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New York City Bankruptcy Conference

Second Circuit Updates with Bill Rochelle

Bill Rochelle, Moderator
American Bankruptcy Institute

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Second Circuit Updates

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Supreme Court

Last Term

Justice Gorsuch for the majority bans third-party releases for those who don't surrender all their assets to the court, and that would be broader than a discharge.

Supreme Court Reverses *Purdue*: No Nondebtor, Third-Party, Nonconsensual Releases

In a 5/4 decision, the Supreme Court reversed the Second Circuit's *Purdue* decision and declined an invitation to anoint chapter 11 as the remedy for deficiencies in the state and federal tort systems.

In his 20-page majority opinion June 27, Justice Neil M. Gorsuch defined the question before the Court as "whether a court in bankruptcy may effectively extend to nondebtors the benefits of a Chapter 11 discharge usually reserved for debtors." He held "that the bankruptcy code does not authorize a release and injunction that, as part of a plan of reorganization under Chapter 11, effectively seeks to discharge claims against a nondebtor without the consent of affected claimants."

Justice Gorsuch telegraphed the outcome when he said in the very first paragraph that the owners and executives of the opioid manufacturer were aiming for absolution from claims against them "without securing the consent of those affected or placing anything approaching their total assets on the table for their creditors."

The Profit by the Owners from Opioids

Justice Gorsuch recited the facts and procedural history, focusing on the profits that the owners and managers of the Purdue opioid manufacturer had realized in the years leading up to the filing of the company's chapter 11 case in 2019. In the years before the opioid crisis grabbed national attention, the owners and managers received some 15% of company revenue, compared to about 70% each year after 2007. Ultimately, they received distributions of about $11 billion.

In the original chapter 11 plan, the owners proposed to contribute $4.325 billion, spread over 10 years, in exchange for nonconsensual "releases" of all claims, present and future, that might be brought against them. Justice Gorsuch noted that "thousands" of "opioid victims" voted against the plan. The U.S. Trustee, eight states and others opposed confirmation of the plan.

The bankruptcy court confirmed the plan over objections by the U.S. Trustee, eight states and others. On appeal, the district court reversed and vacated the decision confirming the plan. *In re Purdue Pharma, L.P.*, 635 14 B.R. 26 (S.D.N.Y. 2021). To read ABI's report, click here.

After reversal in district court, the owners contributed another $1.675 billion to the plan to alleviate objections from states. Justice Gorsuch said that the owners' "proposed contribution still fell well short of the $11 billion they received from the company between 2008 and 2016."

On the debtor's appeal, the Second Circuit reversed and reinstated the plan over a dissent. *Purdue Pharma LP v. City of Grand Prairie (In re Purdue Pharma LP)*, 69 F.4th (2d Cir. May 30, 2023). To read ABI's report, click here.

The U.S. Trustee filed an application with the Supreme Court for a stay pending appeal. The Court treated the application as a petition for *certiorari* and granted the petition in August along with a stay. The Court heard argument on December 4.

The Merits and Section 1123(b)(6)

Before turning to Section 1123(b)(6) and the principal reason for reversing the Second Circuit, Justice Gorsuch noted that the owners "have not filed for bankruptcy and have not placed virtually all their assets on the table for distribution to creditors, yet they seek what essentially amounts to a discharge."

If there were any basis for a discharge in favor of nondebtors, Justice Gorsuch said it would be found in Section 1123(b)(6). It provides that a chapter 11 plan may include "any other appropriate provision not inconsistent with the applicable provisions of this title."

The plan proponents argued before the Court that the releases were permissible because they were nowhere prohibited in the Bankruptcy Code. As a so-called catchall subject to the *ejusdem generis* canon, Justice Gorsuch said that the subsection is "not necessarily" given the broadest possible construction but "must be interpreted in light of its surrounding context."

"Viewed with that much in mind," Justice Gorsuch said, "we do not think paragraph (6) affords a bankruptcy court the authority the plan proponents suppose." Rather, he said that "the catchall cannot be fairly read to endow a bankruptcy court with the 'radically different' power to discharge the debts of a nondebtor without the consent of affected nondebtor claimants." The other subsections in Section 1123(b), he said, authorize releases "without consent only to the extent such claims concern the debtor."

Justice Gorsuch said that "no one (save perhaps the dissent) thinks [that the catchall] provides a bankruptcy court with a roving commission to resolve all such problems that happen its way."

Other Grounds for Reversal

In the Bankruptcy Code, Justice Gorsuch found three other grounds for reversal. First, the Code reserves discharges for the debtor. Second, the Code requires the debtor to submit all of the debtor's assets to the court. Furthermore, he said, a discharge is not "unbounded," because some claims are exempted from discharge. The Purdue plan, he said, "transgresses all these limits too."

Third, Justice Gorsuch pointed to Section 524(g)(4)(A)(ii) and said that the Code authorizes nondebtor releases "but does so in only one context," namely, plans dealing with asbestos.

Saying that "word games cannot obscure the underlying reality," Justice Gorsuch rejected the idea that the plan just gave releases to the owners, not discharges.

Prior Law

"History" offers a "third" ground for dismissal, Justice Gorsuch said, observing that "pre-code practice may sometimes inform our interpretation of the code's more 'ambiguous' provisions." From 1800 to 1978, he said,

> No one has directed us to a statute or case suggesting American courts in the past enjoyed the power in bankruptcy to discharge claims brought by nondebtors against other nondebtors, all without the consent of those affected.

As far as policy is concerned, Justice Gorsuch noted arguments going both ways. If a policy decision were to be made, "it is for Congress to make," he said.

What the Opinion Does Not Decide

Justice Gorsuch devoted the last page of his decision to noting what the opinion does not decide. First, he said,

> Nothing in what we have said should be construed to call into question consensual third-party releases offered in connection with a bankruptcy reorganization plan; those sorts of releases pose different questions and may rest on different legal grounds than the nonconsensual release at issue here.

Likewise, he said that the decision does not say "what qualifies as a consensual release," nor does the decision "pass upon a plan that provides for the full satisfaction of claims against a third-party nondebtor." The statement appears to express no view on whether a consensual release must be "opt-in" rather than "opt-out."

Of significance with respect to plans already confirmed, Justice Gorsuch said, "because this case involves only a stayed reorganization plan, we do not address whether our reading of the bankruptcy code would justify unwinding reorganization plans that have already

become effective and been substantially consummated." The statement is pertinent to the confirmed Boy Scouts plan, where an appeal is pending in the Third Circuit. The statement is another way of saying that the opinion says nothing about the validity of the doctrine of equitable mootness.

Holding that "the bankruptcy code does not authorize a release and injunction that, as part of a plan of reorganization under Chapter 11, effectively seeks to discharge claims against a nondebtor without the consent of affected claimants," Justice Gorsuch reversed and remanded.

The Lengthy Dissent

Joined by Chief Justice John G. Roberts, Jr., Sonia Sotomayor and Elena Kagan, Justice Brett Kavanaugh "respectfully" dissented in a 54-page opinion. However, he was dissenting "respectfully but emphatically," which became evident with his choice of language, as the reader will see below.

Justice Kavanaugh said that the majority's decision was "wrong on the law and devastating for more than 100,000 opioid victims and their families." Chapter 11, he said, was designed to prevent a race to the courthouse by vesting "bankruptcy courts with broad discretion to approve 'appropriate' plan provisions. 11 U.S.C. § 1123(b)(6)."

In the case at hand, he said that "the Bankruptcy Court exercised that discretion appropriately — indeed, admirably." It was, he said, a "shining example of the bankruptcy system at work." In making a categorical preclusion of nondebtor releases for "no good reason," he said that the majority "now throws out . . . a critical tool for bankruptcy courts to manage mass-tort bankruptcies like this one."

Justice Kavanaugh said that mass torts "present the same collective-action problem that bankruptcy was designed to address," by preventing "victims from litigating outside of the bankruptcy plan's procedures." He found authority for the releases in Section 1123(b)(6), saying that the word "appropriate" was broad and all-encompassing authority that "empowers a bankruptcy court to exercise reasonable discretion." He said that the majority's decision "flatly contradicts the Bankruptcy Code" and that the Code "does not remotely support that categorical prohibition."

In terms of history, Justice Kavanaugh said that "courts have been approving such nondebtor releases almost as long as the current Bankruptcy Code has existed since its enactment in 1978." He lauded the Second Circuit for having "developed a non-exhaustive list of factors for determining whether a non-debtor release is appropriately employed and appropriately tailored in a given case."

Judge Kavanaugh said that the majority's use of the *ejusdem generis* canon was "dead wrong" for two reasons. "First," he said, "its common thread is factually wrong. And second, its purported common thread disregards the evident purpose of § 1123(b)."

The majority should not have relied on Section 524(g), Justice Kavanaugh said, because the "very text of § 524(g) expressly precludes the Court's inference." He quoted the statute as follows: "'Nothing in [§ 524(g)] shall be construed to modify, impair, or supersede any other authority the court has to issue injunctions in connection with an order confirming a plan of reorganization.' 108 Stat. 4117, note following 11 U.S.C. § 524."

Justice Kavanaugh disagreed with the majority's belief that a release was the same as a discharge. He pointed out that the release only pertains to claims related to Purdue.

Concluding his dissent, Justice Kavanaugh said that the majority's opinion "makes little sense legally, practically, or economically." Pointing to Boy Scouts, the Catholic Church cases, breast implants, Dalkon Shield and others, he said that nondebtor releases "have been indispensable to solving that problem and ensuring fair and equitable victim recovery."

Justice Kavanaugh said that the "Court's decision will lead to too much harm for too many people for Congress to sit by idly without at least carefully studying the issue." If the majority believed that $5.5 billion to $6 billion from the owners was not enough, he said that the Court "at most" should have remanded for the lower courts to decide "whether the releases were 'appropriate' under 11 U.S.C. § 1123(b)(6) (if anyone had raised that argument here, which they have not)."

Note: Justice Kavanaugh said that the U.S. Trustee opposed the plan "for reasons that remain mystifying."

The opinion is *Harrington v. Purdue Pharma L.P.*, 23-124 (Sup. Ct. June 27, 2024).

Reversing the Fourth Circuit, the Supreme Court gives a flexible interpretation to traditional notions of constitutional standing in bankruptcy cases and appeals.

Supreme Court Says that Insurance Neutrality Doesn't Deprive an Insurer of Standing

Reversing the Fourth Circuit, the Supreme Court held that an "insurance neutral" chapter 11 plan does not deprive the insurer of standing to raise objections to the plan. For a unanimous Court, Justice Sonia Sotomayor said, "Courts must determine on a case-by-case basis whether a prospective party has a sufficient stake in reorganization proceedings to be a 'party in interest'" under Section 1109(b).

Justice Sotomayor said that the Fourth Circuit had "conflate[d] the merits of an insurer's objection with the threshold §1109(b) question of who qualifies as a 'party in interest.'"

The Court's June 6 opinion is far from the last word on standing in bankruptcy court or on appeal. In the first place, the case directly deals only with standing in chapter 11. Even in chapter 11 cases, Justice Sotomayor said that "the Court today does not opine on the outer bounds of §1109," the statutory standard governing standing in chapter 11.

The opinion could be read to mean that a creditor can object to a plan and presumably mount an appeal with regard to a provision that does not directly affect that creditor. The opinion does not tell us when a creditor loses standing because the effect is too indirect.

The opinion might also be read to mean that the contemporary notion of "insurance neutrality" is too narrow.

The 'Insurance Neutral' Plan

Facing 14,000 pending lawsuits, the corporate debtor proposed a chapter 11 plan under Section 524(g) to create a trust wiping away present and future asbestos claims. All asbestos claims were to be channeled to a trust.

The principal asset for the trust was the debtor's primary insurance policy, with a coverage limit of $500,000 per claim. The insurer was obliged by the policy to defend and indemnify the debtor, even if the claim were false or fraudulent. Defense costs were not counted against the

policy limit for each claim, meaning that the policy was non-eroding. More to the consternation of the insurer, policy had no maximum aggregate limit.

The plan divided asbestos claims into two classes: (1) insured claims covered by the policy; and (2) uninsured claims not covered by the policy. Uninsured claims, of which there were few, were to be paid entirely by the trust.

Claims covered by insurance were to be litigated nominally against the debtor in the tort system, but subject to the coverage limit for each claim. The trust would pay the $5,000 deductible for each insured claim.

The claims covered by insurance remained subject to the insurer's prepetition coverage defenses. In short, the insurer was on the hook for any claim that fell under the policy under the unmodified terms of the policy.

The uninsured claims were subject to antifraud provisions under the plan to protect the trust by requiring the claimants to provide disclosures designed to avoid fraud and duplicate claims. The case came to the Supreme Court because the plan had no antifraud provisions for insured claims.

Unsecured creditors were to be paid in full.

The only class impaired by the plan, asbestos claimants, voted unanimously in favor of the plan. The only confirmation objection came from the insurer, which was not entitled to vote because its unsecured claim would be paid in full and it retained all its rights under the insurance policy.

For lack of antifraud provisions applicable to insured claims, the insurer contended that the plan was not proposed in good faith and was not insurance neutral. The bankruptcy court wrote an opinion recommending that the district court approve the plan, finding that it was insurance neutral and filed in good faith. Because the plan was insurance neutral, the bankruptcy court concluded that the insurer was not a party in interest under Section 1109(b) and thus lacked standing to challenge the plan.

The district court confirmed the plan, adopting the bankruptcy court's findings *in toto* after *de novo* review.

On appeal, the Fourth Circuit affirmed. *Truck Insurance Exchange v. Kaiser Gypsum Co. (In re Kaiser Gypsum Co.)*, 60 F.4th 73 (4th Cir. Feb. 14, 2023). *cert. granted sub nom. Truck Ins. Exch. v. Kaiser Gypsum Co.*, No. 22-1079, 2023 WL 6780372 (Oct. 13, 2023). To read ABI's report on the Fourth Circuit affirmance, click here.

The Fourth Circuit found the plan to have been "insurance neutral," giving the insurance company no standing in the bankruptcy court or on appeal to object to the merits of the plan pertaining to any aspects of the plan other than insurance neutrality. In a footnote, the appeals court said that the insurer had Article III, or constitutional, standing to challenge the finding of insurance neutrality.

The insurer filed a petition for *certiorari*, urging the Court to resolve a split of circuits. The Court granted *certiorari* in October. Argument took place on March 19. It was the last of three bankruptcy cases to be argued this term but the first to be decided.

Section 1109(b) Is 'Capacious'

Without directly mentioning the constitutional restraint on standing imposed by the case or controversy requirement under Article III of the Constitution, Justice Sotomayor stated the question as "whether an insurer with financial responsibility for a bankruptcy claim is a 'party in interest' under" Section 1109(b).

The section provides that "[a] party in interest . . . may appear and be heard on any issue in a case under this chapter." The section goes on to say that parties in interest include "the debtor, the trustee, a creditors' committee, an equity security holders' committee, a creditor, an equity security holder, or any indenture trustee."

Parsing the statute, Justice Sotomayor said that the "text is capacious." She found a "common thread [that] the seven listed parties . . . may be directly affected by a reorganization plan." She cited the Court's own precedent for saying "that Congress uses the phrase 'party in interest' in bankruptcy provisions when it intends the provision to apply 'broadly.' " *Hartford Underwriters Ins. Co.* v. *Union Planters Bank, N. A.*, 530 U. S. 1, 7 (2000). Consulting a dictionary, she concluded that "parties in interest" refers "to entities that are potentially concerned with or affected by a proceeding."

Justice Sotomayor girded her broad reading of "party in interest" by reference to "historical context and purpose." Historically, she noted how adoption of the Bankruptcy Code in 1978 "moved from an exclusive list to the general and capacious term 'party in interest,' accompanied by a nonexhaustive list of parties in interest."

In terms of purpose, the justice said, "Broad participation promotes a fair and equitable reorganization process."

Alleged Collusion Gave Rise to Standing

Applying general principles to the facts of the case, Justice Sotomayor noted how the insurer had alleged collusion between the debtor and asbestos claimants by including no antifraud

provisions in the plan to protect the insurer. The allusion to alleged collusion led immediately to a finding of standing, when she said,

> An insurer with financial responsibility for bankruptcy claims can be directly and adversely affected by the reorganization proceedings in these and many other ways, making it a "party in interest" in those proceedings.

Note the reference to "directly and adversely," terms that are used in defining standing under Article III of the Constitution. The reference means that Justice Sotomayor was anchoring the notion of standing under Section 1109(b) to traditional concepts of constitutional standing.

Critique of 'Insurance Neutral'

Justice Sotomayor devoted the remainder of her 15-page opinion to a refutation of the Fourth Circuit's analysis finding no standing to challenge the plan. "Conceptually," she said,

> [T]he insurance neutrality doctrine conflates the merits of an objection with the threshold party in interest inquiry. The §1109(b) inquiry asks whether the reorganization proceedings might affect a prospective party, not how a particular reorganization plan actually affects that party.

Justice Sotomayor explained that insurance neutrality is "too limited in scope" and "zooms in on the insurer's prepetition obligations and policy rights. That wrongly ignores all the other ways in which bankruptcy proceedings and reorganization plans can alter and impose obligations on insurers."

Observing that insurance neutrality does not coincide with lack of standing, Justice Sotomayor might be understood as not telling the Fourth Circuit to reverse on the merits following remand, when she said,

> Whether and how the particular proposed Plan here affects [the insurer's] prepetition and postpetition obligations and exposure is not the question. The fact that [the insurer's] financial exposure may be directly and adversely affected by a plan is sufficient to give [the insurer] . . . a right to voice its objections in reorganization proceedings.

The Narrow Opinion

Section 1109 applies only in chapter 11. The section does not generally confer standing on shareholders or debtors in chapter 7, for example. Justice Sotomayor concluded her opinion by saying that "the Court today does not opine on the outer bounds of §1109." However, she quoted

the *Collier* treatise, saying that "a party in interest is 'not intended to include literally every conceivable entity that may be involved in or affected by the chapter 11 proceedings.'"

Despite the paucity of *dicta* prescribing rules for other cases, the opinion is not silent. Just before reversing and remanding, Justice Sotomayor dropped a quote with the words "truly peripheral" that will be used in the future to define when a party's interest is insufficient to confer standing.

Justice Sotomayor said, "There may be difficult cases that require courts to evaluate whether truly peripheral parties have a sufficiently direct interest. This case is not one of them."

Judges in the future will tell us what "truly peripheral" means. Some courts might question whether there is standing in a case where the interest is more than "peripheral." Nonetheless, *dicta* from the Supreme Court is highly persuasive, to say the least.

Observations

The opinion is narrow. It does not define the outer limits of standing; it does not deal with chapters 7, 12 and 13, and it does not explicitly say whether the more exacting "person aggrieved" standard for appellate standing in some circuits survived adoption of the Bankruptcy Code.

A "person aggrieved" is typically defined as a party who is directly and adversely affected pecuniarily. Without saying so directly, the opinion seems to replace "person aggrieved" for appellate standing with a less exacting standard.

Perhaps Section 1109(b) can be seen as presumptively bestowing standing on the enumerated parties, because Congress cannot grant standing broader than Article III permits.

The opinion does not tell us whether stockholders, for instance, will always have standing in chapter 11. Can the presumption be overcome if the bankruptcy court conducts a hearing and decides that the debtor is hopelessly insolvent and that shareholders lack standing?

By saying that "truly peripheral parties" can lack standing, is Justice Sotomayor telling us that Section 1109(b) would be unconstitutional as applied if a peripheral party was granted standing?

The opinion does seem to open the door to conferring standing for more wide-ranging appellate attacks on confirmation and other orders of the bankruptcy court. The opinion may enable more appeals to survive motions to dismiss. Often, though, appellate courts will have an easier time ruling on the merits than deciding nettlesome issues about standing.

Because standing is jurisdictional, appellate courts must address the question before tackling the merits. The opinion provides appellate courts with more leeway to find standing and reach the merits.

The opinion is *Truck Ins. Exch. v. Kaiser Gypsum Co.*, 22-1079 (Sup. Ct. June 6, 2024).

Saying that the constitutional infirmity was "small" and "short-lived," the majority decided that prospective relief was enough because Congress subsequently enacted a law mandating uniformity in the future with regard to fees for U.S. Trustees and Bankruptcy Administrators.

No Refunds for Overpayment of Unconstitutional U.S. Trustee Fees, Supreme Court Rules

Differing with all four circuits that had held to the contrary, the Supreme Court ruled in a 6/3 decision on June 14 that chapter 11 debtors in 48 states who paid $326 million in unconstitutionally higher U.S. Trustee fees are not entitled to refunds.

The Supreme Court decided two years ago that the 2018 increase in U.S. Trustee fees paid by chapter 11 debtors was unconstitutional because it was not immediately applicable in the two states with Bankruptcy Administrators rather than U.S. Trustees. *Siegel v. Fitzgerald*, 142 S. Ct. 1770 (Sup. Ct. June 6, 2022). *Siegel* explicitly left open the question of whether debtors who had paid too much were entitled to refunds. To read ABI's report, click here.

Justice Ketanji Brown Jackson wrote the opinion of the Court nixing the idea of refunds. The majority held that "prospective parity" was a sufficient remedy, because Congress had amended the statute in 2020 to ensure that fees would always be uniform in the future. Justice Neil M. Gorsuch penned a dissent joined by Justices Clarence Thomas and Amy Coney Barrett.

The Constitutional Violation in *Siegel*

The fees paid by chapter 11 debtors to the U.S. Trustee program increased in 2018, but the increase did not become effective for 10 months in the two states that have Bankruptcy Administrators rather than U.S. Trustees. In U.S. Trustee districts, the increase applied to pending cases, but the increase did not apply to pending cases in Bankruptcy Administrator districts. The circuits were split 2/2 on whether the increase violated the uniformity aspect of the Bankruptcy Clause of the U.S. Constitution.

Unanimously, the Supreme Court resolved the split in *Siegel* by finding a violation of the Bankruptcy Clause.

Before *Siegel* came to the Supreme Court, the Fourth Circuit had not reached the question of remedy because the appeals court had found no constitutional violation. Reversing and leaving

open the question of remedy, the Court in *Siegel* remanded for the appeals court to consider the question of refunds.

Hammons Fall on Remand

Before *Siegel* came to the Supreme Court, the Tenth Circuit had ruled in *Hammons Fall* that the disparate fee increase was unconstitutional and called for a refund. Having lost in the circuit, the government had filed a petition for *certiorari* in *Hammons Fall*. One year ago, the Supreme Court granted the *certiorari* petition, vacated the judgment and "remanded for further consideration in light of *Siegel*."

On remand in the Tenth Circuit, the government strenuously argued that the debtor was not entitled to a refund, because Congress had already supplied prospective relief by a technical amendment in 2020 that mandates fee uniformity going forward in U.S. Trustee and Bankruptcy Administrator districts.

Last August, the Tenth Circuit "reinstate[d] our original opinion," which required the government to pay a refund based on what the debtor would have paid were it in a Bankruptcy Administrator district. The government filed another petition for *certiorari*, which the Supreme Court granted in late September. The Court heard oral argument on January 9. As we said in this space after argument, the justices "who spoke seemed skeptical about the idea that the remedy for a due process violation requires refunds to those who paid too much."

'Small' Violations Don't Merit a Refund

Justice Jackson carefully laid out the procedural history before turning to the merits.

"Across remedial contexts," Justice Jackson cited the Court's precedent to say that "'the nature of the violation determines the scope of the remedy.'" *Swann v. Charlotte-Mecklenburg Bd. of Ed.*, 402 U.S. 1, 16 (1971). Citing other precedent, she said that the Court tries to limit the solution to the problem when there is a constitutional flaw in a statute. Precedent therefore called for her to "bear down upon the particulars of the constitutional violation we identified in *Siegel*."

Referring to the constitutional violation, Justice Jackson said that the flaw was in the lack of uniformity, not in higher fees. She then said that "the fee disparity at issue here was short lived" and "small."

The disparity was "small," Justice Jackson said, because lower fees were paid in only 2% of chapter 11 cases and that "98% of the relevant class of debtors still paid uniform fees." She quickly drew the conclusion that "Congress likely would not have intended relief that is impractical or unworkable." Instead, she said that "Congress would have wanted prospective parity, not a refund or retrospective raising of fees."

Furthermore, Justice Jackson said that requiring refunds would cause "extreme disruption" and would "would significantly undermine Congress's goal of keeping the U.S. Trustee Program self-funded." She added that refunds would cost the government "approximately $326 million." In short, refunds "would transform a program Congress designed to be self-funding into an enormous bill for taxpayers."

Delving further into the facts, Justice Jackson cited the government for saying that 85% of the chapter 11 cases eligible for refunds had already been closed. Consequently, she said that the debtor offered "no meaningful path to reducing the small existing disparity through refunds."

In sum, Justice Jackson said that "Congress would have wanted prospective parity, and that remedy is sufficient to address the small, short-lived disparity caused by the constitutional violation we identified in *Siegel*."

Justice Jackson devoted the last four pages of her opinion to refuting the dissenters. Of perhaps principal significance, she answered the dissenters' argument that refunds were required in view of the Court's awards of refunds in tax cases. Analyzing the tax cases, she concluded that the debtor is "not entitled to relief under them."

Justice Jackson reversed and remanded, holding that Congress' requirement of uniform fees going forward "cures the constitutional violation, and due process does not require another result."

The Dissent

Overall, Justice Gorsuch seemed concerned that the precedent being set by the bankruptcy opinion would deprive plaintiffs of remedies in other cases with constitutional violations. In the first paragraph of dissent, he said, "What's a constitutional wrong worth these days? The Court's answer today seems to be: not much."

Seeing the majority as having departed from precedent, Justice Gorsuch said,

> Never mind that a refund is the traditional remedy for unlawfully imposed fees . . . . As the majority sees it, supplying meaningful relief is simply not worth the effort. Respectfully, that alien approach to remedies has no place in our jurisprudence.

Failing to see the fee disparity as "small," Justice Gorsuch noted that the debtor had paid $2.5 million in unconstitutionally excessive fees. He said that the Court's "longstanding precedent should make short work of this case" and that "[t]raditional remedial principles" require monetary relief. For him, "the majority's *prospective* remedy for a *past* injury is no remedy at all." [Emphasis in original.]

Apart from traditional remedies given for constitutional violations, Justice Gorsuch said that the "this Court's due process precedents would demand the same result." He disputed the majority's conclusion that "our due process precedents are limited to the tax context."

Justice Gorsuch said that he "struggle[d] to understand why today the majority so readily dismisses any remedy in this case . . . . One possibility is that the majority views Bankruptcy Clause violations as less worthy of relief than other constitutional violations."

The "other possibility," Justice Gorsuch said, was the majority's belief that "supplying relief isn't worth the trouble because the constitutional violation at issue here was, as the majority puts it, "'short-lived and small.'" How could it be "small," he said, "when it cost [the debtor] $2.5 million and, as the majority itself emphasizes, cost others millions more?"

"Respectfully" dissenting, Justice Gorsuch ended his opinion by considering "what [the majority's] kind of thinking could mean for those seeking retrospective relief for other constitutional violations." He could imagine "today's decision receiving a warm welcome from those who seek to engage in only a dash of discrimination or only a brief denial of some other constitutionally protected right."

"The rest of us can only hope that the Court corrects its mistake before it metastasizes too far beyond the bankruptcy context," Justice Gorsuch said in the last sentence of his dissent.

Observation

The opinion has implications for every debtor that was in chapter 11 when the U.S. Trustee fees increased. There is a class action pending in the Court of Federal Claims in Washington, D.C., aiming to recover refunds for debtors nationwide who paid too much. *See Acadiana Management Group LLC v. U.S.*, 19-496 (Ct. Cl.). The plaintiff in the class action seems to be facing an uphill fight after the Supreme Court's decision.

The plaintiff in *Acadiana* is not giving up, however. "We are accepting Justice Gorsuch's invitation in footnotes 4 and 9 of his dissent to continue to litigate the class action," Bradley Drell told ABI.

In footnote nine, Justice Gorsuch said, "Given the weight the majority places on [the debtor's] inability to recover for all affected debtors, it's far from clear what the impact of today's decision is on [the *Acadiana* class] action." Mr. Drell, from Gold, Weems, Bruser, Sues & Rundell in Alexandria, La., is counsel for the plaintiff in *Acadiana*.

The opinion is *Office of the U.S. Trustee v. John Q. Hammons Fall 2006 LLC*, 22-1238 (Sup. Ct. June 14, 2024).

A Supreme Court nonbankruptcy decision means there is no right to a jury trial in the claims-allowance process in bankruptcy.

Supreme Court's *Jarkesy* Opinion Clarifies *Granfinanciera* on Jury Trial Rights

At the end of the term, the Supreme Court decided a nonbankruptcy case that puts to rest several bankruptcy questions arising in the wake of *Northern Pipeline*, *Granfinanciera* and *Stern v. Marshall*.

In this writer's view, *SEC v. Jarkesy*, 144 S. Ct. 2117, 219 L. Ed. 2d 650 (June 27, 2024), tells us definitively that a defendant in a fraudulent transfer suit brought under Section 548 is entitled to a jury trial in district court. Of perhaps greater significance, there is no right to a jury trial or final adjudication in district court in claims allowance, even if the creditor were entitled to a jury trial had there been no bankruptcy.

Although fair minds might differ, this writer also reads *Jarkesy* to mean that the bankruptcy court may impose sanctions for violations of the discharge injunction and the automatic stay as long as the sanctions are civil, not criminal.

Dodd Frank and *Jarkesy*

In the Dodd-Frank Wall Street Reform and Consumer Protection Act in 2010, Congress for the first time gave the Securities and Exchange Commission the power in administrative proceedings before an administrative law judge (ALJ) to impose penalties for violations of securities law.

Invoking Dodd Frank and proceeding before an ALJ, the SEC imposed a $300,000 civil penalty and other sanctions on an individual for violations of antifraud provisions of securities laws. The Fifth Circuit reversed in a divided opinion, invoking *Granfinanciera, S. A. v. Nordberg*, 492 U. S. 33 (1989). Because the enforcement action was not conducted in federal district court, the appeals court found a violation of Seventh Amendment jury trial rights.

The Supreme Court granted *certiorari* and affirmed on June 27 in a 6/3 opinion by Chief Justice John G. Roberts, Jr. Justice Sonia Sotomayor penned a dissent joined by Justices Elena Kagan and Ketanji Brown Jackson. Justice Neil M. Gorsuch wrote a concurring opinion joined by Justice Clarence Thomas. The three opinions totaled 98 pages.

Granfinanciera Clarified

For the majority, the Chief Justice ruled that the so-called public rights exception to the Seventh Amendment did not apply for reasons explicated in *Granfinanciera*. But first, he explained why there were Seventh Amendment rights.

Citing *Granfinanciera*, the Chief Justice said that the "Seventh Amendment extends to a particular statutory claim if the claim is 'legal in nature.'" Furthermore, it is "immaterial" whether the claim is statutory.

Because some claims are both equitable and legal in nature, the Chief Justice said that "the remedy is all but dispositive." Given that the SEC's civil penalties were to punish and deter, not compensate, he concluded that the remedy was at common law and conferred jury trial rights.

Even though jury trial rights were in play, the government argued that the public rights exception applied and deprived the offender of Seventh Amendment rights.

Citing *Granfinancera*, *Northern Pipeline Constr. Co. v. Marathon Pipe Line Co*., 458 U. S. 50 (1982), and *Stern v. Marshall*, 564 U. S. 462 (2011), the Chief Justice said that the Court has "repeatedly explained that matters concerning private rights may not be removed from Article III courts." He went on to say that "the matter presumptively concerns private rights, and adjudication by an Article III court is mandatory" if the "suit is in the nature of an action at common law."

In an understatement reflecting the Court's conflicting jurisprudence, the Chief Justice conceded that the "Court 'has not "definitively explained" the distinction between public and private rights,' and we do not claim to do so today."

Granfinanciera held the key to the decision because it was a case in which Congress purported to take away jury trial rights by installing a claim for fraudulent transfer in Article I bankruptcy courts even though "fraudulent conveyance [actions] were well known at common law," the Chief Justice said. Digging deeper into *Granfinanciera*, he said that fraudulent transfer actions, unlike the claims-allowance process, "were not 'closely intertwined' with the bankruptcy process."

Saying that "*Granfinanciera* effectively decides this case," the Chief Justice affirmed the Fifth Circuit because a "defendant facing a fraud suit has the right to be tried by a jury of his peers before a neutral adjudicator."

Observations

The opinion of the Court effectively says that the bankruptcy claims-allowance process implicates public rights because the rights and recoveries of other creditors are affected by the

outcome of claim objections. *Jarkesy* eliminates any arguments that might remain about the right to a jury in deciding the validity or amount of claims.

The Court's discussion of *Granfinanciera* also eliminates any idea that fraudulent transfer suits could be litigated to finality in bankruptcy court if the defendant has neither filed a claim nor waived an objection to the jurisdiction and power of the bankruptcy court.

When it comes to the right to a jury trial for violations of the automatic stay or the discharge injunction, the implications of *Jarkesy* are more opaque. In *Taggart v. Lorenzen*, 139 S. Ct. 1795, 1799 (2019), the Court held unanimously that the bankruptcy court "may impose civil contempt sanctions when there is no objectively reasonable basis for concluding that the creditor's conduct might be lawful under the discharge order." However, *Taggart* does not deal with jury trial rights.

Citing *Tull v. United States*, 481 U. S. 412, 422 (1987), the Chief Justice indicated in *Jarkesy* that public rights are implicated when the relief is "solely to 'restore the status quo.'" By that token, civil sanctions for violations of discharge or the automatic stay seem to involve the restoration of the status quo, disabling a violator from claiming the right to a jury trial.

Some might argue that the invocation of public rights should not apply to the imposition of punitive damages under Section 362(k) for the willful violation of a stay protecting an individual debtor. This writer believes that the more draconian sanctions in Section 362(k) were imposed by Congress to ward off creditors' temptations to pursue individuals who, given their bankrupt status, lack the wherewithal to act against violators.

Whatever the sanctions may be for violation of the automatic stay, they are "closely intertwined" with the bankruptcy process because the automatic stay and discharge are the principal remedies afforded debtors under the Bankruptcy Code. Being "closely intertwined" with the enforcement of debtors' remedies, sanctions seem to this writer to fall within the public rights exception.

The opinion is *SEC v. Jarkesy*, 144 S. Ct. 2117, 219 L. Ed. 2d 650 (June 27, 2024).

The unanimous decision on March 19 by Justice Gorsuch contains language that could be used on both sides of the argument about the validity of equitable mootness.

Supreme Court Rules on Mootness, but Not Equitable Mootness

In the world of bankruptcy, the validity of the doctrine of equitable mootness is an issue that the Supreme Court has been ducking. On March 19, the Court handed down a non-bankruptcy decision on constitutional mootness. Although the unanimous decision by Justice Neil M. Gorsuch includes quotations that could be employed on both sides of the argument, the opinion doesn't give a solid clue on how the justices would rule on the validity of equitable mootness.

Equitable mootness is not a product of Article III's requirement that there must be a case or controversy. When equitable mootness is invoked to dismiss an appeal, there typically is an extant case or controversy.

Not based on the Constitution, equitable mootness is a prudential doctrine — that is, something invented by courts. Most often, equitable mootness is invoked to dismiss an appeal from an order confirming a chapter 11 plan.

Although the circuits are not uniform in their application of the doctrine, three factors usually resulting in a finding of equitable mootness are the lack of a stay pending appeal, substantial consummation of the plan and an adverse effect on parties not before the court on appeal.

The 'No-Fly' List

The individual in the case before the Supreme Court was born in Eritrea and lived in Sudan before his family moved to the U.S., where he became a citizen. As an adult, he traveled to Sudan on business.

While in Sudan, he was told by U.S. officials that he was on the no-fly list and could not return to the U.S. While still abroad some years later, he sued the U.S. government, claiming a due process violation for having no notice about the basis for his classification and no method to secure redress.

Soon after the suit was filed, the government removed him from the no-fly list and then moved to dismiss the suit as moot. In support of dismissal, the government said that he would not be placed on the no-fly list in the future "based on currently available information."

The district court twice dismissed the case as moot, but the Ninth Circuit twice reversed, not seeing the case as moot. To resolve a circuit split, the Supreme Court granted the government's petition for *certiorari*.

The Merits

When there is a case or controversy as Article III requires, Justice Gorsuch cited Supreme Court precedent for saying that federal courts have a "virtually unflagging obligation" to hear the case. "But," he said, "events in the world overtake those in the courtroom, [when] a complaining party manages to secure outside of litigation all the relief he might have won in it."

"When that happens," Justice Gorsuch said, "a federal court must dismiss the case as moot." He added, "federal judges are not counselors or academics; they are not free to take up hypothetical questions that pique a party's curiosity or their own."

Of possible application to the bankruptcy world, Justice Gorsuch said:

> The limited authority vested in federal courts to decide cases and controversies means that they may no more pronounce on past actions that do not have any "continuing effect" in the world than they may shirk decision on those that do.

Justice Gorsuch went on to say:

> [O]ur precedents hold [that] a defendant's "'voluntary cessation of a challenged practice'" will moot a case only if the defendant can show that the practice cannot "'reasonably be expected to recur.'" [Citations omitted.]

Also of possible application to equitable mootness, Justice Gorsuch said, "a defendant might suspend its challenged conduct after being sued, win dismissal, and later pick up where it left off," were it easier to show mootness.

Affirming the circuit court, Justice Gorsuch decided that the case was not moot because the government's statement only referred to reliance on actions taken in the past. "[N]one of that," he said, "speaks to whether the government might relist him if he does the same or similar things in the future."

"In all cases," Justice Gorsuch said, "it is the defendant's 'burden to establish' that it cannot reasonably be expected to resume its challenged conduct."

Observations

The opinion by Justice Gorsuch is founded on the notion that a case is not moot if the defendant can take the challenged action again in the future. In the bankruptcy sphere, cases found to be equitably moot usually deal with legal questions that are likely to recur in other cases.

Perhaps fatally so, the Supreme Court's decision is distinguishable because the same creditor in a bankruptcy case would not be raising the same question in the future against the same debtor.

The question is this: Does the Supreme Court's focus on the ability of someone to raise the same issue suggest that the high court would frown on equitable mootness regarding a question that's endemic in bankruptcy cases?

The opinion is *F.B.I v. Fikre*, 22-1178 (Sup. Ct. March 19, 2024).

The Supreme Court again retreated from the idea that there's a strong federal policy in favor of arbitration.

Supreme Court Ruled Again on Arbitration, but Not (Yet) in Bankruptcy Cases

When the Supreme Court writes an opinion on arbitration, we pay attention because the high court will decide, one of these days, whether or when arbitration agreements are enforceable in bankruptcy.

Will the Supreme Court say that arbitration is always enforceable? (Unlikely.) Or, will arbitration never be enforceable in bankruptcy? (Also unlikely.)

What's the dividing line? Will arbitration be enforceable if the dispute is noncore but unenforceable if it's core?

Once there's a final order, bankruptcy disputes are appealable. Will the lack of appeal from an arbitration award factor into the question about enforceability of arbitration agreements in bankruptcy cases?

And finally, will arbitration agreements be enforceable against a debtor in possession but not against a trustee, because a trustee will not have been a party to the arbitration agreement?

If anything, the latest arbitration decision from the Supreme Court on April 12 implies a broader interpretation of exceptions to arbitration.

The Employer Was a Commercial Bakery

The case involved one of the country's largest commercial bakeries. Two individuals were local distributors for the bakery, which had plants in 19 states and distribution throughout the country.

The bakery delivered baked goods to a warehouse, where they were picked up by the distributors and sold to retailers in the state. In a purported class action, the distributors sued the bakery in federal district court for violations of federal labor laws.

The distributorship agreement had a clause saying that "any claim" must be arbitrated. The bakery filed a motion to compel arbitration. The outcome turned on an exception to arbitration contained in the Federal Arbitration Act, 9 U.S.C. § 1. The section says that "nothing herein

contained shall apply to contracts of employment of seamen, railroad employees, *or any other class of workers engaged in foreign or interstate commerce.*" [Emphasis added.]

The district court granted the motion to compel arbitration and was upheld in the Second Circuit, over dissent. According to the unanimous, nine-page opinion by Chief Justice John G. Roberts, Jr., the majority on the Second Circuit reasoned that the bakery was in the baking business, not in the transportation business, making the exception inapplicable.

The Supreme Court granted *certiorari* to resolve a split with the First Circuit.

Focus on the Employee, Not the Employer

Justice Roberts surveyed the Supreme Court's more recent authorities on arbitration, noting how the Court had ruled in 2001 that the exception in Section 1 "is limited to transportation workers." *Circuit City Stores Inc. v. Adams*, 532 U.S. 105 (2001). Later, the Court said that the exception applies to workers who are "engaged" in commerce and does not turn on the industry of the employer.

The relevant question, Justice Roberts said, asks what the employee does for the employer, not what the employer does. Thus, he said, "A transportation worker need not work in the transportation industry to fall within the exemption from the FAA provided by § 1 of the Act."

The Chief Justice ruled that the Second Circuit "erred in compelling arbitration on the basis that petitioners work in the bakery industry." He vacated the judgment of the Second Circuit and remanded for further proceedings, expressing "no opinion on any alternative grounds in favor of arbitration raised below, including that petitioners are not transportation workers . . . ."

Observation

The opinion is another example showing the Supreme Court's retreat from the idea that there is a strong federal policy in favor of arbitration.

As Justice Elena Kagan said in May 2022, "The policy is to make 'arbitration agreements as enforceable as other contracts, but not more so.' *Prima Paint Corp. v. Flood & Conklin Mfg. Co.*, 388 U.S. 395, 404, n. 12 (1967)." *Morgan v. Sundance Inc.*, 596 U.S. 411, 42 S. Ct. 1708, 1713 (Sup. Ct. May 23, 2022). To read ABI's report, click here.

In bankruptcy, keep in mind that contracts are not enforceable in all respects. Similarly, forum-selection clauses largely yield to the Bankruptcy Code.

If arbitration agreements are enforceable like any other contract in bankruptcy, perhaps arbitration clauses are only enforceable when a debtor is suing someone who has not filed a proof

of claim or otherwise submitted to jurisdiction. Perhaps courts will say that an arbitration agreement by a debtor does not bind a trustee because the trustee did not sign the arbitration agreement.

The opinion is *Bissonnette v. LePage Bakeries Park St. LLC*, 23-51 (Sup. Ct. April 1, 2024).

A per curiam decision from the Seventh Circuit raises the question of whether Truck Insurance overruled 'person aggrieved' sub silentio.

Seventh Circuit Dismisses Based on 'Person Aggrieved' Without Citing *Truck Insurance*

Employing the "person aggrieved" standard for appellate standing, an opinion from the Seventh Circuit could be cited for the principle that an owner of a limited liability corporation has no standing to appeal the LLC's conversion from chapter 11 to chapter 7.

The Seventh Circuit's nonprecedential opinion raises the question of whether the Supreme Court's *Truck Insurance* decision last term silently overruled "person aggrieved."

Companion Chapter 11 Cases

An individual owned an LLC. Evidently, the individual and the LLC were insolvent, and both filed chapter 11 petitions. The owner and the LLC were represented by the same counsel, and the cases were substantively administered.

A creditor filed a motion to convert both cases to chapter 7, followed by motions for summary judgment in both cases. The LLC and the owner both opposed summary judgment in their own cases.

The *per curiam* opinion from the Seventh Circuit on October 23 says that the owner did not join the LLC's opposition to summary judgment, nor did the owner file an opposition to summary judgment in the LLC's case.

The bankruptcy court converted the LLC's case to chapter 7. The owner appealed, but the district court dismissed the appeal for the owner's lack of standing. The owner appealed to the circuit.

'Person Aggrieved' Lives in the Seventh Circuit

Addressing the merits, the appeals court began by citing and quoting decisions from the Seventh Circuit in 2010 and 2006:

> "Bankruptcy standing is narrower than Article III standing"; only a person "aggrieved" by an order of the bankruptcy court can appeal it.

The panel said that the owner had standing under the "person aggrieved" standard only if he had objected to conversion of the LLC's case and was "affected pecuniarily" by conversion. Even if the owner had appeared and opposed conversion of the LLC's case, the panel said he "lack[ed] standing to appeal for the reason that the order did not pecuniarily affect him."

Citing and quoting a Seventh Circuit opinion from 1998, the panel said, " An order pecuniarily affects him only if it diminishes his property, increases his burdens, or impairs his rights." Once again quoting the 1998 decision, the panel went on to say, "This rule limits appeals to 'only those persons whose interests are directly affected by a bankruptcy order to appeal.'"

The owner contended that he was directly affected because he lost his interest in the LLC's assets. The panel said that "he is incorrect," because the LLC's "property, rights, and burdens are legally distinct from" the owner's. In short, "the conversion order had no direct pecuniary effect on him," the panel said.

Nonetheless, the owner might have retained an interest in the LLC had it reorganized in chapter 11. The panel dispensed with the argument by saying that the "liquidation of [the LLC's] assets in Chapter 7 did not diminish the value of [the owner's] interest in those assets — the company's insolvency already did that."

The panel affirmed dismissal of the appeal, saying that injuries must be "imminent" and not "conjectural" to confer standing. "[W]ithout a pecuniary loss from the conversion order itself, [the owner] lacked standing to appeal it."

Observations

The panel does not cite *Truck Insurance Exchange v. Kaiser Gypsum Co.*, 602 U.S. 268 (2024), the Supreme Court's pronouncement on June 6 about standing in bankruptcy cases. *Truck Insurance* involved Section 1109(b), which gives standing in a chapter 11 case to a "party in interest, including the debtor, the trustee, a creditors' committee, an equity security holders' committee, a creditor, an *equity security holder*, or any indenture trustee." [Emphasis added.]

The unanimous Court in *Truck Insurance* said that the "text is capacious" and that "parties in interest" refers "to entities that are potentially concerned with or affected by a proceeding." *Id.*, 602 U.S. at 271, 276. To read ABI's report on *Truck Insurance*, click here.

Truck Insurance would mean that the owner indeed had standing in the bankruptcy court to oppose conversion of the LLC's case because he was the equivalent of an equity security holder. It is not clear whether *Truck Insurance* means that parties with standing in bankruptcy court always have standing to appeal anything that happens in a chapter 11 case. It is also unclear whether *Truck*

Insurance effectively overrules "person aggrieved," because the Court did not mention "person aggrieved" even once.

This writer believes that *Truck Insurance* should be read as having overruled "person aggrieved," *sub silentio*.

The insurance company's financial rights in *Truck Insurance* were not impaired by the debtor's chapter 11 plan, but the insurance company wanted the plan to be more favorable to it. If the "person aggrieved" standard were alive and well, the Supreme Court would not have heard the case.

In the comment box below, we invite readers to opine on whether *Truck Insurance* overrules "person aggrieved."

The opinion is *Young v. Lake County Treasurer*, 24-1415 (7th Cir. Oct. 23, 2024).

Did the notion of 'prudential standing' in bankruptcy cases survive Truck Insurance?

Constitutional and Prudential Standing Survived *Truck Insurance*, Judge Kinsella Says

The Supreme Court held last term in *Truck Insurance* that a broadly defined party in interest under Section 1109(b) has the right to appear and be heard in a chapter 11 case. Bankruptcy Judge Wendy A. Kinsella of Syracuse, N.Y., interpreted the decision to mean that a Section 1109(b) party in interest will not have standing in a chapter 11 case without also satisfying the demands of prudential standing and Article III constitutional standing.

Like *Truck Insurance*, the case before Judge Kinsella involved insurance companies. Specifically, the debtor was a Catholic diocese dealing with sexual abuse claims in a chapter 11 reorganization.

With a plan on the table, insurers sought discovery, but the debtor contended that the insurance companies lacked standing because they have "not acknowledged or been found to be financially responsible for the survivors' claims," Judge Kinsella said in her December 9 opinion.

According to Judge Kinsella, the plan proponents contended that the insurers had no standing to undertake discovery without demonstrating that they would "suffer a concrete and particularized injury in fact that is actual and imminent, not speculative, as a result of plan confirmation." The plan proponents also took the position that the insurers "cannot object to confirmation on the ground that a plan infringes upon the rights of another non-objecting party."

Of course, the outcome would turn mostly, if not entirely, on *Truck Insurance Exchange v. Kaiser Gypsum Company, Inc.*, 602 U.S. 268 (June 6, 2024). To read ABI's report, click here.

Standing Under *Truck Insurance*

To rule on the insurers' standing to take discovery, Judge Kinsella first analyzed whether the insurance companies were "parties in interest" under the Supreme Court's interpretation of Section 1109(b) in *Truck Insurance*. The subsection gives standing in a chapter 11 case to a "party in interest, including the debtor, the trustee, a creditors' committee, an equity security holders' committee, a creditor, an equity security holder, or any indenture trustee."

Quoting the Supreme Court, Judge Kinsella said, "The inquiry of whether an entity is a party in interest is 'whether the reorganization proceedings might affect a prospective party, not how a particular reorganization plan actually affects that party.'" *Id.* at 283.

Although the insurers had not admitted liability, Judge Kinsella pointed out that the debtor had asserted that the insurance companies had financial responsibility, had filed an adversary proceeding claiming breach of contract, and had banked on assigning the insurance policies to the trust to be created under the plan.

Finding "that liability does not need to be acknowledged or adjudicated before the teachings of *Truck* apply," Judge Kinsella held that *Truck Insurance* was "directly on point [and that the insurers] are parties in interest in this case under § 1109(b) and *Truck*."

Constitutional and Prudential Standing Survived

Finding the insurers to be parties in interest "does not end the analysis," Judge Kinsella said. She went on to say,

> [N]either § 1109(b) nor the *Truck* holding satisfies or replaces constitutional and prudential standing requirements. In bankruptcy court, a party must satisfy (1) Article III Constitutional standing; (2) federal court prudential standing; and (3) the party in interest standing under § 1109(b).

The failure of the Supreme Court to discuss constitutional or prudential standing was not "an implicit rejection of these requirements," Judge Kinsella said. Believing that *stare decisis* applied because *Truck Insurance* was "void of any reference to Article III and prudential standing," the judge found herself required to "follow the existing Second Circuit precedent which not only requires party in interest standing, but constitutional and prudential standing as well."

Citing bankruptcy court decisions predating *Truck Insurance*, Judge Kinsella said that the Court's new pronouncement did "not overturn well established precedent recognizing that while '[a] party in interest may object to confirmation of a plan, 11 U.S.C. § 1128(b), it cannot challenge portions of the plan that do not affect its direct interests.'"

Acknowledging that she was citing precedent that "predates *Truck*," Judge Kinsella said that the authorities were "consistent with the Supreme Court's stated intention to allow the [insurers] a full and fair opportunity to be heard without allowing them to derail the confirmation process."

Constitutional and Prudential Standing Sometimes Satisfied

Having established that the concepts of constitutional and prudential standing still apply, Judge Kinsella turned to the question of whether the insurers met those standards.

Constitutional standing, or Article III standing, Judge Kinsella said, is "very generous" and requires only a "trifle" of injury. Generally, she said, a party in interest will also have constitutional standing.

In the diocese case, the insurers were alleging that the plan would alter their rights in "many specific ways." Finding "potential injuries," Judge Kinsella decided that the insurers had "constitutional standing to obtain *certain discovery* in connection with the Plan." [Emphasis added.]

Addressing prudential standing, "a judicially crafted doctrine," Judge Kinsella cited courts in the Second Circuit for having said "that '[p]rudential limitations on standing are especially important in bankruptcy proceedings which often involve numerous parties who may seek to assert the rights of third parties for their own benefit.'"

On prudential standing, the debtor and the insurers differed. The insurers took the position that they were entitled to discovery on all aspects of the plan, while the debtor contended that the insurers were not entitled to discovery that would only involve the survivors' treatment under the plan.

Generally, Judge Kinsella said, "most" of the insurers' discovery requests were relevant to confirmation issues that "may directly impact them." On the other hand, she said that the insurers had no standing to take discovery "where only the third-party survivors' rights are implicated."

Applying Rules 26 and 34 alongside the principles laid out in her opinion, Judge Kinsella granted or denied discovery requests in the final 48 pages of her opinion.

Observations

Interpreting *Truck Insurance*, Judge Kinsella is on the right track. She is correct that the Court's unanimous opinion does not mention Article III or constitutional standing.

Standing is a jurisdictional requirement arising from Article III of the Constitution. Common law or even a statute cannot confer standing that would give rise to jurisdiction beyond Article III. Understanding that Section 1109(b) cannot confer standing more than the Constitution allows, this writer interprets *Truck Insurance* as having recognized a presumption of standing under Section 1109(b).

A presumption of standing makes good sense in chapter 11. With thousands of parties sometimes involved in one case, a presumption of standing obviates the possibility of arguments over standing repeatedly in the reorganization.

Like any other, a presumption of standing can be overcome. It stands to reason, therefore, that a party in interest might lack constitutional standing in particular circumstances, just like Judge Kinsella said.

There is a point in Judge Kinsella's opinion where reasonable parties may disagree. She found no standing for the insurers regarding issues that affect only abuse survivors.

Understandably, the insurers would wish to kill any plan the diocese might offer. It would therefore be in their interest to defeat the plan by showing that any feature is impermissible under Section 1129.

Officious intermeddling can be ethically obnoxious, but when interjection would foster a party's justifiable ends, perhaps the Constitution grants standing.

The survival of prudential standing has been in doubt, even before *Truck Insurance*. In *Lexmark Int'l, Inc. v. Static Control Components, Inc.*, 572 U.S. 118 (2014), the Supreme Court decried the use of "prudential standing" and more recently said that federal courts have a "virtually unflagging obligation" to exercise Article III jurisdiction. *See, e.g.*, *Colorado River Water Conservation Dist. v. U.S.*, 424 U.S. 800, 817 (1976); and *FBI v. Fikre*, 601 U.S. 234, 240 (March 19, 2024).

If the issue were to reach the Supreme Court, the justices might decide that prudential standing in bankruptcy cases is a dead letter.

One final point. *Truck Insurance* only dealt with the peculiarities of Section 1109(b) in chapter 11 cases. The concept of a presumption of standing may not apply in chapters 7, 12, 13 and 15.

The opinions are of the writer, not ABI.

The opinion is *In re Roman Catholic Diocese of Syracuse, New York*, 20-30663 (Bankr. N.D.N.Y. Dec. 9, 2024).

Fourth Circuit says there's nothing in the Bankruptcy Code requiring 'anti-fraud' provisions in a mass tort chapter 11 plan. The appeals court also holds that an 'asbestos' plan isn't filed in bad faith when the plan gives an insurer no more rights than the insurer has under its policy.

On Remand from the Supreme Court in *Truck Ins.*, Fourth Circuit Upholds Confirmation

On remand following the Supreme Court's reversal 11 months ago in *Truck Ins. Exch. v. Kaiser Gypsum Co.*, 602 U.S. 268 (Sup. Ct. June 6, 2024), the Fourth Circuit upheld confirmation of the debtor's chapter 11 plan dealing with asbestos claims.

The Supreme Court reversed last year, ruling that the insurer had standing to object to confirmation of the plan even though the plan was "insurance neutral."

On different issues arising on remand, the April 29 opinion by Circuit Judge G. Steven Agee holds that the plan was filed in good faith because it gave the insurer only the rights the insurer had under the existing insurance policy. Good faith does not require giving the insurer more rights than those already contained in the existing policy, even when other parties under the plan have more rights of defense than the insurer.

Among other things, the appeals court said that sending insured claims through the tort system rather than through the trust created by the plan was "not evidence of bad faith."

The Asbestos Plan

Facing 14,000 pending lawsuits, the corporate debtor proposed a chapter 11 plan under Section 524(g) to create a trust wiping away present and future asbestos claims. All asbestos claims were channeled to a trust.

The principal asset for the trust was the debtor's primary insurance policy, with a coverage limit of $500,000 per claim. The insurer was obliged by the policy to defend and indemnify the debtor, even if the claims were false or fraudulent. Defense costs were not counted against the policy limit for each claim, meaning that the policy was non-eroding. The policy had no maximum aggregate limit.

Asbestos claims under the plan were divided into two classes: (1) insured claims covered by the policy; and (2) uninsured claims not covered by the policy. Uninsured claims, of which there were few, were to be paid entirely by the trust.

Claims covered by insurance were to be litigated nominally against the debtor in the tort system, but subject to the coverage limit for each claim. The trust would pay a $5,000 deductible for each insured claim.

The claims covered by insurance remained subject to the insurer's prepetition coverage defenses. Thus, the insurer was liable for any claim that fell under the unmodified terms of the policy.

The trust was funded by the insurance policy, $49 million from the debtor's parent and a $1 million note issued by the debtor.

The uninsured claims were subject to anti-fraud provisions under the plan to protect the trust by requiring the claimants to provide disclosures designed to avoid fraud and duplicate claims. The plan had no anti-fraud provisions for insured claims.

Unsecured creditors were to be paid in full.

Asbestos claimants, the only class impaired by the plan, voted unanimously in favor of the plan. The only confirmation objection came from an insurer. The insurer was not entitled to vote because its unsecured claim would be paid in full. The insurer retained all its rights under the insurance policy.

Confirmation and Appeals

The insurer objected to confirmation, contending that the plan was not proposed in good faith and was not insurance neutral for lack of anti-fraud provisions covering insured claims. The bankruptcy court wrote an opinion recommending that the district court approve the plan, finding that it was insurance neutral and filed in good faith. The bankruptcy court also decided that the plan met all requirements for an asbestos plan under Section 524(g).

Because the plan was insurance neutral, the bankruptcy court concluded that the insurer was not a party in interest under Section 1109(b) and thus lacked standing to lodge an objection to the plan.

The district court confirmed the plan, adopting the bankruptcy court's findings *in toto* after *de novo* review. *In re Kaiser Gypsum Co.*, 16-31602, 2021 WL 3215102 (W.D.N.C. July 28, 2021).

On appeal, the Fourth Circuit affirmed. *Truck Insurance Exchange v. Kaiser Gypsum Co. (In re Kaiser Gypsum Co.)*, 60 F.4th 73 (4th Cir. Feb. 14, 2023), *cert. granted sub nom. Truck Ins. Exch. v. Kaiser Gypsum Co.*, No. 22-1079, 2023 WL 6780372 (Oct. 13, 2023). To read ABI's report on the Fourth Circuit affirmance, click here.

Finding the plan "insurance neutral," the Fourth Circuit believed that the insurance company had no standing in the bankruptcy court or on appeal to object to the merits of the plan pertaining to any aspects of the plan other than insurance neutrality. In a footnote, the appeals court said that the insurer had Article III, or constitutional, standing to challenge the finding of insurance neutrality.

The insurer filed a petition for *certiorari*, based on a split of circuits. The Court granted *certiorari* and heard argument in March 2024. The Supreme Court reversed on June 6, 2024.

For a unanimous Court, Justice Sonia Sotomayor explained why the insurer had standing even though the plan was insurance neutral:

> The fact that [the insurer's] financial exposure may be directly and adversely affected by a plan is sufficient to give [the insurer] . . . a right to voice its objections in reorganization proceedings.

Truck Ins. Exch., supra, 602 U.S. at 284. To read ABI's report on *Truck Insurance*, click here.

Dealing only with standing, the opinion was narrow and did not reach the merits regarding the insurer's plan objections. The Court reversed and remanded for further proceedings.

Good Faith

Reaching the merits for the first time on remand, Judge Agee said that the Fourth Circuit was confronted with two questions: (1) Was the plan proposed in good faith as required by Section 1129(a)(3), and (2) did the plan satisfy the four requirements for an asbestos plan under Section 524(g)?

On good faith, Judge Agee said that the Fourth Circuit has never declared what it means in the confirmation context. However, he said that the court "must consider the totality of the circumstances." The plan, he said, was found by the district court to be the product of arm's-length negotiations and comported "with the objectives of the Bankruptcy Code."

Judge Agee said that the "unchallenged" findings by the district court "satisfie[d] § 1129(a)(3)'s good faith requirement."

In derogation of the good faith findings, Judge Agee said that the insurer "bristles at the fact that insured asbestos claims — but not uninsured asbestos claims — are to be litigated in the tort system under the Plan." However, he said that "bankruptcy courts routinely allow claimants to pursue insured claims through the tort system, a fact that [the insurer] does not contest." Referring to the case at hand, he said that "the Debtors' refusal to add anti-fraud measures for the insured claims in the tort system, without more, does not signify bad faith."

"Simply put," Judge Agee said,

> the Debtors are merely utilizing the contractual insurance rights to which they are entitled. [The insurer's] dissatisfaction with this state of affairs does not give it a cognizable basis to rewrite the policy it freely entered under the guise of the Debtors' purported "bad faith."

In response to the insurer's contention that the tort system does not deal adequately with fraudulent claims, Judge Agee said, "The adversarial and discovery processes in state and federal courts are more than enough to protect [the insurer] from the fraudulent claims that it fears will occur." He added, "Unless and until [the insurer] provides concrete evidence to support its position, its concerns will remain purely speculative and thus cannot support its bad faith argument."

Stopping short of laying down a rule for all cases, Judge Agee said that "the necessity of [anti-fraud provisions] will inevitably vary on the facts of any given case." On the other hand, he said "there is nothing in the Bankruptcy Code that legally requires" anti-fraud provisions.

Judge Agee affirmed the district court's finding of good faith.

Section 524(g)

The final section of Judge Agee's opinion dealt with the issue of whether or not the plan satisfied the additional confirmation requirements for asbestos plans contained in Section 524(g).

Judge Agee conducted a detailed analysis of the plan and concluded that the plan complied with Section 524(g). Anyone confronting an asbestos plan should read the opinion in full text to understand how the debtor structured the plan to comply with Section 524(g).

Judge Agee's decision is a blueprint for drafting a mass tort plan in compliance with Section 524(g). He affirmed the judgment of the district court confirming the plan.

The Concurrence

Circuit Judge Arthur M. Quattlebaum, Jr., "joined the majority opinion" but wrote "separately to point out that [the insurer] has company in failing to point to evidence to support its position about good faith."

Judge Quattlebaum agreed that the district court's findings on good faith were not clear error. He said that the debtor had not given "much of a response" at oral argument to explain why the debtor "would not require or provide anti-fraud-related disclosures and authorizations to [the insurer]."

Judge Quattlebaum said that the information sought in the anti-fraud provisions was "so basic that any asbestos plaintiff would be required to provide it in discovery. So, I do not understand why [the debtor] would not agree to require claimants, at the outset, to provide the information [that the insurer] seeks."

Because the insurer "did not point to specific evidence of actual claimants committing fraud in this case," Judge Quattlebaum "concur[red] in the majority's decision."

The opinion is *Truck Insurance Exchange v. Kaiser Gypsum Co. Inc. (In re Kaiser Gypsum Co. Inc.)*, 21-1858 (4th Cir. April 29, 2025).

This Term

In an 8-1 opinion, the Supreme Court holds that the waiver of sovereign immunity under Section 106(a) does not extend to suits brought by a trustee under state law standing in the shoes of an actual creditor.

Supreme Court Holds: § 106(a) Doesn't Waive Sovereign Immunity for § 544(b) Suits

In an 8-1 decision written by Justice Ketanji Brown Jackson, the Supreme Court resolved a split of circuits by holding that Section 106(a) does not permit a bankruptcy trustee to sue the federal government for receipt of a fraudulent transfer under state law and Section 544(b)(1), because no actual creditor could sue the government outside of bankruptcy.

In her 19-page opinion for the Court on March 26, Justice Jackson saw the "actual creditor" requirement in Section 544(b)(1) as bringing sovereign immunity back into play as a defense for the Internal Revenue Service, even though Section 106(a) waives sovereign immunity for suits under Section 544.

The Fraudulent Transfer to the IRS

The case arose from an often-occurring fraudulent transfer to the Internal Revenue Service: A corporation paid $145,000 in federal income taxes owed by one of its owners. The corporation ended up in bankruptcy three years later. Because the transfer did not occur within two years of filing, the chapter 7 trustee could not sue under Section 548(a)(1)(B).

The 7 trustee therefore invoked Section 544(b)(1) to sue the IRS for receipt of a fraudulent transfer under Utah law. The section allows a trustee to "avoid any transfer of an interest of the debtor in property . . . that is voidable under applicable law by a creditor holding an [allowable] unsecured claim."

The government agreed there was an actual creditor and admitted the elements of a constructively fraudulent transfer. However, the government contended that sovereign immunity would have prevented an actual creditor from suing the IRS outside of bankruptcy, thus disabling the trustee from suing under Section 544(b)(1).

Responding, the trustee argued that the waiver of sovereign immunity as to Section 544 contained in Section 106(a) allowed suit based on a state-law claim. The subsection provides that

"sovereign immunity is abrogated as to a governmental unit to the extent set forth in" 59 sections of the Bankruptcy Code, including Section 544.

On cross motions for summary judgment, Bankruptcy Judge R. Kimball Mosier of Salt Lake City ruled in favor of the trustee and entered judgment for $145,000. *Miller v. United States (In re All Resort Group Inc.)*, 617 B.R. 375 (Bankr. D. Utah 2020). The district court affirmed. *See U.S. v. Miller*, 20-00248, 2021 BL 340200 (D. Utah Sept. 08, 2021). To read ABI's report on the district court's affirmance, click here. The IRS appealed to the circuit.

Tenth Circuit Affirms

The Tenth Circuit affirmed in *U.S. v. Miller*, 71 F.4th 1247 (10th Cir. June 27, 2023). Focusing on the language in Section 106(a), the Denver-based appeals court noted that Congress "abrogated" immunity "with respect to" Section 544. The circuit court cited Supreme Court authority for the proposition that "with respect to" has a "broadening effect." To read ABI's report, click here.

The Tenth Circuit's opinion deepened an already existing circuit split. The Ninth and Fourth Circuits had already held that the waiver of immunity in Section 106(a) allows claims against the government under state law for recovery of fraudulent transfers. *See In re DBSI, Inc.*, 869 F.3d 1004 (9th Cir. 2017); and *Cook v. U.S. (In re Yahweh Center Inc.),* 27 F.4th 960 (4th Cir. 2022). To read ABI's reports, click here and here.

The Seventh Circuit held to the contrary in 2014 in *In re Equip. Acquisition Res. Inc.*, 742 F.3d 743 (7th Cir. 2014). The Seventh Circuit reasoned that Section 106(a) did not modify the actual creditor requirement in Section 544(b). As it turns out, Justice Jackson followed the Seventh Circuit's approach.

To resolve the circuit split, the Court granted the government's petition for *certiorari*. The appeal was argued on December 2, 2024. To read ABI's report on oral argument, click here.

Section 106 Is Only Jurisdictional

Justice Jackson began her analysis of the merits by citing the *Collier* treatise for the idea that a trustee is "powerless" in the absence of an actual creditor who could have sued. "This 'actual creditor' requirement serves as an important check on the trustee's §544(b) powers," she said.

Justice Jackson saw the "dispute [as] turn[ing] on the interplay between §106(a) and §544(b) of the Bankruptcy Code." Referring to Section 548(a), she conceded that "§106(a) waives the Government's sovereign immunity with respect to the federal cause of action created by §544(b)."

Justice Jackson began her analysis from the proposition that waivers of sovereign immunity are jurisdictional "but do not themselves typically create any new substantive rights against the Government."

On the topic of substantive rights, Justice Jackson said that Section 106 is "merely jurisdictional." She quoted Section 106(a)(5), which says, "Nothing in this section 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." The trustee's theory, she said, "would thus transform that statute from a jurisdiction-creating provision into a liability-creating provision."

The 'Text' and 'Structure'

Having decided that Section 106 does not create substantive rights, Judge Jackson turned to the "text and structure of §106 and §544[, which] make clear that §106(a)'s waiver of sovereign immunity does not operate to modify §544(b)'s substantive requirements."

If Section 106(a) were to modify the elements of a claim under Section 544(b), Justice Jackson said it "would necessarily give the trustee a substantive claim for relief against the Government that does not 'otherwise exis[t]' under §544(b) or Utah law."

Justice Jackson noted that the actual creditor requirement is "unique" to Section 544(b) and "reflects a deliberate congressional choice to tie the trustee's rights under subsection (b) to the rights of an actual creditor under 'applicable law.'" She observed that "Section 544(b) was expressly 'derived' from §70e of the Bankruptcy Act of 1898, which had long been understood to give trustees the same rights as creditors under state law."

Given the "long-settled understanding of the trustee's §544(b) powers," Justice Jackson said it "would be so anomalous to treat §106(a) as expanding the trustee's rights beyond those of an actual creditor."

"Even if the language and logic of §544 and §106(a)" broadened the sovereign immunity waiver, Justice Jackson said "that our precedents would still foreclose that reading," because "Congress must use unmistakable language to abrogate sovereign immunity." *Financial Oversight and Management Bd. for P. R. v. Centro De Periodismo Investigativo, Inc.*, 598 U.S. 339, 342 (2023)."

'Close, but No Cigar'

Justice Jackson said that the trustee had a "slightly" better argument in saying that a narrow "reading of §106(a) would blunt the impact of Congress's decision to include §544 on the list of provisions subject to §106(a)'s immunity waiver." She paraphrased the trustee as contending that

"the Government's reading of §106(a) effectively robs the immunity waiver of any meaningful purpose with respect to §544; it simply grants federal courts jurisdiction over a set of inherently unwinnable claims."

Justice Jackson was "not persuaded." Even if Section 106(a) would let the trustee win "under §544(b), [the trustee] might still prevail against the Government under §544's other subprovision — subsection (a)." She noted that "subsection (a), unlike subsection (b), does not contain an actual-creditor requirement."

In addition, Justice Jackson said that Section 106(a) has an "independent function" by "grant[ing] federal courts jurisdiction to hear §544(b) claims brought against state governments" in states that have waived sovereign immunity "under their own fraudulent-transfer statutes."

Justice Jackson ended her opinion by reversing the Tenth Circuit and holding:

> Section 106(a) of the Bankruptcy Code abrogates sovereign immunity for the federal cause of action created by §544(b). It 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.

The Dissent

Justice Neil M. Gorsuch wrote a three-page dissent.

Apart from the question of sovereign immunity, Justice Gorsuch began from the concession that a fraudulent transfer claim existed under Utah law. He continued:

> Thus, under "applicable law," the relevant transfers are "voidable," and the bankruptcy trustee can use §544(b)(1) to set them aside. That remains true even though the trustee must sue the United States to void the relevant transfers, because §106(a)(1) bars the government from raising a sovereign-immunity defense in the trustee's action.

Justice Gorsuch asked whether "the federal government [could] defeat the claim by raising the affirmative defense of sovereign immunity?" He answered his own question by saying, "With respect to a private creditor pursuing relief in state court, the answer is yes. With respect to a trustee pursuing relief in a federal bankruptcy proceeding, the answer — thanks to §106(a)(1) — is no."

Justice Gorsuch "respectfully" dissented, saying he would "agree with the majority of circuits to have considered the question that bankruptcy trustees may avoid fraudulent transfers to the United States under §544(b)."

The opinion is *U.S. v. Miller*, 23-824 (Sup. Ct. March 26, 2025).

Most justices seemed inclined to believe that the waiver of sovereign immunity in Section 106(a) does not abrogate the "actual creditor" requirement in Section 544(b)(1).

Supreme Court Argument: May a Trustee Sue the IRS for Fraudulent Transfers

If FanDuel took bets on how the Supreme Court will decide cases, this writer would wager that the justices will hold that Section 106(a) does not permit a bankruptcy trustee to sue the federal government for receipt of a fraudulent transfer under Section 544(b)(1), when no actual creditor could sue the government outside of bankruptcy.

The comments and questions from the justices are not an infallible indication of how the Court will rule, but a majority (if not all) of the justices seem to be aligned with the idea that the "actual creditor" requirement in Section 544(b)(1) brings sovereign immunity back into play as a defense for the Internal Revenue Service, even though Section 106(a) waives sovereign immunity.

In mid-2023, the Tenth Circuit, in *U.S. v. Miller*, 71 F.4th 1247 (10th Cir. June 27, 2023), sided with the Ninth and Fourth Circuits. All three held that the waiver of immunity in Section 106(a) allows claims against the government under state law for recovery of fraudulent transfers. *See In re DBSI, Inc.*, 869 F.3d 1004 (9th Cir. 2017); and *Cook v. U.S. (In re Yahweh Center Inc.),* 27 F.4th 960 (4th Cir. 2022). To read ABI's reports, click here and here. To read ABI's report on *Miller* in the Tenth Circuit, click here.

There is a circuit split because the Seventh Circuit had held to the contrary in 2014 in *In re Equip. Acquisition Res. Inc.*, 742 F.3d 743 (7th Cir. 2014). The Seventh Circuit reasoned that Section 106(a) did not modify the actual creditor requirement in Section 544(b).

Based on the circuit split, the government filed a petition for *certiorari* in *Miller*. The Court granted the petition on June 24, near the end of the last term. Oral argument took place on December 2.

The Admittedly Fraudulent Transfers to the IRS

The Internal Revenue Service receives constructively fraudulent transfers when a corporation pays federal income taxes owing by an owner. That's what happened in the case before the Tenth Circuit. The IRS conceded that it had received fraudulent transfers.

The corporation's chapter 7 trustee sued the IRS in bankruptcy court under Section 544(b)(1) for receipt of a constructively fraudulent transfer under Utah law. The section allows a trustee to "avoid any transfer of an interest of the debtor in property . . . *that is voidable under applicable law by a creditor holding an [allowable] unsecured claim.*" [Emphasis added.]

The trustee could not sue under Section 548, because the bankruptcy occurred more than two years after the transfer.

Although no actual creditor could have sued the IRS because there is no waiver of sovereign immunity outside of bankruptcy for cases of the sort, the waiver of sovereign immunity in Section 106(a) allowed the trustee to sue.

Section 106(a)(1) "abrogates" sovereign immunity as to dozens of provisions in the Bankruptcy Code, including Sections 544, 547 and 548. But the question remains: Did the Section 106(a)(1) waiver eliminate the "actual creditor" requirement in Section 544(b)(1)? In substance, the Tenth Circuit believed that the sovereign immunity waiver in Section 106(a)(1) effectively ended any sovereign immunity argument under Section 544(b)(1).

Section 106(a)(5) also plays a role. It provides:

> Nothing in this section 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 the Supreme Court, the Solicitor General took the position that Section 106(a) has "no bearing" on the outcome because the waiver of sovereign immunity does not alter the substantive requirement in Section 544(b) that there must be an "actual creditor" entitled to sue. Furthermore, the government argued that Section 106(a)(5) does not allow alteration of the "actual creditor" requirement under state law.

The Government's Argument

As custom, the justices made life miserable for both sides. However, comments from the bench seemed to favor a ruling for the government.

In what may have been the question most favorable to the trustee, Justice Neil M. Gorsuch observed that the sovereign immunity waiver in Section 106 does not "single out" Section 544(a), which would have allowed the trustee to sue successfully had the bankruptcy occurred within two years of the transfer.

The government responded to Justice Gorsuch by saying that Section 106 does not create "any substantive claim for relief that doesn't otherwise exist." Justice Gorsuch responded, "No, it doesn't create a new cause of action. I grant you that."

Justice Gorsuch may still be the trustee's best hope, because he went on to talk about *Moore v. Bay*, 284 U.S. 4 (1931), written by Justice Oliver Wendell Holmes, Jr. He described *Moore v. Bay* as meaning that "sometimes a trustee's powers to avoid property transfers can transcend the rights of the creditor in whose shoes he might otherwise step."

The government distinguished *Moore v. Bay*, pointing out how the case held that a trustee could recover the full amount of the transfer, not just the smaller amount that the creditor could have recovered on its own outside of bankruptcy.

Justice Ketanji Brown Jackson seemed to be in the government's camp when she said,

> [W]hat's happening there is the trustee gets the avoidance power but only to the extent that an actual creditor could have [e]ffected the same kind of disruption in the market by bringing this kind of action on his own.

