives the federal government's sovereign immunity with respect to the underlying state law cause of action incorporated through § 544(b)." *In re All Resort Group*, 617 B.R. 375, 394 (Bankr. D. Utah 2020), *aff'd*, 2021 WL 5194698 (D. Utah. Sept. 8, 2021), *aff'd*, 71 F.4th 1247 (10th Cir. 2023), *rev'd,* 2025 WL 906502 (U.S. Mar. 26, 2025). It accordingly avoided the transfers and entered a judgment against the IRS in the amount of approximately $145,000. The district court affirmed the ruling on appeal, and the IRS appealed to the Tenth Circuit.

A three-judge panel of the Tenth Circuit also affirmed.

The Tenth Circuit explained that the crux of the dispute was whether the abrogation of sovereign immunity in section 106(a) "reaches the underlying state law cause of action that § 544(b)(1) authorizes the Trustee to rely on in seeking to avoid the transfers at issue." *Miller*, 71 F.4th at 1252. The Tenth Circuit panel held that it does.

According to the court, in accordance with Supreme Court precedent, the phrase "with respect to" in section 106(a) must be construed broadly and "clearly expresses Congress's intent to abolish the [IRS's] sovereign immunity in an avoidance proceeding arising under § 544(b)(1), regardless of the context in which the defense arises." *Id.* at 1253. It also noted that the broad language of section 106(a)(2) authorizing a bankruptcy court "to hear and determine any issue with respect to the application of § 544" bolsters this interpretation because it presumes that the court has subject matter jurisdiction, which would not be the case if the government were immune from suit. "The authority which [section 106(a)(2)] plainly confers," the Tenth Circuit wrote, "would be substantially curtailed if Congress had intended an assertion of sovereign immunity to preclude a bankruptcy court from considering whether a trustee has satisfied the substantive elements of an underlying state law cause of action invoked pursuant to § 544(b)(1)." *Id.* at 1254.

The Tenth Circuit distinguished *EAR*, noting that the Seventh Circuit "never meaningfully addressed the scope of § 106(a) as reflected in its text" and its ruling was likely motivated by federal tax policy considerations that were not based on the text of the provision, including concerns regarding the proliferation of actions seeking to recover tax payments. *Id.*

The Tenth Circuit found the decision in *DBSI* to be "more faithful to the text of § 106(a)" because the Ninth Circuit relied on established principles of statutory construction. The Tenth Circuit also agreed with the Ninth Circuit's reasoning that: (i) Congress was aware that section 544(b)(1) codified a trustee's power to invoke state law when it enacted section 106(a)(1); and (ii) adopting the government's position would render section 106(a)(1) "largely meaningless" with respect to section 544(b)(1) because a trustee would always be required to show that a governmental unit provided for a separate waiver of sovereign immunity with respect to the underlying non-bankruptcy law.

The Supreme Court agreed to hear the IRS's petition for review of the Tenth Circuit's decision.

THE SUPREME COURT'S RULING

The Supreme Court, resolving the circuit split in favor of what had been the minority approach on the interaction between sections 544(b) and 106(a) of the Bankruptcy Code.

Writing for the 8–1 majority, Justice Ketanji Brown Jackson initially explained that the "actual creditor" requirement in section 544(b) acts as an important limitation on a bankruptcy trustee's avoidance powers. Without this check, she noted, a trustee could use the provision to avoid transactions that could never have been invalidated outside of bankruptcy. Thus, Justice Jackson wrote, the actual creditor requirement "mitigates the disruptive potential of a trustee's avoidance power by ensuring that the trustee has 'no greater rights of avoidance than the actual creditor would have if that creditor were asserting invalidity on its own behalf.'" *Miller*, 2025 WL 906502, at *4 (quoting COLLIER at ¶ 544.06[3]).

According to the Court, an expansive construction of section 106(a) to provide for abrogation of immunity from underlying state law causes of action "does not simply give courts jurisdiction to hear § 544(b) claims against the Government; it also alters the substantive requirements of the claim itself." By permitting a bankruptcy trustee to assert claims against a governmental unit that no creditor could prosecute because of sovereign immunity, Justice Jackson explained, such a broad interpretation of section 106(a) would transform the provision "from a jurisdiction-creating provision into a liability-creating provision"—a transformation that the Court has rejected in the past. *Id.* (citing *Meyer*, 510 U.S. at 484; *U.S. v. Navajo Nation*, 556 U.S. 287, 290 (2009)).

In addition, the Court concluded that the text and structure of sections 106 and 544 make clear that the abrogation of sovereign immunity in section 106 does not operate to alter section 544(b)'s substantive requirements. In particular, the Court noted:

- The express language of section 106(a)(5) "plainly refutes" the idea.
- Section 106(a) "does not meaningfully alter the substantive obligations of trustees" under any of the 58 other provisions listed together with section 544, such that "it would be odd to read" section 106(a) as modifying the elements of section 544(b). *Id.* at *6.

- Because section 544(b) includes an actual-creditor requirement, whereas section 544(a) permits a trustee to invalidate certain transfers that "could have" been avoided by a lien creditor, "whether or not such a creditor exists," the former "reflects a deliberate congressional choice to tie the trustee's rights . . . to the rights of an actual creditor under 'applicable law.'" *Id.* at *8.
- Eliminating the actual-creditor requirement in section 544(b) "would upend decades of practice and precedent" under both the Bankruptcy Code and section 70e of the former Bankruptcy Act of 1898, "which had long been understood to give trustees the same rights as creditors under state law. *Id.* (citing S. Rep. No. 95-989, p. 85 (1978); H.R. Rep. No. 95-595, p. 370 (1978)).
- The trustee's restricted power in section 544(b) avoidance litigation is reinforced by the fact that defendants in such litigation are entitled to assert the same defenses against the trustee that they could have raised against the triggering creditor under state law.

For all of these reasons, the Court concluded that lawmakers did not use "unmistakable language" to abrogate sovereign immunity in actions brought by a trustee under section 544(b). *Id.*

The Court rejected the argument that the language "with respect to" in section 106(a)(1) requires a broad reading of the provision's abrogation of sovereign immunity to encompass "all subjects that concern or regard" the listed Bankruptcy Code provisions, including the meaning of "applicable law" in section 544(b). According to Justice Jackson, "context cuts decidedly against" such a broad reading. *Id.* at *9. She explained that reading section 106(a) to "reach the elements of § 544(b) would not only run counter to our traditional understanding of sovereign immunity waivers as purely jurisdictional, but also contravene the text and structure of § 106(a) and § 544(b), and defy our established rule that sovereign-immunity waivers must be construed narrowly." *Id.* The use of "a malleable phrase like 'with respect to,'" Justice Jackson wrote, "cannot blunt the countervailing force of those contextual considerations and interpretive principles." *Id.* (citation omitted).

The Court also rejected the contention that, by expanding the scope of section 106(a)'s immunity abrogation in 1994 to add the 59 Bankruptcy Code provisions, Congress intended the scope of the immunity waiver in section 106(a) to be broad. Since it was enacted in 1978, Justice Jackson emphasized, "§ 106(a) has always been understood to provide only a 'limited waiver of sovereign immunity in bankruptcy cases.'" *Id.* at *10. Moreover, she noted, the legislative history of section 106 indicates that the policy underlying the provision was designed "'to achieve approximately the same result that would prevail outside of bankruptcy.'" *Id.* (quoting S. Rep. No. 95-989, at 29; H.R. Rep. No. 95-595, at 317). According to Justice Jackson, the 1994 amendments to section 106 did not "dislodge[] that original understanding," but were adopted merely to overturn the Supreme Court's decisions in *Hoffmann* and *Nordic Village* (briefly discussed above). *Id.*

The Court was more receptive to the argument that the IRS's interpretation of section 106(a) "effectively robs the immunity waiver of any meaningful purpose with respect to § 544" because it "grants federal courts jurisdiction over a set of inherently unwinnable claims." However, it rejected this contention as well, explaining that the trustee could prevail in certain kinds of avoidance litigation against a governmental unit under section 544(a), which has no triggering creditor requirement. It similarly rejected the argument that the immunity abrogation in section 106(a) must be interpreted to give substantive effect to all of section 544's subsections, not merely subsection 544(a). According to Justice Jackson, this "strained reading" of section 106(a) cannot bear up under scrutiny given the sheer number of provisions catalogued in section 106(a) that "cannot plausibly be the subject of an immunity waiver." *Id.* at *11.

The majority accordingly ruled that, although section 106(a) abrogates sovereign immunity for the "federal cause of action created by § 544(b)," section 106(a) "does not take the additional step of abrogating sovereign immunity for whatever state-law claim supplies the 'applicable law' for a trustee's § 544(b) claim." *Id*. at *12.

Justice Neil Gorsuch dissented, agreeing with the position staked out by the majority of federal circuits on this question—namely, that by operation of section 106(a), a bankruptcy trustee may sue a governmental unit to avoid a transfer under section 544(b) even though the triggering creditor could not due to sovereign immunity. *Id.* He reasoned that his interpretation of section 106(a) did not "modify the elements" of any fraudulent transfer claim or "create any substantive claim for relief" that did not "otherwise exist." Rather, according to Justice Gorsuch, "it merely acknowledges that . . . Congress has chosen to waive an affirmative defense to an otherwise valid claim." *Id.* at *13.

OUTLOOK

The ability of a bankruptcy trustee or DIP to step into the shoes of a triggering creditor to seek avoidance of transfers or obligations under applicable non-bankruptcy law is an important component of the Bankruptcy Code's "strong-arm" powers designed to augment the bankruptcy estate for the benefit of all stakeholders. In many cases, litigation to avoid transfers or obligations under section 544(b) and applicable non-bankruptcy law can cast a far wider net than avoidance litigation under section 548 because the look-back period under state avoidance laws (and other non-bankruptcy laws, such as the IRC) can significantly exceed section 548's two-year look-back period.

Governmental units, including the IRS, have long combatted bankruptcy litigation seeking avoidance and recovery of transfers by arguing that the extended look-back periods under applicable non-bankruptcy law should not apply, that avoidance either conflicts with or is preempted by other federal law consistent with policy considerations (e.g., tax revenue enhancement), or that the governmental unit in question is immune to suit under the doctrine of sovereign immunity.

The Supreme Court's decision in *Miller* is welcome news for the IRS and other governmental units intent upon warding off avoidance liability, but a blow to trustees and DIPs seeking to maximize the value of the bankruptcy estate for the benefit of all stakeholders. The decision could spur Congress to amend sections 106 or 544 if it disagrees. The ruling also underscores the Supreme Court's apparent hesitancy to find a waiver of sovereign immunity in a statute or to interpret statutes as permitting lawsuits against the United States.

NEW YORK BANKRUPTCY COURT RECOGNIZES ENGLISH SCHEME OF ARRANGEMENT PROCEEDING UNDER CHAPTER 15 DESPITE CONCERNS OF IMPROPER COMI MANIPULATION

Corinne Ball • Dan T. Moss • Ben Larkin • David Harding

Approaching its 20-year anniversary, chapter 15 of the Bankruptcy Code has proven to be an invaluable tool for facilitating cross-border bankruptcy and insolvency cases. As foreign debtors have increasingly relied on chapter 15 to obtain "recognition" and enforcement in the United States of foreign bankruptcy proceedings and related foreign court orders, some courts have expressed concerns about debtors improperly manufacturing venue for foreign bankruptcy proceedings in countries with which they have minimal contacts. This issue was remarked upon by Judge Michael E. Wiles of the U.S. Bankruptcy Court for the Southern District of New York in *In re Mega Newco, Ltd*., No. 24-12031 (MEW), 2025 WL 601463 (Bankr. S.D.N.Y. Feb. 24, 2025). In an unpublished ruling, the bankruptcy court granted chapter 15 recognition of a UK "scheme of arrangement" proceeding commenced by a newly formed English subsidiary of a Mexican company for the purpose of restructuring the Mexican company's U.S. law-governed debt. The court also recognized and enforced a UK court's order approving the debtor's scheme, which included releases and injunctions of litigation against non-debtor third parties. However, Judge Wiles noted that he would have had "serious questions" about recognizing the scheme if there had been evidence that the restructuring "structure" had been opposed, unfair, or thwarted creditor expectations.

