

# ONE FIRM WORLDWIDE®

## BUSINESS RESTRUCTURING REVIEW

### MESSAGE FROM THE BUSINESS RESTRUCTURING & REORGANIZATION PRACTICE LEADER

In the 20 years since Jones Day launched the *Business Restructuring Review* as a platform for keeping clients and friends informed of significant developments in business bankruptcy, restructuring, and related areas, the world has faced a series of challenges that have profoundly changed the way that we look at almost everything. Bankruptcy and restructuring is no exception.

The bankruptcy and restructuring landscape has shifted during the last two decades in ways that might have been difficult to imagine at the turn of the millennium. The rise of private capital and the market shift to privately held companies has fundamentally changed the tenor of restructurings. Out-of-court restructurings have largely supplanted “free fall” chapter 11 cases, and chapter 11 itself now usually features asset sales and pre-packaged or pre-negotiated bankruptcies by which companies can sometimes obtain confirmation of comprehensive restructuring plans in mere days rather than months or years. Restructuring has more frequently become a global phenomenon, with an explosion of cross-border cases and enactment of laws in many countries designed to harmonize and coordinate cross-border proceedings.

These developments demand creative solutions, and we at Jones Day are at the forefront in innovating to address and anticipate the needs of our clients. Finally, although much has changed in bankruptcy and restructuring in recent years, our dedication to providing our clients and friends with incisive, informative, and timely analysis of ongoing developments has not. We look forward to our next 20 years of interaction with you.

— Heather Lennox

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## LAWYER SPOTLIGHT: HEATHER LENNOX

Heather Lennox, a partner in the Cleveland and New York offices, serves as Global Practice Leader of the Firm's Business Restructuring & Reorganization ("BRR") Practice, effective January 2022.

Heather has been a partner in the Firm's BRR Practice since 2002 and has led some of the most important restructuring cases in the United States over the past two decades, including work on behalf of the City of Detroit, Peabody Energy, Hostess Brands, and FTD. She is a member of the

National Bankruptcy Conference, which advises Congress on national bankruptcy policy, and a Fellow in the American College of Bankruptcy. She served as Partner-in-Charge of the Firm's Cleveland Office from 2016 to 2022.

Heather has been named a "Dealmaker of the Year" by *The American Lawyer* and is recognized as one of the nation's leading lawyers by legal directories; she also has earned top rankings for many years running in *Chambers*, *Best Lawyers in America*, *IFLR1000*, and *Lawdragon 500 Leading Global Restructuring & Insolvency Lawyers*. In 2020, Heather was named to *Cleveland Magazine's* "Cleveland 500" list.

"Heather joined Jones Day as an associate in Cleveland in 1992 and has spent her entire exceptionally successful legal career as a member of our Firm," says Kevyn Orr, Partner-in-Charge of the U.S. Region. "Through her leadership on numerous high-profile restructurings, she has become nationally recognized for her excellence as a bankruptcy lawyer. She is rooted in Jones Day's culture, has been a great leader of the Firm's Cleveland Office as its Partner-in-Charge and in other roles, and will be an excellent Practice Leader."

Heather succeeds Bruce Bennett, who has led Jones Day's BRR Practice since 2016, and will continue to advise clients as a partner in the practice.

## MODIFICATION OF SECURED LOAN UNDER CRAM-DOWN CHAPTER 11 PLAN WARRANTED DUE TO PLAN FEASIBILITY THREAT

Brad B. Erens • Mark G. Douglas

Many recent court rulings concerning the treatment of secured creditors under a chapter 11 plan have focused on "cram-up" plans involving reinstatement of secured loans to avoid impairment (and the ability to vote on the plan) or "cram-down" confirmation involving either the sale of the lender's collateral, subject to the lender's right to "credit bid" its claim, and attachment of its lien to the proceeds, or treating the secured claim in a way that provides the lender with the "indubitable equivalent" of its claim.

A ruling recently handed down by the U.S. Bankruptcy Court for the District of New Jersey explores another avenue to confirmation of a plan over the objection of a secured creditor. In *In re Ocean View Motel, LLC*, 2022 WL 243213 (Bankr. D.N.J. Jan. 25, 2022), the court ruled that a plan could be confirmed over a

secured lender's objection even though a new secured note given to the lender eliminated his prepetition contractual right to file a deed in lieu of foreclosure in the event of the debtor's default. According to the court, the terms of the new note, which was secured by collateral valued significantly greater than the amount of the debt, more than satisfied the Bankruptcy Code's minimum requirements for cram-down confirmation, and if not eliminated, the deed in lieu of foreclosure provision threatened the plan's feasibility and the debtor's prospects for a successful reorganization.

### IMPAIRMENT OF CLAIMS UNDER A CHAPTER 11 PLAN

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

or interest holders that receive or retain nothing under a plan are deemed to reject it. See 11 U.S.C. § 1126(g).

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

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

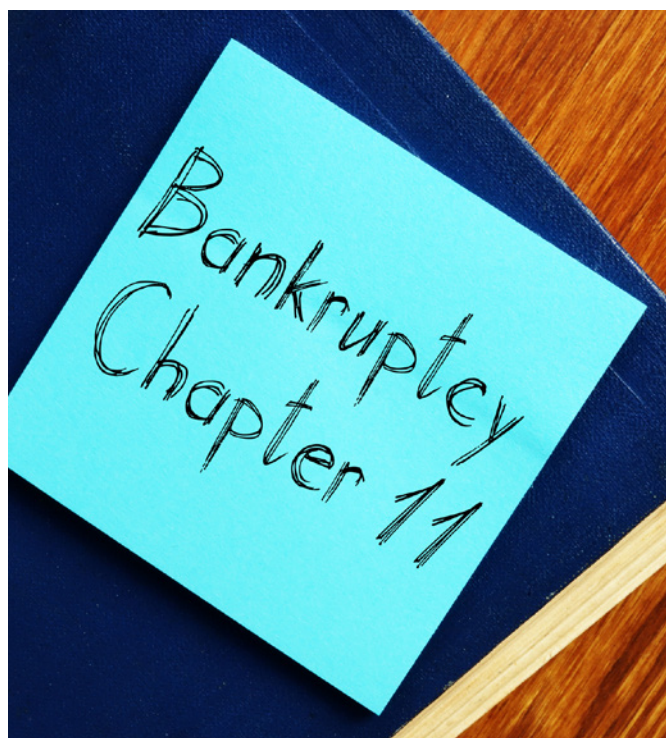
### CRAM-DOWN CONFIRMATION REQUIREMENTS

If a class of creditors does not agree to impairment of the claims in the class under the plan and votes to reject it, the plan can be confirmed only if it satisfies the “cram-down” requirements of section 1129(b) of the Bankruptcy Code. Among those requirements are the mandates that, with respect to dissenting classes of creditors, the plan must be “fair and equitable,” and the plan must not “discriminate unfairly.” 11 U.S.C. § 1129(b)(1).

**Fair and Equitable Treatment of Secured Creditors.** With respect to a dissenting class of secured claims, section 1129(b)(2)(A) provides that a plan is “fair and equitable” if the plan provides for: (i) the secured claimants’ retention of their liens and receipt of deferred cash payments equal to at least the value, as of the plan effective date, of their secured claims; (ii) the sale, subject to the creditors’ right to “credit bid” their claims under section 363(k), of the collateral free and clear of all liens, with attachment of the creditors’ liens to the sale proceeds and treatment of the liens under option (i) or (iii); or (iii) the realization by the secured creditors of the “indubitable equivalent” of their claims.

The Bankruptcy Code does not define “indubitable equivalent,” but courts interpreting the term have defined it as, among other things, “the unquestionable value of a lender’s secured interest in the collateral.” *In re Philadelphia Newspapers, LLC*, 599 F.3d 298, 310 (3d Cir. 2010); accord *In re Sparks*, 171 B.R. 860, 866 (Bankr. N.D. Ill. 1994) (a plan provides the indubitable equivalent of a claim to the creditor where it “(1) provides the creditor with the present value of its claim, and (2) insures the safety of its principle [sic]”); see generally COLLIER ON BANKRUPTCY (“COLLIER”) ¶¶ 361.03[4] and 1129.04[2][c][i] (16th ed. 2022) (discussing the

derivation of the concept from *In re Murel Holding Corp.*, 75 F.2d 941 (2d Cir. 1935), and explaining that “abandonment, or unqualified transfer of the collateral, to the secured creditor,” substitute collateral, and the retention of liens with modified loan terms have been deemed to provide the “indubitable equivalent”). See, e.g., *In re River East Plaza, LLC*, 669 F.3d 826 (7th Cir. 2012) (30-year U.S. Treasury bonds substituted as collateral for an undersecured mortgage loan were not the indubitable equivalent of the mortgage because the bonds carried a different “risk profile” and they impermissibly stretched out the time period over which the lender would be paid); *In re LightSquared Inc.*, 513 B.R. 56 (Bankr. S.D.N.Y. 2014) (a chapter 11 plan that would provide a first-lien secured creditor with a note secured by a third-priority lien on existing and new collateral did not provide the secured creditor with the indubitable equivalent, where there was enormous disagreement as to valuation and unresolved regulatory hurdles); *In re Colony Beach & Tennis Club, Inc.*, 508 B.R. 468 (Bankr. M.D. Fla. 2014) (a chapter 11 plan under which the collateral securing the claims of an undersecured lender that elected to have its claim treated as fully secured would be sold free and clear of liens in exchange for receiving either payment in an unspecified amount in one year or the right to have its collateral transferred back to it did not provide the indubitable equivalent of its claim), *aff’d*, 2015 WL 3689075 (M.D. Fla. June 12, 2015); *In re DBSD N. Am., Inc.*, 419 B.R. 179 (Bankr. S.D.N.Y. 2009) (a chapter 11 plan under which a first-lien creditor would receive an amended loan facility secured by a first lien on substantially all of the debtor’s assets, but eliminated or loosened certain covenants and included less restrictive cross-default provisions, provided the first-lien creditor with the indubitable equivalent of its claim), *aff’d*, 2010 WL 1223109 (S.D.N.Y. Mar. 24, 2010), *aff’d in part, rev’d in part on other grounds*, 634 F.3d 79 (2d Cir. 2011).



**No Unfair Discrimination.** The Bankruptcy Code does not define “unfair discrimination,” and “[c]ourts have struggled to give the unfair discrimination test an objective standard.” COLLIER at ¶ 1129.03[a]. Nevertheless, most courts agree that the purpose underlying the requirement is “to ensure that a dissenting class will receive relative value equal to the value given to all other similarly situated classes.” *In re LightSquared Inc.*, 513 B.R. 56, 99 (Bankr. S.D.N.Y. 2014); *accord In re SunEdison, Inc.*, 575 B.R. 220 (Bankr. S.D.N.Y. 2017); *In re 20 Bayard Views, LLC*, 445 B.R. 83 (Bankr. E.D.N.Y. 2011); *In re Johns-Manville Corp.*, 68 B.R. 618, 636 (Bankr. S.D.N.Y. 1986), *aff’d*, 78 B.R. 407 (S.D.N.Y. 1987), *aff’d*, 843 F.2d 636 (2d Cir. 1988).

Courts have historically relied on a number of tests to determine whether a plan discriminates unfairly. Several courts have adopted some form of the unfair discrimination test (“Markell test”) articulated by Bruce A. Markell in his article *A New Perspective on Unfair Discrimination in Chapter 11*, 72 Am. Bankr. L.J. 227, 249 (1998). See, e.g., *In re Armstrong World Indus., Inc.*, 348 B.R. 111 (D. Del. 2006); *In re Quay Corp., Inc.*, 372 B.R. 378 (Bankr. N.D. Ill. 2007); *In re Exide Techs.*, 303 B.R. 48 (Bankr. D. Del. 2003). The Markell test was first applied by a bankruptcy court in *In re Dow Corning Corp.*, 244 B.R. 705 (Bankr. E.D. Mich. 1999), *aff’d in relevant part*, 255 B.R. 445 (E.D. Mich. 2000), *aff’d in part and remanded*, 280 F.3d 648 (6th Cir. 2002). Under the Markell test, a rebuttable presumption that a plan unfairly discriminates will arise when the following elements exist:

(1) a dissenting class; (2) another class of the same priority; and (3) a difference in the plan’s treatment of the two classes that results in either (a) a materially lower percentage recovery for the dissenting class (measured in terms of the net present value of all payments), or (b) regardless of percentage recovery, an allocation under the plan of materially greater risk to the dissenting class in connection with its proposed distribution.

*Id.* at 710. The burden then lies with the plan proponent to rebut the presumption by demonstrating that “outside of bankruptcy, the dissenting class would similarly receive less than the class receiving a greater recovery, or that the alleged preferred class had infused new value into the reorganization which offset its gain.” *Id.*

### **OCEAN VIEW**

Ocean View Motel, LLC (“OVM”) owns a hotel in Wildwood, New Jersey. OVM’s principals were originally Mark Jones (“Jones”) and Harry Falterbauer (“Falterbauer”), who together owned several other properties in the vicinity. In 2015, Jones bought out Falterbauer’s interest in the company, agreeing to pay the purchase price over time under a series of loan agreements. The loans, which were made by Falterbauer to both Jones and OVM, were secured by a junior mortgage on the hotel.

After Jones and OVM defaulted on the loans in the fall of 2018, Falterbauer sued to foreclose on the hotel. The parties settled

the litigation in 2019 under an agreement among Jones, OVM, and Falterbauer whereby Falterbauer acquired the senior mortgage debt, OVM executed a new \$1.5 million promissory note in Falterbauer’s favor, and OVM and Jones agreed to give Falterbauer a signed deed in lieu of foreclosure authorizing Falterbauer to take possession of the hotel upon default.

OVM and Jones defaulted again in 2020 but prevented Falterbauer from filing the deed in lieu of foreclosure by obtaining a temporary state court injunction. OVM filed for chapter 11 protection on September 30, 2020, in the District of New Jersey. At that time, the hotel’s value was at least \$2.1 million.