The trustee had a glint of hope from questions asked by Justice Elena Kagan. She asked,

> [W]hy would Congress have gone to this trouble of waiving sovereign immunity if the trustee was always going to lose anyway as a result of the substantive question in the suit?

The trustee had lodged an argument based on policy: If a trustee cannot sue the IRS, it opens the door for corporate owners to have their companies pay their personal taxes. With the IRS having been paid, the owners would gain by having no nondischargeable debt owing to the IRS.

The government turned the argument around, saying that a successful suit against the IRS would allow the owners "to go free" because the bankruptcy trustee is only entitled to single recovery.

The Trustee's Argument

When it came time for the trustee to argue, the trustee's counsel was met immediately with a question by Justice Clarence Thomas. He implied that the trustee's theory would modify the "actual creditor" requirement, in contravention of Section 106(a)(5).

The trustee contended that the government's theory meant that there needed to be two waivers of sovereign immunity: the general waiver in Section 106(a), and a second for Section 544(b)(1).

Justice Jackson responded, "[I]sn't that a function of Congress's policy choice to incorporate state law as the requirement of 544(b)?"

Justice Jackson was not through. She said,

> I thought the waiver of sovereign immunity was a threshold issue that didn't tell us anything about the merits of whether or not you win the action underlying it.

Justice Jackson saw two different questions: (1) Does the waiver of sovereign immunity allow a trustee to sue; and (2) if the trustee can sue, can the trustee win on the merits?

Justice Sonia Sotomayor seemed of the same mind when she prevailed on the trustee's counsel to admit that Section 544(b) incorporates state law defenses. She said, "I'm not sure why we're going to have to incorporate 106(b) in the state law defenses." Similarly, Justice Amy Coney Barrett won a concession from the trustee to say that state law defenses are available even if there is a waiver of immunity.

Similarly, Justice Kagan said, "[T]his waiver of sovereign immunity is not supposed to affect the substance."

Along the same lines, Justice Jackson said it was "strange" that a trustee could recover "under circumstances in which no actual creditor could." She elaborated,

> If we think about what 544 is really about, then it seems to me to undermine your view that we should be reading 106 to allow for the trustee to recover money that an actual creditor would not have been able to recover.

The case is *U.S. v. Miller*, 23-824 (Sup. Ct.).

To resolve a circuit split, the Supreme Court has agreed to decide whether a trustee can sue the government to recover a fraudulent transfer under state law when sovereign immunity would bar an 'actual creditor' from suing.

Supreme Court to Rule on Waiver of Sovereign Immunity for Suits Under Section 544(b)(1)

To resolve a split of circuits, the Supreme Court has granted *certiorari* to decide whether the waiver of sovereign immunity in Section 106(a) permits a bankruptcy trustee to sue the federal government for receipt of a fraudulent transfer under Section 544(b)(1), when an actual creditor could not sue the government outside of bankruptcy.

One year ago in *U.S. v. Miller*, 71 F.4th 1247 (10th Cir. June 27, 2023), the Tenth Circuit sided with the Ninth and Fourth Circuits, which both had held that the waiver of immunity in Section 106(a) allows claims against the government under state law. *See In re DBSI, Inc.*, 869 F.3d 1004 (9th Cir. 2017); and *Cook v. U.S. (In re Yahweh Center Inc.),* 27 F.4th 960 (4th Cir. 2022). To read ABI's reports, click here and here. To read ABI's report on *Miller* in the Tenth Circuit, click here.

There is a circuit split because the Seventh Circuit held to the contrary in 2014 by ruling that the immunity waiver in Section 106(a) did not allow suit, reasoning that Section 106(a) did not modify the actual creditor requirement in Section 544(b). *See In re Equip. Acquisition Res. Inc.*, 742 F.3d 743 (7th Cir. 2014).

Fraudulent Transfer to the IRS

The Internal Revenue Service is often the recipient of constructive fraudulent transfers, for example, when a corporation pays federal income taxes owing by one of the owners. And so it was in the case before the Tenth Circuit last year.

The corporation's chapter 7 trustee brought suit in bankruptcy court against the IRS under Section 544(b)(1) for receipt of a constructively fraudulent transfer under Utah law. The section allows a trustee to "avoid any transfer of an interest of the debtor in property . . . *that is voidable under applicable law by a creditor holding an [allowable] unsecured claim.*" [Emphasis added.]

The government conceded that there was an actual creditor and did not contest the elements of a constructively fraudulent transfer. However, the government contended that sovereign immunity would have prevented an actual creditor from suing the IRS outside of bankruptcy. Without an

actual creditor to raise the fraudulent transfer claim, the government contended that the bankruptcy trustee was precluded from suing under Section 544(b)(1).

On cross motions for summary judgment, Bankruptcy Judge R. Kimball Mosier of Salt Lake City ruled in favor of the trustee and entered judgment for about $145,000. The IRS appealed, but the district court affirmed. *See U.S. v. Miller*, 20-00248, 2021 BL 340200 (D. Utah Sept. 8, 2021). To read ABI's report on the district court affirmance, click here.

On the government's second appeal, the Tenth Circuit agreed with the trustee's theory that the broad waiver of sovereign immunity applicable to Section 544 by virtue of Section 106(a) allowed suit based on a state-law claim. The Tenth Circuit affirmed the two lower courts and parted company with the Seventh Circuit. *U.S. v. Miller, supra*.

After two extensions of time, the U.S. Solicitor General filed a petition for *certiorari* on January 29. The Court considered the petition in conference on June 17 and granted the petition on June 24. The grant was not surprising because there is a circuit split, and the Court grants review about half the time when the federal government files a petition for *certiorari*.

The Government's Theory

The Solicitor General urged the high court to resolve the circuit split because "bankruptcy courts have frequently addressed this question over the last two decades" and reached decisions that the government believes were wrong.

If the allegedly fraudulent transfer to the IRS had occurred within two years of bankruptcy, the trustee could have maintained suit under Section 548 because that section is one of those listed in Section 106(a) as to which sovereign immunity is "abrogated." Since the transfer occurred more than two years before bankruptcy and less than the four years permitted by Utah law, the trustee was compelled to sue under Section 544(b)(1) with its "actual creditor" requirement.

The government believes that the Tenth Circuit was wrong because "no actual creditor could obtain relief outside of bankruptcy," given the government's sovereign immunity. "Because no actual unsecured creditor could have avoided the federal tax payments at issue here under Utah fraudulent-transfer law," the government argues that "the Chapter 7 trustee had nobody's shoes to step into when seeking to avoid those tax payments under Section 544(b) by invoking that state law."

Indeed, the government believes that Section 106(a) has "no bearing" on the outcome because the waiver of sovereign immunity does not alter the substantive requirement in Section 544(b) that there must be an "actual creditor" entitled to sue.

The date for oral argument had not been set. If the parties do not request a lengthy extension of time to file their briefs, argument could be held before the end of the year.

The petition for certiorari is found in *U.S. v. Miller*, 23-824 (Sup. Ct.).

Reorganization

Solvent Companies and Bad Faith

Houston's Bankruptcy Judge Christopher Lopez decided that the newest plan by a Johnson & Johnson subsidiary didn't qualify for nondebtor releases permissible in asbestos cases.

Third J&J Filing Dismissed on Grounds Different from the First Two Dismissals

Dismissing Johnson & Johnson's third attempt at extinguishing talc claims through chapter 11, Bankruptcy Judge Christopher Lopez of Houston nixed theories for evading the *Purdue* prohibition of nondebtor releases.

In his March 31 opinion, Judge Lopez put strictures on releases for nondebtors that can sometimes be permissible in asbestos cases under Section 524(g)(4)(A)(ii). The product of a two-week trial, his 57-page, single-spaced opinion is the definitive, detailed, inside history of J&J's efforts at obtaining absolution for talc claims through creative legal theories.

After saying that J&J was willing to commit $9 billion to discharge 90,000 claims, Judge Lopez opened his opinion by describing the previous chapter 11 cases that ended in two dismissals in New Jersey that were upheld in the Third Circuit. For those without time to read the entire 57 pages, the first five pages provide a workable summary of the findings and holdings to follow. He pointed out, "This case is different. It is not like *Boy Scouts*, *Purdue Pharma*, or *Imerys*."

The Third Chapter 11 Case

Immediately after the second dismissal in New Jersey was upheld in the Third Circuit, Judge Lopez described the negotiations leading to a new chapter 11 plan and the third filing in Houston in September 2024.

With a contribution of $9 billion from J&J over time, the new plan would have released claims against all J&J entities, not only the newly formed subsidiary named Red River Talc that became the debtor after being created under a Texas divisional merger. Hundreds of nondebtors also would be released, including retailers. Creditors were not given the option of opting out and would be bound by releases even if they voted against the plan.

Aiming for nondebtor releases that are permissible in an asbestos case under Section 524(g), the debtor needed 75% of the affected class to accept the plan. When the vote first came in, only 70% were accepting. The acceptance level jumped to 83% after a law firm purportedly changed the votes of its 11,000 clients from reject to accept.

The chapter 11 filing in Houston brought a motion to transfer venue to New Jersey, which Judge Lopez denied. Then, the U.S. Trustee and "many parties" objected to confirmation of the plan and sought dismissal of the case.

The Defective Vote on the Plan

Judge Lopez devoted the largest part of his opinion to explaining how "over 90,000 votes were cast, but at least half of them cannot count. There were numerous prepetition voting irregularities and solicitation hiccups that make it impossible certify the vote." Consequently, he found that "the requisite 75% claimant support has not been met for plan confirmation purposes."

Although voting ended too quickly, the major flaw resulted from lawyers who purported to vote on behalf of their clients. Judge Lopez gave examples explaining why "the majority of these votes were not supported by a power of attorney."

For instance, Judge Lopez said that thousands of votes submitted by two law firms based on their retention agreements "do not give them express authority to vote on behalf of their clients in this bankruptcy." "With one or two exceptions," he said, "the majority of the engagement letters for the law firms that" voted on behalf of their clients had the same flaws.

"Another reason these votes cannot be certified is that the lawyers," Judge Lopez said, "were likely settling claims without client approval."

With regard to the law firm whose clients switched from reject to accept, Judge Lopez said that "women with cancer had two business days and a weekend to respond and indicate their votes. This is an 'unreasonably' short time for a creditor vote under Bankruptcy Rule 3018(b), and therefore, regardless of the other issues the Court has discussed, these votes cannot be counted."

Judge Lopez ruled that "the entire vote cannot be certified." The master ballots used by law firms to vote for hundreds or thousands of clients "would have worked, but it was not carefully followed."

The *Purdue* Violation

Beyond the vote, "The Plan contains improper nonconsensual third-party releases," Judge Lopez said. He identified releases in favor of "hundreds of nondebtor third parties related to J&J." In addition, he said, "There is no dispute that voters had no opportunity to opt in or opt out of these releases. Thus, voters who affirmatively voted to reject the Plan would still be bound by the Third-Party Releases."

The debtor contended that the *Purdue* prohibition did not apply because it was a "full pay" plan, possibly carved out by the Supreme Court from the nondebtor release proscription. *See Harrington v. Purdue Pharma L.P.*, 602 U.S. 204, 226-27 (2024). Judge Lopez did "not read *Purdue* as implicitly endorsing the third-party releases in this case because this is not a 'full pay' case." Moreover, he said, "the Fifth Circuit has stated many times that nonconsensual third-party releases are not permissible."

Nondebtor Releases Under Section 524(g)

In asbestos cases, Section 524(g) can permit nondebtor releases. In the debtor's plan, there would have been releases for 700 entities, including retailers who sold the J&J product. The plan would not be feasible without the nondebtor releases, because retailers would have indemnification claims against J&J.

For permissible nondebtor releases, Judge Lopez cited the Second and Third Circuits for holding "that § 524(g)(4)(A)(ii) only enjoins actions against third parties that are derivative of claims against the debtor." He held that claims against retailers were not derivative claims qualifying for releases under Section 524(g)(4)(A)(ii).

Dismissal or 'Redo'?

Judge Lopez ended his opinion by addressing the question of dismissal for "cause" under Section 1112(b)(1).

Regarding the Third Circuit's dismissal of prior filings for lack of "financial distress," Judge Lopez said that the Philadelphia-based court's "decision is not binding on this Court. But, under Fifth Circuit precedent, a debtor's financial condition is a factor a court can consider in its analysis." He went on to say in a footnote that the Houston case had "countless factual differences" from the prior New Jersey cases, so that the third filing could not be dismissed "under the doctrine of collateral estoppel."

Turning to the facts of the third filing with regard to dismissal, Judge Lopez said that the debtor "unnecessarily rushed the solicitation process at the cost of obtaining actual votes from creditors." He said that the plan was not feasible since retailers could not be given releases.

Normally, Judge Lopez said that a court would deny confirmation, then call for a new disclosure statement, a new plan and new solicitation, with opt in or opt out for nondebtor releases. "But that will not work here," he said. "There is no way to confirm the solicited plan or the amended versions. The entire construct of the Plan requires re-thinking from a post-*Purdue* perspective."

Judge Lopez found that it was "in the best interests" of the debtor and creditors "to dismiss this case for cause." He mentioned the "prepetition voting and solicitation irregularities, including the unreasonably short voting time for thousands of creditors [that were] all done to get to 75% at any cost."

Judge Lopez dismissed the case, saying that "not any one individual factor . . . requires this result" but that it is "all of them together that require the Court to dismiss this case."

The opinion is *In re Red River Talc LLC*, 24-90505 (Bankr. S.D. Tex. March 31, 2025).

The 'attenuated possibility of insolvency' in the future does not establish 'financial distress,' Circuit Judge Ambro said, interpreting his own prior opinion.

Dismissal of Second J&J Chapter 11 Filing Upheld by Return Mail in the Circuit

Eight days after the appeal was submitted, the Third Circuit upheld dismissal of a Johnson & Johnson subsidiary's second attempt at disposing of present and future claims based on its Baby Powder, which allegedly contained traces of asbestos.

Circuit Judge Thomas L. Ambro was the author of the first decision in January 2023 dismissing the chapter 11 petition filed by J&J subsidiary LTL Management LLC. He held that the petition was filed in bad faith, because there was no "financial distress."

Two hours after the first case was dismissed, LTL filed a second time in the same bankruptcy court in New Jersey. The bankruptcy judge dismissed the second filing for lack of "financial distress." The Third Circuit accepted a direct appeal.

The new opinion on July 25 allowed Judge Ambro to explain why his first opinion should not be read narrowly. For instance, he said, "the *'attenuated' possibility of insolvency* far in the future does not offer sufficient financial distress today to justify a Chapter 11 filing." [Emphasis added.]

On the other hand, Judge Ambro said that "a mass-tort defendant has a viable case for bankruptcy" when "*future insolvency is a realistic possibility based on meaningful evidence* — not just the result of a highly speculative 'worst-case' scenario." [Emphasis added.]

Judge Ambro's new opinion is nonprecedential. This writer expects it nonetheless will be the definitive interpretation of the first *LTL* decision.

The Second Filing

Judge Ambro's first decision was 40 pages in length. *In re LTL Mgmt., LLC*, 64 F.4th 84 (3d Cir. 2023). To read ABI's report, click here. The new opinion is a scant 12 pages.

Reciting history more succinctly in the new opinion, Judge Ambro said that "J&J *claims to have transferred all talc liability* to the newly formed LTL, which received a funding agreement directly obligating J&J to cover LTL's talc liabilities and bankruptcy expenses up to roughly $61.5 billion." [Emphasis added.] He had called for dismissal of the first petition, given "[w]ell-

established Third Circuit caselaw [that] bars a bankruptcy absent financial distress." He said that the funding agreement was "an ATM disguised as a contract."

In the second chapter 11 filing, Judge Ambro explained how J&J had modified the funding agreement by narrowing the coverage to some $30 billion underwritten only by the parent holding company. He quoted testimony by LTL's inside counsel as admitting that J&J "agreed to shrink the funding agreement to . . . place LTL in financial distress." The bankruptcy court granted a motion by the talc committee to dismiss the second filing in July 2023. *In re LTL Mgmt., LLC*, 652 B.R. 433 (Bankr. D.N.J. 2023). To read ABI's report, click here.

Factfinding Is Ok

On a direct appeal, the debtor contended that the bankruptcy court "erred in its factfinding" and that the bankruptcy court had misapplied Judge Ambro's first decision.

As to factfinding, Judge Ambro pointed to testimony from the debtor's own expert who said that liability was not more than $21 billion, less than the holding company's $30 billion going-concern value. Judge Ambro said that the bankruptcy court did not err by failing to consider the possibility of "blockbuster verdicts," because the debtor "points to no evidence projecting the likelihood and size of those verdicts."

Finding no clearly erroneous findings of fact because "any risk of funding exhaustion is, on this record, quite 'attenuated,'" Judge Ambro turned to the question of whether the bankruptcy court had misapplied his first decision.

The First Decision Isn't Narrow

The debtor contended that the bankruptcy court erred in believing that the first decision only looked to current conditions.

Judge Ambro began the analysis by observing that "bankruptcy requires 'apparent' financial distress." He saw no error below because the debtor's assets exceeded its worst-case scenario. On those facts, he saw no "insolvency-based financial distress." Furthermore, he said that "the 'attenuated' possibility of insolvency far in the future does not offer sufficient financial distress today to justify a Chapter 11 filing."

Even if the parent holding company were required to liquidate assets, Judge Ambro said "that is not the question — our analysis must focus on LTL."

The Ad Hoc Committee's Argument

An ad hoc committee of creditors who support the plan made a different argument: Vast creditor support presented "unusual circumstances" under Section 1112(b)(2) to bypass dismissal in the interest of creditors.

The bankruptcy court had rejected the argument, Judge Ambro said, in "a thoughtful review of the caselaw" because "that 'lack of financial distress is not the type of "bad faith" that could be subject to the § 1112(b) exception[.]'"

Talc Committee Fees

The bankruptcy court had authorized the continued existence of the talc committee after dismissal because the committee was responsible for having the second filing dismissed. The debtor argued that the committee ceased to exist on dismissal and was not entitled to have the debtor pay its expenses. Judge Ambro disagreed.

Among other grounds, Judge Ambro cited Section 1109(b) to mean that the committee had an "indisputable interest in litigating appeals on behalf of those it represents." Were there no entitlement to recover fees, he said that "an official committee could win a dismissal for its constituents but be unable to defend that order from an appellate challenge."

The opinion is *In re LTL Management LLC*, 23-2971 (3d Cir. July 25, 2024).

Given that chapter 7 has remedies like denial of discharge for a debtor's misconduct, bad faith in chapter 11 doesn't allow dismissal on conversion to chapter 7.

On a Split, Ninth Circuit BAP Holds: Misconduct in '11' Doesn't Prevent Conversion to '7'

On a question where the circuits are split, the Ninth Circuit Bankruptcy Appellate Panel hewed to Ninth Circuit precedent by holding that a debtor's bad faith in chapter 11 does not preclude the debtor from converting the case to chapter 7 under Section 1112(a). Even if the case already has been converted to chapter 7, the debtor's conduct in the prior chapter 11 case does not allow dismissal of the chapter 7 case under Section 707.

To put the BAP's rationale into a few words, chapter 7 has remedies like denial of discharge to account for a debtor's bad faith. Consequently, the existence of a statutory remedy for bad faith does not allow bad faith to represent "cause" for dismissal under Section 707, especially since chapter 7 can benefit creditors generally.

The Debtor's Misbehavior in Chapter 11

The individual debtor in chapter 11 had "failed to provide the type of complete disclosures contemplated by the Code," the BAP said in a nonprecedential, *per curiam* opinion on April 8. Despite being "repeatedly warned . . . that his case was subject to dismissal," the debtor persisted with "incomplete and conflicting disclosures."

The bankruptcy court entered an order directing the debtor to show cause why his case should not be converted or dismissed. Before the hearing, the debtor filed a request for conversion to chapter 7.

The court converted the case to chapter 7, but the conversion order directed the debtor to show cause why the chapter 7 case should not be dismissed. At the ensuing hearing, the bankruptcy court dismissed the chapter 7 case under Section 707(a).

The debtor appealed to the BAP.

Prior Ninth Circuit Authority

In pertinent part, Section 707(a) provides that the "court may dismiss a case under this chapter only after notice and a hearing and only for cause, including — (1) unreasonable delay by the debtor that is prejudicial to creditors . . . ."

The BAP described the bankruptcy court as having dismissed on "two related grounds: (i) that Debtor's conduct was an abuse of the bankruptcy process that qualified as 'cause' under § 707(a); and (ii) that Debtor's conduct qualified as 'unreasonable delay by the debtor that [was] prejudicial to creditors' under § 707(a)(1)."

In view of the subsequent decision by the Supreme Court in *Marrama v. Citizens Bank of Mass.*, 549 U.S. 365 (2007), the BAP was tasked with deciding whether it remained bound by two Ninth Circuit decisions, *Neary v. Padilla (In re Padilla)*, 222 F.3d 1184 (9th Cir. 2000); and *Sherman v. S.E.C. (In re Sherman)*, 491 F.3d 948 (9th Cir. 2007).

In *Padilla*, the Ninth Circuit held "that bad faith *per se* can properly constitute 'cause' for dismissal of a Chapter 11 or Chapter 13 petition but not of a Chapter 7 petition under § 707(a)." *Padilla*, *supra*, 222 F.3d at 1192-93.

In *Padilla*, the Ninth Circuit explained why bad faith was not available for dismissing a chapter 7 case: In chapters 11 and 13, the appeals court said that the debtor "retain[s] its assets [to] reorder its contractual obligations to its creditors. In return for these benefits, the debtor must approach its new relationship with the creditors in good faith." *Id*. By contrast, the circuit court said that chapter 7 "requires no ongoing relationship between the debtor and its creditors and should be available to any debtor willing to surrender all of its nonexempt assets, regardless of whether the debtor's motive in seeking such a remedy was grounded in good faith . . . ." *Id*.

In *Sherman*, the chapter 7 debtor's misconduct was misrepresentation of liabilities and expenses. The BAP characterized the circuit court as "holding that such misrepresentations did not provide 'cause' for dismissal under § 707(a)" because "§ 727(a)(4)(A) [denial of discharge for knowingly and fraudulently making a false oath] covered the specific conduct by the debtor."

In *Sherman*, the BAP characterized the Ninth Circuit as having "held that the proper remedy was to deny the debtor a discharge under § 727(a)(4)(A), not dismiss the case under § 707(a)."

With six circuits having held to the contrary, the BAP admitted that "*Padilla* represents a minority view" and that those circuits decided that bad faith is grounds for dismissal under Section 707(a).

Marrama

Marrama "complicat[es] our analysis," the BAP said. The panel described the Supreme Court in *Marrama* as having "held that the debtor's bad faith conduct with respect to his chapter 7 filing

precluded conversion to a chapter 13," in part because bankruptcy is reserved for honest but unfortunate debtors.

Later, the Supreme Court handed down *Law v. Siegel*, 571 U.S. 415 (2014). There, the BAP described the Court as holding that Section 105(a) "does not authorize courts to take action in contravention of the Code."

While there was no dispute that Section 707(a) controlled, the BAP said that "we must contend with *Marrama*" but decided "that we are bound by *Padilla* notwithstanding the Supreme Court's decision in *Marrama*."

To begin with, *Marrama* involved conversion from chapter 7 to chapter 13. The BAP mentioned how the Supreme Court "itself noted that allowing a chapter 7 debtor an absolute right to convert to a chapter 13 case would provide the debtor an opportunity to retake control of property of the estate and potentially 'take actions that would impair the rights of creditors.' *Marrama*, 549 U.S. at 375 n.13."

Similarly, the BAP noted how the Ninth Circuit in *Padilla* mentioned that, "unlike chapter 7, chapters 11 and 13 allow debtors not only to retain assets but to continue their relationship with creditors . . . . And, while chapters 11 and 13 explicitly invoke good faith as a requirement to plan confirmation, chapter 7 is silent with respect to good or bad faith."

Furthermore, there is a difference in the conversion statutes. The BAP said:

> Unlike § 707(a), § 1112(b) and § 1307(c) allow for dismissal **or conversion to a chapter 7 case** for cause. While this difference may seem elementary, it is integral to why conversions **to** chapter 7 are different from conversions **from** chapter 7. [Emphasis in original.]

The BAP decided that "these distinctions place *Padilla* beyond the holding of *Marrama,*" because "a chapter 7 case is itself a remedy to bad faith conduct in a chapter 11 or chapter 13 case, and because of the different relationship a chapter 7 debtor has with the estate as compared to chapter 11 and chapter 13 debtors." It was therefore "unlikely" that *Marrama* "overruled Padilla," the BAP said. Indeed, the BAP said, "*Law* actually bolsters the holding in *Padilla*."

Remaining bound by *Padilla*, the BAP saw "no meaningful distinction between the conduct at issue in this case and the conduct at issue in *Sherman*." Likewise bound by *Sherman*, the BAP reversed the bankruptcy court's holding that the debtor's misconduct in chapter 11 amounted to "cause" for dismissal under Section 707(a).

Section 707(a)(1)

The bankruptcy court also based dismissal on "unreasonable delay" under Section 707(a)(1).

The BAP once again observed "that chapter 7 contains alternative remedies for courts and parties in interest to police abuse by debtors" and that "dismissal of a chapter 7 case is an extraordinary remedy." Furthermore, "§ 707(a)(1) does not specify whether 'delay' includes preconversion delay of the case under a different chapter."

The BAP held "that Congress likely intended § 707(a)(1) to apply only to conduct that delays a chapter 7 case." In other words, "the court must analyze whether the delay caused by the debtor delayed the **chapter 7** case, and whether such delay caused prejudice to creditors in the chapter 7 context." [Emphasis in original.]

The BAP reversed and remanded for the bankruptcy court to determine "whether Debtor's conduct caused unreasonable delay to the **chapter 7 case**." [Emphasis in original.]

The opinion is *White v. U.S. Trustee (In re White)*, 24-1154 (B.A.P. 9th Cir. April 8, 2025).

Executory Contracts & Leases

The 'billing approach,' not the 'accrual approach,' decides whether there is a priority claim for personal property and real estate leases more than 60 days after filing.

Second Circuit Takes Sides on a Section 365(d)(5) Circuit Split

In a fine example of statutory construction taking sides on an issue where circuits are split, the Second Circuit concluded that the "billing approach" is the proper method for interpreting Section 365(d)(5).

When a chapter 11 debtor is subject to an unexpired lease for personal property, Circuit Judge Gerard E. Lynch held in his February 3 opinion that Section 365(d)(5) requires "the debtor to pay obligations once they come due under the operative lease, regardless of when the obligation can be said to have accrued." The holding has the effect of expanding the right to a priority claim.

The same rule presumably applies to real property leases covered by Section 365(d)(3).

Given the split of circuits, the decision is a prime candidate for a *certiorari* petition.

Brokerage Fees for Aircraft Leases

The chapter 11 debtor was an airline that, of course, leased aircraft. Before bankruptcy, a broker had arranged for the airline to lease 20 aircraft. To avoid having the airline pay the brokerage fees in full when entering into the leases, the leases characterized the brokerage fees as "additional rental payments" to be paid in a schedule over the term of the leases. The leases referred to the "additional rental payments" as "unconditional obligations" of the airline.

Once in chapter 11, the airline did not assume the leases. As required by Section 365(d)(5), the airline began paying the aircraft lessors 60 days after filing. However, the airline did not pay "additional rent" to the broker.

Over time, the airline eventually rejected all of the aircraft leases.

Not having been paid, the broker filed proofs of claim and a motion under Section 365(d)(5) to compel payment as priority claims. In pertinent part, the subsection provides:

> The trustee shall timely perform all of the obligations of the debtor, except those specified in section 365(b)(2), first arising from or after 60 days after the order for relief in a case under chapter 11 of this title under an unexpired lease of personal property . . . , until such lease is assumed or rejected . . . , unless the court, after notice and a hearing and based on the equities of the case, orders otherwise with respect to the obligations or timely performance thereof.

The airline objected to the motion to compel payment, contending that Section 365(d)(5) did not require payment as a priority claim because the broker performed no services after bankruptcy. Based on the "plain meaning" of the statute and "commercial realities," Bankruptcy Judge David S. Jones of New York ruled in favor of the broker and compelled payment of about $4.3 million. He discerned that the additional rent came due on the dates specified in the leases. *In re Avianca Holdings S.A.*, 20-11133, 2023 BL 26972, 2023 WL 494255 (Bankr. S.D.N.Y. Jan. 26, 2023).

The airline appealed, but District Judge Katherine Polk Failla affirmed. *In re Avianca Holdings S.A.*, 23-1211, 2023 BL 472816, 2023 WL 9016495 (S.D.N.Y. Dec. 29, 2023). To read ABI's report, click here.

District Judge Failla succinctly described Section 365(d)(3) as meaning that the debtor "must perform all of the debtor's obligations under any unexpired lease of personal property arising after the expiration of the sixty-day grace period until that lease is assumed or rejected — unless the court orders otherwise." Even more tersely, she said that "an obligation may be entitled to such priority if it 'aris[es]' after the bankruptcy filing."

The airline appealed to the circuit.

The Circuit Split on Section 365(d)(5)

Judge Lynch characterized the appeal as presenting "a single question: did [the airline's] obligation to pay the additional rental payments 'first aris[e] from or after 60 days after the order for relief in a case under chapter 11 of this title'?" As a question of statutory interpretation, he undertook *de novo* review.

Judge Lynch wrote his opinion to be intelligible for readers who know nothing about bankruptcy. With regard to executory contracts and leases, he explained that "the debtor is generally not required to make a decision about its executory contracts immediately after filing for Chapter 11, or even within any set time frame before plan confirmation." During the interregnum, he said, "creditors sit in limbo."

Lessors of nonresidential real property and personal property, Judge Lynch said, "are granted enhanced protections during the waiting period following the initial bankruptcy filing." He explained that "the debtor must resume making any contractually set payments that arise after a

certain period of time during the bankruptcy before the relevant lease is assumed or rejected, *regardless of whether the debtor is receiving a post-petition benefit*." [Emphasis added.]

Because the broker performed no services after filing, Judge Lynch said that the broker was not entitled to administrative claims under Section 503(b). The broker's "sole path to a priority claim here is through Section 365(d)(5)."

For the broker to have priority claims, Judge Lynch said that the broker must "show that [the airline's] obligation to pay the additional rental payments first arose at least 60 days after the petition date."

Judge Lynch described "a deep, pre-existing split of authority regarding the proper method for determining when a debtor's obligation arises." On one side of the fence is the "accrual approach," advocated by the airline, which "requires the debtor to pay only those obligations that accrued post-petition, irrespective of when those obligations come due under the operative lease."

The accrual approach, Judge Lynch said, has been followed by several bankruptcy and district courts in New York, along with the Seventh Circuit and the Tenth Circuit Bankruptcy Appellate Panel.

Espoused by the broker, the "billing approach" is on the other side of the fence. Judge Lynch said it "requires the debtor to pay obligations once they come due under the operative lease, regardless of when the obligation can be said to have accrued."

Judge Lynch cited the Third and Sixth Circuits plus the Eighth Circuit Bankruptcy Appellate Panel for adopting the billing approach, along with a decision by Justice Sonia Sotomayor when she was on the district court in New York.

Judge Lynch said that both approaches are "plausible" because "Section 365(d)(5) does not explicitly specify when an obligation can be said to have arisen."

The Billing Approach

To decide which approach to adopt, Judge Lynch found the answer in "two contextual clues." In the subsection, the words "timely perform" require "the existence of some presently existing duty that the debtor must fulfill." The word "obligations" refers to an act for which someone is legally bound.

From dictionaries, Judge Lynch said that the statutory language — "first arising from or after 60 days after the order for relief" — "is best understood as specifying that the duty the debtor must perform has to 'originate from' or 'come into being' under an unexpired lease of personal property 60 days after the order for relief or later."

"That is the 'billing date' approach," Judge Lynch said.

Judge Lynch said there is a "critical difference between when a creditor's claim arises and when a debtor's obligation arises, while [the airline's] position conflates them." Furthermore, he said that the airline's "approach would reimpose Section 503(b)(1)'s requirement that there be a post-petition benefit to the estate." He emphasized "that Section 365(d)(5) speaks in terms of the *debtor's obligations*, not the *creditor's claims*." [Emphasis in original.]

Judge Lynch noted how Section 365(d)(5) has different requirements for priority treatment than Section 503(b), because "365(d)(5) explicitly requires priority payment of the debtor's obligations first arising 60 days post-petition '*notwithstanding* section 503(b)(1) of this title.'" [Emphasis in original.] He added that Section 365(d)(5) "refocuses the relevant inquiry on whether the debtor has a performance obligation, instead of on whether the debtor receives a post-petition benefit."

Judge Lynch said that his reading "aligns with sound bankruptcy policy," as shown in the 1994 House Report, which he characterized as saying that the amendment "tip[s] the balance slightly in favor of creditor protection." In other words, "Section 365(d)(5) is best understood as a specific intervention that grants creditors under unexpired leases of personal property priority treatment, over other general unsecured creditors."

Judge Lynch ended his opinion by saying that the airline did not avail itself of "two safety valves." First, the debtor had a 60-day grace period when payments were not required. Second, the debtor could have petitioned "the bankruptcy court for a hearing to amend its payment obligations after the 60-day grace period elapses." The debtor, he said, "chose not to use either of the safety valves that Congress built into Section 365(d)(5)."

Judge Lynch affirmed the judgment of the district court.

The opinion is *Avianca Holdings S.A. v. Burnham Sterling & Co. LLC (In re Avianca Holdings S.A.)*, 24-255 (2d Cir. Feb. 3, 2025).

Once affirmed in the Ninth Circuit, the debtor could file a petition for certiorari to resolve an important circuit split on assumption of intellectual property contracts.

Circuits Are Split on Assuming a Franchise Agreement when the Franchisor Objects

Developing Ninth Circuit law, Bankruptcy Judge René Lastreto, II, of Fresno, Calif., ruled under the federal Lanham Act and California's Franchise Relations Act that a franchisee cannot assume a franchise agreement if the franchisor objects.

The corporate debtor owned and operated six fast-food restaurants under a franchise agreement. The debtor intended to confirm a chapter 11 plan and continue operating the restaurants by assuming the franchise agreement under Section 365(a). The debtor did not intend to assign or sell the assets or the franchise agreement. The debtor pledged to cure monetary defaults promptly and to demonstrate adequate assurance of future performance.

The franchisor objected to the debtor's motion to assume. The October 10 opinion by Judge Lastreto leaves the impression that the franchisor did not want the debtor to continue operating restaurants under its flag. However, the franchisor had identified a third party to whom the debtor could sell the locations with the franchisor's blessing.

The franchisor contended that Section 365(c)(1), combined with the Lanham Act and the CFRA, allows a franchisor to nix the assumption of a franchise agreement, even if the debtor does not intend to assign or sell the business. The subsection provides that a debtor or trustee

> may not *assume or assign* any executory contract . . . , whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties, if — (1) (A) applicable law excuses a party, other than the debtor . . . from accepting performance from or rendering performance to an entity other than the debtor . . . , whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties; and (B) such party does not consent to such assumption or assignment. [Emphasis added.]

The Two Tests

Judge Lastreto explained how the circuits are split on the interpretation of Section 365(c)(1). Under the so-called hypothetical test adopted in the Third, Fourth, Ninth and Eleventh Circuits, a

debtor may not even assume a contract if the trademark holder objects, because the subsection says that the debtor "may not assume *or* assign." [Emphasis added.] The Ninth Circuit authority is *Catapult Entertainment, Inc. v. Perlman (In re Catapult Enter.)*, 165 F.3d 747 (9th Cir. 1999).

Under the so-called actual test, the First and Fifth Circuits interpret the subsection to mean that a debtor may assume an agreement if the trademark holder objects, but may not assign the agreement over objection.

Judge Lastreto admitted that the "hypothetical test often has devastating effects on the ability of Chapter 11 debtors to reorganize, especially when a debtor franchisee depends upon maintenance of the franchise for any kind of reorganization." However, he said that "the Ninth Circuit has spoken to this issue unambiguously in *Catapult*, and the court is obligated to apply the hypothetical test to this case."

Significance of the Word 'Or'

Catapult barred assumption of a nonexclusive patent license, leaving Judge Lastreto to decide whether the hypothetical test also applies to franchise agreements covered by the Lanham Act and the CFRA.

Judge Lastreto found no controlling Ninth Circuit law to say whether federal trademark law qualifies as "applicable law" under Section 365(c)(1). However, a Nevada district court decision persuaded him to conclude that trademark law is "applicable law." *N.C.P. Mktg. Grp. v. Blanks (In re N.C.P. Mktg. Grp.)*, 337 B.R. 230, 236 (D. Nev. 2005), *aff'd* 279 Fed. Appx. 561 (9th Cir. 2008), *cert. denied*, 556 U.S. 1145 (2009).

Judge Lastreto held that the franchisor's "rights under the Lanham Act represent 'applicable law' that excuses [the franchisor] from accepting performance from or rendering performance to an entity other than [the debtor] under § 365(c)(1)." He reached the same conclusion regarding the CFRA.

Under the CFRA, he said that the "relevant question" was whether there was "a hypothetical third party to whom [the debtor] might be excused from accepting or rendering performance because such a hypothetical third party might not qualify for [the franchisor's] standards for approval under CFRA." Consequently, state law was an alternative ground for denying the motion to assume.

Judge Lastreto denied the debtor's motion to assume the franchise agreement.

Note

We reported a decision handed down in July by Bankruptcy Judge Mina Nami Khorrami of Columbus, Ohio, who took sides with the minority of circuits and predicted that the Sixth Circuit would adopt the "actual test" for Section 365(c)(1). Judge Nami Khorrami held that "the plain language of the statute" does not prohibit a debtor "from assuming an executory contract if it does not intend on assigning it." *In re Welcome Group 2 LLC*, 660 B.R. 874 (Bankr. S.D. Ohio July 10, 2024).

No appeal was taken from Judge Nami Khorrami's decision. In her opinion, she noted that a majority of bankruptcy courts follow the actual test. To read ABI's report on *Welcome Group*, click here.

Chances are the debtor in the case before Judge Lastreto will sell the business and moot the assumption question, obviating the possibility of bringing the circuit split to the Supreme Court on a petition for *certiorari*. Too bad. Circuit splits like this need to be resolved.

The opinion is *Pinnacle Foods of California LLC*, 24-11015 (Bankr. E.D. Cal. Oct. 10, 2024).

Venue, Jurisdiction & Power

Deciding a bankruptcy appeal, the Sixth Circuit deepened an existing circuit split on time limitations for Rule 60(b)(4) motions.

A Bankruptcy Case on Rule 60(b) Could End Up in the Supreme Court Next Term

A bankruptcy decision from the Sixth Circuit could result in a grant of *certiorari* to resolve a circuit split on a nonbankruptcy question: Is there any time limit under Rule 60(b)(4) to set aside a default judgment for lack of personal jurisdiction?

The circuits are split, with six circuits and the leading treatise saying there is no time limitation when a judgment was entered without subject matter or personal jurisdiction. Over a dissent, the Sixth Circuit is the only circuit believing that a motion to set aside a void judgment must be made within a "reasonable time."

The Default Judgment

A chapter 11 debtor filed an adversary proceeding to recover some $50,000 in unpaid invoices. The debtor mailed the summons and complaint addressed to the defendant at the corporation's address, but the papers were not addressed to any corporate officer because the corporation had listed itself as the agent for the service of process.

Eventually, the bankruptcy court entered a default judgment in favor of the debtor. The debtor's chapter 11 case was converted to chapter 7. Five years after entry of the default judgment, the trustee attached the defendant's bank account. Six years after the entry of judgment, the defendant moved under Bankruptcy Rule 9024 and Federal Rule 60(b)(4) to set aside the judgment.

The bankruptcy court never reached the question of whether the judgment was void for failure to address the papers to a corporate officer. Instead, the bankruptcy court denied the motion to void the judgment on the grounds that the delay in filing the Rule 60(b)(4) motion was unreasonable. The district court affirmed.

Rules 60(b) and 60(c)

Under Rule 60(b)(4), the court may relieve a party of a final judgment if "the judgment is void." With regard to the timing, Rule 60(c)(1) says that a "motion under Rule 60(b) must be made within a reasonable time — and for reasons (1), (2), and (3) no more than a year after the entry of

the judgment or order or the date of the proceeding." The one-year requirement does not apply to a Rule 60(b)(4) motion to set aside a void judgment.

The question is: Does the "reasonable time" requirement in Rule 60(c)(1) apply to a judgment that is void under Rule 60(b)(4), or is there no time limit to set aside a judgment that is void for lack of subject matter or personal jurisdiction?

There is no time limit to set aside a void judgment, according to the *Wright & Miller* treatise along with First, Fifth, Seventh, Ninth, Tenth and District of Columbia Circuits.

The Majority on the Panel

Unable to set aside a judgment that might have been void for lack of personal jurisdiction, the defendant appealed to the Sixth Circuit. On appeal, Circuit Judge Joan Larsen affirmed for a split panel in an opinion on July 26, once again making the Sixth Circuit the only Court of Appeals requiring void judgment to be set aside within a "reasonable time."

Citing Sixth Circuit precedent saying that a Rule 60(b)(4) motion must be filed within a "reasonable time," Judge Larsen said,

> Rule 60(c)(1) speaks in plain terms: "All" Rule 60(b) motions "must be filed 'within a reasonable time.'"

Judge Larson spent the bulk of her opinion rebutting arguments by the dissenter, Circuit Judge David W. McKeague. Among other things, she said that the Supreme Court's bankruptcy decision in *United Student Aid Funds, Inc. v. Espinosa*, 559 U.S. 260, 271 (2010), "did not consider whether the motion was timely under Rule 60(c)(1); it simply decided what kinds of defects make a judgment void within the meaning of Rule 60(b)(4)."

Judge Larson "acknowledge[d] that our circuit appears to be out of step with the majority view, which holds that Rule 60(b)(4) motions may be brought at any time," but she saw the panel as bound by prior Sixth Circuit precedent holding that the "plain terms" of Rule 60(c))(1) "impose[] a reasonable-time requirement on each of the enumerated grounds in Rule 60(b)." In her view, "a reasonable time limitation . . . comports with basic equitable principles."

The Dissent

"Respectfully" dissenting, Judge McKeague said that he "firmly" believed that "this Court should renounce that rule and join every other federal circuit in holding that the mere passage of time cannot render a void judgment valid." He said, "Courts have no power to enforce void judgments" because "the passage of time cannot render it valid."

Judge McKeague cited *Espinosa* for the proposition "that untimeliness alone cannot be the basis for denying a motion to vacate a void judgment." He said he "would vacate the bankruptcy court's determination that [the defendant's] motion was untimely and remand for the court to consider whether the judgment was, in fact, void." To his way of thinking, "[e]nforcement of a legal nullity is a true injustice. Where a judgment is void, it cannot stand."

Observations

Based entirely on the rule, timeliness applies to motions under Rule 60(b)(4) even though the one-year limitation does not. Is the rule nonetheless unconstitutional as applied or beyond the rulemaking power when applied to a case like this?

Or, perhaps a Rule 60(b)(4) motion is timely no matter the length of the delay? Holding that a Rule 60(b)(4) motion is always timely would avoid reaching constitutional or rulemaking questions.

The opinion is *Burton v. Coney Island Auto Parts Unlimited Inc. (In re Vista-Pro Automotive LLC)*, 23-5881 (6th Cir. July 26, 2024).

The Bankruptcy Code dropped 'person aggrieved' as the standard for appellate standing. Did it survive nonetheless?

Fifth Circuit Draws 'Person Aggrieved' into Question for Appellate Standing

In two *non*precedential opinions in July 2023, the Fifth Circuit espoused continuing adherence to "person aggrieved" as the standard for appellate standing. In a precedential opinion on May 13, the New Orleans-based appeals court cast doubt on the continuing validity of the "person aggrieved" doctrine.

In the new opinion, Circuit Judge Edith H. Jones nevertheless held that the appellants lacked appellate standing under the less-exacting Article III standard because she also held that no one has a right to serve on a creditors' committee.

Leaked Confidential Information

Beset with sexual abuse claims, the Archdiocese of New Orleans filed a chapter 11 petition. The U.S. Trustee appointed two official committees, one representing trade creditors and another for sexual abuse tort claimants.

Bankruptcy Judge Meredith S. Grabill of New Orleans entered an elaborate confidentiality order restricting access to information and documents concerning sexual abuse claims. The order prohibited disclosure except to authorized persons and only for authorized purposes.

The protected material included information about a particular priest, the allegations made against him and the high school where he worked.

Not counsel for the official tort committee, a lawyer was representing four of the claimants on the abuse claimants' committee in their individual capacities. Having access to the confidential information, he allegedly disclosed information about the priest, which ended up in a local newspaper.

The lawyer was identified after extensive investigations. Judge Grabill removed the four committee members whom the lawyer was representing and replaced them with other abuse claimants. The district court dismissed the former committee members' appeal from being removed from the committee. The district court concluded that they lacked appellate standing under the "person aggrieved" standard. *In re The Roman Catholic Church of the Archdiocese of*

New Orleans, 22-1738, 2022 BL 294980, 2022 US Dist. Lexis 151083 (E.D. La. Aug. 11, 2022). To read ABI's report, click here.

Appellate Standing in the Circuit

The former committee members appealed to the circuit, without success.

Judge Jones began her analysis of appellate standing by reciting how the former Bankruptcy Act, repealed in 1978, limited appellate standing to "a person aggrieved." That standard was omitted with the adoption of the Bankruptcy Code, as the Fifth Circuit noted in *Matter of Highland Cap. Mgmt., L.P.* (*In re Highland Cap. Mgmt.*), 74 F.4th 361, 366 (5th Cir. July 19, 2023). To read ABI's report, click here.

"Nonetheless," Judge Jones said:

> [V]arious of this court's opinions, relying largely on a footnote's worth of *dicta* in a 1994 opinion, have continued to apply the "person aggrieved" standard for appeals from bankruptcy courts. Not only that, but the courts have described this as a higher and "more exacting" standard for evaluating standing in bankruptcy appeals than in cases arising under Article III.

"In light of the statutory change," Judge Jones paraphrased the Sixth Circuit for saying that "the ground for imposing this superseded gloss on the provisions governing bankruptcy appeals to district courts and courts of appeals is uncertain at best."

Judge Jones wasn't through. She continued by saying that "this court's 'exacting' 'person aggrieved' test may be incompatible with the Supreme Court's decision in *Lexmark*, which cast doubt on the role of prudential standing rules in federal courts. *Lexmark Int'l, Inc. v. Static Control Components, Inc.*, 572 U.S. 118, 134 S. Ct. 1377, 1386 (2014)."

Unless the Fifth Circuit were to sit *en banc* and abandon "person aggrieved," Judge Jones was compelled to follow the strict appellate rule. But even if "Article III standing controls this appeal," she said, "the outcome would be the same," because the former committee members "cannot show that the bankruptcy court's order removing them from the Committee injured a legally protected interest."

In particular, Judge Jones noted that the former committee members had not been sanctioned. Furthermore, "no creditor has a 'right' to serve or continue serving on a Creditors Committee," she said.

Having no right to serve on a committee and not having been sanctioned, the former committee members "have failed to demonstrate an injury to any legally protected interest," Judge Jones said.

There was more, since the "statutory procedures for appointing members of a Creditors Committee do not guarantee any member the right to *remain* on the Committee." [Emphasis in original.] She pointed to Section 1102(a)(1), where the U.S. Trustee appoints committees "as the United States Trustee deems appropriate."

The former committee members contended there was a violation of Section 1102(a)(4) when the bankruptcy judge removed the committee members with having first provided notice and a hearing. Judge Jones conceded that the former committee members were correct in that the bankruptcy judge removed them *sua sponte*, "without notice and hearing or a formal request from a party in interest."

However, Judge Jones saw a distinction between having a right to serve on a committee and the procedures for changing committee membership under Section 1102(a)(2). She therefore held "that a lack of proper notice and hearing under Section 1102(a)(4) cannot violate a legally protected interest when there is no underlying right to remain on a Creditors Committee, and when the ultimate outcome of the proceeding would have been the same."

Judge Jones also saw the case on appeal as "readily distinguishable from constitutionally footed due process cases, where courts have identified a legally protected property interest requiring a pre-deprivation hearing." In addition, she said that the former committee members "have not pointed to any authorities suggesting that there is any right to serve on a Creditors Committee, nor have they identified any property rights that have been negatively affected by their removal from the Committee."

Having found that neither the former committee members' property rights nor their substantive rights were "negatively affected" or "impaired," Judge Jones affirmed the district court and ruled that the appellants lacked standing to appeal.

Observation

In addition to *Highland Capital Management*, *supra*, the Fifth Circuit reaffirmed its adherence to "person aggrieved" as the standard for appellate standing in *Dugaboy Investment Trust v. Highland Capital Management LP (In re Highland Capital Management LP)*, 22-10983, 2023 BL 260605, 2023 US App Lexis 19553, 2023 WL 4842320 (5th Cir. July 28, 2023).

An appeal *sub judice* in the Supreme Court may determine whether Judge Jones is correct in questioning the durability of "person aggrieved." *See Truck Ins. Exch. v. Kaiser Gypsum Co.*, 22-1079 (Sup. Ct.).

Sometimes referred to as *Kaiser Gypsum*, *Truck Insurance* will resolve a split of circuits and decide whether any creditor or "party in interest" may object to confirmation of a chapter 11 plan, even if the creditor has no financial stake underpinning the objection.

In a broader sense, *Truck Insurance* will tell us the extent to which concepts of standing under Article III apply to bankruptcy cases, in the first instance and on appeal. *Truck Insurance* was argued in the Supreme Court on March 19. To read ABI's report, click here.

The opinion is *Adams v. Roman Catholic Church of the Archdiocese of New Orleans (In re Roman Catholic Church of the Archdiocese of New Orleans)*, 22-30539 (5th Cir. May 13, 2024).

The Third Circuit splits from Seventh and Tenth Circuit opinions dating from 1987 and 1990.

Third Circuit Holds: Magistrate Judges May Issue Final Orders on Bankruptcy Appeals

Creating a circuit split, the Third Circuit held that "a magistrate judge may enter final judgment in a bankruptcy appeal" if there is "consent of the parties and referral by a district court." The Seventh and Tenth Circuits had ruled to the contrary in 1987 and 1990, holding that magistrate judges may not enter final orders in bankruptcy appeals.

The Third Circuit remanded its case to the bankruptcy court for further, substantial proceedings. There may be no petition for *certiorari* or rehearing *en banc*, because both parties were in favor of a final order by the magistrate judge. The Third Circuit had appointed an *amicus* to argue against the appellate power of magistrate judges, but the *amicus* lacks standing to pursue the issue further.

The bankruptcy judge in Delaware was presiding over an adversary proceeding between the holder of a royalty interest in an oil and gas property and the operator of the site. The bankruptcy judge granted summary judgment in favor of the operator.

On the ensuing appeal, Judge Freeman said in her May 7 opinion said that "the parties consented to proceed before a Magistrate Judge for all proceedings, including final judgment." She went on to say that the magistrate judge raised the question of her own jurisdiction *sua sponte*.

On the merits, the magistrate judge affirmed the bankruptcy court, with a proviso that her decision should be taken as a report and recommendation if there were no power to enter a final order.

Pivotal Statutory Amendments

Judge Freeman said that the circuit's "jurisdiction to hear this appeal turns on whether the Magistrate Judge had jurisdiction to enter a final judgment in the bankruptcy appeal." She noted how the circuit had "appointed David R. Kuney, Esq. as *Amicus Curiae* to argue the position that a magistrate judge lacks jurisdiction to issue a final judgment in a bankruptcy appeal." She thanked the "*Amicus* for his service to the Court." Prof. Kuney is an Adjunct Professor at the Georgetown University Law School.

The outcome turned on 28 U.S.C. § 636(c), which provides:

> Notwithstanding any provision of law to the contrary — (1) Upon the consent of the parties, a full-time United States magistrate judge . . . may conduct any or all proceedings in a jury or nonjury civil matter and order the entry of judgment in the case, when specially designated to exercise such jurisdiction by the district court or courts he serves.

Immediately, Judge Freeman noted how the Third Circuit had ruled in 1983, soon after adoption of the Bankruptcy Code, that "a magistrate judge lacked jurisdiction under section 636(c)(1) to issue a final order in a bankruptcy appeal, notwithstanding the consent of the parties. *In re Morrissey*, 717 F.2d 100, 101 (3d Cir. 1983)." However, the statutes then were different.

Judge Freeman said that the appeals court ruled as it did in *Morrissey* because, at the time, 28 U.S.C. § 1334(c) was written to mean that a "district court may not refer an appeal under that section to a magistrate or to a special master." She referred to the preclusion of appeals to magistrate judges as the "Express Prohibition."

In response to the Supreme Court's *Northern Pipeline* decision in 1982 finding the bankruptcy court's jurisdiction to be unconstitutional, Judge Freeman said that Congress "completely rewrote" the bankruptcy court's jurisdiction in 1984 with a new Section 1334. She said that "[t]he Express Prohibition on the referral of bankruptcy appeals to magistrate judges 'was repealed by simple omission,'" quoting the Fifth Circuit in *Minerex Erdoel, Inc. v. Sina, Inc.*, 838 F.2d 781, 785 (5th Cir. 1988).

Judge Freeman said that the new jurisdictional statute presented the appeals court with "a question of first impression in this Circuit under the current statutory regime." Since 1984, she held that "there has been no barrier to magistrate judges' authority to enter final judgments in bankruptcy appeals pursuant to section 636(c) with the consent of the parties."

Citing a Third Circuit opinion in a criminal case, Judge Freeman said that a magistrate judge's jurisdiction is coextensive with the district court's jurisdiction when the parties consent.

Judge Freeman buttressed her reading of the statute "with the reality that magistrate judges function as part of a district court" and with the Third Circuit's holding "that entry of final judgment by a magistrate judge upon consent of the parties, as a general matter, does not violate Article III of the United States Constitution." Furthermore, she said, "The right to an Article III adjudicator is a personal right that is subject to waiver," according to Supreme Court precedent.

Judge Freeman said she "cannot agree" with the Seventh and Tenth Circuits, which held that magistrate judges are not permitted to enter final orders on bankruptcy appeals. *See In re Elcona Homes Corp.*, 810 F.2d 136, 139 (7th Cir. 1987); and *Virginia Beach Fed. Sav. & Loan Ass'n v. Wood*, 901 F.2d 849 (10th Cir. 1990).

Having found jurisdiction, Judge Freeman affirmed in part and remanded in part for further proceedings on issues other than jurisdiction.

The opinion is *Chenault-Vaughan Family Partnership Ltd. V. MDC Reeves Energy LLC (In re MTE Holdings LLC)*, 23-1916 (3d Cir. May 7, 2025).

The Ninth Circuit held that a debtor's claim for malicious prosecution must be brought in bankruptcy court and may not be filed in state court.

Circuits Are Split on the Extent to Which Bankruptcy Law Preempts State Law

The Ninth Circuit recently held that federal courts have exclusive jurisdiction over claims like malicious prosecution that arise from actions taken in bankruptcy cases.

One of the judges on the panel concurred, noting a circuit split and implying that Ninth Circuit law may be out of step with Supreme Court authority.

The facts and procedural history were exceptionally complex. Suffice it to say that a surgeon was in chapter 7. One of the surgeon's patients had died soon after surgery. By then, the doctor was in bankruptcy. A lawyer for the family of the deceased filed an adversary proceeding alleging that the medical malpractice claim was nondischargeable as willful and malicious injury or debt resulting from false representation.

Eventually, the doctor beat the medical malpractice suit. Later, the doctor sued the lawyer in state court for malicious prosecution, abuse of process and intentional infliction of emotional distress resulting from the allegedly meritless dischargeability suit.

Ultimately, the state trial court gave the doctor an $8 million judgment against the lawyer. On appeal, the state appellate court upheld the finding of liability for malicious prosecution, vacated the damages award and called for a new trial on damages. In a complex settlement, the lawyer gave the doctor an $8 million judgment on the condition that the debt would be discharged in the lawyer's bankruptcy.

The lawyer collaterally attacked the $8 million settlement by suing in federal district court and contending that the bankruptcy court had exclusive jurisdiction over claims for malicious prosecution arising from conduct occurring in the bankruptcy case. Consequently, the lawyer argued that any judgment in state court for malicious prosecution was void.

The district court dismissed the suit in federal court, ruling that the *Rooker-Feldman* doctrine barred collateral attack on the state court judgment. The doctor appealed.

Exclusive Federal Jurisdiction

Circuit Judge Daniel P. Collins began analysis of the merits by explaining how *Rooker-Feldman* arose from Supreme Court decisions in 1923 and 1983. The two cases, he said, stand for the proposition that a district court may not exercise what is effectively appellate review of a state court civil judgment.

However, Judge Collins said that the Ninth Circuit has "held that a 'state court judgment entered in a case that falls within the federal courts' exclusive jurisdiction *is* subject to collateral attack in the federal courts,' *Gonzales v. Parks*, 830 F.2d 1033, 1036 (9th Cir. 1987) (emphasis added), and that the *Rooker-Feldman* doctrine therefore does not bar such suits."

Judge Collins went on to cite *MSR Exploration, Ltd. v. Meridian Oil, Inc.*, 74 F.3d 910 (9th Cir. 1996), and described how the Ninth Circuit "held that 'state malicious prosecution actions for events taking place within . . . bankruptcy court proceedings are completely preempted by federal law.' *Id*. at 912." He also cited *Gonzales v. Parks*, 830 F.2d 1033, 1036 (9th Cir. 1987), to mean that "the state courts lack 'subject matter jurisdiction to hear a claim that the filing of a bankruptcy petition constitutes an abuse of process.'"

Judge Collins interpreted Ninth Circuit authority to mean that a "federal claim may only be 'brought in the bankruptcy court itself' and cannot even be brought as a later 'separate action in the district court.'" *MSR*, *supra*, at 916.

"It follows inexorably," Judge Collins said, that the doctor's "malicious prosecution claim is completely preempted by federal law and may only be asserted in federal court as part of [the doctor's] bankruptcy proceedings."

Because the doctor's claim was "completely preempted" by federal law and was within the federal courts' exclusive jurisdiction, Judge Collins reversed the district court's dismissal, holding that *Rooker-Feldman* did not apply.

The Concurrence

Circuit Judge Milan D. Smith, Jr., concurred "in full." However, his concurrence reads like an invitation for *en banc* review or the precursor to a petition for *certiorari* to resolve a circuit split.

Three times, Judge Smith said, the Ninth Circuit has held that *Rooker-Feldman* does not apply "if Congress expressly authorizes the federal district courts to review state-court judgments by statute." One of the cases held that a federal court may review a state court judgment about violations of the automatic stay.

In the case on appeal, Judge Smith said that Ninth Circuit precedent "controls the result here" and means that the doctor's "malicious prosecution claim for events taking place within federal

bankruptcy proceedings is, in reality, an exclusively federal claim for bankruptcy sanctions arising under Title 11 of the bankruptcy code and is completely preempted by federal law."

"Notably," Judge Smith cited the Third and Seventh Circuits for being "two other federal courts of appeals [that] have issued decisions that directly conflict with *MSR*'s broad holding." Moreover, he said that "the Supreme Court has sharpened the test for determining whether a state-law cause of action is completely preempted by federal law in the intervening years since we issued our 1996 decision in *MSR*."

For himself, Judge Smith said he was "skeptical that 11 U.S.C. § 105 and Rule 9011 of the Federal Rules of Bankruptcy Procedure would satisfy the modern test for completely preempting state-law malicious prosecution claims for events taking place within bankruptcy proceedings."

Judge Smith did not see the later Supreme Court decisions as being "clearly irreconcilable" with *MSR*. "Absent *en banc* reconsideration of MSR's broad *holding*, we are bound by it," he said.

The opinion is *Cogan v. Trabucco (In re Trabucco)*, 22-16948 (9th Cir. Aug. 21, 2024).

A district court in Houston denied a motion to dismiss a confirmation appeal as equitably moot, although reversal might alter ownership of the reorganized debtor.

A Plan Appeal Wasn't Equitably Moot, Even Though Reversal Might Rejigger New Equity

A district judge in Houston decided that an appeal from confirmation of a chapter 11 plan was not equitably moot, even though reversal could mean redistribution of the new debtor's equity.

The debtor, a software developer, negotiated a restructuring support agreement before filing with the holders of 80% of the first- and second-lien notes. The plan eliminated $1.6 billion in secured debt. Unsecured creditors were to be paid in full.

First-lien holders took back debt and had the right to receive new equity at a discount in an equity rights offering. Second-lien holders were slated to receive new equity.

To supply the cash required to operate the reorganized business and to confirm and consummate the plan, a majority of the lenders backstopped the equity rights offering. In return, the majority were to receive some of the new equity.

A minority of the lenders objected to the plan because they had not been given the opportunity to participate in the backstop. They contended that the plan violated Section 1123(a)(4), which requires the same treatment for every claim in a class.

The bankruptcy court confirmed the plan. The minority filed an appeal. Waiting several days, the minority filed a motion for a stay pending appeal in the district court. District Judge Andrew S. Hanen denied the stay motion, finding, among other things, that the appellants lacked a likelihood of success on appeal.

Following denial of the stay motion, the debtor and the majority lenders filed a motion to dismiss the appeal as equitably moot. Judge Hanen denied the motion in an opinion on October 23.

The Origins of Equitable Mootness

Accepted in "virtually every circuit," Judge Hanen said that equitable mootness was "a concept in bankruptcy law that has existed for approximately four decades," going back to a decision from

the Ninth Circuit in 1981. Although widely used, he said that courts have "cautioned against its widespread use."

In the Fifth Circuit, Judge Hanen said that equitable mootness "is looked at with great scrutiny, especially when it involves appeals concerning the rights of secured creditors."

To establish equitable mootness, Judge Hanen said that the debtor must show that (1) the plan was not stayed pending appeal; (2) the plan was substantially consummated; and (3) reversal "would either affect the rights of third parties or the success of the Plan." In the case on appeal, he said that the first two requirements were "certainly met."

The minority lenders were complaining on appeal that they had not been given an opportunity to invest in the equity backstop, for which they would have had a better recovery on their claims. The minority argued that the majority could be ordered to sell some of the extra equity to the minority.

No Stay and Substantial Consummation

The debtor and the majority argued on appeal that the lack of a stay pending appeal *per se* weighed in favor of dismissal.

Judge Hanen said that the injury to the minority "seems plainly remedial with either a monetary award or a redistribution of the equity allocation and would not require an unwinding of the plan that would affect the debtor." For that reason, he said that "denying the stay in this case weighs *against*" dismissal. [Emphasis in original.]

Substantial consummation "weighs in favor of equitable mootness," Judge Hanen said, because the plan "certainly has been substantially consummated."

Partial Relief Is a Big Deal

Citing the Fifth Circuit, Judge Hanen said that "[n]umerous courts" have held that the availability of partial relief would not disturb a reorganization. "In short," he said, equitable mootness "is improper" if the "Court *can* fashion a remedy without upsetting the reorganization." [Emphasis in original.]

Were he to order the majority to sell a portion of the new equity to the minority, Judge Hanen said there would be "no need to upset the Plan or the actions of third parties." Consequently, he said that the third factor "weighs heavily against a finding of equitable mootness."

Judge Hanen denied the motion to dismiss for equitable mootness.

Observations

Equitable mootness is a prudential doctrine running against the Supreme Court's recent pronouncements that federal courts have a "virtually unflagging obligation" to exercise Article III jurisdiction. S*ee, e.g.*, *Colorado River Water Conservation Dist. v. U.S.*, 424 U.S. 800, 817 (1976); and *F.B.I v. Fikre*, 601 U.S. 234, 240 (March 19, 2024).

In equitable mootness cases, there is always an extant case or controversy conferring constitutional jurisdiction. In appeals like this, the question not about jurisdiction; the question is whether there is an available remedy.

Equitable mootness has retarded the development of bankruptcy law. Were there no such doctrine, critical questions like those answered by the Supreme Court last term in *Purdue* would have been resolved decades earlier. Indeed, the different composition of the Court in prior years might have led to a different result, given that *Purdue* was 5/4.

Because there will be constitutional jurisdiction, this writer would have appellate courts dispense with equitable mootness and rule on the merits. Often, the merits is an easier question than equitable mootness.

In the event of reversal, the appellate court could remand for the bankruptcy court to decide whether there is an available remedy, possibly partial. After all, deciding whether there is an available remedy sounds like a factual question that should be addressed in the trial court, which is already vastly more familiar with the case.

The foregoing opinions are those of the writer, not ABI.

The opinion is *Ad Hoc Group of Excluded Lenders v. Convergeone Holdings Inc.*, 24-02001 (S.D. Tex. Oct. 23, 2024).

District court upholds an 'opt-out' chapter 11 plan with releases for nondebtors.

District Court Doesn't Say Whether 'Person Aggrieved' Survived *Truck Insurance*

Upholding confirmation of an "opt-out" chapter 11 plan's nondebtor releases, a decision by a district court in Cedar Rapids, Iowa, underscores the need for an appellate court, somewhere, to decide whether the *Truck Insurance* decision last term in the Supreme Court extinguished the "person aggrieved" standard for appellate standing in bankruptcy cases.

A Catholic hospital sold the assets and confirmed a chapter 11 plan with two categories of nondebtor releases. In the first category, the debtor and creditors released the major players in the reorganization, such as official committees and their members, bondholder representatives and a related order of nuns.

The second category of releases ran in favor of the major players' current and former officers, directors, affiliates, employees, agents, financial advisors and consultants. In his March 3 opinion, Chief District Judge C.J. Williams referred to the second group as the Remote Released Parties.

The plan enabled creditors to opt out of releases by checking a box on the ballot. However, the plan provided that creditors who voted in favor of the plan or who did not vote would grant the releases, including the Remote Released Parties.

The hospital's former corporate manager had a general unsecured claim for more than $30,000. The former manager opted out and opposed confirmation, contending that the Supreme Court's *Purdue* decision precluded releases in favor of the Remote Released Parties. Chief Bankruptcy Judge Thad J. Collins overruled the objection and confirmed the plan.

The former manager appealed and was denied a stay pending appeal by both Judge Collins and the magistrate judge. On appeal, the former manager only challenged the releases in favor of the Remote Released Parties.

Standing to Appeal

Together, District Judge Williams considered both the merits and the debtor's motion to dismiss the appeal based on the former manager's lack of appellate standing.

In bankruptcy appeals, the Eighth Circuit historically employs the "person aggrieved" standard for deciding whether the appellant has standing to appeal. To be a person aggrieved, Judge Williams said that the appellant must be "directly and adversely affected pecuniarily." More particularly, he said that the "possibility of harm" is not enough.

Because the former manager had opted out, Judge Williams said that it never gave up its claims against the released parties. As a result, he said, "Any decision by this Court about the Third-Party Releases will not alter [the former manager's] ability to go after claims that it never lost in the first place."

Even so, the former manager contended that it had the right to appeal, alleging that the releases were not permissible following *Harrington v. Purdue Pharma L.P.*, 602 U.S. 204 (2024). To read ABI's report, click here. Responding, Judge Williams said, "The 'person aggrieved' standard, however, requires something more than a general objection that a plan is not confirmable."

More particularly, Judge Williams said that "only … those parties who have been directly harmed by a bankruptcy court's order" have appellate standing. "A general objection to a plan as unconfirmable, without showing how the party was harmed, does not meet this standard."

On that basis, Judge Williams concluded that the former manager had no appellate standing.

Nonetheless, the former manager contended that its recovery from the liquidating trust would be greater had the debtor not released the Remote Released Parties. Judge Williams said that the former manager had not identified a single claim against Remote Released Parties that could have increased the recovery. Consequently, he held that the "abstract possibility of a claim that might increase [the former manager's] recovery does not satisfy the person aggrieved standard."

For a last stab at standing, the former manager argued that its status as an impaired creditor by itself conferred appellate standing.

Judge Williams responded by saying that the Eighth Circuit "does not appear to have adopted a *per se* rule that grants an impaired creditor standing based on its status as an impaired creditor alone because, unlike the broad right of participation reflected in bankruptcy level standing, the 'person aggrieved' standard is much more restrictive and does not automatically apply to an entire class."

For lack of appellate standing, Judge Williams granted the motion to dismiss.

The Merits

To cover all bases, Judge Williams reviewed the merits in case it were later held that the former manager had appellate standing. The former manager took the position that releases in favor of the Remote Released Parties were impermissible following *Purdue*.

Judge Williams said that *Purdue* went to "great lengths" to say that the decision was narrow and that the Court was not addressing what consensual releases might be. Furthermore, he said, the *Purdue* plan had been stayed pending appeal, but the hospital's plan "has been at least partially consummated."

Even if *Purdue* were controlling, Judge Williams said that the releases "are permissible because they are consensual releases," citing bankruptcy court decisions from the Southern and Northern Districts of New York.

Judge Williams closed his opinion by deciding that releasing the Remote Released Parties was permissible under the five-part test followed by courts in the Eighth Circuit as set forth in *In re Master Mortgage Investment Fund, Inc.*, 168 B.R. 930 (Bankr. W.D. Mo. 1994). He granted the motion to dismiss the appeal and said he "would still affirm" if the former manager had standing.

Observations

With regard to standing, Judge Williams did not mention *Truck Insurance Exchange v. Kaiser Gypsum Company, Inc.*, 602 U.S. 268 (June 6, 2024), where the Supreme Court broadly defined parties in interest who have standing to appear and be heard in chapter 11 cases under Section 1109(b). In proceedings in bankruptcy court, someone has standing who might be "potentially" affected by the reorganization. To read ABI's report, click here.

Truck Insurance did not address appellate standing. The Court held that an insurance company had standing in bankruptcy court to challenge a chapter 11 plan even though the plan was "insurance neutral" and did not impair the insurance company's rights as an insurer.

Nonetheless, did *Truck Insurance* address person aggrieved *sub silentio*? As a matter of constitutional law under Article III, may courts contrive prudential notions of standing to narrow the scope of who may appeal?

Remember, in *Lexmark Int'l, Inc. v. Static Control Components, Inc.*, 572 U.S. 118 (2014), the Supreme Court decried the use of "prudential standing" and more recently said that federal courts have a "virtually unflagging obligation" to exercise Article III jurisdiction. *See, e.g.*, *Colorado River Water Conservation Dist. v. U.S.*, 424 U.S. 800, 817 (1976); and *FBI v. Fikre*, 601 U.S. 234, 240 (March 19, 2024).

Needless to say, there's good reason to narrow the scope of appellate standing, otherwise anyone associated with a chapter 11 case could appeal despite the lack of financial interest in the

outcome. Is it possible that the constitutional requirement of a case or controversy becomes more narrow when ascending the appellate ladder? Would an appeal be a mere advisory opinion or theoretical conjecture if the outcome of the appeal would not affect the rights of the appellant?

The opinion is *Mercy Health Network Inc. v. Mercy Hospital, Iowa City, Iowa*, 24-68 (N.D. Iowa March 3, 2025).

Delaware judge wouldn't allow a chapter 11 debtor to restructure the same secured debt a second time in a different venue.

No Second Restructuring of the Same Debt in a Different Venue

Bankruptcy Judge John T. Dorsey of Delaware had confirmed a corporate debtor's chapter 11 plan. He didn't permit the debtor to file another chapter 11 case in California for a second restructuring of the secured debt that had been restructured in the first reorganization in Delaware.

Employing Bankruptcy Rule 1014(b) and Section 1127(b) in his January 30 opinion, Judge Dorsey transferred the case to Delaware and dismissed the new California petition as a bad faith filing. The petition in California had been filed three years after the Delaware plan had become effective.

We invite our readers to compare the case before Judge Dorsey with Johnson & Johnson's newest shot at resolving talc liability with a third chapter 11 petition in Houston, following the dismissals of two chapter 11 filings in New Jersey. In making the comparison, note that J&J created a new, Texas-based debtor called Red River Talc LLC in place of LTL Management LLC, the subsidiary that the Third Circuit dismissed for having no "financial distress." Are the distinctions significant? Does it matter that one case was confirmed and the other dismissed?

The Second Chapter 11 Filing Three Years Later

A corporate debtor had filed a chapter 11 petition in Delaware encumbered with debt in the original principal amount of about $173.5 million secured by substantially all of the assets. The debtor owned a luxury hotel in California that fell on hard times during the pandemic.

In late 2021, Judge Dorsey confirmed a chapter 11 plan giving the lender a restructured secured loan in the principal amount of some $185 million. The good times didn't last long, though, because planned renovations of the hotel ran over budget, and business didn't improve as expected following the pandemic.

The lender had allowed the debtor to sell part of the project and put the remainder on the market. When a buyer didn't appear, the lender started foreclosure. The lender gave the debtor another chance by agreeing to take a haircut for being taken out. When a new lender didn't appear, the debtor filed a new chapter 11 case in California one day before the scheduled foreclosure sale.

The lender filed a motion in Judge Dorsey's court to transfer venue to Delaware and dismiss the new petition. Note: The original chapter 11 case in Delaware had not been closed.

Two Bites at the Apple Prohibited

The lender's motion to transfer venue was governed by Bankruptcy Rule 1014(b), which provides:

> If petitions commencing cases under the Code . . . are filed in different districts by, regarding, or against (1) the same debtor . . . on motion filed in the district in which the petition filed first is pending . . ., the court may determine, in the interest of justice or for the convenience of the parties, the district or districts in which the case or cases should proceed.

The lender's motion to dismiss was governed by Section 1112(b), under which "cause" for dismissal is shown if the petition was not filed in good faith.

The lender contended that the new petition was filed in bad faith because "the debtors' sole purpose in filing the new case was to evade the consequences of their defaults under the chapter 11 plan previously confirmed by this Court." In that vein, Judge Dorsey said,

> Courts have held that chapter 11 filings made for the purpose of modifying a previously confirmed and substantially consummated plan in violation of Section 1127(b) of the Code are made in bad faith and must be dismissed under Section 1112(b) of the Code.

In pertinent part, Section 1127(b) provides that a "reorganized debtor may modify [a confirmed] plan at any time after confirmation of such plan and before substantial consummation of such plan . . . ."

The debtor contended that Rule 1014(b) did not apply because the first case was "substantially complete" and the debt restructured in the prior case was new debt to be handled in a new chapter 11 case. Judge Dorsey disagreed, saying, "It is clear from the record in this case that the [debt restructured in the first case] arose out of the First Bankruptcy Case and is therefore governed by the [Delaware] Plan." He added that the debt restructured in Delaware was "not new debt that came into existence independent of the First Bankruptcy Case, but rather was a product of the bankruptcy process."

Having found the ability to transfer venue, Judge Dorsey held that the new petition, filed "for the purpose of restructuring the [debt restructured in the first case], would have the effect of modifying the substantially consummated Plan, contrary to the provisions of Section 1127(b) of the Code."

Judge Dorsey then turned to the question of whether there were "changed circumstances" justifying a new filing. He said that the "plain text" of Section 1127(b) does not allow any exception to the requirement that a modification must occur before "substantial consummation." Quoting a 1998 decision by Bankruptcy Judge Conrad B. Duberstein, he said that the section provides "finality" with respect to confirmation orders for both the debtor and creditors.

To protect finality, Judge Dorsey said that "Debtors must show e*xtraordinary, unforeseeable changed circumstances* to avoid dismissal under Section 1112(b) of a second chapter 11 case that would result in a de facto modification of a previous plan." [Emphasis added.]

Judge Dorsey went on to find that the debtor's financial problems occurring after confirmation in the first case "were foreseeable, and none rise to the level of extraordinary." He distinguished authorities proffered by the debtor to justify a new filing.

In one case, the debt to be affected was new debt unrelated to the first bankruptcy. In the second case, the plan had not been substantially consummated, and the court in the third case found that changed circumstances were "entirely unforeseeable."

Judge Dorsey granted the motion to transfer venue and dismissed the petition in the second case that had been filed in California.

