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BUSINESS RESTRUCTURING REVIEW

THE YEAR IN BANKRUPTCY: 2023

Dan T. Moss

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

We also wrote that 2022 would be remembered for the continuing controversy over the legitimacy of seeking bankruptcy protection as a way to deal with mass-tort liabilities in chapter 11 plans that release company owners and other insiders from liability as a quid pro quo for funding payments to creditors. Other memorable developments in 2022 included rising inflation and soaring energy costs due, among other things, to wartime supply chain disruptions, the right-sizing woes of the tech sector, the increasing incidence of "creditor-on-creditor" litigation in bankruptcy, and the tax-driven year-end rush to liquidate special purpose acquisition companies, or SPACs, effectively marking an end to the "blank-check" company gold rush that peaked in 2021.

BUSINESS BANKRUPTCY TRENDS IN 2023

The business bankruptcy landscape in 2023 was similar, but with some notable differences. Many of the trends developing or continuing in 2022 persisted. However, although predictions in late 2022 of a recession proved to be overblown, the long-anticipated wave of business bankruptcy filings caused by higher interest rates, high inflation (albeit easing significantly in the later part of the year), and the collapse of zombie companies that had survived on COVID-era government support produced a significant increase in the volume of business bankruptcy filings in 2023.

If 2022 kicked off the crypto winter, 2023 was the year for "crypto accountability," both in the nation's bankruptcy and criminal courts, as well as a surprising "crypto rebound." The year also included some spectacular bank failures triggered by the inability of lenders like Silicon Valley Bank and First Republic Bank to deal with a stampede to withdraw billions in customer deposits because they were tied up in long-term investments—leading to urgent regulatory action to prevent systemic risk in the banking sector.

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The long-smoldering controversy regarding the validity of chapter 11 provisions that release non-debtors from liability continued to be center stage in 2023, with the U.S. Supreme Court finally taking up the issue in the bankruptcy case of Purdue Pharma L.P. (with a ruling expected later this year), whose confirmed chapter 11 plan released the founding Sackler family from opioid liabilities in exchange for up to $6 billion to fund a trust for the payment of such claims. Also prominent in the courts in 2023 was the propriety of the "Texas Two-Step," a corporate reorganization technique recently used by several prominent companies in combination with a bankruptcy filing to deal with mass tort liabilities. In addition, disputes continued in 2023 over the validity of "liability-management transactions" (including drop-down, uptiering, and double-dip transactions). Court rulings issued in some of these cases are discussed in more detail below in the section titled "Notable Business Bankruptcy Decisions in 2023."

BUSINESS BANKRUPTCY FILINGS IN 2023

According to data provided by Epiq AACER, a leading provider of U.S. bankruptcy filing data, commercial bankruptcy filings in calendar year 2023 increased 19% to 25,627 from the 21,479 registered the previous year. By contrast, there were 32,506 commercial bankruptcy filings during the height of the pandemic in 2020. Commercial chapter 11 filings increased 72% in 2023 to 6,569 from the previous year's total of 3,819—but still short of the 7,128 commercial chapter 11 filings during pandemic-fueled 2020. Subchapter V elections for small business debtors within chapter 11 also substantially increased in calendar year 2023, as the 1,939 filings represented a 45% increase from the 1,334 recorded in 2022.

According to data produced by Reorg, a global provider of data, analytics, and credit intelligence for leveraged finance and

LAWYER SPOTLIGHT: DAN T. MOSS

Dan T. Moss

Dan Moss, a partner in the Washington and New York offices, has in-depth experience in business finance and restructuring, particularly complex corporate and cross-border reorganizations, distressed acquisitions, and crypto-related matters. As Chambers USA noted, "he is good at developing pragmatic business solutions."

Dan represents debtors, creditors, and creditor committees in some of the largest corporate and government reorganizations, and counsels clients on avoidance litigation and corporate governance matters. He served as co-lead counsel for Diebold Nixdorf in its recent successful restructuring in 71 days of more than $2.7 billion in funded debt. The restructuring involved the first-ever dual proceeding under the United States Bankruptcy Code and the recently enacted Dutch restructuring law, the Dutch Act on Confirmation of Extrajudicial Plans (*Wet Homologatie Onderhands Akkoord*). Dan also served as lead counsel for Spark Networks SE and its subsidiaries in the first-ever cross-border restructuring under the recently enacted German Act on the Stabilization and Restructuring Framework for Companies (*Gesetz über den Stabilisierungs- und Restrukturierungsrahmen für Unternehmen* ("StaRUG")) and recognition of Spark's StaRUG proceeding under chapter 15 of the U.S. Bankruptcy Code.

Other significant experience includes serving as co-lead counsel for the Official Committee of Unsecured Creditors in the Toys "R" Us Property Company I and Peabody Energy chapter 11 cases, and being involved in nearly all aspects of the City of Detroit's historic chapter 9 proceeding. Dan also oversaw all aspects of Jones Day's representation of the Chapter 7 Trustee of Anthracite Capital, one of the largest chapter 7 cases ever filed, resulting in a recovery of approximately $47 million for the estate and a release of more than $33 million in secured affiliate claims.

Dan is involved in the representation of disabled veterans and other pro bono activities. He is an active leader of INSOL International and writes frequently about cross-border restructuring matters. In November 2023, Dan was welcomed as a new member of the International Insolvency Institute.

restructuring professionals, there were 450 chapter 11 filings in 2023 by companies with at least $10 million in debt, representing an 70% increase over 2022. Of those chapter 11 filings, the real estate sector led with 23% of the cases in 2023, followed by consumer discretionary with 17% and healthcare with 16%. Approximately 140 companies filed for chapter 11 in 2023 with at least $100 million in debt, compared to 60 in 2022. Reorg also reported that there were 31 chapter 11 filings in 2023 by companies with liabilities exceeding $1 billion, compared to 21 in 2022.

Bloomberg Law data indicate that chapter 15 petitions were filed in 2023 on behalf of 164 foreign debtors, compared to 89 foreign debtors. Only a single municipality filed for chapter 9 protection in 2023, compared to two in 2022.

S&P Global Market Intelligence reported that U.S. private equity portfolio company bankruptcies spiked to record high in 2023. Bankruptcy filings by private equity and venture capital-backed companies in the U.S. increased to 104 in 2023, the highest annual total on record. This represents 174% growth over the 38 U.S. portfolio company bankruptcy filings in 2022.

Some of the most notable business bankruptcy filings of 2023 included the following.

WeWork, Inc., the real estate company that offered 20 million square feet of office space in more than 660 locations in 37 countries, which filed for bankruptcy protection in on November 6, 2023, in the District of New Jersey with $3.8 billion in debt (against only $45 million in assets) and a pre-negotiated chapter 11 plan to trim its portfolio of office space.

Diebold Nixdorf, Inc., an international manufacturer, seller, installer, and servicer of self-service transaction systems (such as ATMs), which, together with its U.S., Canadian, and European subsidiaries (collectively, "Diebold"), successfully restructured more than $2.7 billion in debt through coordinated cross-border restructuring proceedings in just 71 days. Those proceedings included a restructuring case under the Dutch Act on Confirmation of Extrajudicial Plans (*Wet Homologatie Onderhands Akkoord* ("WHOA")), a chapter 11 filing for Diebold's U.S. subsidiary Diebold Holding Company Inc., and a chapter 15 case in which a U.S. bankruptcy court recognized Diebold's WHOA proceeding and enforced the terms of Diebold's Dutch court-approved scheme of arrangement as part of the first-ever cross-border restructuring involving dual main proceedings under chapter 11 of the U.S. Bankruptcy Code and the WHOA. Jones Day represented Diebold in the restructuring.

Johnson & Johnson indirect subsidiary ***LTL Management, LLC*** ("LTL"), which filed for chapter 11 protection for the second time on April 4, 2023, in the District of New Jersey hours after a bankruptcy court ordered the dismissal of its 2021 chapter 11 filing following a Texas Two-Step corporate reorganization designed to manage billions of dollars in anticipated liabilities from talc-related litigation. The bankruptcy court dismissed LTL's second chapter 11 case on July 28, 2023, concluding, in accordance with a January 2023 ruling by the U.S. Court of Appeals for the Third Circuit, that the bankruptcy filing was not made in good faith due to the lack of any immediate financial distress. Jones Day represented LTL in its first chapter 11 case.

Mall owner ***Pennsylvania Real Estate Investment Trust***, which filed for chapter 11 protection in the District of Delaware on December 10, 2023, with $2.2 billion in debt and a prepackaged plan to implement a $880 million balance sheet restructuring in the face of an imminent $1.2 billion debt maturity. The filing came after a 2020 prepackaged bankruptcy that culminated in the confirmation of a chapter 11 plan in December 2020 under which the company was recapitalized.

Diamond Sports Group LLC ("Diamond"), an American media and entertainment company operating as Bally Sports, a group of regional sports channels that was formerly known as the Fox Sports Networks. Diamond filed for chapter 11 protection on March 14, 2023, in the Southern District of Texas with $13.5 billion in debt in an effort to resolve disputes with many professional sports teams over broadcasting rights and revenues generated by televised or streamed sporting events.

Ninety-nine-year-old Nashville-based trucking company ***Yellow Corp.***, which filed for chapter 11 protection on August 6, 2023, with $1.2 billion in debt in the District of Delaware, blaming a labor dispute with the International Brotherhood of Teamsters union for its demise. The filing came little more than a week after it terminated its 30,000 employees and three years after it tapped $700 million in unrepaid pandemic relief funds.

SVB Financial Group, the former parent company of Silicon Valley Bank ("SVB"), which filed for chapter 11 protection on March 17, 2023, in the Southern District of New York with $3.3 billion in debt one week after its banking subsidiary SVB, a key lender to the technology industry, was seized by federal regulators because its tech-concentrated customer base withdrew tens of billions of dollars in deposits in just two days, causing bank stocks around the world to plummet.