OVM proposed a chapter 11 plan under which Falterbauer would receive a new note secured by the hotel in the amount of approximately \$1.6 million amortized over 20 years at 7% interest. The note provided for default-rate interest but eliminated Falterbauer’s remedy of filing a deed in lieu of foreclosure. OVM had no other secured debt. The plan proposed to pay administrative and other priority claims either in full on the effective date or as otherwise agreed by the creditors or permitted under the Bankruptcy Code. The plan would pay general unsecured creditors in full over four years and provided that Jones would retain his ownership interest in OVM.

Only Falterbauer voted to reject the plan and objected to its confirmation. He argued that the plan discriminated unfairly and was not fair and equitable because it eliminated his contractual right to file a deed in lieu of foreclosure, which would force him, at his expense, to start foreclosure proceedings once again in state court upon OVM’s likely post-bankruptcy default. OVM countered that Falterbauer’s loan was protected by a large equity cushion, that a deed in lieu of foreclosure is not a standard commercial lending practice in New Jersey, and that “the feasibility of the plan would be negatively impacted by the threat of this hostile creditor being able to foreclose upon 30 days’ delay in payment.” *Ocean View*, 2022 WL 243213, at \*2.

### **THE BANKRUPTCY COURT’S RULING**

In his ruling, U.S. Bankruptcy Judge Andrew Altenburg, Jr. noted that a chapter 11 plan may “modify the rights of holders of secured claims.” See 11 U.S.C. § 1123(b)(5). He further explained that, if a secured creditor does not agree to modifications that impair its claim and votes to reject the plan, the plan can be confirmed only if, among other things, the plan does not discriminate unfairly (11 U.S.C. § 1129(b)(1)) and the plan’s treatment of the secured claims is “fair and equitable” within the meaning of section 1129(b)(2)(A).

Initially, Judge Altenburg explained that the plan did not unfairly discriminate because “there is no different treatment of similarly situated classes.” *Id.* at \*1.

Next, Judge Altenburg found that OVM’s plan satisfied the “minimal elements” of subsection 1129(b)(2)(A)(i) because Falterbauer would retain the liens securing his claim and receive deferred

cash payments with a present value equal to the amount of the claim. Moreover, he explained, the hotel securing his claim was worth well more than the amount of Falterbauer's claim, the loan would accrue default-rate interest at 12%, and OVM was obligated to pay his attorneys' fees and costs in the event of post-confirmation default.

Judge Altenburg noted that eliminating certain terms of a loan agreement "is not an unusual event in the plan confirmation process." *Id.* at \*3 (citing *In re Am, Trailer & Storage, Inc.*, 419 B.R. 412, 440-41 (Bankr. W.D. Mo. 2009) (in determining whether modification of loan documents is appropriate, considering: "(1) whether the proposed terms and covenants unduly harm the secured creditor with respect to its collateral position; and (2) whether the inclusion of terms and conditions from the pre-bankruptcy loan documents would unduly impair the debtor's ability to reorganize.")). He agreed with OVM that the feasibility of its plan "would be hampered by the ability of one unfriendly creditor to end [OVM's] operations upon default on his claim only." *Id.* at \*4. Eliminating the deed in lieu provision, he wrote, "contributes to the plan's feasibility, as [it] prevent[s] confirmation from being followed by the liquidation or need for further financial reorganization." *Id.* (citing 11 U.S.C. § 1129(a)(11)).

Judge Altenburg accordingly overruled Falterbauer's objection and confirmed OVM's chapter 11 plan.

## OUTLOOK

Secured claims can be treated in a variety of ways under a chapter 11 plan. As noted, a secured loan, even if accelerated, can be reinstated under circumstances that would render the secured creditor unimpaired (and therefore deemed to accept the plan). See 11 U.S.C. § 1124. *Ocean View* is an example of a case where unimpairment was not an option due to the existence of a prepetition loan provision that, if retained, threatened the debtor's prospects for continuing to do business after emerging from bankruptcy, thereby calling into question the feasibility of its chapter 11 plan. Under those circumstances, the bankruptcy court found that the cram-down plan's treatment of the secured creditor's claim was fair and equitable even though it eliminated one of the secured creditors' contractual remedies. In so ruling, the court strove to strike a balance between what it perceived to be protecting the interests of a secured creditor in accordance with the Bankruptcy Code's nonconsensual plan confirmation requirements and affording the debtor a reasonable prospect of successfully reorganizing.

Although the court never had to address the issue, it would have been interesting if it had examined whether the plan's treatment of the secured claim provided the lender with the indubitable equivalent of its claim.



## HERTZ BANKRUPTCY COURT WEIGHS IN ON MAKE-WHOLE PREMIUMS, SOLVENT-DEBTOR EXCEPTION, AND PENDENCY INTEREST

Daniel J. Merrett • Mark G. Douglas

Perhaps surprisingly given the rarity of such cases, a handful of high-profile court rulings recently have addressed whether a solvent chapter 11 debtor is obligated to pay postpetition, pre-effective date interest ("pendency interest") to unsecured creditors to render their claims "unimpaired" under a chapter 11 plan and, if so, at what rate. Some of these cases have also involved the enforceability of noteholder claims for "make-whole" premiums triggered by the debtors' redemption of their notes prior to maturity and whether such claims must be disallowed as the "economic equivalent" of unmatured interest. All of these issues were recently examined by the bankruptcy court that presided over the chapter 11 cases of auto rental giant The Hertz Company and its affiliates.

In *In re The Hertz Corp.*, 2021 WL 6068390 (Bankr. D. Del. Dec. 22, 2021), the U.S. Bankruptcy Court for the District of Delaware dismissed in part claims asserted by unsecured noteholders for make-whole premiums and pendency interest. In so ruling, the court held that: (i) a make-whole premium was due under the terms of one, but not the other, of two note indentures; (ii) the court would not discount the possibility that the make-whole premiums could be disallowed as the economic equivalent of unmatured interest, but it lacked sufficient evidence to make that determination; (iii) even if make-whole premium claims were disallowed as unmatured interest, such claims would be impaired by the Bankruptcy Code, rather than by the debtors' chapter 11 plan; (iv) the pre-Bankruptcy Code "solvent debtor" exception obligating a solvent debtor to pay interest on unsecured claims only partially survived enactment of the Bankruptcy Code; and (v) the appropriate rate of pendency interest under the "solvent debtor" exception is the federal judgment rate rather than the contract rate.

*Hertz* is far from the end of the story on many of these issues. Appeals involving some of them are currently pending before two circuit courts of appeals, which are expected to issue decisions in the near future.

### THE BANKRUPTCY CODE'S PRIORITY SCHEME

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

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

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

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

### IMPAIRMENT OF CLAIMS UNDER A CHAPTER 11 PLAN

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

Section 1124 provides that a class of claims is impaired under a plan unless the plan: (1) “leaves unaltered the legal, equitable, and contractual rights” to which each creditor in the class is entitled; or (2) cures any defaults (with limited exceptions), reinstates the maturity and other terms of the obligation, and compensates each creditor in the class for resulting losses.

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

### CRAM-DOWN CONFIRMATION REQUIREMENTS

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

Therefore, in the case of a chapter 11 debtor that can pay its creditors in full, the best interests test in section 1129(a)(7) would require that any impaired unsecured creditors be paid pendency interest on their allowed claims “at the legal rate.” *Id.* § 726(a)(5).

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

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

## DISALLOWANCE OF CLAIMS FOR UNMATURED INTEREST AND THE SOLVENT DEBTOR EXCEPTION

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

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

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

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

In pre-Bankruptcy Code cases where the debtor possessed adequate assets to pay all claims in full with interest—meaning that the payment of interest to one creditor did not impact the recovery of other creditors—principles of equity dictated that creditors be paid interest to which they were otherwise entitled, most commonly at the rate determined by their contracts with the debtor. See *Am. Iron & Steel Mfg. Co. v. Seaboard Air Line*

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

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

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

In cases where interest on a claim is permitted, the rate of interest payable is unclear. As noted, section 726(a)(5) refers to interest at “the legal rate,” which could mean the contract rate, the post-judgment rate, the federal statutory rate specified in 28 U.S.C. § 1961, or some other rate.

Whether the solvent debtor exception survived enactment of the Bankruptcy Code in 1978 is disputed. A handful of rulings from the federal circuit courts have suggested that the exception survived. See, e.g., *Ultra*, 943 F.3d at 765–66 (“Our review of the record reveals no reason why the solvent debtor exception could not apply. As other circuits have recognized, ‘absent compelling equitable considerations, when a debtor is solvent, it is the role of the bankruptcy court to enforce the creditors’ contractual rights.’ . . . That might be the case here. . . . But ‘mindful that we are a court of review, not of first view,’ we will not make the choice ourselves or weigh the equities on our own.”) (citations omitted); *Gencarelli v. UPS Capital Bus. Credit*, 501 F.3d 1, 7 (1st Cir. 2007)

(holding that, in contrast to section 506(b)'s reasonableness limitation on oversecured creditors' secured claims for fees, costs, and charges, section 502(b) does not disallow unreasonable prepayment penalties in a solvent debtor case (as long as allowable under state law), and noting that "[t]his is a solvent debtor case and, as such, the equities strongly favor holding the debtor to his contractual obligations as long as those obligations are legally enforceable under applicable non-bankruptcy law"); *Official Comm. of Unsecured Creditors v. Dow Corning Corp.* (*In re Dow Corning Corp.*), 456 F.3d 668, 678 (6th Cir. 2006) (noting that "[t]he legislative history of the Bankruptcy Code makes clear that equitable considerations operate differently when the debtor is solvent: '[C]ourts have held that where an estate is solvent, in order for a plan to be fair and equitable, unsecured and undersecured creditors' claims must be paid in full, including postpetition interest, before equity holders may participate in any recovery'" (quoting 140 Cong. Rec. H10,752–01, H10,768 (1994) (statement of Rep. Brooks, Chairman of the House Committee on the Judiciary and co-author of the Bankruptcy Reform Act of 1994))).

## RECENT COURT RULINGS

There have been a handful of recent court rulings addressing the continued vitality of the solvent debtor exception.

In *In re Ultra Petroleum Corp.*, 624 B.R. 178 (Bankr. S.D. Tex. 2020) ("UPC"), *leave to appeal granted*, No. 21-20008 (5th Cir. Jan. 5, 2020), the bankruptcy court ruled that, based on the legislative history, "Congress gave no indication that it intended to erode the solvent debtor exception" when it enacted the Bankruptcy Code. *Id.* at 198. Moreover, it noted, "[e]quitable considerations" continue to support it, including the policy against allowing a windfall at the expense of creditors to any debtor that can afford to pay all of its debts. *Id.*

According to the court, this conclusion is also supported by post-Bankruptcy Code court rulings involving solvent debtors as well as the 1994 removal from the Bankruptcy Code of section 1124(3). In short, the court wrote, there is a "monolithic mountain of authority, developed over nearly three hundred years in both English and American courts, holding that a solvent debtor must make its creditors whole." *Id.* at 200 (citations omitted).

The court explained that, standing alone, neither section 105(a) of the Bankruptcy Code (giving the bankruptcy court broad equitable power), section 1129(a)(7) (the best interests test), nor section 1129(b)(1) (requiring a cram-down chapter 11 plan to be fair and equitable with respect to dissenting impaired classes of creditors) is a statutory source for the solvent debtor exception. Instead, the court wrote, "piecing these Bankruptcy Code provisions together," the solvent debtor exception flows through section 1124(1), which provides that, to render a class of claims unimpaired, a plan must leave unaltered the claimants' "legal, equitable, and contractual rights." *Id.* at 202. According to the court, "[b]ecause an unimpaired creditor has equitable rights to be treated no less favorably than an impaired creditor and to be

paid in full before the debtor realizes a recovery, a plan denying post-petition interest in a solvent debtor case alters the equitable rights of an unimpaired creditor under § 1124(1)." *Id.* at 203.

Finally, the bankruptcy court held that the default contract rate is the appropriate rate of pendency interest rather than the federal judgment rate. The court explained that the noteholders' right to pendency interest was based on "two key equitable rights"—the right to receive no less favorable treatment than impaired creditors and the right to have their contractual rights fully enforced. *Id.* at 204. According to the court, if the noteholder class were paid interest at the federal judgment rate, it would be worse off than if it were impaired under the debtors' plan because "even though the [noteholders] would receive identical interest as a hypothetical impaired class, as an unimpaired class the Claimants were deprived of the right to vote for or against the plan." *Id.* In addition, the court noted, limiting the noteholder class to pendency interest at the federal judgment rate would contravene the purpose of the solvent debtor exception, which dictates that when a debtor is solvent, "a bankruptcy court's role is merely to enforce the contractual rights of the parties." *Id.*

In *In re Cuker Interactive, LLC*, 622 B.R. 67 (Bankr. S.D. Cal. 2020), the court held that, in accordance with Ninth Circuit precedent, a solvent debtor must pay pendency interest to general unsecured creditors "at the legal rate." *Id.* at 69 (citing *In re Cardelucci*, 285 F.3d 1231 (9th Cir. 2002) (applying the federal judgment rate in cases where creditors were impaired); *In re PG&E Corp.*, 610 B.R. 308 (Bankr. N.D. Cal. 2019) ("PG&E") (pendency interest must be paid at the federal judgment rate to render unsecured claims unimpaired), *aff'd sub nom. Official Committee of Unsecured Creditors v. PG&E Corp.*, No. 20-04570 (HSG) (N.D. Cal. May 21, 2021), *appeal filed*, No. 21-16043 (9th Cir. June 17, 2021); *In re Beguelin*, 220 B.R. 94 (B.A.P. 9th Cir. 1998) (same)).