The opinion is *In re SC SJ Holdings LLC*, 21-10549 (Bankr. D. Del. Jan. 30, 2025).

Plans & Confirmation

The Third Circuit majority upheld nondebtor, nonconsensual releases because they were part of a sale, making the appeal statutorily moot under Section 363(m).

Third Circuit Upholds Boy Scouts' Nonconsensual Releases, *Purdue* Notwithstanding

With a minor modification, the Third Circuit upheld confirmation of the Boy Scouts of America's chapter 11 plan and its nonconsensual, nondebtor, third-party releases that would no longer be permissible following the Supreme Court's *Purdue* decision, which came down while BSA's appeal was pending in the circuit.

In a 62-page opinion on May 13, Circuit Judge Cheryl Ann Krause decided that the Boy Scouts' plan was not equitably moot, even though the plan was substantially consummated. Nonetheless, she upheld the plan by ruling that confirmation of the plan was statutorily moot under Section 363(m) because insurance companies bought back their policies from the debtor.

"If proposed today," Judge Krause said, "the [BSA] Plan would be unconfirmable in the wake of *Purdue*." In other words, Section 363(m) allowed implementation of a plan that the Supreme Court no longer permits.

Circuit Judge Marjorie O. Rendell wrote a 16-page concurring opinion that reads like a dissent. In her view, the plan was not statutorily moot under Section 363(m). She would have reached the same result and upheld confirmation given her belief that the appeal was equitably moot. In other words, the judges were split on equitable mootness.

The Third Circuit's *Boy Scouts* decision ranks in importance with opinions from the Supreme Court and covers more territory than a typical Supreme Court decision. Given the breadth of the *BSA* decision, we will report today on Section 363(m), because statutory mootness was the principal basis for upholding confirmation. Subsequently, we will describe why the majority decided that equitable mootness did not require dismissal of the appeal. Separately, we will report the concurrence by Judge Rendell.

Will Section 363(m) become a workaround to permit nonconsensual, nondebtor releases? Will equitable mootness survive a trip to the Supreme Court?

The Insurance Policy Buyback

Laying out the facts and the plan in detail, Judge Krause said that the Boy Scouts had paid $150 million by 2019 to resolve 250 sexual abuse suits. When it became evident that the organization could not defend the suits individually, the Boy Scouts filed a chapter 11 petition in Delaware in early 2020. When the deadline for claims arrived, there were over 82,000 claims with a maximum value of $3.6 billion.

With help from mediation, the debtor constructed a plan with a trust funded by almost $2.5 billion in "noncontingent assets." The largest chunk, $1.6 billion, would come from insurance companies buying back their policies. In return for the $1.6 billion, the sale agreements required the insurers to have a "complete release" from abuse claims. Judge Krause described them as "nonconsensual third-party releases."

All nine classes of voting creditors were in favor of the plan. Dealing with objections, the bankruptcy court held a 22-day confirmation trial, heard from 26 witnesses and took more than 1,000 exhibits. The bankruptcy judge wrote a 269-page opinion confirming the plan in July 2022.

The district court upheld confirmation in a 155-page opinion in March 2023, given that nondebtor releases were permissible under Third Circuit precedent. *National Union Fire Insurance Co. of Pittsburgh v. Boy Scouts of America (In re Boy Scouts of America)*, 650 B.R. 8 (D. Del. March 28, 2023). To read ABI's report, click here.

Two groups of creditors with sexual abuse claims appealed, asking the Third Circuit to set aside confirmation altogether under the authority of *Purdue*, among other theories. Two insurance companies also appealed, seeking more narrow relief that would not overturn the entire plan.

Purdue came down from the Supreme Court in June 2024, after the district court's affirmance. The Third Circuit heard argument in the Boy Scouts' appeal in November 2024, following *Purdue*.

Jurisdiction

On the merits, Judge Krause first established that the bankruptcy court had "related to" jurisdiction to impose nondebtor releases. In the Third Circuit, the existence of "related to" jurisdiction turns on whether the outcome could have a "conceivable" effect on the bankruptcy estate.

Judge Krause had little difficulty finding effects on the estate. Were tort claimants at liberty to sue insurers, the pool of coverage would be reduced, leaving the Boy Scouts with less insurance to pay claims. Likewise, the Scouts had indemnity obligations to nondebtors that would arise were there lawsuits against nondebtors.

Finding conceivable effects, Judge Krause held that "the Bankruptcy Court properly exercised related-to jurisdiction over these third-party claims."

Statutory Mootness

The debtor's "first argument" to uphold confirmation, Judge Krause said, was based on statutory mootness under Section 363(m). The subsection reads:

> The reversal or modification on appeal of an authorization under subsection (b) or (c) of this section of a sale or lease of property does not affect the validity of a sale or lease under such authorization to an entity that purchased or leased such property in good faith, whether or not such entity knew of the pendency of the appeal, unless such authorization and such sale or lease were stayed pending appeal.

If other prerequisites for the application of Section 363(m) are present, Judge Krause said that the court cannot declare a sale moot if there is relief that would not affect the validity of the sale. On the other hand, if appellate relief "would necessarily affect the sale's validity, the relief is unavailable, so the appeal must be dismissed."

Quoting Third Circuit authority, Judge Krause said that the subsection "does not prohibit the appeal of challenges to all sales and leases, but 'only those challenges that would claw back the sale from a good-faith purchaser.'"

With regard to the appeals mounted by the two insurance companies, Judge Krause said they were not challenging the validity of the insurance policy buyback. Therefore, she said, "§ 363(m) poses no barrier to our consideration of the merits of their appeal."

It was a different story for the tort claimants aiming to overturn the entire plan. For them, Judge Krause had "little difficulty concluding that the relief they seek would affect the validity of the Insurance Policy Buyback authorized by the Confirmation Order" because they wanted to "vacate the Plan in its entirety" and in the process unwind "the sale of BSA's insurance policies."

Whether the sale of the insurance policies had actually occurred was a bone of contention, because most of the price paid by the insurance companies was being held in escrow until confirmation was upheld by a final order no longer subject to appeal. Judge Krause rejected the argument, saying that "the fact that every last cent has not been handed over does not mean a sale has not occurred."

Judge Krause also rejected the argument that Section 363(m) did not apply because the sale was part of a plan, not a freestanding sale. She said that the Third Circuit had "dispatched this argument years ago."

The tort claimants contended that they were not seeking to overturn the sale, only the nondebtor releases. Judge Krause dismissed the contention, saying that "the Settling Insurers would receive

less than they bargained for in exchange for their cash contribution to the Settlement Trust, which 'would materially increase . . . the purchase price.'"

Of perhaps more substance, the tort claimants argued that statutory mootness would immunize plans from appellate review whenever a plan was combined with a sale. Judge Krause responded as follows:

> Our decision does not read § 363(m) to immunize from appellate review all facets of a plan whenever a § 363(b) sale is involved. Put differently, a challenge to a § 363(b) sale that is "collateral" to or would not otherwise "affect the validity of the sale" falls outside the ambit of § 363(m) [citation omitted], and given the breadth of issues a reorganization plan may resolve that do not necessarily implicate the terms of a § 363(b) sale, *see* 11 U.S.C. § 1123(a) – (b), the vast majority of challenges, no doubt, will fall into this category.

Applying the principles to the case on appeal, Judge Krause said that "the nonconsensual third-party releases challenged by the [tort] Claimants go to the heart of the Bankruptcy Court's § 363(b) authorization, so § 363(m) prevents us from disrupting them on appeal."

Judge Krause dismissed the appeal by the tort claimants who "would strike at the heart of the Insurance Policy Buyback." The appeals by the insurance companies were in a different category that escaped dismissal because they were "collateral to the Insurance Policy Buyback."

At the conclusion of the discussion of statutory mootness, Judge Krause dropped a footnote that ranks as perhaps the most significant statement in the opinion.

It was an "unusual case," Judge Krause said, because the Supreme Court handed down *Purdue* and "abrogate[d] our precedent on that issue" while the appeal was pending. "So were the Plan proposed today," she said, "we harbor little doubt that the Bankruptcy Court would neither authorize the Insurance Policy Buyback nor confirm the Plan with its impermissible releases."

Next

On Monday, we will explain why Judge Krause decided that the appeal was not equitably moot as to the insurance companies who were appealing. She dismissed the appeal as statutorily moot as to the tort claimants who wanted to overturn confirmation altogether.

Question

Assume there's another mass tort case where confirmation requires an insurance buyback, but the insurers refuse to buy back their policies without nonconsensual, nondebtor releases. Are we

certain that no bankruptcy court will ever confirm such a plan and that an appellate court won't dismiss the appeal as statutorily moot? Does Section 363(m) override Supreme Court precedent?

The opinion is *In re Boy Scouts of America*, 23-1664 (3d Cir. May 13, 2025).

Holding $1.4 billion in escrow did not preclude invocation of equitable mootness, Third Circuit majority says.

As to Appealing Insurers, the *Boy Scouts* Plan Was Not Equitably Moot

We reported on Friday how the Third Circuit, despite the Supreme Court's *Purdue* decision, upheld nonconsensual, nondebtor releases in the Boy Scouts of America's chapter 11 plan because Section 363(m) meant that confirmation was statutorily moot.

Today, we describe how Circuit Judge Cheryl Ann Krause decided in her May 13 majority opinion that confirmation was not equitably moot and how she ruled on the appeals by the two insurers whose appeals avoided statutory mootness. Tomorrow, we will describe how Circuit Judge Marjorie O. Rendell effectively dissented by coming to the conclusion that all appeals should have been held to be equitably moot.

The Evolution of Equitable Mootness

Judge Krause began her discussion of equitable mootness by mentioning how the doctrine became law in the Third Circuit "by a slim margin." Indeed, it was the slimmest of margins. Equitable mootness was adopted by a 7/6 *en banc* decision in *In re Continental Airlines*, 91 F.3d 553 (3d Cir. 1996) (*en banc*). The dissenting opinion was written by then-Circuit Judge (now Justice) Samuel A. Alito, Jr.

Citing her concurrence in a 2015 Third Circuit decision and a dissent in the Sixth Circuit, Judge Krause said that the "doctrine [of equitable mootness] is not without its critics." The *Boy Scouts* case, she said, "highlights a potentially troubling aspect of adherence to the doctrine," because "Congress took great care to define the circumstances where appellate remedies are unavailable, *see* 11 U.S.C. §§ 363(m) [and] 364(e)."

Listing four denials of *certiorari* between 2016 and 2023, Judge Krause said that "the Supreme Court has yet to consider the question [of equitable mootness] — and not for lack of opportunity."

Mentioning how "[o]ur criteria for invoking the doctrine have shifted over time," Judge Krause said that invocation of equitable mootness requires a substantially consummated plan and a showing that relief on appeal would "'(a) fatally scramble the plan and/or (b) significantly harm third parties who have justifiably relied on plan confirmation.'"

Substantial Consummation

Judge Krause was not called upon to apply equitable mootness to the tort claimants because she had already dismissed their appeals for being statutorily moot. The insurance companies that had also taken appeals were not attempting to overturn the plan entirely, thus raising the question of equitable mootness as to their appeals.

First, Judge Krause inquired as to whether the plan had been substantially consummated given that the settling insurance companies had paid $200 million into the trust and had placed another $1.4 billion into escrow. Local scout councils, she said, had turned over $439 million of their required $500 million. She said that the payments into escrow by the insurers "qualifies as a 'transfer.'"

Plan distributions had already begun, with $18.5 million having been distributed to some 5,500 claimants. Judge Krause concluded that substantial consummation, the first prong of equitable mootness, had been shown.

Having found substantial consummation, Judge Krause turned to the question of whether the insurance companies' appeals would "imperil[] the Plan's success." She said that the two insurers "do not seek invalidation of the releases; instead, they ask us to grant them each narrow, cabined relief."

At the conclusion of her decision on equitable mootness, Judge Krause dropped another pregnant footnote. Not having applied equitable mootness to the appeals by the tort claimants, she said, "should not be read, by negative implication or otherwise, to suggest that those claims are equitably moot."

Judge Krause said that "we need not resolve whether" the appeals by the tort claimants are not equitably moot in view of the fact that settling insurers had "nearly $1.5 billion" in escrow that could be recovered were there a reversal of confirmation.

Given the narrow relief that the insurers sought on appeal, Judge Krause decided against dismissing the appeals as equitably moot and therefore turned to the merits of the insurers' two appeals.

The Merits

With regard to one of the appealing insurers, Judge Krause said that the plan left that insurer's "contractual rights and defenses intact." She rejected that insurer's appeal for more protection in the plan because "we decline to rewrite the Plan and fasten suspenders to this already well-secured belt."

The appeal by the second group of insurers was another matter. Relying on *Purdue*, those insurers complained that the plan "non-consensually release[d] their claims and vitiate[d] their ability to recover certain defense costs." Specifically, they argued that the plan "impermissibly releases and enjoins contribution and indemnity claims they could otherwise assert against the Settling Insurers."

Judge Krause determined that the plan in fact would not enable the appealing insurers to recover the full amount of their indemnification and contribution claims from the settling insurers. She "therefore conclude[d] that *Purdue* controls, and the judgment reduction provision is unlawful insofar as it operates to extinguish the [appealing insurers'] claims without their consent."

As she had done pages earlier in a footnote, Judge Krause said in her conclusion,

> If proposed today, the Plan would be unconfirmable in the wake of *Purdue* and the [tort claimants] could not have their claims released without their consent. And that temporal happenstance, we recognize, is a bitter pill to swallow, "but bankruptcy inevitably creates harsh results for some players." *In re Weinstein Co. Holdings LLC*, 997 F.3d 497, 511 (3d Cir. 2021).

Judge Krause reversed and remanded with instructions for the bankruptcy court to modify the confirmation order as requested by the appealing insurers whose contributions rights were cut off.

The opinion is *In re Boy Scouts of America*, 23-1664 (3d Cir. May 13, 2025).

The circuit courts are diverging on the utility of equitable mootness to avoid reversing confirmation of chapter 11 plans.

'Dissent' in *Boy Scouts* Favored Using Equitable Mootness to Uphold Nondebtor Releases

In the third and last of our reports on the May 13 *Boy Scouts of America* opinions by the Third Circuit, we're covering the 16-page concurrence by Circuit Judge Marjorie O. Rendell that reads like a dissent.

Judge Rendell reached the same result — upholding the plan's nonconsensual, nondebtor releases — by reaching the polar opposite conclusions on statutory mootness and equitable mootness. Where the majority saw the tort claimants' appeals as statutorily moot under Section 363(m), she said they weren't. Where the majority didn't see equitable mootness, she did.

Judge Rendell saw the majority's statutory mootness opinion as "fundamentally flawed." Instead, she said she would have dismissed the tort claimants' appeals as "equitably moot," because equitable mootness "is firmly rooted in our precedent, and, as counsel for [the debtor] urged at oral argument, if ever there were a case crying out for application of the doctrine, this is it."

Statutory Mootness

Judge Rendell explained why she was unwilling to "stretch" statutory mootness under Section 363(m). The subsection reads:

> The reversal or modification on appeal of an authorization under subsection (b) or (c) of this section of a sale or lease of property does not affect the validity of a sale or lease under such authorization to an entity that purchased or leased such property in good faith, whether or not such entity knew of the pendency of the appeal, unless such authorization and such sale or lease were stayed pending appeal.

Judge Rendell described the "first fundamental flaw in the majority's" opinion on Section 363(m) as follows:

> [T]he statute's clear indication [is] that it does not apply to sales in reorganization plans as well as the common sense observation that the non-consensual third-party releases were not accomplished by way of the purported § 363 authorization, but by way of plan confirmation.

Judge Rendell noted it was an "appeal from the confirmation order, not the sale," and that "the majority's opinion endorses an end run around Chapter 11's requirements, including the Supreme Court's holding in *Harrington v. Purdue Pharma L.P.*" She said that "§ 363 itself distinguishes between sales under § 363(b) and (c) and sales under a plan." Citing the Fifth and Eleventh Circuits, she said that "several courts have suggested that sales accomplished under plans do not fall within § 363(m)'s ambit."

"If that is not enough," Judge Rendell said, "some of the Settling Insurers constructed the 'sale' of their policies such that they will not occur until the Confirmation Order is affirmed on appeal, meaning that the majority's approach will not finally resolve this case." She added:

> This arrangement was almost certainly crafted in an attempt to insulate the Plan and Confirmation Order from appellate review — otherwise, the buybacks of the insurance policies would have been confirmed, as is typical, by § 1123(a)(5)(D), which allows a plan to sell "all or any part of the property of the estate, either subject to or free of any lien." 11 U.S.C. § 1123(a)(5)(D).

More succinctly, Judge Rendell said, "Using § 363(m) to avoid an appeal deprives the sale of any real scrutiny," "goes far beyond what § 363 contemplates," and "shields from review the non-consensual third-party releases that the Supreme Court invalidated in *Purdue*."

Judge Rendell said that the majority's opinion "sets a dangerous transactional precedent, one that will result in Article III courts not having the capacity to review Confirmation Orders if the parties agree to call key intra-plan transactions 'sales.' Indeed, today's decision relegates the Supreme Court's holding in *Purdue* to a mere plan-drafting guide."

Judge Rendell would have held that "Section 363(m) clearly contemplates not only an authorized sale, but a sale that has occurred." Observing that "some of the Settling Insurers' agreements included provisions that their sales will not be completed unless and until there is a successful appeal," she concluded that the tort claimants' "appeals are not statutorily moot as applied to those sales."

Equitable Mootness

Because "statutory mootness does not finally resolve this case" given that the buybacks of the insurance policies "have not occurred," Judge Rendell said, "[w]e can avoid these complications if we rely instead on equitable mootness," a "discretionary principle that the circuit courts have unanimously adopted."

"Even where it is applied," Judge Rendell said, "the reviewing court has discretion to address the merits of the appeal if it wishes." By contrast, she said that Section 363(m) operates as an "on-off" switch that can strip courts "of any ability to review that provision."

Judge Rendell saw "not only error, but mischief, in the majority's approach." She concurred in the result "but believe[d] that equitable mootness is the way we should reason through the dismissal of the [tort] Claimants' appeals."

Observations

Recall the *Serta Simmons* decision in late December, where the Fifth Circuit called equitable mootness a "judge-created doctrine of pseudo-abstention," not a matter of "real mootness" that "implicates our jurisdiction under Article III." *Excluded Lenders v. Serta Simmons Bedding LLC (In re Serta Simmons Bedding LLC)*, 125 F.4th 555, 585 (5th Cir. Dec. 31, 2024).

Although the Fifth Circuit's reversal of the *Serta Simmons* confirmation order might cost some secured creditors millions of dollars, the appeals court said, "We will not save such sophisticated parties from the consequences of their actions." *Id*. at 588.

By admitting that the plan flaunted *Purdue*, were all three Third Circuit judges on the *Boy Scouts* appeal politely recommending that the Supreme Court rule on equitable mootness?

The opinion is *In re Boy Scouts of America*, 23-1664 (3d Cir. May 13, 2025).

The Fifth Circuit declines to adopt a securities industry guidebook for what's a permissible financing.

Fifth Circuit Bans Uptier Financings for Violating the Principle of Ratable Treatment

In a remarkable opinion, the Fifth Circuit banned so-called uptier financings. The decision by Circuit Judge Andrew S. Oldham included an equally remarkable discussion of equitable mootness where the Fifth Circuit had no hesitation in reversing confirmation of a consummated chapter 11 plan that may mean millions of dollars in losses for some creditors.

Given the gravity of the December 31 opinion, we will deal with uptier financing today. Tomorrow, we will cover equitable mootness and issues related to relief that an appeals court can grant on reversing plan confirmation.

The Norm of Ratable Treatment

Judge Oldham began his opinion by saying, "Ratable treatment is an important background norm of corporate finance." It is, he said, "a lender's 'sacred right' under syndicated loan agreements."

"The norm of ratable treatment," Judge Oldham said, "provides that the borrower may not choose to repay only one of its lenders. Rather, it must proportionally allocate [the repayment] among the relevant lenders according to their share of the outstanding debt."

"Uptiers," Judge Oldham said, "are a relatively new and controversial exception to the ratable treatment norm . . . . They are controversial because, according to critics, uptiers create a zero-sum game of 'lender-on-lender violence.'"

Judge Oldham said that an uptier financing works by amending

> the terms of a credit facility to allow the issuance of new super-priority debt. Because a majority of lenders in the existing facility must typically consent to such an amendment, the borrower purchases consent by allowing these lenders to exchange their existing debt for new super-priority debt, often at an above-market price . . . . Since not all of the lenders participate in the uptier, the uptier is a non-*pro rata* transaction that violates the norm of ratable treatment.

Judge Oldham said that the advantages of an uptier include "play[ing] lender groups off of each other and avoid[ing] the expense of dealing with holdouts." Furthermore, "[t]he costs of an uptier transaction are borne entirely by the minority lenders, who end up with subordinated debt worth less than before."

The Serta Simmons Uptier Financing

Having extolled the virtues of ratable treatment, Judge Oldham described the uptier financing by bedding-maker Serta Simmons Bedding LLC.

In 2016, the company had sold a series of syndicated loans yielding $1.95 billion in first lien debt and $450 million in second lien loans.

To protect "the sacred right of *pro rata* sharing," Judge Oldham described the 2016 loan agreement as having a provision preventing the company from "pay[ing] its obligations to one lender while offering nothing to the rest." As further protection, he said that the agreement included another provision that "generally requires [the] unanimous consent of any affected lender to waive, amend, or modify" the *pro rata* sharing requirement. Other provisions in the agreement could be modified by a simple majority vote of lenders.

There were two exceptions to the *pro rata* repayment requirement. One was a "Dutch option," and the second was an "open market purchase." The loan agreement, Judge Oldham said, did not define "open market purchase." The "patent ambiguity in the undefined term," he said, "forms the foundation of this case."

With the company facing financial difficulty, Judge Oldham described how the company cobbled together an uptier financing in 2020 with some but not all of its first and second lien lenders. The parties and Judge Oldham called them the "Prevailing Lenders."

The Prevailing Lenders provided new $200 million financing in the form of first-out, super-priority debt. They traded $1.2 billion in existing financing for $875 million in second-out, super-priority debt. Overall, the deal gave the company more cash and less debt. However, Judge Oldham said that the deal allowed the Prevailing Lenders "to jump the creditor line and get paid before their erstwhile first and second lien comrades."

Anticipating litigation in the future, the Prevailing Lenders voted by a bare majority to amend the 2016 loan agreement to allow the uptier financing. They also labeled the uptier financing an "open market purchase."

There was more. The company agreed to indemnify the Prevailing Lenders for any losses or liabilities they might incur as a consequence of the uptier financing.

The Serta Simmons Chapter 11 Case

The company filed a chapter 11 petition in early 2023 in Houston. The case was assigned to Bankruptcy Judge David R. Jones, who resigned several months later.

Immediately, the debtor filed an adversary proceeding seeking a declaration that the uptier financing did not violate the 2016 loan agreement. Opposition came from lenders in the 2016 financing who were not among the Prevailing Lenders. The parties and Judge Oldham referred to the opponents as the "Excluded Lenders."

The bankruptcy court granted summary judgment to the Prevailing Lenders and held that the uptier financing was a permitted "open market purchase." The bankruptcy court certified a direct appeal, which the Fifth Circuit accepted.

After dismissing counterclaims for breach of contract asserted by the Excluded Lenders in the adversary proceeding, the bankruptcy court entered final judgment in favor of the debtor and the Prevailing Lenders. Again, the Fifth Circuit accepted a direct appeal.

The Chapter 11 Plan

Because the prepetition indemnification of the Prevailing Lenders would not survive confirmation of the debtor's chapter 11 plan, the plan gave the Prevailing Lenders a new indemnification. The bankruptcy court confirmed the plan and approved "the settlement indemnity [as] a fair and equitable component of a § 1123(b)(3) settlement," Judge Oldham said.

The Fifth Circuit accepted a direct appeal of the confirmation order.

Appellate Jurisdiction

Having consolidated four appeals, Judge Oldham first addressed the Fifth Circuit's appellate jurisdiction and the jurisdiction of the bankruptcy court. Meticulously but quickly, he decided that the bankruptcy court had jurisdiction and power to enter final judgments, with one exception.

The exception was state law breach-of-contract claims by the Excluded Lenders against the Prevailing Lenders, where the bankruptcy court did not have constitutional power to enter a final judgment under *Stern v. Marshall*, 564 U.S. 462, 482 (2011). However, Judge Oldham held that the lack of objection by the debtor and the Prevailing Lenders was implied consent under *Wellness International Network, Ltd. v. Sharif*, 575 U.S. 665 (2015), allowing the bankruptcy court to enter final judgment dismissing the Excluded Lenders' counterclaims.

Judge Oldham also held that the Fifth Circuit had appellate jurisdiction under 28 U.S.C. § 158(d).

It Wasn't an Open market Purchase

On the merits, Judge Oldham first undertook *de novo* review of the bankruptcy court's decision on summary judgment holding that the uptier financing was a permissible open market purchase. Under New York law governing the 2016 financing, he explained why the uptier financing was not an open market transaction.

By referencing dictionaries and by analogy to the Federal Reserve's open market activities, Judge Oldham concluded that "an open market purchase is a purchase of corporate debt that occurs on the secondary market for syndicated loans."

Judge Oldham added that "the words 'open market' point to a specific 'market,' not merely a general context where private parties engage in non-coercive transactions with each other." He rejected the idea "that there is an open market wherever there is competition." Properly, he said, "an open market is one tied to a specific market, like the stock market or the commodities market or the securities market."

Applied to the case at hand, Judge Oldham said that "an open market purchase occurs on the specific market for the product that is being purchased . . . , and the market for that product is the 'secondary market' for syndicated loans."

If the company had wanted to effect an "open market purchase and thereby circumvent the sacred right of ratable treatment," Judge Oldham said, "it should have purchased its loans on the secondary market. Having chosen to privately engage individual lenders outside of this market," he said that the debtor "lost the protection of" the provision in the 2016 loan agreement that gave an exception for open market purchases.

For the same reason that the uptier financing was not an open market transaction, Judge Oldham decided that it also was not subject to the exception for Dutch auctions.

Other Rejected Arguments

Of significance in future cases dealing with syndicated loans, Judge Oldham rejected the Prevailing Lenders' reliance on "a guide published by the Loan Syndications and Trading Association" (LSTA) to show "that industry usage supports their expansive definitions of 'open market purchase.'"

While the "LSTA guide carries some weight," Judge Oldham said, "it is not binding authority." Even if it were dispositive, he said that "its discussion of open market purchases does not support the 2020 Uptier."

Holding "that the 2020 Uptier was not a permissible open market purchase within the meaning of the 2016 Agreement," Judge Oldham reversed "the bankruptcy court's contrary ruling."

In one paragraph, Judge Oldham ruled in favor of the Excluded Lenders in their appeal from the bankruptcy court's denial of their counterclaims for breach of contract. He said that the counterclaims were "largely based" on the issue of open market purchases.

Judge Oldham reversed and remanded for reconsideration of the Excluded Lenders' breach of contract claims. In words the bankruptcy court likely will not ignore on remand, he added that "the Excluded Lenders have a strong case that [the debtor] and the Prevailing Lender plaintiffs breached the 2016 Agreement."

Observations

Prof. Stephen J. Lubben provided ABI with the following commentary:

> The Court's ruling on "open market purchases" was refreshingly sensible, compared to the typical hyper-literalism we normally see in corporate finance decisions. Too often courts say [that] "while the parties might not have intended this result, it was not technically prohibited, and the parties are sophisticated, so too bad for you."
>
> That just encourages even more outrageous abuse in the next case. I am hopeful that the *Serta* decision will reset the situation with regard to aggressive "liabilitymanagement transactions," which are often little more than a flagrant attempt to favor one group over another in the forthcoming chapter 11 case.

Among the commentators cited in his opinion, Judge Oldham included Prof. Lubben's "Holdout Panic," 96 AM. BANKR. L.J. 1 (2022). Prof. Lubben occupies the Harvey Washington Wiley Chair in Corporate Governance & Business Ethics at Seton Hall University School of Law.

The opinion is *Excluded Lenders v. Serta Simmons Bedding LLC (In re Serta Simmons Bedding LLC)*, 23-20181 (5th Cir. Dec. 31, 2024).

Fifth Circuit didn't permit plan proponents to structure a chapter 11 plan so that an appeal would be equitably moot.

Fifth Circuit Holds that Equitable Mootness Doesn't Protect Parties to the Appeal

Yesterday, we covered the *Serta Simmons* decision, where the Fifth Circuit decided that the company's uptier financing before bankruptcy was not a permissible "open market purchase" and thereby violated the Excluded Lenders' rights to ratable treatment.

Today, we cover the Fifth Circuit's narrowing of the doctrine of equitable mootness, thereby allowing the appeals court to set aside confirmation of the debtor's consummated chapter 11 plan at the cost of millions of dollars to some secured creditors.

Equitable Mootness Doesn't Protect Parties to the Appeal

Yesterday, we reported how the debtor's confirmed chapter 11 plan gave the Prevailing Lenders an indemnification by the debtor for any losses or liabilities they might incur for having participated in the prebankruptcy uptier financing. As we also reported yesterday, the Fifth Circuit decided that the uptier financing violated the rights of the Excluded Lenders.

The Prevailing Lenders argued that equitable mootness barred the appeals court from setting aside confirmation and granting relief to the Excluded Lenders.

Circuit Judge Andrew S. Oldham began his discussion of equitable mootness by calling it a "judge-created doctrine of pseudo-abstention," not a matter of "real mootness" that "implicates our jurisdiction under Article III."

Under Fifth Circuit authority, Judge Oldham said that equitable mootness turns on three factors: (1) whether there was a stay; (2) whether the plan was substantially consummated; and (3) whether granting relief would affect either the rights of parties not before the court or the success of the plan.

The plan had been substantially consummated, but the Excluded Lenders failed to obtain a stay pending appeal three times. Judge Oldham said that the Fifth Circuit "never said that the failure to obtain a stay mandates finding an appeal equitably moot."

Considering the rights of parties not before the court, Judge Oldham said that nixing the indemnification

> would affect [the debtor], which would no longer be on the hook for liability related to the 2020 Uptier, as well as those holders of super-priority debt who participated in the Uptier (*i.e.*, the Prevailing Lender plaintiffs). The former would benefit from excision; the latter would not. But both are present here.

In terms of affecting the plan, Judge Oldham said that the debtor "would face an easier future without a massive liability hanging over its head. So it is also unclear how excision [of the indemnification] would threaten the success of the Plan."

The debtor and the Prevailing Lenders contended that the appeals court could not excise the indemnification "without unwinding the entire Plan and triggering a whole new confirmation proceeding." Responding, Judge Oldham said, "[O]ur precedent does not indicate that the remedy of excision requires thus." Citing *In re Highland Cap. Mgmt. LP*, 48 F.4th 419, 430-31 (5th Cir. 2022), he added, "we have said just the opposite."

Given that removing indemnification would help the debtor, Judge Oldham said that "excision does not toll doom for the Plan, and the third factor properly weighs against equitable mootness."

Beyond the three factors pertaining to equitable mootness, the Prevailing Lenders contended that removing indemnification would be unfair because, as Judge Oldham said, they "agreed to support the Plan only because of the settlement indemnity."

Without indemnification, Judge Oldham recounted how the Prevailing Lenders said "they would have exacted some other consideration from [the debtor]." Accordingly, he said, they "contend it is unfair for this court to excise the indemnity now without letting them go back to the drawing board, which we cannot do without upending the Plan."

Judge Oldham gave the argument what he called "a full-throated rebuttal."

Were he to invoke equitable mootness, he said that "the appellees' argument would effectively abolish appellate review of even clearly unlawful provisions in bankruptcy plans. Parties supporting such provisions could always argue they would have done things differently if they had known the provisions would later be excised."

"From the moment the Prevailing Lender plaintiffs agreed to a controversial indemnity arising out of a contentious transaction," Judge Oldham said, "they could foresee the adverse consequences of an unfavorable appellate ruling."

Declining to dismiss the appeals as equitably moot, Judge Oldham said, "We will not save such sophisticated parties from the consequences of their actions."

Jevic Doomed the Plan's Indemnification

Having decided that the appeals were not equitably moot, Judge Oldham turned to the question of whether "the Plan's inclusion of the indemnity was an impermissible end-run around the Bankruptcy Code."

Citing Section 502(e)(1)(B), Judge Oldham said that "the bankruptcy court must disallow any contingent claim for reimbursement where the claiming entity is co-liable with the debtor." In fact, the Prevailing Lenders had filed proofs of claim based on their indemnification rights under the 2016 loan agreement, but they had agreed to disallow the claims under Section 502(e)(1)(B).

Judge Oldham said that the Prevailing Lenders "resurrected the pre-petition indemnity as a *settlement* indemnity." [Emphasis in original.] However, he said it was a "mistake" when the bankruptcy court approved the new indemnification as part of a settlement underlying the plan. It was, he said, "an impermissible end-run around § 502(e)(1)(B)'s disallowance of contingent claims for reimbursement."

To the Prevailing Lenders' contention that the indemnity was a settlement permissible under Section 1123(b)(3)(A), Judge Oldham said that "*Czyzewski v. Jevic Holding Corp.*, 580 U.S. 451 (2017)[,] is . . . directly applicable to these appeals." He "decline[d] to read § 1123(b)(3)(A) as an escape hatch from the Code's explicit disallowance of certain claims." [Recall that *Jevic* set aside a so-called structured dismissal that violated the rules of priority.]

Judge Oldham therefore held "that the Plan indemnity was an impermissible end-run around the Code."

The Indemnity Violated Equal Treatment

Even if the indemnity in the plan was a permissible settlement under Section 1123(b)(3)(A), Judge Oldham explained why "its inclusion in the Plan violated the Code's requirement of equal treatment." He said that the value of the indemnity "varied dramatically" depending on whether or not the lender had participated in the uptier financing.

For the Prevailing Lenders, Judge Oldham said that "the indemnity was potentially worth millions or even tens of millions of dollars." But for lenders who were not in the uptier, he said that "the indemnity was worth little or even nothing." He therefore held that "the Plan indemnity constituted impermissible unequal treatment."

The Remedy and the Admonition

Excising "the offending indemnity in . . . the Plan," Judge Oldham reversed "the bankruptcy court's final order confirming the Plan insofar as it approved the Plan's indemnity relating to the 2020 Uptier."

Judge Oldham said that the company's 2020 uptier "was the first major uptier . . . . But it was far from the last."

"Though every contract should be taken on its own, today's decision suggests that such exceptions will often not justify an uptier," Judge Oldham said.

Observations

Recall that Judge Oldham said, "We will not save such sophisticated parties from the consequences of their actions."

Judge Oldham's words should instill caution, if not fear, in the hearts of those contemplating chapter 11 plans in the Fifth Circuit with questionable provisions.

The bankruptcy court in Houston is considering a Johnson & Johnson subsidiary's third stab at a chapter 11 plan dealing with talc liability. If a plan is confirmed, an appeal presumably will find its way to the Fifth Circuit.

Does Judge Oldham's *Serta Simmons* opinion suggest that the Fifth Circuit might have a skeptical approach to a case that was twice dismissed in the Third Circuit on opinions by one of the circuits' foremost authorities on chapter 11?

The opinion is *Excluded Lenders v. Serta Simmons Bedding LLC (In re Serta Simmons Bedding LLC)*, 23-20181 (5th Cir. Dec. 31, 2024).

Picking up where Serta Simmons left off, the Fifth Circuit nixes another creative chapter 11 plan.

Another Fifth Circuit Humdinger: This Time, Limiting Gatekeeping

When it comes to limiting creative uses of chapter 11, the Fifth Circuit is on a roll.

On December 31, the Fifth Circuit barred so-called uptier financings that utilized creative drafting to evade provisions in bond indentures that demand "ratable treatment" whenever a debtor is paying some holders but not others. *Excluded Lenders v. Serta Simmons Bedding LLC (In re Serta Simmons Bedding LLC)*, 125 F.4th 555 (5th Cir. Dec. 31, 2024). To read ABI's report, click here.

In the reorganization of Highland Capital Management LP, the Fifth Circuit for the second time wrote an opinion on a direct appeal from confirmation. The circuit's first opinion in August 2022 authorized bankruptcy judges to be gatekeepers with power to stop groundless lawsuits aimed at people or entities involved in the reorganization. *NexPoint Advisors LP v. Highland Capital Management LP (In re Highland Capital Management LP)*, 48 F.4th 419, 424 (5th Cir. Aug. 19, 2022). To read ABI's report, click here.

In the second confirmation opinion on March 18, the Fifth Circuit said that gatekeeping "is patently beyond the power of an Article I court under § 105" if it protects anyone other than the debtor, independent directors, the creditors' committee and committee members for conduct within the scope of their duties.

In this writer's view, gatekeeping no longer has much practical significance in the Fifth Circuit, because those protected by gatekeeping are even better protected by exculpations.

The bigger question is this: After *Serta Simmons* and the new *Highland Capital* opinion, is the Fifth Circuit sending a message to bankruptcy judges about reining in exotic features of chapter 11 plans beyond uptier financings and gatekeeping?

In the Fifth Circuit's new *Highland Capital* opinion on March 18, only one circuit judge from the first panel was on the panel in the new case. One of the circuit judges from the *Serta Simmons* panel also was on the new *Highland Capital* panel.

Exculpations and Gatekeeping

In both *Highland Capital* opinions, the Fifth Circuit noted the "continued litigiousness" expected after confirmation from the debtor's former chief executive, who was forced out during the chapter 11 case. To head off continual litigation, the chapter 11 plan as originally confirmed included both exculpations and gatekeeping.

The exculpations, which might be viewed as equivalent to releases, were conferred on the debtors and its successors, the debtor's general partner, independent directors, the creditors' committee and its members, the professionals retained by the debtor and the committee, the debtor's new chief executive, and persons related to the foregoing.

The gatekeeping provisions were broader. No one could sue a "Protected Party" unless the bankruptcy court had first authorized the suit after deciding it made a "colorable claim."

The Protected Parties were broader than those receiving exculpations and included the debtor's subsidiaries, the reorganized debtor, the trust created by the plan, the trustees for the trust, and the creditors' oversight committee.

Entities related to the ousted chief executive took a direct appeal from confirmation of the plan containing exculpations and gatekeeping. In the 2022 opinion, the panel "reverse[d] only insofar as the plan exculpates certain non-debtors in violation of 11 U.S.C. § 524(e), str[uck] those few parties from the plan's exculpation, and affirm[ed] on all remaining grounds." *Highland Capital*, *supra*, 48 F.4th at 424. Specifically, the Fifth Circuit limited the exculpations to cover only the debtor, a trustee, the creditors' committee and committee members.

Following a motion for rehearing after the first opinion, Circuit Judge Jennifer Walker Elrod said in the new March 18 opinion that the appeals court granted panel rehearing and modified the original opinion. In the modified opinion, she said,

> We granted panel rehearing and made one substantive change to the opinion: deleting the sentence, "The injunction and gatekeeper provisions are, on the other hand, perfectly lawful," and replacing it with the sentence, "We now turn to the Plan's injunction and gatekeeper provisions." *Id.* at 438.

On remand in bankruptcy court, the debtor proposed amending the exculpations as directed by the Fifth Circuit. Over objection by entities related to the ousted chief executive, the bankruptcy court did not narrow "Protected Parties" to line up with those receiving exculpations. *See In re Highland Capital Management LP*, 2023 BL 66255 (Bankr. N.D. Tex. Feb. 27, 2023). To read ABI's report, click here.

For a second time, the Fifth Circuit accepted a direct appeal of the chapter 11 plan as modified.

Limits on Gatekeeping Power

On the second appeal, Judge Elrod stated the question as being "whether the bankruptcy court erred in failing to narrow the definition of 'Protected Parties' used in the Gatekeeper Clause coextensively with its narrowing of the definition of 'Exculpated Parties.'"

Citing Fifth Circuit authority, Judge Elrod said that Section 105(a) does not give a bankruptcy court a "roving commission to do equity." She added, "[W]e have always recognized and enforced limitations on bankruptcy courts' power to shield non-debtors from liability."

Citing the Supreme Court's *Purdue* opinion last term and the Fifth Circuit's opinions in *In re Pac. Lumber Co.*, 584 F.3d 229 (5th Cir. 2009), and *In re Zale Corp.*, 62 F.3d 746 (5th Cir. 1995), Judge Elrod said that the two courts "have definitively held that bankruptcy courts may not approve a confirmation plan that non-consensually releases non-debtors from liability related to a bankruptcy proceeding."

Taking a victory lap given that *Zale* and *Pacific Lumber* anticipated *Purdue* by decades, Judge Elrod said,

> [T]his court had held the same [as *Purdue*]: . . . any provision that non-consensually releases non-debtors from liability for debts and/or conduct, and any injunction that acts to shield non-debtors from such liability, must be struck from a bankruptcy confirmation plan.

Although the Fifth Circuit "recognized that bankruptcy courts have some power to perform gatekeeping functions," Judge Elrod said, "they nonetheless do not have unrestricted power to protect non-debtors from liability via a pre-filing injunction." She added, "[W]e have never extended the *Barton* doctrine to give bankruptcy courts gatekeeping power over claims against non-debtors."

The Holding

Drawing from the 2022 opinion in *Highland Capital* and the revised opinion after rehearing, Judge Elron held:

> The clear weight of Supreme Court and Fifth Circuit precedent dictates our holding: that a proper reading of *Highland I* requires that the definition of "Protected Parties" used in the Plan's Gatekeeper Clause be narrowed coextensively with the definition of "Exculpated Parties" used in the Exculpation Provision. Any other reading of *Highland I* would improperly grant the bankruptcy court authority to enforce what is *perhaps the broadest gatekeeper injunction ever written into a bankruptcy confirmation plan*. Such authority is patently beyond the power of an Article I court under § 105. [Emphasis added.]

To ensure there would be no mistake, Judge Elrod reversed and remanded for the district to:

> revise the Plan's definitions of both "Exculpated Parties" and "Protected Parties" to read simply: "collectively, (i) the Debtor; (ii) the Independent Directors, for conduct within the scope of their duties; (iii) the Committee; and (iv) the members of the Committee in their official capacities, for conduct within the scope of their duties."

Observations

In the comment box below, we invite readers to offer their views on questions like the following:

1. Are *Serta Simmons* and the new *Highland Capital* opinions remarkable, or are they nothing more than reflections of the Fifth Circuit's longstanding prohibition of nondebtor releases?
2. Do *Serta Simmons* and *Highland Capital* have significance beyond uptier financings and gatekeeping?
3. In *Serta Simmons* and *Highland Capital*, is the Fifth Circuit sending a message to bankruptcy judges in the Fifth Circuit to be leery about exotic features chapter 11 plans?
4. Do the two opinions suggest anything about how the Fifth Circuit will rule should opt in vs. opt out come up on appeal?

The opinion is *Highland Capital Management Fund Advisors LP v. Highland Capital Management LP (In re Highland Capital Management LP),* 23-10534 (5th Cir. March 18, 2025).

Professors disagree on whether latent asbestos claims can be discharged without a trust for future claimants.

New York Court Holds that 'Future' Asbestos Claims Can Be Discharged Without a Trust

Discharge resulting from confirmation of a chapter 11 plan barred talc claims that were first diagnosed after confirmation, even though the chapter 11 plan did not invoke Section 524(g) and there was neither a future claims representative nor a trust fund for "future" claimants, according to an opinion by Bankruptcy Judge David S. Jones of New York.

In his August 12 opinion, Judge Jones held that Section 524(g) "is permissive and allows but does not require use of certain mechanisms for dealing with latent asbestos-related injuries."

The Revlon Plan

Cosmetics manufacturer Revlon filed a chapter 11 petition in June 2022, but asbestos or talc claims were not the primary reason for reorganization. Nonetheless, the debtor was aware there were asbestos claims arising from products containing talc.

"Future" talc claimants were unknown to the debtor. The debtor published notice of the claims bar date in two large newspapers in the U.S. The claims notices did not mention talc or asbestos claims.

Aware there could be latent talc claims, the order setting the bar date said that a talc claim, if filed before confirmation, would be timely if there was a diagnosis after the filing date. The talc claimants admitted that the bar notice was "typical."

The illnesses of some 42 talc claimants were all first diagnosed after confirmation. They sued the reorganized debtor in courts around the country, to which the debtor responded with a motion in bankruptcy court to enforce the injunction in the plan. The talc claims contended that discharge did not apply to them because the plan did not comply with Section 524(g), there was neither a future claims representative nor a trust for future claims, and 75% of talc claimants had not accepted the plan.

Judge Jones said that "the Plan does not attempt to employ or satisfy the requirements of 11 U.S.C. § 524(g), which . . . establishes one available means of providing for and satisfying the entitlements of individuals asserting claims based on pre-petition exposure to asbestos."

Section 524(g)

Responding to the talc claimant's contention that discharge did not apply to them, Judge Jones decided with little ado that the talc claimants' claims were prepetition claims. He then addressed the question of whether the debtor was obliged to comply with Section 524(g).

Judge Jones quoted the section that says that "a court that enters an order confirming a plan of reorganization under chapter 11 **may issue**, in connection with such order, an injunction in accordance with this subsection to supplement the **injunctive effect of a discharge under this section**." [Emphasis in original.]

He said that "Section 524(a) already enjoins any act to collect on a debt discharged under Section 1141[, but Section 524(g)] goes further and includes a detailed scheme that meets the special needs of bankruptcy cases in which the debtor faces extensive liability on account of asbestos-related claims." He went on to say that "no part of Section 1141(d) carves out any exception to discharge for asbestos claims or refers to Section § 524(g) as an exclusive or required method of accomplishing a discharge of asbestos-exposure liability."

To buttress his conclusion, Judge Jones said that "none of the cases cited by the Talc Claimants hold the use of 11 U.S.C. § 524(g) to be mandatory for debtors to obtain the discharge of prepetition asbestos claims against them." He also cited the Second Circuit as having "rejected the argument that the lack of a future claims representative . . . amounted to a denial of due process as to a claimant who brought an asbestos-liability claim against a debtor that had gone through bankruptcy."

Judge Jones held "that Section 524(g) does not affect the ability of a debtor in bankruptcy to obtain a discharge from asbestos-related liability through a plan that does not employ the means established by Section 524(g)." He found support for his holding in *Purdue*, where the Supreme Court did "not read § 524(g) to 'impair' or 'modify' authority previously available to courts in bankruptcy." *Harrington v. Purdue Pharma L.P.*, 219 L. Ed. 2d 721, 144 S. Ct. 2085 at n.5 (Sup. Ct. June 27, 2024).

Notice

Although conceding that they were "unknown" creditors, the talc claimants contended that notice of the bar date did not afford due process.

Judge Jones admitted that the bar notice did not mention talc claims, "but it described the claims covered in broad terms that clearly encompassed the Talc Claimants . . . . Effective and sufficient notice required nothing more."

Holding "that the Talc Claimants have failed to carry their burden of showing the Debtors provided inadequate notice," Judge Jones granted the debtor's motion to enforce the confirmation order and the plan injunction.

Observations

When it comes to personal injury claims that are not manifest until after discharge, law professors are on both sides of the street.

In the opinion of Prof. Anthony J. Casey, "The opinion is correct. This is just a regular old discharge." In a message to ABI, he explained why:

> The issue is entirely straightforward. Claims against the debtor that arose pre-confirmation are discharged. These claims arose pre-confirmation.
>
> The only question is notice, and the judge correctly finds publication notice to be constitutionally sufficient.
>
> The Section 524(g) issue is a red herring. It allows certain options that (after *Purdue*) aren't available in other cases. But Judge Jones is correct that it is entirely permissive. The debtor does not have to go the Section 524(g) route.

Prof. Ralph Brubaker has a different point of view. He told ABI:

> Discharging the claim of a future claimant who has not yet been injured or discovered the injury, and whose interests were not represented by a future claims representative during the Chapter 11 case, is clearly unconstitutional.
>
> The conclusion to the contrary is based upon an impoverished and cramped understanding of the Supreme Court's due process jurisprudence, and produces the kind of obvious injustice that is the stuff of *Alice's Adventures in Wonderland*.

Prof. Casey is the Donald M. Ephraim Professor of Law and Economics at the University of Chicago Law School. Prof. Brubaker is the James H.M. Sprayregen Professor of Law at the University of Illinois College of Law.

The opinion is *In re RML LLC*, 22-10784 (Bankr. S.D.N.Y. Aug. 12, 2024).

In the Spirit Airlines reorganization, no creditors with an economic interest had opposed confirmation of a plan with opt-out releases for nondebtors.

Opt-Out Plan Confirmed with Impaired Creditors Almost Unanimous in Support

Confirming the chapter 11 plan for Spirit Airlines, Bankruptcy Judge Sean Lane of New York wrote an opinion that could be read to mean that the Supreme Court's *Purdue* decision in June did not affect pre-existing authority in the Southern District of New York allowing so-called opt-out plans to confer releases on nondebtors.

The March 7 decision by Judge Lane differs from the *Smallhold* opinion by Delaware's Bankruptcy Judge Craig T. Goldblatt, who excised releases from creditors who did not vote and were not given a chance to opt out. However, Judge Goldblatt allowed releases to be given by creditors who voted for or against the plan, if they did not opt out. *In re Smallhold Inc.*, 665 B.R. 704 (Bankr. D. Del. Sept. 25, 2024). To read ABI's report, click here.

The Opt-Out Plan

The debtor negotiated a "prepackaged" chapter 11 plan. Among other things, the plan converted $800 million of notes into new equity, included a $350 million backstopped equity offering, was financed in part by a new revolving credit facility, and paid priority and unsecured claims in full or left them unimpaired.

Senior noteholders were impaired by the plan but voted 100% in favor of the plan. In another impaired class, holders of convertible notes voted 95.5% in number and almost 100% in amount in favor of the plan. Naturally, existing equity interests were extinguished and deemed to have rejected the plan.

Judge Lane had held a confirmation hearing and entered an order on February 20 confirming the plan. He found that the plan satisfied the requirements for confirmation. However, he left open the question of whether the plan's nondebtor releases were permissible following the Supreme Court's decision in *Harrington v. Purdue Pharma L.P.*, 144 S. Ct. 2071 (2024). To read ABI's report on *Purdue*, click here.

In his March 7 opinion, Judge Lane explained why the opt-out plan was permissible after *Purdue*.

SEC and U.S. Trustee Alone Object

The plan contained releases in favor of the major nondebtor players in the reorganization. With the opportunity to opt out, the plan contained releases binding unimpaired creditors along with the impaired senior and convertible noteholders. Notably, 98.1% of the senior and convertible noteholders had consented in writing to the releases by having signed the restructuring support agreement negotiated before filing.

Simplified, the plan provided that creditors would have consented to the nondebtor releases by (1) voting for or against the plan without checking the opt-out box on the ballot, (2) abstaining from voting but not checking the opt-out box, or (3) failing to submit a form with the opt-out box checked. Judge Lane said that 190 opt-out elections had been received.

The only objections to the releases came from the U.S. Trustee and the Securities and Exchange Commission. The U.S. Trustee took the position that *Purdue* requires affirmative consent. The SEC took a narrower approach by contending that the failure to return a ballot not was evidence of consent.

Almost All Impaired Creditors Had Written Consents

Addressing the objections, Judge Lane began by saying that "*Purdue Pharma* made it clear that *consensual* third-party releases were not the subject of its decision." [Emphasis in original.] He went on to say that "*Purdue Pharma* expressly declined to discuss how parties may manifest their consent to third-party releases."

Judge Lane defined an opt-out plan as one where the creditor doesn't return a form with the opt-out box checked. An opt-in plan is one where the party must return a form and check a box indicating consent to granting releases.

Reviewing cases decided before *Purdue*, Judge Lane said that "the majority of judges" in New York did not require opting in, as long as the parties were given "clear and prominent notice and explanation of the releases and [were] provided an opportunity to decline to grant them."

In cases decided after *Purdue*, Judge Lane cited *In re Roman Cath. Diocese of Syracuse*, 2024 Bankr. LEXIS 2807, at *5 (Bankr. N.D.N.Y. Nov. 14, 2024), as allowing creditors to evidence consent by having been given the opportunity to opt out. To read ABI's report, click here. Next, he cited *In re Tonawanda Coke Corp.*, 662 B.R. 220, 223 (Bankr. W.D.N.Y. 2024), where the ability to opt out wasn't enough. However, *Tonawanda* involved a chapter 11 plan with a tiny distribution and large tort claims. To read ABI's report, click here.

"Given the weight of the authority in this Circuit," Judge Lane held "that the proposed Third-Party Releases here are consensual — and the proposed opt-out mechanism permissible." Among

other things, he noted that the releases were "clearly worded and prominently presented in all of the Plan materials." Distinguishing *Tonawanda*, he said that the case before him was "not a situation where the affected parties have little or no economic incentive to pay attention to the bankruptcy, such as where a creditor is receiving no recovery or a *de minimus* one."

Of perhaps most importance, Judge Lane noted that the only impaired creditors granting releases were parties to the restructuring support agreement that had been signed by 98.1% of the holders of impaired claims. "As for parties who voted on the Plan but did not exercise the opt-out," he said, "those parties have manifested their intent by taking the affirmative act of voting on the Plan while declining to exercise the opt-out."

For Judge Lane, the "most difficult" category included creditors who were not voting but were deemed to have accepted the plan, and those who could have voted but didn't. For those groups, he said that they had been given "a clear and prominent vehicle for opting out." Furthermore, he said "that no concerns as to the Third-Party Releases were raised by the Committee, which represents all unsecured creditors (and thus all of the classes of creditors who are being asked to provide the Third-Party Releases)."

Factually, Judge Lane distinguished pre-*Purdue* cases relied on by the objectors.

Authorities Outside the Second Circuit

Following *Purdue*, Judge Lane said that "the majority of courts outside this jurisdiction have permitted an opt-out mechanism for a consensual release given circumstances similar to those presented here." He cited *In re Lavie Care Ctrs*., 2024 Bankr. LEXIS 2900 (Bankr. N.D. Ga. Dec. 5, 2024); and *In re Robertshaw US Holding Corp.*, 662 B.R. 300 (Bankr. S.D. Tex. 2024). To read ABI's reports, click here and here. Judge Lane said that the "Objectors rely on several cases outside the Second Circuit that are distinguishable from the facts here."

Judge Lane considered the objectors' reliance "on the thoughtful discussion of releases" by Bankruptcy Judge Goldblatt in *Smallhold*. There, he said that parties who "did not have the opportunity to vote on the plan could not be found to consent to the third-party release, notwithstanding the ability to opt out." *Smallhold*, he said, could not be reconciled with authorities in the Fifth Circuit, where nonconsensual third-party releases have never been permitted. Courts in that circuit, he said, "have routinely allowed consensual releases using an opt-out mechanism before *Purdue Pharma*."

Analogy to Contract Law

Judge Lane ended his 47-page opinion by addressing the U.S. Trustee's contention that the releases were not permissible as a matter of contract law, similar to the analysis by Judge Goldblatt

in *Smallhold*. He said that the Restatement (Second) of Contracts "clearly recognizes that silence and/or inaction may constitute consent" in three circumstances.

Prominently, Judge Lane said that "silence and inaction will constitute acceptance of an offer when 'the offeror has stated or given the offeree reason to understand that assent may be manifested by silence or inaction, and the offeree in remaining silent and inactive intends to accept the offer.' Restatement (Second) of Contracts § 69(1)(b)." The exception, he said, was "tricky" when applied to nonvoting creditors.

However, Judge Lane found no reason to decide the question as a matter of contract law "given the Court's conclusions above that consent exists as to these creditors under applicable federal bankruptcy law."

Approving the releases "and the opt-out mechanism in the Plan," Judge Lane directed the parties to submit an order consistent with the confirmation order.

Observations

Judge Lane's opinion is an excellent survey of pre- and post-*Purdue* caselaw on opt-in versus opt-out. The opinion, however, may have limited precedential value because no one with an economic interest opposed the releases. Moreover, noteholders with an economic interest had given virtually unanimous written consents to the releases.

Keeping in mind that general unsecured creditors were unimpaired, Judge Lane's decision might be seen as standing for the principle that nondebtor releases are permissible when impaired creditors are overwhelmingly in favor of the releases and everyone else is paid in full.

The opinion is *In re Spirit Airlines Inc.*, 24-11988 (Bankr. S.D.N.Y. March 7, 2025).

Bankruptcy Judge Paul Baisier of Atlanta disagreed with Bankruptcy Judge Craig Goldblatt of Delaware about requiring creditors to vote before they are saddled with nondebtor releases in chapter 11 plans.

Bankruptcy Courts Don't Agree on What's a 'Consensual' Nondebtor Release

Since the Supreme Court handed down *Purdue*, bankruptcy courts in reported decisions have different answers for an unanswered question: What constitutes a "consensual" release given to nondebtors in a chapter 11 plan?

In an opinion on December 5, Bankruptcy Judge Paul Baisier of Atlanta decided that creditors who were given notice have conferred consensual releases in favor of nondebtors if they neither vote nor opt out.

Judge Baisier's holding is at odds with a decision in late September by Delaware Bankruptcy Judge Craig T. Goldblatt, who held that a creditor would be bound by a nondebtor release if the creditor voted on the plan but did not opt out. A creditor who did not vote would not be bound. *In re Smallhold Inc.*, 24-10267, 2024 BL 337399, 2024 WL 4296938 (Bankr. D. Del. Sept. 25, 2024). To read ABI's report, click here.

Judge Baisier aligned himself with Bankruptcy Judge Christopher M. Lopez of Houston, who imposed nondebtor releases on anyone who did not opt out, including creditors who did not vote on the plan. *In re Robertshaw US Holdings Corp.*, 24-90052, 2024 BL 292649, 2024 Bankr. Lexis 1958 (Bankr. S.D. Tex. Aug. 16, 2024). To read ABI's report, click here.

The Atlanta Debtors

The 282 debtors before Judge Baisier had been operators of 140 nursing homes. Mediation resulted in agreement on a chapter 11 plan.

Judge Baisier said that the plan "provides for a full release of claims against various third parties who made substantial contributions to this case and their affiliates by any creditor who does not affirmatively opt out of the release." He added that "the Plan would not be possible, and unsecured creditors (and even certain of the secured creditors) would most likely get nothing from any other possible resolution of these cases."

The debtor sent the plan, disclosure statement and ballots to some 6,400 creditors, but only 850 votes were cast. In other words, only 13% of creditors voted.

The ballots contained a box that a creditor could check to opt out. The plan did not permit creditors to vote for the plan but opt out, and creditors who did not vote would be bound by the releases. In substance, any creditor who did not check the opt-out box would be giving a release.

Among those who voted, Judge Baisier said that "well over" 500 opted out. He added that "the vast majority of the 'opt out' ballots were submitted by those who voted against the Plan." One class of creditors did not approve the plan, requiring Judge Baisier to confirm the plan via cramdown.

What's 'Consensual'?

The U.S. Trustee lodged the only objection to confirmation, contending that an opt-out release is not consensual. Judge Baisier said that *Purdue* did not question the efficacy of consensual releases, nor did the Court say what a consensual release is. *See Harrington v. Purdue Pharma L.P.*, 144 S. Ct. 2071 (2024). To read ABI's report, click here.

Having found no "circuit level decisions addressing the issue of whether an opt-out mechanism renders a third-party release consensual," Judge Baisier said that "an overwhelming majority of [decisions by bankruptcy courts] find that a creditor's vote to accept a plan containing a third-party release (like the Plan) makes the release consensual, and this Court agrees."

"A somewhat harder question," Judge Baisier said, "is whether a party that votes to reject the Plan or sends a ballot abstaining from voting has consented to the Release if they do not choose to opt out."

The "hardest question," he said, "is what to do with creditors that take no action." On that question, he said that courts "are markedly split on the issue, with some categorically finding that a release cannot be consensual absent an affirmative act to opt in, and others finding that opt-out mechanisms that (as is the case here) provide adequate notice and a simple opt-out process can result in a consensual release."

In *Smallhold*, Judge Baisier said that "Judge Goldblatt transitioned away from a default model of determining consent to a third-party release to another model for making that determination — a contract model." He went on to say that "the basis for the enforcement of consensual releases has not as far as this Court has been able to determine been described anywhere as a 'contract' for them."

For himself, Judge Baisier said "evidence of consent . . . appears to be the touchstone for determining whether a creditor can be bound to a release."

Employing the evidence-of-consent standard, Judge Baisier held that creditors who voted for the plan have consented. Similarly, he held that creditors who voted against the plan would be giving releases if they did not check the opt-out box.

Judge Baisier then dealt with the 5,550 creditors who did not vote. If someone received a ballot, he said, "You cannot simply ignore it." That is to say, someone who did not vote would be giving releases.

"However, that is not the end of the story," Judge Baisier said. He created a rebuttable presumption that silence is acceptance.

"As to any individual creditor there may be some set of facts . . . that would make it unreasonable to assume that their failure to respond constitutes their consent to the result," Judge Baisier said. As examples, he mentioned someone in the hospital or not residing where the plan was sent.

To allow for rebutting the presumption, Judge Baisier held that the confirmation order must provide "an opportunity for those people and entities to make a case to this Court sometime after confirmation that they should not be bound, [and] that they should not be 'deemed' to have consented." Furthermore, he said that the "opportunity cannot be time-bounded but should include some provision that requires the party seeking relief to identify the claims or types of claims they seek to pursue and the identities or types of defendants they intend to seek them against."

Observations

The decision by Judge Baisier does not scribe a bright line regarding creditors who did not vote. Let's see whether debtors and releasees will be satisfied with the possibility of having thousands of creditors entitled to opt out after confirmation.

Regarding creditors who do not vote, this writer believes that the definitive opinion ultimately will be based on due process concepts. By analogy, notice by publication has been sufficient for discharging claims held by unknown creditors. But will the same concept hold for barring creditors from suing nondebtors?

And what about acceptance of a distribution by a creditor who did not vote? If voting is required to impose releases (as Judge Goldblatt held), does accepting a distribution, no matter how small, effect a release of nondebtors? And what's the result when nondebtors contribute no cash or property toward creditors' distributions?

And what if the distribution is small, as it was in *In re Tonawanda Coke Corp.*, 662 B.R. 220 (Bankr. W.D.N.Y. Aug. 27, 2024). There, Chief Bankruptcy Judge Carl L. Bucki of Buffalo, N.Y.,

decided that state contract law does not permit a plan to confer releases on nondebtors when creditors are only entitled to opt out. The plan had $300,000 for distribution among creditors with more than $282 million in unsecured claims. He held that creditors "have not given consent as required by the Supreme Court" in *Purdue* "[a]bsent a writing expressly agreeing to a release of nondebtors." To read ABI's report, click here.

The opinion is *In re Lavie Care Centers LLC*, 24-55507 (Bankr. N.D. Ga. Dec. 5, 2024).

In the first opinion on the issue after Purdue, Bankruptcy Judge Christopher Lopez holds that Purdue did not change Fifth Circuit law where 'hundreds' of 'opt-out' plans have been confirmed with nondebtor releases.

Houston Judge Confirms an 'Opt-Out' Plan with Nondebtor Releases

In the first opinion on the topic since the Supreme Court's *Purdue* decision in late June, Bankruptcy Judge Christopher M. Lopez of Houston confirmed a so-called opt-out chapter 11 plan with nondebtor, third-party releases. He held that *Purdue* did not change governing law in the Fifth Circuit.

The chapter 11 reorganization before Judge Lopez was preceded by pitched battles between creditor groups that continued after filing. On the main battlefield, there was a settlement in bankruptcy court that satisfied all but one group of sophisticated lenders. They objected to confirmation of the plan on several grounds, but Judge Lopez dismissed their objections in his August 16 opinion.

The only other objection came from the U.S. Trustee, who opposed confirmation because the plan would bestow releases on nondebtors. The debtor contended that the releases were consensual because creditors could opt out.

The U.S. Trustee argued that the supposedly consensual releases were coercive and that the releases should be given only by creditors who opt in. Notably, any creditor who voted in favor of the plan could not opt out, and creditors who did not vote would be bound by the releases. In addition, creditors who opted out could not sue unless the bankruptcy court were to determine that the claims were colorable.

The debtor gave extensive notice about the opt-out provisions in the plan. About 100 creditors opted out, Judge Lopez said in his opinion.

Opting Out Is Ok

Addressing the U.S. Trustee's confirmation objection and citing *Bank N.Y. Tr. Co. v. Off. Unsecured Creditors' Comm. (In re Pac. Lumber Co.)*, 584 F.3d 229 (5th Cir. 2009), and *Feld v. Zale Corp. (In re Zale Corp.)*, 62 F.3d 746 (5th Cir. 1995), Judge Lopez said in his August 16 opinion that *Purdue* "did not change law in this Circuit." *Harrington v. Purdue Pharma L.P.*, 219

L. Ed. 2d 721, 144 S. Ct. 2085 (Sup. Ct. June 27, 2024). To read ABI's report on *Purdue*, click here.

In the wake of *Pacific Lumber* and *Zale*, Judge Lopez said that "Fifth Circuit case law appeared to prohibit non-consensual third-party releases." However, he went on to say that the plan before him "does not include non-consensual third-party releases like the ones addressed in *Purdue*."

Did *Purdue* change Fifth Circuit law on consensual releases? As Judge Lopez read *Purdue*, "the Supreme Court said nothing [that] should cast doubt on consensual" releases. He quoted the majority opinion in *Purdue* where Justice Neil M. Gorsuch said, "Nor do we have occasion today to express a view on what qualifies as a consensual release." *Purdue*, 144 S. Ct. at 2087–88.

Citing a decision from a bankruptcy judge in Delaware before *Purdue*, Judge Lopez saw "nothing improper with an opt-out feature for consensual third-party releases in a chapter 11 plan." *See In re Arsenal Intermediate Holdings, L.L.C.*, 23-10097, 2023 WL 2655592, at *6–8 (Bankr. D. Del. Mar. 27, 2023). To read ABI's report on *Arsenal*, click here.

"Hundreds of chapter 11 cases have been confirmed in this District with consensual third-party releases with an opt-out. And, again, *Purdue* did not change the law in this Circuit," Judge Lopez said. Regarding the plan before him, Judge Lopez recited how the debtor had given detailed notices about the plan and the opt-out provisions.

Furthermore, Judge Lopez said that the "third-party releases are also narrowly tailored to this case." As often happens, he said that the releases were a "core" consideration in the plan to eliminate more than $640 million in debt.

Citing support from the official creditors' committee, Judge Lopez overruled the U.S. Trustee's objection and said he would confirm the plan, given how "the third-party releases are consensual and narrowly tailored."

The opinion is *In re Robertshaw US Holdings Corp.*, 24-90052 (Bankr. S.D. Tex. Aug. 16, 2024).

After Purdue, bankruptcy judges are now split on whether mass-tort plans are permissible if creditors must opt out.

Upstate New York Bankruptcy Judge Nixes an 'Opt-Out' Plan with Nondebtor Releases

In a chapter 11 plan with a tiny distribution and large tort claims, Chief Bankruptcy Judge Carl L. Bucki of Buffalo, N.Y., decided that state contract law does not permit a plan to confer releases on nondebtors when creditors are only entitled to opt out.

The August 27 decision by Judge Bucki could also be seen as a declination to confer releases on nondebtors who made no financial contribution to the pool for creditors.

The debtor had operated a coke foundry described by Judge Bucki as having "accumulated substantial debt" from the "alleged emission of toxic pollutants." After a six-year sojourn in chapter 11, the corporate debtor cobbled together $300,000 for distribution among creditors with more than $282 million in unsecured claims.

The proposed plan called for releasing not only the debtor but also the debtor's officers, directors, shareholders and agents. Nondebtor releases were also earmarked for the debtor's and the committee's professionals, among others. Whether they voted or not, creditors would be conferring releases unless they opted out when voting on the plan.

The U.S. Trustee lodged an objection to approval of the disclosure statement, contending that the plan with nondebtor releases could not be confirmed unless a creditor were to *opt in*. The debtor protested, saying that consent could be inferred by giving creditors the opportunity to *opt out*.

Like the debtor's plan in the *Purdue* decision from the Supreme Court in late June, Judge Bucki said that the plan of the debtor before him "contemplates a release from liability for the benefit of various third parties." He noted, though, that *Purdue* did not express a view on what qualifies as a consensual release. *See Harrington v. Purdue Pharma L.P.*, 219 L. Ed. 2d 721, 144 S. Ct. 2071 (Sup. Ct. June 27, 2024). To read ABI's report on *Purdue*, click here.

Quoting the majority opinion in *Purdue*, Judge Bucki recited how Justice Neil M. Gorsuch remarked that "nothing in the bankruptcy code contemplates (much less authorizes)" nondebtor releases. *Purdue*, 114 S. Ct. at 2088. With nondebtor releases not authorized anywhere in the Bankruptcy Code, Judge Bucki said that "any such arrangement would be governed instead by state law."

Judge Bucki decided that New York law would apply because "nearly all" creditors either transacted business in New York or sustained injuries that emanated from New York. He cited Section 5-1103 of the New York General Obligations Law, which governs some types of contracts. It says that an agreement to "discharge" an "obligation" must be in writing and signed by the party against whom it would be enforced.

"Under this standard," Judge Bucki said, "the release becomes a mere proposal that no one can enforce."

In "many" chapter 11 cases, only a "small percentage" of creditors vote on the plans, Judge Bucki said. In addition, he said that "many" who do vote "may overlook" the box for opting out.

Without prejudice to the filing of a modified plan and disclosure statement, Judge Bucki sustained the objection to the disclosure statement. He held that creditors "have not given consent as required by the Supreme Court" in *Purdue* "[a]bsent a writing expressly agreeing to a release of nondebtors."

Observations

The decision by Judge Bucki may not be a revelatory departure from an opinion handed down 11 days earlier in Houston when Bankruptcy Judge Christopher M. Lopez confirmed a plan with opt-outs. *See In re Robertshaw US Holdings Corp.*, 24-90052, 2024 BL 292649, 2024 Bankr Lexis 1958 (Bankr. S.D. Tex. Aug. 16, 2024). To read ABI's report, click here.

To begin with, the distributions to tort claimants in the case before Judge Bucki were miniscule. Unlike *Purdue*, the released nondebtors were not making financial contributions toward the payment of creditors' claims. In addition, the definition of released parties was remarkably broad.

When a chapter 11 plan has small or perhaps infinitesimally small distributions to each creditor, it might be fair to assume that creditors generally would fare better from lawsuits against allegedly responsible third parties and that the failure to opt out could be attributed to a failure to read or understand the disclosure statement.

Having the viability of nondebtor releases turn on state law is a troublesome concept. In chapter 11 cases with thousands of tort claimants, the governance of state law might result in releases that are binding in some states but not in others. In addition, deciding the choice of law for each claim could be burdensome if not impossible in a very large case.

The order by Judge Bucki is interlocutory, obviating an appeal absent certification of an interlocutory appeal. A case like this deserves review in the Second Circuit.

The opinion is *In re Tonawanda Coke Corp.*, 18-12156 (Bankr. W.D.N.Y. Aug. 27, 2024).

Stays & Injunctions

A receiver was tagged $45,000 for failing to turn over estate property by demanding payment of administrative fees.

Fifth Circuit Arguably Expands the *Barton* Doctrine's *Ultra Vires* Exception

Reversing the district court, The Fifth Circuit arguably expanded the *ultra vires* exception to the *Barton* doctrine in a nonprecedential opinion, which means that receivers, without demanding payment, must immediately turn over property when the owner files a bankruptcy petition.

A plaintiff obtained a default judgment for more than $170,000. The state court appointed a receiver to collect the judgment on behalf of the plaintiff. Later, the state court entered an order specifically directing the receiver to seize the property of a third-party, nondefendant corporation.

The receiver seized the third party's property. Two weeks later, the third party filed a chapter 11 petition and demanded that the receiver turn over its property. The receiver agreed to return the property, but only after payment of administrative expenses.

According to the Fifth Circuit's *per curiam* opinion on December 31, the debtor paid the fees, and the receiver turned over the property 10 days later.

In bankruptcy court, the debtor brought an adversary proceeding against the receiver, asserting claims including turnover and stay violation. Finding that the receiver had held estate property hostage, Bankruptcy Judge Jeffrey P. Norman found a stay violation and ordered the receiver to pay the debtor $45,000.

The receiver appealed and won a reversal in district court based on the *Barton* doctrine. *See Berleth v. Preferred Ready-Mix LLC (In re Preferred Ready-Mix LLC)*, 660 B.R. 214 (S.D. Tex. March 31, 2024). To read ABI's report, click here.

The district court narrowly interpreted the *ultra vires* exception to the *Barton* doctrine. Unwilling to "stretch the *ultra vires* exception to a place where it has not gone before" (*Id*. at 221), the district court decided that the bankruptcy court had no subject matter jurisdiction, vacated the bankruptcy court order and remanded with instructions to dismiss the suit in bankruptcy court without prejudice.

The debtor appealed to the Fifth Circuit and won, based on the appeals court's more expansive understanding of the *ultra vires* exception.

The *Ultra Vires* Exception to the *Barton* Doctrine

Citing *Barton v. Barbour*, 104 U.S. 126, 128 (1881), the Fifth Circuit said that the "doctrine generally requires that a party seeking to sue a receiver must obtain leave from the court that appointed the receiver." When the doctrine applies, the court lacks subject matter jurisdiction.

After adoption of the Bankruptcy Act of 1898, the doctrine was extended to cover bankruptcy trustees and was subsequently broadened by many circuits to protect court-appointed officials and fiduciaries, such as trustees' and debtors' counsel, real estate brokers, accountants, and counsel for creditors' committees.

"Importantly," the Fifth Circuit said, the *Barton* doctrine is subject to the *ultra vires* exception, which applies to "actions taken by a receiver without appointing court authority." Specifically, *Barton* said that the *ultra vires* exception applies "if, by mistake or wrongfully, the receiver takes possession of property belonging to another." *Id.* at 134.

Focusing on the case on appeal, the appeals court decided that "the *ultra vires* exception to the *Barton* doctrine applies because [the receiver] only had appointing court authority to seize and maintain [the debtor's] property, not property of the bankruptcy estate." The circuit court held that the receiver "was without authority — and acted *ultra vires* — when he continued to seize and maintain possession of property of the bankruptcy estate despite receiving notice of the bankruptcy petition and a demand for turnover."

The exception applicable, the appeals court ruled that the debtor "therefore did not need leave from the appointing court to sue [the receiver] in bankruptcy court for his belated return of property of the bankruptcy estate post-demand for turnover." The court reversed and remanded "for further proceedings not inconsistent with this opinion."

Observations

Take it as a given that the *ultra vires* exception did apply. Would the Supreme Court's decisions in *Fulton* and *Taggart* alter the result?

Fulton tells us that maintaining the *status quo* does not violate the automatic stay. Standing alone, simply holding estate property was not a stay violation if there was no turnover order from the bankruptcy court. By demanding fees, however, the receiver did more than maintain the *status quo*. Thus, *Fulton* might not help the receiver.

Taggart could be more helpful for the receiver in terms of sanctions. The Supreme Court taught us in *Taggart* that the bankruptcy court "may impose civil contempt sanctions when there is no objectively reasonable basis for concluding that the creditor's conduct might be lawful under the discharge order." *Taggart v. Lorenzen*, 139 S. Ct. 1795, 1799 (2019).

Under *Taggart*, was it "objectively reasonable" for the receiver to demand fees? That's a close question.

The opinion is *Berleth v. Preferred Ready-Mix LLC (In re Preferred Ready-Mix LLC)*, 24-20158 (5th Cir. Dec. 31, 2024).

The same district judge who correctly predicted that Purdue's nonconsensual releases were prohibited has nonetheless upheld a preliminary injunction barring suits against nondebtors.

Purdue Preliminary Injunction Protecting Nondebtors Upheld on Appeal

For the first time in an Article III court after the Supreme Court banned nonconsensual, nondebtor releases in *Harrington v. Purdue*, a district judge in New York has upheld a preliminary injunction barring suits against nondebtors.