Retail drugstore chain ***Rite Aid Corporation***, which filed for chapter 11 protection on October 15, 2023, in the District of New Jersey with nearly $4 billion in debt amid weak sales, store closings, and a deluge of litigation over its alleged role in the U.S. opioid epidemic.

Aerospace supplier ***Wesco Aircraft Holdings (d/b/a Incora)***, which filed for chapter 11 protection on June 1, 2023, in the Southern District of Texas with $7.1 billion in debt, citing depressed demand for aircraft maintenance and litigation over its efforts to restructure its debt outside of bankruptcy.

Fifty-two-year-old retailer ***Bed Bath & Beyond***, which filed for chapter 11 protection on April 23, 2023, in the District of New Jersey with $5.2 billion in debt and a plan to liquidate its inventory and close its stores after miscalculating the popularity of online shopping.

Giant theater chain ***Cineworld Group***, the parent company of Regal Cinemas, which filed for chapter 11 protection on September 7, 2023, in the Southern District of Texas with $10.7 billion in debt and a plan to transfer ownership of the company to lenders after the increased popularity of online streaming and the suspension of film production during the pandemic saddled it with an unmanageable debt load.

Notable bankruptcy exits in 2023 included: (i) drug maker ***Mallinckrodt PLC***, which emerged from bankruptcy in November 2023 (for the second time in three years) after obtaining confirmation of a prepackaged chapter 11 plan that significantly reduced the amount required to fund a trust to pay opioid claimants and provided for a debt-for-equity swap to cancel more than $2 billion in debt; (ii) ***Diebold Nixdorf, Inc.***, an international manufacturer, seller, installer, and servicer of self-service transaction systems (such as ATMs), which, together with its U.S., Canadian, and European subsidiaries, successfully restructured more than $2.7 billion in debt through coordinated cross-border restructuring proceedings in just 71 days; (iii) ***Bed Bath & Beyond Inc.***, a big-box retailer chain specializing in housewares, furniture, and specialty items, which obtained confirmation of a liquidating chapter 11 plan in September 2023 after selling its name and associated intellectual property to overstock.com in a bankruptcy auction; (iv) party products retailer ***Party City Holdco.***, which emerged from bankruptcy in October 2023 after obtaining confirmation of a chapter 11 plan that provides for a transfer of ownership of the company to creditors pursuant to a $1 billion debt-for-equity swap; and (v) physician staffing company ***Envision Healthcare***, which emerged from bankruptcy in early November 2023 after obtaining confirmation of a pre-negotiated chapter 11 plan that trimmed more than $7 billion in debt from the company's balance sheet and split the reorganized debtor into two companies.

NOTABLE BUSINESS BANKRUPTCY DECISIONS IN 2023

Bankruptcy Appellate Standing. Federal appellate courts have traditionally applied a "person aggrieved" standard to determine whether a party has standing to appeal a bankruptcy court order or judgment. However, this standard, which requires a direct, adverse, and financial impact on a potential appellant, is derived from a precursor to the Bankruptcy Code and does not appear in the existing statute. It also arguably conflicts with the general constitutional standing rule that governs litigation in federal courts, which, among other things, requires a litigant to demonstrate "a concrete and particularized injury in fact."

The U.S. Court of Appeals for the Ninth Circuit addressed the interplay between these standards in *Clifton Capital Group LLC v. Sharp (In re East Coast Foods Inc.)*, 66 F.4th 1214 (9th Cir. 2023). The Ninth Circuit reversed a district court ruling affirming a bankruptcy court order approving an award of enhanced fees to a chapter 11 trustee, concluding that the appellant lacked constitutional standing to appeal the fee order because any injury to the appellant was "too conjectural and hypothetical." In so ruling, the Ninth Circuit held that an appellant must satisfy the requirements for constitutional standing in the first instance rather than the more exacting "person aggrieved" standard.

In *Truck Insurance Exchange v. Kaiser Gypsum Co. (In re Kaiser Gypsum Co.)*, 60 F.4th 73 (4th Cir. Feb. 14, 2023), cert. granted, No. 22-1079 (Oct. 13, 2023), the U.S. Court of Appeals for the Fourth Circuit ruled that a chapter 11 debtor's insurer did not have standing to appeal an order confirming a chapter 11 plan as a "party in interest" under section 11109(b) of the Bankruptcy Code because the plan, which created a trust for the payment of the uninsured claims of asbestos injury plaintiffs, was "insurance neutral," meaning that the insurer had no financial stake underpinning its objection, and the insurer lacked standing under Article III of the U.S. Constitution to object to other aspects of the plan. The U.S. Supreme Court agreed to review the ruling on October 13, 2023, to resolve a claimed split among the federal circuit courts of appeals concerning the interplay of section 1109(b) and Article III in bankruptcy cases.

Jones Day represents Kaiser Gypsum Company, Inc. in connection with the litigation.

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

Bankruptcy and appellate courts, however, have long disagreed as to whether this provision is jurisdictional—meaning that it can never be waived and an appellate court lacks jurisdiction to hear any appeal of an unstayed sale or lease authorization order—or

instead a defense that can be invoked by the proponents of the sale (e.g., the debtor, the bankruptcy trustee, or the purchaser) on appeal subject to waiver, forfeiture, and similar doctrines. The U.S. Supreme Court settled this question in *MOAC Mall Holdings LLC v. Transform Holdco LLC*, 143 S. Ct. 927, 2023 WL 2992693 (2023). A unanimous court ruled that that section 363(m) is not jurisdictional, and that an appeal of a 2019 bankruptcy court order approving the assignment of a lease between Sears, Roebuck & Co. and MOAC Mall Holdings LLC as part of Sears's sale of substantially all of its assets was not moot.

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

Bankruptcy and appellate courts disagree over the standard that should apply to a request for payment of a break-up fee or expense reimbursement to the losing bidder in a sale of assets outside the ordinary course of the debtor's business. Some apply a "business judgment" standard, while others require that the proposed payments satisfy the more rigorous standard applied to administrative expense claims. The U.S. Court of Appeals for the Fifth Circuit addressed this question in *Matter of Bouchard Transportation Co., Inc.*, 74 F.4th 743 (5th Cir. 2023). The Fifth Circuit affirmed lower court orders approving a $3.3 million breakup fee and more than $885,000 in expense reimbursement to a disappointed "stalking-horse" bidder in an auction of the debtors' assets, finding that the payments satisfied both the business judgment test under section 363(b) of the Bankruptcy Code and the standard for approval of administrative expense claims under section 503(b).

Chapter 11 Plan Provisions. In *In re Serta Simmons Bedding*, *LLC*, 2023 WL 3855820 (Bankr. S.D. Tex. June 6, 2023), *notice of appeal filed*, No. 23-90020 (Bankr. S.D. Tex. June 6, 2023), *stay pending appeal denied*, No. 23-90020 (Bankr. S.D. Tex. June 21, 2023), stay pending appeal denied, No. 4:23-cv-2173 (S.D. Tex. June 29, 2023), *direct appeals certified*, No. 23-90026 (5th Cir. Sept. 18, 2023), the U.S. Bankruptcy Court for the Southern District of Texas confirmed the chapter 11 plan of bedding manufacturer Serta Simmons Bedding, LLC and its affiliates (collectively, "Serta"). In confirming Serta's plan, the court held that: (i) a 2020 "uptier," or "position enhancement," transaction ("PET") whereby Serta issued new debt secured by a priming lien on its assets and purchased its existing debt from participating lenders at a discount with a portion of the proceeds did not violate the terms of a 2016 credit agreement; (ii) the plan's nonconsensual exculpation provision was overly broad because it covered Serta's independent directors and managers, but was approved as amended to remedy this defect; (iii) the plan did not impermissibly indemnify lenders that participated in the PET; and (iv) distribution under the plan of $1.5 million to existing equity holders without paying in full the claims of nonparticipating lenders did not violate the "absolute priority rule" because equity provided "new value" in exchange.

Section 1124(2) of the Bankruptcy Code gives chapter 11 debtors a valuable tool to use in situations where long-term prepetition debt carries a significantly lower interest rate than the rates available at the time of emergence from bankruptcy. Under this section, in a chapter 11 plan, the debtor can "cure" any defaults under the relevant agreement and "reinstate" the maturity date and other terms of the original agreement, thus enabling the debtor to "lock in" a favorable interest rate in a prepetition loan agreement upon bankruptcy emergence.

For decades, however, courts have struggled to determine exactly what a debtor must do to cure defaults, for purposes of cure and reinstatement in a chapter 11 plan, where payment terms under the loan agreement have been accelerated and the agreement requires the payment of a higher default rate of interest. The U.S. Bankruptcy Court for the Southern District of New York addressed this conundrum in *In re Golden Seahorse LLC*, 652 B.R. 593 (S.D.N.Y. 2023). The court ruled that, based upon a close examination of sections 365(b)(2)(D), 1123(d), and 1124(2) of the Bankruptcy Code, a debtor was obligated to pay default-rate interest to cure a monetary default under a loan that would be reinstated in a chapter 11 plan.

Good Faith Filing Requirement. In *In re LTL Mgmt.*, LLC, 64 F.4th 84 (3d Cir. 2023), the U.S. Court of Appeals for the Third Circuit reversed a bankruptcy court order denying motions filed by an official committee of talc claimants to dismiss the chapter 11 case of a debtor that was an indirect subsidiary of a manufacturer of talc-based astringent powder. The debtor was created as part of a Texas Two-Step corporate restructuring pursuant to which the debtor had assumed responsibility for the manufacturer's talc-related liabilities. In reversing the bankruptcy court's order and remanding the case below with instructions to dismiss the debtor's chapter 11 case, the Third Circuit held that: (i) in evaluating a debtor's good faith in filing for chapter 11 protection, the court would consider only the financial condition of debtor, and not its pre-bankruptcy predecessor which, due to the pre-bankruptcy corporate restructuring, no longer existed; (ii) despite its massive talc-related liabilities, the debtor was not in financial distress on the bankruptcy petition date and, therefore, could not show its chapter 11 filing served a "valid bankruptcy purpose" for purposes of the good faith filing inquiry; and (iii) "unusual circumstances" did not preclude dismissal of the debtor's chapter 11 case.