On the basis of that precedent, the court ruled that, in accordance with the solvent debtor exception, the bankruptcy court's role in a case involving a solvent debtor was "merely to enforce the contractual rights of the parties." *Cuker*, 622 B.R. at 71 (quoting *UPC*, 624 B.R. at 195). However, the *Cuker* court explained, construing the solvent debtor exception to require the payment of contract-rate interest might be problematic in cases with a significant number of creditors because several interest rates might apply, leading to an administrative morass and different treatment of creditors in the same class. For this reason, the court held that pendency interest must be paid at the federal judgment rate.

In *In re Mullins*, 633 B.R. 1 (Bankr. D. Mass. 2021), the court reasoned that lawmakers' use of the phrase "fair and equitable" in sections 1129(b)(1) and 1129(b)(2) "was intended to codify at least a century of bankruptcy jurisprudence . . . and grounded the solvent debtor exception as it related to impaired creditors in that provision." *Id.* at 10. It also explained that the legislative history of the provision does not suggest that "Congress intended to abrogate the solvent debtor exception." *Id.* at 11.



Construing section 1129(b) as not abrogating the solvent debtor exception, the court noted, does not conflict with section 502(b) (2). It explained that, although section 502(b)(2) unambiguously provides that pendency interest cannot be included as part of an allowed claim, “there is a significant distinction between whether postpetition interest can be part of an allowed claim and whether there are circumstances under which the debtor may be required to pay postpetition interest on an allowed claim.” *Id.* at 15.

The court emphasized that it was not adopting a “free-floating solvent debtor exception and a balancing of the equities test.” *Id.* at 10 n.8. Rather, it wrote, “well-developed jurisprudence and the evidentiary record in this and in future cases will dictate the course of the ‘solvent debtor exception’ in these rare cases—unless a future statutory amendment or other controlling appellate authority mandates a different approach.” *Id.* Moreover, because the court concluded that the statutory provisions codifying the absolute priority rule and the best interests test required the payment of pendency interest in this case, the court also declined to decide “whether the solvent debtor exception is founded more generally in an ‘equitable right’ inherent in insolvency proceedings under the Code rather than in § 1129(b) or any other specific provisions of the Code.” *Id.* at 16 n.12.

Addressing the appropriate rate of pendency interest, the court agreed with the majority of other courts, finding that, to satisfy the “best interests” test, which incorporates section 726(a)(5)’s dictate that interest be paid at “the legal rate” in a case involving sufficient assets, pendency interest must be paid at the federal judgment rate.

## **HERTZ**

Citing disruption to their car rental business caused by the COVID-19 pandemic, the Hertz Corporation and its affiliates (collectively, “debtors”) filed for chapter 11 protection on May 22, 2020, in the District of Delaware. After an auction process, the bankruptcy court confirmed a chapter 11 plan for the debtors on June 10, 2021.

The plan provided for the payment of unsecured creditors in full, including the holders of two series of senior unsecured notes issued by the debtors prepetition (“22/24 Notes” and “26/28 Notes” and, collectively, “Senior Notes”), together with pendency interest at the federal judgment rate, as well as a distribution to shareholders of cash and new warrants or subscription rights. In accordance with the terms of the relevant indentures, the Senior Notes were accelerated upon the debtors’ bankruptcy filing. In addition, redemption of the notes prior to the stated maturity date under certain specified conditions triggered the debtors’ obligation to pay the noteholders a redemption or make-whole premium designed to compensate the noteholders for the loss of future interest payments if the debt was paid off before maturity. The plan, however, did not provide for the payment of make-whole premiums to the holders of the Senior Notes or certain other unsecured noteholders.

The plan confirmation order preserved the rights of unsecured noteholders to assert entitlement to make-whole premiums and additional interest as necessary to render their claims unimpaired. The plan went effective on June 30, 2021.



On July 1, 2021, the indenture trustee (“Senior Note Trustee”) for the 22/24 Notes and the 26/28 Notes filed a complaint seeking a declaratory judgment that, in addition to the principal and prepetition interest paid to the Senior Noteholders on the effective date of the plan (in excess of \$2.7 billion), the debtors were obligated to pay approximately \$272 million, consisting of: (i) make-whole premiums due under the Senior Notes totaling approximately \$147 million; and (ii) pendency interest at the contract default rate in excess of the federal judgment rate (approximately \$125 million). The debtors filed a motion to dismiss the complaint.

## THE BANKRUPTCY COURT’S RULING

**Entitlement to Make-Whole Premium.** Addressing the Senior Noteholders’ claims for the payment of make-whole premiums, U.S. Bankruptcy Judge Mary Walrath concluded that the Senior Note Trustee stated a plausible claim that make-whole premiums were due under the indentures because the redemption of the Senior Notes was at the debtors’ option, rather than involuntary—i.e., a consequence of acceleration of the Senior Notes triggered by a bankruptcy filing that the debtors were forced to make due to the pandemic. She rejected the debtors’ argument that redemption of the Senior Notes was involuntary because: (i) they filed for bankruptcy in good faith (i.e., not in a strategic effort to avoid paying the make-whole premiums); and (ii) any alternative to redemption, including reinstatement of the Senior Notes, was hypothetical at best.

The decision to file for chapter 11, Judge Walrath wrote, “was perhaps the best option for the Debtors in light of the drastic effects on their business caused by the pandemic, but it was not the only option.” *Hertz*, 2021 WL 6068390, at \*5. She further noted that although the debtors “chose” to conduct an auction for a plan sponsor and ultimately selected the highest and best offer, “that too was not the Debtors’ only option.” According to Judge Walrath, “[a]t numerous junctures in any bankruptcy case, a debtor in possession has multiple paths from which to choose,” and “[e]ven though the Debtors acted in good faith and in the fulfillment of their fiduciary duties, the Court concludes that their actions were voluntary.” *Id.*

Even so, due to the different language contained in the indentures, Judge Walrath found that the debtors’ motion to dismiss the Senior Note Trustee’s claims for make-whole premiums should be granted with respect to the 22/24 Notes. Under the relevant language of the 22/24 Notes indenture, the Senior Note Trustee failed to state a claim that a make-whole premium was due because the make-whole was due only if the 22/24 Notes were redeemed “prior to maturity” rather than prior to their originally scheduled maturity, which was a separately defined term under the 22/24 Notes Indenture. Since Hertz’s bankruptcy filing accelerated the 22/24 Notes, their maturity was brought forward, and any subsequent redemption did not trigger the make-whole obligation. *Id.* at \*6. By contrast, the 26/28 Notes indenture did not specify that any optional redemption must be “prior to maturity,” and the Senior Note Trustee stated a claim that a premium would

be due “because [the notes] were redeemed before the initial period stated” in the relevant indenture section. *Id.* at \*7.

## Disallowance of Make-Whole Premium as Unmatured Interest.

Next, Judge Walrath considered whether, even if due under the terms of the indentures, the make-whole premiums should be disallowed under section 502(b)(2) as the “economic equivalent” of unmatured interest, an issue that has been disputed by the courts. *Compare UPC*, 624 B.R. at 188-95 (concluding that a make-whole premium was liquidated damages rather than unmatured interest and should not be disallowed under section 502(b)(2)), with *In re MPM Silicones LLC*, 2014 WL 4436335, at \*17-18 (Bankr. S.D.N.Y. Sept. 9, 2014) (ruling that noteholders’ claim to a make-whole premium based on the debtor’s breach of a no-call provision was unmatured interest disallowed under section 502(b)(2)), *aff’d in part and rev’d in part on other grounds*, 874 F.3d 787 (2d Cir. 2017). See generally COLLIER at ¶ 502.03[3](a) (collecting cases).

Judge Walrath declined to decide the issue. The judge noted that, based on relevant case law and other authority, she was “not prepared to conclude, as a legal matter, that make-wholes cannot be disallowed as unmatured interest,” but determined that more evidence of the economic substance of the make-whole premiums was necessary. Nevertheless, Judge Walrath suggested in *dicta* that the Senior Note Trustee might be unable to present evidence that the make-whole premiums were “not, in fact, the economic equivalent of unmatured interest due under those Senior Notes.” *Hertz*, 2021 WL 6068390, at \*9.

**Impairment and the Solvent-Debtor Exception.** Judge Walrath then examined whether, even if the make-whole premiums were the economic equivalent of unmatured interest, the claims of the Senior Noteholders, in accordance with the solvent-debtor exception, would be impaired under the debtors’ plan if the noteholders were not paid the premiums. Initially, citing *Ultra*, *PPI*, and *PG&E*, she explained that “any modification of the Noteholders’ claim to unmatured interest or to the [make-whole] premium (if it is the economic equivalent of unmatured interest) is an impairment of the Noteholders’ contract claims by operation of section 502(b)(2) of the Bankruptcy Code, not the Debtors’ Plan.” *Hertz*, 2021 WL 6068390, at \*11. As a consequence, Judge Walrath ruled, the Senior Noteholders’ claims “are not impaired within the meaning of section 1124(1).” *Id.*

Judge Walrath noted that, “in essence,” the Bankruptcy Code “is silent on what treatment unimpaired creditors must receive in a solvent chapter 11 debtor case.” *Id.* According to their express terms, she explained, “sections 1129(a)(7) and 726(a)(5) provide what treatment impaired creditors are entitled to receive, not what treatment unimpaired claims are entitled to receive in a solvent chapter 11 debtor case.”

The judge rejected the argument that, by repealing section 1124(3), lawmakers intended that unimpaired creditors must be paid their contract rate of interest in a solvent debtor chapter 11 case. Congress, she explained, could have so

provided by either: (i) amending section 1124(3) to require that unimpaired creditors receive their contract rate of interest, in addition to payment in full of their allowed claims; or (ii) amending section 502(b)(2) to provide that unmatured interest is disallowed “except in the case of a solvent debtor.” Yet it did neither.

She characterized the district court’s ruling in *UPC* on this point as “not persuasive.” She explained that the *UPC* court impermissibly relied on equitable principles to modify the express language of the section 502(b)(2) of the Bankruptcy Code when it ruled that the solvent debtor exception survives and that unimpaired creditors were entitled to contract-rate pendency interest “because they were entitled to have their equitable rights fully enforced under section 1124(1).” “When a debtor is solvent,” Judge Walrath wrote, “the Bankruptcy Code does not waive the application of section 502(b)(2).” *Id.* at \*15.

In addition, Judge Walrath characterized as “problematic” the bankruptcy court’s decision in *In re Energy Future Holdings Corp.*, 540 B.R. 109 (Bankr. D. Del. 2015), where the court ruled that a bankruptcy court has the equitable power to award the contract rate “or such other rate as the Court deems appropriate.” *Hertz*, 2021 WL 6068390, at \*15. In particular, she explained: (i) the *Energy Future* court relied on the “fair and equitable” test of section 1129(b), “which by its express terms does not apply to unimpaired creditors”; (ii) “it provides no guidance to debtors or creditors as to precisely how unimpaired creditors must be treated and thus will result in endless litigation”; and (iii) it “runs counter to recent Supreme Court jurisprudence (and Congressional amendments) that have sought to curb the bankruptcy court’s exercise of equitable discretion.” *Id.*

Judge Walrath wrote that “after consideration of the cases cited by the parties, the express language of the Bankruptcy Code, and its Legislative History, the Court is convinced that the solvent debtor exception survived passage of the Bankruptcy Code only to a limited extent.” *Id.* She explained that the Bankruptcy Code expressly codified the solvent debtor exception in section 506(b) as to oversecured creditors and in sections 1129(a)(7) and 726(a)(5) as to unsecured creditors. Judge Walrath further noted that: (i) although sections 1129(a)(7) and 726(a)(5) currently apply only to unsecured creditors impaired by a chapter 11 plan, they applied to all unsecured creditors—impaired and unimpaired—when the Bankruptcy Code was originally enacted; and (ii) when Congress amended the Bankruptcy Code in 1984 to limit the scope of section 1129(a)(7) to impaired classes, “it was motivated by the desire to require voting only by impaired creditors, rather than by a desire to assure that unimpaired creditors get their contract rate of interest.” *Id.* at \*16.

Judge Walrath also determined that neither the Bankruptcy Code nor its legislative history expressly states that unimpaired creditors are entitled to their contract rate of interest “or even to more than impaired creditors in the case of a solvent debtor.” *Id.* Instead, she wrote, the legislative history “provides strong evidence Congress intended that unimpaired creditors in a solvent chapter 11 debtor case should receive post-petition interest only

in accordance with sections 1129(a)(7) and 726(a)(5).” *Id.* Moreover, Judge Walrath reasoned, the legislative history to the repeal of section 1124(3) suggests that lawmakers believed that there is no legitimate reason in a solvent debtor chapter 11 case to distinguish between impaired and unimpaired unsecured creditors who are receiving full payment of their claims in cash under a plan. As a consequence, she ruled, “both should receive the same treatment: payment of their allowed claim plus post-petition interest at the federal judgment rate in accordance with section 726(a)(5).” *Id.*

Judge Walrath accordingly held that the Senior Note Trustee failed to state a plausible claim that the debtors were obligated to pay pendency interest on the Senior Notes at the rates specified in the indentures rather than at the federal judgment rate.

## OUTLOOK

The entitlement of noteholders to make-whole premiums in chapter 11 cases has been the subject of a considerable amount of litigation. At least for the moment, *Hertz* has not added significantly to the discussion, principally because the court, based on the inadequate evidence before it, declined to decide whether the make-whole premiums in the case before it were the economic equivalent of unmatured interest that must be disallowed in bankruptcy. In addition, the court’s conclusions regarding impairment of claims pursuant to the Bankruptcy Code versus impairment pursuant to the plan are consistent with other recent decisions.

The aspects of the ruling concerning the solvent debtor exception and the appropriate rate of pendency interest are more significant. The holding reinforces the well-established statutory and equitable principle that debtors with the means to pay all of their creditors in full should be obligated to do so. *Hertz* adds to the mix by concluding that the solvent-debtor exception only partially survived enactment of the Bankruptcy Code because it applies only to impaired classes of creditors. By contrast, the courts in *Mullins* and *UPC* agreed that the solvent debtor exception survived the enactment of the Bankruptcy Code in its entirety, but they notably disagreed over the statutory basis for its continued application. The *Hertz* court found their rationale to be unconvincing, ruling that a solvent chapter 11 debtor is obligated to pay pendency interest to impaired classes of unsecured creditors at the federal judgment rate. As noted, two circuits may soon add to the growing body of case law on these issues.