District Judge Colleen McMahon warned the parties in the *Purdue* case that they must agree on a new chapter 11 plan "pretty soon," or she would no longer permit preliminary injunctions.

The 40 Preliminary Injunctions

In her November 26 opinion, Judge McMahon recounted the history of the *Purdue* case and how the bankruptcy court had issued a preliminary injunction soon after the chapter 11 filing in 2019. The preliminary injunction barred everyone from suing nondebtors and even prevented the enforcement of governments' police and regulatory powers. In 2020, not long after the chapter 11 filing, Judge McMahon said that she had upheld the preliminary injunction.

Judge McMahon recited how she had written the opinion that overturned Purdue's confirmation. *In re Purdue Pharma, L.P.*, 635 B.R. 26 (S.D.N.Y. 2021). To read ABI's report, click here. She was reversed when the Second Circuit reinstated confirmation. *Purdue Pharma, LP v. City of Grande Prairie (In re Purdue Pharma, LP)*, 69 F.4th 45 (2d Cir. 2023). To read ABI's report, click here. The Supreme Court granted *certiorari* and reversed the Second Circuit at the end of the last term in late June, nixing nonconsensual, nondebtor third-party releases. *Harrington v. Purdue Pharma L.P.*, 144 S. Ct. 2071 (2024). To read ABI's report, click here.

When the *Purdue* case returned to the bankruptcy court, Bankruptcy Judge Sean H. Lane of New York entered preliminary injunctions several more times to facilitate mediation designed for cobbling together a new plan with contributions from the Sackler family. Since the outset of the case, Judge McMahon said that the preliminary injunction has been extended about 40 times.

When Bankruptcy Judge Lane entered a preliminary injunction after the Supreme Court set aside the nonconsensual releases in the *Purdue* plan, the State of Maryland filed an appeal,

professing a desire to pursue unfair and deceptive trade practice claims against nondebtors that had been frozen since the chapter 11 filing in 2019.

On appeal, the state argued that *Harrington v. Purdue* deprived the bankruptcy court of power to enjoin litigation against nondebtors.

The Standards Are Met for a 'P.I.'

Before turning to the merits, Judge McMahon considered whether the bankruptcy court had jurisdiction after *Harrington v. Purdue* to issue preliminary injunctions of the sort.

Judge McMahon said that the Supreme Court's holding was "narrow" and only banned nonconsensual releases protecting nondebtors, but "otherwise left unchanged the Bankruptcy Court's power." In the Second Circuit, she said that a preliminary injunction "would fall within the 'related to' jurisdiction of the Bankruptcy Court."

Judge McMahon cited bankruptcy courts that have recently decided that *Harrington v. Purdue* does not prohibit the issuance of preliminary injunctions. *See, e.g.*, *In re Parlement Techs., Inc.,* 661 B.R. 722, 724 (Bankr. D. Del. 2024); and *In re Diocese of Buffalo, N.Y.,* 663 B.R. 197, 200 (Bankr. W.D.N.Y.). To read ABI's reports, click here and here.

Having found jurisdiction and power, Judge McMahon analyzed whether the debtors had satisfied the usual four requirements for issuance of a preliminary injunction.

With regard to the likelihood of a successful reorganization, Judge McMahon said that the mediators and "most of the major stakeholders" were "confident" that "a successful reorganization plan is imminent." Concerning imminent irreparable harm, she deferred to the bankruptcy court's finding that "mediation efforts would cease" if war "were to break out."

In terms of the balance of harm and the public interest, Judge McMahon decided that the "public interest in securing a significant voluntary contribution from the [nondebtors] far outweighs Maryland's interest in advancing its administrative proceeding today."

"In light of the progress of mediation to date," Judge McMahon upheld the latest preliminary injunction," because "the balance of the hardships and the public interest both favor leaving the injunction in place in order to facilitate the ongoing mediation."

The 'Elephant in the Room'

In the last two pages of her opinion, Judge McMahon said, "The 'elephant in the room' is that the Preliminary Injunction has been in effect for a very, very long time." If there is no agreement on a plan over the 2024 holidays, she said "there will no doubt be another 'modest' request — and

quite possibly another — and yet another . . . . [E]very single time, the parties will tell Judge Lane that they are inching ever closer to an agreement and only need a little more time."

"But there must be an end to this mediation process," Judge McMahon said. When there are more extensions, "it becomes less and less convincing that the parties really are on the cusp of a deal, or that the public interest would be better served by prolonging the stay, rather than by ramping up litigation against the (perhaps recalcitrant) Sacklers."

Judge McMahon said that agreement on a "plan needs to come pretty 'soon,' or the preliminary injunction factors will cease to favor further postponement of the ability of parties who have every right to sue the Sacklers to start the war of all against all."

Observation

Ordinarily, opening the floodgates to litigation is an empty threat. This writer believes the threat is real this time, because it was Judge McMahon who overturned Purdue's original plan against the weight of Second Circuit authority.

The opinion is *State of Maryland v. Purdue Pharma LP (In re Purdue Pharma LP)*, 24-7042 (S.D.N.Y. Nov. 26, 2024).

The Second Circuit gives competitors license to mount false advertising unless it's 'virtually certain' to affect a debtor's customer contracts or goodwill.

Misleading Ads to Poach a Debtor's Customers Is No Stay Violation, Circuit Says

The Second Circuit gave a virtual *carte blanche* allowing businesses to use misleading advertising aimed at poaching customers from a competitor in chapter 11 reorganization, in a decision upholding a district judge who reversed the bankruptcy court.

In her June 24 decision, Circuit Judge Maria Araújo Kahn said it would be an "unimaginable result" if the automatic stay were interpreted to prohibit "any action that affects consumer choice." Without even citing the First Amendment, she saw no basis for making a distinction between "improper" and "legitimate" advertising when it comes to the automatic stay.

The opinion also definitively holds at the circuit level that *Taggart* is the standard for automatic stay violations, not just discharge violations.

$19.2 Million for a Stay Violation Reversed

A provider of commercial and residential communications services, the debtor filed a chapter 11 petition to reorganize. A competitor quickly mounted a direct mail campaign targeting the debtor's customers.

The advertising informed the recipients that the debtor was in chapter 11 and asked whether the debtor would be able to stay in business. The advertising said that the debtor's future was "unknown" and insinuated that the debtor might cease providing services.

Alleging that the advertising was "knowingly false" and caused "confusion" among its customers, the debtor filed an adversary proceeding in bankruptcy court in Manhattan, contending that the competitor had violated the automatic stay.

Granting summary judgment in favor of the debtor, the bankruptcy court held that the competitor's advertising violated the automatic stay in Section 362(a)(3) as "an act to control property of the estate, namely, the debtors' customers or contracts with those customers." The bankruptcy court reserved decision on damages until it decided whether the competitor's actions satisfied the standards for civil contempt.

After trial, the bankruptcy court issued an order imposing almost $19.2 million in sanctions for a "literally false and intentionally misleading advertising campaign that wrongfully interfered with the Debtors' customer contracts and goodwill." *In re Windstream Holdings Inc.*, 627 B.R. 32, 37–38 (Bankr. S.D.N.Y. 2021).

On appeal, District Judge Cathy Seibel reversed, writing an opinion that focused on when advertising could violate the automatic stay and whether there was a "fair ground of doubt" about a stay violation under *Taggart v. Lorenzen*, 139 S. Ct. 1795 (2019).

Even if the advertising interfered with customer contracts and harmed the debtor's goodwill, Judge Seibel found no "control" over estate property. She also found a "fair ground of doubt" about whether the advertisements were stay violations. *Windstream Holdings Inc. v. Charter Communications Inc. (In re Windstream Holdings Inc.)*, 634 F. Supp. 3d 99 (S.D.N.Y. Oct. 6, 2022). To read ABI's report, click here.

The Second Circuit affirmed Judge Seibel on both grounds.

Is *Taggart* the Standard?

When it comes to automatic stay violations regarding a corporate debtor, Circuit Judge Kahn began her analysis of the merits by observing how the authority to impose sanctions is contained in Section 105(a), not in Section 362(k), which only applies to individual debtors.

Next, Judge Kahn laid out the contempt standard for discharge violations contained in *Taggart v. Lorenzen*, 139 S. Ct. 1795,1799 (2019), where the Supreme Court held that a bankruptcy court may hold a creditor in civil contempt when there is objectively "no fair ground of doubt" that the creditor violated the discharge injunction. The "no fair ground of doubt" standard is met "when there is no objectively reasonable basis for concluding that the [party's] conduct might be lawful under the discharge order." *Id*. at 560. To read ABI's report on *Taggart*, click here.

Judge Kahn described the "open question" as being "whether the same standard also applies to stay violation contempt proceedings." With little analysis, she saw "no reason why *Taggart's* objective standard should not apply equally to a civil contempt action for violation of the automatic stay provision."

Fair Ground of Doubt?

To decide whether there was a "fair ground of doubt" about a stay violation, Judge Kahn first analyzed whether customer contracts and goodwill are considered estate property.

Judge Kahn cited the Second Circuit for having held "that contract rights are property of the estate, and that therefore those rights are protected by the automatic stay. *See In re AMR Corp.*,

730 F.3d 88, 102–03 (2d Cir. 2013)." She agreed with the district court that the debtor had "some kind of contracts" with customers that were estate property.

Next, Judge Kahn cited Circuit Judge Learned Hand for having held "that a debtor's goodwill can be properly categorized as property of the estate, protected by the automatic stay. *See Mut. Life Ins. Co. v. Menin*, 115 F.2d 975, 977 (2d Cir. 1940) (Hand, J.)." Following the most renowned judge ever to sit on the Second Circuit, Judge Kahn held that the debtor's goodwill "is properly classified as property of the estate."

Exercise of Control?

Even though the customer contracts and goodwill were estate property, did the competitor exercise control?

Rather than "tak[ing] possession or exercis[ing] control over [the debtor's] customer contracts or goodwill," Judge Kahn said that the competitor "launched an advertising campaign to convince [the debtor's] customers to switch their subscriptions to [the competitor]." She lauded the district judge for having said that impairing or interfering with estate property involves litigation "or other legal action that would, or did, indirectly destroy or transfer control of the debtor's property."

"Conduct that affects consumer behavior is different from the type of conduct proscribed by § 362(a)(3) of the Bankruptcy Code," Judge Kahn said. Citing the Fifth Circuit 40 years ago, she added, "The Bankruptcy Code does not prevent a third-party competitor from informing the public about a debtor's insolvency or even criticizing the debtor for its inability to sustain its business." She explained that the competitor's "advertisements were only factually likely, as opposed to legally certain, to affect [the debtor's] customer contracts and goodwill."

Citing the Supreme Court for having "repeatedly held that actions that interfere with the debtor's property do not necessarily violate the automatic stay," Judge Kahn held that "the stay provision should not be construed so broadly as to impose sanctions on [the competitor] for its conduct here."

Focusing on the relationship between advertising and the automatic stay, Judge Kahn said,

> Construing "exercise control" to include any action that affects consumer choice would prohibit any advertising (indeed, any competition) with a debtor during bankruptcy — an unimaginable result.

Unlike the bankruptcy court, Judge Kahn saw no distinction between "legitimate" advertising and "improper" advertising. She was "not convinced that this distinction is tenable as the Bankruptcy Code does not distinguish between 'improper' and 'legitimate' actions that violate the automatic stay."

Being "skeptical" that the competitor exercised control over estate property, Judge Kahn affirmed the district court, finding, "at least, a 'fair ground of doubt' that [the competitor] violated the automatic stay."

The opinion is *Windstream Holdings Inc. v. Charter Communications Inc. (In re Windstream Holdings Inc.)*, 22-2891 (2d Cir. June 24, 2024).

Having previously set aside a $240,000 sanction as criminal contempt, the Fifth Circuit affirmed $450,000 in civil contempt against the same contemnor in the same bankruptcy case.

First Nixing $240,000 for Contempt, Fifth Circuit Approves $450,000 for Civil Contempt

Three months ago, the Fifth Circuit set aside the bankruptcy court's imposition of $240,000 in contempt sanctions against an individual and others, holding that the award was damages for criminal contempt, which the bankruptcy court had no power to impose. A circuit judge dissented and would have upheld the award as civil contempt.

On July 1, a different panel in the Fifth Circuit upheld an award of $450,000 in civil contempt sanctions imposed by the same bankruptcy judge against the same individual. In the new opinion, Circuit Judge Leslie H. Southwick cited the Supreme Court for saying that contempt sanctions permit the court to "do rough justice." *Goodyear Tire & Rubber Co. v. Haeger*, 581 U.S. 101, 110 (2017).

Evidently, the size of an award isn't determinative or perhaps not even relevant in deciding whether a sanction is criminal rather than civil. The opinion three months ago was in *Charitable DAF Fund LP v. Highland Capital Management LP (In re Highland Capital Management LP)*, 98 F.4th 170 (5th Cir. April 4, 2024). To read ABI's report on the April decision, click here.

The Grounds for Contempt

To fend off appointment of a chapter 11 trustee, the corporate debtor's chief executive resigned his positions as an officer, director and employee. In his place, three independent directors took over along with a chief restructuring officer.

Two months later, the debtor moved in bankruptcy court for a temporary restraining order and a preliminary injunction barring the former CEO from interfering with the debtor's operations. The bankruptcy court entered an elaborately detailed temporary restraining order, or TRO, precluding the former CEO from interfering with the business or importuning any entity controlled by him from interfering.

One month after the TRO, the debtor moved in bankruptcy court to hold the former CEO in contempt of the TRO for interfering with the debtor's sale of assets. After an evidentiary hearing,

the bankruptcy judge found the former CEO in contempt and imposed $450,000 in compensatory civil sanctions. The district court affirmed. The former CEO appealed again.

Federal Rule 65(d)(1)

Judge Southwick began his discussion of the merits by saying that contempt citations are reviewed for abuse of discretion, although the scope of an injunction is a legal question subject to *de novo* review. Regarding the quantum of damages, however, the trial court is given "substantial deference." *Haeger*, *supra*.

The first question revolved around Federal Rule 65(d)(1)(C), which requires an injunction to "describe in reasonable detail — and not by referring to the complaint or other document — the act or acts restrained . . . ." In other words, the rule prohibits an injunction from referring to outside documents, Judge Southwick said.

Judge Southwick noted that the rule only requires "reasonable detail." Bowing to practical considerations, he said that the "complexity" resulting from the debtor's 2,000 related entities "makes a higher level of detail impractical, especially given the danger of easy evasion were the terms crafted more narrowly."

"Although not necessary to our holding," Judge Southwick said that the Fifth Circuit "has deemed it relevant that a party could have, but did not, seek district court clarification." Focusing on the TRO as an "equitable remedy," he said, "it would be inequitable for us to reward this belated attack on the TRO's clarity."

Evidence of Violations

To justify a finding of civil contempt under Fifth Circuit precedent, Judge Southwick said there must be "clear and convincing evidence" that an order was in effect, that the order proscribed "certain conduct," and that the contemnor "failed to comply." Willfulness, he said, "is not required." Again citing the Fifth Circuit, he said, "we review the bankruptcy court's determination that such evidence exists only for an abuse of discretion."

Reciting the former CEO's own deposition testimony, Judge Southwick held that "the bankruptcy court did not abuse its discretion in concluding that clear and convincing evidence existed that [the former CEO] violated" two provisions in the TRO.

The Amount of the Sanction

Before deciding whether $450,000 was too much, Judge Southwick said that reimbursement of legal fees "is a permissible sanction."

At the trial on the TRO violation, the debtor alleged there were six grounds of contempt, but the bankruptcy court only sustained two of the claims. To assess damages, the bankruptcy court reviewed the debtor's attorneys' time records.

From the approximately $1.25 million in time charges for the period in question, the bankruptcy judge "conservatively" estimated that some $366,000 was related to the TRO and the contempt motion.

Using "conservative math," the bankruptcy court tagged on another $33,400 spent by debtor's counsel in preparing for and conducting the contempt hearing. The bankruptcy judge raised the award to $450,000 to account for time spent by local counsel who worked on the matter but whose time records were not submitted.

To judge the efficacy of the sanction, Judge Southwick said that the bankruptcy judge "considered the probable effectiveness of the sanction, [the former CEO's] financial resources and the burden of the sanction, and his willfulness in disregarding the TRO."

Evaluating the size of the award, Judge Southwick again quoted *Haeger* in saying that the offended party "'may recover only the portion of his fees that he would not have paid but for the misconduct.' *Haeger*, 581 U.S. at 109."

Judge Southwick read *Haeger* to mean that the "rule is flexible enough that a court may use estimates or decide that an entire category of expenses was incurred solely because of the misconduct at issue." He held that the bankruptcy court "did not err in granting all fees for work done to protect the reorganization plan from [the former CEO's] interference, without regard to which grounds for contempt ultimately proved successful." He added that the bankruptcy court "was permitted to use estimates given its 'superior understanding of the litigation,'" again quoting *Haeger*.

Concluding the opinion, Judge Southwick said that appellate review is conducted in "recognition of the goal of such awards everywhere: 'to do rough justice.' *Id*. (quoting *Fox v. Vice*, 563 U.S. 826, 838 (2011)). Complete accuracy is neither required nor expected." He affirmed, saying that the "bankruptcy court's judgments in these matters are entitled to our 'substantial deference.' *Id*."

The opinion is *Dondero v. Highland Capital Management LP (In re Highland Capital Management LP)*, 22-10889 (5th Cir. July 1, 2024).

In the first decision on the topic after Purdue, Delaware's Judge Goldblatt denied the debtor's motion for a preliminary injunction to stop a lawsuit against nondebtors.

Delaware Judge Explains How to Obtain a PI Protecting Nondebtors After *Purdue*

Writing the first decision on a question left open by the Supreme Court in its *Purdue* decision last month, Delaware's Bankruptcy Judge Craig T. Goldblatt declined to enter a preliminary injunction at the outset of a chapter 11 case that would have barred suits against the debtor's former officers.

Judge Goldblatt's July 15 opinion could be read to mean that nondebtor injunctions after *Purdue* will not be permissible without showing that an injunction is necessary for the success of the chapter 11 effort. However, the opinion is not a *per se* bar to preliminary injunctions stopping suits against nondebtors.

The Prepetition Suit

The corporate debtor had operated a website known as Parler. Three years before the chapter 11 filing in April, a former executive sued the debtor and some of its former executives in state court in Nevada, alleging that the website was removed from the "app store" for having failed to stop the site from being used to incite violence. The suit also claimed that the defendants had schemed to oust him and deprive him of his interest in the company.

Some of the defendants asserted their rights of indemnification in cross claims against the debtor. After the bankruptcy filing, the debtor removed the suit to federal district court in Nevada.

In chapter 11, the debtor filed a motion asking Judge Goldblatt to impose a 60-day preliminary injunction barring the plaintiff from suing the former officers. Among other things, the debtor contended that the indemnification obligations meant that the suit was in substance a suit against the company and that answering discovery requests would distract management from prosecution of a chapter 11 plan.

At the outset of his opinion, Judge Goldblatt said that "cases have long recognized that bankruptcy courts may enter a preliminary injunction that operates to stay actions against non-debtors."

The Effect of *Purdue*

The landscape on nondebtor injunctions changed when the Supreme Court handed down its decision in *Harrington v. Purdue Pharma L.P.*, 219 L. Ed. 2d 721 (Sup. Ct. June 27, 2024). To read ABI's report, click here. To watch ABI's webinar on *Purdue*, click here.

As Judge Goldblatt said, the Supreme Court "held in *Purdue Pharma* that non-debtors may not receive permanent injunctive relief in the form of a third-party release, under a plan of reorganization, even when a bankruptcy court finds that the release is necessary to facilitate the debtor's reorganization."

The *Purdue* decision, Judge Goldblatt said, "raises the question [of] whether courts may grant third parties the protection of a preliminary injunction." While *Purdue* "does not preclude the entry of such a preliminary injunction," he said that it "does affect how courts should consider what is meant by 'likelihood of success on the merits' when applying the traditional four-factor test applicable to requests for preliminary injunctions."

After *Purdue*, "success on the merits" cannot mean the likelihood of obtaining nondebtor, nonconsensual, third-party releases. However, Judge Goldblatt said that preliminary injunctions "may still be granted if the Court concludes that" management needs a breathing spell from outside litigation or the parties might be able to negotiate a plan with consensual releases. "Both of those outcomes," he said, "may be viewed as 'success on the merits' for this purpose."

The Four-Part Test for PIs After *Purdue*

The requisites for obtaining a preliminary injunction are: (1) likelihood of success on the merits; (2) irreparable harm; (3) harm to the defendant; and (4) the public interest. To be successful in the Third Circuit, the movant must establish the first two factors. The court will consider the third and fourth factors only if the first two have been shown.

Judge Goldblatt began application of the four-part test for preliminary injunctions by analyzing "likelihood of success" and what the term means after *Purdue*. "Some" pre-*Purdue* cases, like the Third Circuit's decision in *WR Grace*, "focused more on avoiding the harm that the litigation against the third parties could cause to the debtor without directly addressing the debtor's right to obtain permanent relief," Judge Goldblatt said.

Judge Goldblatt read the pre-*Purdue* cases to imply "that 'success on the merits' is the debtor's successful confirmation of a plan of reorganization," not the likelihood of obtaining a permanent injunction.

Likewise, Judge Goldblatt pointed to the Fourth Circuit's *A.H. Robbins* decision as justifying an injunction by stopping interference with reorganization. He saw "nothing" in *Purdue* to require

reconsideration of *WR Grace* or *A.H. Robbins* in terms of justification for a preliminary injunction, as opposed to a permanent injunction.

Applying the Four-Part Test

Judge Goldblatt said that none of the arguments proffered by the debtor "demonstrates that there is anything sufficiently exceptional about the circumstances here to warrant the entry of a preliminary injunction." He explained why.

First, regarding indemnification rights, Judge Goldblatt said that dilution of the recoveries by other creditors "is not, without more, a sufficient basis to conclude that minimizing the debtor's indemnity obligation is critical to the success of this bankruptcy case." Furthermore, security interests covering all of the debtor's properties could make indemnification rights "wholly beside the point."

Judge Goldblatt concluded that "the debtor has not met its burden of proving that the preliminary injunction . . . is necessary to the success of the bankruptcy case."

Second, regarding responding to discovery in the Nevada suit, Judge Goldblatt read caselaw as "suggest[ing] that the cost of participating in discovery will not in the typical case be a basis for granting a third-party injunction."

Third, with regard to diverting the attention of management from the reorganization, Judge Goldblatt noted that the defendants were all former officers. He was "unaware of any case in which a court granted a preliminary injunction . . . in the absence of the members of management being named as parties in the third-party action."

Fourth, the debtor contended that judgment against the former officers would have a collateral estoppel effect on the debtor. Judge Goldblatt dismissed the argument because the debtor was only seeking a 60-day injunction, and no trial could be held in Nevada in such a short time.

Conclusion

Summing up, Judge Goldblatt said that the debtor had not shown that a preliminary injunction would be "critical to the success of the bankruptcy case" or that the absence of an injunction would result in irreparable harm. "Because the debtor cannot establish these factors," he said that it was "essentially the end of the analysis."

Even if he were to employ the entire four-factor analysis, Judge Goldblatt said he still would not issue a preliminary injunction. So, he denied the motion for a preliminary injunction.

Observation

Although the debtor lost in the case before Judge Goldblatt, his opinion is a checklist showing debtors in the future what they must show to warrant a preliminary injunction. For debtors generally, the opinion looks to be more of a win than a loss.

The opinion is *Parlement Technologies Inc.*, 24-10755 (Bankr. D. Del. July 15, 2024).

A magistrate judge decided that a bankruptcy court's order from another district halting suits against nondebtors was unenforceable because it was not an 'injunction' made under Section 105(a).

A Magistrate Judge Refuses to Enforce an Order Staying Actions Against Nondebtors

A decision by a magistrate judge in Michigan counsels attorneys for chapter 11 debtors to take care in drafting orders intended to expand the automatic stay to halt lawsuits against nondebtors.

Not to keep you in suspense, the Michigan magistrate judge declined to enforce an order entered by the bankruptcy court in Houston purporting to stay all lawsuits against nondebtors "in their entirety . . . on an interim basis pursuant to section 362 of the Bankruptcy Code."

The plaintiff was a prisoner who filed a lawsuit *pro se* in federal district court in Michigan claiming that the defendants committed "deliberate indifference to his serious medical needs in violation of the Eighth Amendment."

One of the defendants was an individual employed by Wellpath Holdings Inc., which filed a chapter 11 petition in Houston on November 11. The prisoner did not name Wellpath as a defendant.

In the chapter 11 case, Wellpath obtained as series of orders from the bankruptcy court that purported to stay lawsuits against nondebtors, like the employee, "on an interim basis pursuant to section 362 of the Bankruptcy Code." Wellpath filed a suggestion of bankruptcy with the court in Michigan and attached a copy of the bankruptcy court's orders purporting to halt the prisoner's lawsuit, among all others.

In an opinion and order on December 4, Magistrate Judge Kimberly G. Altman of Detroit declined Wellpath's invitation to put the prisoner's suit on ice.

Citing a 1993 decision by the Sixth Circuit, Judge Altman said that a bankruptcy court cannot "stay proceedings against non-debtor defendants under 11 U.S.C. § 362." *See Patton v. Beardon*, 8 F.3d 343 (6th Cir. 1993). She quoted a bankruptcy court in Ohio that said, "[T]he only entity to which the § 362 stay applies is the debtor. As such, it may not be extended to third parties such as the [d]ebtor's co guarantors. *In re Nat'l Staffing Servs. LLC*, 338 B.R. 35, 36-37 (Bankr. N.D. Ohio 2005)."

On the other side of the fence, Judge Altman quoted the Sixth Circuit for having said, "Some courts have held that the debtor's stay may be extended to non-bankrupt parties in unusual circumstances." *Patton v. Beardon*, 8 F.3d 343, 349 (6th Cir. 1993). However, she went on to quote the Sixth Circuit for having also said that extensions of the automatic stay "were in fact injunctions issued by the bankruptcy court after hearing and the establishment of unusual need to take this action to protect the administration of the bankruptcy estate." *Id*.

Even if there were "unusual circumstances," the circuit court in *Patton* said that "the bankruptcy court would first need to extend the automatic stay under its equity jurisdiction pursuant to 11 U.S.C. § 105." *Id*.

"The order from Wellpath's bankruptcy proceeding," Judge Altman said, "does not cite 11 U.S.C. § 105(a) and does not set forth the preliminary-injunction factors or contain any analysis on the subject." Indeed, she said, "The phrase 'preliminary injunction' is in fact nowhere to be found."

Given that "no preliminary injunction has been issued," Judge Altman held that "neither this Court nor the bankruptcy court can otherwise 'extend' the automatic stay to non-debtor defendants."

Judge Altman ruled that "the case [brought by the prisoner] will not be stayed and will proceed against [the Wellpath employee] and all the other defendants," because "Wellpath is not a party to this case, and its bankruptcy stay has not properly been extended to non-debtor parties, like [the employee]."

Observations

The federal district court in Michigan was not sitting as an appellate court in review of the order entered by the bankruptcy court in Houston.

This writer invites readers to explain the basis on which the Michigan court could decline to enforce the order of the bankruptcy court in another district.

The opinion is *Levitan v. Maclean*, 23-12439 (E.D. Mich. Dec. 4, 2024).

A district judge in Ohio declined to sit as an appellate court by deciding whether a bankruptcy court in another state had properly 'spread' the automatic stay.

District Courts Disagree on Enforcing an 'Automatic Stay' Protecting Nondebtors

Last month, we reported one of several decisions where district courts in the Eastern District of Michigan refused to enforce an order by the bankruptcy court in Houston that "spread" the Section 362 automatic stay to stop lawsuits against nondebtors. *See Levitan v. Maclean*, 23-12439 (E.D. Mich. Dec. 4, 2024). To read ABI's report, click here.

Declining to rule as though she was on an appellate court reviewing the decision from Houston, the Chief District Judge for the Northern District of Ohio has decided to enforce the injunction aimed at halting lawsuits against nondebtors.

You decide who has the better argument: Chief District Judge Sara Lioi of Akron, Ohio, or the district judges who found fault with "spreading" the automatic stay.

To Stay or Not to Stay, That Is the Question

In the case before Judge Lioi, the plaintiff brought a Section 1983 action against Wellpath LLC and several individual defendants. Wellpath provides medical services for prisons and jails throughout the country. The individual defendants were often employees of Wellpath.

After Wellpath began a chapter 11 reorganization in Houston, Judge Lioi said that the bankruptcy court entered an order that "stays 'any lawsuits' in which Wellpath is a defendant, including 'claims against the Non-Debtor Defendants . . . pursuant to section 362 of the Bankruptcy Code.'" As debtor in possession, Wellpath filed a suggestion of bankruptcy and argued that "this entire case must be stayed," Judge Lioi said.

Quoting Section 362(a)(1), Judge Lioi said it was "clear" that the suit must be stayed against Wellpath. However, she went on to cite the Sixth Circuit for the idea that a "bankruptcy stay may also be extended to encompass non-debtors."

"It appears the bankruptcy court intended to do so here," Judge Lioi said, "as its interim order stayed any case in which Wellpath is a defendant, including 'claims against the Non-Debtor Defendants[.]'" She went on to say that "several courts have stayed actions in which Wellpath is a defendant in their entirety."

"Several decisions in the Eastern District of Michigan," Judge Lioi said, "have come to a different conclusion as to the scope of the stay." She described them as relying on the principle "that district courts have 'jurisdiction concurrent with the originating bankruptcy court to determine the applicability of the bankruptcy court's automatic stay.'"

Exercising jurisdiction to define the scope of the automatic stay, Judge Lioi said that "those decisions conclude that the bankruptcy court's interim order 'does not cite 11 U.S.C. § 105(a) and does not set forth the preliminary-injunction factors or contain any analysis on the subject' and therefore 'does not require a stay of proceedings against' the non-debtor defendants."

"To allow this matter to proceed as to the non-debtor defendants strikes the Court as more akin to granting relief from the bankruptcy court's stay order, a power vested in the bankruptcy court," Judge Lioi said. "[T]hat issue," she said, "is best resolved by the bankruptcy court itself or appealed to the appropriate district court in Texas.

"[A]ny potential deficiencies in the interim order may well be resolved by the bankruptcy court's final order, which is currently set for a hearing in January 2025," Judge Lioi said. She therefore "defer[s] to the bankruptcy court on this issue and does not consider the lack of § 105 analysis to overcome the bankruptcy court's stated intention to extend the stay to include 'Non-Debtor Defendants[.]'"

Calling for a status report by January 31, Judge Lioi stayed the case, "subject to the lifting of the stay as to some or all defendants."

The opinion is *McLemore v. County of Mahoning*, 23-1144 (N.D. Ohio Dec. 30, 2024).

An opinion by Bankruptcy Judge Carl L. Bucki might be read, incorrectly, to mean that Purdue precludes preliminary injunctions stopping suits against nondebtors.

No More Injunctions Barring Suits Against Nondebtors in a Diocese Sexual Abuse Case

Bankruptcy Judge Craig T. Goldblatt of Delaware wrote an opinion in July explaining how a chapter 11 debtor, after *Purdue*, can obtain a preliminary injunction halting lawsuits against nondebtors. *Parlement Technologies Inc.*, 661 B.R. 722 (Bankr. D. Del. July 15, 2024). To read ABI's report, click here.

Chief Bankruptcy Judge Carl L. Bucki of Buffalo, N.Y., wrote an opinion that might be read to mean that preliminary injunctions protecting nondebtors are no longer available after *Harrington v. Purdue Pharma L.P.*, 144 S. Ct. 2071 (2024). To read ABI's report on *Purdue*, click here.

This writer understands Judge Bucki's September 30 opinion more properly to mean that the bankruptcy court will not issue a preliminary injunction protecting nondebtors when the chapter 11 case is almost five years old; there is no plan, and the creditors' committee and the debtor are at an impasse, despite years of mediation.

Seven Prior Injunctions

The Diocese of Buffalo, N.Y., filed a chapter 11 petition in February 2020, looking to resolve some 800 lawsuits asserting sexual abuse claims against the diocese and nondebtor affiliates like schools and parishes.

Promptly after the chapter 11 filing, the debtor commenced an adversary proceeding to halt lawsuits against nondebtor, affiliated entities. Seven times, Judge Bucki granted preliminary injunctions stopping lawsuits against affiliates that were not covered by the automatic stay.

Most recently, Judge Bucki granted a preliminary injunction in January 2024. At the time, the Second Circuit's decision in *Purdue* meant that the diocese might be able to confirm a plan with nonconsensual releases for nondebtors. However, argument in *Purdue* had been held in the Supreme Court one month before.

Recognizing that the Supreme Court might ban nonconsensual releases, Judge Bucki structured the injunction he issued in January to expire after the decision in *Purdue*. When the Supreme Court reversed the Second Circuit in *Purdue* and barred nonconsensual releases of nondebtors, the diocese filed a new motion seeking a preliminary injunction covering all of the diocese's affiliates.

Grounds for Preliminary Injunctions

Judge Bucki recited Second Circuit standards in nonbankruptcy cases for preliminary injunctions. Basically, there must be a likelihood of success on the merits, or serious questions with the balance of hardship tipping "decidedly" in favor of the plaintiff. In addition, the plaintiff must show the likelihood of irreparable harm.

In the case before him, Judge Bucki found "neither a likelihood of success nor serious questions for litigation." However, the debtor argued that Section 105(a) provides the basis for an injunction covering affiliates not protected by the Section 362 automatic stay.

Judge Bucki responded by pointing to language in Section 105(a), which provides that the "court may issue any order . . . that is necessary or appropriate to carry out the provisions of" the Bankruptcy Code. Among the applicable provisions of the Code, he identified Section 1106(a)(5), which says that a debtor "shall" file a plan "as soon as practicable."

"Recognizing this need to develop a plan," Judge Bucki said that he had "relied on section 105(a) in [his] four most recent decisions granting a temporary stay of all litigation against parishes and affiliates." After *Purdue*, though, he said that the debtor could no longer propose a plan with nonconsensual releases.

Judge Bucki recognized that nothing in *Purdue* "expressly prohibits a temporary stay of litigation against parishes and affiliates." However, he went on to say that "the outcome in *Purdue Pharma* strikes the rationale for any further such injunction."

According to Judge Bucki, three years of mediation failed to produce a plan, and the debtor reported a "breakdown in negotiations" with the official creditors' committee. Although the debtor might succeed with a plan having consensual releases, the judge said he could not "foresee the likely development of a fully consensual plan."

Judge Bucki denied the motion for a preliminary injunction, finding "insufficient justification to use section 105 for the purpose of granting a stay of all lawsuits against parishes and affiliates."

Observations

Out of context, some language in Judge Bucki's opinion could be taken to mean that preliminary injunctions stopping lawsuits against nondebtors are no longer available after *Purdue*.

After almost five years in chapter 11, Judge Bucki could not see the likelihood of a consensual plan conferring releases on nondebtors. This writer therefore interprets the opinion to mean that injunctions might issue earlier in cases where the possibility of a plan is alive and well. In *Parlement*, Judge Goldblatt saw no *per se* bar to preliminary injunctions stopping suits against nondebtors.

Presumably, a debtor at the outset of a chapter 11 case could demonstrate the four factors required by Judge Goldblatt for issuance of a preliminary injunction stopping lawsuits against nondebtors. Judge Goldblatt did not interpret "success on the merits" to require the likelihood of confirming a plan with nonconsensual releases.

The opinion is *Diocese of Buffalo, N.Y. v. JMH 100 Doe (In re Diocese of Buffalo, N.Y.)*, 20-01016 (Bankr. W.D.N.Y. Sept. 30, 2024).

Retention & Compensation

The district judge who excoriated Jackson Walker in a decision last year will now decide whether the firm must disgorge what it was paid in dozens of large chapter 11 cases.

Fate of Jackson Walker Is Now in the Hands of a District Judge from Another District

By withdrawing the reference, the mishegoss resulting from the bankruptcy judge in Houston cohabiting with a lawyer in his court has now been consolidated into the courtroom of District Judge Alia Moses, the Chief District Judge for the Western District of Texas.

Technically speaking, the matter remains in the Southern District of Texas because Judge Moses is sitting by designation in the Southern District of Texas to review matters involving former Bankruptcy Judge David Jones and the Houston-based law firm of Jackson Walker, or JW.

Withdrawing the reference to herself in an opinion on April 9, Judge Moses was already steeped in the alleged misdoings involving Jones, JW and former JW partner Elizabeth Freeman, who was Jones's paramour. In an opinion on August 16, Moses reluctantly dismissed a lawsuit against Jones, Freeman, JW and a nationwide firm for which JW had served as local counsel in large chapter 11 cases in Houston.

In her opinion last year, Judge Moses dealt with a lawsuit filed by a shareholder of a large chapter 11 debtor whose case was pending before Jones. The defendants included Jones, Freeman, JW and the debtor's general bankruptcy counsel. Judge Moses said she was dismissing the suit last year "with consternation."

Withdrawal of the reference primarily means that Judge Moses will preside over 34 actions in which the U.S. Trustee is seeking to revoke JW's retention and force JW to disgorge millions in fees paid while the relationship between Jones and Freeman was a secret. Before we describe the decision on withdrawal of the reference, we'll hit some of the high points in Judge Moses's opinion last year where she took "no pleasure" in dismissing.

The Reluctant Dismissal

After the relationship between Jones and Freeman became public, a former shareholder in a large case in Jones's court sued him, Freeman and the debtor's general counsel. The complaint stated claims based on RICO and *Bivens*, a theory based on a Supreme Court opinion recognizing an implied cause of action resulting from an unreasonable search and seizure.

Judge Moses recited the "serious" allegations in the complaint, saying "they remain only allegations." She accepted them as true in deciding whether the suit could survive a dismissal motion. Granting dismissal in her 38-page opinion last year, she decided that the former shareholder lacked standing to pursue the RICO claims and that the *Bivens* allegations failed to state a claim. *Van Deelen v. Jones*, 2024 BL 289434, 2024 U.S. Dist. LEXIS 148920, 2024 WL 3852349 (S.D. Tex. Aug. 16, 2024). To read the opinion, click here.

Although dismissing, Judge Moses said that "nothing . . . redeems Jones's misconduct" and that the relationship between Jones and Freeman was "a glaring appearance of impropriety." She added, "Whether through hubris, greed, or profound dereliction of duty, Jones flouted these statutory and ethical requirements by presiding over dozens of cases from which he was obviously disqualified."

Although obliged to dismiss the suit, Judge Moses said that the former shareholder's "allegations, if true, show that he suffered injustice in Jones's courtroom."

Dismissing, Judge Moses said she "takes no pleasure in this result" and that the allegations, "if true, cast doubt on the integrity of numerous high-profile bankruptcy cases."

The Bankruptcy Court Report and Recommendation

Withdrawal of the references was long in process. Having commenced 34 proceedings aimed at revoking JW's retention and forcing the firm to disgorge fees it was paid, the U.S. Trustee filed motions to withdraw the references in November 2023. The following month, the Chief Bankruptcy Judge in the Southern District of Texas, Eduardo V. Rodriguez, issued a report recommending that the references remain with the bankruptcy judges.

If the district court were to withdraw the references, the Chief Bankruptcy Judge recommended that the matter remain in bankruptcy court until ready for trial. After trial in district court, the Chief Bankruptcy Judge recommended that the distribution of disgorged funds, if any, be determined in the "sound discretion" of the bankruptcy judges presiding over those cases.

Emphatic Withdrawal of the References

Ruling on the recommendation, Judge Moses noted that the U.S. Trustee did not contend that reference withdrawal was mandatory. Rather, Judge Moses was deciding whether withdrawal was for "cause" under 28 U.S.C. § 157(d). In the Fifth Circuit, the governing authority is *Holland Am. Ins. Co. v. Succession of Roy*, 777 F.2d 992 (5th Cir. 1985).

On the merits, Judge Moses decided to withdraw the references in two pages. She said that *Holland* calls for the court to consider whether the matter is core or noncore, along with

consideration of the promotion of uniformity in administration, the reduction of forum-shopping, the fostering of economical use of debtors' and creditors' resources, and the expedition of the bankruptcy process.

Turning to the case at hand, Judge Moses said that many of the issues were not those that could only arise in bankruptcy, even though Jones was a judge. Already being "thoroughly acquainted with the facts," she said that "uniformity, economy, and expediency all weight in favor of withdrawal."

But Judge Moses was not through. The *Holland* factors, she said, "are not exhaustive. Beyond the *Holland* factors, the Court considers the fact that judicial proceedings must both be and appear impartial . . . . [T]he appearance of bias provides 'cause' to appropriately adapt judicial assignment processes to cure such concerns."

Terminating references to the bankruptcy courts and calling for a status conference, Judge Moses added:

> This unique case nevertheless requires stiff measures. The need to reestablish public trust and confidence in the court system alone impels withdrawal in this highly unusual case.

Observations

This writer reads the opinion by Judges Moses to mean that bankruptcy judges in Houston shouldn't touch matters involving JW. No matter how Houston bankruptcy judges might rule, their decisions could be questioned.

If Houston judges were tough on JW, Jones and Freeman, some could say they were too tough because they felt betrayed by Jones. Or, if Houston judges were easy on Jones, some could say they were partial to someone who had been a friend and colleague.

It is well that the Chief District Judge in Houston selected the Chief District Judge from another district to preside.

The opinion is *In re Professional Fee Matters Concerning the Jackson Walker Law Firm*, 23-4787 (S.D. Tex. April 9, 2025).

The majority in the Fourth Circuit based a bright-line rule on the presence of the word 'the' in Section 327(a).

Split Fourth Circuit Panel Bars Use of Equity to Correct an Oversight in Retention

Over a dissent, the majority on a Fourth Circuit panel laid down a bright-line rule in holding that "Section 327(a) does not authorize former trustees, following conversion, to file an after-the-fact application to employ professionals for the period they were trustees."

Once a trustee is out of office under any chapter of the Bankruptcy Code, the opinion means that a "former" trustee cannot rectify an oversight by applying for retroactive retention of a professional.

The dissenter said that the "majority's reading . . . extends a faux textualism to the point of hollow formalism, which, paradoxically, forecloses more natural textual readings." "When equity merges with textualism," the dissenter said, "we shouldn't pass it up."

A Parade Though the Chapters

The individual debtor made a tour of almost every chapter in the Bankruptcy Code. The debtor originally filed in chapter 7, where a trustee was appointed. The trustee applied for and obtained court authority to retain an attorney.

When the debtor converted the case to chapter 11, the chapter 7 trustee was appointed to serve as the chapter 11 trustee. Although the law firm continued to serve the trustee in chapter 11, the trustee never filed an application to retain the firm as his chapter 11 counsel.

Later still, the debtor converted the case to chapter 13 where a different person was tapped to serve as the chapter 13 trustee.

After conversion to chapter 13, the former chapter 11 trustee filed an application to retain the firm for the chapter 11 case and to pay the firm some $44,000, mostly for services during the chapter 11 case. Initially, the bankruptcy court approved a small part of the fee application for services that the law firm had performed during the initial chapter 7 case.

Ultimately, the bankruptcy court granted the former chapter 11 trustee's application to retain the firm retroactively for the chapter 11 case and to pay for the work performed during the chapter 11 case. The district court affirmed.

The debtor appealed. For himself and Circuit Judge Julius N. Richardson, Circuit Judge A. Marvin Quattlebaum, Jr., reversed in an opinion on July 26.

The Question

Judge Quattlebaum stated the question as:

> [M]ay a former trustee — whose services were terminated by virtue of conversion under § 348(e) — apply under § 327(a) for retroactive approval to employ professionals and seek their compensation under § 330 for work performed while he was the acting trustee?

Judge Quattlebaum said there were no answers in any circuit. The only reported cases, he said, were those where a trustee obtained retroactive approval to retain lawyers while the trustee was still serving as trustee.

The Word 'The'

Judge Quattlebaum based his conclusion on the idea that the chapter 11 trustee was "terminated" under Section 348(e) when the case converted from chapter 11 to chapter 13. Once the case converted and the former chapter 11 trustee was no longer the trustee, Judge Quattlebaum held that "that neither § 327(a) nor Rule 2014(a) authorized [the former chapter 11 trustee] to employ professionals."

Judge Quattlebaum based his holding primarily on the word "the" appearing in Section 327(a). The subsection provides in relevant part:

> [T]he trustee, with the court's approval, may employ one or more attorneys, accountants, appraisers, auctioneers, or other professional persons . . . to represent or assist the trustee in carrying out the trustee's duties under this title.

From the word "the," Judge Quattlebaum first deduced "that *one* trustee might employ professionals." [Emphasis in original.] "Interpreting 'the trustee' to mean a single, current officeholder also makes sense from a temporal standpoint," he said.

"Second," Judge Quattlebaum said, "context clarifies that 'the trustee' refers to the acting trustee at the time the application is made." Third, he said, "[c]ommon sense suggests that someone whose fiduciary office has ended should not be able to employ professional persons to assist them in that office."

Judge Quattlebaum held "that § 327(a)'s reference to 'the trustee' means only the currently serving, active trustee . . . . Since [the former chapter 11 trustee] wasn't the current trustee when he sought to employ the law firm, he fell outside of the statute's parameters."

Judge Quattlebaum conceded that "many of our sister circuits have affirmed approvals of after-the-fact § 327(a) applications by bankruptcy courts." However, he said, "all the cases . . . involve a current and active trustee filing an after-the-fact application seeking retroactive approval, not a former trustee."

If he "were permitted to use equity," Judge Quattlebaum said, the former trustee's argument "might be compelling," because the firm "actually did work . . . . We cannot find any basis in the text of § 327(a) or case law to permit such an application" and "cannot use equitable principles to contravene statutory requirements."

Judge Quattlebaum reversed the district court and remanded with instructions to send the case to bankruptcy court to set aside the fee allowance, because "[n]othing in § 327(a) permits a former trustee to employ a professional."

The Dissent

Circuit Judge J. Harvey Wilkinson, III, "respectfully" dissented. He said, "Bankruptcy courts across the country have exercised their equitable discretion to grant after-the-fact authorizations of professional services already performed under § 327(a)."

Believing that the majority "makes too much of the words 'the trustee,'" Judge Wilkinson saw "the majority [as] read[ing] into the statute a nonexistent limitation on bankruptcy courts' broad discretion over the employment and compensation of professionals." Although the case had converted and the chapter 11 trustee was "automatically terminated," he said that the former trustee "was still 'the trustee' over the chapter 11 case" with continuing responsibilities.

Judge Wilkinson said he would "not adopt that rigid reading of § 327(a), which firmly closes off the path to fair compensation for attorney work already performed simply because the trustee who oversaw that work is no longer the active trustee . . . . Rather than divest bankruptcy courts of their equitable discretion when considering fee applications like the one before us, I would leave open a path to fair compensation for work fairly done."

The opinion is *David v. King*, 23-1856 (4th Cir. July 26, 2024).

Concurrent representation of a 43% shareholder was disqualifying while representing a creditor with 79% of the debt did not disqualify.

Concurrent Representation of a Major Creditor/Shareholder Is/Isn't Disqualifying

A bankruptcy judge in Virginia disqualified a large firm from representing a chapter 11 debtor because the firm's clients included an entity that controlled 43% of the debtor's common stock and had two members on the board of 13. The shareholder was a $14 million dollar-a-year client.

A bankruptcy judge in New Jersey approved retention of a large firm to be the chapter 11 debtor's counsel even though the firm's clients included a creditor that held 79% of the debtor's debt. The firm had only billed the creditor $2.4 million since the inception of the representation three years before.

Can the two decisions be reconciled? You decide.

The Engagement Approved in New Jersey

About a year before the chapter 11 filing, the debtor in New Jersey effected a transaction where a creditor became the debtor's senior secured noteholder with 79% of the debtor's debt. Several months later, the debtor engaged one of the country's largest law firms that eventually put the debtor into chapter 11. The law firm had represented neither the debtor nor the secured noteholder in the prebankruptcy transaction.

The U.S. Trustee filed an objection to the retention, and the official creditors' committee lodged a limited objection. The committee said that the prebankruptcy transaction would be a "central issue" in the case. In his May 16 opinion, Bankruptcy Judge Michael B. Kaplan of Trenton, N.J., said that the firm had made proper disclosure of the representation of the secured noteholder in unrelated matters.

Judge Kaplan said that retention was governed by Section 327(a), which says that a professional must "not hold or represent an interest adverse to the estate, and that [is] disinterested. . . ." In turn, Section 101(14)(C) defines a "disinterested person" as someone who "does not have an interest materially adverse to the interest of the estate or of any class of creditors or equity security holders, by reason of any direct or indirect relationship to, connection with, or interest in, the debtor, or for any other reason."

Citing Section 327(c), Judge Kaplan said that a concurrent representation of a creditor is not an automatic disqualification. The subsection says that "a person is not disqualified for employment under this section solely because of such person's employment by or representation of a creditor, unless there is objection by another creditor or the United States trustee, in which case the court shall disapprove such employment if there is an actual conflict of interest."

Judge Kaplan concluded that the firm's representation of the secured noteholder in "unrelated matters does not present a significant risk that its representation of the Debtors in this bankruptcy case will be in any way impacted or limited." In addition, he gave "significant" weight to the forward-looking conflict waivers that the debtor and the secured noteholder had both signed with the firm that ended up representing the debtor.

Judge Kaplan focused on the "competing economic interests." The firm had billed the secured noteholder $2.4 million since the inception of the representation (in other matters) a couple of years before. The billings to the creditor represented 0.03% of the firm's revenue in 2023. He concluded that the firm was disinterested because "these sums are not insignificant [but] are relatively *de minimis* when considered in the context of the [firm's] total annual . . . revenues" and "do not create any type of conflict or adverse interest that would warrant disqualification."

Judge Kaplan identified "policy considerations" as justifying retention. Disqualifying the firm "would be detrimental" and "unworkable," he said. Furthermore, barring the firm from working on matters involving the secured noteholder would be "impractical."

Finding neither an actual nor potential conflict, Judge Kaplan approved the retention.

Disqualification in Virginia

The chapter 11 debtor in Virginia was a large manufacturing concern. Proposed co-counsel for the debtor was one of the country's largest law firms. The U.S. Trustee objected to the retention.

In his May 30 opinion, Bankruptcy Judge Brian F. Kenney of Alexandria, Va., focused on the firm's concurrent representation of an entity that controlled 43% of the common stock and two of the 13 seats on the board. Because lawyers at the firm were representing both the debtor and the controlling shareholders, he said that erecting an ethical wall was "impossible."

In terms of billings, the $14 million in legal fees paid by the controlling shareholder represented 1.4% of the firm's collections in 2023. Of course, the controlling shareholder had signed a waiver consenting to the firm's representation of the debtor.

Judge Kenney found the firm had "satisfied" the disclosure requirements under Rule 2014(a). He also decided that possible preferences that the firm had received before filing were not grounds for disqualification.

Focusing on the clients' consents and the representation of the controlling shareholder in "unrelated matters," Judge Kenney said that while "consent may satisfy certain State bar rules on conflicts, it is not a substitute for disinterestedness under Section 327(a)."

There was a prepetition restructuring support agreement that earmarked 5% of the new equity to existing shareholders. Given that the controlling shareholder had 43% of the stock, he said it was "not an academic concern." In fact, he said that "the Court cannot see how [the firm] could possibly negotiate a plan adversely to [the controlling shareholder's] position."

Judge Kenney rejected the idea of having conflicts counsel, saying that "it cannot be used as a substitute for general bankruptcy counsel's duties to negotiate a plan of reorganization."

Even if Section 327(c) were applicable, Judge Kenney found "an actual conflict of interest" because the firm "cannot be expected to negotiate a Plan that contravenes the interests of its $14 million dollar-a-year client." Saying that the billings paid by the controlling shareholder were not *de minimis*, he distinguished the New Jersey case, discussed above, because billings for the secured creditor represented only 0.03% of the firm's annual revenue.

Judge Kenney denied the retention application.

Observations

What about the appearance of impropriety from the viewpoint of creditors? How or when can creditors be confident that debtor's counsel will not tip the scales in favor of a concurrent client who represents a major force in the case? Is the percentage of the firm's revenues enough assurance?

Perhaps it's a small client, but what if it's a client landed by one of the firm's biggest rainmakers? Would a bankruptcy lawyer avoid taking action to annoy a client of a big rainmaker?

As a matter of contract law, a client can presumably sign a forward-looking conflict waiver with unknowable effects years down the road. Even though the client-creditor may be bound by the waiver, why are other creditors bound by the effect of the waiver?

Prof. Nancy B. Rapoport is writing an article discussing the Virginia and New Jersey cases. She says,

> The proportion of billings attributable to the client should be a factor in the court's consideration, but it shouldn't be the only factor. [Debtor's counsel in the New Jersey case] happens to be incredibly profitable, so should it get a pass because

it rakes in so much that no one client is going to be a high percentage of its annual billings?

* * * * *

We need to focus on fact-specific nuance here, rather than on the argument that Big Law firms are, well, really big and thus need to have the ethics rules applied in a way that benefits them to the detriment of their clients.

One of the country's leading experts on ethics in bankruptcy cases, Prof. Rapoport is a UNLV Distinguished Professor and the Garman Turner Gordon Professor of Law at the University of Nevada, Las Vegas William S. Boyd School of Law.

The opinions are *In re Invitae Corp.*, 24-11362 (Bankr. D.N.J. May 16, 2024); and *In re Enviva Inc.*, 24-10453 (Bankr. E.D. Va., May 30, 2024).

Expedience is no substitute for disinterestedness when it comes to retention of a chapter 11 debtor's general counsel.

A Partial Ethical Wall Didn't Give Rise to Disinterestedness, Judge Kenney Said

Some folks don't know how to take "no" for an answer.

Denying a motion for reconsideration, Bankruptcy Judge Brian F. Kenney of Alexandria, Va., stood by his guns, refused for a second time to allow a large law firm to be the debtor's general counsel, and concluded that a "partial ethical wall" would not confer disinterestedness on a firm that was concurrently representing a company that controlled 43% of the debtor's common stock and two of the 13 seats on the debtor's board.

The Partial Ethical Wall

A major manufacturing concern, the debtor tapped one of the country's largest firms to be co-counsel in its chapter 11 case. The U.S. Trustee objected, and Bankruptcy Judge Kenney denied the retention application on May 30, finding that the firm was not disinterested. *In re Enviva Inc.*, 24-10453, 2024 BL 185223 (Bankr. E.D. Va. May 30, 2024). To read ABI's report, click here.

Denying the retention application in May, Judge Kenney focused on the firm's concurrent representation of an entity that controlled 43% of the common stock and two of the 13 seats on the board. When initially applying for retention, the firm took the position that erecting an "ethical wall" was impossible because lawyers at the firm were representing both the debtor and the controlling shareholder.

Before the time elapsed for appealing denial of retention, the debtor filed a motion for reconsideration under Bankruptcy Rules 9023 and 9024.

As grounds for reconsideration, the firm described what the U.S. Trustee characterized as a "partial ethical wall." In summary, the partial wall worked like this: Lawyers who billed time to the debtor but not the shareholder after the petition date would be prohibited from working for the shareholder. Conversely, lawyers who billed time to the shareholder after the petition date but not to the debtor would be prohibited from working for the debtor.

For lawyers who had billed time after filing to both the shareholder and the debtor, the firm proposed the following: Lawyers who billed fewer than 12.5 hours for the shareholder could work

for the debtor, but lawyers who billed more than 12.5 hours to the shareholder could not work for the debtor.

For partners who worked more than 10 hours for the debtor after filing, the firm said that those partners would not participate in any of the partners' income flowing from representation of the shareholder in 2024 and 2025.

Finally, the debtor and the committee agreed to the formation of a plan evaluation committee composed of six board members to review any chapter 11 plan independently. The evaluation committee would have its own counsel but could not retain financial advisors. The board, though, would remain responsible for negotiating the plan. The evaluation committee could be disbanded.

Rule 9023 Analysis

Judge Kenney first evaluated the reconsideration motion under Rule 9023, which incorporates Federal Rule 59. Under the rule, amending a judgment requires a change in law, newly discovered evidence or manifest injustice.

Judge Kenney said there was no change in the law and that the partial ethical wall was not newly discovered facts. The wall was "newly created," he said.

To amend the retention-denial order under Rule 59, Judge Kenney searched for clear error of law or manifest injustice. He said that lack of an ethical wall was "only one factor" in denying retention in May. In 2024, he estimated that billings to the shareholder would exceed $9 million.

Furthermore, 13 timekeepers worked for both the debtor and the shareholder after filing, but only two would be walled off. He said that the "post-petition time-keeping . . . does not inform the Court as to how extensive the overlap might have been during the run-up to the bankruptcy filing."

Judge Kenney found that the "proposed ethical wall is insufficient." Next, he turned to the compensation arrangement and said that it did not render the firm disinterested, because partners had shared income from the shareholder in 2023 and early 2024.

Judge Kenney gave three reasons why the plan evaluation committee did not solve the "disinterestedness problem." For reasons one and two, he said that the committee is not irrevocable and will not have its own financial advisors.

"[M]ost importantly," Judge Kenney said, the committee will not have primary responsibility for negotiating the plan. He concluded that the committee "is only so much window dressing, an attempt to make it appear that [the firm] is disinterested," given that it can be disbanded "at any time."

Judge Kenney found no grounds for reconsideration under Rule 9023.

Rules 9024 and 60(b)

The debtor proposed that reconsideration was proper under Rule 60(b)(5) and (6) because enforcement of the prior order was "no longer equitable."

Judge Kenney said that his prior decision was "not inequitable" and that the motion for reconsideration "does not present circumstances that justify relief."

Judge Kenney Throws a Lifeline

Finding no grounds for retention under Section 327(a) as general counsel, Judge Kenney looked at Section 327(e) and retention for a "specified special purpose."

The debtor told Judge Kenney about the expenses it "inevitably will encounter" by loss of the firm's "deep institutional knowledge" and "specific expertise" regarding the debtor's tax matters, securities laws disclosures, and contract renegotiations. Judge Kenney accepted the arguments as "true" but said they "elide the disinterestedness standard . . . in favor of expediency in the employment of counsel."

"As long as the matters do not involve [the firm's] other clients," Judge Kenney said the firm could be retained as special counsel under Section 327(e). But he warned that "Section 327(e) is not to be employed as an end-run around Section 327(a)'s more general requirement of disinterestedness."

Judge Kenney denied the motion for reconsideration.

The opinion is *In re Enviva Inc.*, 24-10453 (Bankr. E.D. Va. July 2, 2024).

Judge Dale Somers adopted a 'liberal' construction of Section 1107(b) to retain a professional person who had been an officer of the debtor.

A Former Officer Was Not 'Disinterested' but Could Be Retained as a Professional Person

Adopting a "liberal construction" of Section 1107(b), Chief Bankruptcy Judge Dale L. Somers of Topeka, Kan., allowed a chapter 11 debtor's former vice president and treasurer to be retained as the debtor in possession's chief restructuring officer, or CRO.

The individual tapped to be the CRO had served as the debtor's treasurer and vice president for more than three years before the filing. One month before the filing, the individual had resigned as vice president and treasurer.

The official creditors' committee supported retaining the proposed CRO. The U.S. Trustee lodged the only objection, contending that the CRO was disqualified under Section 327(a) because he was not disinterested. The subsection allows a trustee or a chapter 11 debtor in possession to retain a "professional person" who does "not hold or represent an interest adverse to the estate, and that [is a] disinterested person[]."

In turn, a "disinterested person" is defined in Section 101(14) as someone who "(A) is not a creditor, an equity security holder, or an insider; (B) is not and was not, within 2 years before the date of the filing of the petition, a director, officer, or employee of the debtor; and (C) does not have an interest materially adverse . . . ."

The proposed CRO was a "professional person," meaning that the CRO must pass muster under Section 327(a), Judge Somers ruled.

Judge Somers decided that the proposed CRO was not disinterested because he had been an officer within two years of bankruptcy, but the rules are different in chapter 11. "Notwithstanding section 327(a)," Section 1107(b) says that "a person is not disqualified for employment under section 327 of this title by a debtor in possession solely because of such person's employment by or representation of the debtor before the commencement of the case."

The U.S. Trustee took the position that the CRO was disqualified even under Section 1107(b) because the CRO had been a corporate officer within two years of bankruptcy. In response, the debtor argued that Section 1107(b) immunized the CRO because he had been employed by the debtor.

For Judge Somers, the question was this: Does employment by the debtor make a former officer eligible for retention?

The U.S. Trustee wanted Judge Somers to adopt a "narrow construction" of Section 1107(b), "under which an applicant's prior employment is the only disqualifying factor." In other words, the U.S. Trustee took the position that the proposed CRO should be disqualified for having been an officer because Section 1107(b) only allows retention of someone who was employed but had not been an officer.

The U.S. Trustee wanted Judge Somers to adopt the "narrow construction" of Section 1107(b) described in an opinion by Delaware Bankruptcy Judge Mary F. Walrath. In *In re Essential Therapeutics, Inc.*, 295 B.R. 203, 207-08 (Bankr. D. Del. 2003), Judge Walrath disqualified a former officer. She "conclude[d] that section 1107(b) must be narrowly construed and is not meant to eliminate all the specific tests for disqualification enumerated in section 101(14) *except* the mere fact of prior employment or retention."

Judge Somers was persuaded to examine the "totality of the circumstances" and follow decisions with a more liberal construction of Section 1107(b), such as an opinion by Bankruptcy Judge D. Michael Lynn of Fort Worth, Texas, in *In re Talsma*, 436 B.R. 908 (Bankr. N.D. Tex. 2010).

Judge Somers said that the proposed CRO's service as an officer made him "knowledgeable" about the debtor's business, finances, operation, and books and records. Without him, he said that the "efficiency of Debtor's Chapter 11 case would be seriously impaired."

Rejecting a narrow construction of Section 1107(b), Judge Somers approved retention of the CRO, despite his having been an officer within two years of filing.

The opinion is *In re Lodging Enterprises LLC*, 24-40423 (Bankr. D. Kan. Sept. 17, 2024)

Preferences, Fraudulent Transfers & Claims

The Fifth Circuit declines to adopt a securities industry guidebook for what's a permissible financing.

Fifth Circuit Bans Uptier Financings for Violating the Principle of Ratable Treatment

In a remarkable opinion, the Fifth Circuit banned so-called uptier financings. The decision by Circuit Judge Andrew S. Oldham included an equally remarkable discussion of equitable mootness where the Fifth Circuit had no hesitation in reversing confirmation of a consummated chapter 11 plan that may mean millions of dollars in losses for some creditors.

Given the gravity of the December 31 opinion, we will deal with uptier financing today. Tomorrow, we will cover equitable mootness and issues related to relief that an appeals court can grant on reversing plan confirmation.

The Norm of Ratable Treatment

Judge Oldham began his opinion by saying, "Ratable treatment is an important background norm of corporate finance." It is, he said, "a lender's 'sacred right' under syndicated loan agreements."

"The norm of ratable treatment," Judge Oldham said, "provides that the borrower may not choose to repay only one of its lenders. Rather, it must proportionally allocate [the repayment] among the relevant lenders according to their share of the outstanding debt."

"Uptiers," Judge Oldham said, "are a relatively new and controversial exception to the ratable treatment norm . . . . They are controversial because, according to critics, uptiers create a zero-sum game of 'lender-on-lender violence.'"

Judge Oldham said that an uptier financing works by amending

> the terms of a credit facility to allow the issuance of new super-priority debt. Because a majority of lenders in the existing facility must typically consent to such an amendment, the borrower purchases consent by allowing these lenders to exchange their existing debt for new super-priority debt, often at an above-market price . . . . Since not all of the lenders participate in the uptier, the uptier is a non-*pro rata* transaction that violates the norm of ratable treatment.

Judge Oldham said that the advantages of an uptier include "play[ing] lender groups off of each other and avoid[ing] the expense of dealing with holdouts." Furthermore, "[t]he costs of an uptier transaction are borne entirely by the minority lenders, who end up with subordinated debt worth less than before."

The Serta Simmons Uptier Financing

Having extolled the virtues of ratable treatment, Judge Oldham described the uptier financing by bedding-maker Serta Simmons Bedding LLC.

In 2016, the company had sold a series of syndicated loans yielding $1.95 billion in first lien debt and $450 million in second lien loans.

To protect "the sacred right of *pro rata* sharing," Judge Oldham described the 2016 loan agreement as having a provision preventing the company from "pay[ing] its obligations to one lender while offering nothing to the rest." As further protection, he said that the agreement included another provision that "generally requires [the] unanimous consent of any affected lender to waive, amend, or modify" the *pro rata* sharing requirement. Other provisions in the agreement could be modified by a simple majority vote of lenders.

There were two exceptions to the *pro rata* repayment requirement. One was a "Dutch option," and the second was an "open market purchase." The loan agreement, Judge Oldham said, did not define "open market purchase." The "patent ambiguity in the undefined term," he said, "forms the foundation of this case."

With the company facing financial difficulty, Judge Oldham described how the company cobbled together an uptier financing in 2020 with some but not all of its first and second lien lenders. The parties and Judge Oldham called them the "Prevailing Lenders."

The Prevailing Lenders provided new $200 million financing in the form of first-out, super-priority debt. They traded $1.2 billion in existing financing for $875 million in second-out, super-priority debt. Overall, the deal gave the company more cash and less debt. However, Judge Oldham said that the deal allowed the Prevailing Lenders "to jump the creditor line and get paid before their erstwhile first and second lien comrades."

Anticipating litigation in the future, the Prevailing Lenders voted by a bare majority to amend the 2016 loan agreement to allow the uptier financing. They also labeled the uptier financing an "open market purchase."

There was more. The company agreed to indemnify the Prevailing Lenders for any losses or liabilities they might incur as a consequence of the uptier financing.

The Serta Simmons Chapter 11 Case

The company filed a chapter 11 petition in early 2023 in Houston. The case was assigned to Bankruptcy Judge David R. Jones, who resigned several months later.

Immediately, the debtor filed an adversary proceeding seeking a declaration that the uptier financing did not violate the 2016 loan agreement. Opposition came from lenders in the 2016 financing who were not among the Prevailing Lenders. The parties and Judge Oldham referred to the opponents as the "Excluded Lenders."

The bankruptcy court granted summary judgment to the Prevailing Lenders and held that the uptier financing was a permitted "open market purchase." The bankruptcy court certified a direct appeal, which the Fifth Circuit accepted.

After dismissing counterclaims for breach of contract asserted by the Excluded Lenders in the adversary proceeding, the bankruptcy court entered final judgment in favor of the debtor and the Prevailing Lenders. Again, the Fifth Circuit accepted a direct appeal.

The Chapter 11 Plan

Because the prepetition indemnification of the Prevailing Lenders would not survive confirmation of the debtor's chapter 11 plan, the plan gave the Prevailing Lenders a new indemnification. The bankruptcy court confirmed the plan and approved "the settlement indemnity [as] a fair and equitable component of a § 1123(b)(3) settlement," Judge Oldham said.

The Fifth Circuit accepted a direct appeal of the confirmation order.

Appellate Jurisdiction

Having consolidated four appeals, Judge Oldham first addressed the Fifth Circuit's appellate jurisdiction and the jurisdiction of the bankruptcy court. Meticulously but quickly, he decided that the bankruptcy court had jurisdiction and power to enter final judgments, with one exception.

The exception was state law breach-of-contract claims by the Excluded Lenders against the Prevailing Lenders, where the bankruptcy court did not have constitutional power to enter a final judgment under *Stern v. Marshall*, 564 U.S. 462, 482 (2011). However, Judge Oldham held that the lack of objection by the debtor and the Prevailing Lenders was implied consent under *Wellness International Network, Ltd. v. Sharif*, 575 U.S. 665 (2015), allowing the bankruptcy court to enter final judgment dismissing the Excluded Lenders' counterclaims.

Judge Oldham also held that the Fifth Circuit had appellate jurisdiction under 28 U.S.C. § 158(d).

It Wasn't an Open Market Purchase

On the merits, Judge Oldham first undertook *de novo* review of the bankruptcy court's decision on summary judgment holding that the uptier financing was a permissible open market purchase. Under New York law governing the 2016 financing, he explained why the uptier financing was not an open market transaction.

By referencing dictionaries and by analogy to the Federal Reserve's open market activities, Judge Oldham concluded that "an open market purchase is a purchase of corporate debt that occurs on the secondary market for syndicated loans."

Judge Oldham added that "the words 'open market' point to a specific 'market,' not merely a general context where private parties engage in non-coercive transactions with each other." He rejected the idea "that there is an open market wherever there is competition." Properly, he said, "an open market is one tied to a specific market, like the stock market or the commodities market or the securities market."

Applied to the case at hand, Judge Oldham said that "an open market purchase occurs on the specific market for the product that is being purchased . . . , and the market for that product is the 'secondary market' for syndicated loans."

If the company had wanted to effect an "open market purchase and thereby circumvent the sacred right of ratable treatment," Judge Oldham said, "it should have purchased its loans on the secondary market. Having chosen to privately engage individual lenders outside of this market," he said that the debtor "lost the protection of" the provision in the 2016 loan agreement that gave an exception for open market purchases.

For the same reason that the uptier financing was not an open market transaction, Judge Oldham decided that it also was not subject to the exception for Dutch auctions.

Other Rejected Arguments

Of significance in future cases dealing with syndicated loans, Judge Oldham rejected the Prevailing Lenders' reliance on "a guide published by the Loan Syndications and Trading Association" (LSTA) to show "that industry usage supports their expansive definitions of 'open market purchase.'"

While the "LSTA guide carries some weight," Judge Oldham said, "it is not binding authority." Even if it were dispositive, he said that "its discussion of open market purchases does not support the 2020 Uptier."

Holding "that the 2020 Uptier was not a permissible open market purchase within the meaning of the 2016 Agreement," Judge Oldham reversed "the bankruptcy court's contrary ruling."

In one paragraph, Judge Oldham ruled in favor of the Excluded Lenders in their appeal from the bankruptcy court's denial of their counterclaims for breach of contract. He said that the counterclaims were "largely based" on the issue of open market purchases.

Judge Oldham reversed and remanded for reconsideration of the Excluded Lenders' breach of contract claims. In words the bankruptcy court likely will not ignore on remand, he added that "the Excluded Lenders have a strong case that [the debtor] and the Prevailing Lender plaintiffs breached the 2016 Agreement."

Observations

Prof. Stephen J. Lubben provided ABI with the following commentary:

> The Court's ruling on "open market purchases" was refreshingly sensible, compared to the typical hyper-literalism we normally see in corporate finance decisions. Too often courts say [that] "while the parties might not have intended this result, it was not technically prohibited, and the parties are sophisticated, so too bad for you."
>
> That just encourages even more outrageous abuse in the next case. I am hopeful that the *Serta* decision will reset the situation with regard to aggressive "liabilitymanagement transactions," which are often little more than a flagrant attempt to favor one group over another in the forthcoming chapter 11 case.

Among the commentators cited in his opinion, Judge Oldham included Prof. Lubben's "Holdout Panic," 96 AM. BANKR. L.J. 1 (2022). Prof. Lubben occupies the Harvey Washington Wiley Chair in Corporate Governance & Business Ethics at Seton Hall University School of Law.

The opinion is *Excluded Lenders v. Serta Simmons Bedding LLC (In re Serta Simmons Bedding LLC)*, 23-20181 (5th Cir. Dec. 31, 2024).

Bound by circuit precedent, the Eighth Circuit held that a prior receivership does not cleanse the bankruptcy estate of the in pari delicto defense.

The Time Has Come to Reconsider Whether Trustees Are Subject to *In Pari Delicto*

Bankruptcy trustees are subject to the *in pari delicto* defense, but, curiously, receivers are not. The defense puts bankruptcy trustees at a disadvantage when it comes to pursuing fraudulent transfers effected by the debtor before bankruptcy.

The imposition of the *in pari delicto* defense stems from the outdated notion that a bankruptcy trustee steps into the shoes of the debtor and is therefore subject to defenses that could be raised against a debtor if the debtor were to pursue a fraudulent transfer outside of bankruptcy. The defense disembowels a trustee who is precluded from recovering fraudulent transfers that damaged creditors.

The *in pari delicto* defense was a creature of common law originally applicable in altogether different circumstances. If judges and courts dreamed up the defense, this writer believes that courts have the ability to eradicate the defense when it comes to bankruptcy trustees.

When a bankruptcy trustee succeeds a receiver, the existence of the receivership before bankruptcy does not "cleanse" the estate of the *in pari delicto* defense, the Eighth Circuit said, bound by the circuit's own precedent.

The Thomas Petters Ponzi Scheme

Thomas Petters conducted a Ponzi scheme that blew up in 2008 about the same time as Bernie Madoff's. Petters is serving a 50-year jail sentence.

The federal government prevailed on the district court to appoint a receiver with power to put the Petters empire into bankruptcy. And that's what the receiver did. Five days after appointment, the receiver put the Petters business into chapter 11. The receiver became the chapter 11 trustee.

The trustee (formerly the receiver) filed a lawsuit under Minnesota law in bankruptcy court against the bank that Petters used, alleging that bankers were aware of the fraud and thereby aided and abetted a breach of fiduciary duty.

After the suit was removed to district court, the jury awarded the trustee a judgment against the bank for almost $485 million in compensatory damages and $80 million in punitive damages. The bank had raised the *in pari delicto* defense. The district court rejected the defense, reasoning that receivership meant that the trustee was not bound by the debtor's prior fraudulent acts.

The bank appealed and won a reversal in a September 12 opinion for the Eighth Circuit by Circuit Judge Steven M. Colloton.

Eighth Circuit Precedent

Citing *Grassmueck v. Am. Shorthorn Ass'n*, 402 F.3d 833, 837 (8th Cir. 2005), Judge Colloton said that the "equitable defense of *in pari delicto* embodies the principle that a plaintiff who has participated in wrongdoing may not recover damages resulting from the wrongdoing." In Minnesota, the defense kicks in when the plaintiff's fraud was "no less than" the defendant's.

The bank argued that the defense would bar the suit in state court because Petters orchestrated the fraud and was necessarily more culpable than the bank.

Citing Eighth Circuit precedent, Judge Colloton said that the "trustee in bankruptcy stands in the shoes of the debtor." Again citing *Grassmueck*, he said that the "defense of *in pari delicto* is thus available in an action by a bankruptcy trustee against another party if the defense could have been raised against the debtor."

Judge Colloton said that "[s]tate law governs whether the defense could have been raised against the debtor." Citing the Supreme Court, he said that "state law governs a federal receiver's rights in a state-law cause of action," even though the receiver-trustee "was appointed by a federal court."

As it turns out, a receiver has an escape hatch under Minnesota law, where a receiver represents the rights of the creditors of the receivership. Judge Colloton cited the Minnesota Supreme Court for holding that a receiver is therefore not bound by the fraudulent acts of former officers of the corporation. He quoted the state's highest court:

> "[W]hen an act has been done in fraud of the rights of the creditors of the insolvent corporation[,] the receiver may sue for their benefit, even though the defense set up might be valid as against the corporation itself."

German-Am. Fin. Corp. v. Merchs.' & Mfrs.' State Bank of Minneapolis, 225 N.W. 891, 893 (Minn. 1929).

For Judge Colloton, the question then became whether the defense evaporated because the case had been in receivership briefly. However, he said that the trustee "is acting in this case as a bankruptcy trustee, not as a receiver."

Once again citing *Grassmueck*, Judge Colloton said that a "bankruptcy trustee steps into the shoes of the debtor and is subject to any defenses that could be raised against the debtor, including the defense of *in pari delicto*."

Judge Colloton described the trustee as having argued that "he stepped into the shoes of a 'cleansed' receivership entity that is no longer bound by its prior wrongdoing." Under Minnesota law, however, Judge Colloton said that "the appointment of a receiver does not change the receivership entity."