RECOGNITION AND PROCEDURES UNDER CHAPTER 15

Enacted in 2005, chapter 15 governs cross-border bankruptcy and insolvency proceedings in the United States. It is patterned on the 1997 UNCITRAL Model Law on Cross-Border Insolvency (the "Model Law"), which has been adopted in some form by more than 50 countries.

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

Under section 1515 of the Bankruptcy Code, the "foreign representative" of a non-U.S. debtor—defined in section 101(24) as the representative or person authorized to administer the reorganization or liquidation of the debtor's assets or affairs—may file a petition in a U.S. bankruptcy court seeking "recognition" of a "foreign proceeding." 11 U.S.C. § 1515.

The basic requirements for recognition under chapter 15 are: (i) the proceeding must be "a foreign main proceeding or foreign nonmain proceeding" within the meaning of section 1502; (ii) the "foreign representative" applying for recognition must be a "person or body"; and (iii) the petition must satisfy the requirements of section 1515, including that it be supported by the documentary evidence specified in section 1515(b). 11 U.S.C. § 1517(a). If these requirements are satisfied, "an order recognizing a foreign proceeding shall be entered." *Id.*

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

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

11 U.S.C. § 101(23).

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

A debtor's COMI is presumed to be the location of the debtor's registered office, or "habitual residence" in the case of an individual. *See* 11 U.S.C. § 1516(c). However, this presumption can be overcome. *See In re ABC Learning Centres Ltd.*, 445 B.R. 318, 328 (Bankr. D. Del. 2010) (stating that "the COMI presumption may be overcome particularly in the case of a 'letterbox' company not carrying out any business" in the country where its registered office is located), *aff'd*, 728 F.3d 301 (3d Cir. 2013). Various factors are relevant in determining a debtor's COMI, including:

- The location of each debtor entity's headquarters, managers, employees, investors, primary assets, and creditors, as well as the jurisdiction whose law would apply to most of the debtor's disputes, *In re SPhinX, Ltd.*, 351 B.R. 103 (Bankr. S.D.N.Y. 2006), *aff'd*, 371 B.R. 10 (S.D.N.Y. 2007);
- The location of a debtor entity's liquidation or reorganization activities and administrative functions, *Morning Mist Holdings Ltd. v. Krys (In re Fairfield Sentry Ltd.)*, 714 F.3d 127 (2d Cir. 2013);
- The situs of each debtor entity's "nerve center," including the location from which such entity's "activities are directed and controlled[,]" *id.* at 138;
- The regularity of a debtor entity's activities in the relevant location and the ascertainability of these activities by creditors, *id.*; *In re British Am. Ins. Co.*, 425 B.R. 884, 912 (Bankr. S.D. Fla. 2010); *In re Betcorp Ltd.*, 400 B.R. 266, 289 (Bankr. D. Nev. 2009); and
- Creditors' expectations regarding the location of a debtor's COMI, *In re Serviços de Petróleo Constellation S.A.*, 613 B.R. 497 (Bankr. S.D.N.Y. 2019); *In re Oi Brasil Holdings Coöperatief U.A.*, 578 B.R. 169, 228 (Bankr. S.D.N.Y. 2017).

COMI can sometimes be found to have shifted, or "migrated," from a foreign debtor's original principal place of business or habitual residence to a new location. *See Pirogova,* 593 B.R. at 410; *In re Creative Finance Ltd. (In Liquidation)*, 543 B.R. 498 (Bankr. S.D.N.Y. 2016). In *Fairfield Sentry*, the Second Circuit ruled that, due principally to the present verb tense of the language of section 1517, the relevant time for assessing COMI is the chapter 15 petition date, rather than the date a foreign insolvency proceeding is commenced with respect to the debtor. *See also In re Ran*, 607 F.3d 1017 (5th Cir. 2010) (same); *In re Brit. Am. Ins. Co. Ltd.*, 425 B.R. at 910 (same).

In *Fairfield Sentry*, the Second Circuit also expressed concern about possible COMI "manipulation," ruling that a court "may look at the period between the commencement of the foreign proceeding and the filing of the Chapter 15 petition to ensure that a debtor has not manipulated its COMI in bad faith." *Fairfield Sentry*, 714 F.3d at 138; *see also In re O'Reilly*, 598 B.R. 784 (Bankr. W.D. Pa. 2019) (denying the petition of a foreign bankruptcy trustee for recognition under chapter 15 of a debtor's Bahamian

bankruptcy case and finding that, although the case was otherwise eligible for recognition, the debtor's COMI was no longer in the Bahamas when the trustee filed the chapter 15 petition, and the trustee failed to demonstrate that the debtor even had an "establishment" there); *In re Ocean Rig UDW Inc.*, 570 B.R. 687 (Bankr. S.D.N.Y. 2017) (ruling that scheme of adjustment proceedings pending in the Cayman Islands should be recognized as "foreign main proceedings" under chapter 15, even though the debtors' COMI had been shifted to the Caymans less than a year before the proceedings were commenced, because the country in which the debtors' COMI had previously been located did not have a law permitting corporate restructurings), *appeal dismissed*, 585 B.R. 31 (S.D.N.Y. 2018), *aff'd*, 2019 WL 1276205 (2d Cir. Mar. 19, 2019).

An "establishment" is defined by section 1502(2) as "any place of operations where the debtor carries out a nontransitory economic activity." *See In re Mood Media Corp.*, 569 B.R. 556 (Bankr. S.D.N.Y. 2017) (concluding that an "establishment" must be an actual place from which economic market-facing activities are regularly conducted). Unlike with the determination of COMI, there is no statutory presumption regarding the determination of whether a foreign debtor has an establishment in any particular location. *See British American*, 425 B.R. at 915.

A foreign debtor's restructuring activities alone are inadequate to support a finding that the debtor has an establishment for purposes of foreign nonmain proceeding recognition. *See Ran*, 607 F.3d at 1028 (holding that if a foreign "bankruptcy proceeding and associated debts, alone, could suffice to demonstrate an establishment, this would render the framework of Chapter 15 meaningless. There would be no reason to define establishment as engaging in a nontransitory economic activity."); *see also In re Modern Land (China) Co.*, 641 B.R. 768, 785-86 (Bankr. S.D.N.Y. 2022) (same); *Rozhkov v. Pirogova (In re Pirogova)*, 612 B.R. 475, 484 (S.D.N.Y. 2020) (same).

Recognition under chapter 15 "is not to be rubber stamped by the courts," and the bankruptcy court must independently determine whether a foreign proceeding qualifies as either a main or a nonmain proceeding under chapter 15. *See In re Bear Stearns High-Grade Structured Credit Strategies Master Fund, Ltd.*, 374 B.R. 122, 125 (Bankr. S.D.N.Y. 2007), *aff'd*, 389 B.R. 325 (S.D.N.Y. 2008); *accord In re Glob. Cord Blood Corp.*, 2022 WL 17478530, at *6 (Bankr. S.D.N.Y. Dec. 5, 2022) ("'But recognition is not a rubber stamp exercise,' and the burden rests on the foreign representative to prove each of the requirements of Section 1517.") (quoting *Creative Finance*, 543 B.R. at 514).

MEGA NEWCO

Mega Newco Ltd. (the "debtor") is a wholly owned subsidiary of Mexican financial services company Operadora de Servicios, S.A. De C.V., Sofom, E.R. ("ODS"). ODS is based and headquartered in Mexico.

Sometime during 2024, ODS and an ad hoc committee collectively holding more than 25% of New York law-governed notes (the "U.S. Notes") issued by ODS reached agreement on the terms of a restructuring under which noteholders would receive partial cash payments or equity in ODS, or the right to buy new notes issued by ODS. ODS also negotiated arrangements to refinance and restructure other debt obligations contingent on the completion and enforcement of the U.S. Notes restructuring.

However, because the U.S. Notes could not be restructured in the United States outside of a case under chapter 11 of the Bankruptcy Code without the consent of 100% of the noteholders, ODS in September 2024 created a wholly owned subsidiary—the debtor—organized under English law with a registered office in London for the purpose of facilitating a restructuring of the U.S. Notes under a UK scheme of arrangement pursuant to the UK Companies Act 2006.

Deploying such a structure to implement a balance sheet restructuring is not uncommon in the United Kingdom, and UK courts have sanctioned many similar schemes of arrangement, since the structure was first used in *Re Codere Finance (UK) Ltd*, [2015] EWHC 3778 (Ch). In a related context, UK courts have also exercised jurisdiction over and sanctioned schemes of arrangement where the governing law in the subject debt documents changed to English immediately prior to the commencement of a UK scheme proceeding in order to secure a sufficient connection to the jurisdiction (*see Re Apcoa Parking Holdings GmbH & Ors*, [2014] EWHC 3849 (Ch); *Re Tele Columbus*, [2024] EWHC 181 (Ch)).

At the time of its formation, the debtor became a co-obligor on, and a guarantor of, the U.S. Notes, and agreed that ODS could seek contribution from the debtor for any payment made by ODS on the U.S. Notes.

UK law permits approval of a consensual scheme dealing with a single series of note obligations, as distinguished from the entirety of a debtor's obligations, and is generally less costly and faster than a chapter 11 reorganization. For a scheme of arrangement to become effective, a simple majority in number representing at least 75% in value of claims held by voting creditors must vote in favor of the scheme.

ODS did not have a registered office in the United Kingdom and had no substantial business operations or facilities there. Therefore, ODS could not have proposed a scheme of arrangement on its own behalf due to the lack of a sufficient connection with the United Kingdom that would have given a UK court jurisdiction to approve such a scheme.

The debtor commenced a UK scheme proceeding on November 14, 2024 ("the UK Proceeding"). It proposed a scheme of arrangement (the "UK Scheme") designed to implement the proposed restructuring of the U.S. Notes as well as certain other obligations of ODS and its other affiliates. The UK Scheme also provided, in accordance with UK law, for releases of, and an injunction of litigation against, the debtor, ODS, and various third parties for liabilities arising from the U.S. Notes, negotiation and implementation of the scheme, and the restructuring, except for claims for fraud or willful misconduct. The debtor expressly disclosed in the UK Proceeding that it was created to enable the English court to have jurisdiction over the UK Scheme.

On November 25, 2024, the debtor's foreign representative (the "FR") filed a petition in the U.S. Bankruptcy Court for the Southern District of New York seeking recognition of the UK Proceeding under chapter 15 as a foreign main proceeding. The FR also sought an order recognizing and enforcing the UK Scheme, including the scheme's third-party release/injunction provisions.

The UK Scheme was approved at a meeting of creditors on February 3, 2025, with nearly 76% of creditors (by value) appearing at the meeting and voting unanimously in favor. The UK High Court of Justice (the "UK Court") sanctioned the UK Scheme on February 5, 2025, without objection.

On February 7, 2025, the bankruptcy court entered an order recognizing the UK Proceeding under chapter 15 as a foreign main proceeding, and recognizing and enforcing the UK Scheme. *See In re Mega Newco Limited*, No. 24-12031 (MEW) (Bankr. S.D.N.Y. Feb. 7, 2025) [Doc. No. 25]. Among other things, the court found that the debtor's COMI is in the United Kingdom. In its recognition order, the bankruptcy court also stated that the injunctive relief set forth in the order implementing the third-party releases in the UK Scheme was "appropriate and necessary to prevent the risk that the English Scheme Proceeding may be thwarted by the actions of particular creditors, a result inimical to the purposes of Chapter 15 of the Bankruptcy Code as set forth in section 1501(a) of the Bankruptcy Code." It further noted that "[s]uch actions could put in peril the Debtor's ability to successfully restructure."