# CONFIRMATION DENIED: CHAPTER 11 PLAN DID NOT SATISFY NEW VALUE EXCEPTION TO ABSOLUTE PRIORITY RULE WITHOUT MARKET TESTING

Paul M. Green • Mark G. Douglas

When existing interest holders attempt to retain ownership of a chapter 11 debtor after confirmation of a nonconsensual plan of reorganization, the Bankruptcy Code's plan confirmation requirements, including well-established rules regarding the classification and treatment of creditor claims and equity interests, can create formidable impediments to their reorganization strategy. In *In re Platinum Corral, LLC*, 2022 WL 127431 (Bankr. E.D.N.C. Jan. 13, 2022), the U.S. Bankruptcy Court for the Eastern District of North Carolina applied the Bankruptcy Code's "cram-down" confirmation requirements in denying confirmation of a chapter 11 plan under which one of the debtor's existing equity holders would receive 100% of the new equity in the reorganized company in exchange for cancellation of a prepetition unsecured "loan" and a \$100,000 cash infusion.

According to the court, one of the insiders' loan was properly characterized as a capital infusion and the plan violated the "absolute priority rule" because the old owner, whose claims were subordinate to other unsecured claims, would receive value under the plan without paying the more senior dissenting class of unsecured claims in full. The court also found that the owner's promised \$100,000 cash infusion did not satisfy the "new value exception" to the absolute priority rule because the value of the new equity to be distributed to him under the plan had not been market tested.



## CLASSIFICATION OF CLAIMS AND INTERESTS UNDER A CHAPTER 11 PLAN

Section 1122 of the Bankruptcy Code provides that, except with respect to a class of "administrative convenience" claims (i.e., relatively small unsecured claims, such as trade claims below a certain dollar amount), a plan may place a claim or interest in a particular class "only if such claim or interest is substantially similar to the other claims or interests of such class." The

Bankruptcy Code, however, does not define "substantially similar." This task was left to the courts, relying upon past practice under the former Bankruptcy Act and lawmakers' statements in connection with the enactment of the Bankruptcy Code indicating that the term should be construed to mean similar in legal character or effect as a claim against the debtor's assets or as an interest in the debtor. See *generally* COLLIER ON BANKRUPTCY ("COLLIER") ¶ 1122.03[1] (16th ed. 2022). Thus, interests, such as stock, may not be classified together with claims, such as trade or bond debt, because the relationship between the debtor and its creditors, who assume credit risk but not enterprise risk, is fundamentally different from the relationship between the debtor and its stockholders, who do shoulder enterprise risk as investors.

In passing on the propriety of a plan's claims-classification scheme, courts generally examine the nature of the claim (e.g., senior or subordinated, secured or unsecured) and the relationship of the claim to the debtor's property. For example, secured claims must be classified separately from unsecured claims, and priority claims should not be placed in the same class as general unsecured claims. *Id.*

Although the Bankruptcy Code provides that only substantially similar claims may be classified together, it does not require that all substantially similar claims be placed into a single class. Instead, substantially similar claims may be divided into separate classes if separate classification is reasonable. *Id.*

A classification scheme designed to fabricate an accepting impaired class under section 1129(a)(10) is sometimes referred to as class "gerrymandering." The practice can involve, among other things: (i) classification of claims whose holders are favorable to a plan in the same class with the claims of creditors who are not, with the expectation that supporting claims will sufficiently outnumber dissenting claims to ensure acceptance of the plan by the class as a whole; or (ii) separately classifying the claims of dissenting creditors from the claims of creditors favorable to the plan to ensure that the dissenting creditors cannot defeat cram-down confirmation.

The latter form of gerrymandering has arisen almost exclusively in single-asset real estate cases, where the plan proponent attempts to classify the mortgagee's unsecured deficiency claim separate from the claims of other unsecured creditors. That practice has been invalidated by a majority of the circuit courts of appeals that have faced the issue. See *id.* at ¶ 1122.03[5].

## RECHARACTERIZATION

The power to treat a debt as if it were actually an equity interest is derived from principles of equity. It emanates from the bankruptcy court's power to ignore the form of a transaction and give effect to its substance. See *Pepper v. Litton*, 308 U.S. 295, 305 (1939). However, because the Bankruptcy Code does not expressly empower a bankruptcy court to recharacterize debt as equity, some courts disagree as to whether they have the authority to do so and, if so, the source of such authority.

Every circuit court of appeals that has considered the issue has upheld the power of a bankruptcy court to recharacterize a claim as equity, notwithstanding the parties' characterization of a prepetition advance as a "debt." See generally COLLIER at ¶ 510.02 (citing cases). Some circuits have held that a bankruptcy court's power to recharacterize derives from the broad equitable powers set forth in section 105(a) of the Bankruptcy Code, which provides that "[t]he court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of [the Bankruptcy Code]." See *In re Dornier Aviation (N. Am.), Inc.*, 453 F.3d 225 (4th Cir. 2006); *In re SubMicron Sys. Corp.*, 432 F.3d 448 (3d Cir. 2006); *In re Hedged-Invs. Assocs., Inc.*, 380 F.3d 1292 (10th Cir. 2004); *In re AutoStyle Plastics, Inc.*, 269 F.3d 726 (6th Cir. 2001). In *Hedged Investments*, the Tenth Circuit explained that, if courts were bound by the parties' own characterization of a transaction, "controlling equity owners of a troubled corporation could jump the line of the bankruptcy process and thwart the company's outside creditors' and investors' priority rights." *Hedged Investments*, 380 F.3d at 1298.

The Fifth and Ninth Circuits have taken a different approach, holding instead that section 502(b)(1) of the Bankruptcy Code, which provides in relevant part that "the court . . . shall allow [a] claim . . . except to the extent that . . . such claim is unenforceable against the debtor and property of the debtor, under any agreement or applicable law," is the proper statutory authority for recharacterization. See *In re Lothian Oil Inc.*, 650 F.3d 539 (5th Cir. 2011); *In re Fitness Holdings Int'l, Inc.*, 714 F.3d 1141 (9th Cir. 2013).

The Eleventh Circuit has also recognized the legitimacy of the remedy, but without specifying the source of the court's power to exercise it. See *In re N & D Props., Inc.*, 799 F.2d 726, 733 (11th Cir. 1986) (noting that shareholder loans may be deemed capital contributions "where the trustee proves initial under-capitalization or where the trustee proves that the loans were made when no other disinterested lender would have extended credit"). In *In re Airadigm Communs., Inc.*, 616 F.3d 642, 653 (7th Cir. 2010), the Seventh Circuit declined to decide whether recharacterization of a debt was appropriate (although the bankruptcy court concluded below that it did not have the power to do so), but noted that the "overwhelming weight of authority" supports the authority of bankruptcy courts to recharacterize loans as equity.

In *AutoStyle*, the Sixth Circuit applied an 11-factor test derived from federal tax law. Among the enumerated factors are the labels given to the alleged debt; the presence or absence of a fixed maturity date, interest rate, and schedule of payments; whether the borrower is adequately capitalized; any identity of interest between the creditor and the stockholder; whether the loan is secured; and the corporation's ability to obtain financing from outside lending institutions. This and similar tests have been adopted by many other courts. See, e.g., *Dornier Aviation*, 453 F.3d at 233 (applying *AutoStyle* factors); *SubMicron Sys. Corp.*, 432 F.3d 448 (seven-factor test); *Hedged Investments*, 380 F.3d at 1298 (13-factor test); *N & D Props.*, 799 F.2d at 733 (two-factor test); *In re Transcare Corp.*, 2020 WL 8021060, \*37 (Bankr. S.D.N.Y. July 6,

2020) (noting that "[c]ourts in this District have adopted the eleven-factor analysis set forth in *AutoStyle*"). Under the *AutoStyle* test, no single factor is controlling. Instead, each factor is to be considered in light of the particular circumstances of the case.

In *Lothian Oil* and *Fitness Holdings*, the Fifth and Ninth Circuits respectively ruled that state law should determine whether a debt should be recharacterized as equity. *Lothian Oil*, 650 F.3d at 543-44; *Fitness Holdings*, 714 F.3d at 1148.

## CRAM-DOWN CHAPTER 11 PLANS

If a class of creditors or shareholders votes to reject a chapter 11 plan, it can be confirmed only if the plan satisfies the "cram-down" requirements of section 1129(b) of the Bankruptcy Code. Among those requirements are the mandates that, with respect to dissenting classes of creditors and shareholders: (i) the plan must be "fair and equitable"; and (ii) the plan must not "discriminate unfairly." 11 U.S.C. § 1129(b)(1).

**Fair and Equitable.** Section 1129(b)(2)(B) of the Bankruptcy Code provides that a plan is "fair and equitable" with respect to a dissenting impaired class of unsecured claims if the creditors in the class receive or retain property of a value equal to the allowed amount of their claims or, failing that, in cases not involving an individual debtor, if no creditor or equity holder of lesser priority receives or retains any distribution under the plan "on account of" its junior claim or interest. This requirement is sometimes referred to as the "absolute priority rule."

**The New Value Exception to the Absolute Priority Rule.** A "new value exception" to the "fair and equitable" requirement set forth in section 1129(b)(2)(B) was developed under pre-Bankruptcy Code law. See *Case v. Los Angeles Lumber Prods. Co.*, 308 U.S. 106 (1939). Under this new value exception to the absolute priority rule, a junior stakeholder (e.g., a shareholder or subordinated creditor) could retain an equity interest under a chapter 11 plan over the objection of a senior impaired-creditor class, provided that the junior stakeholder contributed new capital to the restructured enterprise. According to some courts, that contributed capital must be: (i) new; (ii) substantial; (iii) necessary for the success of the plan; (iv) reasonably equivalent to the value retained; and (v) in the form of money or money's worth. See, e.g., *In re Crowe*, 2021 WL 2212005 (Bankr. D. Ariz. June 1, 2021).

In *In re Bonner Mall Partnership*, 2 F.3d 899 (9th Cir. 1993), *motion to vacate denied, case dismissed sub nom. U.S. Bancorp Mortg. Co. v. Bonner Mall Partnership*, 513 U.S. 18 (1994), the Ninth Circuit held that "if a proposed plan satisfies all of these [five] requirements, i.e., the new value exception, it will not violate section 1129(b)(2)(B)(ii) of the Code and the absolute priority rule." Such a plan, the court wrote, "will not give old equity property 'on account of' prior interests, but instead will allow the former owners to participate in the reorganized debtor on account of a substantial, necessary, and fair new value contribution."

Courts disagree as to whether the new value exception survived the enactment of the Bankruptcy Code in 1978, principally because the concept is not explicitly referred to in section 1129(b) (2) or elsewhere in the statute. See *generally* COLLIER at ¶ 1129.03[4](c) (“One of the more hotly contested issues after adoption of the Code has been whether the so-called “new value” cases continued to have validity. The Supreme Court has three times declined to rule on the matter, and the circuit courts are currently in disarray. Other appellate courts tend to favor the doctrine’s existence, but some are unsure. Each side has arguments to make.”) (footnotes omitted).

Since the enactment of the Bankruptcy Code, the U.S. Supreme Court has only obliquely addressed the legitimacy of the new value exception. In *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197 (1988), the court held that, even if the new value exception survived the enactment of the Bankruptcy Code, the new value requirement could not be satisfied by promised future contributions of labor. The Court was similarly reluctant to tackle the issue head-on in the other two cases to date in which it had an opportunity to do so. In 1994, the Court declined to vacate on appeal the Ninth Circuit’s *Bonner Mall* opinion, and in 1999, it similarly declined to overrule the Seventh Circuit’s interpretation of the corollary in *Bank of Am. Nat. Tr. & Sav. Ass’n v. 203 N. LaSalle St. P’ship*, 526 U.S. 434 (1999). Instead, in *LaSalle*, the Court held that one or two of the five elements of the new value corollary could not be satisfied when old equity retains the exclusive right to contribute the new value i.e., without a market test of the new value.

“It is enough to say, assuming a new value corollary,” the Court wrote in *LaSalle*, “that plans providing junior interest holders with exclusive opportunities free from competition and without benefit of market valuation fall within the prohibition of § 1129(b)(2)(B)(ii).” According to the Court, the absolute priority rule is violated if a plan provides for “vesting equity in the reorganized business in the Debtor’s partners without extending an opportunity to anyone else either to compete for that equity or to propose a competing reorganization plan.”

**No Unfair Discrimination.** The Bankruptcy Code does not define “unfair discrimination,” and “[c]ourts have struggled to give the unfair discrimination test an objective standard.” COLLIER at ¶ 1129.03[a]. Nevertheless, most courts agree that the purpose underlying the requirement is “to ensure that a dissenting class will receive relative value equal to the value given to all other similarly situated classes.” *In re LightSquared Inc.*, 513 B.R. 56, 99 (Bankr. S.D.N.Y. 2014); *accord In re SunEdison, Inc.*, 575 B.R. 220 (Bankr. S.D.N.Y. 2017); *In re 20 Bayard Views, LLC*, 445 B.R. 83 (Bankr. E.D.N.Y. 2011); *In re Johns-Manville Corp.*, 68 B.R. 618, 636 (Bankr. S.D.N.Y. 1986), *aff’d*, 78 B.R. 407 (S.D.N.Y. 1987), *aff’d*, 843 F.2d 636 (2d Cir. 1988).