Once the receiver became the trustee, Judge Colloton said that the receiver had no claims to bring because the claims became part of the bankrupt estate, and "bankruptcy law governed his ability to bring [the estate's] claims as the trustee." Once again citing *Grassmueck*, he said the trustee became subject to any defenses that could have been raised against the debtor.

In short, Judge Colloton said that the debtor "itself was never 'cleansed,' so the *in pari delicto* defense was never 'extinguished.'" Consequently, he said, "Bankruptcy law does not provide a vehicle for [the debtor] or its trustee to proceed unbound by [the debtor's] own wrongdoing."

Judge Colloton reversed and remanded with instructions to enter judgment for the bank. The district court, he said, committed legal error in deciding that the defense was unavailable against the trustee. "Even assuming that the bank aided the scheme to the degree that [the trustee] alleges, [the bank] cannot be more culpable than the entity that orchestrated the scheme."

Observations

Judge Colloton had no choice but to rule how he did. The outcome was foreordained by *Grassmueck*.

Courts dealing with the *in pari delicto* defense in a bankruptcy case might recognize that a bankruptcy trustee since the adoption of the Bankruptcy Code does not step into the shoes of the debtor. Rather, Section 541(a) creates an estate, and the trustee is given powers in Section 704 to administer the estate. A trustee does not assume title to estate property.

In the case before the Eighth Circuit, the trustee was using the so-called strong-arm powers in Section 544 to bring claims that could have been asserted by an actual creditor or a holder of a judicial lien. Presumably under Minnesota law, a creditor of Petters could have sued the bank without facing the *in pari delicto* defense. If a creditor could have sued, then why not the trustee asserting the claims creditors who are immune to *in pari delicto*?

Eradication of the *in pari delicto* defense would not require a change in state law, because a bankruptcy trustee is asserting a federal right under the strong-arm powers.

One of these days, a circuit court sitting *en banc* should reconsider whether *in pari delicto* applies to bankruptcy trustees. This writer cannot fathom why a federal bankruptcy trustee is disadvantaged when compared to a federal receiver.

The opinions in this piece are those of the writer, not ABI.

The opinion is *Kelley v. BMO Harris Bank N.A.*, 23-2551 (8th Cir. Sept. 12, 2024).

Fancy drafting by 'brilliant financiers and lawyers,' the judge said, didn't validate an uptier transaction when the 'effect' was to release collateral without a two-thirds vote.

In Lender-on-Lender Violence, an 'Uptier' Financing Bites the Dust, this Time in Houston

As a sequel to the Fifth Circuit's remarkable *Serta Simmons* opinion at the end of December, Bankruptcy Judge Marvin Isgur of Houston overturned a different "uptier" transaction that emerged from a tussle among sophisticated lenders in what's being called lender-on-lender violence.

Judge Isgur distilled the practical effect of a series of simultaneous transactions to conclude that the top dogs had violated the terms of the governing bond indenture when they provided $250 million in new funding designed to put their larger, existing debt above everyone else's.

Among other things, the Fifth Circuit decided in *Serta Simmons* that the debtor's uptier financing before bankruptcy was not a permissible "open market purchase" and thereby violated the rights to ratable treatment that belonged to lenders who were not permitted to put their debt on top of the pile. *Excluded Lenders v. Serta Simmons Bedding LLC (In re Serta Simmons Bedding LLC)*, 23-20181 (5th Cir. Dec. 31, 2024). To read ABI's report, click here.

The January 17 opinion by Judge Isgur didn't turn on the open market purchase. He identified other grounds in finding that a breach of contract occurred in implementing the uptier financing.

The Existing Debt

Judge Isgur conducted a 35-day trial over six months with 21 witnesses and hundreds of exhibits. His explication of the facts reads like the detail in a doctoral dissertation. To understand the gravity of the holdings in his report and recommendations, a cursory summary of the uptier transaction is sufficient.

The debtor had two series of senior secured notes, one for $650 million due in 2024 and another for $900 million due in 2026. In addition, there was $525 million in unsecured notes. The indentures for both secured issues required a two-thirds vote to authorize a non-*pro rata* transaction, including the release of collateral.

Facing a liquidity crisis, the debtor received proposals from existing noteholders. The superior proposal came from a group called the Majority, which held more than two-thirds of the 2024 notes. As Judge Isgur said, their proposal was not "actionable" because they "did not control two-thirds of the 2026 Notes."

To skirt the problem, Judge Isgur said that the majority "decided to proceed by sleight of hand."

The indenture for the pivotal 2026 notes only required a majority vote to issue new notes. By issuing another $250 million in 2026 secured notes to themselves, the Majority would then claim to control more than two-thirds of the enlarged issue, thus allowing them to vote to allow the release of collateral. That's what they did.

The Uptier Transaction

In automatic, simultaneous transactions, the Majority authorized the issuance to themselves of $250 million in new 2026 secured notes. Then holding more than two-thirds of the 2026 notes, the majority modified the indenture to allow the release of collateral. Next, the majority exchanged their outstanding secured and unsecured notes for, as Judge Isgur put it, "new, super-senior first-lien and second-lien notes."

In other words, the Majority invested $250 million and moved their existing secured and unsecured notes into a super-priority category ahead of everyone else.

Before bankruptcy, an investor group called the Minority had sued in state court, alleging that they had been stripped of their liens. They wanted the state court to declare the transaction null and void and unenforceable. They also wanted the state court to unwind the transaction.

The debtor filed a chapter 11 petition, stopping the suit in state court. On the day of filing, the debtor filed an adversary proceeding asking Judge Isgur to declare that the uptier transaction was valid and enforceable. The Minority answered with counterclaims asking Judge Isgur to declare breach of contract.

In his January 17 opinion, Judge Isgur ruled on the breach of contract claims, leaving remedies for later determination. Because the Majority held more than two-thirds of the 2024 notes, there was no breach of contract. The opinion therefore focused on the question of whether the uptier financing breached the indenture for the 2026 notes.

Good Faith Wasn't an Issue

The contract claims were governed by New York law, where "the good faith of a breaching party to a contract does not insulate the breaching party from liability," Judge Isgur said. Facing a "severe liquidity crisis," he said that the debtor "acted in what it sincerely believed was its best

interest." However, he went on to say, "Not all actions taken in the best interest of a party are done in good faith."

Nonetheless, Judge Isgur made no findings about the debtor's good faith. Rather, he ruled on whether the transaction complied with the indenture, adding that the debtor's and the Majority's "mental states have no effect on any contract-based claims."

The outcome turned on the provision in the 2026 indenture, which said that "no amendment, supplement or waiver may (1) have the effect of releasing all or substantially all of the Collateral from the Liens . . . or altering the priority of the security interests of the Holders of the 2026 Secured Notes in the Collateral . . . ."

The critical words were "have the effect of." That is to say, did the issuance of the $250 million in additional notes "have the effect of" releasing collateral? Judge Isgur determined that he was obliged to look "beyond the contract to the resulting effect."

As a fact, Judge Isgur found that the Majority would not have bought the additional $250 million in notes without the uptier, and that the completion of the uptier occurred automatically upon the purchase of the $250 million in notes. In other words, the uptier was the "inevitable result" of the sale of the new notes.

Judge Isgur ruled that the transaction "failed" at the issuance of the new notes and "did not release the liens securing the 2026 Notes." As a result, he held that the "2026 Notes remain secured by first liens."

Judge Isgur declared "that the rights, liens, and interests that were for the benefit of all of the holders of 2026 Notes . . . remained in full force and effect . . . ."

The opinion is *Wesco Aircraft Holdings Inc. v. SSD Investments Ltd. (In re Wesco Aircraft Holdings Inc.)*, 23-3091 (Bankr. S.D. Tex. Jan. 17, 2025).

Following the Supreme Court's Morgan v. Sundance, the appeals court interpreted an arbitration agreement like any other contract, with no policy favoring arbitration over litigation.

Second Circuit Doesn't Compel a Liquidating Trustee to Arbitrate with an Insurer

Strictly construing the arbitration clause in an insurance policy, the Second Circuit upheld the bankruptcy court by holding that the trustee of a liquidating trust was not compelled to arbitrate a claim against the insurer.

The corporate debtor confirmed a chapter 11 plan creating a liquidating trust. The trustee of the liquidating trust sued the debtor's officers and directors. A settlement ensued in which the officers and directors assigned to the trustee their rights to pursue insurance coverage.

The liquidating trustee then sued the insurer for the officers' and directors' defense costs and indemnification rights. The insurer moved to compel arbitration.

The insurance policy called for arbitration of any "dispute between the insurer and the policyholder regarding any aspect of this policy." As the Second Circuit said in its nonprecedential opinion on April 15, "policyholder" was defined to mean the debtor.

In bankruptcy court and on appeal, the insurer argued that the dispute was arbitrable based on the idea that the liquidating trustee was seeking relief in his capacity as the policyholder. The insurer also contended that the officers and directors were subject to the arbitration clause because they were asserting rights given them by the insurance policy.

Chief Bankruptcy Judge Alan S. Trust of Central Islip, N.Y., denied the arbitration motion. After affirmance in district court, the insurer appealed to the Second Circuit. The appeal was heard by a panel composed of José A. Cabranes, Gerard E. Lynch and Raymond J. Lohier, Jr.

Citing Second Circuit authority, the panel said that the "threshold question" was whether the parties agreed to arbitrate and whether the disputes were within the scope of the arbitration agreement.

Parsing the complaint, the panel said that the "allegations and claims for relief . . . relate entirely to [the insurer's] duty to defend and indemnify the directors and officers in connection with the earlier adversary proceedings." It was, the appeals court said, "a dispute between insureds

and the insurer, not a dispute between the policyholder and the insurer" and "thus falls outside the scope of the Arbitration Provision."

Contrary to the insurer's idea that the trustee was acting in the shoes of the debtor-insured, the panel said that "the Trustee here is acting only as the assignee of the insureds, not as the policyholder." The court added, "the directors and officers cannot be compelled to arbitrate their disputes with [the insurer] as third-party beneficiaries." The policy, the panel said, was only an agreement to arbitrate between the insurer and the debtor, "not any disputes between [the insurer] and the directors and officers."

The Second Circuit upheld the judgment of the district court affirming Bankruptcy Judge Trust's denial of the arbitration motion.

Observation

The Second Circuit interpreted the arbitration agreement like any other contract.

The opinion doesn't say a word about a federal policy favoring arbitration, an idea extinguished by the Supreme Court in *Morgan v. Sundance, Inc.*, 596 U.S. 411 (May 23, 2022). For the unanimous Court, Justice Elena Kagan said, the "policy is to make 'arbitration agreements as enforceable as other contracts, but not more so.' *Prima Paint Corp. v. Flood & Conklin Mfg. Co.*, 388 U.S. 395, 404, n. 12 (1967)." *Id*. at 418.

Justice Kagan added, "a court must hold a party to its arbitration contract just as the court would to any other kind. But a court may not devise novel rules to favor arbitration over litigation." *Id*. To read ABI's report, click here.

The opinion is *Ehrenberg v. Allied World National Assurance Co. (In re Orion Healthcorp Inc.)*, 24-2511 (2d Cir. April 15, 2025).

The Fifth Circuit joins two other circuits in requiring 'more' to amend a proof of claim after confirmation of a chapter 11 plan.

Amending a Claim After Confirmation Requires 'Compelling Circumstances'

Joining two other circuits, the Fifth Circuit upheld Bankruptcy Judge Stacey G.C. Jernigan by holding that amending a proof of claim after confirmation of a chapter 11 plan requires a showing of "compelling circumstances."

The facts were complex but amounted to this: When the debtor confirmed a chapter 11 plan, the creditor had a claim on file for zero dollars. After confirmation, the creditor amended the claim, seeking almost $4 million. In substance, the bankruptcy court expunged the amended $4 million claim.

The district court affirmed, but the creditor appealed to the Fifth Circuit. In an opinion on May 21, Circuit Judge Catharina Haynes affirmed.

In the circuit, the creditor argued that the bankruptcy court incorrectly applied multiple factors in expunging the claim and should have followed what it claimed to be a two-factor test from the Fifth Circuit's opinion in *In re Kolstad*, 928 F.2d 171 (5th Cir. 1991). Judge Haynes reviewed the bankruptcy court's decision for abuse of discretion.

Judge Haynes explained that *Kolstad* dealt with a claim that was amended after the bar date but before confirmation. She therefore said that "*Kolstad* did not address or even consider whether a *post-confirmation amendment* warrants a heightened showing as other circuits have." [Emphasis in original.]

Furthermore, Judge Haynes said that *Kolstad* "did not hold that a bankruptcy court must rigidly apply two factors in determining whether a proof of claim may be amended." The two *Kolstad* factors she referred to were whether the claimant was effectively filing a new claim, and the degree of prejudice caused by the claimant's delay. She said that *Kolstad* "did not rule out a more holistic approach, which comports with the equitable nature of bankruptcy courts."

Judge Haynes held "that in circumstances like the case at bar — a post-confirmation amendment — more is required." By "more," she said, "we mean 'compelling circumstances,'" as the Seventh and Eleventh Circuits held in *Holstein v. Brill*, 987 F.2d 1268, 1270–71 (7th Cir. 1993), and *In re Winn-Dixie Stores, Inc.*, 639 F.3d 1053, 1056 (11th Cir. 2011).

Judge Haynes explained why "more" is required: "Post-confirmation amendments warrant a heightened showing because a confirmed plan of reorganization is equivalent to a final judgment in civil litigation . . . . This potential *res judicata* effect justifies ratcheting up the legal standard because post confirmation amendments may 'mak[e] the plan infeasible,' 'disrupt the orderly process of adjudication,' and 'alter the distribution[s] to other creditors,'" quoting *Holstein* and *Winn-Dixie*.

The bankruptcy court, Judge Haynes said, "did not apply the incorrect legal standard when it" expunged the amended claim. "Instead," she said, "it considered several equitable factors, including the fact that [the creditor] did not identify any appropriate reason — let alone a compelling reason — for its nearly year-long delay in seeking a post-confirmation amendment." She added, "This unexcused delay would have been sufficient by itself for the bankruptcy court to deny the post-confirmation amendment."

Finding no abuse of discretion, Judge Haynes affirmed.

The opinion is *CLO Holdco Ltd. v. Kirschner (In re Highland Capital Management LP)*, 23-10660 (5th Cir. May 21, 2024).

The 'ordinary course' defense only applies to credit terms with healthy customers, not to debtors in financial distress, even if pressure is ordinary in the industry.

Applying Pressure on the Debtor Obviates the 'Ordinary Course' Defense to a Preference

Following Third Circuit precedent where there may be a circuit split, Bankruptcy Judge Craig T. Goldblatt of Delaware held that the "ordinary course" defense to a preference is not available when the creditor "was imposing credit pressure on the debtor to extract payment and thus reduce its own exposure."

Early in his January 15 opinion, Judge Goldblatt foreshadowed the outcome when he said that "the ordinary course defense is intended to capture circumstances in which the debtor's decision to make the payment was simply business as usual, . . . not terms that are imposed when a debtor runs into financial trouble."

Tightened Credit Terms

The debtor was a retailer. The creditor was a "logistics provider" that arranged for shipments of goods to the debtor's locations.

Originally, the debtor had a $3 million credit limit, with payments due in 30 days. When the debtor was encountering "financial distress," Judge Goldblatt said that the creditor responded by tightening credit terms." Specifically, the creditor first lowered the credit limit to $1.75 million and later to $1 million. In addition, email correspondence showed that the creditor was imposing "credit pressure." At one point, the creditor imposed a "credit hold" and refused to make shipments without a $300,000 wire transfer.

The debtor confirmed a chapter 11 plan creating a liquidating trust. The trust filed a preference complaint against the debtor for about $3.1 million.

When the trustee filed a motion for summary judgment, the creditor raised the ordinary course defense but conceded that all of the elements of a preference were present under Section 547(b). Judge Goldblatt characterized the creditor as contending that the ordinary course defense "ought to be available so long as the credit pressure it applied to the debtor was commonplace within the relevant industry."

Credit Pressure Isn't 'Ordinary'

Judge Goldblatt was charged with ruling on the applicability of the ordinary course defense contained in Section 547(c)(2). The subsection provides that a trustee may not avoid a preferential 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."

Judge Goldblatt explained that the defense "is intended to encourage vendors to continue to deal with distressed companies on ordinary terms." He said it is an "objective test [that] looks to the general norms of the creditor's industry."

The creditor, Judge Goldblatt said, was primarily relying on its credit manager, who testified that "it is common in the transportation and logistics industry for a supplier to tighten the credit terms once it becomes clear that a customer is facing financial difficulty."

Judge Goldblatt said that the case was calling on him to decide

> 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.

Judge Goldblatt cited the Third Circuit for having "expressly rejected the claim . . . that conduct of the defendant . . . should be treated as ordinary because it was similar to the treatment the defendant afforded to two other vendors." *In re Molded Acoustical Prods. Inc.*, 18 F.3d 217, 227 (3d Cir. 1994).

Again citing the Third Circuit, Judge Goldblatt went on to say,

> One's dealings with companies facing financial distress is not the measure of ordinariness. Rather, "ordinary terms are those which prevail in healthy, not moribund, creditor-debtor relationships."

Id.

Drawing from the Third Circuit, Judge Goldblatt said that the purpose of the ordinary course defense "is to 'deter[] the failing debtor from treating preferentially its most obstreperous or demanding creditors" and to "discourag[e] … creditors from racing to dismember the debtor.'" *Id*. at 219.

As further support for his conclusion, Judge Goldblatt cited other authority where the Third Circuit "found that the debtor's payments were not made in the ordinary course when the defendant . . . 'tightened its credit terms [and] imposed a credit limit.'" *In re Hechinger Inv. of Delaware, Inc.*, 489 F.3d 568, 578 (3d Cir. 2007).

Judge Goldblatt said that his decision was in accord with a recent opinion by Delaware's Bankruptcy Judge Mary F. Walrath in *In re Center City Healthcare LLC*, 664 B.R. 208 (Bankr. D. Del. Aug. 27, 2024). He described Judge Walrath as having said that the ordinary course standard "is based on the terms that prevail when the debtor is healthy, not in financial distress." To read ABI's report on *Center City*, click here.

Judge Goldblatt granted partial summary judgment in favor of the trustee by striking the creditor's ordinary course defense. Disputed issues of fact regarding "new value" precluded entry of final judgment.

The opinion is *FI Liquidating Trust v. C.H. Robinson Co. Inc. (In re Fred's Inc.)*, 21-51065 (Bankr. D. Del. Jan. 15, 2025).

The circuits are split on whether a bankruptcy court can compel marshalling by the IRS.

A District Court Decision Implies that Marshaling Is Impermissible in Bankruptcy

Based on statutory language and the Supreme Court's *Jevic* decision, District Judge Matthew J. Kacsmaryk of Amarillo, Texas, took sides on a circuit split in holding that "a bankruptcy court may not, as a *per se* matter, invoke the equitable remedy of marshaling against the United States in a tax collection case."

Although the case involved marshaling when the Internal Revenue Service had a priority claim, Judge Kacsmaryk's February 10 opinion could be read to mean that marshaling is never permissible in bankruptcy.

The IRS Priority Claim and Lien

The individual chapter 7 debtors owned real property allegedly worth $1.1 million that was exempt under Texas law. The IRS had recorded a tax lien against the property, but the tax lien was not subject to the state exemption.

The IRS also had a valid, unsecured $255,000 priority claim for the same debt covered by the tax lien. The chapter 7 trustee was holding almost $470,000 for distribution for creditors.

The trustee filed a motion asking the bankruptcy court to require marshaling by compelling the IRS to collect its priority claim by foreclosing the lien on the exempt real estate. To the extent that foreclosing came up short, the bankruptcy court would have allowed the IRS to be paid any deficiency through the priority claim.

Without marshaling, the IRS presumably would recover the $255,000 tax claim in full by recovery on the priority claim. Without marshaling, the distribution to other creditors would be cut in half. Moreover, the debtors would retain all of the $1.1 million in exempt property.

With marshaling, the IRS still would be paid in full by foreclosing the tax lien, but other creditors would have a larger recovery. With marshaling, the debtors would be paying the IRS, not creditors.

The trustee and the IRS cross moved for summary judgment. The bankruptcy court granted the trustee's motion to require marshaling and denied the cross motion by the IRS. Judge Kacsmaryk granted a motion by the IRS for an interlocutory appeal.

The Split

Judge Kacsmaryk described marshaling as "an equitable doctrine that allows courts to require a creditor who can resort to two or more funds for payment to seek payment from a fund other than the only one that another creditor may access." Quoting the Supreme Court, he said it was designed "'to prevent the arbitrary action of a senior lienor from destroying the rights of a junior lienor or a creditor having less security.'" *Meyer v. U.S.*, 375 U.S. 233, 237 (1963).

As courts of equity, Judge Kacsmaryk said that bankruptcy courts "can order marshaling even without explicit statutory authority," given that marshaling traces its origin to English common law.

With regard to bankruptcy and governmental claims, Judge Kacsmaryk said that the circuits are split. Among other courts, he listed the Ninth and Second Circuits and the Ninth Circuit Bankruptcy Appellate Panel for having held that marshaling "may not be invoked against the government."

On the other side of the fence, Judge Kacsmaryk said that "some circuit and district courts have applied it against the government."

Although the Fifth Circuit has not addressed the question, Judge Kacsmaryk cited a district court in Texas for holding that it "may not be invoked against the United States."

The Statutory Answer

Judge Kacsmaryk found the answer in Sections 507 and 726.

Section 726 says that property of the estate "shall" be paid "first" toward priority claims in Section 507, where the IRS has an eighth priority claim. Citing *Jevic*, he said, "This order is not negotiable." *Czyzewski v. Jevic Holding Corp.*, 580 U.S. 451, 457 (2017). Quoting the Court, he said that "'priority is an absolute command'" in chapter 7 liquidations. *Id*. at 464.

Judge Kacsmaryk rejected the trustee's idea that marshaling only obliged the IRS to pursue its lien first. "But when Congress prescribes an order of claim disbursement with mandatory language," he said, "it removes the bankruptcy court's discretion to deviate for mere equitable reasons."

Judge Kacsmaryk cited a bankruptcy court in Texas in 1990 and scholarly commentators from 1985 and 1990 for having called the "doctrine of marshaling in bankruptcy . . . into question."

Based on Sections 507 and 726, Judge Kacsmaryk held that "a Trustee representing unsecured creditors may not seek to marshal against a government agency like the IRS with a valid, priority, unsecured tax claim in a bankruptcy estate."

The Anti-Injunction Act

Judge Kacsmaryk had another statutory basis for his holding: the Anti-Injunction Act, 26 U.S.C. § 7421(a). He quoted the Supreme Court as saying that the "manifest purpose" of the Act "'is to permit the United States to assess and collect taxes alleged to be due without judicial intervention.'" *Enoch v. Williams Packing & Navigation Co.*, 370 U.S. 1, 7 (1962).

"The Anti-Injunction Act," Judge Kacsmaryk said, "allows no exceptions for a bankruptcy court to raise hurdles to tax collection." He cited the Second Circuit for holding that a junior lienholder cannot invoke marshaling against the government.

Judge Kacsmaryk found a violation of "the Anti-Injunction Act's plain text" by demanding "that the IRS seek its revenue outside the bankruptcy estate." He reversed the bankruptcy court and granted the IRS's motion for summary judgment on marshaling.

The opinion is *U.S. v. Ries*, 24-146 (N.D. Tex. Feb. 10, 2025).

When a DIP sues a former officer, the bankruptcy 'exception' in a D&O policy provides coverage when the 'insured vs. insured' exclusion would otherwise deny coverage.

The 'Insured vs. Insured' Exclusion in a D&O Policy Doesn't Apply to a DIP

The "insured vs. insured" exclusion in a directors' and officers' liability insurance policy did not absolve the insurer of the obligation to provide defense for a company's former chief executive when the former CEO was sued by the company after the company filed a chapter 11 petition, under the circumstances presented to Bankruptcy Judge Marvin Isgur of Houston.

The company was the operator of a nonprofit hospital. The CEO left the company just short of two years before the company filed a chapter 11 petition.

After he left the company and before the company's bankruptcy, the company sent the former CEO a letter demanding $3 million for the former CEO's fraudulent conduct. When the former CEO tendered the demand letter to the D&O carrier, the insurer took up coverage with a reservations of rights. Five months later, but again before the insured's bankruptcy, the carrier withdrew defense, citing the so-called insured vs. insured provision in the D&O policy.

After the insurer's withdrawal, the insured filed a chapter 11 petition and became a debtor in possession. As DIP, the insured sued the former CEO in bankruptcy court. The former CEO tendered the complaint to the insurer.

In the adversary proceeding, the former CEO filed a cross claim against the insurer. One of the claims in the cross complaint sought a declaration that the insurer was obliged to provide defense. The insurer filed a motion to dismiss the cross claim, contending that the insured vs. insured exclusion deprived the former CEO of insurance coverage.

Judge Isgur denied the motion to dismiss in an opinion on October 3.

The Exclusion and the Exception

There was no dispute that the former CEO was an insured person under the policy and that the complaint in bankruptcy court, as well as the prebankruptcy demand letter, were claims under the policy. There was a dispute over the insured vs. insured exclusion.

The exclusion provided that there would be no coverage for a claim "brought by or on behalf of any Insured," meaning the debtor. However, the exclusion had an exception for "any Claim brought or maintained by or on behalf of a bankruptcy or insolvency trustee, examiner, receiver or similar official for the Company or any assignee of such trustee, examiner, receiver or similar official."

Before deciding whether the exclusion or the exception applied, Judge Isgur laid out the governing standards under Texas law. Among other things, the Fifth Circuit has held that the insurer must provide coverage "[i]f *any* allegation in the complaint is *even potentially* covered by the policy." *Evanston Ins. Co. v. Legacy of Life, Inc.*, 645 F.3d 739, 745 (5th Cir. 2011), *certified question answered*, 370 S.W.3d 377 (Tex. 2012). [Emphasis in original.]

Judge Isgur cited other Fifth Circuit authority for holding that an insurer must defend the entire lawsuit if the complaint potentially includes even one covered claim under the policy. The Fifth Circuit also said that "a reviewing court must interpret the complaint liberally and construe the exception narrowly, resolving any ambiguity in favor of the insured." *City of Coll. Station, Tex. v. Star Ins. Co.*, 735 F.3d 332, 337 (5th Cir. 2013).

A DIP Is Akin to a Trustee

Naturally, the former CEO contended that the DIP was akin to a bankruptcy trustee. A bankruptcy court in Chicago came to that conclusion in *In re HA 2003, Inc.*, 310 B.R. 710 (Bankr. N.D. Ill. 2004). In *HA*, the court noted that Section 1107(a) gives the DIP all of the rights, powers and duties of a trustee. Similarly, Bankruptcy Rule 6009 allows a DIP to prosecute a suit on behalf of the estate.

Judge Isgur agreed with *HA*, holding that the "bankruptcy exception thus permits coverage for a Claim brought by or on behalf of a bankruptcy trustee or similar official for a debtor or debtor-in-possession."

Judge Isgur conceded that the policy had an "ambiguity," because the DIP was "clearly defined" in the policy to be the insured. On the other hand, he said that a DIP is a "similar official" to a bankruptcy trustee under the exception. When there are ambiguities, he cited the Fifth Circuit for holding "that ambiguities in an insurance policy must be construed against the insurer and in favor of the insured."

The insurer pointed to decisions where the insured vs. insured exclusion precluded a defendant from having coverage. In those cases, though, Judge Isgur said that the "insured v. insured exclusions in these cases did not contain a bankruptcy exception."

Judge Isgur denied the insurer's motion to dismiss, holding that the "insured v. insured exclusion is overridden by the bankruptcy exception" and that the insurer breached contract by denying coverage for the demand letter and the adversary proceeding.

The opinion is *Walker County Hospital Corp. v. Brown (In re Walker County Hospital Corp.)*, 22-3099 (Bankr. S.D. Tex. Oct. 3, 2024).

To defeat motions to dismiss, preference and fraudulent transfer complaints need not contain all the information to be learned in discovery, Bankruptcy Judge Craig Goldblatt says.

Sufficiency of Preference and Fraudulent Transfer Complaints Described by Judge Goldblatt

Bankruptcy Judge Craig T. Goldblatt of Delaware wrote an opinion describing how much detail a preference and fraudulent transfer complaint must have to survive a motion to dismiss for failure to state a claim.

Having been given derivative standing to pursue avoidance actions, the creditors' committee in a chapter 11 case filed a complaint to recover preferences or constructively fraudulent transfers. The defendant filed a motion to dismiss for failure to state a claim under Rules 12(b)(3) and (b)(6), which Judge Goldblatt denied in his October 30 opinion.

Pleading Standards

Following the Supreme Court's *Iqbal* and *Twombly* decisions, Judge Goldblatt said that a "pleading that simply recites the elements is improperly conclusory." These days, he said, a "complaint must 'contain plausible facts which state a claim.'"

In the Third Circuit, courts apply a three-step test, Judge Goldblatt said. First, courts note the elements that a plaintiff must plead. Second, the courts accept well-pleaded facts as true and disregard legal conclusions. Third, the courts must decide whether the factual allegations are sufficient to state a plausible claim for relief.

On a motion to dismiss, "the court must draw 'all reasonable inferences' from the properly alleged facts 'in favor of the non-moving party,'" Judge Goldblatt said.

"Usually," Judge Goldblatt said, "a reviewing court should consider only the allegations within the four corners of a complaint, which includes materials attached to the complaint." Therefore, he said, "plaintiffs are not required to provide actual "copies of the invoices, bills, canceled checks or other tangible evidence to substantiate" their complaint."

Sufficiency of the Preference Claims

To state a preference claim, Judge Goldblatt said that the plaintiff must (a) identify the nature and amount of each antecedent debt, (b) identify each alleged preference, and (c) allege that it conducted reasonable due diligence into the "defendant's known or reasonably knowable affirmative defenses."

To allege the nature and amount of the antecedent debt, Judge Goldblatt said that the complaint "must identify the amounts owed, describe the relationship between the parties, and link the allegedly preferential transfers to that relationship." The defendant argued that the complaint was deficient because the complaint did not identify which of the three agreements between the parties gave rise to the preferential transfers.

Judge Goldblatt said that the complaint stated that there were "agreements" between the parties for the provision of goods and/or services, which gave rise to "$195,699.29" in preferences. He said that the committee was "not required to identify the specific agreements in its complaint." The complaint, he said, "only needs to give enough detail to allow the defendant to identify the payment in question," not "everything [the defendant] might wish to know about the plaintiff's claims."

Judge Goldblatt ruled that the committee had "sufficiently alleged the nature and amount of each antecedent debt and ha[d] provided enough detail to allow [the defendant] to identify the payments at issue." To the extent that the defendant wants more information, he said that "it will be entitled to discovery in accordance with the rules."

Identification of the Preference

To identify the preference, Judge Goldblatt said that the plaintiff must identify the date of the transfer, the name of the transferor, the name of the transferee, and the amount of the transfers.

The defendant contended that the complaint was insufficient because it did not identify the specific contract that gave rise to the transfer. Judge Goldblatt dismissed the argument, saying that the committee had sufficiently identified the transfers, for the reasons previously given.

The Conduct of Due Diligence

The defendant argued that the committee had not sufficiently pleaded due diligence as required by Section 547(b) because the complaint did not specify the agreements that gave rise to the preferences.

Judge Goldblatt retorted by saying that because "the diligence element is a condition precedent governed by Rule 9(c) of the Federal Rules of Civil Procedure, it is not subject to the *Iqbal* and *Twombly* standard." To plead diligence adequately, he said, "the plaintiff need only advance a 'general allegation' that 'all conditions precedent have occurred.'"

In the complaint, Judge Goldblatt recited how the committee stated that "it conducted its 'own due diligence' into [the defendant's] reasonably knowable affirmative defenses by reviewing 'the books and records' in its possession."

Judge Goldblatt said that the committee satisfied Section 547(b) because it "only needs to allege that it conducted reasonable due diligence into the defendant's known or reasonably knowable affirmative defenses."

Sufficiency of the Fraudulent Transfer Claims

The defendant argued that the constructively fraudulent transfer claims were inadequately pleaded because the complaint did not meet the heightened pleading standard in Rule 9(b), which requires that "a party must state with particularity the circumstances constituting fraud or mistake."

"Constructively fraudulent transfers are not subject to the heightened pleading standard that applies in cases of actual fraud," Judge Goldblatt said. For an adequate pleading, he said, "the plaintiff need only allege that 'there was a transfer for less than reasonably equivalent value at a time when the [debtor was] insolvent.'"

Judge Goldblatt denied the motion to dismiss, because the committee had adequately pleaded both preferential and constructively fraudulent transfers.

The opinion is *In re Pack Liquidating LLC*, 22-10797 (Bankr. D. Del. Oct. 30, 2024).

Good faith and attention to detail should enable a failing business to avoid WARN Act liability.

Delaware Judge Writes a Treatise for Avoiding WARN Act Liability

Facing the possibility of bankruptcy, managers of the business face a dilemma created by the federal Worker Adjustment Retraining Notification Act, known as the WARN Act. To avoid liability for back pay, the WARN Act requires giving workers 60 days' written notice of plant closings or mass layoffs.

However, giving a WARN Act notice to avoid liability could quickly turn the possibility of bankruptcy into reality, by driving away customers and workers.

On December 19, Bankruptcy Judge Craig T. Goldblatt of Delaware surveyed the law nationwide and wrote a 67-page opinion telling company executives how to behave and what to write to workers to avoid WARN Act liability.

The Precipitous Liquidation

The business in question was Yellow Corp., once one of the country's largest truckers. In precarious financial condition, the company had hired an investment banker to hunt down new investment or modify existing loan agreements. Facing a liquidity crunch, the company asked the union pension fund for a deferral of a contribution. The pension fund refused.

When the company didn't make the payment, the union gave notice of a strike in 72 hours. Both sides saw the strike notice as a bluff, but customers reacted otherwise. Daily shipments fell from about 45,000 to almost nothing in a matter of days. New financing or modification of loan agreements no longer feasible, the company filed a chapter 11 petition to liquidate.

In chapter 11, individuals, unions and pension funds filed proofs of claim under the WARN Act. In addition, the debtor was named as a defendant into two adversary proceedings professing WARN Act liability. Following discovery, both sides filed motions for summary judgment.

Ruling on summary judgment, Judge Goldblatt dealt with statutory exceptions to WARN Act liability.

The First Two Exceptions

Judge Goldblatt first dealt with the so-called faltering company exception in 29 U.S.C. § 2102(b)(1). As the judge said, it provides an exception to the notice requirement if "as of the time that notice would have been required," the employer (a) "was actively seeking capital or business which, if obtained would have enabled the employer to avoid or postpone the shutdown" and (b) "the employer reasonably and in good faith believed that giving the notice required would have precluded the employer from obtaining the needed capital or business."

When notice ultimately is given, Judge Goldblatt said that it "must contain a brief statement explaining why one or more of the exceptions applies."

With regard to the first exception, Judge Goldblatt said that "the summary judgment record clearly indicates that the debtors' efforts, through [the company's investment banker], to explore options either to refinance existing indebtedness or to attract new capital was sufficient to fall within the faltering company exception." He added, "Retaining an investment banker that is actively engaged in exploring the market for sources of new liquidity is precisely the kind of activity that qualifies under the faltering company exception."

The second exception is in 29 U.S.C. § 2102(b)(2). As Judge Goldblatt said, it provides an exception to the requirement of 60 days' notice "if the layoff is 'caused by business circumstances that were not reasonably foreseeable as of the time' notice would have been required."

To determine whether the event was not reasonably foreseeable, Judge Goldblatt quoted the Third Circuit, which said that "the court must ask, applying an objective standard, 'whether a similarly situated employer' using its 'commercially reasonable business judgment would have foreseen' the businesses' closure as of the date notice would have been required."

On summary judgement, Judge Goldblatt said that the "record makes clear that the debtors' shut down was caused by an unforeseeable business event," namely, the "history of brinksmanship." The debtor, he said, "had every reason to believe . . . that the [the union] would come to the table before the clock ran out." He added that the business failure was caused, "at least in substantial part, by the [union's] miscalculation about the effect of sending a strike notice."

Judge Goldblatt ruled that "the summary judgment record makes clear that the layoffs were 'caused by business circumstances that were not reasonably foreseeable at the time,' within the meaning of the WARN Act."

The Notices Fall Short

For either exception to apply, Judge Goldblatt said that the accompanying regulations require the that the debtor "must 'give as much notice as is practicable and at that time shall give a brief statement of the basis for reducing the notification period.'"

When the company eventually gave the notices, Judge Goldblatt said they "did not contain enough facts adequately to justify the reduced notice." The first notice was "devoid of actual facts," and the second notice was "a closer question" but did not contain "language specific to the company's circumstances."

Judge Goldblatt therefore held that the debtor "may not validly invoke the WARN Act's faltering company exception."

The Liquidating Fiduciary Exception

The company had another escape hatch, the liquidating fiduciary exception that arises under the WARN Act's definition of an "employer" as a "business enterprise" with more than 100 employees. Judge Goldblatt cited the federal Department of Labor's commentary in saying that "a fiduciary 'whose sole function in the bankruptcy process is to liquidate a failed business … does not succeed to the notice obligations.'"

The question, Judge Goldblatt said, "is whether, at the time of the layoffs, the debtors were still engaged in their usual business activity." Applying caselaw, he concluded that "the debtors were no longer 'employers' within the meaning of the WARN Act after they had both stopped picking up new shipments and delivered the final shipment."

On the earlier date when nonunion employees were fired, Judge Goldblatt found "no dispute" that the debtors were employers. A few days later, when union workers were fired, the record was unclear, and he was unable to grant summary judgment one way or the other, given "a genuine dispute of material fact."

Waivers of WARN Act Liability

Initially, the debtor agreed to pay severance to employees who signed waivers of WARN Act liability. Later, but still before bankruptcy, the debtor decided to pay severance to everyone. The question arose as to whether the waivers were enforceable.

As a matter of contract law, Judge Goldblatt said that the record did not support summary judgment for either side, because it "boils down to whether the debtors made a knowingly false statement when they represented to employees that they were required to sign the release in order to obtain the severance payment."

'Good Faith' Could Preclude Liability

Judge Goldblatt said that Section 2104(a)(4) "allows courts to, in their discretion, reduce a company's liability under the Act if the employer shows that the violative 'act or omission' was

'in good faith and that the employer had reasonable grounds for believing that the act or omission was not a violation' of the WARN Act."

While the record could not justify granting summary judgment, Judge Goldblatt told the parties that he "views the debtors' violation of the WARN Act in this case to be something of a technical one." Therefore, he said, "the parties should appreciate that if the evidence at trial is broadly consistent with the existing record, there is a substantial prospect that the Court will exercise the discretion afforded to it by § 2104(a)(4)."

Judge Goldblatt granted and denied summary judgment in part.

The opinion is *Moore v. Yellow Corp. (In re Yellow Corp.)*, 23-50457 (Bankr. D. Del. Dec. 19, 2024).

Sales

Second Circuit leaves open the question of whether a trustee can sell a 'general' or 'derivative' claim that's subject to a valid lien held by a creditor.

Second Circuit Allows Sale of 'General' Claims Subject to a Creditor's Disputed Lien

A bankruptcy trustee may settle or sell an estate's "general" claim against a third party even when a creditor has a lien secured by the same claim, at least when the lien is subject to *bona fide* dispute, the Second Circuit held in affirming a decision by retired Bankruptcy Judge Robert D. Drain.

The August 15 opinion by Circuit Judge Robert D. Sack left open the question of whether a trustee can sell or settle a "general" claim when a creditor has a valid lien on the claim.

Note: "General" claims are sometimes referred to as "derivative" claims, meaning a claim that could be brought by the debtor. Derivative claims also include claims that a creditor could assert that are common to all creditors.

The Common Claims

Before bankruptcy, the individual debtor allegedly made himself judgment-proof by a slew of fraudulent transfers to third parties. In arbitration before bankruptcy, a creditor won an award against the debtor for almost $15 million. Also before bankruptcy, the creditor sued the debtor and third parties in state court, alleging claims including fraudulent transfer and reverse veil-piercing. The third-party defendants allegedly were recipients of fraudulent transfers.

Also before bankruptcy, the state court confirmed the debtor's attachment of two pieces of real property allegedly owned by third parties as a result of fraudulent transfers by the debtor. After the debtor filed a chapter 7 petition, the lawsuit in state court was removed to the bankruptcy court.

The bankruptcy trustee reached a settlement with the debtor and nondebtor defendants in the suit by the creditor that had been in state court. Over the creditor's objection, Bankruptcy Judge Drain approved the settlement and was affirmed in district court. The creditor appealed to the circuit but fared no better.

To settle, the chapter 7 trustee was utilizing the so-called strong-arm powers under Section 544(b)(1), which allow a trustee to "avoid any transfer of an interest of the debtor in property or

any obligation incurred by the debtor that is voidable under applicable law by a creditor holding an [allowed] unsecured claim."

The Claims Were Estate Property

The creditor contended in the circuit that the fraudulent transfer and reverse-veil-piercing claims were not estate property, giving the trustee no power to settle or sell.

Judge Sack said that "general" claims are property of the estate, while "personal" claims are not. A general claim is one that could be brought by any creditor. A personal claim is one that redresses injury to a particular creditor in which other creditors have no interest.

Citing *In re Tronox Inc.*, 855 F.3d 84 (2d Cir. 2017), Judge Sack said that fraudulent transfer claims are "paradigmatic" examples of general claims, because every creditor has a similar claim for diversion of estate assets. To read ABI's report on *Tronox*, click here.

In the case at hand, Judge Sack said that the injuries to the lienholder were not peculiar to the creditor who had sued in state court. He therefore held that the fraudulent transfer claims were estate property, giving the trustee the right to sell or settle.

The same held for the lienholder's reverse-veil-piercing claims, because they resulted from the debtor's attempt to defraud all of his creditors.

The lienholder disagreed by pointing to a decision from the highest state court in New York that could be read to say that veil-piercing is not a claim but rather a remedy. Judge Sack parsed the opinion from the New York Court of Appeals and concluded that reverse-veil-piercing and alter-ego claims are estate property.

Settlement Despite Attachment Lien

In the circuit, the holder of the attachment lien argued that the trustee could not settle and sell the claims because the creditor had a pre-bankruptcy attachment lien on the claims.

In bankruptcy court, counsel for the lienholder admitted that the attachment lien was subject to *bona fide* dispute. Bankruptcy Judge Drain held that the trustee could sell the claims despite the lien under Section 363(f)(4) because there was a *bona fide* dispute.

Beyond counsel's admission, Judge Sack ruled that there was a dispute because the attachment lien expired in 90 days under New York Civil Practice Law and Rule (CPLR) 6214(e).

For the first time in the circuit, the lienholder argued that CPLR 6216 instead applied because it was a lien on real property, and liens under CPLR 6216 do not expire. Judge Sack dismissed the argument because it was raised for the first time on appeal.

Jevic

The creditor-lienholder argued that the sale violated the principles enunciated in *Jevic*, where the Supreme Court held that a so-called structured dismissal cannot distribute property in violation of the rules or priority in bankruptcy. *Czyzewski v. Jevic Holding Corp.*, 580 U.S. 451 (2017). To read ABI's report on *Jevic*, click here.

Judge Sack rejected the *Jevic* analogy, saying that it applies to final distributions and that the creditor-lienholder could raise the issue again "at a later stage in the bankruptcy litigation."

Finding that Bankruptcy Judge Drain had not abused his discretion in approving the settlement under the requirements of *In re Iridium Operating LLC*, 478 F.3d 452 2 (2d Cir. 2007), Judge Sack affirmed the district court's order upholding the sale and settlement of the general claims.

The opinion is *Stadtmauer v. Tulis (In re Nordlicht)*, 22-1223 (2d Cir. Aug. 15, 2024).

For a sale 'free and clear,' nondebtors can be enjoined from suing.

In '363' Sales, Three Courts Say *Purdue* Doesn't Bar Injunctions Protecting Buyers

Following the *Purdue* decision from the Supreme Court last year, three bankruptcy courts have permitted sales of estate property to bar suits against nondebtor purchasers of estate assets.

The third decision came on January 24 from Bankruptcy Judge Keith L. Phillips of Richmond, Va., in a case involving insurance policies covering asbestos claims.

The debtor was a shipyard that went out of business in the 1980s but was saddled with 126,000 lawsuits for exposure to asbestos. By the time the debtor filed a chapter 11 petition last year, only 2,700 claims remained.

The debtor had several insurance policies that had not been exhausted. Apparently, there were disputed coverage questions. The debtor and the insurers entered into a settlement agreement where the insurers bought back the policies with effect as though "the policies had never been issued," Judge Phillips said.

The settlement agreement contained an injunction that would bar anyone with a claim against the debtor from suing the settling insurers. Over objection from the U.S. Trustee and another shipyard that was a co-defendant alongside the debtor in some lawsuits, Judge Phillips had approved the settlement providing for a sale of the policies under Section 363.

The other shipyard filed a notice of appeal together with a motion for a stay pending appeal, which Judge Phillips denied in his January 24 opinion.

Purdue Doesn't Apply to 363 Sales

In the Fourth Circuit on a motion for a stay pending appeal, Judge Phillips said that the appellant must show (1) a likelihood of success on the merits, (2) irreparable harm if the stay is denied, (3) that the other party will not be substantially harmed by the stay, and (4) that the public interest will be served by a stay.

First, Judge Phillips addressed the likelihood of success on appeal. He characterized the other shipyard as contending that *Purdue's* limitation on nondebtor injunctions also applies to Section 363 sales. *See Harrington v. Purdue Pharma L.P.*, 144 S. Ct. 2071 (2024). To read ABI's report, click here.

Judge Phillips began by citing authorities for the principle that bankruptcy courts may sell estate property "free and clear" by enjoining creditors from suing the purchaser. In bankruptcy cases, he said that "[i]nsurers and their insureds who have filed chapter 11 cases because of mass tort claims often enter into settlement agreements characterized as 'buyback' transactions to obtain funds to pay claimants." Buybacks, he said, are "entered into to facilitate an orderly distribution of funds to asbestos-related claimants while avoiding extensive litigation costs associated with resolving disputes over coverage issues."

Judge Phillips cited a decision by Bankruptcy Judge Corali Lopez-Castro of Miami, who, he said, "acknowledged that *Purdue* did not call into question negotiated settlements governed by Bankruptcy Rule 9019 or the sale of the Debtors' insurance policies under § 363." *In re Bird Global, Inc.*, 23-20514 (Bankr. S.D. Fla.).

Judge Phillips sided with Judge Lopez-Castro. He said that allowing "a creditor to independently pursue its claim against property of the debtor after it been sold in bankruptcy would have a chilling effect on the sale of assets in bankruptcy. *Purdue* was not intended to thwart that process."

Judge Phillips found "noting" in *Purdue* to suggest "that the protections afforded a buyer pursuant to § 363, including the ability of the purchaser to obtain the asset free of the claims of the debtor's creditors, were intended to be abrogated."

Next, Judge Phillips cited a decision by Bankruptcy Judge Martin Glenn of New York who, he said, approved "a settlement agreement containing releases and injunctions." Judge Glenn "was not persuaded by the argument urged by the United States Trustee that *Purdue* is applicable in the context of a § 363 sale in addition to the context of plan confirmation."

Finding no likelihood of success on appeal, Judge Phillips went on to find no irreparable harm besetting the other shipyard while finding "substantial" harm to the debtor were there a stay pending appeal. In terms of public policy, he decided that "public policy is best served by preserving the finality of sales in bankruptcy."

Judge Phillips denied the motion for a stay pending appeal.

The opinion is *In re Hopeman Brothers Inc.*, 24-32428 (Bankr. E.D. Va. Jan. 24, 2025)

New York's Judge Philip Bentley interpreted Section 363(f)(5) to permit a sale free and clear whenever a creditor could conduct a foreclosure or a UCC sale.

Bankruptcy Judge Rejects a District Court's Narrow View of Sales Free and Clear

A district judge in New York wrote an opinion in 2014 espousing a narrow reading of Section 363(f)(5) that would allow the sale of property free and clear of liens only when the debtor or the trustee, not a creditor, "could compel the interest holder to accept a money satisfaction for its interest." *Dishi & Sons v. Bay Condos LLC*, 510 B.R. 696, 710 (S.D.N.Y. 2014).

Because a trustee or an owner would seldom have the right to compel a lienholder "to accept a money satisfaction of such interest" in "a legal or equitable proceeding," *Dishi* would typically bar selling liened property free and clear in bankruptcy cases.

Since district court opinions are not binding authority even in the same district, bankruptcy courts in New York typically do not follow *Dishi.* New York's Bankruptcy Judge Philip Bentley wrote an opinion on March 4 politely explaining why *Dishi* is not the best or proper reading of Section 363(f)(5). Because the underlying order by Judge Bentley is already final, there will not be an appeal.

Selling a Hotel Free and Clear

The debtor operated a leased hotel in Manhattan that fell on hard times during the pandemic. With $114 million in first-lien debt and no financing to operate, Judge Bentley said that the debtor's "only viable option" was to sell the assets.

After 13 months of mediation, the parties negotiated a global settlement calling for a sale to the holder of the first lien on a $78 million credit bid. To permit the hotel to reopen, the buyer was willing to pony up $20 million in cash to cure defaults on leases and contracts.

The only objection to the sale and confirmation of the plan came from the holder of a $189,000 mechanic's lien, who wrapped itself in the *Dishi* flag. The mechanic's lien was deeply underwater and would be treated as a general unsecured debt under the plan.

Sustaining the *Dishi* objection, Judge Bentley said, "would effectively elevate this lien holder's rights from those of an unsecured to a secured creditor, enabling it to demand to be paid as the price of dropping its objection to the sale."

The Best Reading of Section 363(f)(5)

The outcome turned on the interpretation of Section 363(f), which provides that a "trustee may sell property . . . free and clear of any interest in such property of an entity other than the estate, only if . . . (5) such entity could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest."

Judge Bentley explained why Section 363(f)(5) "is often the only available basis for a free-and-clear sale." Subsection (1), he said, is construed "narrowly, to apply only to a limited number of non-bankruptcy laws that permit non-judicial sales free and clear of liens." If "the holder of a lien that is not in *bona fide* dispute refuses to consent," he said that "subsections (2), (3) and (4) by their terms do not apply."

"For decades" before *Dishi*, Judge Bentley said that "many courts and commentators considered it settled that section 363(f)(5) made free-and-clear sales widely available because foreclosure sales and UCC sales satisfied that subsection." If *Dishi* were to govern, he said that "Section 363(f)(5) would rarely be satisfied."

Judge Bentley said that *Dishi* "was right" in rejecting a "sweepingly broad construction" that would permit a sale free and clear if it were theoretically possible for a governmental condemnation to extinguish interests in property. Instead, he favored "a middle-ground construction" that would not "encompass . . . any conceivable hypothetical proceeding . . . but only proceedings that might realistically be brought in the case before the court if the automatic stay were lifted or did not apply." In most cases, he said, "this would include either foreclosure proceedings or UCC sales."

Employing a "realistic possibility" standard, Judge Bentley said, "does not render sections 363(f)(1) through (4) superfluous." Unlike eminent domain takings, he said that foreclosure sales "do not extinguish all interests in the property," such as "easements and covenants running with the land" and nondisturbance agreements.

"Most important," Judge Bentley said, his interpretation "conforms more closely" with "the text, statutory context and purposes of this subsection." He pointed out that "section 363(f)(5) is written in the passive voice." By comparison, he said that "*Dishi's* interpretation drastically narrows this language."

Judge Bentley said that the propriety of his interpretation was "even clearer" when considering "the Bankruptcy Code's other provisions concerning the treatment of secured debt." Among other sections, he mentioned Section 506(a), where a secured creditor's claim can be bifurcated into a secured and unsecured claim when the lien is partially underwater.

Pragmatically speaking, Judge Bentley said that *Dishi* "would depress the price any potential buyer would be willing to pay" or "enable holders of out-of-the-money liens to extract payment of hold-up value in exchange for waiving their liens."

Judge Bentley overruled the objection and allowed the debtor to sell the lease "free and clear of all liens, claims and encumbrances."

The opinion is *In re Urban Commons 2 West LLC*, 22-11509 (Bankr. S.D.N.Y. March 4, 2025).

A district judge in Indiana says that a bankruptcy court cannot have exclusive jurisdiction over disputes in the future except in the circumstances specified in Section 1334.

Bankruptcy Court Can't Have Exclusive Jurisdiction over Disputes from a Sale Order

An order of the bankruptcy court approving the sale of estate property cannot give the bankruptcy court exclusive jurisdiction over disputes arising from the sale, for reasons explained by District Judge Joseph S. VanBokkelen of Hammond, Ind.

Procedurally, the facts were complex. Assume that the chapter 11 debtor sold assets to a buyer pursuant to a sale order entered by the bankruptcy court in Delaware.

According to Judge VanBokkelen's September 6 order, the sale order provided that the bankruptcy court "shall retain exclusive jurisdiction to enforce and implement the terms and provisions of the Purchase Agreement, . . . including . . . retaining jurisdiction to . . . (c) resolve any disputes arising under or related to the Purchase Agreement . . . ."

Take it as a given that the debtor sued the buyer in federal district court in Indiana based on diversity of jurisdiction, asserting claims for breach of contract under the purchase agreement. The buyer filed a motion in the Indiana district court to dismiss for lack of jurisdiction and failure to state a claim.

On the jurisdiction motion, the buyer argued that the Indiana court had no jurisdiction because the sale order reserved exclusive jurisdiction in the bankruptcy court.

"Despite the apparent conferral of exclusive jurisdiction" in the sale approval order, Judge VanBokkelen cited *Owen Equip. & Erection Co. v. Kroger*, 437 U.S. 365, 374 (1978), for the proposition that "it is the Constitution and Congress, not the courts, that determine the scope of jurisdiction of the federal courts."

Judge VanBokkelen cited 28 U.S.C. § 1334(b), which provides that "the district courts shall have original *but not exclusive jurisdiction* of all civil proceedings arising under title 11, or arising in or related to cases under title 11." [Emphasis added.] He paraphrased the subsection as meaning that "even state courts could have jurisdiction to hear these claims because the federal district courts' jurisdiction is not exclusive."

Section 1334 specifies when there is exclusive jurisdiction. Subsection (a) grants "original and exclusive jurisdiction of all cases under title 11." Subsection (e)(1) confers exclusive jurisdiction over "all the property, wherever located, of the debtor as of the commencement of such case, and of property of the estate."

Given that the grants of exclusive jurisdiction did not cover claims in the complaint, Judge VanBokkelen said it was "not within a bankruptcy court's power to grant itself exclusive jurisdiction over all disputes related to the purchase agreement or the interpretation of its sale order." He denied the motion to dismiss for lack of jurisdiction, finding that he had "jurisdiction to hear this matter, as the bankruptcy court lacks authority to deem itself the only court with jurisdiction over the interpretation of the Sale Order and Purchase Agreement."

Although Judge VanBokkelen found he had jurisdiction, he ultimately dismissed the complaint for failure to state a claim, after a lengthy analysis of choice of law.

Observations

Entry of the sale order presumably fell within the bankruptcy court's exclusive jurisdiction for having arisen as part of the "case" under Section 1334(a). Does enforcement of the sale order also fall under Section 1334(a)'s exclusive jurisdiction, or is enforcement nonexclusive under Section 1334 as having arisen under, in or related to a case under title 11?

The opinion is *Buy Direct LLC v. DirectBuy Inc.*, 15-344 (N.D. Ind. Sept. 6, 2024).

Affirming Bankruptcy Judge Michael Romero, the district court holds that an exemption remains valid even though the exempt property remains subject to a nondischargeable domestic support obligation.

Trustee May Not Liquidate Estate Property Solely to Benefit a DSO Creditor

Affirming Bankruptcy Judge Michael E. Romero, a district judge in Denver wrote an opinion standing for the proposition that a trustee may not liquidate estate property solely for the benefit of the holder of a nondischargeable domestic support obligation.

The chapter 7 debtor scheduled assets with a total value of about $13,000. The debtor claimed exemptions under Colorado law covering all the assets.

The debtor's schedules also listed a priority unsecured claim arising from a domestic support obligation of almost $20,000. We shall refer to a domestic support obligation as a DSO.

The Objection to the Exemption Claim

The chapter 7 trustee objected to the debtor's exemption claim. According to the March 27 opinion by District Judge Charlotte N. Sweeney, the trustee reasoned that the debtor was not entitled to the exemption under state law given the existence of the DSO claim that covered all of the debtor's property.

Bankruptcy Judge Romero overruled the trustee's objection to the exemption while declaring that the exempt assets would remain subject to the nondischargeable DSO claim. The trustee appealed.

The appeal dealt with the trustee's efforts to deny the exemption, take the assets into the estate, and then distribute the assets to the former wife, less, however, the trustee's commissions and expenses of administration. In other words, denying the exemption would have meant a smaller recovery by the former wife. The former wife would have been paying the trustee for administering the estate.

State Law

As he had done unsuccessfully in bankruptcy court, the trustee rested the appeal on Colo. Rev. Stat. § 13-54-106, which provides that state exemptions do not apply to "arrearages for child support or for child support debt."

In bankruptcy cases, District Judge Sweeney noted how the former wife's DSO was "further protected" by Section 522(c). The subsection provides that exempt property

> is not liable during or after the case for any debt of the debtor that arose, or that is determined under section 502 of this title as if such debt had arisen, before the commencement of the case, except — (1) a debt of a kind specified in paragraph (1) or (5) of section 523(a) (in which case, notwithstanding any provision of applicable nonbankruptcy law to the contrary, such property shall be liable for a debt of a kind specified in such paragraph).

Section 523(a)(5) refers to DSOs, which are defined in Section 101(14A) and encompassed the former wife's DSO claim.

Synthesizing the Code, Judge Sweeney said that "exempt property remains liable during or after the case for any DSO debt." The case at hand, however, involved a state exemption. She said that the "Tenth Circuit has not addressed if a debtor with a DSO can claim Colorado exemptions pursuant to § 13-54-106."

Examining sparse Colorado appellate authority on Section 13-54-106, Judge Sweeney identified a state Court of Appeals decision which held that a personal injury award, exempt under state law, is not protected from garnishment by the holder of a DSO. She interpreted the decision to mean that "otherwise exempt property does not lose its exempt status but is nonetheless available to DSO creditors."

Affirming Judge Romero, Judge Sweeney therefore held "that the plain language of § 13-54-106 . . . unambiguously permits the garnishment of otherwise exempt property for collection of child support arrearages."

Section 522(a)(2)

Alternatively, the trustee relied on Section 544(a)(2), which gives a trustee the avoiding power of a hypothetical judicial lien creditor. Specifically, the trustee relied on a decision from the Tenth Circuit Bankruptcy Appellate Panel holding that the powers given to a trustee under Section 544(a) are not limited to avoidance of transfers but subsume broader rights including objecting to exemptions.

In other words, the trustee seemed to be saying that the trustee could step into the shoes of a DSO creditor, to whom the state exemption was not applicable.

Synthesizing Tenth Circuit authority, Judge Sweeney came to the conclusion that a trustee can use Section 544(a)(2) to defeat an improperly-claimed exemption but may not use Section 544(a)(2) to reach exempt assets that are not estate property.

Having already held that the assets were exempt, Section 544(a)(2) was therefore not available to the trustee.

Policy

Judge Sweeney reached the same result based on policy. Since the DSO was larger than all of the assets, she observed that "the administration of the Assets would be for the benefit of only a single creditor — the DSO creditor — rather than unsecured creditors."

Judge Sweeney paraphrased Bankruptcy Judge Romero for having "concluded that it would be 'improper' (as it would be where a chapter 7 trustee seeks to liquidate fully-encumbered property for the benefit of a single secured creditor) to permit the Trustee to liquidate the Assets where the sole benefit to the estate would be the recoupment of administrative costs."

The trustee, Judge Sweeney said, "fails to address whether there is a true benefit to the estate under the facts here." She decided that Judge Romero "did not err in determining that allowing the Trustee to administer the Assets would run afoul of the [Trustee's] Handbook's directive prohibiting trustees from administering an asset where the proceeds of liquidating will primarily benefit the trustees."

Judge Sweeney affirmed Judge Romero's decision, finding no error in the interpretation of state law.

The opinion is *Rodriguez v. Tucker (In re Tucker)*, 24-304 (D. Colo. March 27, 2025).

Small Biz. Reorg. Act

New York's Judge John Mastando saw no reason a Subchapter V plan couldn't enjoin lawsuits against nondebtors for the life of a five-year plan.

Purdue Doesn't Preclude Injunctions from Protecting Nondebtors for the Life of a Plan

Although nondebtor, third-party releases are no longer permissible in chapter 11 plans after *Purdue*, Bankruptcy Judge John P. Mastando, III, of New York decided that a Subchapter V plan may contain a preliminary injunction barring suits against a nondebtor for the five-year life of the plan.

The corporate debtor was a notable Broadway producer. An individual was the sole owner and president of the corporate debtor.

Claiming it had not received its share of the income from a pair of productions, an investor initiated an arbitration against the corporate debtor and the owner. The arbitrator gave the investor an award of $2.6 million against the debtor and the owner, jointly and severally. The district confirmed the award, which was automatically stayed for 30 days.

On the 29th day, the debtor corporation filed a chapter 11 petition under Subchapter V. The debtor filed an adversary proceeding and persuaded Judge Mastando to enter a preliminary injunction preventing the investor from enforcing the arbitration award against the owner.

The debtor filed a chapter 11 plan that would have given the owner a release from liability on the arbitration award. In return, the plan required the owner to supply $600,000 toward payments under the plan.

In an opinion in November 2023, Judge Mastando found authority to confirm the plan over objections by the investor and the U.S. Trustee. However, he read the Second Circuit's decision in *In re Purdue Pharma LP*, 69 F.4th 45 (2d Cir. May 30, 2023), *cert. granted sub nom. Harrington v. Purdue Pharma L.P.*, No. (23A87), 2023 WL 5116031 (U.S. Aug. 10, 2023), as requiring him to issue a report and recommendation to the district court regarding confirmation of the plan. *See In re Hal Luftig Co.*, 655 B.R. 508 (Bankr. S.D.N.Y. Nov. 22, 2023). To read about the bankruptcy court's rationale for imposing a nonconsensual, nondebtor release, click here.

The Rejected R&R

The U.S. Trustee and the investor objected to the report and recommendation. District Judge Denise Cote sustained their objections in an 11-page opinion in March 2024. *See In re Hal Luftig Co.*, 657 B.R. 704 (S.D.N.Y. March 19, 2024). To read ABI's report, click here.

Having issued her decision before the Supreme Court decided *Purdue*, Judge Cote stopped short of precluding nonconsensual, nondebtor releases in all Subchapter V cases. However, she found that the case failed one of the Second Circuit's *Purdue* factors, which required that the impacted class must have voted "overwhelmingly." *Purdue*, *supra*, 69 F.4th at 78-79. In the case before her, the affected class had rejected the plan.

Judge Cote remanded for "further proceedings consistent with this Opinion." She held, "Resolving these issues through a nonconsensual release within the Debtor's bankruptcy is not permissible." *Hal Luftig*, *supra*, 657 B.R. at 709.

On Remand

On return to bankruptcy court, the debtor dropped the idea of a nondebtor release, naturally. Instead, the revised plan extended the preliminary injunction protecting the owner until the closure of the chapter 11 case, dismissal, or the grant or denial of discharge. The injunction applied only to the investor's claims against the owner.

Both unsecured classes voted against the plan, including the class with the investor and its claim, which by that time had risen to $2.9 million.

Conceding that the plan satisfied the other confirmation requirements for a nonconsensual plan under Section 1129(a) as incorporated by Section 1191, the investor argued that the plan was not "fair and equitable" and thus failed to comply with Section 1191. More particularly, the investor contended that the plan was "untenable" under the Supreme Court's decision in *Harrington v. Purdue Pharma L.P.*, 602 U.S. 204 (2024). To read ABI's report, click here.

Dealing with the investor's confirmation objection in his February 24 opinion, Judge Mastando cited Second Circuit authority for the notion that a preliminary injunction may cover nondebtors under Sections 362(a) and 105(a). *Queenie, Ltd. v. Nygard Int'l.*, 321 F.3d 282 (2d Cir. 2003). Furthermore, he said that the "Supreme Court did not address the bankruptcy courts' authority to grant non-consensual third party automatic stay extensions in *Purdue Pharma*."

Judge Mastando said it was an issue of first impression as to whether a nondebtor preliminary injunction could be extended for the life of a chapter 11 plan. In part, he found the answer in Section 362(c)(4), where the Code provides that the automatic stay continues in a chapter 11 case until a discharge is granted or denied.

Given that the plan's stay extension was consistent with Section 362(c)(4), Judge Mastando held that the longer "duration [of the stay] does not render the relief facially impermissible." Next, he ruled that the extended stay satisfied the four requirements for a preliminary injunction.

Judge Mastando closed his opinion by examining whether the longer stay duration made the plan unfair and inequitable. As to the investor's idea "that *Purdue Pharma* prohibits bankruptcy courts from, as part of a plan, temporarily enjoining creditors' collection efforts against non-debtors," he said that the argument was "without merit." He also rejected the idea that the stay extension "'amounts to a discharge' over the life of the Third Amended Plan."

Judge Mastando explained that the investor was not left without recourse. The claim remains valid, he said, and the investor could pursue the claim after the debtor's discharge. He similarly "reject[ed] the argument that such relief 'goes against all concepts of fairness and equity.'"

Overruling the objection and awaiting submission of an order confirming the plan, Judge Mastando said it was "inappropriate to impose any requirement that would effectively allow an objecting unsecured creditor to derail an otherwise confirmable plan . . . solely because that creditor holds the largest unsecured claim against the estate."

The opinion is *In re Hal Luftig Co. Inc.*, 22-11617 (Bankr. S.D.N.Y. Feb. 24, 2025).

A bankruptcy judge in San Antonio disagreed with two bankruptcy judges in Houston by holding that a nonvoting class is equivalent to rejecting a plan in Subchapter V of chapter 11.

Texas Courts Are Split on Ignoring Nonvoting Classes in Confirming a Sub V Plan

Two bankruptcy courts in Houston decided in 2023 that a plan under Subchapter V of chapter 11 can be confirmed as a consensual plan even if there are no votes in a class. *See In re Franco's Paving LLC*, 654 B.R. 107 (Bankr. S.D. Tex. 2023); and *In re Hot'z Power Wash, Inc.*, 655 B.R. 107 (Bankr. S.D. Tex. 2023). To read ABI's reports on the two Texas cases, click here and here.

Now, we have a split among the districts in Texas.

Houston is in the Southern District of Texas. Bankruptcy Judge Michael M. Parker of San Antonio, in the Western District of Texas, split with his Houston colleagues by holding in a March 28 opinion that a nonvoting class is equivalent to a class that rejects the plan, precluding confirmation as a consensual plan.

In the case before him, Judge Parker was able to confirm as a nonconsensual plan under Section 1191(b).

Consensual and nonconsensual plans differ in one significant regard: Many courts are holding that a corporation in Subchapter V can have nondischargeable claims if confirmation is nonconsensual, whereas no claims are nondischargeable if the plan is consensual.

One Class Doesn't Vote

The debtor in the case before Judge Parker operated a restaurant. The plan had three impaired, voting classes. Two classes of unsecured creditors voted unanimously in favor of the plan.

The third class had one creditor, a secured lender with liens on most of the assets. The secured creditor did not vote, meaning there were no votes in the class. Counsel for the secured creditor told Judge Parker at a hearing that the lender did not oppose the plan but declined to vote.

Citing the two Houston cases, the debtor implored Judge Parker to confirm as a consensual plan by ignoring the nonvoting class. He declined the invitation.

The Two Governing Statutes

To decide whether a nonvoting class is the same as a rejecting class, Judge Parker cited the two governing statutes. For each class of claims or interests, Section 1129(a)(8) says that "such class has accepted the plan" or is unimpaired for the plan to be confirmed.

Section 1126(c) says that a "class of claims has accepted a plan if such plan has been accepted by creditors . . . that hold at least two-thirds in amount and more than one-half in number of the allowed claims of such class . . . that have accepted or rejected such plan."

Judge Parker described the two Houston judges as having "found that a non-voting class is ignored when determining whether a plan has satisfied § 1129(a)(8)." Judge Parker gave reasons why he was "unpersuaded":

> Congressional preference for consensual plans does not require a court to interpret all statutory language in subchapter V in favor of confirmation of consensual plans any more than the Code's goal of a "fresh start" means that a court should interpret statutory language to grant a debtor and its associates a broad, unrestricted discharge regardless of (i) debtor misbehavior, (ii) notice to creditors and (iii) specific exceptions to discharge.
>
> It's true that Congress would prefer that a debtor would propose a plan which would encourage creditors to affirmatively vote for it, but nothing in the Code converts a creditor's pacificity or affirmative decision not to vote (as in this case) into an affirmative vote in favor of the plan.

Unlike the two Houston courts, Judge Parker did not see the statute as creating an "unsolvable mathematical problem" when the denominator in a fraction is zero because no creditor voted. He said, "The Court does not, however, believe the statute requires that sort of mathematical calculation."

Judge Parker disagreed with the "notion that Congress did not contemplate a non-voting class of creditors." The idea, he said, "is contravened by § 1126 itself, which provides in subsection (a) that creditors may accept or reject a plan."

By using the word "may" rather than "shall," Judge Parker said that "Congress left open a third option — the possibility that creditors could choose not to vote on a plan. Impaired creditors are not confined to a binary 'accept/reject' but instead may abstain."

Where a court must find that a class accepts or rejects a plan, Judge Parker read the two Houston decisions as creating "a third course — the bankruptcy court can merely 'ignore' or 'not count' the non-voting class." He disagreed with the idea of ignoring a class, saying that a "class

either accepts the plan under § 1129(a)(8), or it does not." He saw "[n]othing in the Code [that] allows the Court to equate abstention of a class with acceptance."

Disregarding nonvoting classes "itself invites an absurd scenario," Judge Parker said. He asked, "could a debtor confirm a plan consensually where no creditors vote at all?"

If non-voting classes are disregarded, Judge Parker said that "a debtor could theoretically confirm a 'consensual' plan . . . without a single accepting vote if no creditors vote at all, as all of the non-voting classes are 'ignored.'" He could not "endorse a reading which could result in this logical conclusion."

Judge Parker approvingly cited cases with his point of view where the judge saw nonvoting classes as having rejected the plan. *See, e.g.*, *In re M.V.J. Auto World, Inc.*, 661 B.R. 186 (Bankr. S.D. Fla. 2024); and *In re Florist Atlanta*, 24-51980, 2024 Bankr. LEXIS 1842 (Bankr. N.D. Ga. Aug. 6, 2024). To read ABI's reports, click here and here.

Because a class had not voted, Judge Parker held that the plan "cannot be confirmed under § 1191(a)" as a consensual plan. However, he went on the find that "the plan can be confirmed non-consensually under § 1191(b)."

The opinion is *In re Sushi Zushi of Texas LLC*, 24-51147 (Bankr. W.D. Tex. March 28, 2025).

Bankruptcy Judge Paul Bonapfel differed with two judges in Houston by holding that a nonaccepting class in Subchapter V means that a plan must be confirmed in cramdown.

Another Bankruptcy Judge Decided that Sub V Classes with No Votes Aren't Accepting

Because he writes a leading treatise on bankruptcy, the world listens when Bankruptcy Judge Paul W. Bonapfel speaks.

In an opinion on August 6, Judge Bonapfel, of Atlanta, ruled that a plan with classes of creditors having no votes must be confirmed as a nonconsensual plan.

The debtor proposed a plan with three classes of creditors. Only one class voted in favor of the plan. No one in the other two classes voted. In a class by itself, the Small Business Administration did not vote, and no one among unsecured creditors voted. Quoting Bankruptcy Judge Kesha L. Tanabe, Judge Bonapfel said this "is an example of what one court has rightly characterized as the 'apathetic creditor problem.'"

The debtor had two theories for confirming the plan as a consensual plan under Section 1191(a) despite the lack of votes in two classes.

First, the debtor wanted Judge Bonapfel to believe that a class accepts the plan when no one votes. Second, the debtor wanted Judge Bonapfel to follow two bankruptcy courts in Texas by deciding that classes with no votes may be disregarded. *See In re Franco's Paving LLC*, 654 B.R. 107 (Bankr. S.D. Tex. 2023), and *In re Hot'z Power Wash, Inc.*, 655 B.R. 107 (Bankr. S.D. Tex. 2023)." To read ABI's reports on the two Texas cases, click here and here.

Citing the *Collier* treatise and *In re M.V.J. Auto World Inc.,* 2024 WL 3153327 (Bankr. S.D. Fla. June 21, 2024), Judge Bonapfel "decline[d] to accept either of these theories and conclude[d], as most courts do, that acceptance for purposes of § 1129(a)(8) requires affirmative acceptance by the class." To read ABI's report on *Auto World*, click here.

The debtor nonetheless prevailed, because no one objected to confirmation, and Judge Bonapfel could confirm the plan under Section 1191(b) as a so-called cramdown plan.

Judge Bonapfel made another noteworthy point. Utilizing Section 1194(b), the corporate debtor proposed making plan payments itself rather than through the Subchapter V trustee.

Section 1183(c) does not specify when a trustee is terminated following confirmation of a cramdown plan under Section 1191(b). Thus, the question arose as to whether the trustee's services could be terminated on substantial consummation.

In a consensual plan under Section 1191(a), the trustee's services are terminated on substantial consummation. Judge Bonapfel saw "nothing in subchapter V [that] limits the court's authority to similarly terminate the services of a trustee upon substantial consummation of a cramdown plan confirmed under § 1191(b) when a subchapter V trustee will not be making payments to creditors and will have no postconfirmation duties to perform."

Judge Bonapfel therefore decided that the trustee's services would terminate on substantial consummation, with the understanding the trustee would be reappointed were services required, for instance, if the debtor wanted to modify the plan or sell estate property.

The opinion is *In re Florist Atlanta Inc.*, 24-51980 (Bankr. N.D. Ga. Aug. 6, 2024).

Disagreeing with two bankruptcy courts in Houston, Miami's Judge Isicoff holds that a Sub V plan with a nonvoting class can be confirmed only as a nonconsensual plan.

Courts Are Now Split on Ignoring Nonvoting Classes in Subchapter V Plans

A dissenting voice has been raised on the question of whether a Subchapter V plan can be confirmed *consensually* if there are no votes in a class.

Bankruptcy Judge Laurel M. Isicoff of Miami disagreed with two bankruptcy judges in Houston who decided that a class isn't counted if there are no votes in the class.

The Subchapter V debtor filed a chapter 11 plan with two creditor classes, both secured with one creditor in each. One secured class was populated by a bank, and the second secured class had the U.S. Small Business Administration.

The bank accepted the plan, but the SBA did not vote. There were no objections to confirmation, but the U.S. Trustee, the Subchapter V trustee and the bank argued that the plan could not be confirmed as a consensual plan under Section 1129(a)(8) because the SBA class had no votes.

The resolution rested on the interpretation of Sections 1191(a) and 1129(a)(8).

Section 1191(a) says that the court "shall" confirm a Subchapter V plan "only if" all the requirements of Section 1129(a) have been met other than subparagraph 1129(a)(15), which applies to an individual debtor where an unsecured claimholder objects to confirmation.

Among the confirmation requirements, Section 1129(a)(8) requires that each class "has accepted" the plan or is "unimpaired."

When "an impaired class of creditors fails to cast a ballot at all," Judge Isicoff characterized the debtor as arguing that the "class should not be counted at all for purposes of section 1129(a)(8), citing two cases from the Southern District of Texas — *In re Franco's Paving LLC*, 654 B.R. 107 (Bankr. S.D. Tex. 2023), and *In re Hot'z Power Wash, Inc.*, 655 B.R. 107 (Bankr. S.D. Tex. 2023)." To read ABI's reports on the two Texas cases, click here and here.