On February 24, 2025, the U.S. bankruptcy court issued a written opinion on its ruling.

THE BANKRUPTCY COURT'S OPINION

In its written opinion, the bankruptcy court explained that, consistent with its previous ruling in *Mood Media* and the decisions in *Ran*, *Modern Land*, and *Pirogova*, the debtor's restructuring activities in the UK Proceeding alone were insufficient to demonstrate that the debtor had an "establishment" for purposes of chapter 15 recognition of the UK Proceeding as a foreign nonmain proceeding. According to Judge Wiles, because the debtor never engaged in any business or regular market-facing activities in the United Kingdom, its restructuring activities alone were inadequate. Otherwise, he wrote, "any proceeding in which a debtor sought relief would automatically qualify as a 'foreign main proceeding,' and the requirement of an 'establishment' would be deprived of any meaning." *Mega Newco*, 2025 WL 601463, at *2.

By contrast, Judge Wiles explained, the debtors' UK restructuring activities—"apparently . . . the only activities in which [the debtor] has ever engaged"—could be considered in determining whether the debtor's COMI is in the United Kingdom for purposes of chapter 15 recognition of the UK Proceeding as a foreign main proceeding. *Id.* at *3. Given the absence of any objections to recognition of the UK Proceeding under chapter 15 as a foreign main proceeding, or to enforcement of the UK Scheme in the United States, and without any evidence of unfairness to the holders of the U.S. Notes, the bankruptcy court concluded that chapter 15 recognition was warranted.

However, Judge Wiles expressed reservations regarding possible COMI manipulation:

> I nevertheless cannot help but see significant risks in the structure that has been used here. Chapter 15 is premised on the idea that a debtor who seeks to restructure an obligation is actually the subject of a foreign proceeding, and that the foreign proceeding is located in the country where that debtor has its COMI. Here, the whole structure admittedly was created for the purpose of restructuring the U.S. Notes issued by [ODS]. However, [ODS] is not a party to the [UK Proceeding], and [ODS's] COMI is in Mexico, not the U.K. [The debtor] was created, and then voluntarily subjected itself to [ODS's] liabilities under the U.S. Notes, just so that the U.S. Notes issued by [ODS] could be restructured in a jurisdiction that was not otherwise available. . . . If we were routinely to allow this structure in all cases, no matter what the circumstances, the ordinary predicates for Chapter 15 relief could be stripped of meaning. Any debtor company could restructure its obligations anywhere it chose without even subjecting itself to a foreign proceeding. All that a debtor would need to do is to form a new subsidiary in a jurisdiction of its choice and then cause that new subsidiary to assume the parent company's obligations. The parent company's COMI would no longer be relevant to the parent's restructuring of its debts. The laws of the chosen jurisdiction would govern a restructuring, no matter how those laws might affect the legitimate expectations of creditors and regardless of whether the debtor had chosen a particular jurisdiction for the purpose of favoring insiders or for other improper reasons.

Id.

The bankruptcy court then considered whether the "underlying structure" of the U.S. Notes restructuring was an "improper manipulation of COMI" such that the court should disregard the form of the transaction and instead examine whether ODS on its own had satisfied the conditions for chapter 15 recognition and relief.

The court emphasized that this structure "could be used in another case as a way of frustrating and thwarting the legitimate expectations of creditors." *Id.* at *4. Even so, Judge Wiles concluded that the case before him did not involve "frustration or thwarting of creditor rights." Instead, he noted, the debtor was formed and the UK Proceeding was commenced "for laudable objectives." According to the bankruptcy court, those actions facilitated an efficient restructuring that would enhance all stakeholders' recoveries and maximize the value of the underlying businesses, and therefore, were "fully consistent with the stated purposes of Chapter 15." *Id*.

"Ironically," Judge Wiles noted, declining to enforce the UK Court's order approving the UK Scheme would itself "thwart creditor expectations" in this case. He wrote that it would be "absurd" to "thwart the creditors' constructive desires and expectations in the guise of supposedly protecting them." *Id*.

Finally, the bankruptcy court noted that, if there were evidence—or even a contention—that the reorganization structure of the U.S. Notes was unfair or thwarted third-party expectations, there would be "serious questions" as to whether it should be approved. Without any evidence of these things, and given the creditors' overwhelming support of the UK Scheme, the court saw "no cause in this particular case to look past the form of the transactions or to pursue theoretical issues that no affected party wishes to pursue." *Id*.

OUTLOOK

Although unpublished and therefore not precedential, the bankruptcy court's decision in *Mega Newco* is significant for a number of reasons.

First, in recognizing the UK Proceeding and enforcing the UK Court's order sanctioning the UK Scheme under principles of international comity, the bankruptcy court demonstrated the important role of chapter 15 and U.S. courts in providing assistance to foreign bankruptcy courts presiding over the bankruptcy and restructuring cases of foreign debtors. The bankruptcy court in *Mega Newco* not only recognized the debtor's UK Proceeding, thereby facilitating implementation of the UK Scheme in the United States, but also recognized and enforced the UK Court's order sanctioning the UK Scheme, including its provisions releasing claims and enjoining litigation against third parties arising from the restructuring and the U.S. Notes without the consent of all affected creditors.

Such nonconsensual third-party releases in non-full payment chapter 11 plans have been effectively banned in the United States after the U.S. Supreme Court's 2024 ruling in the Purdue Pharma chapter 11 cases. *See Harrington v. Purdue Pharma LP*, 603 US 204 (2024). However, as illustrated by *Mega Newco*, this does not mean that such releases in a foreign debtor's restructuring plan cannot be recognized and enforced in the United States in a chapter 15 case.

Despite the controversial nature of such releases—even before *Purdue Pharma*—many U.S. bankruptcy courts have recognized and enforced foreign restructuring plans providing for third-party releases in chapter 15 cases. *See, e.g., In re Vitro S.A.B. de CV*, 701 F.3d 1031, 1062 (5th Cir. 2012) ("We conclude that, although our court has firmly pronounced its opposition to [non-debtor] releases, relief is not thereby precluded under § 1507, which was intended to provide relief not otherwise available under the Bankruptcy Code or United States law."); *In re Americanas S.A.*, 2024 WL 3506637 (Bankr. S.D.N.Y. July 22, 2024) (recognizing and enforcing under chapter 15 a Brazilian debtor's bankruptcy plan that permitted nonconsensual third-party releases, without, however, any legal analysis or mention of *Purdue Pharma*); *In re Agrokor d.d.,* 591 B.R. 163 (Bankr. S.D.N.Y. 2018); *In re Sino-Forest Corp.*, 501 B.R. 655 (Bankr. S.D.N.Y. 2013); *In re Metcalfe & Mansfield Alternative Investments*, 421 B.R. 685 (Bankr. S.D.N.Y. 2010).

Further, at least one court in a post-*Purdue* chapter 15 case recognized a foreign restructuring plan approved in a Mexican *concurso mercantile* proceeding that included nonconsensual third-party releases over the objections of a major creditor, observing that: (i) *Purdue* is limited to the chapter 11 context; (ii) recognition of the restructuring plan was appropriate under the principles of comity; and (iii) nonconsensual third-party releases are not manifestly contrary to the public policy of the United States under section 1506 of the Bankruptcy Code, given that such releases are expressly authorized in the context of asbestos-related claims under section 524(g). *In re Crédito Real, S.A.B. de C.V., SOFOM, E.N.R.*, Case No. 25-10208 (Bankr. D. Del. Mar. 11, 2025), ECF No. 51 (bench ruling; written decision forthcoming), *appeal docketed*, Case No. 25-00371 (D. Del. Mar. 26, 2025).

Second, there is a troubling aspect of Judge Wile's commentary in *Mega Newco*. Specifically, as noted, section 1517(a) of the Bankruptcy Code provides that a U.S. bankruptcy court "shall" enter an order recognizing a foreign proceeding if the statutory requirements specified for recognition are satisfied. This does not mean that a bankruptcy court cannot refuse to order such relief if the court determines that the very high bar of being "manifestly contrary to the public policy of the United States" has been surmounted. *See* 11 U.S.C. § 1506. However, section 1506 requires a "narrow reading" and "does not create an exception for any action under Chapter 15 that may conflict with public policy, but only an action that is 'manifestly contrary.'" *Fairfield Sentry*, 714 F.3d at 139); *accord ABC Learning*, 728 F.3d at 309 (the public policy exception should be invoked only under exceptional circumstances concerning matters of "fundamental importance" to the United States).

Judge Wiles appears to be second-guessing the UK Court's decision to take jurisdiction over the debtor's restructuring based on the UK Court's determination that a sufficient connection existed such that it could sanction the UK Scheme. As noted earlier, UK courts have sanctioned schemes based on similar "sufficient connections" to the United Kingdom. In the absence of any suggestion that recognition of the UK Proceeding violated section 1506—an issue that the bankruptcy court did not even address—the court appears to have stepped outside the statutory confines of chapter 15. It is inappropriate for a U.S. bankruptcy court to second-guess a foreign court's conclusion and, further, the motivations of the Mexican parent in creating the debtor for the purpose of seeking approval of a scheme of arrangement restructuring the U.S. Notes under UK law. It is an uncontroversial proposition that a chapter 15 court does not sit as an appellate court of the foreign proceeding. *Universal Cas. & Sur. Co. v. Gee (In re Gee)*, 53 B.R. 891, 902, 904 (Bankr. S.D.N.Y. 1985) (noting that if the bankruptcy court is satisfied with the procedural fairness of the foreign proceeding (e.g., because the foreign proceeding accords the interested parties' appropriate procedures to contest the entering into of the winding-up order and appeal the court's determination and allows for the equitable distribution of assets) and that the foreign proceeding is not repugnant to U.S. laws and policies, it "should not sit as an appellate court over the foreign proceedings."); *In re Oi S.A.*, 587 B.R. 253, 273 (Bankr. S.D.N.Y. 2018) ("It is simply not this Court's role to second guess the wisdom of the [foreign] courts or overrule their decisions, which would be fundamentally inconsistent with comity."); *In re Rede Energia S.A.*, 515 B.R. 69, 100 (Bankr. S.D.N.Y. 2014) ("[I]t is not appropriate for this Court to superimpose requirements of U.S. law on a case in [foreign jurisdiction] or to second-guess the findings of the foreign court."); *SNP Boat Serv. S.A. v. Hotel Le St. James*, 483 B.R. 776, 786 (S.D. Fla. 2012) ("To inquire into a specific foreign proceeding is not only inefficient and a waste of judicial resources, but more importantly, necessarily . . . transform[s] a domestic court into a foreign appellate court where creditors are always afforded the proverbial 'second bite at the apple.' Chapter 15's directive that courts be guided by principles of comity was intended to avoid such a result."); *In re Metcalfe & Mansfield Alternative Invs.*, 421 B.R. 685, 697 (Bankr. S.D.N.Y. 2010) ("The relief granted in the foreign proceeding and the relief available in a U.S. proceeding need not be identical. A U.S. bankruptcy court is not required to make an independent determination about the propriety of individual acts of a foreign court.").

Lastly, it has been well established that a foreign debtor's lack of good faith prior to filing a petition for recognition under chapter 15 is not alone a sufficient justification to deny recognition. *See In re Culligan Ltd.*, 2021 WL 2787926 (Bankr. S.D.N.Y. July 2, 2021); *In re Manley Toys Ltd.*, 580 B.R. 632, 648 (Bankr. D.N.J. 2018), *aff'd*, 597 B.R. 578 (D.N.J. 2019); *In re Creative Fin. Ltd.*, 543 B.R. at 515 (Bankr. S.D.N.Y. 2016). Even if it were, "manipulating" or "manufacturing" COMI for the purpose of seeking approval of a restructuring under the laws of a forum whose bankruptcy laws are more favorable to a successful restructuring cannot, without more, be deemed improper. *See Ocean Rig*, 570 B.R. at 703.