Courts have historically relied on a number of tests to determine whether a plan discriminates unfairly. These include: (i) the “mechanical” test, which prohibits all discrimination and requires that the recoveries of similarly situated creditors be identical;

(ii) the “restrictive” approach, which narrowly defines unfair discrimination to mean that, absent subordination, disparate treatment of similarly situated creditors is not permitted; and (iii) the “broad” approach, which considers whether (a) a reasonable basis for discrimination exists, (b) the debtor can consummate a plan without discrimination, (c) the discrimination is proposed in good faith, and (d) the extent of discrimination is directly proportional to its rationale. See *generally* Denise R. Polivy, *Unfair Discrimination in Chapter 11: A Comprehensive Compilation of Current Case Law*, 72 Am. Bankr. L.J. 191, 196-208 (1998) (discussing cases applying the various tests).

Several courts have adopted some form of the unfair discrimination test (“Markell test”) articulated by Bruce A. Markell in his article *A New Perspective on Unfair Discrimination in Chapter 11*, 72 Am. Bankr. L.J. 227, 249 (1998). See, e.g., *In re Armstrong World Indus., Inc.*, 348 B.R. 111 (D. Del. 2006); *In re Quay Corp., Inc.*, 372 B.R. 378 (Bankr. N.D. Ill. 2007); *In re Exide Techs.*, 303 B.R. 48 (Bankr. D. Del. 2003). The Markell test was first applied by a bankruptcy court in *In re Dow Corning Corp.*, 244 B.R. 705 (Bankr. E.D. Mich. 1999), *aff’d in relevant part*, 255 B.R. 445 (E.D. Mich. 2000), *aff’d in part and remanded*, 280 F.3d 648 (6th Cir. 2002). Under the Markell test, a rebuttable presumption that a plan unfairly discriminates will arise when the following elements exist:

- (1) a dissenting class; (2) another class of the same priority; and (3) a difference in the plan’s treatment of the two classes that results in either (a) a materially lower percentage recovery for the dissenting class (measured in terms of the net present value of all payments), or (b) regardless of percentage recovery, an allocation under the plan of materially greater risk to the dissenting class in connection with its proposed distribution.

*Id.* at 710. The burden then lies with the plan proponent to rebut the presumption by demonstrating that “outside of bankruptcy, the dissenting class would similarly receive less than the class receiving a greater recovery, or that the alleged preferred class had infused new value into the reorganization which offset its gain.” *Id.*

### **PLATINUM CORRAL**

Platinum Corral, L.L.C. (“PCL”) is a Golden Corral restaurant franchise headquartered in North Carolina. At the time it filed for bankruptcy in 2021, PCL’s two members were its CEO and president, L. William Sewell, III (“Sewell”), who held an 87.5% ownership interest, and John Pierce, who owned the remaining interests.

Beginning in 2014, PCL faced a significant cash crunch and needed to obtain financing to meet operating expenses. Sewell made a series of loans to the company from 2014 to 2017 aggregating approximately \$11 million. The proceeds were used to pay PCL’s operating expenses as well as payroll, sales, and property taxes. Other former members of PCL also made loans to PCL during this period, all of which were repaid in full.

In 2018, PCL and Sewell entered into a formal loan agreement to refinance the various loans made by Sewell. The debt was evidenced by an unsecured payable-on-demand promissory note (together with all renewals, "Note 1") dated December 31, 2017, in the principal amount of \$10.975 million with interest accruing (but not payable until called) at 6% per annum. Each year thereafter, PCL executed a renewal note to reflect the year-end updated loan balance after deducting payments made during the previous year and adding unpaid accrued interest.

In December 2017, PCL refinanced a portion of its \$17.1 million debt to third-party lenders by obtaining \$16.2 million in secured financing from Pacific Premier Bank ("PPB"). After no third-party lender was willing to loan the additional funds needed to refinance the remainder of PCL's debt, Sewell provided the company with \$900,000, which was evidenced by a second unsecured payable-on-demand promissory note dated January 2, 2018 (together with all renewals, "Note 2"), accruing interest at the rate of 6% per annum. Like Note 1, Note 2 was renewed at the end of each year to reflect the outstanding loan balance. Both Note 1 and Note 2 were reflected in PCL's books and records as "loans."

PCL filed for chapter 11 protection on April 20, 2021, in the Eastern District of North Carolina. Sewell filed separate unsecured claims based on Note 1 (\$13,767,050) and Note 2 (\$910,283).

PCL proposed a chapter 11 plan that included 13 classes of claims and interests. Class 11 contained unsecured claims consisting of trade debt and contract rejection damages claims, which were estimated to be \$6.5 million. The plan proposed to distribute \$1.2 million to the creditors in the class over five years. Sewell's claims based on Note 1 and Note 2, which were subordinated to the claims of all other creditors, were placed in a separate class (Class 12). The plan provided that the Class 12 claims would be deemed satisfied upon plan confirmation by the issuance of 100% of the equity in the reorganized company to Sewell in exchange for Sewell's agreement to provide \$100,000 in new capital. Certain other unsecured claims, including claims under PCL's Golden Corral franchise agreement and its food service distribution agreement, and PPB's unsecured deficiency claim, were placed into Classes 4, 8, and 9. PCL's old equity (Class 13) would be canceled under the plan.

Only Class 11 voted to reject the plan.

PCL's unsecured creditors' committee objected to confirmation of the plan. Among other things, the committee argued that: (i) by giving value to Class 12 without paying Class 11 creditors in full, the plan violated the absolute priority rule and was therefore not "fair and equitable"; (ii) the \$100,000 payment promised by Sewell did not satisfy the new value exception in the absence of a market test of PCL's value as a going concern; (iii) the plan unfairly discriminated against the Class 11 creditors; and (iv) Sewell's claims based on Note 1 and Note 2 should be recharacterized as capital contributions.



### THE BANKRUPTCY COURT'S RULING

The bankruptcy court denied confirmation of PCL's chapter 11 plan.

Applying the *AutoStyle* factors (as approved by the Fourth Circuit in *Dornier Aviation*), U.S. Bankruptcy Judge Joseph N. Callaway ruled that Note 1 was properly classified as a claim, but that Note 2 should be recharacterized as equity. Among other things, he found that, although both obligations were labeled "promissory notes," bore interest, and were payable upon demand, the loans evidenced by Note 1 were made at a time when PCL had other available sources of funding and the loan proceeds were used to pay operating expenses, indicating that the Note 1 obligation was a bona fide loan. According to Judge Callaway, "virtually nothing indicates Note 1 would not be legally enforceable as a matter of law in a state court collection action." *Platinum Corral*, 2022 WL 127431, at \*7.

By contrast, Judge Callaway explained, the Note 2 loan was made by Sewell so that PPB could receive a first lien on all of PCL's assets to secure new financing, and the Note 2 loan proceeds were used to refinance operating debt when no third-party lender was willing to make a loan to PCL, given the lack of any encumbered assets to secure financing. "The use of funds to pay off a loan secured by the Debtor's assets," he wrote, "is a capital contribution." *Id.* Judge Callaway accordingly ruled that

Sewell had an allowed unsecured claim based on Note 1 in the amount of approximately \$13.7 million, but Sewell's claims based on Note 2 would be recharacterized as equity.

Judge Callaway then examined whether separate classification of the unsecured Note 1 claim (Class 12) and unsecured trade and contract rejection claims (Class 11) was permissible. He ruled that it was, finding that the primary purpose behind the split was not to manipulate class voting by manufacturing an accepting impaired class (gerrymandering). In particular, Judge Callaway explained, there were "ample business plan reasons to divide non-insider trade debt and insider note debt," and the unsecured claim division was made in good faith. *Id.* at \*9. Moreover, he noted, classifying all unsecured claims together and giving the same treatment to all creditors in the class would be problematic because: (i) creditor recoveries in an "all-encompassing unsecured class" would be reduced drastically; and (ii) unsecured creditors other than Sewell neither wanted to hold equity in the reorganized company, nor were they eligible to do so, because Golden Corral had the right to determine who could become a member of a franchise company.

However, because PCL's plan proposed to distribute new equity to Class 12—containing the recharacterized Note 2 claim—but did not pay in full the claims in dissenting Class 11, Judge Callaway held that the plan violated the absolute priority rule. He also noted that the new member interests to be issued to insider Sewell, to the exclusion of any other stakeholder, were a potentially valuable property right (projected to be worth approximately \$2.8 million) if PCL returned to pre-pandemic profitability levels during the five years after plan confirmation.

Judge Callaway next ruled that Sewell's \$100,000 cash contribution in exchange for the new equity interests did not satisfy the new value exception. He explained that: (i) the testimony of PCL's financial expert that the new equity was worthless was unconvincing; and (ii) there was inadequate evidence to establish the reorganized company's value as a going concern without conducting the market valuation test mandated by the Supreme Court's ruling in *LaSalle*.

Judge Callaway noted that the market test can be waived. Waiver might be warranted, for example, if plan exclusivity had expired or a marketing effort would be futile because there were no other eligible buyers or if eligible purchasers declined to bid. Judge Callaway also acknowledged that Sewell might be the best (or even the only) candidate to guide reorganized PCL into a successful future. However, without any evidence of futility or the absence of qualified bidders, he determined that the plan could not be confirmed.

Finally, Judge Callaway found that PCL's chapter 11 plan was not fair and equitable to creditors in dissenting Class 11 because Sewell (the sole Class 12 creditor) would receive all of the upside potential after confirmation if PCL's retained earnings projections were met or exceeded.

He accordingly denied confirmation of PCL's plan and directed the company to file an amended plan remedying the defects.

## OUTLOOK

*Platinum Corral* illustrates some of the difficulties associated with successfully reorganizing closely held businesses in chapter 11. Frequently, the only stakeholders willing and able to continue operating the reorganized business are its existing owners, without whom both secured and unsecured creditors are likely to realize far less recovery on their claims. In many such chapter 11 cases, a pre-bankruptcy owner's efforts to retain control of a debtor that cannot pay its creditors in full are frequently thwarted by the Bankruptcy Code's cram-down confirmation requirements, especially where creditor payouts are meager and any new capital infusion is deemed inadequate. This is precisely what happened in *Platinum Corral*.

Interestingly, the debtor in *Platinum Corral* was not eligible to file for bankruptcy as a "small business debtor" under subchapter V of chapter 11 because its secured and unsecured debts exceeded \$7.5 million (see 11 U.S.C. §§ 101(51)(D) and 1181(a) (as temporarily amended by the CARES Act of 2002 and the Bankruptcy Relief Extension Act of 2021)). Had it qualified as a small business debtor under subchapter V, neither the absolute priority rule nor the remainder of section 1129(b) of the Bankruptcy Code would have applied to PCL's chapter 11 plan. See 11 U.S.C. § 1181(a). Although subchapter V provides that a non-consensual plan must not discriminate unfairly and must be fair and equitable with respect to dissenting classes, the definition of "fair and equitable" in subchapter V does not include the absolute priority rule. See 11 U.S.C. § 1191.





## CROSS-BORDER BANKRUPTCY UPDATE: BAD FAITH NOT A BASIS FOR DENYING CHAPTER 15 RECOGNITION

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Despite the absence of any explicit directive in the Bankruptcy Code, it is well understood that a bankruptcy court can dismiss a chapter 11 case if it not filed in good faith. A ruling recently handed down by a Bankruptcy Appellate Panel for the Ninth Circuit (“BAP”) suggests that no such good faith filing requirement applies to a petition seeking recognition of a foreign bankruptcy under chapter 15 of the Bankruptcy Code. In *In re Black Gold S.A.R.L.*, 2022 WL 488438 (B.A.P. 9th Cir. Feb. 17, 2022), the BAP reversed a bankruptcy court order denying chapter 15 recognition of a Monaco bankruptcy proceeding. After initially granting provisional relief under section 1519 of the Bankruptcy Code, the bankruptcy court concluded that the petition was inconsistent with the objectives of chapter 15 as set forth in section 1501 because of the debtor’s bad faith conduct in attempting to evade payment of a judgment and shield its principals from tort liability. On appeal, according to the BAP, once the Bankruptcy Code’s requirements for chapter 15 recognition are satisfied, recognition is mandatory unless it would be “manifestly contrary” to U.S. public policy—a threshold that is rarely met in chapter 15 proceedings.

### PROCEDURES, RECOGNITION, AND RELIEF UNDER CHAPTER 15

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

Both chapter 15 and the Model Law are premised upon the principle of international comity, or “the recognition which one nation allows within its territory to the legislative, executive or judicial acts of another nation, having due regard both to international duty and convenience, and to the rights of its own citizens or of other persons who are under the protection of its laws.” *Hilton v. Guyot*, 159 U.S. 113, 164 (1895).

Chapter 15 replaced section 304 of the Bankruptcy Code. Section 304 allowed an accredited representative of a debtor in a foreign bankruptcy proceeding to commence a limited “ancillary” bankruptcy case in the United States for the purpose of enjoining actions against the foreign debtor or its assets located in the United States or, in some cases, repatriating such assets or their proceeds abroad for administration in the debtor’s foreign bankruptcy.

The policy behind section 304 was to provide any assistance necessary to ensure the economic and expeditious administration of foreign bankruptcy proceedings. In deciding whether to grant injunctive, turnover, or other appropriate relief under former section 304, a U.S. bankruptcy court had to consider “what will best assure an economical and expeditious administration” of the foreign debtor’s estate, consistent with a number of factors, including comity. See 11 U.S.C. § 304(c) (repealed 2005) (listing factors that are now included in section 1507(b) as a condition to the court’s decision post-recognition to grant “additional assistance, consistent with the principles of comity,” under chapter 15 or other U.S. law).

Section 1501(a) of the Bankruptcy Code states that the purpose of chapter 15 is to “incorporate the [Model Law] so as to provide effective mechanisms for dealing with cases of cross-border insolvency with the objectives of,” among other things, cooperation between U.S. and foreign courts, greater legal certainty for trade and investment, fair and efficient administration of cross-border cases to protect the interests of all stakeholders,

protection and maximization of the value of a debtor's assets, and the rehabilitation of financially troubled businesses.

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

Section 1502 provides that "for the purposes of [chapter 15] . . . 'debtor' means an entity that is the subject of a foreign proceeding."