Both courts in Texas, Judge Isicoff said, "held that a non-voting class can be ignored for purposes of whether section 1129(a)(8) is satisfied." The two courts, she said, read Congress as having created "a streamlined chapter 11 process for small business debtors" and as having shown a "clear articulation of a preference for consensual plans confirmed under section 1191(a)."

To disregard a nonvoting class, Judge Isicoff understood the two Texas courts as believing that "Congress clearly never contemplated that there would be a class of impaired creditors where no creditor voted" and that Section 1126(c) created a "mathematical absurdity."

Judge Isicoff proceeded to explain why she disagreed and was concluding that Section 1129(a)(8) had not been met because "each class of impaired claims did not accept the Debtor's Plan." With regard to a nonvoting class, she said that "the Bankruptcy Code on this point is neither silent nor absurd, but, rather, unambiguous and consistent with the purposes of the Bankruptcy Code." She demonstrated how the Code envisions a nonvoting class.

First, Judge Isicoff said, Section 1126(a) says that a claimholder "may" vote to accept or reject. It does not say that a claimholder "shall" vote. Second, the mathematical formula in Section 1126(c) takes into account class members who do not vote.

"It is not absurd," Judge Isicoff said, "that no creditors in a class voting on a plan should be treated any differently than a situation where there is not a sufficient number of creditors voting in favor of a plan to satisfy section 1129(a)(8)."

Judge Isicoff held that "the Plan must satisfy section 1129(a)(8)" and that "Section 1129(a)(8) requires that each impaired class accept the plan." Although she could not confirm the plan as a consensual plan, she confirmed the plan as nonconsensual "because the Plan satisfies all of the other applicable provisions of section 1129(a)."

Observations

Except where statutory language in Subchapter V deviates from the norm, caselaw in "regular" chapter 11 should apply in Subchapter V, and *vice versa*. Not considering a nonvoting class in "regular" chapter 11 would be a notable development.

A requisite in both "regular" chapter 11 and Subchapter V, Section 1129(a)(8) requires that each class be unimpaired or "has accepted the plan." In this writer's view, not voting is not the equivalent of "has accepted," because "has accepted" is language that contemplates an affirmative act.

Given the lack of specific textual support for disregarding nonvoting classes, other courts may be inclined to believe that Section 1129(a)(8) should not be ignored in Subchapter V, akin to the

majority's opinion nixing a creative interpretation of chapter 11 plans in *Harrington v. Purdue Pharma L.P.*, 23-124 (Sup. Ct. June 27, 2024).

The opinion is *In re M.V.J. Auto World Inc.,* 23-16612 (Bankr. S.D. Fla. June 21, 2024).

The Code doesn't contain any rules specifying when a Subchapter V plan should have a five-year duration rather than three years.

Three Years Is the 'Default' Duration for a Subchapter V Plan, Judge Robinson Says

Subchapter V of chapter 11 does not prescribe when a "cramdown" plan must have a five-year duration as opposed to three years.

In terms of the duration of a plan, Bankruptcy Judge Shad M. Robinson of Austin, Texas, concluded that the bankruptcy court has "broad discretion" in deciding whether a plan satisfies the "fair and equitable" requirement contained in Section 1191(b) and (c)(2)(A). His May 24 decision could be read to mean that a debtor must proffer detailed evidence about the income and expenses of the business to establish that the plan is fair and equitable and how long the plan must run.

The debtor was a small medical clinic in a small town in west Texas. The clinic had been in operation about five years before filing a chapter 11 petition and electing treatment under Subchapter V. Annual income was slightly above $1 million a year. The debtor was an LLC owned by a couple who were the managers and were employed by the business.

The secured bank creditor had a bifurcated claim with about $55,000 secured and $280,000 unsecured. Including the bank's unsecured claim, there were some $475,000 unsecured claims.

The debtor proposed a three-year plan that would have paid unsecured creditors an estimated 8.2% of their claims. The three years of payments to unsecured creditors would have totaled about $39,000. From the total, the bank would have recovered $23,000 on its allowed, unsecured claim.

Neither the U.S. Trustee nor the Subchapter V trustee objected to confirmation. However, the bank voted its secured and unsecured claims against the plan. Because the bank was the only creditor in the secured class, the lack of acceptance by all classes invoked the so-called cramdown requirements for confirmation.

The bank contended that the plan was not proposed in good faith as required by Section 1129(a)(3) and was not fair and equitable under Section 1191(b) and (c)(2)(A).

Good Faith

As Judge Robinson explained, Section 1191(b) directs the court to confirm a cramdown plan if other requirements have been met and "if the proposed subchapter V plan does not 'discriminate unfairly' and is 'fair and equitable' with respect to each class of claims or interests that is impaired under, and has not accepted, the subchapter V plan."

The objection to confirmation raised two issues. Was the plan proposed in good faith under Section 1129(a)(3) and did the devotion of the debtor's disposable income for three years satisfy the fair and equitable test under Section 1191(b) and (c)(2)(A)?

The bank argued that the plan was not filed in good faith because the debtor could pay more were it a five-year plan. Applying a totality of the circumstances test, Judge Robinson found good faith.

To find good faith, Judge Robinson saw the plan as a "legitimate attempt" to reorganize and confirm a plan that would pay creditors more than liquidation. He also found that the plan was proposed with "honest and good intentions" coupled with "fundamental fairness" in dealing with creditors. He therefore overruled the bank's contention that the plan was not proposed in good faith.

Good Faith Doesn't Equal 'Fair and Equitable'

Nonetheless, Judge Robinson said that a finding of good faith "is not outcome determinative" with regard to the fair and equitable test under Section 1191(b) and (c) because "'good faith' under § 1129(a)(3) and 'fair and equitable' under § 1191(b) and (c) are separate and distinct confirmation requirements that must be satisfied." He therefore addressed the question of "whether the proposed three-year payment period under the Plan is fair and equitable."

Judge Robinson began his analysis by noting that "Congress provided no guidance or standards on how the bankruptcy court should fix the duration of a plan under 11 U.S.C. § 1191(c)(2)(A)." However, he accepted the idea that a three-year plan is the "default" period under Section 1191(c) but disagreed with the notion "that a three-year term is generally more reasonable than a five-year term absent 'unusual circumstances.'"

With no rules specified in Subchapter V, Judge Robinson held that "Congress intended to leave to the sound discretion of the bankruptcy courts the sole authority to fix the plan payment period in subchapter V cases." He observed that "the relevant statutes governing the applicable period for plan payments under other sections of the Code are so dissimilar to subchapter V that they do not provide any helpful guidance in determining the appropriate time period for fixing plan payments under § 1191(c)(2)(A)."

In exercising discretion, Judge Robinson said,

> [T]he bankruptcy court should give appropriate deference to the debtor's business judgment and proposed period of payments in its subchapter V plan. Furthermore, this Court agrees that a baseline plan payment period of three years is consistent with the intent of Congress to create a quick, efficient reorganization process that would allow the debtor to obtain a discharge as soon as possible.

When there is no objection to the duration of the plan, Judge Robinson said it would be "uncommon" for the bankruptcy court to raise the issue *sua sponte*. When there is an objection to duration, he said that "the debtor's proposed period of plan payments is no longer given the same deference and the bankruptcy court is tasked with fixing the applicable period of plan payments in a subchapter V case."

Analyzing the debtor's projected income and expenses, Judge Robinson observed that the debtor was creating a $32,000 capital reserve over the course of a three-year plan that would be paying unsecured creditors $39,000. He said that the capital reserve might be reasonable, but "the Court does not have sufficient evidence to make that determination." Similarly, the debtor had not provided sufficient evidence to show whether the salaries to be paid to the debtor's owners were "fair market."

Overall, Judge Robinson said that evidence provided by the debtor was "insufficient . . . for the Court to determine whether the three-year plan payment period is fair and equitable under § 1191(b) and (c)(2)(A)." Similarly, he was given "insufficient evidence . . . for the Court to 'fix' a longer plan payment period not to exceed five years under § 1191(c)(2)(A)."

Concluding the opinion, Judge Robinson said that the three-year plan "may very well be" fair and equitable, but he found "that the Debtor has not met its burden to show by a preponderance of the evidence that the proposed three-year period of plan payments is fair and equitable." He also found "insufficient evidence for the Court determine if it should fix a plan payment period longer than three years but not exceeding five years."

In sum, Judge Robinson overruled the objection about lack of good faith but sustained the objection about failure to establish "fair and equitable." He denied confirmation of the plan but allowed the debtor three weeks to avoid dismissal by filing an amended plan.

The opinion is *In re Trinity Family Practice & Urgent Care PLLC*, 23-70068 (Bankr. W.D. Tex. May 24, 2024).

Differing with eight lower courts, the Fifth Circuit sided with the Fourth Circuit by holding that debts of corporate debtors in Subchapter V can be nondischargeable in nonconsensual plans.

Fifth and Fourth Circuits Hold that Debts in Sub V Can Be Nondischargeable

Taking sides with the only other court of appeals to decide the question, the Fifth Circuit reversed the bankruptcy court on direct appeal and held that debts of corporate debtors in Subchapter V of chapter 11 can be nondischargeable under Section 523(a) in nonconsensual plans.

Beyond the language of the statutes, the Fifth Circuit saw Subchapter V as an example of congressional compromise. In return for omitting the absolute priority rule from Subchapter V, the New Orleans-based appeals court followed the Fourth Circuit by saying that Congress, as a compromise, made some debts nondischargeable as to corporate debtors.

The Nondischargeability Complaint

The debtor was a corporation in Subchapter V of chapter 11. A secured lender filed a complaint contending that its claims were nondischargeable under Sections 523(a)(2)(A), 523(a)(2)(B), 1141(d) and 1192, because the debtor made a misrepresentation by not disclosing that bankruptcy was imminent.

In response to the complaint, the debtor filed a motion to dismiss for failure to state a claim under Rule 12(b)(6), contending that corporations in Subchapter V of chapter 11 may discharge debts that would be nondischargeable by individual debtors in Subchapter V.

The Fourth Circuit had already decided the issue in *Cantwell-Cleary Co. v. Cleary Packaging LLC (In re Cleary Packaging LLC)*, 36 F.4th 509 (4th Cir. June 7, 2022), by holding that debts described in Section 523(a) can be nondischargeable as to corporate debtors, not just individual debtors, if the plan is nonconsensual. To read ABI's report on *Cleary*, click here.

Line by line, the bankruptcy court refuted *Cleary's* reasoning and granted the motion to dismiss. *Avion Funding LLC v. GFS Industries LLC (In re GFS Industries LLC)*, 647 B.R. 337 (Bankr. W.D. Tex. Nov. 10, 2022). To read ABI's report, click here. The bankruptcy court authorized a direct appeal, which the Fifth Circuit accepted and held oral argument on December 5.

The Statutory Language

On the merits, Circuit Judge Stuart Kyle Duncan began his April 17 opinion by saying that "the dischargeability of its debts is governed by § 1141(d)" if "a debtor's bankruptcy plan is confirmed as a consensual plan under § 1191(a)." However, he said that the debtor's "plan was confirmed as a nonconsensual plan under § 1191(b), so the dischargeability of its debts is governed by § 1192."

Quoting Section 1192, Judge Duncan went on to say that confirmation discharges all debts in Section 1141(d)(1)(A) except, among other things, those "of the kind specified in section 523(a) of this title."

Judge Duncan identified a "textual conundrum," given that the preamble to Section 523(a) reads, "A discharge under section 727, 1141, 1192, 1228(a), 1228(b), or 1328(b) of this title does not discharge *an individual debtor* from any debt . . . ." [Emphasis in opinion.] He said that the preamble was "critical" to the bankruptcy court's conclusion that nondischargeability in Subchapter V applies only to individual debtors.

For Judge Duncan, "placing controlling weight" on the word "'individual' in § 523(a) disregards the plain language of § 1192(2)." He noted that Section 1192 deals with the discharge of debts of a "debtor," and that the word "debtor" in Subchapter V refers to "a person." In turn, "person" is defined in Section 101(41) to mean both an individual and a corporation.

"[P]utting all this together," Judge Duncan concluded that "§ 1192 applies to both individual and corporate debtors."

Next, Judge Duncan focused on the statutory language in "§ 1192[, which] excepts from discharge "any *debt . . . of the kind* specified in section 523(a)." [Emphasis in original.] He then said, "We must apply this precise language as written."

For Judge Duncan, "the most natural reading of § 1192(2) is that it subjects both corporate and individual Subchapter V debtors to the categories of debt discharge exceptions listed in § 523(a)." Like the Fourth Circuit "correctly reasoned," he said that "the reference to 'kind[s]' of debt in § 1192 serves as 'a shorthand to avoid listing all 21 types of debts' in § 523(a), 'which would indeed have expanded the one-page section to add several additional pages to the U.S. Code.'" *Cleary, supra*, 36 F.4th at 515.

In addition, he said that Section 1192(2) is "the more specific provision" that should govern the more general.

Like the Fourth Circuit, Judge Duncan said that nondischargeability "gains greater force when we situate § 1192 in the larger context of the Bankruptcy Code . . . . Even traditional Chapter 11

proceedings distinguish discharges for individual and corporate debtors." In addition, he said that Section 1192 is "virtually identical" to Section 1228(a), which courts have interpreted as allowing nondischargeability complaints as to corporate farmers.

"[M]ore importantly," Judge Duncan said, the debtor "misunderstands the compromises Congress made in Subchapter V," by which he was referring to the omission of the absolute priority rule in Subchapter V cases. "To counterbalance that benefit to debtors," he said, "Congress excepted from discharge 'any debt . . . of the kind specified in section 523(a).'"

Believing that accepting the debtor's arguments would "rewrite that compromise," Judge Duncan reversed and remanded, holding "that 11 U.S.C. § 1192(2) subjects both corporate and individual Subchapter V debtors to the categories of debt discharge exceptions listed in § 523(a)."

Observation

So far, eight lower courts, including the Ninth Circuit Bankruptcy Appellate Panel, have disagreed with *Cleary* and the result reached by the Fifth Circuit. To read ABI's report, click here.

The opinion is *Avion Funding LLC v. GFS Industries LLC (In re GFS Industries LLC)*, 25-50237 (5th Cir. April 17, 2024).

The bankruptcy judge in Pensacola, Fla., is giving the Eleventh Circuit an opening to split with the Fourth and Fifth Circuits.

Judge Oldshue Splits with Two Circuits: No Nondischargeability for Sub V Corporations

Although the Fourth and Fifth Circuits have held that corporations in Subchapter V of chapter 11 can be saddled with nondischargeable debts in nonconsensual plans, Bankruptcy Judge Jerry C. Oldshue, Jr., sitting in Pensacola, Fla., swam against the tide by following the Ninth Circuit Bankruptcy Appellate Panel (BAP).

In his February 14 opinion, Judge Oldshue concluded that banning nondischargeability in Subchapter V for corporations "provide[s] the best statutory interpretation of §1192's incorporation of 523(a) by giving effect to all the statutory language, recognizing the long-standing application of §523(a) to only individual debtors, and comporting with the overall purpose of the [Small Business Reorganization Act]."

Companion Suits in State Court and Bankruptcy Court

Several creditors had sued a corporation in state court. Three years later, the corporation filed a petition under Subchapter V of chapter 11. The debtor removed the suit from state court, but Judge Oldshue had abstained because the lawsuit was far advanced, state law issues predominated, the claims were noncore, and a jury trial had been demanded.

In chapter 11, the creditors who had sued in state court filed a complaint seeking a declaration that the debt was nondischargeable under Section 523(a)(2), (4) and (6). The debtor responded with a motion to dismiss.

Sections 1192 and 523(a)

The outcome was controlled by Sections 1192 and 523(a). Applicable to nonconsensual plans, Section 1192 provides that "the court shall grant the debtor a discharge of all debts provided in section 1141(d)(1)(A) of this title . . . *except any debt* — . . . (2) *of the kind* specified in section 523(a) of this title." [Emphasis added.]

Section 523(a) provides that a "discharge under section . . . 1141 . . . does not discharge an *individual debtor*" from 19 types of debt. [Emphasis added.]

Judge Oldshue observed that the "juxtaposition of §1192(2) and the reference to 'individual debtor' in §523(a)'s preamble has resulted in differing opinions on the issue of whether the §523 exceptions to discharge apply to corporate debtors." He cited the Fourth and Fifth Circuits and a district court in Illinois for holding "that both individual and corporate debtors covered by §1192 are subject to the discharge exceptions of §523(a)." *Cantwell-Cleary Co. v. Cleary Packaging LLC (In re Cleary Packaging LLC)*, 36 F.4th 509 (4th Cir. June 7, 2022). To read ABI's report, click here. *Avion Funding LLC v. GFS Industries LLC (In re GFS Industries LLC)*, 99 F.4th 223 (5th Cir. April 17, 2024). To read ABI's report, click here. *Chi. & Vicinity Laborers' Dist. Council Pension Plan, et al. v. R & W Clark Constr., Inc.*, 24 CV 1463, 2024 WL 4789403 (N.D. Ill. Nov. 14, 2024). To read ABI's report, click here.

"[T]he Fourth and the Fifth Circuits," Judge Oldshue said, "have disregarded the reference to 'individual debtor' in §523's preamble and construed the discharge exceptions to apply to both individual and corporate debtors under §1192(2)." The issue, he said, "is not well-settled as other courts have construed the same statutory provisions differently."

Judge Oldshue cited the Ninth Circuit BAP and "other bankruptcy courts, including those in the Eleventh Circuit, [that] have held that the §523 non-dischargeability provisions apply only to individual Subchapter V debtors." *See, e.g.*, *In re Off-Spec Sols., LLC*, 651 B.R. 862 (B.A.P. 9th Cir. 2023); *In re Hall*, 651 B.R. 62 (Bankr. M.D. Fla. 2023). To read ABI's reports, click here and here.

"These courts," Judge Oldshue said, "have found that the better interpretation of §1192 is that it incorporates §523(a)'s limited applicability to individuals." For instance, he said that the Ninth Circuit BAP decided that "adding §1192 to the list of discharge provisions to which [Section 523] applies, extracting only the list of nondischargeable debts from §523(a) without its limitation to individuals, would render the amendment surplusage."

Judge Oldshue found "the reasoning of the Ninth Circuit BAP and the bankruptcy courts in the Eleventh Circuit, holding the exceptions to discharge under §523(a) apply only to individual debtors under §1192(2), convincing. Such decisions provide the best statutory interpretation of §1192's incorporation of 523(a) by giving effect to all the statutory language, recognizing the long-standing application of §523(a) to only individual debtors, and comporting with the overall purpose of the SBRA."

Concluding that the exceptions to discharge in Section 523(a) "only apply to individuals in Subchapter V," Judge Oldshue dismissed the creditors' nondischargeability complaint for failure to state a claim.

Observations

The question is a classic case for application of rules of statutory interpretation, worthy of review by the Supreme Court. Perhaps Judge Oldshue's case will go up on appeal, giving the Eleventh Circuit an opportunity to create a circuit split.

The opinion is *Spring v. Davidson (In re Davidson)*, 23-3005 (Bankr. N.D. Fla. Feb. 14, 2025).

Bankruptcy judges continue to disagree on whether debts of corporations with cramdown plans in Subchapter V can have nondischargeable debts.

Denver Judge Sides with the Circuits: Nondischargeability Infects Subchapter V

Less than a month after Bankruptcy Judge Jerry C. Oldshue, Jr., decided that nondischargeability isn't a "thing" for corporations in Subchapter V of chapter 11, Bankruptcy Judge Thomas B. McNamara of Denver took the opposite tack, sided with the Fourth and Fifth Circuits, and held that corporate debtors in Subchapter V can have nondischargeable debts when they confirm cramdown plans under Section 1191(b).

The corporate debtor filed a petition under Subchapter V and was preparing to confirm a cramdown plan under Section 1191(b) because a class of creditors had rejected the plan. Adding to the debtor's problems, a creditor with a $5.5 million claim filed a complaint alleging that the debt was nondischargeable under Section 523(a)(6) as arising from willful and malicious injury.

Judge McNamara denied the debtor's motion to dismiss the complaint for failure to state a claim under Rule 12(b)(6). His March 17 opinion is a meticulous survey of all authorities coming down both ways on nondischargeability in Subchapter V.

The Split

Judge McNamara recognized the "split of legal authority regarding whether the Section 523(a) nondischargeability provisions (such as Section 523(a)(6)) apply to corporate debtors, including limited liability companies, in Subchapter V cases where the proposed reorganization is nonconsensual."

Disposition of the debtor's motion to dismiss the nondischargeability complaint was controlled by Sections 1192 and 523(a). Applicable to nonconsensual plans, Section 1192 provides that "the court shall grant the debtor a discharge of all debts provided in section 1141(d)(1)(A) of this title . . . *except any debt* — . . . (2) *of the kind* specified in section 523(a) of this title." [Emphasis added.]

As Judge McNamara put it, the "rub" arises from Section 523(a), which provides that a "discharge under section . . . 1141 . . . does not discharge an *individual debtor*" from 19 types of debt. [Emphasis added.]

For most courts, the question is whether the words "individual debtor" in the introductory phrase in Section 523(a) carry over onto Section 1192, which imposes nondischargeability for debtors "of the kind" specified in Section 523(a).

Citing the decision by Judge Oldshue as an example, Judge McNamara said that "most bankruptcy courts construing Sections 1192(2) and 523(a) have concluded — based mainly on the preamble to Section 523(a) as well as policy considerations — that the 20 categories (and subparts) of nondischargeable debt under Section 523(a) apply only to individual Subchapter V debtors." He also cited *Lafferty v. Off-Spec Sols. LLC (In re Off-Spec Sols. LLC)*, 651 B.R. 862 (B.A.P. 9th Cir. 2023), which, so far, is the only appellate court to ban nondischargeability for corporate Subchapter V debtors. To read ABI's report on *Off-Spec*, click here. To read Judge Oldshue's decision, *Spring v. Davidson (In re Davidson)*, 2025 WL 511226 (Bankr. N.D. Fla. Feb. 14, 2025), click here.

Apart from *Off-Spec*, Judge McNamara said that "the analysis used by most bankruptcy courts has not fared well on appeal." Citing the Fourth and Fifth Circuits as the only courts of appeals to confront the question, he said that both held, "as a matter of statutory interpretation, that the discharge of both individual and corporate Subchapter V debtors under Section 1192(2) is subject to the discharge limitations contained in the Section 523(a) categories." *See Avion Funding v. GFS Indus., LLC (In re GFS Indus. LLC)*, 99 F.4th 223 (5th Cir. 2024); and *Cantwell Cleary Co. Inc. v. Cleary Packaging, LLC (In re Cleary Packaging LLC)*, 36 F.4th 509, 517 (4th Cir. 2022). To read ABI's reports, click here and here.

Judge McNamara also cited a district judge in Chicago who upheld the bankruptcy court by deciding that corporate debtors in Subchapter V of chapter 11 can be saddled with nondischargeable debts. *Chicago & Vicinity Laborers' Dist. Council Pension Plan v. R&W Clark Constr. Inc. (In re R&W Clark Constr. Inc.)*, 2024 WL 4789403 (N.D. Ill. Nov. 14, 2024). To read ABI's report, click here.

The Circuit's Logic Is 'Persuasive'

"With due respect to the various Bankruptcy Courts who have ruled otherwise," Judge McNamara found "the traditional statutory analysis employed by the Fourth Circuit Court of Appeals . . . and the Fifth Circuit Court of Appeals . . . far more compelling and persuasive.

"[W]hile the *Off-Spec Solutions* decision is well-written and makes some important points," Judge McNamara "reviewed the arguments of the parties and the case law [and found] the analysis and determination of the *Cleary Packaging* and *GFS Industries* courts to be far more compelling and persuasive than that of the *Off-Spec Solutions* court."

Arriving "at the exact same place as the Fourth and Fifth Circuits," Judge McNamara "endorse[d] those decisions" and denied the debtor's motion to dismiss.

The opinion is *Marmic Fire & Safety Co. Inc. v. ETG Fire LLC (In re ETG Fire LLC)*, 24-1225 (Bankr. D. Colo. March 17, 2025).

Reversing the bankruptcy court, the Chicago district judge follows the Fourth and Fifth Circuits and rejects a contrary holding by the Ninth Circuit BAP.

Chicago District Judge Decides that Sub V Debtors Can Have Nondischargeable Debts

Reversing the bankruptcy court, a district judge in Chicago decided that corporate debtors in Subchapter V of chapter 11 can be saddled with nondischargeable debts.

In his November 14 opinion, District Judge Manish S. Shah followed the Fourth and Fifth Circuits and agreed with a different bankruptcy judge in Chicago, while disagreeing with the Ninth Circuit Bankruptcy Appellate Panel and eight bankruptcy courts.

A creditor held a judgment for more than $3 million against a corporation and its owner. The corporation filed a petition under Subchapter V of chapter 11. The judgment creditor responded with an adversary proceeding seeking a declaration that the debts owing to it were nondischargeable under Section 523(a)(2)(A), (a)(2)(B) and (a)(6).

Believing that nondischargeability does not apply to corporate debtors in Subchapter V just like in "regular" chapter 11, the bankruptcy court granted the debtor's motion to dismiss the complaint for failure to state a claim. *See Chicago & Vicinity Laborers' District Council Pension Plan v. R&W Clark Construction Inc. (In re R&W Clark Construction Inc.)*, 656 B.R. 628 (Bankr. N.D. Ill. Feb. 8, 2024). To read ABI's report on *R&W*, click here.

The creditor appealed to the district court and won a reversal.

Sections 1192 and 523(a)

Apart from a court's concept of policy, the outcome turns on the interpretation of Sections 1192 and 523(a). Applicable to nonconsensual plans, Section 1192 provides that "the court shall grant the debtor a discharge of all debts provided in section 1141(d)(1)(A) of this title . . . *except any debt* — . . . (2) *of the kind* specified in section 523(a) of this title." [Emphasis added.]

Section 523(a) provides that a "discharge under section . . . 1141 . . . does not discharge an *individual debtor*" from 19 types of debt. [Emphasis added.]

Believing there is no nondischargeability for corporations in Subchapter V, the bankruptcy court was persuaded by the Ninth Circuit Bankruptcy Appellate Panel's decision in *Lafferty v. Off-*

Spec Sols., LLC (In re Off-Spec Sols., LLC), 651 B.R. 862 (B.A.P. 9th Cir. 2023), *appeal dismissed per stipulation*, 23-60034, 2023 WL 9291577 (9th Cir. Nov. 12, 2023). To read ABI's report on the BAP opinion, click here.

Concluding that nondischargeability did not apply to corporate debtors in Subchapter V, the BAP saw Section 523(a) and its limitation to individual debtors as being more specific and therefore controlling.

The bankruptcy court declined to follow *Cantwell-Cleary Co. v. Cleary Packaging LLC (In re Cleary Packaging LLC)*, 36 F.4th 509 (4th Cir. June 7, 2022), where the Fourth Circuit held that corporate debtors in Subchapter V may not discharge debts "of the kind" specified in Section 523(a). To read ABI's report, click here. Subsequently, the Fifth Circuit came down the same way in *Avion Funding LLC v. GFS Industries LLC (In re GFS Industries LLC)*, 99 F.4th 223 (5th Cir. April 17, 2024). To read ABI's report, click here.

Notably, Chicago Bankruptcy Judge Deborah L. Thorne of Chicago decided in July that the Fourth and Fifth Circuits had the right idea. She ruled that corporate debtors in Subchapter V are subject to complaints for nondischargeability. *See Christopher Glass & Aluminum Inc. v. Premier Glass Services LLC (In re Premier Glass Services LLC)*, 661 B.R. 939 (Bankr. N.D. Ill. July 31, 2014). To read ABI's report, click here.

Section 1192 Controls

Ruling on the appeal, District Judge Shah decided that Section 1192(2) was "unambiguous" in that it "grants a debtor, either individual or corporate, discharge of all debts except for debts 'of the kind specified in section 523(a).'" On the other hand, he found "trouble" in the preamble to Section 523(a), which says, "A discharge under section . . . 1192 . . . of this title does not discharge *an individual debtor* from" 19 types of debt. [Emphasis added.] Judge Shah devoted 10 pages to explaining why the preamble to Section 523(a) is not controlling.

"When § 1192 refers to the kinds of debt specified in § 523(a)," Judge Shah said, "it is referring to the enumerated debts, not the preamble's reference to types of debtors." The judge said that his conclusion was "bolstered" by bankruptcy courts in Texas and Georgia that had decided in 1995 and 2009 that "virtually identical" language in chapter 12 opens the door to nondischargeability for corporations, not only individual debtors.

Judge Shah saw Congress as having "made a choice to change bankruptcy proceedings for small business debtors and chose to treat individual and corporate debtors the same. To hold that § 523(a) only applies to individuals discharging debt under § 1192 ignores the purposeful change Congress made to the statutory language."

Reversing the bankruptcy court, Judge Shah held that the "'most natural reading' of § 1192(2) applies the exceptions to discharge in the paragraphs of § 523(a) to both corporate and individual debtors."

The opinion is *Chicago & Vicinity Laborers' District Council Pension Plan v. R&W Clark Construction Inc. (In re R&W Clark Construction Inc.)*, 24-1463 (N.D. Ill. Nov. 14, 2024).

The tide is turning against corporate Sub V debtors. Two bankruptcy judges now side with two circuits in holding that debts of corporate debtors can be nondischargeable.

Nondischargeability Is a 'Thing' for Corporate Subchapter V Debtors, Judge Thorne Says

The tide is turning. Bucking the trend in the lower courts, a second bankruptcy judge has held that debts can be nondischargeable as to corporations in Subchapter V of chapter 11.

This time, it's a prominent bankruptcy judge in Chicago who believes in nondischargeability. She disagreed with another Chicago judge but took sides with the only two circuit courts to decide the question so far.

A creditor filed a complaint contending that a debt owing by the corporate Subchapter V debtor was nondischargeable under Section 523(a)(6). Allegedly, the debtor solicited employees and customers in violation of a noncompetition and nonsolicitation agreement.

To make nondischargeability an issue, the creditor contended that the plan could only be confirmed as a nonconsensual plan. The debtor filed a motion to dismiss the complaint for failure to state a claim, which Bankruptcy Judge Deborah L. Thorne denied in her July 31 opinion.

Sections 1192 and 523(a)

Judge Thorne explained that confirmation of nonconsensual plans is governed by Section 1191(b). On confirmation of a nonconsensual plan, Section 1192 provides that "the court shall grant the debtor a discharge of all debts provided in section 1141(d)(1)(A) of this title . . . *except any debt* — . . . (2) *of the kind* specified in section 523(a) of this title." [Emphasis added.]

Section 523(a) provides that a "discharge under section . . . 1141 . . . does not discharge an individual debtor" from 21 types of debt.

Courts believing there's no such thing as nondischargeability for Subchapter V debtors focus on the words "individual debtor" in Section 523(a) to conclude that nondischargeability applies only to individuals. Courts holding that debts can be nondischargeable as to corporations focus on "any debt . . . of the kind" in Section 1192.

Section 1192 Doesn't Refer to the 'Type of Debtor'

Judge Thorne fell into the nondischargeability camp because, she said, "Section 1192(2) does not refer to the preamble but only to the kinds of debts listed in the section."

The Seventh Circuit has not taken sides, but Bankruptcy Judge Timothy A. Barnes of Chicago wrote an opinion in February holding that nondischargeability does not apply to a corporate Subchapter V debtor. *Chicago & Vicinity Laborers' District Council Pension Plan v. R&W Clark Construction Inc. (In re R&W Clark Construction Inc.)*, 656 B.R. 628 (Bankr. N.D. Ill. Feb. 8, 2024). To read ABI's report on *R&W*, click here.

Of course, Judge Thorne cited the Fourth and Fifth Circuits, which both held that corporate Subchapter V debtors can be saddled with nondischargeable debts. *Cantwell-Cleary Co. v. Cleary Packaging LLC (In re Cleary Packaging LLC)*, 36 F.4th 509 (4th Cir. June 7, 2022); and *Avion Funding LLC v. GFS Industries LLC (In re GFS Industries LLC)*, 99 F.4th 223 (5th Cir. April 17, 2024). To read ABI's reports, click here and here.

Judge Thorne found the two circuits to be "persuasive" because "Congress did not add a provision to 1192(2) instructing that the list of nondischargeable debts was limited to only certain types of debtors — entities or individuals." Instead, what "section 1192(2) says is that discharge is not available for '*any debt* . . . of the kind specified in section 523(a).'" [Emphasis in original.]

Judge Thorne deduced that "[n]othing about the use of the phrase 'type of debt' suggests that the court need consider the type of debtor." She agreed with the Fourth Circuit that "Congress used this provision as a 'shorthand to avoid listing all 21 types of debts.'"

The language in Section 1192(2), Judge Thorne said, "closely echoes" Section 1228(a), which has been interpreted to mean that corporate family farmers can have nondischargeable debts.

Judge Thorne conceded that eight bankruptcy courts believe there is no nondischargeability. The eight include the two bankruptcy courts reversed by their circuits.

Also in Judge Thorne's camp is *Ivanov v. Van's Aircraft Inc. (In re Van's Aircraft Inc.)*, 24-06011, 2024 BL 200305 (Bankr. D. Ore. June 11, 2024). To read ABI's story on *Van's*, click here. Notably, the bankruptcy judge in Oregon disagreed with the conclusion reached on the identical topic by the Ninth Circuit Bankruptcy Appellate Panel. Evidently, the parties in the BAP settled because the appeal to the Ninth Circuit was withdrawn. *Lafferty v. Off-Spec Sols., LLC (In re Off-Spec Sols., LLC)*, 651 B.R. 862 (B.A.P. 9th Cir. 2023), *appeal dismissed per stipulation*, 23-60034, 2023 WL 9291577 (9th Cir. Nov. 12, 2023). To read ABI's report on the BAP opinion, click here.

Judge Thorne denied the debtor's motion to dismiss, saying it "is unnecessary to resort to the preamble of section 523(a) when section 1192(2) clearly states that the discharge is limited by the kinds of debts that are of the 'kind specified in section 523(a).'"

The opinion is *Christopher Glass & Aluminum Inc. v. Premier Glass Services LLC (In re Premier Glass Services LLC)*, 24-00096 (Bankr. N.D. Ill. July 31, 2024).

Bankruptcy Judge Hercher agreed with the results in the Fourth and Fifth Circuits but disagreed with some of the appeals courts' logic.

Corporate Debts in Sub V Can Be Nondischargeable, Judge Says, Differing with His BAP

Taking sides with the results reached in the Fourth and Fifth Circuits, Bankruptcy Judge David W. Hercher of Portland, Ore., decided that the types of debts described in Section 523(a) can be nondischargeable for corporations in Subchapter V.

Although sitting in the Ninth Circuit, Judge Hercher disagreed with the Ninth Circuit Bankruptcy Appellate Panel, which ruled one year ago that there's no such thing as a nondischargeable debt for a corporation in Subchapter V. *See Lafferty v. Off-Spec Solutions LLC (In re Off-Spec Solutions LLC)*, 651 B.R. 862 (B.A.P. 9th Cir. July 6, 2023). To read ABI's report, click here.

Like a district court opinion, a BAP opinion is not binding on a bankruptcy judge in the same circuit unless the decision was made in the same case.

The Dischargeability Complaint

The creditor filed a complaint against a corporate debtor in Subchapter V of chapter 11. The complaint made two claims. One claim sought a declaration that the debt was nondischargeable under Section 523(a)(2) as having arisen from fraudulent misrepresentations. The second claim was for a money judgment arising from breach of contract.

The debtor moved to dismiss both claims. In his opinion on June 11, Judge Hercher dealt only with the motion to dismiss the nondischargeability claim and ruled in favor of the creditor by denying the motion to dismiss.

Before turning to the case before him, Judge Hercher laid out the similarities and differences regarding dischargeability in chapters 7, 11, 12 and 13. If the plan in Subchapter V is accepted by all classes, he said that all debts are discharged because Section 1141(d) applies and discharges virtually all debts when the debtor is a corporation.

In the case before him, the plan was a so-called cramdown plan confirmed over the objection of a creditor class. Therefore, discharge was governed by Section 1192. After confirmation and the completion of plan payments, the section provides that "the court shall grant the debtor a

discharge of all debts provided in section 1141(d)(1)(A) of this title, and all other debts allowed under section 503 of this title and provided for in the plan, except any debt — . . . (2) *of the kind* specified in section 523(a) of this title." [Emphasis added.]

Applicable to Subchapter V cases, Section 523(a) provides that a "discharge under section . . . 1141 . . . of this title does not discharge an individual debtor from any debt" described in the following 20 subparagraphs.

Throughout the opinion, Judge Hercher referred to the phrase a "discharge under section . . . 1141 . . . of this title does not discharge an individual debtor" in Section 523(a) as the "preamble."

Analysis of the BAP and the Circuit Opinions

The debtor naturally urged Judge Hercher to follow *Off-Spec*, while the creditor wrapped itself in the flags flown by the Fourth and Fifth Circuits. *See Cantwell-Cleary Co. v. Cleary Packaging LLC (In re Cleary Packaging LLC)*, 36 F.4th 509 (4th Cir. June 7, 2022); and *Avion Funding LLC v. GFS Industries LLC (In re GFS Industries LLC)*, 99 F.4th 223 (5th Cir. April 17, 2024). To read ABI's reports, click here and here.

Judge Hercher described the Fourth Circuit in *Cleary* as holding that debts of corporate debtors in Subchapter V can be nondischargeable because the phrase "of the kind specified in section 523(a)" refers to the type of debt, not the type of debtor. He also mentioned how the Fourth Circuit adopted the positions of bankruptcy courts in two chapter 12 cases in 1995 and 2009 as having held that identical language in chapter 12 can give rise to nondischargeable debts of corporate debtors. He also observed that the Fourth Circuit saw nondischargeability as an offset to the easier confirmation of Subchapter V plans.

In *GFS*, Judge Hercher said that the Fifth Circuit "echoed the reasoning of the Fourth."

In *Off-Spec*, Judge Hercher described the BAP as seeing no conflict between Sections 523(a) and 1192 and deciding that Section 523(a) and its limitation to individual debtors was more specific and should control. He also cited the BAP for saying that the two lower courts' decisions on chapter 12 were "wrong."

Judge Hercher's Analysis

Judge Hercher decided that "debts of the kind" "refers to types of debt, not types of debtors." He therefore concluded that "the plain meaning of 1192(2) is that the discharge under a subchapter V plan confirmed nonconsensually excepts the debts listed in the 523(a) debt-type list — even when the debtor is not an individual."

To his way of thinking, "the 523(a) preamble — and its application only to the discharge of a debtor who is an individual — has no role in the discharge-narrowing work of the cross-references in the second category of discharge sections, including 1192(2)."

If Congress had meant for nondischargeability to apply in Subchapter V only to individuals, Judge Hercher said "it could easily have said so clearly and expressly by excepting in 1192(2) either 'any debt — (2) of an individual debtor of the kind specified in section 523(a)' or as it did in 1141(d)(2), 'any debt — (2) excepted from discharge under section 523.'"

Judge Hercher found no reason to adopt any policy arguments made by the circuits and the BAP because "the meaning of 1192(2) is clear both in isolation and when considered with other Code sections."

Parting Company with the Circuits

Although concurring in the outcome reached in the two circuits, Judge Hercher found two of the circuits' "rationales" to be "questionable."

First, Judge Hercher said that the "general-versus-specific rationale" does not apply because the statutes are not in conflict, since they can be read "in harmony." Second, he did not believe that Congress was following the two lower courts' chapter 12 cases because they were "nonprecedential, unpublished trial-court decisions," making it "unlikely that Congress was aware of them."

Denying the debtor's motion to dismiss the nondischargeability complaint, Judge Hercher predicted that the Ninth Circuit would follow the Fourth and Fifth Circuits to avoid creating a split of circuits.

Updates

In *Off-Spec*, the creditor appealed to the Ninth Circuit, but the parties later withdrew the appeal.

In the case before Judge Hercher, his order denying the motion to dismiss may not be a final order subject to appeal. With regard to jurisdictional issues in a similar circumstance, *see Kiviti v. Bhatt*, 80 F.4th 520 (4th Cir. 2023). To read ABI's report on *Kiviti*, click here.

The opinion is *Ivanov v. Van's Aircraft Inc. (In re Van's Aircraft Inc.)*, 24-06011 (Bankr. D. Ore. June 11, 2024).

A creditor must control a class before its debt can become nondischargeable in Subchapter V.

Nondischargeability in Sub V Only Applies When It's a Nonconsensual, Cramdown Plan

If a corporate debtor under Subchapter V of chapter 11 confirms a *consensual* plan under Section 1191(a), there is no such thing as a nondischargeable debt under Section 523(a), for statutory reasons explained by Bankruptcy Judge Robert M. Matson of Albany, Ga.

In adopting the Bankruptcy Reform Act in 1978, Congress did away with nondischargeable debts for "ordinary" corporations in chapter 11. Why? Because a creditor with a nondischargeable debt in "old" Chapter XI under the former Bankruptcy Act could kill a plan, to the disadvantage of the larger creditor body that would benefit from reorganization.

Taking Judge Matson's January 31 opinion as gospel, a creditor with a nondischargeable debt can kill a Subchapter V plan only if the creditor controls a class that votes against the plan, thereby forcing the debtor to confirm a nonconsensual, cramdown plan under Section 1191(b).

The Consensual Plan

The debtor leased its employees. The lessor paid the employees' wages and could draw funds from the debtor's bank account to cover payroll. Eventually, the lessor's attempt to draw funds from the debtor's bank account failed.

According to the lessor, the debtor made intentionally false representations about the existence of funds in the account to cover the withdrawals. The representations proved false, because the lessor was stuck with $100,000 in bad debt. After the lessor filed suit in state court, the debtor filed a petition under Subchapter V.

However, the debtor did not schedule the lessor as a creditor. Unaware of the bankruptcy, the lessor obtained a default judgment in state court.

The lessor became aware of the bankruptcy when the debtor filed a suggestion of bankruptcy in state court. Because the lessor was unaware of the bankruptcy, the lessor had not filed a proof of claim before the bar date.

The lessor filed a complaint to except the debt from discharge under several subsections in Section

523(a). The debtor objected to confirmation of the debtor's plan, but the objection was resolved in a stipulation with the debtor.

The debtor confirmed a consensual plan under Section 1191(a), evidently because the class including the lessor had voted in favor of the plan. Just after confirmation, the debtor filed a motion to dismiss the nondischargeability complaint.

Although courts are not in agreement, most courts have decided recently that a corporate debtor in Subchapter V can be saddled with a nondischargeable debt. Those cases, though, involved cramdown plans. To read some of the ABI reports on nondischargeability in Subchapter V, click here and here.

When Section 1141(d) Does and Does Not Apply

Addressing the merits of the motion to dismiss, Judge Matson didn't leave the reader in suspense. He stated this holding: "[T]he discharge provisions of § 1192 (and thus the discharge exceptions on which [the lessor] relies) do not apply to a debtor whose plan was confirmed [as a consensual plan] under § 1191(a)."

Judge Matson then rummaged through several statutory provisions to explain how he arrived at his conclusion. He began by saying that a Subchapter V plan can be confirmed in two ways: (1) If the plan is consensual, it's confirmed under Section 1191(a); and (2) if it's nonconsensual or cramdown, it's confirmed under Section 1191(b).

Generally speaking, the breadth of discharge is controlled by Section 1141(d). Broadly, it says that confirmation "discharges the debtor from any debt that arose before such confirmation." The words "any debt," Judge Matson said, mean that "confirmation of a Chapter 11 plan generally results in discharge of debts of the sort identified in § 523(a)."

However, there are exceptions in Section 1141(d). For example, Section 523(a) nondischargeability applies to individuals in chapter 11, and corporations that liquidate don't receive a discharge. In addition, some types of debts owed to a governmental unit are not discharged. *See* Section 1141(d)(2), (3) and (6).

"[M]ost relevant to this case," Judge Matson said, "§ 1141(d) does not apply when the debtor confirms a plan under § 1191(b), but rather § 1192 does." He drew his conclusion from Section 1181(c), which says, "If a plan is confirmed under section 1191(b) of this title, section 1141(d) of this title shall not apply, except as provided in section 1192 of this title."

Judge Matson translated the statutes into intelligible English as follows:

> [T]he discharge provisions of § 1141(d) apply when the debtor confirms [a] consensual plan under § 1191(a) but do not apply when the debtor confirms a nonconsensual plan under § 1191(b). In those cases, § 1192 governs the debtor's discharge instead of § 1141(d).

As authority for his conclusion, Judge Matson cited the Fifth Circuit and a decision by Bankruptcy Judge Joseph G. Rosania, Jr., of Denver. *See In re GFS Indus., LLC*, 99 F.4th 223, 227 (5th Cir. 2024); and *In re Palmer Drives Controls & Sys., Inc.*, 657 B.R. 650, 654 (Bankr. D. Colo. 2024).

For failure "to state a claim upon which relief may be granted," Judge Matson granted the debtor's motion to dismiss the lessor's dischargeability complaint, "[b]ecause § 1192, and by extension the exceptions to discharge, do not apply to the Debtor."

Observations

Judge Matson's decision inferentially explains why it makes sense to have nondischargeability in some Subchapter V cases.

Compared to "regular" chapter 11, corporate debtors in Subchapter V are relatively small. A corporate debtor cannot file in Subchapter V to discharge a nondischargeable debt if that's the primary reason for chapter 11. In those circumstances, a creditor with a comparatively large nondischargeable debt likely would control a class, requiring confirmation of a cramdown plan where nondischargeability is a "thing."

On the other hand, if the nondischargeable debt is small and does not control the class, the creditor with a nondischargeable debt should not be able to kill a chapter 11 case to the disadvantage of other creditors who are in favor of confirmation.

The opinion is *Halo Human Resources LLC v. American Dental of LaGrange LLC (In re American Dental of LaGrange LLC)*, 24-1485 (Bankr. M.D. Ga. Jan. 31, 2025).

A decision by a district judge in Idaho may or may not be irreconcilable with a Ninth Circuit BAP decision that a finding of eligibility for Sub V is interlocutory and not appealable.

An Order Finding //æligibility for Sub V Is a Final, Appealable Order

Differing with a nonprecedential opinion from the Ninth Circuit Bankruptcy Appellate Panel, a district judge in Idaho held that an order finding the debtor ineligible for Subchapter V is a final, appealable order. It is possible, however, that the outcome in Idaho is reconcilable with the BAP decision, because the results in the two bankruptcy courts were the polar opposites of one another.

On the merits after finding an appealable order, District Judge B. Lynn Winmill of Boise, Idaho, affirmed the late Chief Bankruptcy Judge Joseph M. Meier of Boise, Idaho, by holding that student loans obtained to attend medical school are not debts arising from "commercial or business activities" making someone eligible for Subchapter V.

The Student Loan Debt

The debtor had been an addiction counselor who decided to attend medical school to enhance her financial wellbeing and better serve her patients. After obtaining her medical degree and serving a residency, the debtor practiced medicine as an employee for several organizations for most of 13 years before bankruptcy.

More than 10 years after obtaining her medical degree, the debtor for the first time opened her own practice, but it failed within months. She was an employee on filing a chapter 11 petition and electing to proceed under Subchapter V.

All obtained to attend medical school, the debtor's student loan debt had grown from $325,000 to almost $650,000 with interest. The student loans were substantially more than half of the debtor's total debt.

The U.S. Trustee objected to confirmation of the debtor's chapter 11 plan, arguing that the debtor was not entitled to proceed under Subchapter V. According to the objection, the student loan debt did not arise from "commercial or business activities."

Aside from the question of eligibility for Subchapter V, Bankruptcy Judge Meier decided that the debtor had satisfied all requisites for confirmation of a chapter 11 plan.

However, Judge Meier concluded that the debtor was ineligible for Subchapter V because there was no nexus between the medical school student debt incurred years earlier and the commercial activity in which the debtor engaged while operating her own practice. *In re Reis*, 22-00517, 2023 BL 148604 (Bankr. D. Idaho May 2, 2023). To read ABI's report, click here.

Appealability

On the debtor's appeal, the U.S. Trustee took the position that the order finding ineligibility was not final and was not subject to appeal under 28 U.S.C. § 157(a)(1).

In his June 20 opinion, District Judge Winmill naturally took counsel from the two controlling Supreme Court decisions on finality in bankruptcy, *Bullard v. Blue Hills Bank*, 575 U.S. 496 (2015), and *Ritzen Group, Inc. v. Jackson Masonry, LLC*, 589 U.S. 35 (2020). He explained how *Bullard* decided that an order denying confirmation was not a final order because only confirmation or dismissal fixes the rights and obligations of the parties.

On the other hand, denial of a motion to modify the stay was found to be appealable in *Ritzen*, because denial of stay relief gave the bankruptcy court nothing more to do.

From the two cases, Judge Winmill distilled two controlling questions: (1) Was the order made in a "distinct procedural unit"; and (2) did the order "terminate" the "distinct proceeding"?

In the realm of Subchapter V, Judge Winmill said there was "a dearth of authority on whether an order sustaining a trustee's objection to a debtor's election to proceed under Subchapter V is a final, appealable order." He found only one case of import, the Ninth Circuit Bankruptcy Appellate Panel's unreported order in *NetJets Aviation, Inc. v. RS Air, LLC (In re RS Air, LLC)*, 21-1053 (B.A.P. 9th Cir. May 26, 2021).

The bankruptcy court had decided in *RS* that the debtor was eligible for Subchapter V. The BAP dismissed the appeal, finding that the order was interlocutory and not appealable because the "determination of whether a debtor qualifies for subchapter V relief under 11 U.S.C. § 1182(1)(A) is part of the Chapter 11 confirmation process and as such, does not definitively dispose of a discrete issue within the bankruptcy case."

Judge Winmill "respectfully" disagreed with *RS Air*. He said that "Subchapter V eligibility determination is a discrete procedural unit that occurs before, and separately from, plan-confirmation proceedings."

In the case before him, Judge Winmill said that "the entire outcome of this case will be affected, given that the Debtor will be pushed into proceeding as an ordinary Chapter 11 debtor . . . as

opposed to under Subchapter V[, which has] many advantages over proceeding as a regular chapter 11 debtor."

"If a debtor is going to be vaulted into a different chapter of the bankruptcy code, with all the different rules that will apply," Judge Winmill decided, "the bankruptcy court's order denying Dr. Reis's Subchapter V election was a final, appealable order."

The Merits

Turning to the merits, Judge Winmill was faced with deciding whether review would be *de novo* or a search for clear error, in terms of the finding that medical school debts were not commercial.

Judge Winmill found the answer in Judge Meier's refusal to "lay down a categorical rule" saying that debts incurred before opening a business are never commercial debts.

Because Judge Meier did not announce a "per se" rule, Judge Winmill concluded that "the bankruptcy court did not clearly err in determining that [the debtor's] student loan [debt] did not arise from commercial or business activities." He affirmed Judge Meier's order sustaining the U.S. Trustee's objection to the debtor's eligibility for Subchapter V.

Observations

The decisions by Judge Winmill and by the Ninth Circuit BAP are not necessarily irreconcilable, because the outcomes differed in bankruptcy court. In the BAP appeal, the debtor had been found eligible for Subchapter V. In the case before Judge Winmill, the debtor had been found ineligible.

In the BAP appeal, eligibility was but one of more than a dozen issues along the road to confirmation. In the appeal to Judge Winmill, the finding of ineligibility meant "game over" in Subchapter V.

A finding of eligibility is akin to denial of a motion to dismiss a chapter 11 petition. By analogy to denial of dismissal, a finding of eligibility is interlocutory.

A finding that a debtor has no commercial debts is similar to a finding that the debtor has too much debt for Subchapter V. Findings of too much debt or too little commercial debt are both "game over."

In this writer's view, both opinions point in the same direction. The effect of the order in the progress of the case should illuminate the dividing line between final and interlocutory.

The opinion is *Reis v. Garvin (In re Reis)*, 23-00279 (D. Idaho June 20, 2024).

The definition of 'small business' uses the word 'activities,' not 'operations,' making nonoperating small business eligible for Subchapter V.

A Business that Never Generated Income Is Eligible for Subchapter V, Judge Norman Says

Because the statutory definition of "small business" refers to "business activities" not "business operations," Bankruptcy Judge Jeffrey Norman of Houston held that the corporate debtor was eligible for Subchapter V of chapter 11 even though the debtor had never generated income.

The LLC debtor was a holding company that owned patented piping technology. As Judge Norman said in his November 20 opinion, the debtor had raised $4 million from bridge loans and by selling secured notes. However, the debtor had not landed a contract to sell pipe.

Three creditors filed an involuntary petition. The debtor consented to entry of an order for relief in chapter 11 and elected to proceed under Subchapter V. The petitioning creditors objected to Subchapter V designation, contending that the debtor was never a "business," never generated income and was never engaged in commercial or business activities.

Judge Norman explained that the creditors were aiming to file a plan of their own, an impossibility unless the case was under "regular" chapter 11.

Defined in Section 101(51D)(A), a "small business debtor"

> means a person engaged in *commercial or business activities* . . . that has aggregate noncontingent liquidated secured and unsecured debts as of the date of the filing of the petition or the date of the order for relief in an amount not more than" $7.5 million. [Emphasis added.]

Judge Norman said that the Bankruptcy Code "does not provide a definition for 'commercial or business activity.'" To decide whether the debtor qualified, he looked at the totality of the circumstances.

From testimony by the debtor's chief operating officer, Judge Norman found that the debtor had a lease, maintained a bank account, continually attempted to generate business, provided marketing materials to potential investors and retained attorneys to protect intellectual property.

For caselaw precedent, both sides relied on *In re Port Arthur Steam Energy LP*, 629 B.R. 233 (Bankr. S.D. Tex. July 1, 2021), where Bankruptcy Judge Christopher M. Lopez of Houston held that collecting accounts receivable and maintaining the physical assets qualified as being engaged in commercial activities, even though the historical business was no longer operating. To read ABI's report, click here.

Judge Norman also took counsel from *In re Offer Space LLC*, 629 B.R. 299 (Bankr. D. Utah April 22, 2021), where Bankruptcy Judge William T. Thurman held that a nonoperating business qualified for Subchapter V if it had a bank account and was managing its few remaining assets. To read ABI's report, click here.

If Section 101(51D)(A) had used the word "operations" in the definition rather than "activities," Judge Norman said he would have found the debtor ineligible for Subchapter V, because the business was no longer functional or operational on the filing date.

Judge Norman held that the debtor "was engaged in 'commercial or business activities'" and qualified for Subchapter V because there was a lease, a bank account and marketing materials for investors, plus "attempts to generate business" and attorneys to protect intellectual property.

The opinion is *In re GCPS Holdings LLC*, 24-32646 (Bankr. S.D. Tex. Nov. 20, 2024).

Bankruptcy Judge Larson administratively closed a Sub V case after substantial consummation.

Sub V Trustee May Be Discharged When the Debtor Makes Plan Payments

When a nonconsensual plan is confirmed in Subchapter V, the bankruptcy court has discretion to discharge the Subchapter V trustee and close the case after substantial consummation, according to an opinion by Bankruptcy Judge Michelle V. Larson of Dallas.

The corporate debtor in Subchapter V confirmed a nonconsensual chapter 11 plan and gave notice of the effective date of the plan one month later. The plan called for the debtor to make plan payments, not the trustee.

Two months after the effective date, the debtor gave notice of substantial consummation of the plan and filed a motion seeking entry of a final decree and discharging the trustee. The Subchapter V trustee lodged the only objection.

When a plan is nonconsensual, the Bankruptcy Code does not say whether the court may close the case before the completion of plan payments. In her August 22 opinion, Judge Larson said the question was an issue of first impression in the district.

Unlike a consensual plan, the debtor with a nonconsensual plan does not receive a discharge until after the completion of plan payments, as provided in Section 1192.

The Statute

Section 350 and Bankruptcy Rule 3022 say that the court "shall" close the case when it has been "fully administered" and "the court has discharged the trustee." The Advisory Committee Note says that closing the case "should not be delayed solely" because all plan payments have not been made.

Under Section 1101(2), a chapter 11 case has been "substantially consummated" when all property has been transferred under the plan, the debtor or the successor has assumed management and plan payments have commenced.

For Subchapter V plans that were confirmed consensually under Section 1191(a), Section 1182(c)(1) provides that "the services of the trustee shall terminate when the plan has been

substantially consummated." In a nonconsensual case confirmed under Section 1192(b), "the Code is silent regarding termination of the Subchapter V trustee's service," Judge Larson said.

The *Subchapter V Trustee's Handbook*, prepared by the U.S. Trustee program, says that the Subchapter V trustee under a nonconsensual plan should remain in place for the life of the plan, even when the debtor is making plan payments.

Persuasive Authorities

To answer the question, Judge Larson identified three cases on the topic. One held that the trustee should remain in place until all payments have been made and the trustee files the final report. *In re Gui-Mer-Fe*, 21-01659, 2022 WL 1216270, at *8 (Bankr. D.P.R. Apr. 15, 2022).

Judge Larson was persuaded by *In re DynoTec*, 21-30803, 2024 WL 2003065 (Bankr. D. Minn. April 5, 2024), and *In re Florist Atlanta*, 24-51980, 2024 WL 3714512 (Bankr. N.D. Ga. Aug. 7, 2024).

In *DynoTec*, Bankruptcy Judge Kesha L. Tanabe decided that the Code "provides sufficient flexibility to allow for the discharge of a Subchapter V trustee prior to completion of the plan payments, even where such a case was confirmed non-consensually," Judge Larson said.

Judge Larson then went on to say that she found *Florist Atlanta* to be "most persuasive." To read ABI's report on *Florist Atlanta*, click here.

In *Florist Atlanta*, Judge Larson described Bankruptcy Judge Paul W. Bonapfel as having held that "the Bankruptcy Code gives bankruptcy courts discretion to determine, based upon the specific facts of each case, whether, when, and how a non-consensual Subchapter V case should be closed prior to entry of discharge."

The Trustee May Be Discharged

Turning to the facts of the case before her, Judge Larson said the three elements of "substantial consummation" had been shown. Under "traditional analysis," she said that "this case can be considered fully administered."

Next, Judge Larson analyzed whether the trustee could be discharged before completion of her statutory duties. Even if the case where closed and the trustee had not filed her final report, Judge Larson said that the case could be reopened.

In the case before her, Judge Larson said that the trustee was neither administering assets nor making plan payments. She concluded that "the Trustee's statutory duty to file a final report in this case is not sufficient cause to keep these cases open, and it is thus appropriate to order the

termination of the services of the Subchapter V Trustee." Also, closing the case could allow the debtor to avoid incurring some administrative expenses.

Judge Larson held that the debtor had "fulfilled both the predicate statutory requirements under the Bankruptcy Code and this Court's specific requirements under the Confirmation and Post-Confirmation Orders for issuance of a final decree."

"Nevertheless," Judge Larson said, issuing a final decree would be "inappropriate," based on the debtor's "stated intention" to reopen the case three years later to allow entry of discharge. She therefore decided that the "best approach" was "for the case to be 'administratively closed' subject to reopening when the case is ripe for entry of discharge."

Judge Larson ended her opinion by directing the trustee to file her final report within two weeks and for the debtor to pay the trustee's fees in full. She directed that the case be closed administratively when the trustee has been paid.

The opinion is *In re Lager*, 22-30072 (Bankr. N.D. Tex. Aug. 22, 2024).

Consumer Bankruptcy

Discharge/Dischargeability

Bartenwerfer held to make a debt nondischargeable as to someone who was neither a partner nor an agent.

Debt Held Nondischargeable as to Someone Who Didn't Commit a Defalcation

Building on *Bartenwerfer*, Bankruptcy Judge Robert J. Faris of Honolulu held that a husband owed a nondischargeable debt because he was the beneficiary of funds that his wife had misappropriated from a trust for which she was the trustee.

Why was the debt nondischargeable as to the husband when he was not responsible for the misappropriation? *Bartenwerfer* made the debt nondischargeable because the trust held a claim against the husband for unjust enrichment.

The Wife's Misappropriation

The wife had been the trustee for her mother's trust. While serving as trustee before her own bankruptcy, the wife misappropriated almost all of the $850,000 that had been in the mother's trust. In the wife's previous bankruptcy, Judge Faris had held that virtually all of the misappropriated $850,000 was nondischargeable under Section 523(a)(4) as a debt for "defalcation while acting in a fiduciary capacity."

The Ninth Circuit Bankruptcy Appellate Panel upheld the nondischargeability judgment in a 37-page nonprecedential opinion. The wife's second appeal to the Ninth Circuit is pending.

The husband filed his own chapter 13 petition. In the husband's case, the trust's successor trustee filed an adversary proceeding against the husband seeking a declaration that some of the $850,000 was a nondischargeable debt owing by the husband to the trust.

The trustee for the trust filed a motion for partial summary judgment but did not contend that the judgment against the wife had preclusive effect. Instead, Judge Faris relied on undisputed facts in his December 17 opinion.

From the $850,000 that the wife had misappropriated from the trust, Judge Faris found that about $565,000 benefited the husband. Among other things, the wife used misappropriated funds to settle a lawsuit that had been pending against both the husband and wife. She also used misappropriated funds to enlarge the couple's home. In addition, she used misappropriated funds to buy a car in the husband's name.

Bartenwerfer Expands Section 523(a)(4)

The outcome turned on the interpretation of Section 523(a)(4), which provides that a "debt" is nondischargeable "for fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny." Focusing on the word "debt" in Section 523(a)(4), Judge Faris first analyzed whether the husband owed a debt to the trust.

For guidance, Judge Faris looked to *Bartenwerfer v. Buckley*, 598 U.S. 69 (2023), where the high court held a debt to be nondischargeable under Section 523(a)(2)(A) when the debtor was not the person who committed the fraud. The Supreme Court focused "on how the money was obtained, not who committed fraud to obtain it." *Id*. at 72. To read ABI's report on *Bartenwerfer*, click here.

In *Bartenwerfer*, the Supreme Court found the wife liable under state law for the debt because she was a partner with her husband. Similarly, Judge Faris examined Hawaii law and decided that the husband was liable to the trust for unjust enrichment in the amount of some $565,000. Indeed, he said that the husband had not denied "that he benefited from [his wife's] misappropriation of the trust's money."

The Passive Voice Wins the Day

Judge Faris turned to the ultimate question of whether the husband's $565,000 debt to the trust was nondischargeable under Section 523(a)(4).

Judge Faris characterized the husband as having argued "that § 523(a)(4) does not apply because he did not commit any of the types of wrongdoing described in that subsection and [the wife's] wrongdoing cannot be attributed to him."

In *Bartenwerfer*, Judge Faris said that the Supreme Court rejected the same argument because "Congress wrote § 523(a)(2) in the passive voice." In other words, he said, "[T]he identity of the actor is irrelevant. What matters is the nature of the debt."

"The same reasoning applies to subsection (4)," Judge Faris said, because "Congress wrote subsection (4) entirely in the passive voice." Continuing, he said,

> Nothing in subsection (4) specifies that the debtor must be the person who committed the wrong. If the debtor is legally responsible for the damages flowing from such wrongdoing, the debtor's liability is not dischargeable.

Judge Faris pointed to Section 523(a)(6) to buttress his conclusion. He noted how that subsection applies to a "willful and malicious injury *by the debtor* to another entity . . . ." [Emphasis

added.] The words "by the debtor," he said, show that "when Congress wanted to limit nondischargeability to the wrongdoer, it said so."

Granting partial summary judgment for the trust, Judge Faris held that the $565,000 debt for unjust enrichment was nondischargeable as to the husband under Section 523(a)(4). He distinguished cases where "nonbankruptcy law did not hold the debtor liable for the wrongdoing."

Observations

In *Bartenwerfer*, Justices Sonia Sotomayor and Ketanji Brown Jackson concurred, based on the "understanding" that nondischargeability will only be foisted on "agents" or "partners within the scope of the partnership." *Id*. at 84.

In the case before Judge Faris, the husband was neither a partner nor an agent of the wife. Not unexpectedly, the decision by Judge Faris shows that *Bartenwerfer* is being interpreted more broadly than Justices Sotomayor and Jackson would have wished.

The opinion is *Ponce v. Csigi (In re Csigi)*, 23-90019 (Bankr. D. Haw. Dec. 17, 2024).

A decision from a state or federal court before bankruptcy finding a securities law violation isn't required for nondischargeability under Section 523(a)(19).

For Nondischargeability, a Bankruptcy Court Can Find a Securities Law Violation

On a question where the lower courts are divided, the Ninth Circuit Bankruptcy Appellate Panel has decided that a prior decision by a state or federal court finding a violation of securities laws is not required for the bankruptcy court to declare that a debt is nondischargeable under Section 523(a)(19).

As Bankruptcy Judge Robert J. Faris said for the BAP in his November 25 opinion, "An order of the bankruptcy court deciding [the debtors'] liability for a securities violation under Utah law could satisfy § 523(a)(19)."

The Dischargeability Complaint

A creditor loaned $100,000 to a couple for the couple to invest. When the investment turned sour, the creditor sued the couple in state court for violation of state securities laws. Before trial, the couple filed chapter 7 petitions.

In bankruptcy court, the creditor filed a complaint alleging that the debt was nondischargeable under Sections 523(a)(2), (4), (6) and (19). Before trial, the bankruptcy judge acknowledged that courts go both ways but ruled that a finding of a securities law violation must have been made before bankruptcy by a state or federal court before the bankruptcy court can find the debt nondischargeable under Section 523(a)(19).

At trial, the creditor did not present evidence under Section 523(a)(19). After trial, the bankruptcy court found that the creditor had failed to prove a case under Sections 523(a)(2), (4) and (6). Having previously decided that Section 523(a)(19) was not available, the bankruptcy court dismissed the dischargeability complaint.

The creditor appealed to the BAP, alleging error under Sections 523(a)(2), (4), (6) and (19).

Section 523(a)(19) Is Unambiguous

In pertinent part, Section 523(a)(19) provides that a debt is not dischargeable if it

> (A) is for — (i) the violation of any of the Federal securities laws . . . , any of the State securities laws, or any regulation or order issued under such Federal or State securities laws . . . ; and
> (B) results, before, on, or after the date on which the petition was filed, from — (i) any judgment, order, consent order, or decree *entered in any Federal or State judicial or administrative proceeding* . . . .

[Emphasis added.]

Citing the *Collier* treatise and decisions by bankruptcy courts on both sides, Judge Faris recognized that there "is a split of authority both inside and outside of this circuit over whether the bankruptcy court may enter the judgment or order required by subparagraph (B)." He was also "unaware of any appellate decision directly confronting this question."

There being no controlling authority, Judge Faris began his examination "with the language of the statute itself," focusing on the words "any Federal or State judicial or administrative proceeding." He concluded,

> Nothing in the text or context of § 523(a)(19) suggests that we should deviate from the ordinary, broad meaning of the term "any." Thus, a bankruptcy judgment is "any order or judgment," and "any" federal or state proceeding includes a proceeding before a federal bankruptcy court.

Judge Faris identified reasons supporting the conclusion. "Generally," he said, "bankruptcy courts may determine both the liability on and amount of nondischargeable debts," unless "the Bankruptcy Code explicitly states otherwise." Furthermore, "civil claims against the debtor for securities law violations are within the bankruptcy court's subject matter jurisdiction."

Judge Faris ruled that the bankruptcy court committed no error in finding that the creditor had failed to prove a case under Sections 523(a)(2), (4) and (6). Finding the language in Section 523(a)(19) to be "unambiguous," he held, "An order of the bankruptcy court deciding [the debtors'] liability for a securities violation under Utah law could satisfy § 523(a)(19)."

Because the creditor had been effectively precluded at trial from introducing evidence to show a securities law violation, Judge Faris remanded "this issue to the bankruptcy court for further proceedings on [the creditor's] § 523(a)(19) claim."

The opinion is *Stehrenberger v. Stehrenberger (In re Stehrenberger)*, 23-1207 (B.A.P. 9th Cir. Nov. 25, 2024).

Sixth Circuit held that preferring one creditor with a nondischargeable claim before bankruptcy isn't intent to hinder, delay or defraud.

Aggressive Bankruptcy Planning Didn't Result in the Loss of Discharge

Aggressive bankruptcy planning won't necessarily result in a denial of discharge, as shown by a Sixth Circuit opinion reversing the bankruptcy court and directing the entry of discharge.

The Sixth Circuit's opinion dealt with a couple who didn't want their creditors to attach 2018 and 2019 federal tax refunds that amounted to about $60,000. Believing they would have tax liability for 2020, they filed their tax returns with elections for the refunds to be applied to their 2020 taxes.

The IRS Overpayment Elections

The couple were facing problems because the husband's health was deteriorating from cancer, forcing him to stop working and sell business assets to satisfy creditors' claims.

The couple's tax returns were complex because it was unclear how much they would owe in capital gains taxes from the sale of business assets that had depreciated for years. Their accountant completed and filed their returns almost one year after the April 15 deadline for tax year 2018. The tax return showed that they had overpaid their 2018 taxes by about $40,000. In the return that was filed five months before they filed their chapter 7 petition, the couple elected to have the 2018 refund applied to their 2019 taxes.

The couple testified that they applied the overpayment to 2019, believing they would owe taxes in 2019 but that creditors would garnish a 2018 refund before they could pay 2019 taxes.

The couple filed their 2019 tax return three weeks after filing their chapter 7 petition. Again, they elected for the $21,000 refund to be applied to their 2020 taxes.

The chapter 7 trustee filed a complaint to deny the debtors' discharges. With regard to the election made before bankruptcy, the trustee alleged under Section 727(a)(2)(A) that the debtors made a transfer within a year before bankruptcy with intent to hinder, delay or defraud a creditor or the trustee. Regarding the election made after filing, the complaint sought to deny the debtors' discharges under Section 727(a)(2)(B) for having made a post-petition transfer of estate property with intent to hinder, delay or defraud the trustee.

The bankruptcy court dismissed the Section 727(a)(2)(A) claim based on the pre-bankruptcy election. Finding that the couple intended to hinder the trustee by making the post-petition election, the bankruptcy court denied the couple's discharges under Section 727(a)(2)(B). *See Miller v. Wylie (In re Wylie)*, 649 B.R. 852 (Bankr. E.D. Mich. April 17, 2023). To read ABI's report, click here.

On the debtors' appeal, the district court reversed and remanded with instructions to grant discharges, because he was "left with the 'definite and firm conviction' that the bankruptcy court erred in finding that the debtors intended to hinder the trustee." *Wylie v. Miller*, 657 B.R. 602 (E.D. Mich. March 29, 2024). To read ABI's report, click here.

The trustee appealed to the circuit.

Intent to Prefer One Creditor Is Ok

In his October 23 opinion affirming the district court, Circuit Judge Richard Allen Griffin said that the "sole issue on appeal concerns the bankruptcy court's finding that the [debtors] transferred their anticipated 2019 tax refund 'with intent to hinder' the trustee," referring to Section 727(a)(2). The subsection provides that the court will deny a discharge if

> the debtor, with intent to hinder, delay, or defraud a creditor or an officer of the estate charged with custody of property under this title, has transferred (A) property of the debtor, within one year before the date of the filing of the petition; or (B) property of the estate, after the date of the filing of the petition.

To affirm the district court, Judge Griffin said he must be "left with . . . a definite and firm conviction" that the bankruptcy court's finding of intent was "clear error."

Citing the *Collier* treatise, Judge Griffin said that Section 727(a)(2) "requires culpable, specific intent to trigger the denial of discharge." Citing the Supreme Court addressing Section 523(a)(6), he said a debt will be "nondischargeable only if there was 'a deliberate or intentional *injury,* not merely a deliberate or intentional *act* that leads to injury.' In other words, 'actual intent' requires that the debtor intend "the *consequences* of an act, not simply the act itself." *Kawaauhau v. Geiger*, 523 U.S. 57, 61-62 (1998). [Emphasis in original.]

To deny discharges, Judge Griffin summarized the standards to mean there must be "a factual finding that the debtor acted 'with intent to hinder' a trustee under § 727(a)(2)(B)" along with "evidence that the debtor acted with the specific intent to make it more difficult for the trustee to facilitate creditors' collection of debts from the estate."

Judge Griffin devoted the remainder of his opinion to explaining why "the bankruptcy court's findings on credibility and intent for two similar counts under § 727(a)(2) are irreconcilable."

For the election made before bankruptcy, the bankruptcy court found no specific intent because the bankruptcy court found that the debtors only intended for their state and local taxes to be paid. Judge Griffin said that the bankruptcy court correctly decided, as a matter of law, that intending to prefer one creditor over another is not intent to defraud. As authority, he cited 6 *Collier on Bankruptcy* ¶ 727.02[3][c] ("The intent to prefer creditors is not equivalent to the intent to hinder, delay or defraud creditors.").

On the other hand, the bankruptcy court had denied discharges arising from the election made after bankruptcy, based on a finding of intent to hinder, delay or defraud the trustee.

Comparing the two findings, Judge Griffin saw "no meaningful factual differences between the 2018 and 2019 tax elections to support this different finding."

Judge Griffin cited "the bankruptcy court's own reasoning and findings, that evidence [of specific intent] was lacking," when the bankruptcy court found that the debtors were "not intimately familiar" with a trustee's duties and the Bankruptcy Code's pattern of distributions. He therefore saw "no basis to conclude that the [the debtors] even knew, let alone intended, that by trying to make sure their 2020 taxes were paid they would be hindering the trustee."

Judge Griffin affirmed the district court and remanded with instruction for the bankruptcy court to grant the debtors their discharges.

Observations

The opinion does not mean that aggressive bankruptcy planning will never result in the denial of discharge. The denial of discharge might have been upheld on appeal had there been different findings of fact based on the same evidence.

However, the case deals with debtors who made transfers designed to prefer one creditor over another. Based on the idea that intention to prefer one is not intent to defraud, the opinion could be cited for the principle that prepetition payment of a creditor with a nondischargeable claim will not result in the denial of discharge.

Note: The National Consumer Bankruptcy Rights Center and the National Association of Consumer Bankruptcy Attorneys filed an *amicus* brief in support of the debtors. The brief was submitted by attorneys from Kirkland & Ellis LLP.

The opinion is *Miller v. Wylie (In re Wylie)*, 24-1321 (6th Cir. Oct. 23, 2024).

The Tenth Circuit BAP inferred a requirement of justifiable reliance on nondischargeability for actual fraud.

BAP Holds that Nondischargeability for Actual Fraud Requires Justifiable Reliance

Parsing two decisions from the U.S. Supreme Court, the Tenth Circuit Bankruptcy Appellate Panel decided that nondischargeability for actual fraud under Section 523(a)(2)(A) demands justifiable reliance by the creditor, although reliance is not laid out as a requirement in the statute.

The relevant facts boil down to this: The debtors had insurance on their home, which burned to the ground. The insurer paid about $355,000 for the home. Presumably, the proceeds went to the holder of the mortgage in whole or in part.

The debtors had other claims for loss of use of the home and personal property, including claims for loss of a ring and a lawn mower. The insurer delivered a check of about $2,800 to the debtors, including some $1,200 for the mower. The basis for the remainder of the check was unclear from the record.

When all was said and done, the insurer paid almost $580,000 for the losses.

After tendering the check for $2,800, the insurer discovered that the debtors had submitted fraudulent documents showing ownership of the ring and the mower. However, the debtors never chased the $2,800 check, since they evidently knew the insurer suspected fraud.

The insurer sued the debtors in Colorado state court for insurance fraud. On summary judgment, the insurer won a judgment for the entire $580,000. The judgment was upheld in the state supreme court.

To prove a claim for insurance fraud under Colorado law, the insurer was only required to prove that the insureds submitted claims based on fabricated documentation. The proof entitled the insurer to void the policy and recover everything paid under the policy.

After the debtors filed a chapter 7 petition, the insurer filed an adversary proceeding to declare the $580,000 debt nondischargeable for actual fraud under Section 523(a)(2)(A). On summary judgment, the bankruptcy court ruled that the $580,000 debt was nondischargeable.