DISAPPOINTED BIDDER IN BANKRUPTCY ASSET SALES WAIVED ARGUMENT THAT BUYERS DID NOT ACT IN GOOD FAITH BY FIRST RAISING IT ON APPEAL

Caitlin Cahow

The finality of asset sales 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 unless the party challenging the sale obtains a stay pending appeal. A bankruptcy appellate panel ("BAP") for the Sixth Circuit examined the scope of section 363(m) in *Clearview Eastern Fund LLC v. Woodward (In re Human Housing Henrietta Hyatt LLC)*, 666 B.R. 332 (B.A.P. 6th Cir. 2025). The BAP ruled that an appeal of asset sale orders by a disappointed bidder was moot under section 363(m) because the bidder did not obtain a stay pending appeal and waived any challenge to the good faith of the purchasers by failing to raise the issue before the bankruptcy court. The panel also held that merely having a competing bid does not constitute an "adverse interest" sufficient to defeat a buyer's good faith in connection with a sale.

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, 581 (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.") (citations and internal quotation marks omitted).

Bankruptcy and appellate courts have long disagreed as to whether section 363(m) is jurisdictional — meaning that it 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 assignment of a lease was not moot. The Court was also skeptical 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. 2025). 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, at *3 (5th Cir. Jan. 13, 2022) (quoting *In re TMT Procurement Corp.*, 764 F.3d 512, 521 (5th Cir. 2014)); *accord Made in Detroit*, 414 F.3d at 581; *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 (citations and internal quotation marks omitted); *accord Ewell v. Diebert (In re Ewell)*, 958 F.2d 276, (9th Cir. 1992); *In re Abbotts Dairies of Pennsylvania, Inc.*, 788 F.2d 143, 147–148 (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*, 788 F.2d at 149–50; *In re Perona Bros., Inc.*, 186 B.R. 833, 839–840 (D.N.J. 1995); *In re Primel*, 629 B.R. 790, 799 (Bankr. W.D. Pa. 2021); *Factory Mutual Ins. Co. v. Panda Energy Int'l, Inc. (In re Hereford Biofuels, L.P.)*, 466 B.R. 841, 860 (Bankr. N.D. Tex. 2012).

Other courts do not. *See, e.g., Harbison-Fischer Mfg. Co. v. Zinke (In re Zinke)*, 97 B.R. 155, 156–157 (E.D.N.Y. 1989) (declining to adopt the *Abbotts Dairies* rule); *T.C. Investors v. Joseph (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.") (citations and internal quotation marks omitted).

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 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, 363–364 (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, 645 (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.

HUMAN HOUSING

Human Housing Henrietta Hyatt, LLC (the "debtor") owned nine parcels of residential real estate in Kentucky (the "properties"). The properties served as collateral for secured debt held by Toorak Repo Seller I Trust ("Toorak"). The debtor's membership interests were held by Paulette Long ("Long") (51%) and Clarisse D. Clemons-Ferrara ("Ferrara") (49%), with Long acting as the managing member. Long and Ferrara guaranteed the debt to Toorak.

In 2022, the debtor filed a petition as a small-business debtor under subchapter V of chapter 11 in the Western District of Kentucky with the intention of selling the properties. As of the petition date, approximately $1.1 million of the Toorak debt was outstanding, and the debtor valued the properties in its schedules at approximately $864,000.

In February 2022, Toorak moved for relief from the automatic stay to foreclose on the properties or, in the alternative, for an order directing the debtor to make adequate protection payments.

Shortly afterward, the debtor sought bankruptcy court authority to sell the properties free and clear of liens to Develco-Louisville, LLC ("Develco") in a private sale for $700,000. Develco was owned by Long's husband, John.

Toorak and the debtor opposed each other's motions. However, in an agreed order, they later agreed that Toorak would receive $975,000 in full satisfaction of its claim, and in exchange, the debtor and the guarantors would be released from all liability. The order further provided that, if the debtor did not pay the $975,000 within the specified time, the terms of the order would be incorporated into a chapter 11 plan.

In June 2022, having failed to pay Toorak before the deadline specified in the agreed order, the debtor proposed a liquidating chapter 11 plan providing that: (i) Long and Ferrara would retain 100% of the debtor's equity; (ii) Long would remain the debtor's manager; (iii) Toorak would be paid $975,000 from the proceeds of the sale of the properties to Develco, with certain adjustments; and (iv) the debtor, Long, and Ferrara would be released from any liability on the debt and the guaranties. The plan established a May, 27, 2022, deadline for closing the Develco sale, but the court ultimately extended the deadline to March 31, 2023. The plan also provided that if the sale did not close by the deadline, the Long and Ferrara guaranties would not be released and the subchapter V trustee (the "trustee") would have the power to sell the properties, after which Toorak would receive any net sales proceeds in excess of certain administrative expenses, real estate taxes, or penalties.

The bankruptcy court confirmed the debtor's chapter 11 plan on June 24, 2024. Long and Ferrara (essentially plan proponents) did not object to confirmation or appeal the confirmation order.

After the Develco sale failed to close by the appointed deadline, the trustee moved in August 2023 to sell one of the properties (the "Drake property") for $85,000 to Colin Drake ("Drake"). In her motion, the trustee sought a finding by the court that Drake was buying the Drake property in good faith and therefore entitled to the protections of section 363(m). In November 2023, the trustee filed motions to sell the remaining eight properties to Impulse LLC ("Impulse") for $725,000, again requesting a finding that the buyer was a good-faith purchaser within the meaning of section 363(m). Only a county taxing authority responded to the sale motions to ensure that its tax claims would be satisfied from the sale proceeds. Toorak supported the sale motions.

At a November 2023 hearing to consider approval of the sales, Ferrara informed the court that there was a competing offer of $825,000 for the properties from an entity later revealed to be Clearview Eastern Fund LLC ("Clearview"), with which Ferrara had some connection, but without committed financing. Despite adjournment of the hearing to give Clearview an opportunity to present a concrete offer for the properties or for the parties to object to the sales in writing, neither Clearview, Long, nor Ferrara ever did so. At the continued hearing, the trustee informed the court that she had received a nonbinding commitment from Clearview to purchase the properties, with certain conditions and contingencies. Clearview did not object to the sale motions.

On November 29, 2023, the bankruptcy court granted the sale motions. Each of the orders approving the sales included a finding that the buyers were non-insider good-faith purchasers entitled to the protections of section 363(m).

Clearview moved for reconsideration, arguing that it had submitted a higher offer for the properties. On January 3, 2024, Clearview sought a stay of the sale orders pending appeal. Clearview never raised any objection concerning the conduct of the buyers. The bankruptcy court denied both motions.

Immediately afterward, Clearview filed an affidavit with the court claiming for the first time that Clearview had entered into binding contracts with the trustee to purchase some or all of the properties that pre-dated the trustee's agreements for the sale of the properties to Drake and Impulse. Clearview did not claim in its affidavit that either Drake or Impulse had acted in bad faith.

Clearview, Long, and Ferrara (collectively, the "appellants") appealed the sale orders and the order denying reconsideration to the BAP.

THE BANKRUPTCY APPELLATE PANEL'S RULING

A three-judge BAP affirmed the bankruptcy court's orders.

Writing for the panel, Chief BAP Judge Randal S. Mashburn ruled that Long and Ferrara had standing to appeal the sale orders under the "person aggrieved" standard because they would be "directly and adversely affected pecuniarily" by the orders, given their potential exposure under the guarantees. *Human Housing*, 666 B.R. at 345 (citations and internal quotation marks omitted).

The BAP concluded that Clearview did not have appellate standing to challenge the sale orders as a "disappointed bidder" because it did not challenge "the intrinsic structure of the sale [as being] tainted by fraud, mistake, or unfairness" and demonstrate that there was a "bankruptcy interest" served by the appeal, such as an increased return to creditors. *Id.* at 346 (citations and internal quotation marks omitted). According to Judge Mashburn, "a potential bidder without a pecuniary interest cannot upend a sale process blessed by the bankruptcy court through a confirmed plan by subsequently claiming that a bidding process would have been better." *Id.* However, because Clearview argued that it had enforceable pre-existing contracts for the sale of some or all of the properties, the BAP held that Clearview had standing to appeal the sale orders. *Id.* at 347.

Next, the BAP determined that any arguments raised by Clearview in its post-sale-ruling affidavit were waived because they were untimely. *Id.* at 348.

The trustee's principal argument before the BAP was that the appeal was moot under section 363(m) of the Bankruptcy Code. *Id.* at 349. The BAP agreed, finding that the appeal of the sale orders was moot because Long, Ferrara, and Clearview waived any challenge to the bankruptcy court's finding that Drake and Impulse were good-faith purchasers — the "only reviewable issue" when the provision apples in accordance with Sixth Circuit precedent. *Id.* (citations omitted).

Initially, Judge Mashburn explained that the mootness rule set forth in section 363(m) applies to all kinds of bankruptcy asset sales, including sales by a post-confirmation plan liquidation trustee or agent. *Id.*

According to the BAP, an issue not raised before the bankruptcy court is generally waived on appeal unless it involves "novel questions," which was not the case here. *Id.* at 350 (citing *Scottsdale Ins. Co. v. Flowers*, 513 F.3d 546, 552 (6th Cir. 2008)). Moreover, Judge Mashburn noted, consistent with the Sixth Circuit's general waiver rule, "courts in other jurisdictions specifically hold that a challenge to a buyer's good faith may not be raised for the first time on appeal." *Id.* (citations omitted).

In addition, the BAP emphasized that the good-faith standard focuses on the *purchaser's conduct* with respect to the sale, rather than the conduct of the debtor (or, in this case, the trustee). *Id.* at 351. According to Judge Mashburn, Clearview argued that *the trustee* was being unfair in not permitting it to bid or in rejecting its offer, which is "not relevant except to the extent of fraud or collusion with the purchaser, neither of which were alleged." *Id.*

He also noted that although "value" is a factor in good faith, "that element does not require the absolute highest value that could conceivably be obtained." *Id.* Thus, the fact that Clearview may have been willing to submit a higher offer (albeit subject to "serious financing contingencies") did not indicate that the purchasers' offers were not for value. *Id.*

The BAP also determined that the purchasers did not have notice of adverse claims or interests that would defeat their good-faith purchaser designation. *Id.* at 352–353. Having a competing bid, Judge Mashburn explained, does not constitute an "adverse interest"—otherwise "no winning bidder would ever be considered a good-faith purchaser entitled to the protections of § 363(m)." *Id.* at 352 (citation omitted). Moreover, he emphasized, Clearview never argued to the bankruptcy court that the purchasers had notice of an adverse contractual interest based upon purported pre-existing sale agreements, and at all times conducted itself as a competing bidder rather than a binding contract counterparty. *Id.* at 352–353.

By failing to challenge the buyers' good faith in the bankruptcy court, despite having been informed that the trustee was seeking a good-faith finding in connection with the proposed sales, the BAP concluded that the appellants waived any appellate challenge on the basis of good faith. *Id.* at 353.

The BAP accordingly affirmed the sale orders and the related order denying Clearview's motion for reconsideration. *Id.* at 353–354.