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

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

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

More than one bankruptcy or insolvency proceeding may be pending with respect to the same foreign debtor in different countries. Chapter 15 therefore contemplates recognition in the United States of both a foreign "main" proceeding—a case pending in the country where the debtor's center of main interests ("COMI") is located (see 11 U.S.C. § 1502(4))—and foreign "nonmain" proceedings, which may be pending in countries where the debtor merely has an "establishment" (see 11 U.S.C. § 1502(5)). A debtor's COMI is presumed to be the location of the debtor's registered office or habitual residence in the case of an individual. See 11 U.S.C. § 1516(c). An "establishment" is defined by section 1502(2) as "any place of operations where the debtor carries out a nontransitory economic activity."

Pending its decision on a petition for recognition, the bankruptcy court is empowered to grant certain kinds of provisional relief. Section 1519(a) authorizes the court, "where relief is urgently needed to protect the assets of the debtor or the interests of the creditors," to stay any execution against the debtor's assets, entrust the administration of the debtor's assets to a foreign representative, or suspend the right to transfer, encumber, or otherwise dispose of any of the debtor's assets.

Upon recognition of a foreign "main" proceeding, section 1520(a) of the Bankruptcy Code provides that certain provisions of the Bankruptcy Code automatically come into force, including: (i) the automatic stay preventing creditor collection efforts with respect to the debtor or its U.S. assets (section 362, subject to certain enumerated exceptions); (ii) the right of any entity asserting an interest in the debtor's U.S. assets to "adequate protection" of that interest (section 361); and (iii) restrictions on use, sale, lease, transfer, or encumbrance of the debtor's U.S. assets (sections 363, 549, and 552).

Following recognition of a foreign main or nonmain proceeding, section 1521(a) provides that, to the extent not already in effect, and "where necessary to effectuate the purpose of [chapter 15] and to protect the assets of the debtor or the interests of the creditors," the bankruptcy court may grant "any appropriate relief," including a stay of any action against the debtor or its U.S. assets not covered by the automatic stay, an order suspending the right to transfer or encumber the debtor's U.S. assets, and "any additional relief that may be available to a trustee," with certain exceptions. Under section 1521(b), the court may entrust the distribution of the debtor's U.S. assets to the foreign representative or another person, provided the court is satisfied that the interests of U.S. creditors are "sufficiently protected."

Section 1507(a) of the Bankruptcy Code provides that, upon recognition of a foreign main or nonmain proceeding, the bankruptcy court may provide "additional assistance" to a foreign representative "under [the Bankruptcy Code] or under other laws of the United States." However, the court must consider whether any such assistance, "consistent with the principles of comity," will reasonably ensure that: (i) all stakeholders are treated fairly; (ii) U.S. creditors are not prejudiced or inconvenienced by asserting their claims in the foreign proceeding; (iii) the debtor's assets are not preferentially or fraudulently transferred; (iv) proceeds of the debtor's assets are distributed substantially in accordance with the order prescribed by the Bankruptcy Code; and (v) if appropriate, an individual foreign debtor is given the opportunity for a fresh start. See 11 U.S.C. § 1507(b).

Section 1522(a) provides that the bankruptcy court may exercise its discretion to order the relief authorized by section 1519 upon the commencement of a case or by section 1521 upon the recognition of a foreign proceeding "only if the interests of the creditors and other interested entities, including the debtor, are sufficiently protected."

#### **PUBLIC POLICY EXCEPTION TO CHAPTER 15 RELIEF**

Section 1506 of the Bankruptcy Code sets forth a public policy exception to the relief otherwise authorized in chapter 15, providing that "[n]othing in this chapter prevents the court from refusing to take an action governed by this chapter if the action would be manifestly contrary to the public policy of the United States." However, section 1506 requires a "narrow reading" and "does not create an exception for *any* action under Chapter 15 that may conflict with public policy, but only an action that is '*manifestly*

contrary.” *In re Fairfield Sentry Ltd.*, 714 F.3d 127, 139 (2d Cir. 2013); accord *In re ABC Learning Ctrs. Ltd.*, 728 F.3d 301, 309 (3d Cir. 2013) (the public policy exception should be invoked only under exceptional circumstances concerning matters of “fundamental importance” to the United States).

Most courts have concluded that the narrow and rarely invoked public policy exception in section 1506 does not prohibit chapter 15 recognition in situations where the debtor has engaged in bad faith—a circumstance that might warrant dismissal of a bankruptcy case filed under other chapters of the Bankruptcy Code. See *In re Culligan Ltd.*, 2021 WL 2787926, \*14 (Bankr. S.D.N.Y. July 2, 2021) (declining to deny chapter 15 recognition even though the case was filed as a litigation tactic to avoid adverse rulings by a state court); *In re Manley Toys Ltd.*, 580 B.R. 632, 648-52 (Bankr. D.N.J. 2018) (recognizing a Hong Kong liquidation proceeding even though the debtor and its insiders may have acted in bad faith in other litigation and where Hong Kong fraudulent transfer laws were not “manifestly contrary” to U.S. laws), *aff’d*, 597 B.R. 578 (D.N.J. 2019); *In re Creative Fin. Ltd.*, 543 B.R. 498, 502 (Bankr. S.D.N.Y. 2016) (declining to invoke section 1506 to deny recognition even though the chapter 15 case, which was filed after the debtor’s principal caused all of the debtor’s liquid assets to be transferred out of the debtor’s UK bank accounts pending the entry of a final adverse judgment, “was the most blatant effort to hinder, delay or defraud a creditor this Court has ever seen”); *In re Millard*, 501 B.R. 644, 653 (Bankr. S.D.N.Y. 2013) (granting chapter 15 recognition of a Cayman Islands bankruptcy case filed to avoid enforcement of two default tax judgments entered against the debtors in the Mariana Islands). Instead, the question under section 1506 is not whether the debtor’s actions violate public policy but whether the foreign court’s procedures and safeguards fail to comport with U.S. public policy. *Culligan*, 2021 WL 2787926, at \*14.

### **BLACK GOLD**

Black Gold S.A.R.L. (“BG”) is a Monaco limited liability company that until June 2020 operated as a distributor of lubricant products in Europe, Africa, and Asia. BG’s sole shareholders are Lorenzo and Sofia Napoleoni (“Napoleonis”). The company has no other employees, officers, or directors.

BG’s largest customer and creditor was International Petroleum Products and Additives Company, Inc. (“IPAC”), a California-based petroleum additive manufacturer. In 2016, BG agreed to be IPAC’s European sales representative. The parties’ sales agreements obligated BG to maintain the confidentiality of IPAC’s commercial information and prohibited BG from providing service or assistance for competing products.

However, the Napoleonis and a former IPAC employee established a competing additives business, PXL, that appropriated IPAC’s trade secrets and customer list.

IPAC commenced an arbitration proceeding against BG in California to remedy BG’s appropriation of IPAC’s commercial

information and breach of their sales agreements. On May 29, 2019, the arbitrator awarded IPAC more than \$1 million, finding that BG stole IPAC’s trade secrets to manufacture and sell PXL products. A California district court later entered a judgment confirming the award.

IPAC unsuccessfully attempted to collect the debt in the United States and Monaco, including seeking a judgment debtor examination of the Napoleonis. Collection and enforcement efforts were suspended in May 2020 when BG filed an insolvency proceeding in Monaco (“Monaco Proceeding”). The Monegasque court fixed May 29, 2019 (the date that IPAC’s arbitration award became final) as the date of BG’s “cessation of payments” (or insolvency date) and appointed Jean-Paul Samba (“Samba”) as BG’s trustee. Samba had served as a trustee in insolvency proceedings in Monaco since 1983. As a general matter, Monegasque law has certain similarities to chapter 11 (e.g., entry of the insolvency judgment suspends any actions by creditors to enforce or collect debts against or from the debtor) but also differs in certain material respects (e.g., no analogs to U.S. bankruptcy discovery procedures, the legal theory of “alter ego” liability, or the concept of abandonment of estate property).

In November 2020, Samba filed a petition in the U.S. Bankruptcy Court for the Northern District of California seeking chapter 15 recognition of the Monaco Proceeding. At that time, the Monegasque court had not yet determined in accordance with the Monegasque Commercial Code whether the Monaco Proceeding would proceed as a reorganization or a liquidation, but the latter appeared likely as BG had ceased operating.

IPAC opposed recognition. It argued that a U.S. bankruptcy court has never recognized a Monegasque bankruptcy under chapter 15. IPAC also contended that it would be manifestly contrary to U.S. public policy because BG’s insiders were acting in bad faith to exploit the bankruptcy systems in both the United States and Monaco. According to IPAC, the “true purpose” of the bankruptcy cases was to allow the Napoleonis to “escape liability for their international torts.” IPAC also contended that the differences between the bankruptcy laws of Monaco and the United States were so great that the U.S. bankruptcy court should refuse to recognize the Monaco Proceeding.

The bankruptcy court denied the petition for recognition. Among other reasons: (i) the court was skeptical about the timing of the Monegasque court’s designation of the “cessation of payments” date as the same day that IPAC’s California arbitration award became final; and (ii) despite Samba’s extreme lack of candor, the court discovered that the Napoleonis were paying Samba’s attorneys’ fees, and his lawyers also represented BG in the California litigation and the Napoleonis in a separate lawsuit filed in Ohio. The bankruptcy court found that Samba was not acting as a true fiduciary, and that the chapter 15 case was essentially a two-party dispute pitting BG and the Napoleonis against IPAC, rather than a vehicle for any meaningful recovery for creditors.



The bankruptcy court ruled that the chapter 15 petition was not a legitimate use of chapter 15 for the purposes and objectives stated in section 1501 of the Bankruptcy Code. Instead, the court reasoned, the filing was an effort to preclude IPAC from recovering on its judgment and to protect the Napoleonis and PLX from the consequences of their wrongful conduct. It accordingly denied recognition of the Monaco Proceeding without making any findings under section 1517. Samba appealed the ruling to the BAP.

### THE BANKRUPTCY APPELLATE PANEL'S RULING

The BAP reversed on appeal.

Writing for the panel, U.S. Bankruptcy Judge Julia W. Brand stated that the bankruptcy court erred by relying on section 1501 to deny chapter 15 recognition. Instead, she explained, recognition is governed by sections 1515 through 1524, and the requirements for recognition are specifically outlined in section 1517(a).

According to Judge Brand, if all three requirements of section 1517(a) are satisfied, “recognition is mandatory . . . and there is no public policy basis to deny it.” *Black Gold*, 2022 WL 488438, at \*6 (citing *ABC Learning*, 728 F.3d at 306-09; *In re PT Bakrie Telecom Tbk*, 628 B.R. 859, 870 (Bankr. S.D.N.Y. 2021); *In re Creative Finance Ltd.*, 543 B.R. 498, 514 (Bankr. S.D.N.Y. 2016); *Millard*, 501 B.R. at 653–54). Moreover, she explained, lawmakers’ use of the word “shall” in section 1517(a) “removed the court’s discretion in determining recognition if the requirements in all three subparagraphs of § 1517(a) have been satisfied.” *Id.* Judge Brand also noted that the “discretionary factors” that courts formerly applied under section 304(c) of the Bankruptcy Code in determining whether to grant any form of relief to a foreign representative, including recognition, are now embodied in section 1507(b) of the Bankruptcy Code, which applies only *after* recognition.

Judge Brand then examined whether the bankruptcy court should have recognized the Monaco Proceeding under chapter 15 as a foreign main proceeding.

She found that the Monaco Proceeding satisfied all of the elements of section 1517(a) because: (i) the Monaco Proceeding met the definition of a “foreign proceeding” under section 101(23); (ii) Samba qualified as a “foreign representative,” as defined in section 101(24); and (iii) the chapter 15 petition was supported by the documentary evidence required by section 1515.

Judge Brand then addressed whether, despite the petition’s compliance with the requirements of section 1517(a), recognition should be denied because the Monaco Proceeding was manifestly contrary to U.S. public policy. She concluded that recognition should not be denied on that basis.

Judge Brand agreed with the courts in *Culligan*, *Manley Toys*, *Creative Finance*, and *Millard* that, “standing alone,” bad faith is not a proper basis to invoke section 1506 to deny recognition. Even if the BAP were to rule otherwise, she observed, “the conduct here, while objectionable, did not rise to the level of a violation of U.S. public policy, and certainly not ‘manifestly’ so.” *Black Gold*, 2022 WL 488438, at \*10. Although the Monaco Proceeding and BG’s chapter 15 petition were clearly designed to thwart IPAC’s collection efforts, Judge Brand wrote, “Bankruptcies are filed in the United States under other chapters for the same purpose, but the petition may still be filed.” *Id.*

In addition, Judge Brand determined that the differences between the procedural and substantive aspects of Monegasque and U.S. bankruptcy law (including the absence of a creditor discovery mechanism or an alter ego basis for liability) were not significant enough to warrant denial of recognition on public policy grounds. Indeed, she emphasized, merely because a U.S. bankruptcy court has not yet recognized a Monaco proceeding does not mean that chapter 15 recognition is not warranted. Importantly, Judge Brand noted that “the absence of certain procedural or constitutional rights or differences in insolvency schemes will not bar recognition under the public policy exception” in section 1506.

Finally, Judge Brand explained that a U.S. bankruptcy court is not helpless when confronted with misconduct or bad faith in a chapter 15 case. For example, after recognition, the court could abstain from or suspend all proceedings in a chapter 15 case under sections 305(a)(2) and 1529(4) of the Bankruptcy Code. The court could also grant relief from the automatic stay under section 362(d)(1) upon demonstration of “cause.” Finally, Judge Brand noted, the court has the power under section 1517(d) to modify or terminate recognition “if the grounds for granting it were fully or partially lacking or have ceased to exist.” *Id.* at \*11.

The BAP accordingly reversed the bankruptcy court’s order refusing to recognize the Monaco Proceeding under chapter 15.