Jones Day represents debtor LTL Management, LLC in the litigation.

In *In re LTL Mgmt., LLC*, 652 B.R. 433 (Bankr. D.N.J. 2023), the U.S. Bankruptcy court for the District of New Jersey dismissed a second chapter 11 case filed by the debtor on April 4, 2023, holding that, in accordance with the Third Circuit's previous ruling, the second chapter 11 case was also filed in bad faith. The Third Circuit agreed to hear a direct appeal of the ruling on October 20, 2023.

In *In re Aldrich Pump LLC*, 2023 WL 9016506 (Bankr. W.D.N. Car. Dec. 28, 2023), the debtors were created as part of a pre-bankruptcy Texas Two-Step corporate reorganization that: (i) transferred to the debtors contingent liabilities arising from 90,000 asbestos lawsuits; and (ii) created two entities that were contractually obligated to fund payments under any trust established in the debtors' chapter 11 plan pursuant to section 524(g) to fund asbestos liabilities. The debtors proposed a chapter 11 plan under which the funds in the trust would be capped and asbestos claimants would not have the ability to opt out of the proposed treatment of their claims.

Certain asbestos personal injury claimants and their official committee moved to dismiss the debtors' chapter 11 cases on the basis that: (a) the debtors were solvent, able to pay the creditors and not in "financial distress," and were therefore constitutionally barred from filing for bankruptcy; and (b) "cause" existed to dismiss the cases under section 1112(b) of the Bankruptcy Code because, among other things, the Texas Two-Step reorganization was "an improper, prejudicial manipulation of the bankruptcy process designed to delay and suppress recoveries for the asbestos creditors," the debtors were using the chapter 11 process to benefit insiders at the expense of creditors, and the three-year delay in proposing a confirmable chapter 11 plan to deal with the asbestos liabilities was unreasonable and prejudicial to creditors.

The U.S. Bankruptcy Court for the Western District of North Carolina denied the motions. It ruled that "financial distress" or insolvency is not a constitutional or jurisdictional prerequisite for a bankruptcy filing. It deferred to another day the question of whether a capped chapter 11 plan and a "no-opt-out" section 524(g) trust is constitutional if the debtors are neither insolvent nor financially distressed because it may impair asbestos claimants' due process and jury trial rights.

Finally, the bankruptcy court ruled that the debtors did not file for chapter 11 in bad faith. Canvassing relevant a caselaw and applicable precedent, the court concluded that the Fourth Circuit's two-prong test for bad faith dismissal was not met because the movants could not demonstrate that the cases were filed with "objective futility and subjective bad faith." Even though the debtor were not insolvent or in financial distress, the court determined that a chapter 11 filing for the purpose of managing asbestos liabilities was a valid bankruptcy purpose.

Limitations on Avoidance Powers. In *In re Nine W. LBO Sec. Litig.*, 2023 WL 8180356 (2d Cir. Nov. 27, 2023), a divided panel of the U.S. Court of Appeals for the Second Circuit reversed in part a district court's 2020 ruling dismissing fraudulent transfer and unjust enrichment claims brought by a chapter 11 plan litigation trustee and an indenture trustee to recover payments made by apparel and footwear company Nine West Holdings, Inc. as part of a 2014 leveraged buy-out ("LBO"). According to the Second Circuit majority, each component transaction in an LBO should be analyzed individually to determine if it falls within the scope of the "safe harbor" in section 546(e) of the Bankruptcy Code precluding avoidance in bankruptcy of certain securities, commodity, or forward-contract payments. Because the debtor, through its bank agent, qualified as a "financial institution" in relation to payments made to public shareholders as part of the LBO, the majority held that those payments were safe harbored, but that payments made directly to the debtor's officers, directors and other shareholders were not because no financial institution was involved. A dissenting opinion suggests that a "contract-by-contract" analysis would be more appropriate and that all of the transfers should therefore have been shielded from avoidance. Nine West is discussed in more detail elsewhere in this edition of the *Business Restructuring Review*.

In *Petr v. BMO Harris Bank N.A.*, 2023 WL 3203113 (S.D. Ind. May 2, 2023), *appeal filed*, No. 23-1931 (7th Cir. May 17, 2023), the U.S. District Court for the Southern District of Indiana broadly construed the section 546(e) "safe harbor" to bar a chapter 7 trustee from suing under state law and section 544(b) of the Bankruptcy Code to avoid an alleged constructive fraudulent transfer made by the debtor shortly after it had been acquired in an LBO. According to the district court: (i) all of the agreements related to the LBO acquisition were "securities contracts" for purposes of the section 546(e) safe harbor, which insulated from avoidance a transfer made by the debtor one month after the LBO to refinance a loan incurred as part of the transaction; (ii) the safe harbor is not limited to transfers involving publicly-traded securities; and (iii) section 546(e) preempted the trustee's state law constructive fraudulent transfer claims.

Property of the Bankruptcy Estate. Although a debtor's non-exempt property (and even the debtor's entire business) are commonly sold during the course of a bankruptcy case by the trustee or a chapter 11 debtor-in-possession ("DIP") as a means of augmenting the bankruptcy estate for the benefit of stakeholders or to fund distributions under, or implement, a chapter 9, 11, 12 or 13 plan, it is less well understood that causes of action that become part of the bankruptcy estate in connection with a bankruptcy case (*e.g.*, fraudulent transfer, preference or other litigation claims) may also be sold or assigned by a trustee or DIP during bankruptcy to generate value.

The U.S. Court of Appeals for the Eighth Circuit examined the circumstance under which estate avoidance claims can be sold in *Pitman Farms v. ARKK Food Co. LLC (In re Simply Essentials LLC)*, 78 F.4th 1006 (8th Cir. 2023). In affirming an Iowa bankruptcy court's ruling that avoidance causes of action can be sold as property of the estate, the Eighth Circuit rejected the argument that such causes of action cannot constitute estate property because avoidance claims "belong" only to the trustee or the DIP. In so ruling, the Eighth Circuit adopted the broad majority view

that estate property includes a debtor's "inchoate or contingent" interests.

Sanctions. In *In re Markus*, 78 F.4th 554 (2nd Cir. 2023), the U.S. Court of Appeals for the Second Circuit affirmed a bankruptcy court decision imposing sanctions on a chapter 15 debtor's lawyer who repeatedly flouted the court's discovery orders and awarding attorney's fees to the debtor's foreign representative incurred in bringing a motion for sanctions. In so ruling, the Second Circuit reaffirmed its earlier decisions concluding that a bankruptcy court has the inherent authority to impose civil sanctions for contempt. However, the Second Circuit expanded the scope of that inherent authority to include punitive civil contempt sanctions in an amount greater than it had approved in its previous rulings. According to the Second Circuit, "we hold that a bankruptcy court's inherent sanctioning authority includes the power to impose civil contempt sanctions in non-nominal amounts to compensate an injured party and coerce future compliance with the court's orders." Markus is discussed in more detail elsewhere in this edition of the *Business Restructuring Review*.

Third-Party Releases and Exculpation Clauses in Chapter 11 Plans. There is longstanding controversy concerning the validity of third-party release provisions in non-asbestos trust chapter 11 plans that limit the potential exposure of various non-debtor parties involved in the process of negotiating, implementing and funding a plan. In the latest chapter of this debate, the U.S. Court of Appeals for the Second Circuit handed down a long-awaited ruling regarding the validity of non-consensual third-party releases in the chapter 11 plan of pharmaceutical company Purdue Pharma, Inc. and its affiliated debtors (collectively, "Purdue"). In *In re Purdue Pharma L.P.*, 69 F.4th 45 (2d Cir. 2023), *cert. granted sub nom. Harrington v. Purdue Pharma L.P.*, No. (23A87), 2023 WL 5116031 (U.S. Aug. 10, 2023), the Second Circuit reversed a district court decision finding that the bankruptcy court lacked the power to approve a plan provision releasing the founding Sackler family from liabilities arising from Purdue's sale of opioids and affirmed the bankruptcy court order confirming Purdue's chapter 11 plan. The U.S. Supreme Court heard argument in Purdue on December 4, 2023.

Exculpation clauses limiting the liability of certain entities for actions taken in connection with a bankruptcy case are a common feature of chapter 11 plans. However, courts disagree over the permitted scope of such clauses. They also disagree as to whether an order confirming a chapter 11 plan that includes exculpation and third-party release provisions is insulated from appellate review under the doctrine of "equitable mootness." The U.S. District Court for the Southern District of Texas addressed both of these questions in *Bouchard v. Bouchard Transportation Co. (In re Bouchard Transportation Co.)*, 2023 WL 1797907 (S.D. Tex. Feb. 7, 2023). The district court reversed and remanded a bankruptcy court order confirming a chapter 11 plan that included an overbroad exculpation provision, even though the order was not stayed pending appeal, the plan had been substantially consummated, and the plan included a non-severability provision precluding removal or modification of the exculpation provision. Based on Fifth Circuit precedent, the district court held that, to safeguard the integrity of the chapter 11 process, the doctrine of equitable mootness cannot bar appellate review of an order confirming a plan that contains an impermissibly broad exculpation provision.