OUTLOOK

There are several key takeaways from the BAP's ruling in *Human Housing*:

- First, the BAP reinforced the principle 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 Sixth 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.
- Second, the protections provided to good-faith purchasers under section 363(m) are not limited to sales transactions entered into by bankruptcy trustees or chapter 11 debtors, but also include their agents (including liquidating trustees).
- Third, the good-faith standard focuses on the conduct of the purchaser in connection with the sale, not the seller.
- Fourth, a party challenging a bankruptcy asset sale on the basis of lack of good faith waives the argument on appeal by failing to raise the issue in the bankruptcy court.
- Fifth, the good-faith status of a buyer of estate property in bankruptcy is not impugned merely because the buyer is aware of objections to the proposed sale. Instead, such claims must rise to the level of an "adverse interest" in the property to defeat good-faith status under section 363(m). The existence of a competing bid is not an "adverse interest."

CHAPTER 11 FILING WITHOUT CONSENT OF INDEPENDENT DIRECTOR DISMISSED AS UNAUTHORIZED

Mark A. Cody

Courts disagree over whether provisions in a borrower's organizational documents or loan agreements designed to restrict or prevent the borrower from filing for bankruptcy are enforceable as a matter of federal public policy or applicable non-bankruptcy law. There have been a handful of court rulings addressing this issue in recent years, with mixed outcomes. The U.S. Bankruptcy Court for the Northern District of Illinois weighed in on the debate in *In re 301 W N. Ave., LLC*, 666 B.R. 583 (Bankr. N.D. Ill. 2025), *appeal filed*, No. 24 B 2741 (Bankr. N.D. Ill. Jan. 17, 2025) ("*301 West North*"). The bankruptcy court granted a lender's motion to dismiss a chapter 11 filing by a special purpose limited liability company ("LLC") because an independent director appointed by an agent of the lender did not consent to the filing, as was required in the loan agreement and the debtor's LLC agreement. According to the court, the requirement for the director's consent to a bankruptcy filing violated neither federal public policy nor applicable non-bankruptcy law because the director had explicit fiduciary duties to the debtor and its creditors.

BANKRUPTCY RISK MANAGEMENT BY LENDERS

Astute lenders are always looking for ways to minimize risk exposure, protect remedies, and maximize recoveries in connection with a loan, especially with respect to borrowers that have the potential to become financially distressed. Some of these efforts have been directed toward minimizing the likelihood of a borrower's bankruptcy filing by making the borrower "bankruptcy remote." Strategies employed by lenders include implementing a "blocking director" organizational structure or issuing "golden shares" that, as the term is used in a bankruptcy context, give the holder the right to preempt a bankruptcy filing. Depending on the jurisdiction involved and the particular circumstances, including the terms of the relevant documents, these mechanisms may or may not be enforceable.

As a rule, corporate formalities and applicable state law must be satisfied in commencing a bankruptcy case. *See In re NNN 123 N. Wacker, LLC*, 510 B.R. 854 (Bankr. N.D. Ill. 2014) (citing *Price v. Gurney*, 324 U.S. 100 (1945)); *In re Comscape Telecommunications, Inc.*, 423 B.R. 816 (Bankr. S.D. Ohio 2010); *In re Gen-Air Plumbing & Remodeling, Inc.*, 208 B.R. 426 (Bankr. N.D. Ill. 1997). As a result, while contractual provisions that prohibit a bankruptcy filing may be unenforceable as a matter of public policy, other measures designed to preclude a debtor from filing for bankruptcy may be available.

Lenders, investors, and other parties seeking to prevent or limit the possibility of a bankruptcy filing have attempted to sidestep the public policy invalidating contractual waivers of a debtor's

right to file for bankruptcy protection by eroding or eliminating the debtor's authority to file for bankruptcy under its governing organizational documents. *See, e.g., In re DB Capital Holdings, LLC*, 2010 WL 4925811 (B.A.P. 10th Cir. Dec. 6, 2010); *NNN 123 N. Wacker*, 510 B.R. at 862; *In re Houston Regional Sports Network, LP*, 505 B.R. 468 (Bankr. S.D. Tex. 2014); *In re Quad-C Funding LLC*, 496 B.R. 135 (Bankr. S.D.N.Y. 2013); *In re FKF Madison Park Group Owner, LLC*, 2011 WL 350306 (Bankr. D. Del. Jan. 31, 2011); *In re Global Ship Sys. LLC*, 391 B.R. 193 (Bankr. S.D. Ga. 2007); *In re Kingston Square Associates*, 214 B.R. 713 (Bankr. S.D.N.Y. 1997).

These types of provisions have not always been enforced, particularly where the organizational documents include an outright prohibition of any bankruptcy filing. *See In re Lexington Hospitality Group*, 577 B.R. 676 (Bankr. E.D. Ky. 2017) (where an LLC debtor's operating agreement provided for a lender representative to be a 50% member of the debtor until the loan was repaid and included various restrictions on the debtor's ability to file for bankruptcy while the loan was outstanding, the bankruptcy filing restrictions acted as an absolute bar to a bankruptcy filing, which is void as against public policy); *In re Bay Club Partners-472, LLC*, 2014 WL 1796688 (Bankr. D. Or. May 6, 2014) (refusing to enforce a restrictive covenant in a debtor LLC's operating agreement prohibiting a bankruptcy filing and stating that the covenant "is no less the maneuver of an 'astute creditor' to preclude [the LLC] from availing itself of the protections of the Bankruptcy Code prepetition, and it is unenforceable as such, as a matter of public policy").

Many of these efforts have been directed toward "bankruptcy remote" special purpose entities (sometimes referred to as special purpose vehicles) ("SPEs"). An SPE is an entity created in connection with a financing or securitization transaction structured to ring-fence the SPE's assets from creditors other than secured creditors or investors (e.g., trust certificate holders) that provide financing or capital to the SPE.

For example, in *In re Gen. Growth Props., Inc.*, 409 B.R. 43 (Bankr. S.D.N.Y. 2009), the court denied a motion by secured lenders to dismiss voluntary chapter 11 filings by several SPE subsidiaries of a real estate investment trust. The lenders argued, among other things, that the loan agreements with the SPEs provided that an SPE could not file for bankruptcy without the approval of an independent director nominated by the lenders. The lenders also argued that, because the SPEs had no business need to file for bankruptcy and because the trust exercised its right to replace the independent directors less than 30 days before the bankruptcy filings, the SPE's chapter 11 filings had not been undertaken in good faith.

The *General Growth* court ruled that it was not bad faith to replace the SPEs' independent directors with new independent directors days before the bankruptcy filings because the new directors had expertise in real estate, commercial mortgage-backed securities, and bankruptcy matters. The court determined that, even though the SPEs had strong cash flows, bankruptcy remote structures, and no debt defaults, the chapter 11 filings had not been made in bad faith. The court found that it could consider the interests of the entire group of affiliated debtors as well as each individual debtor in assessing the legitimacy of the chapter 11 filings.

Among the potential flaws in the bankruptcy remote SPE structure brought to light by *General Growth* is the requirement under applicable Delaware law for independent directors to consider not only the interests of creditors, as mandated in the charter or other organizational documents, but also the interests of shareholders. Thus, an independent director or manager who simply votes to block a bankruptcy filing at the behest of a secured creditor without considering the impact on shareholders could be deemed to have violated his or her fiduciary duties of care and loyalty. *See In re Lake Mich. Beach Pottawattamie Resort LLC*, 547 B.R. 899 (Bankr. N.D. Ill. 2016) (a "blocking" member provision in the membership agreement of a special purpose limited liability company was unenforceable because it did not require the member to comply with its fiduciary obligations under applicable non-bankruptcy law).

Courts disagree as to the enforceability of blocking provisions and, in particular, "golden shares" that, as the term is used in a bankruptcy context, give the shareholder the right to preempt a bankruptcy filing. For example, in *Lexington Hospitality*, the bankruptcy court denied a motion to dismiss a bankruptcy case filed by an entity wholly owned by a creditor that held a golden share/blocking provision because the court concluded that the entity was not truly independent. 577 B.R. at 684–85. In addition, in *In re Intervention Energy Holdings, LLC*, 553 B.R. 258 (Bankr. D. Del. 2016), the court ruled that a provision in a limited liability company's governance document:

> the sole purpose and effect of which is to place into the hands of a single, minority equity holder [by means of a "golden share"] the ultimate authority to eviscerate the right of that entity to seek federal bankruptcy relief, and the nature and substance of whose primary relationship with the debtor is that of creditor—not equity holder—and which owes no duty to anyone but itself in connection with an LLC's decision to seek federal bankruptcy relief, is tantamount to an absolute waiver of that right, and, even if arguably permitted by state law, is void as contrary to federal public policy.

Id. at 265; *see also In re Tara Retail Group, LLC*, 2017 WL 1788428 (Bankr. N.D. W.Va. May 4, 2017) (even though a creditor held a golden share or blocking provision, it ratified the debtor's bankruptcy filing by its silence), *appeal dismissed*, 2017 WL 2837015 (N.D. W.Va. June 30, 2017).

By contrast, in *In re Squire Court Partners*, 574 B.R. 701, 704 (E.D. Ark. 2017), the court ruled that, where a partnership agreement required the unanimous consent of the partners before the limited partnership could "file a petition seeking, or consent to, reorganization or relief under any applicable federal or state law relating to bankruptcy," the bankruptcy court properly dismissed a bankruptcy filing by the managing partner without the consent of the other partners.

One of the seminal cases addressing this issue is *In re Franchise Services of North America, Inc.*, 891 F.3d 198 (5th Cir. 2018). In *Franchise Services*, as a condition to an investment by a majority preferred stockholder that was controlled by one of the debtor's creditors, the debtor amended its certificate of incorporation to provide that it could not "effect any Liquidation Event" (defined to include a bankruptcy filing) without the approval of the holders of a majority of both its preferred and common stock. The U.S. Court of Appeals for the Fifth Circuit ruled that "[t]here is no prohibition in federal bankruptcy law against granting a preferred shareholder the right to prevent a voluntary bankruptcy filing just because the shareholder also happens to be [controlled by] an unsecured creditor . . . ." *Id.* at 208. The Fifth Circuit rejected the argument that, even if a shareholder-creditor can hold a bankruptcy veto right, such a right "remains void in the absence of a concomitant fiduciary duty." No statute or binding case law, the court explained, "licenses this court to ignore corporate foundational documents, deprive a bona fide shareholder of its voting rights, and reallocate corporate authority to file for bankruptcy just because the shareholder also happens to be an unsecured creditor." *Id.* at 209.

Other notable cases include *In re Insight Terminal Solutions, LLC*, 2019 WL 4640773 (Bankr. W.D. Ky. Sept. 23, 2019); *In re Pace Industries, LLC*, No. 20-10927 (MFW) (Bankr. D. Del. May 5, 2020); and *In re 3P Hightstown, LLC*, 631 B.R. 205 (Bankr. D.N.J. 2021).

In *Insight*, a lender, as a condition to extending the maturity date of a loan to a Delaware LLC, demanded that the borrower and its guarantor amend their operating agreements so that neither would be permitted to file for bankruptcy unless they first obtained the prior written consent of all holders of the membership units in the borrower that had been pledged to secure the loan. After defaulting on the loan, but before the lender could foreclose on the pledged membership units, the borrower and the guarantor again amended their operating agreements to remove the lender consent provision and filed for chapter 11 protection. The lender moved to dismiss. The bankruptcy court denied the motion, finding that the debtors had authority under Delaware law to file for bankruptcy in accordance with their amended operating agreements, and ruling that "attempts to limit the Debtors' access to the bankruptcy process were against public policy and invalid." *Insight*, 2019 WL 4640773, at *3.

In *Pace*, a Delaware corporation amended its certificate of incorporation in connection with a pre-bankruptcy debt-for-equity swap to provide that any voluntary bankruptcy filing by the company or its affiliates "shall require the written consent or affirmative vote of the holders of a majority in interest of the [new preferred stock] . . ., and any such action taken without such consent or vote shall be null and void ab initio, and of no force or effect." The company and certain affiliates later filed prepackaged chapter 11 cases, without the consent of a majority of the preferred stockholders, who moved to dismiss the bankruptcy filings as unauthorized.