## OUTLOOK

*Black Gold* and the handful of similar rulings addressing this issue highlight important distinctions between cases under chapter 11 and chapter 15 of the Bankruptcy Code. In certain circumstances, good faith acts as a gatekeeper to chapter 11. For example, a company facing existential litigation judgments, contingent mass tort claims, or other creditor collection efforts clearly satisfies the good faith requirements of chapter 11.

By contrast, the public policy exception in chapter 15 focuses on the foreign country's insolvency process and procedures, rather than the debtor or its conduct. Chapter 15 was designed to provide a mechanism for U.S. bankruptcy courts to assist foreign tribunals and functionaries in the process of overseeing a foreign debtor's bankruptcy or insolvency. Provided the foreign bankruptcy or insolvency process roughly comports with U.S. public policy, the foreign debtor's (or foreign representative's) intent in seeking recognition under chapter 15 is largely irrelevant. And, to the extent there may be nefarious conduct by debtors or a foreign representative, a bankruptcy court has various tools at hand to address such issues, including, among other things, limiting the amount of additional assistance provided under section 1507 or possibly limiting the foreign representative's authority under section 1520(a)(3) (giving the court the discretion to restrict a foreign representative's ability to operate the debtor's business or to exercise a bankruptcy trustee's rights under sections 363 and 552 of the Bankruptcy Code). Moreover, as the BAP noted in *Black Gold*, the court may abstain from or suspend all proceedings in the chapter 15 case, grant relief from the automatic stay for "cause," or modify or terminate recognition if the circumstances so dictate.

## U.S. SUPREME COURT BANKRUPTCY ROUNDUP

Jane Rue Wittstein • Mark G. Douglas

### SUPREME COURT TO RESOLVE CIRCUIT SPLIT ON CONSTITUTIONALITY OF U.S. TRUSTEE FEE HIKE

This Term, the U.S. Supreme Court accepted *certiorari* in *Siegel v. Fitzgerald (In re Circuit City Stores, Inc.)*, 996 F.3d 156 (4th Cir. 2021), *cert. granted*, No. 21-441 (U.S. Jan. 10, 2022), in order to resolve the growing circuit split over the constitutionality of the 2017 amendment to 28 U.S.C. § 1930(a)(6) ("2017 Amendment"), which greatly increased quarterly fees charged by the United States Trustee ("UST") in large chapter 11 cases. The 2017 Amendment, enacted initially as a temporary measure as part of a large appropriations bill to redress projected UST budget shortfalls, replaced the prior scale that capped quarterly fees at \$30,000 for disbursements over \$30 million with a new scale that assessed a 1% fee on disbursements of \$1 million or more up to a cap of \$250,000 for quarterly disbursements of at least \$25 million. See Additional Supplemental Appropriations for Disaster Relief Requirements Act, 2017, at Division B, Bankruptcy Judgeship Act of 2017, Pub. L. No. 115-72, § 1004, 131 Stat. 1224, 1232 (Oct. 26, 2017).

In the 88 judicial districts ("UST districts") that are part of the UST program (a division of the U.S. Department of Justice, part of the Executive Branch), the UST charged the increased quarterly fees in both new and pending cases effective January 1, 2018. However, in the six North Carolina and Alabama judicial districts ("BA districts") with Bankruptcy Administrators ("BAs") overseeing the administration of bankruptcy cases (managed by the Administrative Office of the United States Courts, and supervised by the Judicial Conference of the United States, part of the Judicial Branch), the Judicial Conference did not adopt the fee increase until September 2018, and then only for new cases filed on or after October 1, 2018.

While the 2017 Amendment has also been challenged on statutory retroactivity, due process, and excessive user fee grounds, the sole issue currently pending before the Supreme Court is whether the disparity in quarterly fees for cases filed before October 1, 2018, based on the judicial district in which a debtor's case was pending, violates Congress's constitutional authority to "establish . . . uniform Laws on the subject of Bankruptcies throughout the United States." U.S. Const. art. I, § 8, cl. 4 ("Bankruptcy Clause"). To date, five federal circuit courts of appeals have addressed this important constitutional issue with respect to the 2017 Amendment, each on a direct appeal from the bankruptcy court.

**The Circuit Split.** In both the Fourth and Fifth Circuits, a majority of a three-judge panel upheld the 2017 Amendment on the basis that the fees were uniform within UST districts and within BA districts, while a dissenting judge objected on the basis that the lack of nationwide geographical uniformity violated the

Bankruptcy Clause. See *Siegel*, 996 F.3d 156; *Hobbs v. Buffets, L.L.C.* (*In re Buffets, L.L.C.*), 979 F.3d 366 (5th Cir. 2020).

The Second Circuit weighed in next, where a three-judge panel unanimously rejected the rationale adopted by the majority in *Siegel* and *Hobbs*, and held that the 2017 Amendment “was unconstitutionally nonuniform on its face” because it *mandated* a fee increase in UST districts but only *permitted* a fee increase in BA districts. See *In re Clinton Nurseries, Inc.*, 998 F.3d 56, 70 (2d Cir. 2021), *cert. pending sub nom. Harrington v. Clinton Nurseries, Inc.*, No. 21-1123 (U.S. Feb. 14, 2022). The government sought rehearing *en banc* of the Second Circuit’s *Clinton Nurseries* decision, which was denied in September 2021.

In October 2021, the majority of a split Tenth Circuit panel joined the Second Circuit in holding that the 2017 Amendment is impermissibly nonuniform because the same fees were not required in BA districts by the terms of the 2017 Amendment. See *John Q. Hammons Fall 2006 LLC v. U.S. Trustee (In re John Q. Hammons Fall 2006 LLC)*, 15 F.4th 1011 (10th Cir. 2021), *cert. pending sub nom. Office of the United States Trustee v. John Q. Hammons Fall 2006, LLC*, No. 21-1078 (U.S. Feb. 2, 2022). The short dissent in *John Q. Hammons* took the position that the debtor’s challenge to geographically nonuniform fees should be rejected because the debtors challenged only the 2017 Amendment, and not the dual UST/BA system as a whole.



In January 2022, an Eleventh Circuit panel found the 2017 Amendment constitutional, based not on the rationale expressed in *Buffets* and *Siegel* (uniformity within UST districts and within BA districts), but on its view that the Judicial Conference’s decision not to increase the fees in BA districts until the fourth quarter of 2018 (and then only prospectively) did not render the 2017 Amendment violative of the uniformity requirement of the Bankruptcy Clause. See *United States Trustee Region 21 v. Bast Amron LLP (In re Mosaic Mgmt. Grp., Inc.)*, 22 F.4th 1291 (11th Cir. 2022). In a separate concurrence, one judge agreed with the Second and Tenth Circuits that the 2017 Amendment was unconstitutionally nonuniform but found that refunding fees in the UST districts would be “at odds with Congress’s intent” and therefore concurred in the result. *In re Mosaic*, 22 F.4th at 1330.

In addition to these circuit court decisions, appeals raising challenges to the 2017 Amendment on uniformity and other grounds are pending in the Federal Circuit, the Sixth Circuit, and the Ninth Circuit.

Against this backdrop, the [sole question presented to the Supreme Court in \*Siegel\*](#) is straightforward: “Whether the [2017 Amendment] violates the uniformity requirement of the Bankruptcy Clause by increasing quarterly fees solely in U.S. Trustee districts.” Yet to answer this question, courts have had to closely examine both the history of the 2017 Amendment and the history of the UST program itself, because the divergence in fees being paid by debtors in UST districts and BA districts under the 2017 Amendment is traceable to Congress’s decision to permit North Carolina and Alabama to remain outside the UST program.

**The 2017 Amendment.** As noted above, Congress enacted the 2017 Amendment as part of the Bankruptcy Judgeship Act of 2017 to address a shortfall in the UST’s budget. Under the 2017 Amendment, the revised fee regime of 28 U.S.C. § 1930(a)(6) was supposed to be both temporary (sunsetting in 2022) and conditional, replacing the prior fee structure only if the balance in the UST System Fund at the beginning of the then-current fiscal year was less than \$200 million. The 2017 Amendment was silent on whether it applied to pending cases and made no change to the statutory language governing fees in BA districts set forth in 28 U.S.C. § 1930(a)(7), which from its inception provided: “the Judicial Conference of the United States *may require* the debtor in a case under chapter 11 of title 11 to pay fees equal to those imposed by paragraph (6) of this subsection.” See 28 U.S.C. § 1930(a)(7) (emphasis added).

As noted above, debtors in UST districts with pending cases were assessed the quarterly fees under the new scale effective January 1, 2018, while in BA districts, only debtors filing new chapter 11 cases on or after October 1, 2018, became subject to the 2017 Amendment’s increased fees.

Although the 2017 Amendment was enacted as a temporary and conditional measure, when it became clear the UST System Fund surplus was projected to exceed \$200 million the following year, annual amendments to 28 U.S.C. § 1930(a)(6) were passed by Congress as part of year-end budget bills to increase the required surplus needed to trigger reversion to the pre-2017 Amendment fee schedule. See Consolidated Appropriations Act, 2020, Pub. L. No. 116-93, § 219 (Dec. 20, 2019) (substituting \$300 million for \$200 million as the surplus threshold); Consolidated Appropriations Act, 2021, Pub. L. No. 116-260, § 218 (Dec. 27, 2020) (same).

In an overhaul of the 2017 Amendment signed into law in January 2021, Congress included amendments to be in effect through 2026 to both: (i) 28 U.S.C. § 1930(a)(6), which replaced the fee schedule of the 2017 Amendment with a new fee schedule no longer tied to the level of surplus in the UST System Fund; and (ii) 28 U.S.C. § 1930(a)(7), by changing the word “may” to “shall” to mandate that the new fees take effect in BA districts. See

Bankruptcy Administration Improvement Act of 2020, S. 4996 (116th Cong.), Pub. L. No. 116-325 (2021) (“2021 Amendment”). Congress expressly dictated that the 2021 Amendment’s terms should apply to new and pending cases beginning with the quarter after its enactment, i.e., the second quarter of 2021. Therefore, because the 2021 Amendment replaced the 2017 Amendment and amended the language of 28 U.S.C. § 1930(a)(7) governing fees in BA districts, the Supreme Court’s resolution of the issue presented in *Siegel* will not impact quarterly fees paid by debtors from the second quarter of 2021 forward.

**The Dual UST/BA System.** The discrepancy in fees paid under the 2017 Amendment by debtors with cases pending in UST districts and in BA districts is rooted in the dual UST/BA system, which itself is a vestige of history and a product of politics. Prior to 1978, bankruptcy judges or “referees” both adjudicated and administered bankruptcy cases. In order to separate the judicial and administrative role, Congress in 1978 created the UST within the Department of Justice as a pilot program in 19 judicial districts to perform the administrative functions previously performed by bankruptcy judges. See Bankruptcy Reform Act of 1978, Pub. L. No. 95–598, § 224, 1978 U.S. Code Cong. & Admin. News (92 Stat.) 2549, 2662–65 (codified at 28 U.S.C. §§ 581 et seq.) (amended 1986).

In 1986, Congress decided to fully implement the UST program. See Bankruptcy Judges, United States Trustees, and Family Farmer Bankruptcy Act of 1986, Pub. L. No. 99-554, 100 Stat. 3088, 3090-95 (Oct. 27, 1986) (“1986 Act”). But the 1986 Act implemented the UST program in only 48 states—Alabama and North Carolina were not required to join the UST program immediately. *Id.* § 302(d)(2)-(3), 100 Stat. at 3119–23. In those two states, the administrative functions of bankruptcy cases were performed by Bankruptcy Administrators, a program operated and overseen by the Judicial Branch. *Id.* Secondary sources from the time period explained that the different treatment was the product of political pressure from those states due to issues with the pilot program in the Northern District of Alabama. See U.S. Gov’t Accountability Office, GAO/GGD-92-133, Bankruptcy Administration: Justification Lacking for Continuing Two Parallel Programs 14 (1992) (noting that bankruptcy judges’ and BA program officials’ “extreme dissatisfaction” with the UST pilot program led to different treatment).

Still, the 1986 Act required Alabama and North Carolina to implement the UST program by 1992. See 1986 Act, § 302(d)(3), 100 Stat. at 3121–23. Two years before the 1992 deadline, however, Congress enacted the Judicial Improvements Act of 1990, Pub. L. No. 101-650, § 317, 104 Stat. 5089 (Dec. 1, 1990), which extended the deadline by 10 years, to 2002. Contemporaneous commentators explained the decision was again due to political lobbying. Dan J. Schulman, *The Constitution, Interest Groups, and the Requirements of Uniformity: The United States Trustee and the Bankruptcy Administrator Programs*, 74 Neb. L. Rev. 91, 123 (1995) (“Bankruptcy judges in both states successfully lobbied Congress, most particularly Senators Helms [North Carolina] and Heflin [Alabama], to avoid being placed within the United States Trustee program.”).

Originally, the chapter 11 quarterly fee provision was adopted specifically for UST districts as part of the 1986 Act to help fund the UST program. See 28 U.S.C. § 1930(a)(6). Because the UST program was not implemented in Alabama or North Carolina, debtors in those states were not required to pay the quarterly fees imposed by section 1930(a)(6). Instead, the BA program was financed by funds from the Judicial Branch. As a GAO study noted in 1992, fees under this arrangement were thus “not uniform” because “[d]ebtors in the UST and BA districts pay the same fees when filing for bankruptcy, but Chapter 11 debtors in BA districts are not subject to the additional quarterly fee that is levied on Chapter 11 debtors in UST districts.” U.S. Gov’t Accountability Office, GAO/GGD-92-133, at 11.