SECOND CIRCUIT ADOPTS "TRANSFER-BY-TRANSFER" APPROACH TO BANKRUPTCY CODE'S SAFE HARBOR FOR SECURITIES CONTRACTS PAYMENTS

Caitlin K. Cahow

The scope of the Bankruptcy Code's "safe harbor" shielding certain securities, commodity, or forward-contract payments from avoidance as fraudulent transfers has long been a magnet for controversy, particularly after the U.S. Supreme Court suggested (but did not hold) in *Merit Mgmt. Grp., LP v. FTI Consulting, Inc.*, 138 S. Ct. 883 (2018), that a debtor may itself qualify as a "financial institution" covered by the safe harbor by retaining a bank or trust company as an agent to handle payments, redemptions, and cancellations made in connection with a leveraged buyout transaction ("LBO").

Bankruptcy and appellate courts in the Second Circuit have made meaningful contributions to the ongoing debate. The U.S. Court of Appeals for the Second Circuit recently weighed in on this issue in *In re Nine W. LBO Sec. Litig.*, 87 F.4th 130 (2d Cir. 2023), *reh'g denied*, Nos. 20-3257-cv (L) *et al.* (2d Cir. Jan. 3, 2024). A divided Second Circuit panel reversed in part a district court's 2020 ruling dismissing fraudulent transfer and unjust enrichment claims brought by a chapter 11 plan litigation trustee and an indenture trustee to recover payments made by apparel and footwear company Nine West Holdings, Inc. as part of a 2014 LBO. *See In re Nine W. LBO Sec. Litig.*, 482 F.Supp. 3d 187 (S.D.N.Y. Aug. 27, 2020), *aff'd in part*, *rev'd in part and remanded*, 2023 WL 8180356 (2d Cir. Nov. 27, 2023) ("*Nine West*").

According to the Second Circuit majority, each component transaction in an LBO should be analyzed individually to determine if it falls within the scope of the safe harbor. Because the debtor, through its bank agent, qualified as a "financial institution" in relation to payments made to public shareholders as part of the LBO, the majority held that those payments were safe harbored. By contrast, the majority held that payments made directly to the debtor's officers, directors, and other shareholders were not safe harbored because no financial institution was involved. The substantial dissenting opinion suggests that a "contract-by-contract" analysis would be more appropriate and that all of the transfers should therefore have been shielded from avoidance.

THE SECTION 546(E) SAFE HARBOR

Section 546 of the Bankruptcy Code imposes a number of limitations on a bankruptcy trustee's avoidance powers, which include the power to avoid certain preferential and fraudulent transfers. Section 546(e) provides that the trustee may not avoid, among other things, a pre-bankruptcy transfer that is a settlement payment "made by or to (or for the benefit of) a … financial institution [or a] financial participant …, or that is a transfer made by or to (or for the benefit of)" any such entity in connection with a securities contract, "except under section 548(a)(1)(A) of the [Bankruptcy Code]." Thus, the section 546(e) "safe harbor" bars avoidance claims challenging a qualifying transfer unless the transfer was made with actual intent to hinder, delay, or defraud creditors under section 548(a)(1)(A), as distinguished from being constructively fraudulent under section 548(A)(1)(B) because the debtor was insolvent at the time of the transfer (or became insolvent as a consequence) and received less than reasonably equivalent value in exchange.

Section 101(22) of the Bankruptcy Code defines the term "financial institution" to include, in relevant part:

> [A] Federal reserve bank, or an entity that is a commercial or savings bank, industrial savings bank, savings and loan association, trust company, federally-insured credit union, or receiver, liquidating agent, or conservator for such entity and, when any such Federal reserve bank, receiver, liquidating agent, conservator or entity is acting as agent or custodian for a customer (whether or not a "customer", as defined in section 741) in connection with a securities contract (as defined in section 741) such customer….

11 U.S.C. § 101(22). "Customer" and "securities contract" are defined broadly in sections 741(2) and 741(7) of the Bankruptcy Code, respectively. Section 741(8) defines "settlement payment" as "a preliminary settlement payment, a partial settlement payment, an interim settlement payment, a settlement payment on account, a final settlement payment, or any other similar payment commonly used in the securities trade." A similar definition of "settlement payment" is set forth in section 101(51A).

The purpose of section 546(e) is to prevent "the insolvency of one commodity or security firm from spreading to other firms

and possibly threatening the collapse of the affected market." H.R. Rep. No. 97-420, at 1 (1982). The provision was "intended to minimize the displacement caused in the commodities and securities markets in the event of a major bankruptcy affecting those industries." *Id.*

Prior to the Supreme Court's ruling in *Merit*, there was a split among the circuit courts concerning whether the section 546(e) safe harbor barred state law constructive fraud claims to avoid transactions in which the financial institution involved was merely a "conduit" for the transfer of funds from the debtor to the ultimate transferee. For its part, the Second Circuit had applied a more expansive interpretation of the section 546(e) safe harbor in *In re Quebecor World (USA) Inc.*, 719 F.3d 94 (2d Cir. 2013), ruling that the safe harbor did apply under such circumstances. In resolving the circuit split in *Merit*, however, the Supreme Court sided with a narrower interpretation of section 546(e).

In *Merit*, a unanimous Supreme Court held that section 546(e) does not protect transfers made through a "financial institution" to a third party, regardless of whether the financial institution had a beneficial interest in the transferred property. Instead, the Supreme Court held that the relevant inquiry is whether the transferor or the transferee in the overarching transaction sought to be avoided (rather than any intermediate transfer) is, itself, a financial institution. Because the parties did not contend that either the debtor, as purchaser, or the selling shareholder in the challenged LBO transaction was a financial institution (even though the conduit banks through which the payments were made met that definition), the Court ruled that the payments fell outside of the safe harbor.

In a footnote, the Court acknowledged that the Bankruptcy Code defines "financial institution" broadly to include not only entities traditionally viewed as financial institutions, but also the "customers" of those entities, when financial institutions act as agents or custodians in connection with a securities contract. The selling shareholder in *Merit* was a customer of one of the conduit banks, yet never raised the argument that it therefore also qualified as a financial institution for purposes of section 546(e). For this reason, the Court did not address the possible impact of the selling shareholder's status on the scope of the safe harbor.

In 2019, the Second Circuit made headlines when it ruled that payments made as part of the 2007 LBO of *Tribune* Co. were protected from avoidance under section 546(e) because, among other things, the debtor itself qualified as a "financial institution" by retaining a bank or trust company as an agent to process the payments made in exchange for shares tendered in the transaction. *See In re Tribune Co. Fraudulent Conveyance Litig.*, 946 F.3d 66 (2d Cir. 2019), *cert. denied*, 209 L. Ed. 2d 568 (U.S. Apr. 19, 2021) ("*Tribune*").

According to the Second Circuit, the entity the debtor retained to act as depositary in connection with the LBO, Computershare Trust Company, N.A. ("Computershare"), was a "financial institution" for purposes of section 546(e) because it was a trust company and a bank. Therefore, the court reasoned, the debtor was likewise a financial institution because, under the ordinary meaning of the term as defined by section 101(22), the debtor was Computershare's "customer" with respect to the LBO payments, and Computershare was the debtors' agent according to the common-law definition of "agency."

In 2020 and 2021, bankruptcy and district courts in the Second Circuit picked up where the Second Circuit left off in Tribune, ruling that pre-bankruptcy recapitalization or LBO transactions were safe-harbored from avoidance as fraudulent transfers because they were effected through a bank or other qualifying "financial institution."

The first court to follow *Tribune* was the district court in *Nine West*, which (as described in more detail below) dismissed more than $1 billion in fraudulent transfer and unjust enrichment claims brought by a chapter 11 plan litigation trustee and an indenture trustee against the debtor's shareholders, officers, and directors to recover payments made as part of a 2014 LBO. Citing *Tribune*, the district court ruled that the payments were protected by the section 546(e) safe harbor because they were made by a bank acting as the debtor's agent.

Shortly thereafter, the U.S. Bankruptcy Court for the Southern District of New York dismissed a chapter 11 plan litigation trustee's complaint seeking to avoid and recover alleged constructive fraudulent transfers. Analyzing the issue under *Merit*, the court ruled that, even though only one of the transfers involved in the "overarching transaction" was effected through a "financial institution," where the "component steps" formed an "integrated transaction," section 546(e) shielded those component steps from avoidance as a constructive fraudulent transfer. *See SunEdison Litigation Trust v. Seller Note*, *LLC (In re SunEdison*, *Inc.)*, 620 B.R. 505 (Bankr. S.D.N.Y. 2020).

In 2021, a different N.Y. district court judge ruled in *Holliday*, *Liquidating Trustee of the BosGen Liq. Trust v. Credit Suisse Secs. (USA) LLC*, 2021 WL 4150523 (S.D.N.Y. Sept. 13, 2021) ("*Boston Generating*"), *appeal filed*, No. 21-2543 (2d Cir. Oct. 8, 2021), *appeal stayed*, No. 21-2543 (2d Cir. Oct. 3, 2022), that payments made to the members of limited liability company debtors as part of a pre-bankruptcy recapitalization transaction were protected from avoidance under section 546(e) because for that section's purposes, the debtors were "financial institutions," as customers of banks that acted as their depositories and agents in connection with the transaction. Applying *Merit*, the court looked to New York fraudulent conveyance law—"the substantive avoiding power"—to determine that the overarching transfer could not be challenged in "piecemeal fashion" by analyzing a component transfer "in a vacuum." *Id.* at *3 ("[A]n allegedly fraudulent conveyance must be evaluated in context; '[w]here a transfer is only a step in a general plan, the plan must be viewed as a whole with all its composite implications.'") (*quoting Orr v. Kinderhill Corp.*, 991 F.2d 31, 35 (2d Cir. 1993) (alterations in original)). The court held that, "[s]uch an approach … would permit a trustee to circumvent the safe harbor by carving up an integrated

securities transaction consisting of multiple component parts." *Id.* This, the court continued, "would unnecessarily restrict the safe harbor and 'seriously undermine … markets in which certainty, speed, finality, and stability are necessary to attract capital.'" *Id.* (citing *Tribune*, 946 F.3d at 900) (alterations in original)).