The stockholders acknowledged cases finding that shareholder bankruptcy consent rights violate public policy if exercised by a shareholder that is also a creditor holding a "golden share," but argued that they were preferred stockholders only, not creditors. They also argued that, consistent with *Franchise Services*, a minority shareholder (which they all were) is not a controlling shareholder with fiduciary duties.

Ruling from the bench, the bankruptcy court denied the motion to dismiss, holding as a matter of first impression that, on these facts, "a blocking right by a shareholder who is not a creditor is void as contrary to federal public policy that favors the constitutional right to file bankruptcy." *Pace*, No. 20-10927 (MFW) (Bankr. D. Del. May 6, 2020), Transcript of Telephonic Hearing at 38 [Doc. No. 147].

The *Pace* court "respectfully declined" to follow *Franchise Services*, noting that it saw "no reason to conclude that a minority shareholder has any more right to block a bankruptcy—the constitutional right to file a bankruptcy by a corporation—than a creditor does." *Id.* at 40. Moreover, it explained, contrary to the Fifth Circuit's interpretation of Delaware law in *Franchise Services*, under Delaware law, "a blocking right, such as exercised in the circumstances of this case, would create a fiduciary duty on the part of the shareholder; a fiduciary duty that, with the debtor in the zone of insolvency, is owed not only to other shareholders, but also to all creditors." *Id.* at 41.

Other factors combined with the blocking right, the court noted (i.e., the debtors were in the zone of insolvency, lacked liquidity, and could not pay their debts as they matured without debt-or-in-possession financing, coupled with severe operational disruption due to the pandemic), supported a finding that the preferred shareholders' blocking right created a fiduciary duty.

In *3P Hightstown*, the bankruptcy court dismissed a chapter 11 case filed by a Delaware LLC because the LLC agreement precluded a bankruptcy filing without the consent of a holder of preferred membership interests whose capital contributions had not been repaid. According to the court, the bankruptcy blocking provision was not void as a matter of public policy because, under both Delaware law and the express terms of the LLC agreement, the holder of the preferred membership interests, which held a non-controlling position, had no fiduciary duties. "In sum," the court wrote, "there is no breach of fiduciary duty which renders the provision at issue violative of public policy." *3P Hightstown*, 631 B.R. at 214.

301 WEST NORTH

301 West North Avenue, LLC (the "debtor") is a Delaware LLC that owns a mixed-use high-rise building in Chicago (the "property"). The debtor has two members (the "Members") and is managed by MK Manager Corp. ("MK").

In 2020, the predecessor-in-interest of BDS III Mortgage Capital G, LLC ("BDS") loaned $26 million to the debtor secured by a mortgage on the property. The loan agreement required the debtor to be a bankruptcy remote entity. It also provided that the debtor appoint an "independent director" or manager acceptable to BDS. Pursuant to a "Staffing Agreement" with CT Corp. Staffing, Inc. ("CTCS"), CTCS designated an independent manager (the "Director") for the debtor who served in that role for more than 500 corporate entities.

The Staffing Agreement provided that the debtor's governing body, prior to making a decision in any matter before it, was required to give the Director reasonable advance notice and an opportunity to investigate the proposed action. The Staffing Agreement had an initial term of one-year, subject to automatic renewal unless either the debtor or CTCS gave 30 days' prior written notice of termination. The Staffing Agreement also obligated the debtor to indemnify CTCS and the Director for any liability arising from services provided under the agreement or any breach of the agreement's representations and warranties, other than liabilities arising solely from the willful misconduct of either CTCS or the Director. Finally, the Staffing Agreement included a covenant that the debtor would not sue CTCS or the Director for anything other than willful misconduct.

The Loan Agreement between the debtor and BDS provided that: (i) the unanimous consent of all of the debtor's members and the Director was required for debtor to file for bankruptcy; (ii) the debtor's organizational documents had to provide that the debtor at all times must have an independent director "reasonably satisfactory" to BDS; (iii) the organizational documents must provide that the debtor's board cannot not take any action requiring the unanimous consent of the board without a Director; and (iv) any resignation, removal, or replacement of the Director be valid only upon advance notice to BDS, and only if supported by evidence that the replacement Director satisfied the terms of the debtor's organizational documents.

The debtor's LLC Agreement provided in relevant part that: (i) the debtor had to remain a "manager managed" single-purpose LLC with one "independent manager" (i.e., the Director) so long as the debt to BDS remained unpaid; and (ii) the debtor could not make "major decisions," including filing for bankruptcy, without the unanimous consent of all managers, including the independent manager. It also included the following provisions regarding the fiduciary duties of the independent manager:

> To the fullest extent permitted by applicable law ... the Independent Manager shall consider only the interests of the Constituent Members and Company (including Company's respective creditors) in acting or otherwise voting on the matters provided for in this Agreement (which such fiduciary duties to the Constituent Members and Company (including Company's respective creditors), in each case, shall be deemed to apply solely to the extent of their respective economic interests in Company exclusive of (x) all other interests (including, without limitation, all other interests of the Constituent Members), (y) the interests of other affiliates of the Constituent Members and Company and (z) the interests of any group of affiliates of which the Constituent Members or Company is a part).
>
> Except as provided [in this Agreement], the Independent Manager shall, in exercising their rights and performing their duties under this Agreement, have a fiduciary duty of loyalty and care similar to that of a director of a business corporation organized under the General Corporation Law of the State of Delaware.

The Director executed the LLC Agreement as "Independent Manager/Special Member." However, when the Members signed the agreement, the Director's signature page was omitted and the agreement was signed instead by MK.

The BDS loan matured in October 2023, at which time the debtor defaulted by failing to pay the outstanding debt in full. BDS then commenced a foreclosure proceeding, which was stayed on February 27, 2024, when the debtor filed for chapter 11 protection in the Northern District of Illinois. The petition was signed by a representative of MK, who declared that he was authorized to file the petition on the debtor's behalf. The MK representative later stated that he was not aware that the Director's consent was required for the filing.

In April 2024, the Director submitted a resignation notice to the debtor, but backdated the notice to August 31, 2022, the last date that the debtor's paid CTCS under the Staffing Agreement. The debtor did not provide BDS with any notice of the Director's resignation, as was required under the LLC Agreement.

BDS submitted a claim in the amount of approximately $30.4 million secured by a mortgage on the property, which the debtor valued at $19.4 million.

In May 2024, the debtor proposed a chapter 11 plan under which BDS would be paid either $17.8 million within 110 days of the plan's effective date or approximately $101,000 per month for 30 years if BDS elected under section 1111(b) of the Bankruptcy Code to have its claim treated as fully secured.

In July 2024, BDS, arguing that the debtor lacked the proper authority to file for bankruptcy, moved to dismiss the chapter 11 case and to bar the debtor from refiling.

THE BANKRUPTCY COURT'S RULING

The bankruptcy court granted the motion to dismiss the debtor's chapter 11 case, but declined to impose a ban on a future bankruptcy filing.

U.S. Bankruptcy Judge David D. Cleary explained that, pursuant to section 1112(b) of the Bankruptcy Code, a bankruptcy court "shall" dismiss a chapter 11 case for "cause," which has construed to include lack of corporate authority to file for bankruptcy.

Judge Cleary concluded that the debtor was not authorized to file for chapter 11 protection because the LLC Agreement required the Director's consent for a bankruptcy filing and no such consent was given, nor was the Director even consulted before the filing. Thus, the burden shifted to the debtor to rebut the evidence that MK lacked authority to file a chapter 11 petition on the debtor's behalf.

The bankruptcy court rejected the debtor's argument that: (i) MK believed that the Director had resigned before filing the chapter 11 petition, such that the Director's consent was not required; (ii) the Director's resignation constituted acquiescence to the bankruptcy filing; and (iii) the Director ratified the bankruptcy filing.

According to Judge Cleary, the Director resigned in April 2024—two months after the bankruptcy filing—even though she backdated her resignation letter to August 2022, and MK's testimony concerning the Director's resignation was not credible. In addition, he explained, the Director did not acquiesce to the bankruptcy filing because the evidence demonstrated that she did not learn of the filing until April 2024, shortly after which she resigned, and therefore lacked full knowledge of the underlying facts (which is required to establish acquiescence).

Moreover, Judge Cleary noted, the record reflected that the Director consistently repudiated the bankruptcy filing. *301 West North,* 666 B.R. at 596 (citation omitted). Finally, the bankruptcy court found that the Director neither expressly nor impliedly ratified the debtor's chapter 11 filing after the fact. Instead, the Director's conduct suggested that she wished to dissociate herself from the debtor as quickly as possible once she learned that it had filed for bankruptcy.

Next, the bankruptcy court ruled that the debtor's organizational documents did not impermissibly restrict its right to file for bankruptcy relief. Judge Cleary acknowledged that provisions in corporate organizational documents that restrict a company's ability to file for bankruptcy or impede its ability to exercise fiduciary duties in evaluating a potential filing are against public policy. However, he explained, provisions that put an independent manager on the board of an LLC, and require that manger to "participate" in certain corporate actions, such as a bankruptcy filing, "are not *presumptively* void." *Id.* at 598 (citing *Lake Michigan*, 547 B.R. at 913).

Compared to other cases in which bankruptcy filing restrictions have been invalidated, the bankruptcy court emphasized, the saving grace in the case before it on public policy grounds was the existence of fiduciary duties in the LLC Agreement requiring the Director to consider the interests of the debtor and its creditors. Judge Cleary rejected the debtor's argument that, because the LLC Agreement required that the Director remain in place until the loan was repaid and provided that the Director could not resign without first giving notice to BDS and its designation of a replacement, "there is nothing independent about [the Director] as she served solely for the benefit of [BDS]." *Id.* at 600. According to the bankruptcy court, such provisions were logical and did "not lead inexorably to the conclusion that the [Director] is not subject to director fiduciary duties affecting the ability to file for bankruptcy protection." *Id.*

The court also rejected the debtor's argument that limiting the "interests" that the Director had to consider to the debtor's "economic interests" allowed her to avoid liability for any breach of fiduciary duty. Judge Cleary wrote that "it is entirely appropriate for an independent manager to consider a debtor's economic interest in determining whether it will authorize the filing of a bankruptcy petition." *Id.* He also noted that the inquiry should be whether an independent manager (such as the Director) has fiduciary duties to the debtor and its creditors, rather than the debtor's members, because the elimination of duties to LLC members is permitted under Delaware law and cannot be interpreted to contravene public policy. *Id.*

In addition, the bankruptcy court rejected the argument that, because the Staffing Agreement indemnified CTCS and the Director and included a covenant not to sue, except for actions amounting to willful misconduct, the already limited fiduciary duties were rendered "completely barren" and violated Delaware law. The key document, Judge Cleary explained, was the LLC Agreement, rather than the Staffing Agreement, which was merely a contract between the debtor and CTCS. "[I]n compliance with Delaware law," he wrote, the LLC Agreement did not permit indemnification if the Director "acted in bad faith or engaged in willful misconduct." *Id.* at 601.

The bankruptcy court declined to issue a ban on future bankruptcy filings by the debtor. According to the court, "[i]f a bar to refiling were imposed, it would effectively prohibit the Debtor from deciding—properly, in compliance with the LLC Agreement—whether or not it should file for relief under the Bankruptcy Code." *Id.*

Finally, the court rejected the debtor's argument that dismissal of the chapter 11 case would not be in the best interests of creditors and the estate. Judge Clearly explained that this assertion is irrelevant because a bankruptcy court is obligated to dismiss a case if it was filed without the required corporate authority. *Id.*

OUTLOOK

The debtor appealed the bankruptcy court's decision on January 17, 2025. As of the writing of this article, the appeal remains pending before the U.S. District Court for the Northern District of Illinois. *See 301 W North Avenue, LLC v. BDS III Mortgage Capital G, LLC*, No. 25-00568 (N.D. Ill. Jan. 17, 2025).