The debtor appealed, with notable success as shown in the BAP's July 11 opinion by Bankruptcy Judge Robert H. Jacobvitz.

Reliance Required for Actual Fraud

The state court judgment for $580,000 established there was a debt. Judge Jacobvitz was tasked with deciding whether the debt was nondischargeable under Section 523(a)(2)(A) for actual fraud. A debt is nondischargeable under the subsection "for money . . . to the extent obtained by — (A) false pretenses, a false representation, or actual fraud, other than a statement respecting the debtor's or an insider's financial condition."

The bankruptcy court had decided that the subsection did not require the insurer to prove reliance, because state insurance law on insurance fraud only required a false statement with intent to deceive and to induce the insurer to pay more than the loss sustained by the insured.

In substance, Judge Jacobvitz was faced with deciding whether dischargeability for actual fraud under Section 523(a)(2)(A) requires more proof than state law for insurance fraud. To find the answer, he examined two prominent cases from the Supreme Court.

In *Field v. Mans*, 516 U.S. 59 (1995), Judge Jacobvitz said that the Supreme Court "held that excepting a debt from discharge under § 523(a)(2)(A) based on a false representation requires proof of justifiable reliance."

Perhaps confusingly, *Husky International Electronics, Inc. v. Ritz*, 578 U.S. 355 (2016), might point in the other direction. Judge Jacobvitz described *Husky* as resolving "a circuit split regarding whether 'actual fraud' in § 523(a)(2)(A) necessarily requires a misrepresentation." Notably, *Husky* involved a constructively fraudulent transfer, not actual fraud.

Judge Jacobvitz interpreted *Husky* as holding that "proof of reliance is not required to except a debt from discharge under § 523(a)(2)(A) based on a fraud that is not an inducement-based fraud, such as a fraudulent conveyance scheme." Or, as we said in ABI's report on *Husky*, "a debt can be nondischargeable for 'actual fraud' under Section 523(a)(2)(A) of the Bankruptcy Code in the absence of a fraudulent misrepresentation to the creditor." To read ABI's report on *Husky*, click here.

"Read together," Judge Jacobvitz said,

> *Husky* and *Field* stand for the proposition that proof of reliance is not required by § 523(a)(2)(A) if the fraud at issue is not of a type that induces reliance, but proof of justifiable reliance is required if the fraud at issue is a false representation because that is a form of fraud that induces a creditor's reliance.

Judge Jacobvitz held that "[p]roof of justifiable reliance, therefore, is required to except a debt from discharge based on a false representation even if the creditor alleges the misrepresentation constituted 'actual fraud.'" He cited five other bankruptcy courts for reaching the same conclusion.

Judge Jacbovitz ruled that the bankruptcy court had employed the "incorrect standard" by not requiring reliance by the insurer.

Applying the standard to the case on appeal, Judge Jacobvitz divined that state insurance law required proof of a false representation. Although the record proved that the debtors had made a false representation, he found that the record did not show the insurer's reliance. Indeed, Judge Jacobvitz said there were material factual disputes precluding summary judgment regarding the insurer's justifiable reliance.

Also precluding summary judgment, Judge Jacobvitz said there was a factual dispute as to whether the insurer had incurred a loss because the debtors never cashed the check for $2,800.

Finally, the debtors argued that nondischargeable debt should be no more than $2,800, rather than the entire $580,000, because the insurer had not incurred an actual loss of $580,000. Judge Jacobvitz did not reach the question because he reversed the grant of summary judgment and remanded for further proceedings.

The opinion is *Grange Insurance Assoc. v. Woods (In re Woods)*, 23-012 (B.A.P. 10th Cir. July 11, 2024).

The Ninth Circuit didn't completely close the door to a finding in another case that student loans for a professional degree could be business debts making the debtor eligible for Subchapter V of chapter 11.

Student Loans for a Professional Degree Weren't Business Debts to Qualify for Sub V

Affirming the district court and the late Bankruptcy Judge Joseph M. Meier of Boise, Idaho, the Ninth Circuit held in a nonprecedential opinion that student loans to obtain a professional degree are not "business" debts making a debtor eligible for Subchapter V of chapter 11 when the debtor didn't have plans to own her own business after graduation.

The individual debtor had taken down $325,000 in loans to attend medical school. By the time she filed a petition under Subchapter V, the debt had grown to $650,000 with interest. The student loans amounted to almost 60% of her secured and unsecured debt.

Deciding that the debtor was not eligible for Subchapter V, Bankruptcy Judge Meier held that the loans had not arisen from commercial or business activities. *In re Reis*, 22-00517, 2023 BL 148604 (Bankr. D. Idaho May 02, 2023). To read ABI's report, click here. The district court affirmed. *Reis v. Garvin (In re Reis)*, 23-00279, 2024 BL 313941 (D. Idaho June 20, 2024). To read ABI's report, click here.

The debtor appealed, to no avail.

In a *per curiam* opinion on February 26, the Ninth Circuit explained that debtors are eligible for Subchapter V only if they then had not more than $7.5 million in secured and unsecured debt, "not less than 50 percent of which arose from the commercial or business activities of the debtor." Section 1182(1)(A) (2022).

The panel explained that the appeal only concerned whether the student loans were classified as arising "from the commercial or business activities of the debtor." The panel characterized the debtor as contending that the loans were business debts "because her medical degree was a required step in order to own and operate a medical practice."

Although today's Section 101(51)(D) does not define "business or commercial activities," the panel said it "is exceptionally broad." However, the panel said that the debtor's argument was "particularly unconvincing looking at the totality of the circumstances."

The panel pointed out that the debtor did not own her own medical practice until 10 years after graduating and incurring the debt. The opinion goes on to cite the record as "not indicat[ing] that [the debtor] had a concrete plan to open her own medical practice either at the time she took out the student loans or in the years immediately following her graduation from medical school."

"Under these circumstances," the panel upheld the lower courts, saying, "we cannot conclude that the record below was such that it demanded the bankruptcy court find that her student loan debt did indeed arise from commercial or business activity."

Observations

The panel did not close the door entirely to characterizing student loans for professional degrees as business debts. In a footnote, the panel said, "We assume without deciding that debts incurred before opening a business, including student loan debt, could qualify as debt arising from commercial or business activities."

This writer reads the opinion as concluding that the bankruptcy court had found that the loans, as a fact, were not business debts. The panel quoted the Supreme Court: "[W]here there are two permissible views of the evidence, the factfinder's choice between them cannot be clearly erroneous." *Anderson v. City of Bessemer City*, 470 U.S. 564, 574 (1985).

As this writer reads the record, there were no disputed issues of fact in bankruptcy court. Rather, the bankruptcy court arguably reached a legal conclusion based on undisputed facts.

If there were mixed questions of law and fact, *U.S. Bank NA v. Village at Lakeridge LLC*, 583 U.S. 387 (March 5, 2018), comes into play. For the unanimous Court, Justice Elena Kagan said that drawing the line between legal or factual conclusions "all depends" on whether the work of the appellate court is "primarily legal or factual." *Id*. at 396. To read ABI's report on *Lakeridge*, click here.

Assuming that the bankruptcy court's work was "primarily" legal in drawing legal conclusions based on undisputed facts, the appellate court could have undertaken *de novo* review of the bankruptcy court's legal conclusions based on undisputed facts.

Even applying *de novo* review, the Ninth Circuit panel could have agreed with the legal conclusion and upheld the lower courts.

The opinion is *Reis v. Garvin (In re Reis)*, 24-4201 (9th Cir. Feb. 26, 2025).

Automatic Stay

The Fifth Circuit undertook a legal analysis of a complex loan agreement to decide there was no 'fair ground of doubt' under Taggart that the lender was violating the discharge injunction.

A Disguised Loan Agreement Didn't Create a 'Fair Ground of Doubt' Under *Taggart*

After a chapter 7 discharge, suing on an unsecured loan agreement that had been dressed up to look like a sale of the debtor's homestead didn't let the lender off the hook under *Taggart*. In a nonprecedential opinion, the Fifth Circuit upheld the bankruptcy court's decision holding the lender in willful contempt of the discharge injunction and granting the debtor an award of damages and attorneys' fees.

The opinion is significant because the Fifth Circuit undertook a thorough legal analysis of a complex document to decide that the loan was unsecured, not secured. *The opinion could be understood to mean that advancing a plausible (but incorrect) legal argument does not avoid contempt liability by giving rise to a "fair ground of doubt" under* Taggart.

The Disguised Loans

Although the language in the documents was complex, a series of three loan agreements boiled down to this: In return for borrowing money, the debtor "sold" his homestead to the lender. At the end of the term of the loan, the debtor could repurchase the home by paying back the loan with interest. Meanwhile, the debtor could remain living in the home.

Only the first of three agreements was filed in the county land records. The three checks from the lender all had notations about a "loan."

When the debtor did not repay the loan, the lender sued in state court, aiming to obtain title to the property. The debtor filed a chapter 7 petition, listing the home as his exempt homestead. The debtor listed the lender as an unsecured creditor.

Through the lender's attorney, the lender received notice of the debtor's discharge. Despite the notice of discharge, the lender returned to state court with a motion seeking a declaration that the lender owned the home. Although the debtor told the creditor that the suit was barred by the discharge order, the lender proceeded to obtain a default judgment stating that the lender owned the home. The lender changed the locks on the home.

The debtor then filed an adversary proceeding in bankruptcy court alleging that the lender committed a willful violation of the discharge injunction.

The bankruptcy judge found the three agreements to be loans, not sales of the home. The bankruptcy court also ruled that the lender had no perfected lien and that the loans were unsecured claims. Finding a willful violation of the discharge injunction, the bankruptcy court awarded the debtor title to the property along with actual damages and attorneys' fees.

On appeal, the district court affirmed, prompting the lender's appeal to the Fifth Circuit.

No 'Fair Ground of Doubt' that the Lender Was Unsecured

The lender was evidently aware of *Taggart*, because the Fifth Circuit's *per curiam* opinion on January 28 characterized the lender as arguing that the "discharge order did not contain clear and specific language prohibiting the [lender] from seeking a declaratory judgment in [state court] that [the lender] had title to the property in question." *See Taggart v. Lorenzen*, 139 S. Ct. 1795 (2019). To read ABI's report, click here.

More particularly, the appeals court described the lender as claiming to have "an objectively reasonable basis for believing they owned the property, such that their conduct did not support a contempt holding."

To hold someone in contempt for violating the bankruptcy discharge, the Fifth Circuit quoted *Taggart* for saying "there must be no objectively reasonable basis for concluding that the creditor's conduct might be lawful under the discharge order" and that there may be no "'fair ground of doubt' as to whether the creditor's conduct might be lawful under the discharge order." *Id*. at 560, 565.

After quoting some of the language in the standard form discharge notice, the appeals court concluded that "the discharge order plainly" precluded the lender from trying to collect an unsecured loan. If it were a lien, the circuit said the lender might have had a right to foreclose.

The appeals court therefore described the question as being "whether the [lender] had an objectively reasonable basis to believe that the discharge order did not bar [the lender's] conduct."

Examining the record, the appeals court identified probative evidence to support the bankruptcy court's finding that the lender was willfully pursuing collection of an unsecured, discharged debt. The circuit court then ruled as follows:

> The [lender] thus had no objectively reasonable basis to believe [its] conduct was lawful under the discharge order, and the bankruptcy court was within its bounds to hold [the lender] in contempt and order the relief it did.

There was more. The Fifth Circuit held that the purchase and sale agreement was void under Texas law and the Texas Constitution. From the legal conclusion, the appeals court went on to say that the lender's belief that it was buying the debtor's property "was not objectively reasonable because the agreements manifestly did not comply with either the Texas Constitution or Texas property law."

Finding that the bankruptcy court's findings were "well supported by the record," the Fifth Circuit affirmed, holding that the lender had made unsecured personal loans and "thereafter willfully violated the discharge order in attempting to collect that debt without a reasonable basis to believe they could properly do so."

The opinion is *Wyly v. Eichor (In re Eichor)*, 24-20238 (5th Cir. Jan. 28, 2025).

Nondebtor releases are valid whether the creditor votes for or against the plan, as long as notice to opt out was clear and conspicuous.

Delaware Judge Sets the Standards for Nondebtor Releases Following *Purdue*

The Supreme Court's *Purdue* decision permits chapter 11 plans to contain releases of creditors' claims against nondebtors as long as (1) creditors can vote for or against the plan, and (2) the plan contains a "clear and conspicuous" notice telling creditors that they can check a box to opt out of the releases, according to an opinion by Bankruptcy Judge Craig T. Goldblatt of Delaware.

Judge Goldblatt said in his September 25 opinion that he has changed his mind about the reason why opt-outs are permissible. Last year, before the Supreme Court decided *Purdue*, he approved opting out based on the idea that failure to opt out was akin to default. *See Arsenal Intermediate Holdings, LLC*, No. 23-10097, 2023 WL 2655592 (Bankr. D. Del. Mar. 27, 2023). To read ABI's report, click here.

In the wake of *Purdue*, Judge Goldblatt believes that a nondebtor release is no longer relief that a debtor would be entitled to receive on a creditor's default. Post-*Purdue*, he believes that a creditor must manifest consent to a release, which can be accomplished if notification to the creditor was sufficient to form a contract.

The Opt-Out Plan

The debtor in Subchapter V of chapter 11 proposed a plan to which there were no objections, aside from the U.S. Trustee's complaint that the plan could not confer nondebtor, nonconsensual third-party releases unless creditors opted in.

The plan contained two classes of creditors affected by nondebtor releases. Unimpaired creditors were in a class of their own. The class contained creditors with priority claims to be paid in full and shareholders whose equity interests were not impaired by the plan. Creditors in the unimpaired class were not permitted to vote on the plan, but the plan would release their claims against nondebtors, with no ability to opt out.

The ballot for unsecured creditors contained a box allowing them to opt out. Regardless of whether a creditor voted for or against the plan, the creditor would confer nondebtor releases unless the creditor checked the opt-out box.

Judge Goldblatt said that notice about opting out was "clear and conspicuous."

Applying *Purdue*

In his 37-page opinion, Judge Goldblatt was searching for a rationale to grant nondebtor releases that holds water after *Harrington v. Purdue Pharma L.P.*, 144 S. Ct. 2071 (2024). To read ABI's report on *Purdue*, click here.

In March 2023, Judge Goldblatt had decided in *Arsenal* that creditors who "did not object to or opt out of a third-party release could essentially be 'defaulted,' with the release being imposed on them, despite their silence." He explained why his theory in *Arsenal* "does not survive *Purdue Pharma*."

After *Purdue*, Judge Goldblatt said that "a third-party release is no longer an ordinary plan provision that can properly be entered by 'default' in the absence of an objection." Following *Purdue*, he said,

> The *nonconsensual* third-party release is now *per se* unlawful. As such, it is not the kind of provision that would be imposed on a creditor on account of that creditor's default.

After *Purdue*, Judge Goldblatt said that "affirmative consent is required." Although "a number of courts have reached a contrary conclusion even after *Purdue Pharma*," he said that he "does not find their reasoning persuasive" because "these decisions provide no limiting principle on what could be accomplished by what they describe as 'consent.'"

Now that "the creditor's silence in the face of a plan and form of ballot can no longer be sufficient," Judge Goldblatt said there must be "some sort of affirmative expression of consent that would be sufficient as a matter of contract law."

What Is Affirmative Consent?

Having established that consent must be evident under principles of contract law, Judge Goldblatt first examined the unimpaired class of creditors who were granting releases without the opportunity to vote or opt out.

"[A]s a matter of ordinary contract law," Judge Goldblatt said that the "silence" of unimpaired creditors, "in the face of language in the plan telling them that they would be giving the third-party release, is insufficient to bind them to it." He therefore held that "creditors who were not solicited to vote have [not] validly consented to giving the third-party releases."

Voting Brings Affirmative Consent

Regardless of whether they voted for or against the plan, unsecured creditors were granting releases unless they checked the box to opt out.

Judge Goldblatt held that voting "is an affirmative step and, coupled with conspicuous notice of the opt-out mechanism, suffices as consent to the third-party releases under general contract principles." He said that "these creditors are in a position analogous to that of a consumer that makes a purchase over the internet, and 'clicks through' to accept the terms and conditions of the sale." Citing the Ninth Circuit, he said "that such action is typically sufficient to give rise to an enforceable agreement."

Judge Goldblatt said that the "same rationale applies to [unsecured creditors] who voted against the plan and elected not to opt out" because they "were provided clear instruction that a vote against the Plan would suffice to manifest agreement to a third-party release if they did not affirmatively opt out by marking the box on the ballot."

Since "the touchstone is whether the creditor engaged in affirmative conduct to indicate the creditor's consent," Judge Goldblatt saw "no basis to distinguish between the creditor who voted in favor of the plan from the one who voted against it."

In short, Judge Goldblatt excised releases for creditors who did not vote and were not given a chance to opt out, but he allowed releases to be given by creditors who voted for or against the plan, as long as they did not opt out.

Observations

Judge Goldblatt believes that actions sufficient to form a contract provide the basis for nondebtor releases via opt-out. This writer asks whether notice and opportunity to opt out should be subject to constitutional standards for due process. It may be, however, that rules for formation of a contract themselves satisfy constitutional standards.

If opting out carries the day around the country, the mechanics should be standard everywhere. Otherwise, the forms used throughout the country will have been drafted by a handful of firms handling the largest chapter 11 cases. Drafting should be the result of a more rigorous process from differing points of view.

Down the road, this writer recommends that there be a Bankruptcy Rule and official forms to prescribe the notice that creditors must be given to effect nondebtor releases via opting out.

The opinion is *In re Smallhold Inc.*, 24-10267 (Bankr. D. Del. Sept. 25, 2024).

Bankruptcy Judge Michelle Harner decided that a mortgage servicer must allow a chapter 13 debtor's continued use of an online payment platform.

Barring Use of an Online Payment Platform Was an Automatic Stay Violation

Bankruptcy Judge Michelle M. Harner of Baltimore decided that a mortgage servicer who barred the chapter 13 debtor from using the servicer's online payment platform had violated the automatic stay *ab initio*.

For the stay violation, Judge Harner imposed no monetary damages under Section 362(k), because the debtor had sought none.

In her October 30 opinion, Judge Harner conjectured whether "the system might benefit from a *per se* rule that mandates" use of online payment portals, but she said that "any such change must be implemented by Congress or an appropriate regulatory agency."

Online Mortgage Payments

The debtor confirmed her chapter 13 plan. Before bankruptcy, the debtor had been using the servicer's online platform to pay her mortgage. Under the plan, the debtor was paying mortgage arrears through the trustee but was paying the servicer directly for postpetition obligations.

After bankruptcy, the servicer barred the debtor from using the online payment platform, claiming that it was a convenience, not a right.

In testimony, a witness for the servicer said it was "policy" to prevent debtors from using the platform because it was "impossible" for the platform to be used by debtors and nondebtors. Perhaps the servicer was concerned that communications sent automatically by the platform might violate the automatic stay.

The debtor filed a motion to hold the servicer in contempt of the automatic stay. The debtor testified that the servicer had no office nearby, that she no longer had a car and that payments by telephone often took hours, because some customer service representatives believed she could not make payments since she was bankrupt. She also testified that mail was unreliable.

The difficulties occasioned by the loss of the platform caused the debtor to default on the mortgage. The servicer moved for a modification of the automatic stay, but the dispute was resolved by stipulation.

There was a separate agreement between the servicer and the debtor governing use of the online payment platform. The agreement said that the servicer could terminate the customer's use of the platform for violation of any agreement with the servicer or the lender. The agreement also allowed the servicer to terminate a customer's use of the platform "without notice."

Judge Harner said that barring use of the online platform made "it more difficult and time-consuming for the debtor to make her payments and removes a commonly used payment method from the debtor's toolkit."

Estate Property?

Judge Harner marched through several steps to decide whether taking away the payment platform violated the automatic stay. She began with Section 362(a)(3), which provides that the filing of the petition gives effect to an automatic stay of "any act to obtain possession of property of the estate or of property from the estate or *to exercise control over property of the estate*." [Emphasis added.]

Before delving into whether there was a stay violation, Judge Harner was obliged to decide whether removal of the platform was done to "exercise control over property of the estate." In other words, was use of the platform an estate asset, given the broad definition of estate property in Section 541(a)(1)?

"It is a well-established principle," Judge Harner said, "that a debtor's prepetition agreements (as well as her rights under those agreements) generally become property of the bankruptcy estate under section 541 of the Code." Citing Section 541(c), she went on to say, "Those interests became property of the estate notwithstanding any provision in the agreement 'that is conditioned on the insolvency or financial condition of the debtor, on the commencement of a case under this title.'"

Even if use of the portal were seen as a property interest of the servicer or a privilege, Judge Harner said, "Many courts have recognized such a contractual right to use as property of the bankruptcy estate under section 541(a) of the Code." Based on the evidence, she concluded that "the Debtor had a prepetition contractual right to use the online portal" and that the "Debtor's right to use the online portal and her interests in the Online Access Agreement came into the bankruptcy estate."

The Stay Was Violated

Having established that there was deprivation of the use of estate property, Judge Harner turned to the question of whether the servicer had violated Section 362(a)(3). She quoted the Supreme Court for having recently said that "§ 362(a)(3) halts any affirmative acts that would alter the *status quo* [of estate property] as of the time of the filing of a bankruptcy petition." *City of Chicago, Illinois v. Fulton*, 592 U.S. 154, 158 (2021).

Having concluded from the facts that the servicer had altered the *status quo*, Judge Harner next raised the question of whether the servicer's action was an "exercise of control." She decided that the action was "akin to a contract termination, which did in fact remove the value of the contract from the bankruptcy estate."

Although every breach of contract is not a stay violation, Judge Harner found "more than a mere breach." The action, she said, "effectively terminated the operative purpose of the Online Access Agreement; it was 'tantamount to a termination.'" She therefore held that the servicer had "changed the status quo and [that the violation of] the automatic stay is void *ab initio*."

Relief and Damages

In her motion, the debtor sought only injunctive relief, not monetary damages under Section 362(k). Furthermore, the record had no "discernable monetary damages to the Debtor," Judge Harner said. In addition, she said that the debtor had not "establish[ed] that she was foreclosed from making her monthly mortgage payments, including through an ACH (Automated Clearing House) or other electronic transfer from her primary bank account to the Servicer."

On the record, Judge Harner said that she could not make a finding of monetary damages under Section 362(k). However, she did "not foreclose the possibility that in a matter with a different factual record, an award of monetary damages under section 362(k), if requested, might be warranted." Furthermore, the debtor's failure "to establish monetary damages under section 362(k) of the Code does not excuse the Servicer's violation of the stay."

"The primary way to abate this violation," Judge Harner said, "is for the Servicer to restore the *status quo* and the Debtor's rights under the Online Access Agreement." On the record, though, she could not "determine whether any such remedy is appropriate or warranted." Therefore, Judge Harner called for more briefing and another hearing.

Judge Harner found herself unable to "address the underlying policy issue, namely whether and when borrowers in financial distress should lose access to online accounts and portals that they have become accustomed to using."

"To the extent that electronic payment methods (such as the online portal) facilitate greater access to credit or success in bankruptcy," Judge Harner said, "the system might benefit from a

per se rule that mandates such access. But any such change must be implemented by Congress or an appropriate regulatory agency."

The opinion is *Klemkowski v. CitiMortgage Inc. (In re Klemkowski)*, 22-10257 (Bankr. D. Md. Oct. 30, 2024).

Jurisdiction

In practical effect, the Second Circuit's opinion means that a chapter 7 debtor may never appeal denial of a motion to dismiss a petition.

Denial of a Debtor's Motion to Dismiss a Petition Isn't Appealable, Second Circuit Says

The Second Circuit held that denial of an individual chapter 7 debtor's motion to dismiss the petition is not a final order and is not subject to appeal.

True, in ordinary civil litigation, the denial of a motion to dismiss is an archetypical interlocutory order not subject to appeal. In bankruptcy, though, when could a debtor ever appeal denial of a motion to dismiss? When the case is over and the property has been distributed, an appeal would be moot.

Respectfully, the Second Circuit needs to rethink the opinion. Otherwise, the opinion could be read to mean that precious few decisions by bankruptcy judges are appealable in the Second Circuit in contested matters.

Denial of the Motion to Dismiss

The individual debtor filed a chapter 7 petition and listed debts of less than $45,000. After a change of heart, the debtor filed a motion under Section 707(a) to dismiss the petition based on several arguments, one being the debtor's claim that he was not an eligible debtor under Section 109(a).

The bankruptcy court denied the motion to dismiss, finding that dismissal was not in the interests of the estate or creditors. The debtor appealed. Without reaching the merits, the district court dismissed the appeal, holding that denial of the dismissal motion was not a final order subject to appeal under 28 U.S.C. § 158(a).

When the debtor appealed a second time, Circuit Judge Michael H. Park dismissed for lack of appellate jurisdiction.

Denial of Dismissal Didn't Finally Dispose of the Dispute — Really?

Under 28 U.S.C. § 158(d), the circuit court has jurisdiction over "all final decisions, judgments, orders, and decrees" from district courts reviewing decisions by bankruptcy courts.

In his August 8 opinion, Judge Park noted how the district court had said that the Second Circuit has not "definitively ruled" on whether denial of a motion to dismiss a bankruptcy case is a final, appealable order. He went on to mention how the district court reported that "other circuits and district courts in this Circuit have concluded that such orders are nonfinal."

Interpreting Section 158(d), Judge Park cited a 2023 decision from the Second Circuit saying that "a district court's order is not final if it 'remand[s] for significant further proceedings in bankruptcy courts,' *In re Décor Holdings, Inc.*, 86 F.4th 1021, 1024 (2d Cir. 2023) (*per curiam*)." [Note: *Décor* held that a motion reopening a default judgment was not a final order, a circumstance quite different from an order denying a debtor's motion to dismiss. In *Décor*, there was a remand for further proceedings. In the case in the Second Circuit, there was no remand for further proceedings having to do with denial of dismissal.]

Judge Park proceeded to hold that the "district court's order denying [the debtor's] motion to dismiss his petition is nonfinal because it did not 'finally dispose of [a] discrete dispute[] within the larger bankruptcy case.' *In re Penn Traffic Co.*, 466 F.3d at 77-78 (alteration omitted)." [Note: In *Penn Traffic*, the district court had reversed and remanded for the bankruptcy court to make findings on whether the debtor properly exercised business judgment in opting to reject an executory contract. Remand required the bankruptcy court to conduct significant further proceedings.]

Applying those principles to the case on appeal, Judge Park held that denial of the motion to dismiss "allowed the case to proceed and did not 'finally dispose' of any claim or dispute." [Didn't the order finally dispose of the debtor's motion to dismiss?]

Judge Park dismissed the appeal for lack of appellate jurisdiction, saying that denial of the motion to dismiss "left work to be done in the bankruptcy court."

Observations

True, denying the motion to dismiss left the bankruptcy court with the chore of administering the entire case, but the bankruptcy court was not charged with doing anything more regarding the debtor's motion to dismiss. Didn't that make the order final?

The rule set down in this case would seem to mean that a chapter 7 debtor cannot appeal denial of dismissal until the case is over, but that cannot be the law.

This writer cannot understand how or when a debtor could ever appeal denial of dismissal. Could the debtor appeal when the bankruptcy court is selling property or settling a dispute? In those circumstances, though, chapter 7 debtors are typically held to lack standing to object unless the estate is solvent.

Once estate property is sold and distributed, it would be too late for the debtor to appeal dismissal because the appeal would be moot.

The Second Circuit cited neither of the two controlling Supreme Court decisions on finality in bankruptcy, *Bullard v. Blue Hills Bank*, 575 U.S. 496 (2015), and *Ritzen Group, Inc. v. Jackson Masonry, LLC*, 589 U.S. 35 (2020). Rather, the Second Circuit's primary authorities were Second Circuit opinions handed down before *Bullard* and *Ritzen*. Notably, neither party cited *Bullard* or *Ritzen* in their briefs to the circuit.

Respectfully, this writer believes that the Second Circuit should have ruled on the merits, because denying the motion to dismiss left the bankruptcy court with no further proceedings regarding dismissal. *Compare Aspen Skiing Co. v. Cherrett (In re Cherrett)*, 873 F.3d 1060, 1065 (9th Cir. 2017) (holding that "the bankruptcy court's order denying [the debtor's] motion to dismiss under § 707(b) was final and appealable to this court.")

The opinion is *Delaney v. Messer (In re Delaney)*, 23-434 (2d Cir. Aug. 8, 2024).

A post-confirmation lawsuit to generate funds to pay a chapter 13 plan establishes 'related to' jurisdiction for noncore claims.

Third Circuit Has a Broad View of 'Related To' Jurisdiction After Plan Confirmation

The Third Circuit pronounced an expansive view of "related to" jurisdiction by allowing chapter 13 debtors to mount a lawsuit in bankruptcy court against a contractor for breach of a contract that occurred after confirmation of the couple's chapter 13 plan.

After a couple confirmed their chapter 13 plan, a fire made their home uninhabitable. They hired a contractor to repair the damage. Following the fire, the debtors fell behind on their plan payments.

After disputes arose between the contractor and the debtors, the contractor walked off the job. Based on "related to" jurisdiction, the debtors sued the contractor in bankruptcy court for breach of contract, among other claims. After trial, Bankruptcy Judge Gregory L. Taddonio issued a 137-page report and recommendation in favor of the debtors.

The district court accepted the bankruptcy court's R&R and entered judgment against the contractor. The contract appealed to the circuit, contending that the bankruptcy court had no subject matter jurisdiction.

In a nonprecedential opinion on October 1, the Third Circuit affirmed.

Under Section 157(a), district courts may refer matters to bankruptcy courts that are "arising under title 11 or arising in or related to a case under title 11 . . . ." The debtors' complaint was not "core," but a bankruptcy court, under Section 157(c)(1), "may hear a proceeding that is not a core proceeding but that is otherwise related to a case under title 11."

In defining the breadth of "related to" jurisdiction, the panel was bound by Third Circuit precedent in *Binder v. Price Waterhouse & Co.* (*In re Resorts Int'l, Inc.*), 372 F.3d 154 (3d Cir. 2004). There, the Third Circuit held that a noncore matter relates to a bankruptcy case "if the outcome could alter the debtor's rights, liabilities, options, or freedom of action . . . [or] in any way impact[] . . . the handling and administration of the bankrupt estate." *Id*. at 164.

Where there has been confirmation of a plan, the Third Circuit went on to say that the existence of "related to" jurisdiction turns on "whether there is a close nexus to the bankruptcy plan or proceeding[s] sufficient to uphold bankruptcy court jurisdiction over the matter." *Id.* at 166–67.

The Third Circuit said that a close nexus exists when the proceeding "affect[s] an integral aspect of the bankruptcy process." *Id.* at 167.

Applying the law to the facts, the panel said there was a "close nexus" to the chapter 13 plan, "an integral aspect of the bankruptcy process," because the debtors had fallen behind on plan payments. There was "related to" jurisdiction given that the debtors "could put any proceeds from the adversary proceeding towards finishing repairs on their home . . . and paying accrued arrearages on their chapter 13 plan."

"Because payment on a confirmed chapter 13 plan qualifies as an 'integral aspect' of the bankruptcy process," the panel held that "the Bankruptcy Court had related-to jurisdiction to hear the [debtors'] adversary proceeding."

Overruling other aspects of the contractor's appeal, the panel affirmed the district court's entry of judgment against the contractor.

The panel consisted of Circuit Judges Cheryl Ann Krause, Stephanos Bibas and Thomas L. Ambro.

The opinion is *Kincaid v. Gruver (In re Gruver)*, 23-1769 (3d Cir. Oct. 1, 2024).

In a split decision, the Ninth Circuit majority held that a chapter 13 debtor has the right to dismiss under Section 1307(b) before the bankruptcy court decides whether the filing was in good faith.

Even if Ineligible for Chapter 13, Ninth Circuit Says the Debtor Can Still Dismiss

Over a dissent, the majority on a Ninth Circuit panel affirmed the Bankruptcy Appellate Panel by holding that a debtor retains an "absolute right" to dismiss a chapter 13 case under Section 1307(b) even when an objecting creditor contends that the debtor filed the chapter 13 petition in bad faith and was never eligible for chapter 13.

A former employer sued the debtor before bankruptcy for breach of a noncompetition and nondisclosure agreement, together with misappropriation of trade secrets. The former employer won a judgment for about $215,000 and recorded the judgment to obtain a lien on the debtor's real property.

The debtor filed a chapter 13 petition, listing about $87,000 in unsecured debt plus $950,000 in secured debt, including $364,000 owing to the former employer. At the time, the debt limit in Section 109(e) was about $1.25 million for secured debts and about $420,000 for noncontingent, liquidated, unsecured debts.

Alleging that the debt resulted from a willful and malicious injury to property or a fraud while acting in a fiduciary capacity, the employer filed an adversary proceeding in bankruptcy court to declare that the judgment was nondischargeable. In addition, the employer alleged that the debtor had concealed assets. The employer also objected to the debtor's homestead exemption.

Rather than fight on all fronts, the debtor filed a motion to dismiss the chapter 13 case under Section 1307(b), which provides, "On request of the debtor at any time, . . . the court *shall dismiss* a case under this chapter." [Emphasis added.]

Arguing that dismissal would further the debtor's wrongdoing and that the debtor had too much unsecured debt for chapter 13, the former employer opposed dismissal and moved for conversion to chapter 7. The former employer contended that the bankruptcy judge could not dismiss the case without first holding a hearing and deciding whether the debtor was eligible for chapter 13.

Bankruptcy Judge Natalie M. Cox of Las Vegas overruled the objection and permitted dismissal. The former employer appealed, losing a second time in an opinion for the BAP by

Bankruptcy Judge Robert J. Faris. *Tico Construction Co. v. Van Meter (In re Powell)*, 644 B.R 181 (B.A.P. 9th Cir. Oct. 21, 2022). To read ABI's report, click here.

Interpreting Section 1307(b), the BAP cited the Second, Sixth and Ninth Circuits for giving a chapter 13 debtor a seemingly absolute right to dismiss a chapter 13 case that has not been previously converted from chapters 7, 11 or 12. The Ninth Circuit opinion is *Nichols v. Marana Stockyard & Livestock Market Inc. (In re Nichols)*, 10 F.4th 956 (9th Cir. Sept. 1, 2021). To read ABI's report on *Nichols*, click here. However, the BAP cited the Fifth and Eighth Circuits for holding that dismissal under Section 1307(b) may be conditioned on the debtor's good faith.

Nichols Controls

In the circuit, the former employer conceded that *Nichols* gave the debtor an "absolute right to dismiss," even if the filing were in bad faith. However, the debtor argued that the word "debtor" in Section 1107(b) must be interpreted to mean a debtor who is eligible for chapter 13.

[Note: To this writer, it appears that the former employer was asking the Ninth Circuit panel to overrule *Nichols*, without asking the circuit to sit *en banc*.]

In her majority opinion on October 1, Circuit Judge Jennifer Sung declined to decide whether "debtor" means someone eligible for chapter 13. Even if the former employer was correct, she held that "the debtor is presumptively a debtor under Chapter 13 — and the petition filing is enough to commence a Chapter 13 case under § 301(a)."

"And once a Chapter 13 case has been commenced under § 301(a)," Judge Sung held that "the debtor has an absolute right to voluntarily dismiss that case under § 1307(b), and the bankruptcy court is not required to conclusively resolve any disputes about the debtor's Chapter 13 eligibility before granting a dismissal request."

Judge Sung based her conclusion on the notion "that a case is commenced [under Section 301(a)] by the filing of a petition — not an eligibility determination by the bankruptcy court." She said that the former employer did "not identify any statutory text that requires or even suggests that the court must verify the debtor's eligibility before a dismissal can be granted under § 1307(b)."

Even if the debtor had filed under chapter 13 in bad faith, Judge Sung cited *Nichols* in holding that the filing of the petition "caused a case to be commenced under chapter 13," requiring the bankruptcy court "to dismiss [the debtor's] Chapter 13 case without further inquiry." She affirmed the BAP.

The Dissent

Circuit Judge Daniel P. Collins "respectfully" dissented. To him, it was "implicit in the language of § 103(j) and § 1307(b) that the various rights and procedures specified in Chapter 13, including the absolute right of voluntary dismissal under § 1307(b), apply only in a case that is *properly* 'under such chapter.'" [Emphasis in original.]

To Judge Collins, it made "no sense" to say that "the Code nonetheless allows the various rights contained within a given chapter to be invoked by an entity that is ineligible to proceed under that chapter." It "cannot be correct," he said, that a debtor could "brazenly falsify his schedules" and "later invoke Chapter 13's absolute right of dismissal when a creditor calls out his false statements and seeks to convert the proceedings to another chapter."

Judge Collins would have reversed.

Note: Circuit Judge Daniel P. Collins is not to be confused with Bankruptcy Judge Daniel P. Collins, who sits in Phoenix.

Observations

Allowing dismissal despite possible bad faith, the BAP alluded to the statement in *Nichols* that the bankruptcy court has "other tools" to deal with abuse. An example, the BAP said, would be imposing a bar to refiling or other conditions under Section 105(a). Another tool might be sanctions under Bankruptcy Rule 9011(c)(1)(A).

In *Caldwell v. Unified Capital Corp. (In re Rainbow Magazine, Inc.)*, 77 F.3d 278, 284 (9th Cir. 1996), the Ninth Circuit said there was "little doubt" that a bankruptcy court has "inherent power" under Section 105(a) to issue sanctions for abuse of process and vexatious conduct.

In the case on appeal, dismissal of the chapter 13 case wasn't necessarily the end of the story. After dismissal, the bankruptcy court retained the power to impose sanctions if the debtor had misbehaved.

The opinion is *Tico Construction Co. v. Van Meter (In re Powell)*, 22-60052 (9th Cir. Oct. 1, 2024).

At least with regard to standing for objections to claims, Delaware's Judge Craig Goldblatt believes that the Truck Insurance standard for chapter 11 also applies in chapter 7.

Judge Goldblatt Engrafts the Standing Rules from *Truck Insurance* onto Chapter 7

Regarding the ability of a creditor to object to claims in a chapter 7 case, the times are changing after the decision last term from the Supreme Court in *Truck Insurance Exchange v. Kaiser Gypsum Company, Inc.*, 602 U.S. 268 (2024). To read ABI's report, click here.

In 2011, a district judge in New York described the "majority rule" as holding that a creditor lacks standing to object to the claim of another creditor unless given authority from the bankruptcy court. *Pascazi v. Fiber Consultants, Inc.*, 445 B.R. 124, 129 (S.D.N.Y. 2011).

Bankruptcy Judge Craig T. Goldblatt of Delaware saw *Truck Insurance* as having overruled the majority. In a decision on October 21, he said that "§ 502(a) must be read to permit not only the chapter 7 trustee, but all parties with a direct financial stake in the outcome of a claims allowance dispute, to object to the allowance of claims." He went on to cite the *Collier* treatise for having said that creditors are parties in interest with standing to object to other creditors' claims.

Truck Insurance and Section 502(a)

Truck Insurance involved a chapter 11 case and the interpretation of Section 1109(b), which is not applicable in chapter 7 cases. For chapter 11 cases, the subsection says that a "party in interest, including the debtor, the trustee, a creditors' committee, an equity security holders' committee, *a creditor*, an equity security holder, or any indenture trustee, may raise and may appear and be heard on any issue in a case under this chapter." [Emphasis added.]

Interpreting Section 1109(b) in *Truck Insurance*, Justice Sonia Sotomayor said for the unanimous Court that the "text is capacious." She concluded that "parties in interest" refers "to entities that are potentially concerned with or affected by a proceeding." *Truck Insurance*, *supra*, 602 U.S. at 271, 276.

As long as a creditor is "potentially" affected by the chapter 11 case, the Supreme Court interpreted Section 1109(b) broadly to mean that a creditor may object to any action taken in a chapter 11 case, even if the action does not affect the objecting creditor.

However, the breadth of standing defined by the Supreme Court in *Truck Insurance* does not apply to chapter 7 cases.

The New York Case

In 2011, District Judge William H. Pauley, III, affirmed a bankruptcy court that had ruled that a creditor lacked standing to object to the claim of another creditor. *See Pascazi, supra.* Citing a decision from an Ohio bankruptcy court in 1988, he said there is "no clear consensus" on whether a creditor can object to another creditor's claim in a chapter 7 case. *Id*., 445 B.R. at 128. In chapter 7 cases, the statutory guidance for creditors' objections to claims is contained in Section 502(a), which says that a filed claim is allowed "unless a party in interest, including a creditor of a general partner in a partnership that is a debtor in a case under chapter 7 of this title, objects."

Judge Pauley conceded that a "creditor is a 'party in interest' under § 502(a) and thus, at least in theory, has standing to object to the claim of another creditor." *Id*. Contrary to the general principle, he cited a Seventh Circuit opinion from 1996 when he said there is a "significant — though not universally adopted — judicial limitation." *Id*. at 129. He proceeded to say that the "majority of courts hold that '[a]s a general rule, absent leave of court, the chapter 7 trustee alone may interpose objections to individual proofs of claim," again citing the Seventh Circuit. *Id*.

At the time, Judge Pauley saw the majority of courts as believing that a creditor may not object to a claim unless the trustee has refused to lodge an objection. Judge Pauley said he was persuaded and adopted "the majority approach," affirming the bankruptcy court's ruling that one creditor lacked standing to object to the claim of another.

Judge Goldblatt's Cut on Standing After *Truck Insurance*

In the case before Judge Goldblatt, one creditor in a chapter 7 case had objected to the allowance of the claim of another creditor. The creditor whose claim was under objection argued that the objector lacked standing. Naturally, Judge Goldblatt said that "11 U.S.C. § 502(a) states that any 'party in interest' has standing to object to the allowance of a claim in a chapter 7 case."

Regardless of the language in Section 502(a), the creditor whose claim was under objection argued that "only the chapter 7 trustee may object to proofs of claim." Citing Judge Pauley's decision, Judge Goldblatt said, "It is true that there are cases that have so held."

However, Judge Goldblatt read *Truck Insurance* to say that "'party in interest' is meant to be interpreted broadly and should include any party who is 'potentially concerned with, or affected by, a proceeding.'"

In view of *Truck Insurance*, Judge Goldblatt decided that Section 502(a) "must be read to permit not only the chapter 7 trustee, but all parties with a direct financial stake in the outcome of a claims allowance dispute, to object to the allowance of claims."

The decision by Judge Goldblatt represents his preliminary thoughts on a dispute that is boiling to the surface. Ultimately, he is likely to hold that a creditor may object to another's claim.

The opinion is *In re Team Systems International LLC*, 22-10066 (Bankr. D. Del. Oct. 21, 2024).

Plans & Confirmation

A 2/1 decision required chapter 13 debtors to accelerate repayment of nondischargeable student loans.

Fifth Circuit: Repayment of Unsecured Term Loan Sometimes Must Be Accelerated in '13'

In a split decision, the majority on the Fifth Circuit panel are requiring chapter 13 debtors to accelerate the repayment of nondischargeable student loans when there is available disposable income. As Circuit Judge Priscilla Richman said in her dissent, the majority sided with the chapter 13 trustee by requiring "repayment of long-term, non-dischargeable student loan debt . . . before it is due in order for the debtors' respective bankruptcy plans to be confirmed."

When unsecured claims can be paid in full, the opinion appears to mean that chapter 13 debtors in the Fifth Circuit must accelerate repayment of unsecured terms loans if there is available disposable income.

For better cash flow, could a chapter 13 debtor avoid the result required in the Fifth Circuit by reaffirming an unsecured term loan?

Disposable Income Enough to Pay Unsecured Claims in Full

The appeal involved two chapter 13 debtors. Both were above median income with five-year plans, and both had nondischargeable student loans. For one debtor, the student loan was "in deferment." The student loan for the other was "in forbearance."

The debtors' disposable income evidently was sufficient to pay the student loans and other unsecured debt in full over the terms of the plans. However, the plans only provided for full payment of other unsecured claims. As Judge Richman said in her dissent, the student loans would "be fully repaid under the terms of the loans, with interest," after completion of plan payments.

Writing for the majority, Circuit Judge Irma Carillo Ramirez characterized the chapter 13 trustee as having objected to confirmation because the two plans did *not* commit to paying all unsecured claims in full over the course of the plans, "even though Debtors were projected to earn enough disposable income during the applicable commitment period to pay all allowed, unsecured claims."

Taking sides with the debtors and overruling the trustee's objections, the bankruptcy judge confirmed the plans. "[A]lthough Debtors' student-loan obligations would not be paid in full during the Plans," the bankruptcy judge reasoned, "§ 1325(b)(1)(A) was nevertheless satisfied

because those obligations would be paid in full 'according to their contractual terms as permitted under § 1322(b)(5).'"

After the district court affirmed, the chapter 13 trustee appealed to the circuit.

The Statutes

For herself and Circuit Judge Andrew S. Oldman, Judge Ramirez said that chapter 13 gives debtors "a significant amount of flexibility" in their plans, quoting circuit authority. However, the outcome of the appeal turned on the interrelationship between Section 1325(b)(1)(A)-(B) and Section 1322(b)(5).

"If the trustee or the holder of an allowed unsecured claim objects to the confirmation of the plan," Section 1325(b)(1) provides that

> the court may not approve the plan unless, as of the effective date of the plan — (A) the value of the property to be distributed under the plan on account of such claim is not less than the amount of such claim; or (B) the plan provides that all of the debtor's projected disposable income to be received in the applicable commitment period beginning on the date that the first payment is due under the plan will be applied to make payments to unsecured creditors under the plan.

Although the plan was not devoting all disposable income to the payment of unsecured claims, the debtors contended they were entitled to confirmation by Section 1322(b)(5), which provides for "the curing of any default within a reasonable time and maintenance of payments while the case is pending on any unsecured claim or secured claim on which the last payment is due after the date on which the final payment under the plan is due."

Judge Ramirez quoted the *Collier* treatise for saying that "'the plan may not be confirmed unless the debtor proposes to pay into the plan all of the debtor's "disposable income" for a specified period or until all allowed unsecured claims are paid in full, whichever is earlier.'" When all disposable income is not devoted to unsecured creditors, she went on to paraphrase *Collier* for saying "that the trustee's § 1325(b)(1) objection may be overcome if the debtor proposes to pay the full value of the allowed, unsecured claims 'under the plan.'"

In both cases, the debtors were neither paying all unsecured claims in full nor were they using all of their disposable income. The question then became whether Section 1322(b)(5) was a safety valve allowing confirmation.

For Judge Ramirez, the question turned on the meaning of "under the plan," as used in both statutes. "In isolation," she said that the debtors' and the trustee's interpretations were both "reasonable."

'13' Means Paying as Much as You Can

Judge Ramirez found the answer in "Chapter 13's statutory scheme."

"On more than one occasion," Judge Ramirez said that the "Supreme Court has made clear that 'under the plan' in § 1325(a)(5)(B)(ii) means the debtor must finish paying off the value of the allowed, secured claim by the end of the plan." Citing the Fifth Circuit, she said that "provisions of Chapter 13 containing 'under the plan' show that the phrase means during the life of the plan."

In terms of policy and quoting the House Report on the amendments that gave rise to chapter 13 as we know it today, Judge Ramirez said that "BAPCPA sought 'to ensure that debtors repay creditors the maximum they can afford.'" "Section 1325(b) operates harmoniously with this purpose," she said.

"Given that § 1325(b)(1)(A)'s use of the phrase 'under the plan' means by the end date of a Chapter 13 plan," Judge Ramirez held that "the statute requires Debtors to pay in full all allowed, unsecured claims — including their student-loan obligations — within the life of the Plans."

'Shall' in 1325(b) Beats Out 'May' in 1233(b)(5)

Judge Ramirez devoted the remainder of her opinion to rebutting the debtors' arguments, beginning with the debtors' idea that the payments on student loans were "under the plans" given that they were "provided for" in the plans. Because the debtors would not be entitled to discharges until having completed all payments under the plans, she said that the debtors' contention would not allow them to have discharges until many years down the road when the student loans were paid in full, long beyond the five-year limit on chapter 13 plans.

While Section 1322(b)(5) says that the "plan may" cure and continue payments on a debt that finally comes due after the plan is over, Judge Ramirez noted that Section 1325(b) uses the word "shall." She would not allow "a permissive provision [in § 1322(b)(5) to] trump[] a mandatory one [in § 1325(b)], which runs counter to ordinary meaning and standard interpretive practices."

Judge Ramirez explained when debtors could employ Section 1322(b)(5): "Debtors may treat their student-loan obligations under § 1322(b)(5) as long as they are contributing 100% of their disposable income to paying off all allowed, unsecured claims (including the student loans)." In other words, a debtor may repay a student loan at the contract or deferral rate only when all disposable income is going to creditors.

Finding that the text in Section 1325(b)(1)(A) was "plain and unambiguous," Judge Ramierz vacated the confirmation order while allowing the "Debtors to file new plans consistent with this decision."

The Dissent

Judge Richman "respectfully" dissented, summarizing the facts as follows:

> The plans provide that all unsecured debt other than the student loans will be repaid in full during the sixty-month duration of the bankruptcy plan. The student loans, however, will be fully repaid under the terms of the loans, with interest, beyond that sixty-month period and will be paid directly to the creditors. Each of the debtors has disposable income, after allowing for one hundred-percent payment of debts during the term of the plan, that could be used to repay the full amounts of the student loans during the sixty-month duration of the plan if that debt is accelerated.

The majority's decision, Judge Richman said, meant that the "repayment of long-term, non-dischargeable student loan debt [would] be accelerated and repaid years before it is due in order for the debtors' respective bankruptcy plans to be confirmed."

Judge Richman disagreed about the interpretation of "under the plan." She said,

> The term "under the plan" as used in § 1325(b)(1)(A) is not limited to during the plan. The concept of during the plan is encompassed within, but not as broad as, "under" the plan. In other words, non-dischargeable debts can be provided for "under the plan" even though they will not be repaid during the plan.

Judge Richman went on to say that "§ 1322(b)(5) aids in understanding that bankruptcy plans may recognize that certain long-term debts are not discharged and will be repaid long after other debts are repaid and discharged under 'the plan.'" Although the wording "is admittedly clumsy," she read it to mean that "a 'plan' may recognize that a future payment or payments will continue to be due under long-term, non-dischargeable loans 'after the date on which the final payment under the plan is due.'"

Judge Richman disagreed with the majority's understanding that the debtors would not be entitled to discharges until paying the student loans in full, years after completion of the five-year plan. She explained:

> Under 11 U.S.C. § 1328(a)(1), "as soon as practicable after completion by the debtor of all payments under the plan," the court "shall grant the debtor a discharge of all debts provided for by the plan . . . except any debt . . . provided for under section 1322(b)(5)."

Judge Richman ended her opinion by taking sides with the First Circuit Bankruptcy Appellate Panel's decision in *In re Nieves*, 647 B.R. 809 (B.A.P. 1st Cir. 2023). She read the BAP as holding that "§ 1322(b)(5) permits a plan to maintain contractual payments for the remaining term of the debt even though the final payment of the debt is to be paid after the three- or five-year term of a plan." She read the BAP as saying that "the intent of Congress was clear and that requiring long-term contracts to be accelerated to be paid within a three- to five-year plan limitation would scuttle protections Congress intended to provide to homeowners and other borrowers under long-term contracts."

The opinion is *Bassel v. Durand-Day (In re Durand-Day)*, 23-10956 (5th Cir. April 21, 2025).

Bankruptcy Judge Michelle Harner decided that a mortgage servicer must allow a chapter 13 debtor's continued use of an online payment platform.

Barring Use of an Online Payment Platform Was an Automatic Stay Violation

Bankruptcy Judge Michelle M. Harner of Baltimore decided that a mortgage servicer who barred the chapter 13 debtor from using the servicer's online payment platform had violated the automatic stay *ab initio*.

For the stay violation, Judge Harner imposed no monetary damages under Section 362(k), because the debtor had sought none.

In her October 30 opinion, Judge Harner conjectured whether "the system might benefit from a *per se* rule that mandates" use of online payment portals, but she said that "any such change must be implemented by Congress or an appropriate regulatory agency."

Online Mortgage Payments

The debtor confirmed her chapter 13 plan. Before bankruptcy, the debtor had been using the servicer's online platform to pay her mortgage. Under the plan, the debtor was paying mortgage arrears through the trustee but was paying the servicer directly for postpetition obligations.

After bankruptcy, the servicer barred the debtor from using the online payment platform, claiming that it was a convenience, not a right.

In testimony, a witness for the servicer said it was "policy" to prevent debtors from using the platform because it was "impossible" for the platform to be used by debtors and nondebtors. Perhaps the servicer was concerned that communications sent automatically by the platform might violate the automatic stay.

The debtor filed a motion to hold the servicer in contempt of the automatic stay. The debtor testified that the servicer had no office nearby, that she no longer had a car and that payments by telephone often took hours, because some customer service representatives believed she could not make payments since she was bankrupt. She also testified that mail was unreliable.

The difficulties occasioned by the loss of the platform caused the debtor to default on the mortgage. The servicer moved for a modification of the automatic stay, but the dispute was resolved by stipulation.

There was a separate agreement between the servicer and the debtor governing use of the online payment platform. The agreement said that the servicer could terminate the customer's use of the platform for violation of any agreement with the servicer or the lender. The agreement also allowed the servicer to terminate a customer's use of the platform "without notice."

Judge Harner said that barring use of the online platform made "it more difficult and time-consuming for the debtor to make her payments and removes a commonly used payment method from the debtor's toolkit."

Estate Property?

Judge Harner marched through several steps to decide whether taking away the payment platform violated the automatic stay. She began with Section 362(a)(3), which provides that the filing of the petition gives effect to an automatic stay of "any act to obtain possession of property of the estate or of property from the estate or *to exercise control over property of the estate*." [Emphasis added.]

Before delving into whether there was a stay violation, Judge Harner was obliged to decide whether removal of the platform was done to "exercise control over property of the estate." In other words, was use of the platform an estate asset, given the broad definition of estate property in Section 541(a)(1)?

"It is a well-established principle," Judge Harner said, "that a debtor's prepetition agreements (as well as her rights under those agreements) generally become property of the bankruptcy estate under section 541 of the Code." Citing Section 541(c), she went on to say, "Those interests became property of the estate notwithstanding any provision in the agreement 'that is conditioned on the insolvency or financial condition of the debtor, on the commencement of a case under this title.'"

Even if use of the portal were seen as a property interest of the servicer or a privilege, Judge Harner said, "Many courts have recognized such a contractual right to use as property of the bankruptcy estate under section 541(a) of the Code." Based on the evidence, she concluded that "the Debtor had a prepetition contractual right to use the online portal" and that the "Debtor's right to use the online portal and her interests in the Online Access Agreement came into the bankruptcy estate."

The Stay Was Violated

Having established that there was deprivation of the use of estate property, Judge Harner turned to the question of whether the servicer had violated Section 362(a)(3). She quoted the Supreme Court for having recently said that "§ 362(a)(3) halts any affirmative acts that would alter the *status quo* [of estate property] as of the time of the filing of a bankruptcy petition." *City of Chicago, Illinois v. Fulton*, 592 U.S. 154, 158 (2021).

Having concluded from the facts that the servicer had altered the *status quo*, Judge Harner next raised the question of whether the servicer's action was an "exercise of control." She decided that the action was "akin to a contract termination, which did in fact remove the value of the contract from the bankruptcy estate."

Although every breach of contract is not a stay violation, Judge Harner found "more than a mere breach." The action, she said, "effectively terminated the operative purpose of the Online Access Agreement; it was 'tantamount to a termination.'" She therefore held that the servicer had "changed the status quo and [that the violation of] the automatic stay is void *ab initio*."

Relief and Damages

In her motion, the debtor sought only injunctive relief, not monetary damages under Section 362(k). Furthermore, the record had no "discernable monetary damages to the Debtor," Judge Harner said. In addition, she said that the debtor had not "establish[ed] that she was foreclosed from making her monthly mortgage payments, including through an ACH (Automated Clearing House) or other electronic transfer from her primary bank account to the Servicer."

On the record, Judge Harner said that she could not make a finding of monetary damages under Section 362(k). However, she did "not foreclose the possibility that in a matter with a different factual record, an award of monetary damages under section 362(k), if requested, might be warranted." Furthermore, the debtor's failure "to establish monetary damages under section 362(k) of the Code does not excuse the Servicer's violation of the stay."

"The primary way to abate this violation," Judge Harner said, "is for the Servicer to restore the *status quo* and the Debtor's rights under the Online Access Agreement." On the record, though, she could not "determine whether any such remedy is appropriate or warranted." Therefore, Judge Harner called for more briefing and another hearing.

Judge Harner found herself unable to "address the underlying policy issue, namely whether and when borrowers in financial distress should lose access to online accounts and portals that they have become accustomed to using."

"To the extent that electronic payment methods (such as the online portal) facilitate greater access to credit or success in bankruptcy," Judge Harner said, "the system might benefit from a

per se rule that mandates such access. But any such change must be implemented by Congress or an appropriate regulatory agency."

The opinion is *Klemkowski v. CitiMortgage Inc. (In re Klemkowski)*, 22-10257 (Bankr. D. Md. Oct. 30, 2024).

Compensation

The debtors' inequitable conduct didn't relieve counsel of the duty to disclose fees charged for post-petition litigation.

Debtors' Lawyer Has No 7th Amendment Right to Sue for Post-Petition Fees, Circuit Says

Holding that a debtor's lawyer has no Seventh Amendment right for a jury to decide what the debtor owes for fees in connection with a chapter 7 case, the Third Circuit upheld bankruptcy courts' power under Section 329 to rule on the adequacy of disclosures and determine the amount of compensation paid to attorneys by chapter 7 debtors for post-petition services.

The April 24 opinion by Circuit Judge Cheryl Ann Krause permits no exception to the rule that lawyers must disclose what they are charging chapter 7 debtors. She reversed the district court and reinstated the judgment issued by Bankruptcy Judge Jerrold N. Poslusny, Jr.

Judge Krause was also the author of a Third Circuit decision just six day earlier where she held that Section 107 "displaces" common law and more broadly protects trade secrets and confidential information than does common law. *Mesabi Metallics Co. LLC v. Cleveland-Cliffs Inc. (In re ESML Holdings Inc.)*, 23-2954 (3d Cir. April 16, 2025). Before Judge Krause's appointment to the Third Circuit in 2014, she had clerked for both the Ninth Circuit and the Supreme Court. To read ABI's report on *Mesabi*, click here.

Big Fees

The decision shows how hard cases sometimes make good law. Given what Judge Krause called their "misconduct," the debtors were not a sympathetic lot, as the facts reveal.

A couple hired a law firm to file a chapter 7 case that the debtors said "would be a simple, no-asset bankruptcy" in New Jersey. It "was anything but," Judge Krause said.

To file the petition, the debtors paid the firm a $3,500 prepetition retainer. In the disclosure on Official Form 2030, the firm said that the retainer covered "all aspects of the bankruptcy case," including adversary proceedings and contested matters.

Judge Krause characterized the firm as saying that "the Debtors 'withheld and concealed information regarding the existence and/or value of their assets,' requiring it to 'conduct[] its own extensive valuation analysis of the [debtors'] properties several times, correct[] the [debtors'] bankruptcy schedules and other submissions several times, and defend[] the [debtors] in litigation' in the Bankruptcy Court."

Given the extra work, the firm had billed the debtors $151,000 over the first 16 months after filing. The debtor and the firm cut a deal where the firm reduced the fee to $113,000. The debtors agreed to pay $100,000 from the impending sale of a home. The firm did not amend the Form 2030 filing, nor did they file a new one to disclose the billings and promised payments.

As it turned out, the couple sold the home but paid the firm nothing. "Instead," Judge Krause said, "they kept the money and used it to purchase a new home." The firm withdrew as counsel and sued the debtors in federal district court in Pennsylvania, requesting a jury trial.

After failing to transfer venue of the Pennsylvania case to New Jersey, the debtors "moved in the Bankruptcy Court in New Jersey for an examination of the reasonableness of [the firm's] fees under § 329(a) and Bankruptcy Rule 2016(b)," Judge Krause said. The firm responded by claiming to have a Seventh Amendment right to a jury trial in Pennsylvania. According to Judge Krause, the firm argued that it "did not violate § 329(a) or Bankruptcy Rule 2016(b) because it was not required to disclose post-petition legal services, and it was [the firm's] attorneys' practice not to do so."

Bankruptcy Judge Poslusny of Camden, N.J., sided with the debtors and ruled that the firm had violated Section 329(a) and Rule 2016(b) by failing to disclose the agreement to pay $113,000 in fees. He ordered the firm to disgorge whatever it had been paid and barred the firm from collecting for any other work in connection with the case. *In re Aquilino*, 20-15628, 2023 WL 2191494, at *7 (Bankr. D.N.J. Feb. 23, 2023).

The firm appealed. Reversing, the district court in New Jersey decided that the firm had the right to a jury trial because it never filed a proof of claim. *In re Aquilino*, 660 B.R. 197, 205–06 (D.N.J. 2024). To read ABI's report on the district court opinion, click here.

The debtor appealed to the circuit. The Executive Office for the U.S. Trustee and the U.S. Trustee filed an *amicus* brief contending there was no right to a jury trial and that the bankruptcy court was empowered to enforce Section 329.

The Statute and the Rule

"Given the need for transparency in bankruptcy cases," Judge Krause said,

> [t]he Code requires attorneys who represent debtors to "file with the court a statement of the compensation paid or agreed to be paid, if such payment or agreement was made after one year before the date of the filing of the petition, for services rendered or to be rendered in contemplation of or in connection with the case by such attorney." 11 U.S.C. § 329(a).

She added,

> Federal Rule of Bankruptcy Procedure 2016(b) makes this disclosure obligation "a continuing one," *In re Stewart*, 970 F.3d 1255, 1258 (10th Cir. 2020), by requiring attorneys to supplement their statements "within 14 days after any payment or agreement not previously disclosed." Fed. R. Bankr. P. 2016(b).

The two provisions yield a "plain and simple rule," Judge Krause said, quoting the Seventh Circuit:

> "[A]ttorneys must inform the bankruptcy court of their compensation and promptly update the filing if their fees change." *In re Dordevic*, 62 F.4th 340, 342 (7th Cir. 2023).

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Contrary to the firm's argument, Judge Krause had "little difficulty" deciding that the bankruptcy court had jurisdiction. She held that the dispute "arose under" the Bankruptcy Code because it was a remedy expressly provided by the Code.

Judge Krause added that "the Bankruptcy Code provides both the right and remedy, and proceedings initiated under § 329(a) therefore fall within § 157(b)(2)'s non-exclusive list of 'core' proceedings."

Having found core jurisdiction, Judge Krause turned to the question of whether the firm had a Seventh Amendment right to a jury trial. Of course, she said, "That right only attaches to claims that are 'legal in nature,' not ones that are equitable. *Granfinanciera, S.A. v. Nordberg*, 492 U.S. 33, 53 (1989)."

When the claim is both legal and equitable, Judge Krause cited *SEC v. Jarkesy*, 603 U.S. 109, 123 (2024), where the Supreme Court said that the remedy is the more important consideration. To read ABI's report, click here. Again citing *Jarkesy*, she said there is no jury trial right when the remedy is solely to restore the *status quo*. *Id*.

From *Jarkesy*, Judge Krause held that "violations of § 329(a) give rise to equitable remedies, not legal ones." Citing the Second, Fifth and Ninth Circuits, she went on to hold that "permissible sanctions for violations of § 329(a) include disgorgement of collected fees and cancellation of fee agreements for bankruptcy-related services."

Having found "a § 329(a) proceeding and a claim that is equitable," Judge Krause ruled that "the District Court erred by concluding that [the firm's] right to a jury trial in the Collection Action extended to the § 329(a) proceeding in the Bankruptcy Court."

The Equities

For several reasons, Judge Krause decided that the equities did not favor the firm. First, she said that the firm violated Section 329(a) and Rule 2016(b) "at a minimum because it was required to, and did not, disclose the Letter Agreement," where the debtors agreed to pay $113,000. Even if the firm's original Form 2030 were compliant, she said that the firm's "subsequent failure to update [the] statement and disclose the Letter Agreement unequivocally violated its disclosure obligation."

Similarly, Judge Krause decided that the bankruptcy court had not abused its discretion. Citing four circuits, she said, "Courts of Appeals that have addressed the issue have regularly held that full disgorgement and cancellation of fee agreements can be an appropriate sanction for violating the Code's disclosure requirements."

Because "the Bankruptcy Court was aware of and considered the Debtors' misconduct that necessitated" the firm's extensive services after filing, Judge Krause found no abuse of discretion, because the bankruptcy court had "considered all relevant factors, including the balance of equities."

Even though it was "a fortuitous result for the Debtors," Judge Krause "reverse[d] the District Court's judgment and . . . reinstate[d] that of the Bankruptcy Court."

The opinion is *In re Aquilino*, 24-1781 (3d Cir. April 24, 2025).**s**

Holding that a debtor's lawyer has no Seventh Amendment right for a jury to decide what the debtor owes for fees in connection with a chapter 7 case, the Third Circuit upheld bankruptcy courts' power under Section 329 to rule on the adequacy of disclosures and determine the amount of compensation paid to attorneys by chapter 7 debtors for post-petition services.

The April 24 opinion by Circuit Judge Cheryl Ann Krause permits no exception to the rule that lawyers must disclose what they are charging chapter 7 debtors. She reversed the district court and reinstated the judgment issued by Bankruptcy Judge Jerrold N. Poslusny, Jr.

Judge Krause was also the author of a Third Circuit decision just six day earlier where she held that Section 107 "displaces" common law and more broadly protects trade secrets and confidential information than does common law. *Mesabi Metallics Co. LLC v. Cleveland-Cliffs Inc. (In re ESML Holdings Inc.)*, 23-2954 (3d Cir. April 16, 2025). Before Judge Krause's appointment to the Third Circuit in 2014, she had clerked for both the Ninth Circuit and the Supreme Court. To read ABI's report on *Mesabi*, click here.

Big Fees

The decision shows how hard cases sometimes make good law. Given what Judge Krause called their "misconduct," the debtors were not a sympathetic lot, as the facts reveal.

A couple hired a law firm to file a chapter 7 case that the debtors said "would be a simple, no-asset bankruptcy" in New Jersey. It "was anything but," Judge Krause said.

To file the petition, the debtors paid the firm a $3,500 prepetition retainer. In the disclosure on Official Form 2030, the firm said that the retainer covered "all aspects of the bankruptcy case," including adversary proceedings and contested matters.

Judge Krause characterized the firm as saying that "the Debtors 'withheld and concealed information regarding the existence and/or value of their assets,' requiring it to 'conduct[] its own extensive valuation analysis of the [debtors'] properties several times, correct[] the [debtors'] bankruptcy schedules and other submissions several times, and defend[] the [debtors] in litigation' in the Bankruptcy Court."

Given the extra work, the firm had billed the debtors $151,000 over the first 16 months after filing. The debtor and the firm cut a deal where the firm reduced the fee to $113,000. The debtors agreed to pay $100,000 from the impending sale of a home. The firm did not amend the Form 2030 filing, nor did they file a new one to disclose the billings and promised payments.

As it turned out, the couple sold the home but paid the firm nothing. "Instead," Judge Krause said, "they kept the money and used it to purchase a new home." The firm withdrew as counsel and sued the debtors in federal district court in Pennsylvania, requesting a jury trial.

After failing to transfer venue of the Pennsylvania case to New Jersey, the debtors "moved in the Bankruptcy Court in New Jersey for an examination of the reasonableness of [the firm's] fees under § 329(a) and Bankruptcy Rule 2016(b)," Judge Krause said. The firm responded by claiming to have a Seventh Amendment right to a jury trial in Pennsylvania. According to Judge Krause, the firm argued that it "did not violate § 329(a) or Bankruptcy Rule 2016(b) because it was not required to disclose post-petition legal services, and it was [the firm's] attorneys' practice not to do so."

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Although lower courts have disagreed, the Second Circuit joined three other circuits in holding that a standing trustee may not retain the percentage fee when chapter 13 cases are dismissed before confirmation. Consequently, '13' debtors with confirmed plans pay standing trustees' fees.

No Circuit Split: 4 Circuits Say No '13' Trustee Fees if Dismissal Precedes Confirmation

Twenty-seven months after oral argument, the Second Circuit avoided making a circuit split, sided with three other circuits, and held that a chapter 13 standing trustee "cannot keep any percentage fee he collects from the debtor's pre-confirmation payments if no plan is confirmed."

Twelve Years and No Mortgage Payments

The lender made a first attempt at foreclosing the debtor's home in 2007. Although the bank won a judgment of foreclosure following the debtor's default, the debtor held off a foreclosure sale by filing five chapter 13 petitions between 2009 and 2017.

When the debtor filed her sixth and final chapter 13 petition in mid-2019, she had not paid her home mortgage for 12 years and was more than $450,000 in arrears. As required, the debtor began making plan payments to the chapter 13 trustee designed largely to cure arrears.

By the time the debtor had filed her motion to dismiss the chapter 13 case more than a year after filing, the debtor had paid some $362,000 to the chapter 13 trustee. Of course, the trustee had retained everything because the debtor had not confirmed a plan. After the court granted dismissal, the trustee filed a final report calling for returning about $341,000 to the debtor. The trustee intended to retain approximately $21,000 as the trustee's percentage fee.

The debtor objected, seeking an order from the bankruptcy court directing the trustee to disgorge the $21,000. The bankruptcy court sided with the trustee, allowing the trustee to retain the $21,000. *In re Soussis*, 624 B.R. 559 (Bankr. E.D.N.Y. Nov. 12, 2020). To read ABI's report, click here. The district court affirmed, portending a split of circuits. *Soussis v. Macco*, 20-05673, 2022 BL 22690, 2022 US Dist Lexis 12386, 2022 WL 203751 (E.D.N.Y. Jan. 24, 2022). To read ABI's report, click here.

The debtor appealed, and the case was well-briefed on both sides. As *amicus*, the National Consumer Bankruptcy Rights Center and the National Association of Consumer Bankruptcy Attorneys were on the debtor's side. The National Association of Chapter Thirteen Trustees was on the trustee's side.

In an impressive 47-page opinion on May 9 that merits reading in full text, Circuit Judge Susan L. Carney reversed and remanded with instructions for the trustee to return the $21,000 to the debtor. Judge Carney said she was siding with the Seventh, Ninth and Tenth Circuits. *See Marshall v. Johnson*, 100 F.4th 914 (7th Cir. 2024); *In re Evans*, 69 F.4th 1101 (9th Cir. 2023), *cert. denied sub nom. McCallister v. Evans*, 144 S. Ct. 1004 (2024); and *In re Doll*, 57 F.4th 1129 (10th Cir. 2023), *cert. denied sub nom*. *Goodman v. Doll*, 144 S. Ct. 1001 (2024). To read ABI's reports, click here, here and here.

Statutory Authority

For the benefit of the uninitiated reader, Judge Carney wrote a detailed explanation of the workings and history of chapter 13. Procedures require the debtor to begin making plan payments soon after filing, but the trustee retains the payments until plan confirmation.

The case on appeal was a matter of statutory interpretation for *de novo* review, Judge Carney said. Whether a chapter 13 trustee can retain the percentage fee paid by a debtor if the case were dismissed before confirmation turns principally on Sections 1326(a)(2) and 586(e)(2).

In pertinent part, Section 1326(a)(2) provides:

> If a plan is not confirmed, the trustee shall return any such payments not previously paid and not yet due and owing to creditors pursuant to paragraph (3) to the debtor, after deducting any unpaid claim allowed under section 503(b).

In pertinent part, Section 586(e)(2) provides that a standing chapter 13 trustee "shall collect such percentage fee from all payments received by such individual under plans in the cases under subchapter V of chapter 11 or chapter 12 or 13 of title 11 for which such individual serves as standing trustee."

Judge Carney pointed out how the inability of a chapter 13 trustee to retain collected fees in cases dismissed before confirmation does not affect the trustee's overall compensation. She explained:

> The percentage fee system does not compensate standing trustees based on the time devoted to or any other aspect of the quality or quantity of work done on a particular Chapter 13 case. Rather, the amount of the percentage fee that the trustee is authorized to "collect" turns simply on the amount of a debtor's actual payments

> to creditors. Thus, the trustee will receive less from a debtor making low monthly payments than from one making high monthly payments, whatever the distribution of the related workloads . . . .
>
> It is in the nature of this system that certain cases — those in which a debtor completes all payments and the payment amounts are large — will provide more support to the trustee and the trustee system than will other cases . . . .
>
> [T[he percentage fee protocol ensures that the standing trustee receives reasonable compensation in any given year from all of the many cases that he administers, not from any single case.

Section 1326(a)(2) Predominates

Turning to the merits, Judge Carney described the chapter 13 trustee and the U.S. Trustee as "arguing that because 28 U.S.C. § 586(e)(2) directs the standing trustee to 'collect' the fee out of all 'payments made under the plan,' the standing trustee is entitled to keep the fee, whether or not the plan is confirmed." She framed the question as whether "the percentage fee established by Section 586" that the trustee collects is "a part of the 'payments . . . proposed by the plan' that . . . the trustee must return to the debtor [under Section 1326(a)(2)] when a plan is not confirmed."

Under the "plain text of the statute," Judge Carney decided that the collected percentage fee is part of the "payments . . . proposed by the plan" that the trustee must return to the debtor. She explained,

> [I]n the Chapter 13 context, the term "payments . . . proposed by the plan," 11 U.S.C. § 1326(a)(1), means the debtor's entire schedule of monthly lump sum payments. This aggregation includes an unspecified amount for the percentage fee. Accordingly, the percentage fee — like the amounts allocated to any other line-items in the plan — must be returned to the debtor if no plan is confirmed.

Buttressing her conclusion, Judge Carney noted there were only two exceptions in Section 1326(a)(2) regarding the trustee's duty to return plan payments to the debtor: (1) payments "not previously paid and not yet due and owing to creditors"; and (2) unpaid administrative expenses under Section 503(b). The parties agreed that a chapter 13 trustee's fees are not administrative expenses, and the trustee's fees were not already owing to creditors.

Judge Carney held that "the payments in 'the amount . . . proposed by the plan' in Section 1326(a)(2) refers to the entire sum of the pre-confirmation payment, including the amounts intended to cover the trustee's percentage fees."

"Because the statute does not authorize the trustee to deduct an amount for the percentage fee," Judge Carney concluded that the collected fees "must be returned to the debtor if no plan is confirmed."

Section 586(e)(2)

Having decided that Section 1326(a)(2) pointed to victory for the debtor, Judge Carney turned to the contention by the U.S. Trustee and the chapter 13 trustee that Section 586(e)(2) "authorizes them to collect and keep the percentage fee, rather than to collect and hold it subject to some future event."

Judge Carney saw "two plausible readings" of Section 586(e)(2), one in favor of the trustee and one for the debtor. She decided that the word "collect" as used in Section 586(e)(2) was "ambiguous." Furthermore, she concluded that "Congress likely did not intend [for Section 586(e)(2)] to resolve the question posed in this case." She decided that Section 586(e)(2) "does not alter our interpretation of the text of Section 1326(a)(2), which in our view requires that the percentage fee be returned to the debtor."

In further support for her conclusion, Judge Carney noted that chapter 12 and Subchapter V of chapter 11 both explicitly allow trustees to retain fees if the case is dismissed before confirmation. She found similar support for her conclusion in the legislative histories of chapters 11, 12 and 13.

Judge Carney closed her opinion by saying that public policy evident in chapter 13 points toward returning collected fees to the debtor. She could not say that the "system is unfair to debtors who secure confirmation of a plan and complete all payments; while those debtors will pay a larger fee, they also benefit most from Chapter 13."

Judge Carney admitted that "[r]easonable minds may disagree about the wisdom of Congress's choices as a matter of public policy, [but we] are bound to apply the structure Congress has created as we understand it."