NINE WEST

In 2014, private equity firm Sycamore Partners Management, L.P. ("Sycamore") acquired The Jones Group, Inc. ("Jones"), a fashion retail company, through an LBO pursuant to a 2013 merger agreement. The transaction involved the merger of Jones into a new Sycamore subsidiary that was ultimately renamed Nine West Holdings, Inc. (the "debtor"). At the close of the merger, Sycamore sold three of the debtor's brands, which allegedly constituted some of Jones's most valuable assets, to newly formed Sycamore affiliates.

Transfers made to Jones shareholders, directors, and officers as part of the LBO included: (i) $1.1 billion paid to public shareholders (the "shareholder transfers") by canceling and converting each share of common stock into the right to receive $15 in cash; (ii) $78 million paid to directors and officers (the "payroll transfers") by canceling and converting each of their restricted stock and stock equivalent units into the right to receive $15 in cash plus unpaid dividends; and (iii) $71 million in "change in control" payments to certain directors and officers.

The shareholder transfers were made by a paying agent "pursuant to a paying agent agreement in customary form" that, among other things, empowered the paying agent to "act as [the debtor's] special agent for the purpose of distributing the Merger Consideration." The payroll transfers and the change in control payments were processed through the debtor's payroll and by other means (i.e., the paying agent was not involved in these transactions).

The debtor filed for chapter 11 protection in the Southern District of New York four years after the LBO was completed. In February 2019, the bankruptcy court confirmed a chapter 11 plan for the debtor that was made possible by Sycamore's contribution of $120 million for the benefit of unsecured creditors, in exchange for a release of any liability related to the LBO. The plan assigned unreleased potential causes of action arising from the LBO to a litigation trustee and empowered the indenture trustee for certain of the debtor's noteholders to prosecute state law fraudulent transfer claims.

The litigation trustee sued the public shareholders (the "shareholder defendants") and the directors and officers (the "D&O defendants") in various federal district courts seeking to avoid the LBO payments as intentional and constructive fraudulent transfers under state law and section 544 of the Bankruptcy Code (all federal avoidance claims were time barred). He also asserted claims against certain D&O defendants for unjust enrichment, disgorgement, and restitution. The indenture trustee separately sued all of the defendants to avoid and recover the payments under state law. All of the litigation was later consolidated in the U.S. District Court for the Southern District of New York.

Invoking the section 546(e) safe harbor as an affirmative defense, the defendants moved to dismiss the litigation (other than the unjust enrichment claims with respect to the change in control payments).

The district court ruled in favor of the defendants on the motion to dismiss.

District Judge Jed S. Rakoff agreed with the shareholder defendants that the $1.1 billion the debtor paid them in connection with the LBO was a "qualifying transaction" for purposes of section 546(e) because the payments were "settlement payments," as defined by section 741(8) of the Bankruptcy Code, and they were "made in connection with a securities contract," as the term "securities contract" is defined in section 741(7).

Judge Rakoff rejected the trustees' efforts to distinguish *Tribune* on the basis that *Tribune* involved payments to public shareholders for the redemption of stock, whereas the debtor's LBO involved the cancellation and conversion of common stock into the right to receive cash. The court noted that the LBO transaction in *Tribune* was a two-step process. While there was a tender offer involving the redemption of common stock, it was followed by a merger involving the cancellation and conversion of the remaining shares to the right to receive cash. Moreover, the court explained that the plain language of section 741(7) covers not only contracts for the repurchase of securities, but also includes as a "catch-all" any other "similar" contract or agreement. Judge Rakoff concluded that "[t]here is no substantive or essential difference between an LBO that is effectuated through share redemption and one effectuated through share cancellation." *Nine West*, 482 F.Supp. 3d at 198.

Alternatively, Judge Rakoff held that the payments made to the shareholder defendants were "settlement payments"—i.e., transfers of cash made to complete the merger—consistent with the Second Circuit's "capacious interpretation of § 741(8)." *Id.* at 199.

Next, guided by *Tribune*, Judge Rakoff determined that the debtor's shareholder transfers involved a "qualifying participant" because the debtor qualified as a "financial institution" under section 546(e) as a "customer" of an agent bank that was also a financial institution. In addition, Judge Rakoff noted that at least 82 of the shareholder defendants independently qualified as "financial institutions" because they were registered investment companies, and one qualified as a commercial bank.

Judge Rakoff also concluded that the payroll payments made to the D&O defendants were protected as both settlement payments and transfers made in connection with a securities contract, even though the payments, unlike the shareholder payments, were not processed by the debtor's agent bank. He reasoned that, because the debtor was a financial institution as

a customer of the agent bank, section 546(e) safe-harbored all transfers made in connection with the LBO. In so ruling, Judge Rakoff rejected the trustees' "transfer-by-transfer" approach, which would distinguish between payments that were processed by the agent bank and those that were not in construing the definition of "financial institution" under section 101(22)(A) of the Bankruptcy Code, protecting only those payments with respect to which a financial institution played an agency role.

Instead, the court opted for the more comprehensive "contract-by-contract" approach, which views the transaction as a whole. This approach, the court reasoned, is more consistent with the text of section 101(22)(A), which provides that a customer of a bank qualifies as a financial institution when the bank is acting as agent in connection with a "securities contract" as opposed to when a bank is acting as agent in connection with a "transfer." *Id.* at 206. The court further concluded that the "contract-by-contract" approach better comports with *Merit*'s holding that "the relevant transfer for purposes of the § 546(e) safe-harbor inquiry is the overarching transfer that the trustee seeks to avoid," and "not any component part of that transfer." *Id.* (internal quotation marks omitted).

Finally, the district court held that section 546(e) preempts the litigation trustee's unjust enrichment claims against the D&O defendants because such claims, however denominated, sought recovery of the same payments that were protected from avoidance under the safe harbor. However, the court did not dismiss the unjust enrichment claims with respect to the change-in-control payments because the D&O defendants did not seek dismissal.

The litigation trustee and the indenture trustee appealed the ruling to the Second Circuit.

THE SECOND CIRCUIT'S RULING

A divided three-judge panel of the Second Circuit affirmed the ruling in part, reversed it in part, and remanded the case below.

The Second Circuit majority agreed with Judge Rakoff's decision insofar as he held that the shareholder payments were protected from avoidance under the section 546(e) safe harbor because the funds were deposited with the debtor's paying agent, which distributed checks or wire transfers to the shareholders in exchange for their shares in accordance with the relevant paying agent agreement.

In so ruling, the Second Circuit majority first examined the meaning of the term "financial institution" in section 101(22)(A) of the Bankruptcy Code. The trustees argued that a "financial institution" includes only bank customers in transactions where the bank acted as the customer's agent, whereas the shareholder and D&O defendants contended that the term applies to any transaction related to a securities contract, provided the bank acted as the customer's agent at some point in connection with that contract (i.e., at some point during the overarching transaction).

The Second Circuit majority concluded that:

> for these purposes, "financial institution" includes bank customers only in transactions where the bank is acting as their agent and that [the paying agent] acted as Nine West's agent in the [shareholder transfers] but not in the [payroll transfers]. We conclude, further, that under the transfer-by-transfer interpretation of § 101(22)(A), [the debtor] was a "financial institution" with respect to the [shareholder transfers] and those payments are therefore safe harbored under § 546(e). The [payroll transfers], however, are not so shielded.

Nine West, 87 F.4th at 143.

The Second Circuit majority faulted the district court for employing a "contract-by-contract" interpretation of section 101(22)(A) in determining that, in accordance with *Tribune*, because the paying agent acted as the debtor's agent in connection with the shareholder transfers made pursuant to the 2013 merger agreement and the 2014 LBO, all transfers made in connection with the LBO were shielded from avoidance by the safe harbor. According to the majority, the court's holding in *Tribune* "does not support such a reading of § 101(22)(A)." *Id.* at 145.

Instead, based on the language of section 101(22)(A), the statutory structure of the Bankruptcy Code, and the purpose of the safe-harbor provision, the Second Circuit majority concluded that section 101(22)(A) must be analyzed on a "transfer-by-transfer" basis to determine if section 546(e) applies.

The majority explained:

> [T]he Bankruptcy Code defines a 'financial institution' to include a 'customer' of a bank or other such entity 'when' the bank or other such entity '*is acting as agent*' for the customer 'in connection with a securities contract,' 11 U.S.C. § 101(22)(A) (emphasis added). It does not provide that a customer is covered when a bank has *ever* acted as a customer's agent in connection with a securities contract. In other words, the text creates a link between a bank 'acting as agent' and its customer with respect to a transaction. To satisfy that link, the plain language of § 101(22)(A) indicates that courts must look to each transfer and determine 'when'

> a bank '*is acting as agent*' for its customer for a transfer, assuming, of course, the transfer is made in connection with a securities contract.

Id. According to the Second Circuit majority, "the transfer-by-transfer approach is the more logical and reasonable interpretation," whereas the "contract-by-contract" interpretation "would lead to the absurd result of insulating every transfer made in connection with an LBO, as long as a bank served as agent for at least one transfer." *Id.*

The transfer-by-transfer approach, the majority noted, is likewise, supported by the "structure" of the Bankruptcy Code, which grants trustees avoidance powers to "help implement the core principles of bankruptcy." *Id.* at 146. While these avoidance powers are not "unfettered" (and are expressly limited by the section 546(e) safe harbor), the majority concluded that a broad interpretation of the safe harbor under a contract-by-contract approach would undermine these avoidance powers "that are so crucial to the Bankruptcy Code." *Id.*

Finally, the court emphasized that a transfer-by-transfer approach is consistent with the safe harbor's purpose in protecting from avoidance transfers that, if avoided, could trigger systemic risk in the financial markets. *Id.* By contrast, the majority reasoned, a broader interpretation of the safe harbor "would limit the avoidance power even where it would not threaten the financial system," which was, in the majority's view, "an expansion of the safe harbor provision likely not intended by Congress." *Id.*

Next, the Second Circuit majority determined that the district court correctly found that the 2013 merger agreement was a "securities contract" and that the shareholder payments were "settlement payments" within the scope of section 546(e). *Id.* at 149–50.