Recent court rulings have not resolved the ongoing dispute over the enforceability of blocking provisions, golden shares, and other provisions (such as the appointment of independent directors by lenders) designed to manage access to bankruptcy protection. However, *301 West North* and other similar rulings, including *Hightstown*, *Pace*, *Franchise Services*, and *Insight*, indicate that the validity of such provisions may hinge on whether the holder of a blocking right has fiduciary duties as a matter of law or contract, in which case the courts have expressed heightened public policy concerns. More generally, these and other relevant decisions reinforce the importance of knowing what approach the courts have endorsed in any likely bankruptcy venue. Given the trillions of dollars of securities issued in connection with SPEs, the enforceability of such provisions in various venues may be economically significant.

The independent manager/director framework highlighted by *301 West North* is emblematic of the significant proliferation and popularity of that structure in recent SPE lending transactions.

DELAWARE BANKRUPTCY COURT: APPLYING CREDIT PRESSURE ON FINANCIALLY DISTRESSED DEBTOR SCUTTLES ORDINARY COURSE PAYMENT PREFERENCE DEFENSE

Daniel J. Merrett

The power of a bankruptcy trustee or chapter 11 debtor-in-possession ("DIP") to avoid pre-bankruptcy preferential transfers is an important tool designed to promote the bankruptcy policy of equality of distribution and to generate value for the bankruptcy estate that can be used to pay creditors and/or fund a plan. However, the Bankruptcy Code contains certain defenses to avoidance, including the "ordinary course payment" defense, which incentivizes vendors and other creditors to continue doing business with financially distressed entities.

Courts disagree on the scope of the defense and, in particular, whether its requirement (in some cases) that payments be made according to "ordinary business terms" means business terms applied when a debtor is in good financial health, as distinguished from terms imposed when the debtor is in financial distress. The U.S. Bankruptcy Court for the District of Delaware weighed in on this debate in *In re Fred's Inc.*, No. 19-11984 (CTG), 2025 WL 208536 (Bankr. D. Del. Jan. 15, 2025). The court granted partial summary judgment to a liquidating trustee in preference litigation, ruling that "ordinary business terms" within the meaning of section 547(c)(2)(B) of the Bankruptcy Code should be assessed in accordance with the "healthy debtor" standard rather than based upon customary industry practice tightening credit terms for financially distressed entities. Because the creditor/transferee applied "credit pressure" to the debtor once it became financially distressed, the court ruled that the creditor could not rely on the ordinary course payment defense.

THE ORDINARY COURSE OF BUSINESS PAYMENT DEFENSE TO PREFERENTIAL TRANSFER AVOIDANCE

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

Section 547(c) sets forth nine defenses or exceptions to preference avoidance. One of those is the "ordinary course payment" defense in section 547(c)(2), which provides as follows:

> The trustee may not avoid under this section a transfer . . . to the extent that such transfer was in payment of a debt

> incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee, and such transfer was—(A) made in the ordinary course of business or financial affairs of the debtor and the transferee; or (B) made according to ordinary business terms . . . .

11 U.S.C. § 547(c)(2).

The ordinary course payment defense was intended to "leave undisturbed normal commercial and financial relationships and protect recurring, customary credit transactions which are incurred and paid in the ordinary course of business of both the debtor and the debtor's transferee." *Comm. of Unsecured Creditors of Gregg Appliances v. Curtis Int'l Ltd. (In re hhgregg, Inc.)*, 636 B.R. 545, 549 (Bankr. S.D. Ind. 2022) (quoting *Kleven v. Household Bank, F.S.B.*, 334 F.3d 638, 642 (7th Cir. 2003)); *accord Desmond v. Northern Ocean Liquidating Corp.* (*In re Nat'l Fish and Seafood, Inc.)*, 2024 WL 1422665 (Bankr. D. Mass. Apr. 1, 2024); *In re Liquidating Est. of H&P, Inc.*, 648 B.R. 767 (Bankr. W.D. Pa. 2023). The defense "is formulated to induce creditors to continue dealing with a distressed debtor so as to kindle its chances of survival without a costly detour through, or a humbling ending in, the sticky web of bankruptcy." *Fiber Lite Corp. v. Molded Acoustical Prods. (In re Molded Acoustical Prods.)*, 18 F.3d 217, 219–220 (3d Cir. 1994) (citations omitted); *accord Auriga Polymers Inc. v. PMCM2, LLC as Tr. for Beaulieu Liquidating Tr.*, 40 F.4th 1273, 1288 (11th Cir. 2022) (citing *In re BFW Liquidation, LLC*, 899 F.3d 1178, 1193 (11th Cir. 2018)). Section 547(c)(2)'s legislative history indicates that its purpose is "to leave undisturbed normal financial relations." H.R. Rep. No. 95-595, at 373 (1977)); *see generally* COLLIER ON BANKRUPTCY ("COLLIER") ¶ 547.04 [2] (16th ed. 2024) ("This section is intended to protect recurring, customary credit transactions that are incurred and paid in the ordinary course of business of the debtor and the debtor's transferee.").

Section 547(c)(2) is an affirmative defense, meaning that the preference defendant bears the burden of proof. *See* 11 U.S.C. § 547(g); *Gulf City Seafoods, Inc. v. Ludwig Shrimp Co., Inc. (In re Gulf City Seafoods, Inc.)*, 296 F.3d 363, 367 (5th Cir. 2002); *In re Liquidating Est. of H&P, Inc.*, 648 B.R. 767, 790 (Bankr. W.D. Pa. 2023).

Section 547(c)(2) was amended in 2005. It previously provided as follows:

> The trustee may not avoid under this section a transfer . . . to the extent that such transfer was—(A) in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee; (B) made in the ordinary course of business or financial affairs of the debtor and the transferee; *and* (C) made according to ordinary business terms.

11 U.S.C. § 547(c)(2) (amended in 2005) (emphasis added).

The 2005 amendments made successful invocation of the ordinary course payment defense considerably easier. A transferee

still must demonstrate that a challenged transfer was "in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee." However, under amended section 547(c)(2), a transferee's additional evidentiary burden is limited to proving *either*: (i) that the transfer was made "in the ordinary course of business or financial affairs of the debtor and the transferee"; *or* (ii) that the transfer was made according to "ordinary business terms." *See Baumgart v. Savani Props. (In re Murphy)*, 2021 WL 2524946, at *2 (Bankr. N.D. Ohio Apr. 19, 2021); *accord In re ASPC Corp.*, 658 B.R. 455 (Bankr. S.D. Ohio 2024) (ruling that the defendant in preference litigation need only demonstrate that the payment satisfied one—but not both—of the tests stated in section 547(c)(2), and noting that "[t]his case illustrates the importance of [the 2005 amendment's] replacement of the conjunctive 'and' with the disjunctive 'or' between the subjective and objective tests for the ordinary course of business defense").

Prior to the 2005 amendments, a preference defendant was required to prove *both* (i) and (ii) to successfully invoke the defense. Because the language of those alternatives remains unchanged, pre-2005 amendment case law interpreting the meaning of the provisions is still relevant. *See, e.g., Pirinate Consulting Group. v. Maryland Dep't of Env't (In re Newpage Corp.)*, 555 B.R. 444, 452 (Bankr. D. Del. 2016); *Pereira v. United Parcel Serv. of Am., Inc. (In re Waterford Wedgewood USA, Inc.)*, 508 B.R, 821, 827 (Bankr. S.D.N.Y. 2014); *see also* COLLIER at ¶ 547.04 [2] (citing cases).

The initial element of the ordinary course payment defense requires that the transfer have been made to pay a debt incurred by the debtor in the ordinary course of business or financial affairs of *both* the debtor and the transferee. This element of section 547(c)(2) is frequently undisputed, and there is relatively little case law addressing it. *See PMC Mktg. Corp.*, 543 B.R. 345, 357 (B.A.P. 1st Cir. 2016) ("There is no precise legal test to determine whether a preferential transfer was made in the ordinary course of business between the debtor and the creditor.") (citations and internal quotation marks omitted); COLLIER at ¶ 547.04 [2][i] (noting that "[m]ost courts assume this requirement is met by inferring from the evidence that there was nothing 'unusual' about the transactions underlying the preferential payment").

Section 547(c)(2)(A) creates a "subjective test," whereas section 547(c)(2)(B) establishes an "objective test." The former is an "inherently fact-intensive inquiry, aimed at determining whether the transfer at issue conformed with the 'normal payment practice between the parties.'" *In re Diversified Mercury Commc'ns, LLC*, 646 B.R. 403, 412 (Bankr. D. Del. 2022) (citing *In re Am. Home Mortg. Holdings, Inc.*, 476 B.R. 124, 135 (Bankr. D. Del. 2012); *Stanziale v. Superior Tech. Res., Inc. (In re Powerwave Techs., Inc.)*, 2017 WL 1373252, at *4 (Bankr. D. Del. Apr. 13, 2017)); *accord Faulkner v. Broadway Festivals, Inc. (In re Reagor-Dykes Motors, LP)*, 2022 WL 120199, at *5 (Bankr. N.D. Tex. Jan. 12, 2022).

In applying the subjective test, some courts consider the following factors:

> (1) the length of time the parties engaged in the type of dealings at issue; (2) whether the subject transfers were in an amount more than usually paid; (3) whether payments at issue were tendered in a manner different from previous payments; (4) whether there appears to have been an unusual action by the debtor or creditor to collect on or pay the debt; and (5) whether the creditor did anything to gain an advantage (such as additional security) in light of the debtor's deteriorating condition.

Diversified Mercury, 646 B.R. at 412 (citing *FBI Wind Down, Inc. v. Careers USA, Inc. (In re FBI Wind Down, Inc.)*, 614 B.R. 460, 487 (Bankr. D. Del. 2020)); *accord Hechinger Inv. Co. v. Universal Forest Prods., Inc. (In re Hechinger Inv. Co.)*, 489 F.3d 568, 578 (3d Cir. 2007); *In re Gaines*, 502 B.R. 633, 641 (Bankr. N.D. Ga. 2013).

By contrast, the objective test examines whether a challenged transfer was "ordinary in the industry." *Reagor-Dykes*, 2022 WL 2046144, at *14; *accord H&P*, 648 B.R. at 790; *In re Whistler Energy II, LLC*, 608 B.R. 655, 662 (Bankr. E.D. La. 2019). For example, the U.S. Court of Appeals for the Sixth Circuit has held that, for purposes of the objective test, "'ordinary business terms' means that the transaction was not so unusual as to render it an aberration in the relevant industry." *Luper v. Columbia Gas of Ohio, Inc. (In re Carled, Inc.)*, 91 F.3d 811. 818 (6th Cir. 1996).

In applying the objective test, every federal circuit court that has addressed the issue has concluded that the phrase "ordinary business terms" in section 547(c)(2)(B) refers to the practices in the preference defendant's industry. *See Miller v. Fla. Mining & Materials (In re A.W. & Associates, Inc.)*, 136 F.3d 1439, 1443 (11th Cir. 1998); *Fiber Lite Corp. v. Molded Acoustical Prods., Inc. (In re Molded Acoustical Prods., Inc.)*, 18 F.3d 217, 220 (3d Cir. 1994); *In re Tolona Pizza Prods. Corp.*, 3 F.3d 1029, 1033 (7th Cir. 1993).

FRED'S

Fred's Inc. (the "debtor") operated a chain of general merchandise retail stores located in the southeastern United States. In 2019, the debtor contracted with C.H. Robinson ("CHR") to provide transportation brokerage services. Under the agreement, the debtor was obligated to pay CHR for its services within 30 days of the debtor's receipt of an invoice. The agreement initially set a credit limit of $3 million as part of an anticipated $45 million relationship.