This discrepancy in fees payable by chapter 11 debtors gave rise to a constitutional challenge. In 1994, the Ninth Circuit ruled that the dual fee structure violated the Constitution’s requirement that bankruptcy laws be geographically uniform. See *St. Angelo v. Victoria Farms, Inc.*, 38 F.3d 1525 (9th Cir. 1994), *amended*, 46 F.3d 969 (9th Cir. 1995); U.S. Const., art. I, § 8, cl. 4. The Ninth Circuit noted that a bankruptcy law “may have different effects in various states due to dissimilarities in state law as long as the federal law itself treats creditors and debtors alike.” *St. Angelo*, 38 F.3d at 1531. However, the court explained, the dual fee structure did not pass this test because it was “federal law, rather than state law, that causes creditors and debtors to be treated differently in North Carolina and Alabama.” *Id.*

Finding “no indication that the exemption in question was intended to deal with a problem specific to North Carolina and Alabama,” and that it could not “discover such a purpose in the structure of the statute or the legislative history of [section 1930(a)(6)]” (*id.* at 1530), the Ninth Circuit held that “because creditors and debtors in states other than North Carolina and Alabama are governed by a different, more costly system for resolving bankruptcy disputes,” the dual fee structure violated the Bankruptcy Clause’s uniformity requirement. *Id.* at 1531–32. Since the dual fee structure was the direct result of Congress’s extension until 2002 of the exemption for North Carolina and Alabama to join the UST system, the Ninth Circuit determined that the “constitutional infirmity in question may be remedied simply by striking down section 317(a)” of the Judicial Improvements Act of 1990, which permitted the BA districts to opt out of the UST system. *Id.* at 1533.

In 2000, Congress addressed the dual fee system found unconstitutional in *St. Angelo*. But rather than abolish the BA program, as *St. Angelo* had contemplated, Congress: (i) amended 28 U.S.C. § 1930 to eliminate the oft-extended requirement that the six judicial districts in North Carolina and Alabama become UST districts; and (ii) simultaneously enacted 28 U.S.C. § 1930(a)(7) to provide that “the Judicial Conference of the United States may require the debtor in a case under chapter 11 of title 11 to pay fees equal to those imposed by paragraph (6) of this subsection.” See Federal Courts Improvement Act of 2000, Pub. L. No. 106-518, § 105, 114 Stat. 2410, 2412 (Nov. 13, 2000) (“2000 Amendment”).

The enactment of the 2000 Amendment did not automatically implement equal fees in UST districts and BA districts; rather, the dual fee structure persisted until the Judicial Conference in September 2001 approved a recommendation “that quarterly fees for chapter 11 cases in BA districts be imposed,” and took action to have the BA districts collect quarterly fees in chapter 11 cases, effective April 1, 2002.

From 2002 until the first quarter of 2018, when the 2017 Amendment raised the cap by up to \$220,000 for chapter 11 quarterly fees in UST districts, quarterly fees in the UST districts and the BA districts were uniform, eliminating any party’s standing to raise the constitutional infirmity identified by the Ninth Circuit in *St. Angelo*. But given that the 2017 Amendment resurrected the dual fee structure for chapter 11 debtors with cases pending before October 1, 2018, based solely on whether their case was pending in a UST district or a BA district, the Supreme Court will have to resolve the circuit split over whether this dual fee structure violates the Bankruptcy Clause.

Moreover, since Congress rejected the *St. Angelo* remedy and instead elected to make the dual UST/BA system permanent, if the Court finds the 2017 Amendment to be unconstitutional, the Court would also have to address whether the proper remedy, as the Second and Tenth Circuits have found, would be to order a refund of any excess fees paid in the UST districts, or whether some other relief is appropriate. Similarly, while only the uniformity issue is currently teed up for review by the Court, unless the Court strikes down the 2017 Amendment for those debtors who paid excess fees, courts will have to continue to review challenges to the increased fees based on statutory retroactivity, due process, and excess user fee grounds. The petitioner’s brief in *Siegel* was submitted on February 24, 2022, so those watching to see how the Court will resolve this rare challenge under the Bankruptcy Clause will not have to wait much longer.



## NOTABLE SUPREME COURT DENIALS OF PETITIONS FOR REVIEW

**“Control Test” for Imputing Fraudulent Intent in Bankruptcy Avoidance Litigation.** In *Kirschner v. Fitzsimons*, No. 21-1006, 2022 WL 516021 (U.S. Feb. 22, 2022), the Supreme Court denied a petition seeking review of a 2021 ruling by the U.S. Court of Appeals for the Second Circuit that largely upheld lower court dismissals of claims asserted by the chapter 11 liquidation trustee of media giant The Tribune Co. (“Tribune”) against various shareholders, officers, directors, employees, and financial advisors for, among other things, avoidance and recovery of fraudulent and preferential transfers, breach of fiduciary duties, and professional malpractice in connection with Tribune’s failed 2007 leveraged buyout (“LBO”). See *In re Trib. Co. Fraudulent Conv. Litig.*, 10 F.4th 147 (2d Cir. 2021), *cert. denied sub nom. Kirschner v. Fitzsimons*, No. 21-1006, 2022 WL 516021 (U.S. Feb. 22, 2022).

In *Trib. Co.*, the Second Circuit affirmed four district court rulings dismissing the liquidating trustee’s claims against all of the defendants except two financial advisors alleged to have received fraudulent transfers in the form of fees paid in connection with the LBO. In so ruling, the Second Circuit adopted the “control test,” rather than a “scope-of-employment agency” standard or a “proximate cause” standard, for determining whether the fraudulent intent of a company’s officers can be imputed to its directors for the purpose of avoidance litigation.

**Good Faith Defense to Fraudulent Transfer Liability in Bankruptcy Avoidance Litigation.** In *Citibank, N.A. v. Picard*, No. 21-1059 (U.S. Feb. 28, 2022), the Supreme Court denied a petition seeking review of a 2021 ruling by the U.S. Court of Appeals for the Second Circuit in *In re Bernard L. Madoff Investment Securities LLC*, 12 F.4th 171 (2d Cir. 2021). In *Madoff*, the Second Circuit revived litigation filed by the Securities Investor Protection Act (“SIPA”) trustee administering the assets of defunct investment firm Bernard L. Madoff Inv. Sec. LLC (“MIS”) seeking to recover hundreds of millions of dollars in allegedly fraudulent transfers made to former MIS customers and certain other defendants as part of the Madoff Ponzi scheme. The court of appeals vacated a 2019 bankruptcy court ruling dismissing the trustee’s claims against certain defendants because the trustee failed to allege that the defendants had not received the transferred funds in “good faith.”

The Second Circuit also reversed a 2014 district court decision in holding that: (i) “inquiry notice,” rather than “willful blindness,” is the proper standard for pleading a lack of good faith in fraudulent transfer actions commenced as part of a stockbroker liquidation case under SIPA; and (ii) the defendants, rather than the SIPA trustee, bear the burden of pleading on the issue of good faith. The ruling, which involved test cases for approximately 90 dismissed actions, breathed new life into avoidance litigation seeking recovery of \$3.75 billion from global financial institutions, hedge funds, and other participants in the global financial markets.



**Immediate Appeal of Chapter 15 Discovery Orders.** In *Estate of Omar Fontana v. ACFB Administração Judicial Ltda.-ME*, No. 21-828 (U.S. Mar. 7, 2022), the Supreme Court denied a petition seeking review of a 2021 decision by the U.S. Court of Appeals for the Eleventh Circuit regarding the finality of a discovery order in a chapter 15 case. In *In re Transbrasil S.A. Linhas Aéreas*, 860 Fed. App'x 163 (11th Cir. 2021), the Eleventh Circuit held in a nonprecedential ruling that an order denying a request to quash a subpoena in the chapter 15 case of a Brazilian airline was not final and could not be appealed immediately because the order was “merely a preliminary step” in the context of a broader proceeding. In *dicta*, however, the Eleventh Circuit appeared to limit its ruling to the facts before it and noted that if the only purpose of the chapter 15 case is to obtain discovery, a discovery order may be final and immediately appealable because the discovery order is effectively the entire proceeding.

The Eleventh Circuit based its ruling on the “framework” established by the Supreme Court for determining the finality of bankruptcy court orders in *Ritzen Grp., Inc. v. Jackson Masonry, LLC*, 140 S. Ct. 582 (2020). In *Ritzen*, the Court held that “the adjudication of a motion for relief from the automatic stay forms a discrete procedural unit within the embrace of the bankruptcy case,” which makes an order conclusively resolving such a motion appealable. *Id.* at 586. Applying that framework to a discovery order, the Eleventh Circuit in *Transbrasil* concluded that the bankruptcy court’s order denying a motion to quash a subpoena in a chapter 15 case was not a final order because, unlike in *Ritzen*, it was not “discrete” or “separate” from the proceeding for which the discovery was sought. Instead, it was “merely a preliminary step” to obtain information that could be used to support claims against affiliates of the chapter 15 debtor in its Brazilian bankruptcy case and to enforce a Brazilian court order enjoining collection efforts in the United States.

In so ruling, the Eleventh Circuit disagreed with a ruling by the U.S. Court of Appeals for the Second Circuit in *In re Barnet*, 737 F.3d 238 (2d Cir. 2013), where the court held that an order denying a motion to stay discovery sought by foreign representatives in a chapter 15 case was immediately appealable because, among other reasons, discovery under chapter 15 is “ancillary to a suit in another tribunal, such that there will never be a final resolution on the merits beyond the discovery itself.” *Id.* at 244.

In *Transbrasil*, the Eleventh Circuit concluded that *Barnet* was both noncontrolling and distinguishable. First, it explained, in *Barnet*, the Second Circuit did not have the benefit of the *Ritzen* framework for examining the finality of bankruptcy court orders. Second, the court wrote, unlike in the case before it, “there is no indication in *Barnet* that any proceedings other than discovery were contemplated in that Chapter 15 case.” *Transbrasil*, 860 Fed. App'x at 169.

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*Jones Day represents MF Global Holdings Ltd., as plan administrator, in bankruptcy court and Second Circuit proceedings challenging the increased UST quarterly fees, including appearing as amicus curiae in Clinton Nurseries and as amicus curiae in Siegel before the Supreme Court.*

*Jones Day represents certain of the defendants in the Tribune fraudulent transfer litigation.*

**Jones Day** was named “Law Firm of the Year” in the field of Bankruptcy and Creditor Debtor Rights/Insolvency and Reorganization Law in the 2022 *U.S. News—Best Lawyers*® “Best Law Firms” list published jointly by *U.S. News and World Report* and *Best Lawyers*®

In a ruling issued February 25, 2022, the U.S. Bankruptcy Court for the District of New Jersey denied motions to dismiss the chapter 11 case of Jones Day client LTL Management LLC (“LTL”), an indirect subsidiary of Johnson & Johnson that filed for bankruptcy to manage thousands of claims against LTL’s predecessor-in-interest alleging that JOHNSON’S® Baby Powder caused ovarian cancer and/or mesothelioma. In denying the dismissal motions, the bankruptcy court: (i) determined that bankruptcy provides the optimal forum to resolve mass tort liability; and (ii) found that the implementation of a “Texas Two-Step” divisional merger prior to the bankruptcy filing did not harm talc claimants. Despite a series of objections by representatives for talc claimants, the bankruptcy court ruled that LTL filed its chapter 11 case in good faith—and not as an improper litigation tactic—and concluded that, as compared with the U.S. tort system, bankruptcy offers both present and future LTL talc claimants the best opportunity to obtain equitable and timely recoveries. The Jones Day restructuring team was led by **Gregory M. Gordon (Dallas)** and included **Dan B. Prieto (Dallas)**, **Brad B. Erens (Chicago)**, **Daniel J. Merrett (Atlanta)**, **Robert W. Hamilton (Columbus)**, **Amanda S. Rush (Dallas)**, **Caitlin K. Cahow (Chicago)**, **Genna Ghaul (New York)**, and **Isel M. Perez (Miami)**.

In the chapter 11 cases of Intelsat S.A. and certain of its direct and indirect subsidiaries (collectively, “Intelsat”), which have been pending in the U.S. Bankruptcy Court for the Eastern District of Virginia since May 2020, **Bruce Bennett (Los Angeles and New York)**, **Michael C. Schneider (New York)**, **Nicholas J. Morin (New York)**, **Ryan Sims (Washington)**, **Chané Buck (San Diego)**, and **Benjamin J. Thomson (New York)** have been part of a team of Jones Day attorneys representing certain Intelsat creditors in

their capacity as lenders and purchasers in a series of financing transactions conducted by Intelsat Jackson Holdings, S.A. in connection with Intelsat’s anticipated emergence from bankruptcy. Intelsat is one of the world’s largest satellite services businesses.

**Roger Dobson (Sydney)** was named to the Hall of Fame in the 2022 edition of *The Legal 500 Asia Pacific* guide in the practice area “Australia Restructuring and Insolvency.”

On March 9, 2022, **Heather Lennox (Cleveland and New York)** participated in a “Behind the Bench” virtual panel discussion jointly sponsored by the National Conference of Bankruptcy Judges and the American Bankruptcy Institute titled “The City of Detroit Bankruptcy: Motown Revisits the Art of the Deal.”

An article written by **Corinne Ball (New York)** titled “Fifth Circuit Speaks Out: Circuit Split Deepens Regarding State Law, Leases and Sales Free and Clear in Bankruptcy” was published in the February 23, 2022, edition of the *New York Law Journal*.

An article written by **Heather Lennox (Cleveland and New York)**, **Matthew C. Corcoran (Columbus)**, **T. Daniel Reynolds (Cleveland)**, and **Nick Buchta (Cleveland)** titled “Delaware Court Holds Rejection Eliminates Non-Debtor’s Exclusive Right to Provide Services to the Debtor” was published on January 20, 2022, by *Lexis Practical Guidance*

An article written by **Charles M. Oellermann (Columbus)** and **Mark G. Douglas (New York)** titled “The Year in Bankruptcy: 2021” was published on January 18, 2022, by *Lexis Practical Guidance*

An article written by **Charles M. Oellermann (Columbus)** and **Mark G. Douglas (New York)** titled “Another New York District Court Widens the Bankruptcy Code’s Securities Contract Safe Harbor” was published on January 20, 2022, by *Lexis Practical Guidance*.

## BUSINESS RESTRUCTURING REVIEW

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