Finally, the Second Circuit majority held that the trustees' claims for unjust enrichment arising from the shareholder transfers "conflict with the purpose of § 546(e)," but that the claims arising from the payroll transfers do not because they do not fall within the scope of the safe harbor. It accordingly ruled that the litigation trustee's state law claims for unjust enrichment arising from the payroll transfers were not preempted by section 546(e). *Id.* at 150.

U.S. Circuit Judge Richard J. Sullivan authored a dissenting opinion in which he agreed with the majority that the safe harbor applied to the shareholder transfers but stated that section 546(e) should also apply to the payroll transfers. Judge Sullivan rejected the majority's transfer-by-transfer approach. "Instead," he wrote, "I believe that the district court's 'contract-by-contract' approach better comports with the plain meaning of section 101(22)(A)'s text and more faithfully gives effect to Congress's purpose in enacting section 546(e)." *Id.* at 151 (dissenting opinion). Judge Sullivan accordingly would have affirmed the district court's ruling in all respects.

OUTLOOK

On January 3, 2024, the Second Circuit denied a petition filed by the shareholder defendant-appellees of Nine West's publicly traded predecessor, Jones, seeking a panel rehearing and rehearing *en banc* of the ruling.

With the Second Circuit's ruling in Nine West, it would appear that the litigation over the debtor's 2014 LBO is far from over. The district court will now have to adjudicate the liquidation trustee's unjust enrichment claims against the D&O defendants as well as the resurrected claims seeking avoidance of the payroll transfers.

Nine West is an important ruling for a number of reasons. First, it reinforces the Second Circuit's groundbreaking decision in *Tribune* expanding the scope of the section 546(e) safe harbor to shield from avoidance constructively fraudulent transfers in which a qualifying financial institution acted as the debtor-transferor's agent. Second, the Second Circuit rejected the "contract-by-contract" approach and adopted the "transfer-by-transfer" approach in interpreting section 546(e) to ensure that the scope of the safe harbor does not reach beyond its underlying purpose by insulating every component of a transaction from avoidance even though a financial institution did not act as the debtor-transferor's agent for each component of the transaction. In addition, Judge Sullivan's full-throated support of the contract-by-contact approach and rejection of the transfer-by-transfer approach in his dissent appears to indicate that the debate over the breadth of the 546(e) safe harbor is alive and well.

On October 3, 2022, the Second Circuit issued an order staying the appeal of the district court's decision in Boston Generating pending the issuance of its ruling in *Nine West*, directing the parties to address the effect of the ruling on the appeal no later than 14 days after it handed down its decision. The remaining litigants submitted post argument letter briefs on December 11, 2023.

CHAPTER 15 FILING AS A LITIGATION TACTIC NOT BAD FAITH JUSTIFYING AUTOMATIC STAY RELIEF

Dan T. Moss • Andrew M. Butler

Debtors in non-U.S. bankruptcy or restructuring proceedings commonly seek to shield their U.S. assets from creditor collection efforts by seeking "recognition" of those proceedings in the United States in a case under chapter 15 of the Bankruptcy Code. If a U.S. bankruptcy court recognizes the debtor's foreign proceeding, the Bankruptcy Code's automatic stay prevents creditor collection efforts, including the commencement or continuation of any U.S. litigation involving the debtor or its U.S. assets. A U.S. bankruptcy court can lift the automatic stay triggered by chapter 15 recognition upon a showing of "cause."

In *In re Culligan Ltd.*, 2023 WL 5942498 (Bankr. S.D.N.Y. Sept. 12, 2023) ("*Culligan II*"), the U.S. Bankruptcy Court for the Southern District of New York considered a motion for relief from the automatic stay filed by the plaintiffs in New York state court litigation against a Bermuda-based debtor's directors, its controlling shareholders and certain other defendants (including the debtor as a nominal defendant) asserting derivative claims challenging the legality of payments made and obligations incurred by the debtor as part of a 2006 restructuring.

In an unpublished ruling, the court denied stay relief as well as a related motion seeking an order directing the debtor's foreign representatives to abandon the state court litigation as having inconsequential value. In so ruling, the bankruptcy court rejected the plaintiffs' argument that stay relief was warranted because the debtor's foreign representatives filed the chapter 15 case in bad faith as a litigation tactic to gain the upper hand in the state court litigation. According to the court, even if there were a good-faith filing requirement in chapter 15, "a bankruptcy filing cannot be said to be in bad faith where the debtor reasonably seeks the benefit of the automatic stay to effectuate an orderly liquidation."

RECOGNITION OF FOREIGN BANKRUPTCY CASES 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 (the "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's stated purpose is "to provide effective mechanisms for dealing with cases of cross-border insolvency" with the objective of, among other things, cooperation between U.S. and non-U.S. courts.

Under section 1515(a) of the Bankruptcy Code, the representative of a foreign debtor 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."

"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." Unlike with the determination of COMI, there is no statutory presumption regarding the determination of whether a foreign debtor has an establishment in any particular location.

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 debtor's right to transfer or encumber its U.S. assets, and, under section 1521(a)(7), "any additional relief that may be available to a trustee," with certain exceptions.

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

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."

CULLIGAN

Culligan Ltd. (the "debtor") was a Bermuda-incorporated holding company for direct and indirect subsidiaries that distributed water purification and filtration units through franchise dealers located exclusively in North America.

In a 2006 restructuring, the debtor borrowed $850 million to refinance existing debt, repay $200 million to an investor, and pay a $375 million dividend to shareholders. The debtor restructured again in early 2012.

In May 2012, certain of the debtor's minority shareholders, consisting of 71 of the 262 Culligan water dealers (collectively, the "plaintiffs"), commenced a derivative action (the "NY litigation") against the debtor's directors, its controlling shareholders, and certain other defendants in New York state court alleging that the consolidated Culligan System entities, including the debtor, violated New York law in assuming debt and paying shareholders and investors as part of the 2006 restructuring because the entities had insufficient capital.

The state court dismissed the complaint in March 2013, ruling that Bermuda law, rather than New York law, applied. The plaintiffs appealed.

On April 29, 2013, the debtor's majority shareholders authorized it to commence a members' voluntary liquidation ("MVL") under the Bermuda Companies Act of 1981. That same day, the Bermuda court appointed joint liquidators for the debtor for the purpose of winding up the company. The liquidators notified the plaintiffs of the filing and expressed their view that the NY litigation should not proceed because they had assumed control of the debtor.

The plaintiffs refused and in 2014 obtained a reversal on appeal of the state court's dismissal ruling. However, during the ensuing six years, the state court dismissed no fewer than four amended complaints on various grounds. Its decision on a motion to dismiss a fifth amended complaint was pending as of July 2021.

In June 2017, one of the debtor's affiliates paid it $11.67 million in connection with the winding-up proceeding, bringing the debtor's total cash holdings to $11.87 million. The liquidators accordingly determined that a distribution should be made to shareholders under the MVL in the amount of approximately $11.34 million. After reserving $500,000 to pay liquidation fees and expenses, as well as fees related to the NY litigation, they distributed $11.1 million to the debtor's shareholders, nearly $400,000 of which they disbursed to 56 of the 71 plaintiffs.

As of June 2019, the debtor had approximately $240,000 remaining in payment obligations to multiple shareholders, including nearly $38,000 to the 15 remaining plaintiffs, and had $288,000 in cash. However, due to expected liabilities arising from anticipated fees in the NY litigation, the liquidators determined that the debtor had become insolvent. In July 2019, they accordingly petitioned the Bermuda court to convert the MVL to a court-supervised liquidation. The court granted that relief and confirmed the liquidators in that role for purposes of the liquidation.

In June 2020, the liquidators sought an order from the Bermuda court restraining the plaintiffs from suing the debtor or commencing litigation in its name anywhere in the world. That proceeding was suspended, however, after the liquidators, as the debtor's foreign representatives, filed a chapter 15 petition on September 17, 2020, in the U.S. Bankruptcy Court for the Southern District of New York seeking recognition of the debtor's Bermuda liquidation as a "foreign main proceeding." They also sought an order confirming that the automatic stay precluded continuation of the NY litigation, due to the risk that the suit "may further deplete the dwindling assets of the Debtor and frustrate the Bermuda Liquidation."

The plaintiffs opposed the recognition petition, arguing that: (i) the foreign representatives were forum shopping and commenced the case to enjoin the NY litigation and thereby circumvent the adverse rulings of the state court; and (ii) the foreign representatives filed the chapter 15 petition in bad faith and for the improper purpose of barring the plaintiffs from prosecuting the NY litigation by application of the automatic stay. According to the plaintiffs, the foreign representatives filed the chapter 15 case in bad faith because the debtor was merely a nominal defendant in the NY litigation, it would not incur any liability, and its litigation costs were covered by insurance. They also asserted that the foreign representatives were not seeking a stay to provide breathing room to conduct good-faith liquidation efforts but, rather, improperly seeking chapter 15 recognition and application of the stay to permanently enjoin—as distinguished from merely to pause—the NY litigation.