After the debtor began to experience financial distress and announced store closings, CHR tightened its credit terms by reducing the debtor's credit limit from $3 million to $1.75 million in June 2019, and then to $1 million the following month. Correspondence between the parties indicated that CHR was imposing credit restrictions to extract payment from the debtor and thereby reduce CHR's exposure. On July 11, 2019, in response to a threat that CHR would stop delivering the debtor's goods, the debtor transferred $800,000 to CHR. Less than a week later, CHR reduced the credit terms under its agreement with the debtor from 30 to 14 days.

In September 2019, the debtor filed for chapter 11 protection in the District of Delaware. Nine months later, the bankruptcy court confirmed a liquidating chapter 11 plan for the debtor. The plan established a liquidating trust that was assigned all of the estate's causes of action, including avoidance claims.

The liquidating trustee (the "trustee") sued CHR to avoid nearly $3.5 million in payments made by the debtor in 15 separate transfers to CHR during the 90 days preceding the bankruptcy petition date. The trustee moved for summary judgment. In his motion, the trustee acknowledged that CHR provided new value to the debtor following the transfers in the amount of approximately $1.93 million, and that CHR was entitled to a defense in that amount under section 547(c)(4) of the Bankruptcy Code, which provides that a bankruptcy trustee may not avoid a preferential transfer to the extent that the transferee subsequently provided new value to or for the benefit of the debtor, with certain exceptions.

In opposing the motion for summary judgment, CHR: (i) disputed the amount of the trustee's preference claim, which CHR asserted was overstated by approximately $330,000; (ii) disputed the amount of its new value defense under section 547(c)(4), which CHR claimed was understated by approximately $43,000; and (iii) acknowledged that its "standard practice" was to adjust a customer's credit limit according to the customer's "credit profile, including its existing financial status and projections of future financial performance," which practice CHR characterized as "standard within the transportation and logistics industry." CHR accordingly invoked the ordinary course payment preference defense in section 547(c)(2)(B).

THE BANKRUPTCY COURT'S RULING

The bankruptcy court granted the trustee's motion for summary judgment in part.

After concluding that the trustee had satisfied his burden of establishing a *prima facie* case for avoidance as preferential of approximately $3.125 million in transfers under section 547(b) of the Bankruptcy Code, U.S. Bankruptcy Judge Craig T. Goldblatt ruled that CHR could not rely on the ordinary course payment preference defense under section 547(c)(2)(B). CHR argued that the payments it received from the debtor were made according to "ordinary business terms" within the meaning of section 547(c)(2)(B) because it is common in the transportation and logistics industry for a supplier to tighten credit terms once a customer begins to face financial difficulty. According to Judge Goldblatt, the "fundamental disagreement between the parties is over whether 'ordinary course' means terms that are ordinary when dealing with a healthy company, or whether the defense is still available when the defendant was imposing credit pressure on the debtor, so long as the defendant can show that it was customary in the relevant industry to impose such credit pressure on customers in financial distress." *Fred's*, 2025 WL 208536, at *7.

Guided by the bankruptcy court's ruling in *In re Erie County Plastics Corp.*, 438 B.R. 89 (Bankr. W.D. Pa. 2010), and the position staked out by the Third and Tenth circuits in *In re Molded Acoustical Prods., Inc.*, 18 F.3d 2017 (3d Cir. 1994), and *In re Meredith Hoffman Partners*, 12 F.3d 1549 (10th Cir. 1994), respectively, Judge Goldblatt concluded that the "healthy debtor" standard should apply. Under that standard, he explained, "[o]ne's dealings with companies facing financial distress is not the measure of ordinariness [,but instead,] ordinary terms are those which prevail in healthy, not moribund, creditor-debtor relationships." *Fred's*, 2025 WL 208536, at *7 (citations and internal quotation marks omitted).

Judge Goldblatt acknowledged that a circuit split apparently exists on this issue. The Second, Eighth, and Ninth Circuits have endorsed the view that the scope of the meaning of "ordinary business terms" extends beyond average transactions to include the "broad range of terms that encompasses the practices employed" by "similarly situated debtors and creditors facing the same or similar problems," including a debtor's financial distress. *See In re Roblin Indus., Inc.*, 78 F.3d 30, 42 (2d Cir. 1996); *In re U.S.A. Inns of Eureka Springs, Arkansas, Inc.*, 9 F.3d 680, 685 (8th Cir. 1993); *In re Jan Weilert RV, Inc.*, 315 F.3d 1192, 1199 (9th Cir.), *as amended*, 326 F.3d 1028 (9th Cir. 2003). However, Judge Goldblatt reasoned that the Third Circuit's approach in *Molded Acoustical Prods.*, in addition to being binding precedent, "better accords with the underlying congressional purpose in adopting the ordinary course defense, which was to keep distressed companies out of bankruptcy by creating an incentive for vendors to continue extending credit." *Fred's*, 2025 WL 208536, at *8.

The bankruptcy court accordingly concluded that CHR could not rely on section 547(c)(2)(B) as a defense to preference liability:

> [T]he summary judgment record makes clear that throughout the preference period [CHR] was applying credit pressure to the debtor, including threatening to discontinue providing services if the debtor failed to make payment. There is nothing in the record to suggest that this is the way a vendor in the shipping and logistics industry would treat a financially healthy customer. Based on the summary judgment record before the Court, the trustee is thus entitled to partial summary judgment that the ordinary course of business defense is unavailable.

Id. at *9.

Finally, the bankruptcy court denied summary judgment regarding the new value defense under section 547(c)(4) due to the existence of a genuine dispute regarding the amount of the new value provided by CHR, but awarded summary judgment to the trustee on his request for prejudgment interest on any avoidance recovery at the federal judgment rate.

OUTLOOK

The principal takeaway from the bankruptcy court's ruling in *Fred's* is that, in assessing potential preference litigation exposure, creditors doing business with financially distressed debtors should be aware of the approach endorsed in any likely venue for the debtor's bankruptcy filing. If a bankruptcy court—like the court in *Fred's*—embraces the "healthy debtor" approach, pre-bankruptcy transfers made by a debtor during the preference period may not be shielded from avoidance under the ordinary course payment defense if the payments were "extracted" by means of credit terms deviating from those applied when the debtor was not in financial distress. If not, creditors that have demanded restricted credit terms due to the debtor's financial distress may still be able to invoke the defense successfully.

Given the important purpose of section 547(c)(2) in encouraging vendors to continue doing business with financially distressed debtors, the uncertainty caused by the circuit split on this issue may be an invitation to Supreme Court resolution of the dispute.

Heather Lennox, ***Bruce Bennett*** ***(Los Angeles)***, ***Corinne Ball*** ***(New York)***, and ***Ben Larkin*** ***(London)*** were ranked by *Chambers Global* 2025 in the field of Restructuring/Insolvency. The Restructuring/Insolvency practice is one of nine Jones Day practices receiving a global-wide practice ranking.

Jasper Berkenbosch ***(Amsterdam)***, ***Fabienne Beuzit*** ***(Paris)***, ***Ben Larkin*** ***(London)***, and ***Juan Ferré*** ***(Madrid)*** were ranked in the field of Restructuring/Insolvency in *Chambers Europe* 2025.

Fabienne Beuzit ***(Paris)*** and ***Jasper Berkenbosch*** ***(Amsterdam)*** were among the "Leading Individuals" ranked in the 2025 edition of *The Legal 500 EMEA* guide in the field of Restructuring and Insolvency or Insolvency. ***Rodolphe Carrière*** ***(Paris)*** was named a "Leading Associate" in the practice area Insolvency.

Part II of a two-part article written by ***Corinne Ball*** ***(New York)*** and ***Christopher DiPompeo*** ***(Washington)*** titled "Rediscovering Section 157(b)(5) Transfers in Mass Tort Bankruptcies" was published in the April 2025 edition of the *ABI Journal*.

Dan B. Prieto ***(Dallas)*** was on a panel discussion titled "Balancing the Imperfections: Is Bankruptcy a Viable Option for Resolving Mass Torts?" on April 4, 2025, at the Biennial Bankruptcy & Restructuring Symposium at Tulane University Law School in New Orleans.

Kevyn D. Orr ***(Washington)*** received a "2025 Diversity in Business Award" from the *Washington Business Journal*. His print profile for the award can be accessed here.

Roger Dobson ***(Sydney)*** was recognized as a "Lawyer of the Year" in the practice area Distressed Investing and Debt Trading in the 2026 edition of *The Best Lawyers in Australia*.™ In addition, Roger and ***Sally A. Stitz*** ***(Brisbane; Global Disputes)*** were recognized in the practice area Insolvency and Reorganization Law.

An article written by ***Corinne Ball*** ***(New York)*** titled "Distressed Investing: New Development in Managing Access to Bankruptcy Relief" was published in the February 26, 2025, edition of the *New York Law Journal*.

Kevyn D. Orr ***(Washington)*** moderated a discussion in April 2025 at the Legends Speaker Series sponsored by operational turnaround and financial restructuring services firm Pivot >.

An article written by ***Heather Lennox*** ***(Cleveland and New York)***, ***Jasper Berkenbosch*** ***(Amsterdam)***, ***Dan T. Moss*** ***(Washington and New York)***, and ***Sid Pepels*** ***(Amsterdam)*** titled "The EU Harmonisation Project and Its Potential for impact" was published in the Q1 2025 edition of *INSOL World*.

An article written by ***Dan T. Moss*** ***(Washington and New York)***, ***Daniel J. Merrett*** ***(Atlanta)***, and ***Ben Rosenblum*** ***(New York)*** titled "*Boston Generating*: Second Circuit Triples Down on Its Holding that Transfers Made Under Securities Contracts Are Safe Harbored in Bankruptcy if the Debtor-Transferee is a Customer of a Financial Institution" was published on March 3, 2025, by the *Harvard Law School Bankruptcy Roundtable*.

An article written by ***Corinne Ball*** ***(New York)***, ***David S. Torborg*** ***(Washington)***, ***Michael C. Schneidereit*** ***(New York)***, and ***Dan T. Moss*** ***(Washington and New York)*** titled "Ninth Circuit: reversal on appeal of order denying Chapter 15 recognition does not retroactively trigger automatic stay in the March 2025 *INSOL International Restructuring Alert*.

An article written by ***Michael C. Schneidereit*** ***(New York)*** and ***Nicholas J. Morin*** ***(New York)*** titled "Fifth Circuit Rules that Serta Simmons Uptier Violated Credit Agreement" was published on April 2, 2025, by *Lexis Practical Guidance*.

An article written by ***Genna Ghaul*** ***(New York)*** titled "Second Circuit: Bankruptcy Code's Lease Assumption and Assignment Provisions Apply Only to 'True Leases'" was published on March 28, 2025, by *Lexis Practical Guidance*.

An article written by ***Daniel J. Merrett*** ***(Atlanta)*** titled "Ninth Circuit: No Injury to Creditors Required for Avoidance of Intentionally Fraudulent Transfer" was published on April 1, 2025, by *Lexis Practical Guidance*.

An article written by ***Dan T. Moss*** ***(Washington and New York)***, ***David S. Torborg*** ***(Washington)***, ***Ryan Sims*** ***(Washington)***, and ***S. Christopher Cundra IV*** ***(Washington)*** titled "New Jersey Bankruptcy Court Ruling Highlights the Utility of Chapter 15 in Enforcing Foreign Bankruptcy Court Orders in the United States as a Matter of Comity" was published on March 30, 2025, by *Lexis Practical Guidance*.

Corinne Ball ***(New York)*** has been awarded the "2025 Outstanding Contributions Award" for her contributions to and service in the field of insolvency and the insolvency community by the International Insolvency Institute, a nonprofit corporation dedicated to the improvement of international insolvency systems and procedures. The award will be presented during the Institute's 25th annual conference in São Paulo, Brazil, on June 8–10, 2025.

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