Judge Carney reversed and remanded "with instructions to the District Court to enter judgment granting [the debtor's] disgorgement motion."

Observations

Not requiring chapter 13 debtors to pay trustees' fees coincides with the idea that debtors should not be punished for attempting chapter 13. However, it is not successful chapter 13 debtors who pay trustees' fees. It's the creditors of successful debtors who pay trustees' fees.

Chapter 13 is not free for debtors whose cases are dismissed. The debtor's counsel fees are administrative expenses that are paid in dismissed cases.

Here's the policy issue for Congress: The efforts of a chapter 13 trustee can be the reason for dismissal. Should creditors of successful debtors pay chapter 13 trustees, or should debtors of dismissed cases pay?

The opinion is *Soussis v. Macco (In re Soussis)*, 22-155 (2d Cir. May 9, 2025).

Courts have at least six theories about compensation for chapter 7 trustees for valuable services rendered when the case converts to chapter 13 before the trustee has made any distributions.

What Are '7' Trustees Paid When the Case Converts to '13' Before Distributions?

Is a chapter 7 trustee paid anything if the trustee discovers nonexempt property that would pay creditors in full but the case converts to chapter 13 before the trustee makes distributions?

In his May 22 opinion, Bankruptcy Judge Robert H. Jacobvitz of Albuquerque, N.M., said that courts have adopted six theories that range from paying nothing to the commission the trustee would have earned. Judge Jacobvitz settled on an allowance governed by Section 330(a)(3) adjusted by the so-called *Johnson* factors.

The debtor filed a chapter 7 petition and scheduled her home with a value that would have resulted in a "no-asset" case with no distribution to unsecured creditors. The chapter 7 trustee suspected that the debtor had undervalued her home. So, the trustee consulted a real estate broker who concluded that the house was worth $100,000 more than the debtor's declared value.

The trustee began making arrangements to obtain court approval for retention of the broker and a sale of the home, at a price that would have paid unsecured creditors in full on their $20,000 in claims, after payment of the mortgage, the brokerage commission and the trustee's commission. To fend off a sale of the home, the debtor converted the case to chapter 13 before the home was sold or the broker was retained.

After conversion, the chapter 7 trustee filed an application for compensation, seeking payment of about $15,000 that would have been his commission had he sold the home and made distributions to the lender and unsecured creditors.

When a chapter 7 trustee has made no distributions before conversion to chapter 13, Judge Jacobvitz said that "bankruptcy courts have taken a variety of approaches" to the trustee's compensation based on six different theories. To decide which course to follow, he laid out the possibly relevant statutes.

In chapter 7, a trustee's compensation is governed by Sections 330(a)(1), 330(a)(7) and 326(a) and (c). Section 330(a)(1) permits "reasonable compensation" plus reimbursement of expenses,

but Section 330(a)(7) says that "the court shall treat such compensation as a commission, based on section 326."

In turn, Section 326(a) gives the trustee "reasonable compensation" on a sliding scale based "upon all moneys disbursed or turned over in the case by the trustee to parties in interest, excluding the debtor, but including holders of secured claims."

In the case at hand, though, Judge Jacobvitz said that the trustee "ha[d] not actually disbursed or turned over any amount to parties in interest." He decided that Section 326(a) was inapplicable because the "plain meaning of § 326(a) prevents a court from employing a legal fiction that moneys disbursed by a chapter 13 trustee to parties in interest constitute moneys disbursed by the chapter 7 trustee."

Similarly, Judge Jacobvitz decided that the "Bankruptcy Code does not permit allowance of compensation to a chapter 7 trustee in *quantum meruit*" because "Section 330, and § 326 if applicable, exclusively govern allowance of compensation to a chapter 7 trustee."

Judge Jacobvitz therefore turned to "§ 330(a)(1), pursuant to which the Court, subject to § 326, is authorized to award 'reasonable compensation' to a trustee for 'actual, necessary services rendered by the trustee' and to § 330(a)(7)," which provides that "reasonable compensation" is a commission based on Section 326. He did not see Section 326(a) as a bar to compensation because it only applies while the case is in chapter 7.

Judge Jacobvitz latched onto Section 330(a)(1) because it "expressly applies to compensation of trustees, and no other statutory provision makes § 330(a)(1) inapplicable to a chapter 7 trustee in a converted chapter 13 case who did not earn a commission while the case was pending under chapter 7."

Using Section 330(a)(1), Judge Jacobvitz applied the standards in Section 330(a)(3) together with *Johnson* factors adopted by the Tenth Circuit. He recognized that the trustee had expended 7.2 hours at his ordinary hourly rate of $250 when acting as an attorney, resulting in a "lodestar" fee of $1,800.

Even when Section 330(a)(3) and the *Johnson* factors apply, Judge Jacobvitz cited the Tenth Circuit for saying that the bankruptcy court still retains "broad discretion" in fixing a fee. He gave "particular weight" to the "substantial benefit" to the estate that the trustee had provided.

Without the trustee's investigation of the value of the home, creditors would have received nothing, but the trustee's work meant that unsecured creditors likely would be paid in full in chapter 13. Judge Jacobvitz therefore decided that "the lodestar amount should be approved and further should be adjusted upward by a $700 fee enhancement."

In total, Judge Jacobvitz awarded $2,500 plus reimbursement of expenses and the state gross receipts tax.

The opinion is *In re Cummings*, 23-10321 (Bankr. D.N.M. May 22, 2024).

Courts are split on whether chapter 7 trustees can be paid on another theory when the trustee had made no distributions to creditors under Section 326(a).

Bankruptcy Courts Disagree on Paying a '7' Trustee Who Made No Distributions

On an issue where the courts are split, Bankruptcy Judge Guy R. Humphrey of Dayton, Ohio, decided that a chapter 7 trustee was entitled to no compensation because the trustee had made no distributions to creditors, even though the chapter 7 trustee had identified assets prompting the debtor to convert to chapter 13 and file a 100% plan.

However, Judge Humphrey decided in his March 10 opinion that the chapter 7 trustee's counsel was entitled to compensation, although the trustee wasn't.

The individual debtor had filed a chapter 7 petition and claimed an exemption for her interest in a trust created by her parents. The chapter 7 trustee investigated and sought an extension of time to object to the exemption claim. The trustee was taking the approach that it was not a spendthrift trust exempt under Section 541(c)(2).

Claiming that she had received a raise at work and could afford chapter 13, the debtor moved for conversion. Initially objecting to conversion, the chapter 7 trustee later dropped her opposition, and the case converted. In chapter 13, the debtor immediately filed a 100% plan.

The chapter 7 trustee filed an application for an allowance of compensation. Counsel for the chapter 7 trustee also filed a fee application. The debtor objected, contending that the chapter 7 trustee was entitled to no compensation because she had made no distributions to creditors.

In chapter 7, a trustee's compensation is governed by Sections 330(a)(1), 330(a)(7), and 326(a) and (c). Section 330(a)(1) permits "reasonable compensation" plus reimbursement of expenses, but Section 330(a)(7) says that "the court shall treat such compensation as a commission, based on section 326."

'No Soup for You!'

Pivotal for Judge Humphrey, Section 326(a) gives the trustee "reasonable compensation" on a sliding scale based "upon all moneys disbursed or turned over in the case by the trustee to parties in interest, excluding the debtor, but including holders of secured claims."

Judge Humphrey pointed out how the BAPCPA amendments in 2005 changed the landscape for chapter 7 trustees. For the most part, the amendments favored chapter 7 trustees by locking in compensation as "a commission, based on section 326," and thereby removing other considerations under Section 330(a) that might result in reducing a trustee's compensation.

Similarly, the amendments removed chapter 7 trustees from the list of professionals subject to the factors in Section 330(a)(3). Now, the subsection only refers to trustees under chapter 11.

In the case before him, Judge Humphrey framed the question as "whether the Trustee is entitled to a statutory fee when no assets were 'disbursed or turned over' during the Chapter 7 case. 11 U.S.C. § 326(a)."

"Multiple courts," Judge Humphrey said, "have found that a Chapter 7 trustee that has not collected any assets cannot be compensated for a commission under § 326(a)." On the other hand, he acknowledged that "some courts, largely considering pre-BAPCPA law, have allowed § 326 fees to Chapter 7 trustees in this type of situation under various theories."

Judge Humphrey cited courts applying a *quantum meruit* theory, and others using a "composite trustee" approach, to compensate a chapter 7 trustee up to the maximum after first deducting the chapter 13 trustee's fee. He also cited the "lodestar" approach utilized to compensate the chapter 7 trustee in *In re Cummings*, 659 B.R. 895 (Bankr. D.N.M. May 22, 2024). To read ABI's report on *Cummings*, click here.

Judge Humphrey said that he "respectfully" disagreed with *Cummings*, because:

1) [T]he specific statutory exception and directive of § 330(a)(7) prevails over the language in § 330(a)(1); and
2) § 330(a)(3) specifically applies to Chapter 11 trustees, and does not reference a Chapter 7 trustee.

"While there may have been a basis to award such compensation prior to the enactment of BAPCPA," Judge Humphrey ruled that the trustee was not entitled to commissions because the "Chapter 7 Trustee did not distribute any funds to creditors or [turn over] such funds to parties in interest."

Ok to Pay the Chapter 7 Trustee's Counsel

Compensation for the chapter 7 trustee's counsel was a different kettle of fish, Judge Humphrey said, because counsel's fee awards are "an administrative expense under §§ 503(b)(2), 507(a)(2), and 330(a) of the Code," and Section 326(a) "does not apply to counsel to the trustee."

The debtor conceded that counsel's services were actually rendered and that the hourly rates were reasonable.

Judge Humphrey found as a fact that the trustee's investigation "did have a bearing on the Debtor's decision to convert the case to Chapter 13" and the debtor's consequent 100% plan. He also decided that the chapter 7 trustee's responsibilities did not end with the conversion motion because the trustee "was sufficiently within her responsibilities to conduct an analysis of the merits of the Debtor's motion to convert."

Judge Humphrey personally reviewed counsel's time records and allowed the requested compensation after one small deduction, because "the services benefitted the bankruptcy estate by resulting in a Chapter 13 plan providing the unsecured creditors with a 100% dividend."

The opinion is *In re Staker*, 24-30527 (Bankr. S.D. Ohio March 11, 2025).

Estate Property

Declining to create a circuit split, Third Circuit Judge Thomas Ambro held that a retirement plan structured according to ERISA is excluded from estate property even if transactions by the trust violated ERISA or IRS Code regulations.

A Retirement Plan that's Not 'Tax-Qualified' Is Still Excluded from Estate Property

Following the Fifth and Seventh Circuits, Thomas L. Ambro wrote an opinion for the Third Circuit holding that "a retirement plan governed by [the Employee Retirement Income Security Act] that is not tax-qualified is still protected by ERISA's anti-alienation bar" and does not become estate property.

In his October 24 opinion, Judge Ambro declined to make federal common law in derogation of Section 541(c)(2), which says, "A restriction on the transfer of a beneficial interest of the debtor in a trust that is enforceable under applicable nonbankruptcy law is enforceable in a case under this title."

The Governing Statutes

Before delving into the facts of the case, Judge Ambro laid out the governing statutes.

ERISA, he said, establishes the standards of conduct for those who administer retirement plans. In addition, retirement plans are given favorable tax treatment for compliance with rules promulgated under the Internal Revenue Code.

Judge Ambro rephrased Section 541(c)(2) to mean "that bankruptcy respects rules protecting trust assets from a beneficiary's creditors. If a creditor cannot access the trust outside bankruptcy, the assets remain out of its reach in bankruptcy." He cited the Supreme Court in *Patterson v. Shumate*, 504 U.S. 753 (1992), for holding that a trust established under ERISA is "a trust that is enforceable under applicable nonbankruptcy law" that takes trust property outside of the bankruptcy estate.

Violations of ERISA and the IRS Code

In his chapter 7 petition, the debtor disclosed ERISA trusts with $1.6 million in assets and claimed them to be excluded from the bankruptcy estate under Section 541(c)(2). The chapter 7

trustee filed a complaint alleging that operations of the trust violated both ERISA and the IRS Code and thus brought the trust assets into the estate.

Judge Ambro characterized Bankruptcy Judge Kathryn C. Ferguson as having "dismissed [the trustee's complaint] because 'a plain meaning reading of § 541(c)(2)' excluded the Retirement Plans from the bankruptcy estate even if they were operated contrary to ERISA and the IRC."

The district court affirmed on the same grounds, prompting the trustee's appeal to the Third Circuit in hopes of creating a circuit split.

The Question on Appeal

The trustee wanted the appeals court to reverse based on *Patterson*. The trustee read *Patterson* to mean that a retirement plan is ERISA-qualified only if it is tax-qualified and follows ERISA's rules.

Judge Ambro conceded there is a split, with two circuit courts on one side and a few bankruptcy courts on the other. He framed the question on appeal as "whether, assuming (as [the trustee] alleges) that the Retirement Plans did not comply with ERISA and the IRC, the former nonetheless provides an 'enforceable' bar to alienation of [the debtor's] interest in the Plans."

Judge Ambro Refuses to Go Beyond the Statutes

Judge Ambro said that the trustee "provides no statutory support for [his] proposition. And we see none in ERISA's text." He agreed with decisions from the Seventh and Fifth Circuits. *See In re Baker*, 114 F.3d 636, 640 (7th Cir. 1997); and *Traina v. Sewell (In re Sewell)*, 180 F.3d 707, 711 (5th Cir. 1999).

Judge Ambro described the Seventh Circuit opinion by Frank H. Easterbrook as having held that "plans governed by ERISA are excluded from the bankruptcy estate under § 541(c)(2) because of the statute's anti-alienation command," and that violations of ERISA did not make ERISA inapplicable, because what matters is the application of ERISA rather than the observation of its rules.

Judge Ambro cited bankruptcy court opinions from Maryland, Michigan and Florida that have held that violations of ERISA or IRS rules would bring trust assets into the bankruptcy estate. The most recent of these contrary opinions was issued in 2000. He said that the three opinions point "to no statute or authority suggesting that ERISA's anti-alienation bar fails to protect from misbehaving plan administrators."

Citing *Law v. Siegel*, 571 U.S. 415 (2014), Judge Ambro said that an appeal to equity must fail, because the Supreme Court held "that equity cannot be used to override bankruptcy's detailed scheme delineating the property of the bankruptcy estate."

Judge Ambro affirmed the lower courts, holding that "interests in trusts are not part of the bankruptcy estate if applicable law prohibits their alienation." There being no language in ERISA or the IRS Code "that disables those protections if a retirement plan violates ERISA's rules or is not tax-qualified," he said that Section 541(c)(2) excludes retirement plans from the bankruptcy estate, "even if their operation did not comply with ERISA and the [IRS Code]."

The opinion is *McDonnell v. Gilbert (In re Gilbert)*, 23-2944 (3d Cir. Oct. 24, 2024).

Eleventh Circuit seems to hold that a mortgage on any property with a principal residence can't be modified even if the principal use of the property is commercial.

Circuits Split: Does Anti-Modification Apply to Any Property with a Principal Residence?

Over a dissent and in disagreement with the *Collier* treatise, the Eleventh Circuit created a circuit split by holding that real property with an alternative purpose is subject to the anti-modification provisions in Section 1123(b)(5) if the real property is also the debtor's primary residence.

The May 23 opinion seems to mean that a mortgage on commercial real property cannot be modified in a chapter 11 plan when even a small part of the property is the debtor's primary residence.

The facts were simple. The debtor owned a plot of 43 acres on which her home was located. The home occupied about 2.5 acres on one edge of the property. The debtor had always leased the remaining 40.5 acres to a farmer who farmed the acreage.

The debtor defaulted on her mortgage and filed a chapter 11 petition along with a plan to modify the mortgage by pegging the property as worth $138,000, to be paid in full about 18 months after confirmation.

The mortgage lender objected to confirmation and filed a motion to modify the automatic stay. The lender contended that Section 1123(b)(5) precluded modification of the mortgage. The bankruptcy court agreed and granted the lift-stay motion. The district court affirmed.

The Majority's Meaning of "Is"

For the majority, Circuit Judge Robert J. Luck laid out the governing statutes. Section 1123(b)(5) permits a plan to "modify the rights of holders of secured claims, other than a claim secured only by a security interest in real property that is the debtor's principal residence . . . ."

In 2005, Congress added Section 101(13A)(A) to provide additional meaning for the words "principal residence." The amendment says that the "term 'debtor's principal residence' . . . means a residential structure if used as the principal residence by the debtor, including incidental property, without regard to whether that structure is attached to real property."

Judge Luck said that Section 1123(b)(5) has "three distinct requirements." (1) The security interest must be in real property; (2) the real property must be the only security for the debt; and (3) the real property must be the debtor's principal residence. He said that the third was the only requirement in dispute.

Even though most of the real property was used as a farm, he said that the third requirement was satisfied because the real property contained the debtor's principal residence.

Judge Luck cited the First and Third Circuits for having reached contrary conclusions. *Lomas Mortg., Inc. v. Louis*, 82 F.3d 1 (1st Cir. 1996); and *In re Scarborough*, 461 F.3d 406, 411 (3d Cir. 2006). He said that those courts "have read the anti-modification provision to require that the debtor use her real property *only* or *exclusively* as her principal residence and for no other purpose." [Emphasis in original.]

Judge Luck described the Third Circuit in *Scarborough* as having "reasoned that '[b]y using the word "is" in the phrase "real property that *is* the debtor's principal residence," Congress equated the terms "real property" and "principal residence."'" *Scarborough*, *supra*, 461 F.3d 411. He disagreed with the Third Circuit because "the average speaker of American English would not understand 'is' . . . to mean *only* or *exclusively* and nothing else."

In addition to relying on his understanding of the meaning of "is," Judge Luck cited the 2005 amendment for the inclusion of "incidental property" within the meaning of "primary residence." In other words, he viewed the 40.5 acres of farmland as "incidental" to the debtor's home.

Judge Luck rejected the idea that the word "only" in Section 1123(b)(5) means that the real property must be the only property that serves as the debtor's principal residence. Instead, he said that "only" is an adverb that modifies "secured."

Judge Luck also rejected the idea of using a totality-of-the-circumstances approach to determine whether the property had a "significant commercial purpose" aside from being the principal residence. He said that adopting the totality-of-the-circumstances approach would add words to the statute.

Judge Luck affirmed the district court's affirmance of the bankruptcy court's order granting relief from the automatic stay.

The Dissent's Meaning of "Is"

Chief Circuit Judge William Pryor "respectfully" dissented.

Judge Pryor began his dissent by reproducing an aerial photograph of the property to show that it was "primarily farmland" with the home on one edge. He criticized the bankruptcy court for

having said it "was immaterial that most of the secured parcel was used exclusively for commercial farming." He also criticized the bankruptcy court for believing that the farmland was "incidental property" even though the statute required that the property be used exclusively as a principal residence.

Judge Pryor interpreted Section 1123(b)(5) to mean that anti-modification "applies only to 'real property that *is* the debtor's principal residence.'" [Emphasis in original.] He undertook a lengthy grammatical analysis of "is" as a third-person singular, present tense verb.

In his way of thinking, Judge Pryor said that "'is' links a subject and a predicate so as to signify that the two are 'equal in identity,'" citing a dictionary. He quoted the *Collier* treatise for saying that anti-modification only applies if the mortgage covers the principal residence and no other property. He also saw the majority as having interpreted "is" to mean "includes."

Judge Pryor cited authorities for the proposition that anti-modification does not apply to multi-family properties. He said there could be cases that are "closer calls" to be resolved in an evidentiary hearing.

Believing that the appeals court should have remanded for the bankruptcy court to decide whether the farmland was "incidental," Judge Prior saw the majority as having erred by holding that the debtor's "40.5 acres of commercial farmland need not be her 'principal residence' for the anti-modification provision to apply."

Observations

If a debtor owns a six-unit apartment building and one unit is the debtor's principal residence, would anti-modification apply in the Eleventh Circuit? What if the debtor owns a 1,000-acre farm and farmed the land; would anti-modification apply if the debtor's principal residence was on the land?

And what if the debtor owns three acres, but a separate building on half of the plot is used as the debtor's car-repair business; would anti-modification apply?

Under the Eleventh Circuit's holding, is all contiguous property always subject to anti-modification if the debtor's principal residence is on the property? Does the Eleventh Circuit draw any lines?

The opinions are in *Lee v. U.S. Bank NA*, 21-13887 (11th Cir. May 23, 2024).

Claiming 100% of FMV didn't enable debtors to exempt more than the statutory cap when there had been no objection to the exemption claim.

Ninth Circuit Employs Equity to Avoid Following the Supreme Court's *Taylor* and *Schwab*

In a case of first impression among the circuits, the Ninth Circuit held that misrepresentations made by individuals in chapter 11 about the value of a home will allow a later chapter 7 trustee to revisit the allowance of a homestead exemption to which no timely objection had been filed.

The Ninth Circuit's July 26 decision analyzes the two prominent Supreme Court decisions regarding the finality of exemptions, *Taylor v. Freeland & Kronz*, 503 U.S. 638 (1992), and *Schwab v. Reilly*, 560 U.S. 770 (2010). The opinion by Circuit Judge Daniel A. Bress explains why the snippet from *Schwab* about claiming "100% of FMV" will not exempt the entire value of an asset when debtors in chapter 11 made misrepresentations in violation of their fiduciary duties to creditors.

The opinion is a rare example of the survival of equity to obviate an inequitable result that seemed mandated by Supreme Court authority.

The Exemption Claim of 100% of FMV

A husband and wife filed a chapter 11 petition in 2015. They claimed a federal homestead exemption that, at the time, was limited to some $46,000. They scheduled the home as being worth $165,430 and subject to a mortgage of some $131,000.

In their schedules, they stated the value of the homestead exemption as "100% of FMV." Assuming the claimed value of the home was $165,000, the entire home was indeed exempt.

There were no objections to the homestead exemption claim by the deadline following the meeting of creditors, but other facts carried the day when the case went to the Ninth Circuit.

In their chapter 11 disclosure statement and plan, the debtors made a pair of fatal representations. For the home, they stated that they were not retaining an exemption of more than the $46,000 allowed by the Bankruptcy Code. If the debtors did not make all payments called for in the plan, the plan said that the value of an asset in excess of the exemption would belong to creditors.

In 2018, more than a year after confirmation, the case converted to chapter 7 on motion of the U.S. Trustee for failure to file financial reports. Having a buyer willing to pay $400,000, the debtors filed a motion in 2021 to compel abandonment of the home. The trustee objected to abandonment and filed a motion to sell.

The bankruptcy court denied the motion to compel abandonment, granted the trustee's motion to sell and ruled that the debtors were only entitled to retain $46,000. Ultimately, the home sold for $422,000, leaving more than $220,000 in escrow to abide a final determination of whether the debtors were entitled to exempt all net proceeds.

The debtors appealed, and the Ninth Circuit Bankruptcy Appellate Panel reversed. *In re Masingale*, 644 B.R. 530 (B.A.P. 9th Cir. 2022). To read ABI's report, click here. Citing Section 522(l), Bankruptcy Rule 1019(2)(B)(i) and *Taylor*, the BAP said that "the property claimed as exempt on such list is exempt" unless "a party in interest objects."

As to the amount of the exemption, the BAP cited *Schwab* for the idea that claiming 100% of fair market value, or FMV, put parties in interest on notice that the debtors intended to claim the full value of the property as exempt.

Despite deciding that the debtors were entitled to retain the entire $220,000, the BAP indicated that it was uncomfortable with a result that allowed debtors to improperly claim an exemption above the statutory cap.

The trustee appealed to the Ninth Circuit and won.

Taylor and *Schwab*

Judge Bress stated the question as being "whether the debtors successfully exempted an above-limit interest, so that the statutory cap for the homestead exemption no longer applies."

In *Taylor*, the debtor claimed an exemption in a discrimination claim for an unknown amount. There was no objection. When the debtor eventually settled for $110,000, the trustee claimed that the proceeds were estate property.

Judge Bress cited *Taylor* for holding "that the trustee's failure to object to the claimed exemption within the 30-day timeframe prevented the trustee from challenging the validity of the exemption."

In *Schwab*, the debtor had claimed an exemption in personal property said to be worth about $11,000. The debtor claimed that the $11,000 exemption was within the limits of the Bankruptcy Code by combining tools of the trade with the wildcard exemption. There was no objection to the objection claim, but it later turned out that the personal property was actually worth some $17,000.

Deciding *Schwab*, the Supreme Court distinguished *Taylor* and allowed the trustee to retain the excess by observing that the debtor in *Taylor* had not claimed that the assets had a value within the dollar amounts permitted by the Code.

In what likely was *dicta*, the Court in *Schwab* said that the debtor would have kept everything had she claimed "100% of FMV." The Court said that a claim of this sort would have encouraged the trustee to object.

Schedule 106C

In the case before the Ninth Circuit, the debtors had filed their schedules before the amendment in 2015 to Schedule 106C. With regard to the amount of an exemption, the schedule today requires the debtor to claim a specific dollar amount or check a box saying "100% of fair market value, up to any applicable statutory limit."

Because the amendment was not in effect at the time, Judge Bress said, "we must consider the implications of a debtor claiming a '100% of FMV' exemption on a Schedule C without checking a box that limits the value to the applicable statutory limit."

Representations Count

Judge Bress said that the debtors "made critical representations within the 30-day objection period," indicating "that they were not claiming an above-limit homestead exemption, or that they would not be entitled to such an exemption until the creditors were paid in full." Those representations "were not mere legalese," he said. They were made "to convince creditors" to proceed with the plan.

As chapter 11 debtors in possession, Judge Bress said that the debtors had fiduciary obligations to their creditors. "Under these circumstances, we do not think it correct to apply *Taylor's* rule of decision," he said.

Judge Bress saw "further support" in *Taylor*, where the debtor had said that the value of the asset was unknown. Indicating that equity sometimes still has a role to play in bankruptcy, he said,

> [P]recedent does not suggest that we should endorse what happened here: debtors saying one thing about the homestead exemption on their Schedule C, saying something contradictory in their Disclosure Statement and proposed Chapter 11 Plan, and then capitalizing on the lack of any objection within the 30-day period.

"Even though *Taylor* allows debtors to secure above-limit exemptions that lack any colorable basis," Judge Bress said, "it does not justify the far greater inequity" shown in the case on appeal."

Judge Bress reversed and limited the debtors' exemption to the $46,000 statutory cap.

Observations

In this writer's view, finality is particularly critical with regard to exemptions, so that debtors can go about their lives without looking over their shoulders. The opinion seems to mean that Supreme Court authority should not be interpreted to encourage baseless exemption claims. Schedule 106C does just that by forcing debtors to take a position on the value of exempt assets. Whether Schedule 106C alters substantive rights after *Schwab* is another question.

The outcome seems to result from application of the doctrine of judicial estoppel, a term that the decision does not employ. It might have been preferable if the opinion had decided whether the holding was a proper invocation of Ninth Circuit rules about judicial estoppel. Chances are, the debtors' misrepresentations hit the bid to apply judicial estoppel.

The decision is a notable reincarnation of equity during an era when equitable powers of bankruptcy courts have been eroding. It remains to be seen whether courts will invoke equity to improve a debtor's outcome rather than to improve the recovery for creditors.

The opinion is *Munding v. Masingale (In re Masingale)*, 22-60050 (9th Cir. July 26, 2024).

If there's a constructive trust on property in the debtor's name, the debtor was only the trustee of the constructive trust and had no legal interest in the property.

A Transfer from the Debtor to a Constructive Trust Isn't a Transfer of Debtor's Property

Even when the debtor had legal title to property, the transfer of the property to a constructive trust is not a transfer of the debtor's property, for reasons explained by the Third Circuit.

Several individuals formed a corporation to buy real property. One of the owners of the corporation lent the corporation the funds necessary to purchase the property. The corporation took title to the property.

When the corporation never repaid the loan, the lender sued the corporation in state court, claiming she was the equitable owner. After trial, the state court imposed a constructive trust on the property and recognized the lender as the equitable owner because she had funded the purchase and was not repaid. The state court directed the corporation to convey title to the lender.

The state appellate court affirmed, and the Pennsylvania Supreme Court denied a petition for leave to appeal. The lender then recorded title to the property in her name.

Several months later, a creditor filed an involuntary petition against the corporation. The creditor ultimately purchased causes of action belonging to the corporation's estate. The creditor then filed an adversary proceeding against the lender, claiming that the transfer of the property was a preference or a fraudulent transfer.

Chief Bankruptcy Judge Gregory L. Taddonio of Pittsburgh granted the lender's motion for summary judgment dismissing the complaint. Judge Taddonio reasoned that the imposition of a constructive trust was not a transfer of the debtor's property, negating both a fraudulent transfer and a preference. The district court affirmed.

The Third Circuit affirmed in a *per curiam*, nonprecedential opinion on January 9.

To prevail, the appeals court cited Section 547(b) to say that the plaintiff "must demonstrate that there was a transfer of a property interest from [the debtor corporation] to [the lender]." Generally speaking, state law determines the interest, if any, that the debtor has in property.

In the case on appeal, the circuit court said,

> The beneficiary of a constructive trust is deemed to have held equitable title from the date the original owner conveyed the property, and the trustee is deemed to "have never owned the equitable interest in [the] property in the first place."

Indeed, Pennsylvania courts hold that a constructive trust is in existence at the inception of the transaction, even if a constructive trust is not judicially decreed until years later. In other words, as the Third Circuit previously said, "a constructive trust arises at the time of the relevant transaction."

By imposition of the constructive trust, the state court held that the lender was the beneficial and equitable title holder and that the debtor, as trustee, held only legal title. The "imposition of a constructive trust," the Third Circuit said, "is not a transfer of an interest from the debtor in the property."

Under state law, the Third Circuit held that the debtor "never had any equitable interest in the property to transfer." Consequently, "any transfer of bare legal title for such property is not a transfer of property of the estate."

The appeals court upheld dismissal of the preference and fraudulent transfer claims because "neither the state court's declaration that [the lender] was the property's equitable owner, nor the subsequent transfer of legal title to her, constituted a transfer of property of the estate."

The opinion is *Snyder v. Biros (In re U Lock Inc.)*, 24-1202 (3d Cir. Jan. 9, 2025).

The Eighth Circuit had held that a debtor has an 'inchoate' property interest in avoidance actions before bankruptcy, but Judge Collins ruled that a lender can't have a lien.

A Lender Can't Have a Lien on Avoidance Actions, Judge Thad Collins Says

The Fifth and Eighth Circuits ostensibly did debtors and trustees a favor by holding that Sections 541(a)(1) and (a)(7) mean that avoidance actions are estate property that may be sold. Respectfully, the circuits should have limited their holdings to Section 541(a)(7), which says that estate property includes property acquired after filing.

Invoking Section 541(a)(1), the circuits held that avoidance actions are "inchoate" property interests of the debtor "as of the commencement of the case." In reporting the Fifth Circuit opinion, we issued the following warning:

> If avoidance actions that arise after bankruptcy are estate property that is deemed to exist on the filing date under Section 541(a)(1), a prepetition secured lender might be able to obtain an enforceable lien on avoidance actions, taking valuable property away from the debtor and creditors. The lien could even sop up claims the debtor might wish to assert against the lender.

That's exactly what happened in a case before Chief Bankruptcy Judge Thad J. Collins of Cedar Rapids, Iowa. The secured lender had a security interest in general intangibles and proceeds. Citing the two circuits, the lender filed a motion to recognize the validity of the security interest in the estate's avoidance actions and any proceeds from them.

The chapter 7 trustee won when Judge Collins issued an opinion on September 9 denying the lender's motion for summary judgment.

The two circuit decisions are *Pitman Farms v. ARKK Food Co. (In re Simply Essentials)*, 78 F.4th 1006 (8th Cir. 2023); and *Briar Cap. Working Fund Cap. v. Remmert (Matter of S. Coast Supply Co.)*, 91 F.4th 376, 382 (5th Cir. 2024), *cert. denied sub nom. Remmert v. Briar Cap. Working Fund Cap., LLC.*, 144 S. Ct. 2631 (2024). To read ABI's reports, click here and here.

Given that Iowa is in the Eighth Circuit, Judge Collins was tasked with explaining why *Simply Essentials* was not controlling and why inchoate property interests do not include avoidance actions. That is what he did in his 22-page opinion.

Inchoate Property Interest

In one of the Eighth Circuit's two holdings, Judge Collins recited how the Court of Appeals said "that avoidance actions are property of the estate under § 541(a)(1) because 'the debtor has an inchoate interest in the avoidance actions prior to the commencement of the bankruptcy proceedings.'" *Simply Essentials*, *supra*, 71 F4th. at 1009. He embarked on an analysis of whether *Simply Essentials* changed the law because he cited six cases and the *Collier* treatise to say that the "weight of the case law that existed before the *Simply Essentials* decision flatly rejected the arguments [that the lender] makes here."

Judge Collins saw "nothing" in *Simply Essentials* that "changes this well-established law" because the opinion "never addressed this issue at all."

Judge Collins said that the lender read "too much" into "an inchoate interest." The lender, he said, had no independent right of recovery before filing because the right of action arose after bankruptcy and "only for the trustee or debtor in possession ('DIP') to pursue, and only for the benefit of the estate — not a single creditor." He pointed out how *Simply Essentials* said that the right of action belonged to the debtor in possession or to a trustee.

Indeed, Judge Collins went on to say that the right of action to file avoidance actions "did not and could not exist pre-petition, or ever" and "do not exist outside of bankruptcy." In fact, avoidance actions were not the debtor's property before filing. They came into being by statute and "not as a continuation of rights already held by Debtor pre-petition." Moreover, the post-petition right of action exists for the benefit of all creditors, not just one.

Judge Collins saw the lender's argument as challenging three "bedrock" principles: (1) Avoidance actions arise by statute after filing; (2) the trustee or the debtor in possession has the exclusive right to pursue avoidance actions, and (3) avoidance actions can be pursued only for the benefit of all creditors.

Recognizing the lender's argument, Judge Collins said, "would undercut or effectively gut" the principle that avoidance actions are for the benefit of the estate generally. If there were a valid lien, avoidance actions could be locked up for the benefit of one creditor.

Judge Collins said that the lender overlooked the second holding in *Simply Essentials*, where the circuit court said that avoidance actions were after-acquired property that became estate property under Section 541(a)(7). As after-acquired property, recoveries could not be "proceeds" from preexisting property. Furthermore, Section 552 would cut off the attachment of security interests in property acquired after filing.

In sum, Judge Collins said that avoidance actions "arise post-petition as after-acquired property, not proceeds." Indeed, he said that the debtor "could not have encumbered those actions pre-petition."

Judge Collins denied the lender's motion for summary judgment, effectively ruling that the lender had no security interest in avoidance actions.

Observations

Bankruptcy law may not provide the only answer to whether there can be a valid security in avoidance actions. Applying Uniform Commercial Code may result in the same answer as Judge Collins's.

To have a perfected security interest, there must be attachment, and attachment cannot occur until the borrower has an interest in the collateral. Assuming, as Judge Collins said, that a pre-filing debtor has no property interest in avoidance actions, there could have been no attachment before filing and therefore no perfected lien to survive the filing of the petition.

The opinion is *In re BDC Group Inc.*, 23-00484 (Bankr. N.D. Ia. Sept. 10, 2024).

Claims

The Ninth Circuit BAP eased the burden on debtors needing to prove that a lender violated Section 524(i) by failing to credit payments made under a plan.

Ninth Circuit Primed to Decide Whether Emotional Distress Damages Survived *Taggart*

The Ninth Circuit Bankruptcy Appellate Panel wrote a decision teeing up a case where the Ninth Circuit can decide whether a claim for intentional infliction of emotional distress from a violation of the discharge injunction survived the Supreme Court's *Taggart* decision.

The December 20 BAP opinion by Bankruptcy Judge Scott H. Gan also closed the door to loopholes that a secured creditor might use to avoid liability under Section 524(i) for failure to credit payments under a chapter 13 plan.

The Cure Required by the Plan

A couple confirmed a plan one month after filing a chapter 13 petition in 2014. When the secured creditor did not file a claim, the debtors filed a claim asserting that the arrears on their home mortgage were about $19,000. The lender never filed an amended claim.

The plan called for curing the $19,000 in arrears during the life of the chapter 11 plan and paying the mortgage currently.

At the end of the 60-month plan, the debtor had paid some $166,000, more than the $165,500 called for under the plan.

The chapter 13 trustee filed a notice of final cure payment. The lender responded with a statement saying that the debtors had paid the arrears in full and that the debtors were current on postpetition payments.

The trustee filed a final report, and the debtors received their discharges.

After discharge, the lender began rejecting the debtor's monthly mortgage payments and claimed that the mortgage was delinquent by more than $10,000. The debtors filed an adversary proceeding in bankruptcy court. The procedural machinations were complex, but here's essentially what happened.

The debtors' complaint alleged that the lender had violated the discharge injunction under Section 524(a)(2) by failing to credit the mortgage payments they made after discharge. The complaint sought damages for intentional infliction of emotional distress.

The lender responded with a motion to dismiss, which the bankruptcy court granted. *Valdellon v. Wells Fargo Bank N.A. (In re Valdellon)*, 659 B.R. 377 (Bankr. E.D. Cal. April 30, 2024). To read ABI's report, click here.

The bankruptcy court reasoned that the failure to credit post-discharge payments could not be in violation of Section 524(i), which deals with payments under a plan. The bankruptcy court also believed that *Taggart v. Lorenzen*, 139 S. Ct. 1795 (2019), obviated the possibility of having emotional distress damages for a discharge violation. To read ABI's report on *Taggart*, click here.

In discovery during the adversary proceeding, it came out that the lender was claiming the actual arrears were more than the $19,000 to be cured under the confirmed plan.

Section 524(i)

The debtors' appeal required the BAP to interpret Section 524(i), which provides,

> The willful failure of a creditor to credit payments received under a plan confirmed under this title . . . shall constitute a violation of an injunction under subsection (a)(2) if the act of the creditor to collect and failure to credit payments in the manner required by the plan caused material injury to the debtor.

Bankruptcy Rule 3002.1(f) and (g) were adopted to create a procedure where, as occurred in this case, the lender agreed with the trustee's determination that defaults had been cured.

In his opinion for the BAP, Judge Gan said that "the court may grant relief through a civil contempt order" because "§ 524(i) makes a willful failure to credit payments under a plan a violation of the discharge injunction." He analyzed the extent to which *Taggart* changed the rules for contempt of the discharge injunction.

Other than declaring there must be no fair ground of doubt about the wrongfulness of the creditor's actions, Judge Gan quoted the Ninth Circuit for saying that *Taggart* "'did not otherwise alter a movant's threshold burden of going forward.' *Mellem v. Mellem (In re Mellem)*, 625 B.R. 172, 178 (9th Cir. 2021)."

To state a claim for contempt under Section 524(i), Judge Gan said that the debtor must alleged a willful failure to credit payments received under the plan and show material injury. To determine whether the debtor's complaint alleged a plausible claim, he said, "it is not necessary for Debtors

to specify exactly how [the lender] failed to credit the payments, when the allegations are that [the lender] failed to give the arrearage payments their curative effect."

The lender, Judge Gan said, "must apply the payments to the debt in the manner directed by the plan." Requiring the debtor to show how the lender misapplied payments "would obviate the statute's purpose in cases where the creditor refuses reinstate a loan and effectuate a cure of prepetition arrears."

In the complaint, the debtors had asserted that they made all payments required by the plan and had made post-discharge payments until the lender stopped accepting their payments. "These allegations," Judge Gan said, "are plausibly suggestive of a violation of § 524(i)," because the lender "is bound by the terms of the confirmed plan" that fixed the cure at $19,000.

Furthermore, Judge Gan said, the entry of the discharge order "necessarily determined that Debtors made all payments under the plan." He therefore held that the "Debtors are not precluded from seeking relief under § 524(i)."

Did *Taggart* End Emotional Distress Damages?

Having held that the debtors were entitled to assert a discharge violation arising from Section 524(i), Judge Gan turned to the question of whether the court could award damages for emotional distress.

Citing the BAP's decision in *Ocwen Loan Servicing, LLC v. Marino (In re Marino)*, 577 B.R. 772, 788-88 (B.A.P. 9th Cir. 2017), *aff'd in part & appeal dismissed in part*, 949 F.3d 483 (9th Cir. 2020), Judge Gan said, "We have previously held that bankruptcy courts can award compensatory damages for emotional distress caused by willful violations of the discharge injunction."

Judge Gan said that the bankruptcy court had rejected the BAP's analysis in *Marino* by relying on the "old soil" statement by the Supreme Court in *Taggart*. "We do not read *Taggart* so broadly," Judge Gan said.

Taggart, Judge Gan said, "did not address the range of permissible compensatory damages available under civil contempt, nor did it hold that courts should not look to § 362(k) by analogy in deciding compensatory damages for civil contempt." He was "not persuaded that *Taggart* compels us to depart from our precedent in *Marino*."

Citing the Supreme Court precedent, Judge Gan said that the "measure of compensation for civil sanctions is not limited to pecuniary losses." He went on to say, "We expect that violations of the discharge injunction often will involve nonpecuniary damages," because one of the benefits of a discharge is "peace of mind."

Judge Gan set aside dismissal of the adversary proceeding and remanded for further proceedings.

The opinion is *Valdellon v. PHH Mortgage Corp. (In re Valdellon)*, 24-1086 (B.A.P. 9th Cir. Dec. 20, 2024).

Eighth Circuit panel disagrees about whether federal preemption bars state law claims for dismissal of an involuntary petition.

Eighth Circuit Holds that § 303(i) Damages Are Available for § 305(a) Dismissal

All three judges on an Eighth Circuit panel agreed that a debtor who wins dismissal of an involuntary petition under Section 305(a)(1) may obtain damages under Section 303(i), even though Section 305(a)(1) has no provisions for damages.

The majority on the circuit panel did not reach the question of whether federal law preempts state law claims for dismissal of an involuntary petition. The dissenter would have ruled that preemption bars claims of the sort under state law.

Before bankruptcy, the debtor had hired a law firm to sue two of his customers. After the law firm ran up $300,000 in fees and allegedly "accomplished almost nothing," the debtor fired the law firm and hired someone else.

Rather than sue to collect unpaid fees, the law firm filed an involuntary bankruptcy petition against the debtor. Instead of filing a motion to dismiss under Section 303(i), the debtor moved to dismiss under Section 305(a)(1), which is titled "Abstention." The debtor contended that dismissal would better serve "the interests of creditors and the debtor," the standard under Section 305(a)(1).

When asked by the bankruptcy court why the debtor was moving under Section 305 rather than Section 303, the debtor's counsel said that a Section 303 dismissal would require notice to all creditors under Section 303(j), while Section 305 does not require broad notice. The debtor believed that broad notice would entail reputational damage.

The bankruptcy court dismissed the involuntary petition under Section 305. Later, the debtor moved in bankruptcy court for the imposition of attorneys' fees and costs under Section 303(i)(1), but the bankruptcy court dismissed, ruling that dismissal under Section 305 does not permit damages under Section 303(i).

Around the same time, the (former) debtor sued the law firm in federal district court on diversity jurisdiction, raising state law tort claims, like abuse of process, for filing a frivolous involuntary bankruptcy petition. The district court dismissed the suit, believing that federal law preempted the state law claims.

The debtor appealed the district court's dismissal to the Eighth Circuit. [Note to readers: We have truncated the procedural history.]

Section 303 Damages Ok Under Section 305

In his August 13 opinion, Circuit Judge James B. Loken ducked the question of preemption. Instead, he said:

> [I]t [is] obvious from the structure and purpose of § 303 that Congress intended that the federal court that dismisses an involuntary case has exclusive jurisdiction to enforce the debtor remedies provided in § 303, including remedies for bad faith filings under § 303(i), and for fraudulent filings under § 303(k)(1).

However, Judge Loken saw "no reason why state tort law is irrelevant in determining whether a petitioning creditor's harassing involuntary petition was a 'bad faith' filing."

Judge Loken went on to hold "that a dismissal in the best interests of creditors under § 305(a)(1) does not preclude an involuntary debtor's subsequent damages claim under § 303(i)(2)." He then said that federal courts "will look to state tort law principles in determining an issue such as bad faith."

In short, Judge Loken found exclusive federal jurisdiction, not federal preemption.

Judge Loken upheld dismissal in the district court, because the debtor had not appealed the bankruptcy court's decision that damages under Section 303 are not available when dismissal was granted under Section 305.

The Concurrence

Chief Circuit Judge Steven M. Colloton concurred in the judgment, but he had different ideas about some of the underlying issues.

Judge Colloton would have agreed with the district court and would have dismissed by holding that the state law claims were preempted.

However, Judge Colloton agreed with the majority that damages under Section 303 are available if there is a Section 305 dismissal.

The opinion is *Stursberg v. Morrison Sund PLLC*, 23-1186 (8th Cir. Aug. 13, 2024).

An involuntary petitioner whose claim was paid after filing is still counted as an involuntary petitioner, the Ninth Circuit BAP says.

Fully Secured, Nonrecourse Creditors Can Be Involuntary Petitioners, BAP Says

On the same day, the Ninth Circuit Bankruptcy Appellate Panel issued two opinions in the same case laying down important rules for involuntary petitions:

(1) Fully secured creditors with nonrecourse claims are counted in deciding whether there are 12 or more creditors; and
(2) If a creditor has a claim on the filing date, the creditor is counted even if the claim is paid off later.

Initially, the only creditor filing the involuntary chapter 7 petition had a judgment claim for more than $7 million. Later, several other creditors filed joinders in the involuntary petition. Ultimately, the bankruptcy judge decided that there were 12 creditors with claims that were "not contingent as to liability or the subject of a bona fide dispute as to liability or amount," the standard in Section 303(b)(1) for deciding who may be an involuntary petitioner and how many involuntary petitioners there must be. If there were fewer than 12 creditors, one involuntary petitioner is enough under Section 303(b)(2).

One of the 12 creditors had a fully secured, nonrecourse claim. The creditor who first filed the involuntary petition therefore contended that the fully secured creditor should not be counted. Were that correct, there would be only 11 creditors, and one involuntary petitioner would be enough.

The bankruptcy judge decided that the fully secured creditor was counted and dismissed the involuntary petition. The petitioning creditor with the $7 million claim filed an appeal.

Fully Secured Creditors Are Counted

Writing the first of the BAP's two decisions on October 29, Bankruptcy Judge William J. Lafferty, III, found no controlling authority to resolve the first question but said that "a majority of out-of-circuit decisions . . . hold that fully secured, nonrecourse creditors are countable creditors for purposes of § 303(b)."

The outcome turned on the interpretation of Section 303(b)(1). When there are 12 or more creditors, the subsection says that the involuntary petition must be filed

> by three or more entities, each of which is either a holder of a claim against such person that is not contingent as to liability or the subject of a bona fide dispute as to liability or amount, . . . , if such noncontingent, undisputed claims aggregate at least [$18,600] more than the value of any lien on property of the debtor securing such claims held by the holders of such claims.

Judge Lafferty said that the subsection "does not explicitly differentiate between petitioning creditors and countable creditors; instead, the statute simply requires that both types of entities must qualify as 'holders.'" He decided that "cases interpreting which entities are eligible as 'holders' under § 303(b) are as relevant to the eligibility of countable creditors as they are to the eligibility of petitioning creditors."

Judge Lafferty said that the language in "§ 303(b) is explicit and specific about which entities qualify as countable creditors." Although a fully secured creditor could not be the sole involuntary petitioner, he said that "§ 303(b) does not otherwise expressly prevent fully secured creditors from qualifying as either a petitioning creditor or a countable creditor."

While a majority of courts "also support this interpretation," Judge Lafferty scrutinized but rejected two opinions holding to the contrary, both from bankruptcy courts in Texas.

Judge Lafferty found support for his conclusion both from legislative history and policy considerations. He observed that fully secured creditors were not counted under the former Bankruptcy Act. He concluded that the omission from the Bankruptcy Code was "intentional" and provided further evidence supporting his holding.

Judge Lafferty identified several policy reasons supporting his conclusion. Affirming the bankruptcy court, he held that "fully secured creditors, whether recourse or nonrecourse, qualify as countable creditors under § 303(b)."

Paid Claims Are Still Counted

Judge Lafferty's second opinion involved a creditor who was leasing a fence to the debtor for $45 a month. The creditor joined as an involuntary petitioner after the filing date but had a $45 claim on the filing date. Sometime after the filing date, a third party paid the $45 claim that existed on the filing date.

When the debtor was challenging the involuntary petition, the $45 creditor had unpaid claims that arose after filing. Later still, the $45 creditor sought to withdraw its joinder in the involuntary petition.

Relying largely on the word "holder" in Section 303(b)(1), the bankruptcy court decided that the $45 creditor could not be an involuntary petitioner because the claim that existed on the filing date had been paid. Judge Lafferty disagreed, although he said it was "a difficult question" and that he "could not find . . . any authorities directly addressing the issues raised in this appeal."

Although the word "holder" was "relevant," Judge Lafferty said that "other statutory provisions compel a different interpretation than the one reached by the bankruptcy court."

Judge Lafferty cited Section 303(c), which says that creditors join as involuntary petitioners "with the same effect as if such joining creditor were a petitioning creditor under section (b) of this section." He went on to explain why "the qualifications of petitioning creditors are assessed as of the petition date."

Judge Lafferty did "not believe that postpetition satisfaction of a party's claim necessarily renders that party a 'noncreditor.'" He cited Section 101(10), which defines a "creditor" as an "entity that has a claim against the debtor that arose at the time of or before the order for relief concerning the debtor." If an order for relief is entered, the court determines the allowance of the claim as of the date of filing.

Even if eligibility for being an involuntary creditor is not determined as of the filing date, Judge Lafferty noted that the creditor held a claim when it joined as a petitioner. Furthermore, as of the filing date, the creditor's future claims were not "contingent." Rather, they were "simply unmatured."

"Because § 303(c) does not explicitly restrict creditors holding unmatured claims from joining a petition," Judge Lafferty held, "a creditor owed a continuing obligation at the time it joins a petition **presently** holds a claim, even if a particular invoice is not due at the time the creditor files its joinder." [Emphasis in original.]

Judge Lafferty reversed the bankruptcy court for failing to count the $45 creditor among the involuntary petitioners. However, he remanded for the bankruptcy court to consider whether the creditor could withdraw its joinder in the involuntary petition.

The opinions are *Wolverine Endeavors VIII LLC v. East West Bank (In re King)*, 24-1007 and 24-1008 (B.A.P. 9th Cir. Oct. 29, 2024).

Cross-Border Insolvency

Because all affected creditors were unanimous in support, Judge Michael Wiles didn't agonize over whether the debtor actually had its center of main interests in the U.K.

Foreign Main Recognition in Chapter 15 Is Easy When No One Objects

When no affected creditors objected, a decision from the bankruptcy court in New York could be read to mean that foreign main recognition in a chapter 15 case will be granted even if the foreign proceeding was pending in a country where the debtor arguably did not have its center of main interests.

The parent was a Mexican financial services company headquartered in Guadalajara. The parent had issued notes in 2020 under an indenture governed by New York law.

The parent negotiated a restructuring with holders of 25% of the U.S. notes. The deal left all creditors of the parent unaffected aside from holders of the U.S. notes. The holders were to receive either partial cash payments or new equity, plus the option to purchase new notes issued by the parent.

Creating a U.K. Subsidiary

In his February 24 opinion, Bankruptcy Judge Michael E. Wiles explained how the parent and the holders faced a problem in effectuating the deal. Among the available jurisdictions, he said that "most of those laws would not have permitted a surgical restructuring of just the U.S. Notes." However, he said,

> U.K. laws permit the approval of a consensual scheme of arrangement that deals with a single set of note obligations, and pursuing such a scheme of arrangement in the English Court also promised to be less expensive and time-consuming than other alternatives.

However, the parent had no connections with the U.K., a requirement for approval of a U.K. scheme of arrangement. To avail itself of U.K. law, the parent incorporated a subsidiary in the U.K. with a registered office in London. Destined to become the debtor, the subsidiary made itself an additional obligor on the U.S. notes, with the right to contribution from the parent for payments on the U.S. notes.

With appearances by 75% of the holders in the U.K court, the subsidiary proposed a scheme of arrangement that was approved without objection and with unanimous support by voting noteholders.

The subsidiary filed a chapter 15 petition in New York seeking foreign main recognition and enforcement of the scheme of arrangement in the U.S. No noteholders objected to recognition, but Judge Wiles was concerned that if he "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."

Two Versions of Foreign Recognition

There are two forms of recognition under chapter 15, foreign nonmain recognition and foreign main recognition.

For foreign nonmain recognition, Judge Wiles said that Sections 1517(b)(2) and 1502 require "an 'establishment' [that] must be an actual place from which economic market-facing activities are regularly conducted," but the subsidiary had "never engaged in any business" in the U.K., and "restructuring activities . . . are not themselves sufficient to show the existence of an 'establishment' in the U.K."

For foreign main recognition, Judge Wiles said that the foreign proceeding must have "tak[en] place in the jurisdiction where the debtor has its center of main interests, or COMI," under Sections 1502(4) and 1517(b)(1).

With regard to the subsidiary, Judge Wiles observed that its registered office was in London and that there was "no 'contrary evidence' in the record before me that indicates that [the subsidiary's] own COMI is located outside the United Kingdom." He said that the "restructuring activities apparently are the only activities in which [the subsidiary] has ever engaged" and "may be considered in determining whether its COMI is in the U.K."

Still, Judge Wiles saw "significant risks in the structure that has been used here" because "the whole structure admittedly was created for the purpose of restructuring the U.S. Notes issued by the Parent."

Were he to grant foreign main recognition regardless of the circumstances, Judge Wiles said that a company "could restructure its obligations anywhere it chose without even subjecting itself to a foreign proceeding" simply by forming "a new subsidiary in a jurisdiction of its choice and then cause that new subsidiary to assume the parent company's obligations." In those circumstances, the "parent company's COMI would no longer be relevant to the parent's restructuring of its debts."

In the case before him, Judge Wiles saw no "frustration or thwarting of creditor rights." Indeed, he said that the proceedings were pursued "for laudable objectives" and enforcement of the U.K. scheme would be "fully consistent with the stated purposes of Chapter 15. See 11 U.S.C. § 1501(a)."

In cases of the sort, Judge Wiles said that "one of the main factors I ought to consider . . . is whether the affected creditors have asserted any objection." There having been no objections, it "would be absurd for me to thwart the creditors' constructive desires and expectations in the guise of supposedly protecting them."

Judge Wiles granted foreign main recognition and enforced the scheme in the U.S., in view of the "overwhelming consent to the English Scheme Proceeding and the approval of the Scheme of Arrangement." He saw "no cause . . . to look past the form of the transactions or to pursue theoretical issues that no affected party wishes to pursue."

The opinion is *In re Mega Newco Ltd.*, 24-12031 (Bankr. S.D.N.Y. Feb. 24, 2025).

Foreign reorganizations with nondebtor releases are not 'manifestly contrary' to public policy after Purdue, according to Delaware's Bankruptcy Judge Thomas Horan.

Nondebtor Releases Are Still Permissible in Chapter 15, Delaware Judge Says

The *Purdue* decision from the Supreme Court banning nonconsensual releases of nondebtors does not preclude a U.S. bankruptcy court in chapter 15 from enforcing foreign plans with nondebtor releases, for reasons explained by Bankruptcy Judge Thomas M. Horan of Delaware.

In his April 1 opinion, Judge Horan described how the "*Purdue* Court held that [Section 1123(b)(6)] does not allow a chapter 11 plan to include nonconsensual third-party releases." Distinguishing the language in Section 1123(b)(6) from the relevant provisions in chapter 15, he held that "the plain language of both section 1521(a)(7) and section 1507(a) permit a U.S. court to enforce a foreign order for nonconsensual third-party releases."

The Mexican Plan

The debtor was one of Mexico's largest nonbank lenders. Financial problems began in 2021 and led to a liquidation proceeding in a Mexican court in 2022. Discussions culminated when the debtor, the Mexican liquidators and an *ad hoc* group of creditors developed a restructuring support agreement. The Mexican liquidator then commenced a proceeding in Mexico to implement the prepackaged plan.

When the plan received support from almost 57% of creditors, the Mexican court overruled objections and approved the prepackaged plan.

The plan contained releases for the *ad hoc* committee members, the Mexican liquidator, the indenture trustee and related parties. The releases barred claims for actions taken during the restructuring. Judge Horan said the releases were "customary in Mexican settlement agreements and . . . permitted under Mexican Bankruptcy Law."

An agency of the U.S. government, the U.S. International Development Finance Corporation, or DFC, had objected unsuccessfully to the Mexican court's approval of the plan. Until appealing in Mexico, the DFC had not objected to the nondebtor releases. The DFC's appeal remains pending in Mexico.

The debtor's foreign representative commenced the chapter 15 case in early February, seeking foreign main recognition and enforcement of the Mexican plan and its releases in the U.S. The DFC lodged the only objection to recognition.

Judge Horan characterized the DFC as contending that the releases are "not authorized under Bankruptcy Code sections 1507 and 1521" and that "appropriate relief" available to a foreign debtor "refers to relief available under the Bankruptcy Code."

Sections 1501, 1506, 1507 and 1521(a)

The outcome turned primarily on four sections in chapter 15. Section 1507(a) provides that the bankruptcy court "may provide additional assistance to a foreign representative . . . ." Upon recognition, Section 1521(a) similarly provides that the court "may . . . grant any appropriate relief, including" seven specific types of relief.

"In determining whether to provide additional assistance," Section 1507(b) directs the U.S. court to "consider whether such additional assistance [is] consistent with the principles of comity."

In addition, Section 1501 states that one of the purposes of chapter 15 is to promote "cooperation" with courts abroad. On the other hand, Section 1506 allows the court to refuse "to take an action governed by this chapter if the action would be manifestly contrary to the public policy of the United States."

In deciding how to rule, Judge Horan said he would "consider[] the centrality of cooperation and comity in reaching [his] decision" and "maximize assistance to the foreign court conducting the foreign main proceeding."

Regarding Section 1506, Judge Horan said that the foreign proceeding must "afford litigants the same fundamental protections that they would have received in a U.S. court," but that the relief need not "be identical to relief that might be available in a U.S. proceeding."

The Differences Between Chapters 11 and 15

For Judge Horan, the question was whether "*Purdue* changes the way courts should interpret sections 1521(a) and 1507," given the Supreme Court's conclusion that Section 1123(b)(6) "does not allow a chapter 11 plan to include nonconsensual third-party releases." The DFC wanted him to apply the same analysis to chapter 15, because Sections 1521(a)(7) and 1507(a) are "catchalls," just like Section 1123(b)(6).

Judge Horan answered the argument by stressing the linguistic differences between the sections in chapter 11 and those in chapter 15.

Unlike Section 1123(b)(6), Section 1521(a) uses the word "including" to show that "appropriate relief" is not limited to the seven specifically listed types of relief. Judge Horan went on to say that "section 1521(a)(7) qualifies its 'any . . . including' language by listing specific relief that a court is not permitted to grant under that section" and that the "list of prohibited relief does not include nonconsensual third-party releases."

Employing the canon "*expressio unius est exclusio alterius,*" Judge Horan concluded that the "list of relief that courts should not grant under section 1521(a)(7) . . . implies that other forms of relief not expressly prohibited are permitted." He therefore deduced that "enforcing foreign orders providing for nonconsensual third-party releases is within the scope of authority that section 1521(a) provides." Because "comity is central to chapter 15, the relief granted in the foreign court does not have to be available in U.S. courts under chapter 11."

Judge Horan held that "the plain language of both section 1521(a)(7) and section 1507(a) permit[s] a U.S. court to enforce a foreign order for nonconsensual third-party releases." Even if chapter 15 were ambiguous, he concluded that "the legislative history and canons of statutory construction confirm this interpretation and corresponding Congressional intent."

Judge Horan noted that "nonconsensual third-party releases are widely accepted by foreign courts." Therefore, "granting bankruptcy courts the authority to enforce nonconsensual third-party releases originating in foreign courts would promote chapter 15's goals of comity and providing assistance to foreign courts."

'Manifestly Contrary'

The DFC argued that enforcing nondebtor releases would be "manifestly contrary" to public policy under Section 1506 as a result of *Purdue*.

Judge Horan retorted by saying that "the Mexican proceeding comported with U.S. standards of procedural fairness[;] . . . the Concurso Plan does not violate any constitutional or statutory rights," and the releases were "customary and permitted under Mexican law."

Far from being "manifestly contrary," Judge Horan said that nondebtor releases are permitted in "asbestos" cases by Section 524(g). Furthermore, he noted how the Supreme Court in *Purdue* said that Congress could have permitted nondebtor releases. "Lack of specific availability in U.S. courts does not equate to manifest contrariness to U.S. public policy," he said.

Judge Horan noted possibly contrary authority from the Fifth Circuit in *Ad Hoc Group of Vitro Noteholders v. Vitro S.A.B. de C.V. (In re Vitro S.A.B. de C.V.)*, 701 F.3d 1031 (5th Cir. 2012). He said the Fifth Circuit "could not deny the relief simply on the basis that third-party releases were not available in its jurisdiction." Rather, he said that the *Vitro* "court only declined to enforce the

plan in that case because of the role in the approval process of the votes of insiders holding intercompany claims."

Judge Horan granted foreign main recognition and enforced the Mexican plan in the U.S., since the "plain language of Bankruptcy Code sections 1521(a) and 1507 giv[es] this Court a broad grant of discretion to aid foreign courts in accordance with principles of comity." He added, "The simple fact that a U.S. court could not grant such releases in a typical chapter 11 plan does not make them manifestly contrary to U.S. public policy."

The DFC is appealing.

Observations

Would Judge Horan's decision give Johnson & Johnson a fourth shot at nondebtor releases?

Assume J&J incorporates a subsidiary abroad, and the subsidiary assumes all of J&J's mass tort liability. Further assume that the foreign court approves a reorganization with discharges for the debtor-subsidiary and for the parent and all affiliates. Assuming the requisites for foreign main recognition were shown, would a U.S. bankruptcy court enforce the nondebtor releases in the U.S.?

Answer: Probably not, but why not?

What about this: A foreign parent has guaranteed a loan from a U.S. bank to one of its subsidiaries. The subsidiary reorganizes abroad with a plan giving a release to the nondebtor parent. Again assuming foreign main recognition, would a U.S. bankruptcy court enforce the release in favor of the nondebtor parent, barring the U.S. bank from collecting from the parent's assets in the U.S.?

In the comment box below, we invite our readers to say how a U.S. bankruptcy court would or should rule.

The opinion is *In re Crédito Real SAB de CV*, 25-10208 (Bankr. D. Del. April 1, 2025).

The Delaware district court affirmed Bankruptcy Judge Thomas Horan, who ruled that a creditor cannot sue a chapter 15 debtor in bankruptcy court on a prebankruptcy claim.

The 'Home Court' Rule Does Not Apply in Chapter 15 Cases, District Judge Says

The "home court" rule does not apply in chapter 15 cases, according to Delaware's Chief District Judge Colm F. Connolly, who affirmed Bankruptcy Judge Thomas M. Horan.

Judge Connolly's September 23 opinion means that a creditor must pursue a prebankruptcy claim against a chapter 15 debtor in the foreign court, because the bankruptcy court in a chapter 15 case does not adjudicate claims.

The Suit on a Prebankruptcy Claim

The Bermudian debtor was the sole limited partner in a fund designed to invest in emerging technology companies. Before bankruptcy, the manager of the fund notified the debtor that it had failed to make a $625,000 capital contribution. Consequently, the manager claimed that the debtor was a "defaulting partner."

Shortly after the notice, the debtor filed winding-up proceedings in Bermuda, where the Bermudian court entered a winding-up order and appointed joint liquidators. The debtor filed a chapter 15 petition in Delaware, where the bankruptcy court granted foreign main recognition.

Meanwhile, the liquidators and the fund were in discovery disputes. On the day when the fund was supposed to produce documents, the fund instead filed an adversary proceeding in the Delaware bankruptcy court. In the adversary proceeding, the fund sought a declaration that the debtor was in breach of contract, that the debtor was a "defaulting partner" and that the fund should be entitled to exercise all remedies.

The liquidators responded by sending a letter to the fund claiming there was a violation of the Section 362 automatic stay. The fund then filed a motion in the bankruptcy court seeking a declaration that there was no stay violation or, alternatively, seeking a modification of the automatic stay.

In a bench opinion, Bankruptcy Judge Horan decided that the automatic stay barred the adversary proceeding and that "home court" rule does not apply in chapter 11. The fund appealed but did not succeed.

No Claims Adjudication in Chapter 15

Addressing the merits, District Judge Connolly began by explaining how Section 1520(a)(1) invokes the Section 362 automatic stay on foreign main recognition "with respect to the debtor and the property of the debtor that is within the territorial jurisdiction of the United States." Almost immediately, he said that the adversary proceeding in bankruptcy court "fit[s] within the prohibitions set forth in § 362(a)(l)" because the fund was seeking "monetary damages and declaratory relief against the Debtor based on the Debtor's prebankruptcy conduct."

Judge Connolly said that the fund wanted him to "ignore" the Bankruptcy Code and "invent an exception to the automatic stay's application in Chapter 15 cases."

Judge Connolly explained why he declined the invitation to allow the adversary proceeding. Quoting Third Circuit authority, he said that "a Chapter 15 court in the United States acts as an adjunct or arm of a foreign bankruptcy court where the main proceedings are conducted" and is "'ancillary' to a foreign debtor's main insolvency proceeding pending before a foreign court."

In chapter 15, neither Section 501 nor Section 502 applies. Section 501 governs the filing of claims, while Section 502 controls the allowance of claims.

Although recognition invokes the Section 362 automatic stay, the ancillary purpose of the U.S. court is shown by the exclusion of Section 501 from chapter 15 cases. As a result, Judge Connolly said that "claims against a foreign debtor in a Chapter 15 case are channeled to the debtor's foreign main proceeding . . . . where distributions to creditors based on those adjudications are made."

Judge Connolly said that the decision by Bankruptcy Judge Horan was "consistent with the rulings of many courts who have refused to adjudicate creditor claims in the United States against a foreign debtor that is the subject of a foreign bankruptcy proceeding."

Given how the Companies Act in Bermuda imposes a stay arising from the liquidation, Judge Connolly said that the "principles of international comity weigh strongly against permitting [the fund's] adversary proceeding to continue within the United States."

No 'Home Court' Rule in Chapter 15

The fund contended that the bankruptcy court erred by not applying the "home court" rule. Judge Connolly characterized the rule as "a judicially created exception to the automatic stay

which permits the filing of an adversary proceeding against a debtor in a case under Chapter 7 or Chapter 11."

Judge Connolly held that "the rationale underlying the home court rule does not apply to cases under Chapter 15 [because] there is no claims adjudication process for the U.S. Bankruptcy Court to oversee" in chapter 15. "Put differently," he said, "the 'home court' of the foreign debtor is the foreign main proceeding — not the Chapter 15 case."

The fund made several other arguments that Judge Connolly rejected. For example, the fund contended that imposing the automatic stay left it with no forum in which to assert its claims, because the Bermudian court did not have jurisdiction over the fund.

The fund could have filed a claim in Bermuda but perhaps chose not to do so to avoid a submission to jurisdiction. In declining to file a claim, Judge Connolly said that the fund "does so at its own peril."

Judge Connolly pointed to the occasions when the fund could have sued the debtor. For example, the fund could have sued in the U.S. prior to foreign main recognition. Or, the fund could have filed a claim in Bermuda or could have asked the Bermudian court for permission to sue the debtor in the Cayman Islands, where the fund was organized.

Having found that the fund violated the automatic stay, Judge Connolly also upheld the decision by Bankruptcy Judge Horan that the fund had not shown "cause" to modify the automatic stay. He affirmed the order by Judge Horan, which found a violation of the automatic stay, and directed the fund to dismiss the adversary proceeding with prejudice.

The opinion is *FTI GP I LLC v. Point Investments Ltd. (In re Point Investments Ltd.)*, 23-630 (D. Del. Sept. 23, 2024).

Faculty

Hon. Lisa G. Beckerman is a U.S. Bankruptcy Judge for the Southern District of New York in New York, sworn in on Feb. 26, 2021. From May 1999 until she was appointed to the bench, she was a partner in the financial restructuring group at Akin Gump Strauss Hauer & Feld LLP. From September 1989 until May 1999, she was an associate and then a partner in the bankruptcy group at Stroock & Stroock & Lavan LLP. Prior to her appointment, Judge Beckerman served as a co-chair of the Executive Committee of UJA-Federation of New York's Bankruptcy and Reorganization Group, as co-chair and as a member of the Advisory Board of ABI's New York City Bankruptcy Conference, and as a member of ABI's Board of Directors of from 2013-19. She is a Fellow and a member of the board of directors of the American College of Bankruptcy, as well as a member of the National Conference of Bankruptcy Judges (NCBJ) and the 2021 NCBJ Education Committee. She also is a member of the Dean's Advisory Board for Boston University School of Law. Judge Beckerman received her A.B. from University of Chicago in 1984, her M.B.A. from the University of Texas in 1986 and her J.D. from Boston University in 1989.

Hon. Philip Bentley is a U.S. Bankruptcy Judge for the Southern District of New York in New York, sworn in on Sept. 7, 2022. Prior to joining the court, he has been a partner in the bankruptcy and restructuring department of Kramer Levin Naftalis & Frankel LLP, where his practice focused on complex litigation in bankruptcy courts, as well as other federal and state courts. In addition to occasionally representing debtors, trustees and examiners, Judge Bentley frequently litigated on behalf of official committees and creditor groups in large bankruptcies, including Purdue Pharma, Puerto Rico, Residential Capital, Madoff Investment Securities, General Motors, W.R. Grace, Adelphia Communications, WorldCom, Dow Corning and SGL Carbon. A regular speaker on bankruptcy issues, he is a member of the Federal Bar Council's Bankruptcy Litigation Committee and of the National Conference of Bankruptcy Judges, and he has served as a court-appointed mediator in several chapter 11 cases, including Celsius Network. Prior to his appointment, Judge Bentley was a member of the advisory board for ABI's annual New York City Bankruptcy Conference, as well as a longstanding member of the Policy Committee of Human Rights Watch. He received his B.A. *cum laude* from Yale University and his J.D. *cum laude* from Columbia Law School, where he was a Harlan Fiske Stone Scholar.

Hon. Martin Glenn is Chief U.S. Bankruptcy Judge for the Southern District of New York in New York, initially sworn in on Nov. 30, 2006, and appointed Chief Judge on March 1, 2022. Previously, he was a law clerk for Hon. Henry J. Friendly, Chief Judge of the U.S. Court of Appeals for the Second Circuit, from 1971-72, and he practiced law with O'Melveny & Myers LLP in Los Angeles from 1972-85 and in New York from 1985-2006, where he focused on complex civil litigation including securities, RICO, financial and accounting fraud, and unfair competition. Judge Glenn is a member of the American Law Institute, International Insolvency Institute, New York Federal-State Judicial Council, New York City Bar, National Conference of Bankruptcy Judges and ABI. He is a past member of the Committee on International Judicial Relations of the U.S. Judicial Conference and the Bankruptcy Judge Advisory Group of the Administrative Office of the U.S. Courts. In addition, he is an adjunct professor at Columbia Law School, a contributing author to *Collier on Bankruptcy* and a frequent lecturer on bankruptcy-related issues. Judge Glenn received his B.S. from Cornell Univer-

sity in 1968 and his J.D. from Rutgers Law School in 1971, where he was an articles editor of the *Rutgers Law Review*.

Hon. Sean H. Lane is a U.S. Bankruptcy Judge for the Southern District of New York in New York, sworn in on Sept. 7, 2010. He previously clerked for Hon. Edmund V. Ludwig, U.S. District Judge for the Eastern District of Pennsylvania, from 1991-92, as well as for Hon. Charles R. Richey, U.S. District Judge for the District of Columbia, from 1992-93. From 1993-97, he practiced with the law firm of BakerHostetler in Washington, D.C., and thereafter served as a trial attorney in the Department of Justice, Civil Division, National Courts Section, until 2000. From 2000 until he was appointed to the bench, Judge Lane served as an assistant U.S. attorney for the Southern District of New York and was also chief of the Tax & Bankruptcy Unit of that office. During his time in the U.S. Attorney's Office, he was awarded the Attorney General's Distinguished Service Award in 2005 and the Henry L. Stimson Medal by the New York City Bar Association in 2008. Judge Lane is a member of the Federal Bar Council and has served as an adjunct professor at both New York University School of Law and Fordham Law School. He received his B.A. from New York University College of Art & Science in 1987 and his J.D. from New York University School of Law in 1991.

Hon. Jil Mazer-Marino is a U.S. Bankruptcy Judge for the Eastern District of New York in Brooklyn, sworn in on Oct. 23, 2020. She previously was a partner at Cullen and Dykman LLP's Bankruptcy and Creditors' rights department, where her practice was nearly entirely bankruptcy-focused. Judge Mazer-Marino has chapter 11 experience representing debtors, creditors and creditor committees in chapter 11 business reorganizations. She also served as a chapter 7 panel trustee for the Southern District of New York for 10 years. Before joining Cullen and Dykman in 2019, Judge Mazer-Marino practiced with Meyer, Suozzi, English & Klein, P.C. from 2008-19, Rosen Slome Marder LLP from 2003-08 and Willkie Farr & Gallagher LLP from 1991-99. She also clerked for former EDNY Chief Bankruptcy Judge Conrad B. Duberstein. Judge Mazer-Marino served as secretary for the Bankruptcy & Corporate Reorganization Committee for the New York City Bar Association, and she is a founder and past president of the Women's Division of the of the New York Institute of Credit. She received her undergraduate degree from the State University of New York at Albany and her J.D. from St. John's University School of Law.

Bill Rochelle is ABI's editor-at-large, based in New York. He joined ABI in 2015 and writes every day on developments in consumer and reorganization law. For the prior nine years, Mr. Rochelle was the bankruptcy columnist for Bloomberg News. Before turning to journalism, he practiced bankruptcy law for 35 years, including 17 years as a partner in the New York office of Fulbright & Jaworski LLP. In addition to writing, Mr. Rochelle travels the country for ABI, speaking to bar groups and professional organizations on hot topics in the turnaround community and trends in consumer bankruptcies. He earned his undergraduate and law degrees from Columbia University, where he was a Harlan Fiske Stone Scholar.

Hon. Michael E. Wiles is a U.S. Bankruptcy Judge for the Southern District of New York in New York, sworn in on March 3, 2015. Previously, he was a partner with Debevoise & Plimpton LLP, where he focused on general commercial litigation and bankruptcy. Judge Wiles has presided over many large bankruptcy cases, including *Westinghouse*, *Pacific Drilling*, *Garrett Motion*, *McClatchy*, *Aegean Marine Petroleum*, *Relativity Media*, *SAS AB* and *Voyager Digital*. He also co-authored the

Collier Business Workout Guide (Mathew Bender 2007). Judge Wiles has appeared on panels organized by ABI, the Association of the Bar of the City of New York, the American College of Investment Council, the Federal Judicial Center and many other organizations to discuss current bankruptcy issues, and he is a judicial delegate to the Committee on Bankruptcy and Reorganization of the Association of the Bar of the City of New York. His publications and written CLE materials include "May Parties Consent to Bankruptcy Court Adjudication of '*Stern* Claims'" (September 2014) (presented at a continuing legal education session at the Association of the Bar of the City of New York); "Ponzi Schemes and Avoidance Actions: 3 Issues," *Law360* (March 7, 2011); "The Good Faith Defense to Fraudulent Transfer Claims" (December 2010) (presented at a continuing legal education session at the Association of the Bar of the City of New York); and "At the Crossroads: The Intersection of the Federal Securities Laws and the Bankruptcy Code," *The Business Lawyer* (November 2007). Judge Wiles received his A.B. from Georgetown University in 1975 and his J.D. from Yale Law School in 1978.