In *In re Culligan Ltd.*, 2021 WL 2787926 (Bankr. S.D.N.Y. July 2, 2021) ("*Culligan I*"), the court granted recognition under chapter 15 to the debtor's liquidation proceeding. Among other things, U.S. Bankruptcy Judge James L. Garrity, Jr. ruled that the narrow and rarely invoked public policy exception in section 1506 did not warrant denial of chapter 15 recognition. He wrote that "courts have generally found that section 1506 does not prohibit recognition in situations where the debtor has engaged in bad faith." *Id.* at *15 (citing *In re Manley Toys Ltd.*, 580 B.R. 632, 648 (Bankr. D.N.J. 2018), *aff'd*, 597 B.R. 578 (D.N.J. 2019); *In re Creative Fin. Ltd.*, 543 B.R. 498, 515 (Bankr. S.D.N.Y. 2016)). Instead, Judge Garrity explained, 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.

Judge Garrity acknowledged that there was evidence to show that the foreign representatives filed the chapter 15 petition as part of their "litigation strategy" to bring an end to the NY litigation and that "the admitted, and apparently entire, purpose of the present chapter 15 filing" was to prevent the plaintiffs from continuing the lawsuit. *Id.* at *15. However, he faulted the plaintiffs' reliance on case law finding bad faith as "cause" for dismissing chapter 11 cases under section 1112(b) of the Bankruptcy Code. Unlike in chapter 11, Judge Garrity reiterated, recognition under chapter 15 is subject to the public policy exception of section 1506, which considers not whether the actions of the debtor violate public policy, but whether the foreign court's procedures and safeguards fail to comport with U.S. public policy. In the absence of any such allegations, Judge Garrity held that the alleged bad faith was not a basis to deny chapter 15 recognition.

Judge Garrity accordingly granted the petition for recognition of the Bermuda liquidation proceeding under chapter 15 as a foreign main proceeding. Upon recognition, the automatic stay precluded continuation of the NY litigation (including the issuance of any decision on the debtor's motion to dismiss the fifth amended complaint as well as the plaintiffs' anticipated filing of a sixth amended complaint). In so ruling, Judge Garrity declined to address whether the foreign representatives were entitled to supplementary injunctive relief under section 1521 (in addition to the automatic stay arising upon recognition under section 1520(a)) and stated that any request by the plaintiffs for relief from the automatic stay to continue the NY litigation was premature because it was not procedurally proper.

On July 30, 2021, the plaintiffs filed a motion for an order: (i) modifying the automatic stay to continue the NY litigation; and (ii) directing the foreign representatives to abandon the NY litigation.

According to the plaintiffs, relief from the stay was warranted in accordance with the 12-factor test set forth in *In re Sonnax Indus.*, Inc., 907 F.2d 1280 (2d Cir. 1990), because, among other things:

- The vast majority of the debtor's assets had already been distributed, such that continuation of the NY litigation would not interfere with the Bermuda liquidation;
- The debtor's legal fees in the NY litigation were mostly covered by insurance;
- The debtor was only a nominal defendant in the NY litigation;
- The debtor had few, if any, creditors, and they would not be prejudiced by continuation of the litigation;
- Success in the NY litigation by the plaintiffs would not result in an avoidable judicial lien; and
- The balance of equities favored stay relief because the successful prosecution of the NY litigation would benefit the debtor's stakeholders, whereas denial of stay relief would sanction the foreign representatives' bad-faith litigation tactic in filing the chapter 15 petition for the purpose of preventing prosecution of the NY litigation.

In addition, the plaintiffs argued that the court should compel the foreign representatives to abandon the NY litigation under section 554(b) of the Bankruptcy Code because the action was of "inconsequential value," and the foreign representatives had a conflict of interest because they were employed by one of the other defendants in the NY litigation.

The foreign representatives opposed the motion. Among other things, they argued that the plaintiffs were effectively asking the court to reconsider its recognition decision, including the court's ruling that the chapter 15 petition was not filed in bad faith. They also claimed that relief from the stay was not justified under the *Sonnax* factors because, among other things: (i) continuation of the NY litigation would burden the debtor because it (rather than its insurer) was responsible for any fees arising from the foreign representatives' participation in the litigation; (ii) stay relief would not lead to resolution of the already protracted action, which was still only in the pleading stage; (iii) the claims in the NY litigation were derivative and belonged to the debtor; and (iv) denial of stay relief would not prejudice the plaintiffs because they would have an opportunity to be heard in the Bermuda court.

The foreign representatives opposed abandonment because section 554 of the Bankruptcy Code is not among the provisions that section 103(a) makes applicable to chapter 15 cases. In

addition, the foreign representatives contended that abandonment is not warranted because, among other things, if allowed to proceed, the NY litigation would continue to burden the debtor because it would be responsible for any fees arising from the foreign representatives' participation in the litigation.

THE BANKRUPTCY COURT'S RULING

The bankruptcy court denied the motion.

Addressing the motion for abandonment first, Judge Garrity explained that sections 103(a) and 1520(a) of the Bankruptcy Code catalogue the provisions of the Bankruptcy Code that apply in a chapter 15 case, but the Bankruptcy Code's abandonment provision—section 554(b)—is not among them. However, he explained, some courts have reasoned that a foreign representative may be permitted to abandon a debtor's property under appropriate circumstances pursuant to section 1521(a)(7), which, as noted previously, authorizes a bankruptcy court, "at the request of the foreign representative," to grant "any additional relief available to a trustee," with certain exceptions not relevant here. *Culligan II*, 2023 WL 5942498, at *13 (citing unpublished orders entered in *In re Motorcycle Tires & Accessories LLC*, No. 19-12706 (Bankr D. Del.) (orders dated Mar. 31, 2020), and *In re Strata Energy Servs. Inc.*, No. 15-20821 (Bankr. D. Wyo.) (order dated Sept. 7, 2016)).

According to Judge Garrity, these cases are distinguishable because a foreign representative (rather than a creditor) moved to abandon the debtor's property and the motions were not contested. Moreover, he noted, even if section 1521(a)(7) can provide authority to grant section 554(b) relief in a chapter 15 case, abandonment was not appropriate in the case before him. Judge Garrity explained that abandonment of property is justified only if the property "is burdensome to the estate or … is of inconsequential value and benefit to the estate." Here, the foreign representatives demonstrated that they would be adversely impacted by abandonment of the NY litigation to the plaintiffs because, among other things, the foreign representatives would incur even more expense litigating any appeal from the motion to dismiss the complaint. In addition, Judge Garrity was "not convinced" that there was any conflict of interest sufficient for him to mandate abandonment of the action to the plaintiffs. *Id.* at *15.

Judge Garrity also rejected the plaintiffs' argument that allowing the foreign representatives to "control and dismiss" the NY litigation would be "manifestly contrary" to U.S. public policy within the meaning of section 1506 of the Bankruptcy Code because it would impinge on the plaintiffs' due process rights. Those rights were protected, he explained, because: (i) the foreign representatives were obligated to obtain the Bermuda court's permission (on notice to the plaintiffs) to seek dismissal or other disposition of the NY litigation, and the plaintiffs had the right to be heard by the Bermuda court in connection with any such request; (ii) if the Bermuda court authorized dismissal or other disposition of the NY litigation, the foreign representatives would have to seek recognition and enforcement of that authority from the U.S. bankruptcy court, where the plaintiffs also had the right to be heard; and (iii) the plaintiffs had the right to oppose dismissal or other disposition of the NY litigation in the NY court.

Judge Garrity concluded that there was no "cause" for relief from the automatic stay to continue with the NY litigation under the *Sonnax* factors. Factors dealing with judicial economy, resolution of the issues in the litigation, and trial readiness all "weigh[ed] heavily against granting relief from the stay given the already protracted nature of the litigation, serious questions regarding the plaintiffs' derivative standing to bring the litigation, and the pending (and anticipated) motions to dismiss. Factors addressing interference with the debtor's bankruptcy case and the unavailability of insurance to cover the debtor's costs also weighed against granting stay relief. In addition, the delay and asset drain attendant to continuation of the NY litigation outweighed any prejudice to the plaintiffs by having to participate in the Bermuda liquidation.

Finally, Judge Garrity rejected the plaintiffs' argument that the stay should be lifted because the foreign representatives filed the debtor's chapter 15 case in bad faith as a litigation tactic:

> [A] bankruptcy filing cannot be said to be in bad faith where the debtor reasonably seeks the benefit of the automatic stay to effectuate an orderly liquidation.… In this case, the Foreign Representatives readily admit that the chapter 15 filing is part of their strategy to enjoin, control, and eventually dismiss, an action that they view as meritless, which is draining the Debtor's limited assets and preventing the orderly completion of the Bermuda Liquidation. This strategy is not so much a tactic to combat a negative outcome in the [NY litigation] as it is a tactic to bring the [NY litigation] to a conclusion in furtherance of the Debtor's wind-down. In the end, the Foreign Representatives "may or may not be correct" that dismissal of the [NY litigation] is the best course of action, … but for the reasons outlined herein, their view is not unreasonable.

Id. at *20 (citations omitted).

OUTLOOK

Culligan II is an important ruling, even though the decision is unpublished and therefore of limited precedential value. In its previous decision recognizing the debtor's Bermuda liquidation proceeding—*Culligan I*—the bankruptcy court granted chapter 15 recognition despite allegations that the company's court-appointed foreign representatives filed the chapter 15 petition solely to enjoin the pending state court litigation. According to the bankruptcy court, although the Bankruptcy Code gives a U.S. court the discretion to deny any chapter 15 relief that is "manifestly contrary" to U.S. public policy, "this exception is not met by a simple finding that the Chapter 15 Petition has been filed as a litigation tactic." See *Culligan I*, 2021 WL 2787926, at *16.

The bankruptcy court doubled down on that message in its most recent ruling, albeit in the context of a motion for relief from the automatic stay to continue the litigation and a motion to compel abandonment of the lawsuit. In denying that relief, the court recognized that the plaintiffs were effectively attempting to relitigate the recognition dispute. The court accordingly rejected their challenge to the debtor's chapter 15 case as a bad-faith litigation tactic for the same reasons stated in *Culligan I*, thereby reinforcing the utility of chapter 15 as a means of providing U.S. court assistance to a debtor's foreign bankruptcy or restructuring proceedings and foreign courts overseeing such proceedings.

NEW YORK BANKRUPTCY COURT: SETOFF AND UNJUST ENRICHMENT CANNOT BE ASSERTED AS AFFIRMATIVE DEFENSES IN BANKRUPTCY AVOIDANCE LITIGATION

Daniel J. Merrett

In a 2021 ruling, the U.S. Court of Appeals for the Second Circuit revived nearly 100 lawsuits seeking to recover fraudulent transfers made as part of the Madoff Ponzi scheme. In one of the latest chapters in that resurrected litigation, the U.S. Bankruptcy Court for the Southern District of New York held in *Picard v. ABN AMRO Bank NV (In re Bernard L. Madoff Investment Securities LLC)*, 654 B.R. 224 (Bankr. S.D.N.Y. 2023), that a defendant in fraudulent transfer litigation cannot offset its fraudulent transfer liability against a claim the creditor asserts against the debtor because there is no mutuality between the two claims. The court also ruled that, depending on the specific facts and equities of the case, recoupment might be asserted as an affirmative defense in avoidance litigation. Finally, it held that unjust enrichment cannot ordinarily be raised as an affirmative defense and is particularly disfavored in bankruptcy because it undermines the Bankruptcy Code's priority scheme.

SETOFF IN BANKRUPTCY

Section 553 of the Bankruptcy Code provides that, with certain exceptions, the Bankruptcy Code "does not affect any right of a creditor to offset a mutual debt owing by such creditor to the debtor that arose before the commencement of the case under this title against a claim of such creditor against the debtor that arose before the commencement of the case." Section 553 does not create setoff rights—it merely preserves certain setoff rights that otherwise would exist under contract or applicable non-bankruptcy law. See Collier on Bankruptcy ("Collier") ¶ 553.04 (16th ed. 2023) (citing *Citizens Bank of Maryland v. Strumpf*, 516 U.S. 16 (1995)); *Feltman v. Noor Staffing Grp., LLC (In re Corp. Res. Servs. Inc.)*, 564 B.R. 196 (Bankr. S.D.N.Y. 2017) (section 553 does not create an independent federal right of setoff, but merely preserves any such right that exists under applicable non-bankruptcy law). As noted by the U.S. Supreme Court in *Studley v. Boylston Nat. Bank*, 229 U.S. 523 (1913), setoff avoids the "absurdity of making A pay B when B owes A." Id. at 528; *see also In re Lehman Brothers Holdings Inc.*, 404 B.R. 752, 756 (Bankr. S.D.N.Y. 2009) (discussing the historical underpinnings of the setoff doctrine).

The Bankruptcy Code defines a "claim," in relevant part, as a "right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured," and it defines a "debt" as a "liability on a claim." 11 U.S.C. §§ 101 (5)(A), (12).

With certain exceptions for setoffs under "safe-harbored" financial contracts, a creditor is precluded by the automatic stay from exercising setoff rights against a debtor in bankruptcy without court approval. See 11 U.S.C. §§ 362(a)(7), (b)(6), (b)(7), (b)(17), (b)(27), and (o). Stayed setoff rights are merely suspended, however, pending an orderly examination of the parties' obligations by the court, which will generally permit a valid setoff unless it would be inequitable to do so. *See In re Ealy*, 392 B.R. 408 (Bankr. E.D. Ark. 2008).

A creditor stayed from exercising a valid setoff right must be granted "adequate protection" (see 11 U.S.C. § 361) against any diminution in the value of its interest caused by the debtor's use of the creditor's property. *Ealy*, 392 B.R. at 414.

Setoff is expressly prohibited by section 553 if: (i) the creditor's claim against the debtor is disallowed; (ii) the creditor acquires its claim from an entity other than the debtor either (a) after the bankruptcy filing date or (b) after 90 days before the petition date while the debtor was insolvent (with certain exceptions); or (iii) the debt owed to the debtor was incurred by the creditor (a) after 90 days before the petition date, (b) while the debtor was insolvent, and (c) for the purpose of asserting a right of setoff, except for setoff under "safe-harbored" financial contracts. See 11 U.S.C. § 553(a)(1)–(3).

Section 553(b) provides that, except for setoffs under safe-harbored financial contracts, the trustee or a chapter 11 debtor-in-possession may recover any amount offset by a non-debtor on or within 90 days before the bankruptcy petition date to the extent the non-debtor improved its position by reducing any "insufficiency."

Thus, for a creditor to be able to exercise a setoff right in bankruptcy, section 553 requires on its face that: (i) the creditor have a right of setoff under applicable non-bankruptcy law; (ii) the debt and the claim are "mutual"; (iii) both the debt and the claim arose prepetition; and (iv) the setoff does not fall within one of the three prohibited categories specified in the provision.

The Bankruptcy Code does not define the term "mutual debt." Debts are generally considered mutual when they are due to and from the same persons or entities in the same capacity, but there is some confusion among the courts on this point. *See In re Am. Home Mortg. Holdings, Inc.*, 501 B.R. 44, 56 (Bankr. D. Del. 2013); *see generally* Collier at ¶ 553.03[3][a] (citing cases).

Creditors typically rely on the remedy of setoff if the mutual debts arise from *separate* transactions, although the issue is murky. See Collier at ¶ 553.10. By contrast, if mutual debts arise *from the same transaction*, the creditor may have a right of "recoupment," which has been defined as "a deduction from a money claim through a process whereby cross demands arising out of the same transaction are allowed to compensate one another and the balance only to be recovered." *Westinghouse Credit Corp. v. D'Urso*, 278 F.3d 138, 146 (2d Cir. 2002); *accord Newbery Corp. v. Fireman's Fund Ins. Co.*, 95 F.3d 1392, 1399 (9th Cir. 1996); *In re Matamoros*, 605 B.R. 600, 610 (Bankr. S.D.N.Y. 2019) ("recoupment is in the nature of a defense and arises only out of cross demands that stem from the same transaction").

Unlike setoff, recoupment is not subject to the automatic stay (*see In re Ditech Holding Corp.*, 606 B.R. 544, 600 (Bankr. S.D.N.Y. 2019)), and may involve both pre- and postpetition obligations. *See Sims v. U.S. Dep't of Health and Human Services (In re TLC Hosps., Inc.)*, 224 F.3d 1008, 1011 (9th Cir. 2000) (citing Collier at ¶ 553.10).

Even though section 553 expressly refers to prepetition mutual debts and claims, many courts have held that mutual postpetition obligations may also be offset. *See Zions First Nat'l Bank, N.A. v. Christiansen Bros., Inc. (In re Davidson Lumber Sales, Inc.)*, 66 F.3d 1560 (10th Cir. 1995); *Official Comm. of Unsecured Creditors of Quantum Foods, LLC v. Tyson Foods, Inc. (In re Quantum Foods, LLC)*, 554 B.R. 729 (Bankr. D. Del. 2016).

However, setoff is available in bankruptcy only "when the opposing obligations arise on the same side of the … bankruptcy petition date." *Pa. State Employees' Ret. Sys. v. Thomas (In re Thomas)*, 529 B.R. 628, 637 n.2 (Bankr. W.D. Pa. 2015); *accord Pereira v. Urthbox Inc. (In re Try the World, Inc.)*, 2023 WL 5537564, at *13 (Bankr. S.D.N.Y. Aug. 28, 2023) (noting that "claims are not in the same right and between the same parties, standing in

the same capacity" where the claims underlying an alleged setoff right accrued prepetition and the "liability for the fraudulent-transfer claim is held by the Trustee as a postpetition obligation") (internal quotation marks and citations omitted); *In re Williams*, 2018 WL 3559098, at *3 (Bankr. D.N.M. July 23, 2018) (section 553 does not permit a creditor to collect a prepetition debt by withholding payment of a postpetition debt owed to the debtor); *In re Enright*, 2015 WL 4875483, at *3 (Bankr. D.N.J. Aug. 13, 2015) (same); *Kramer v. Sooklall (In re Singh)*, 434 B.R. 298, 308 (Bankr. E.D.N.Y. 2010) ("It is well established that a party will be unable to assert a setoff where the party is being sued for fraudulent transfers … because … there is no mutuality of obligations … "); *In re Passafiume*, 242 B.R. 630, 633 (Bankr. W.D. Ky. 1999) ("Claims which arise post-petition lack the requisite mutuality, even if they arise with regard to work performed pre-petition.").

STOCKBROKER LIQUIDATIONS UNDER SIPA

Congress enacted the Securities Investor Protection Act, 15 U.S.C. §§ 78aaa *et seq.* ("SIPA"), in 1970 to deal with a crisis in customer and investor confidence and the prospect that capital markets might fail altogether after overexpansion in the securities brokerage industry led to a wave of failed brokers. The law was substantially revamped in 1978 in conjunction with the enactment of the Bankruptcy Code.

A SIPA proceeding is commenced when the Securities Investor Protection Corporation ("SIPC") files an application for a protective decree regarding one of its member broker-dealers in a federal district court. If the district court issues the decree, it appoints a trustee to oversee the broker-dealer's liquidation and refers the case to the bankruptcy court.

Thereafter, the bankruptcy court presides over the SIPA case, and the case proceeds very much like a chapter 7 liquidation, with certain exceptions. SIPA expressly provides that "[t]o the extent consistent with the provisions of this chapter, a liquidation proceeding shall be conducted in accordance with, and as though it were being conducted under chapters 1, 3, and 5 and subchapters I and II of chapter 7 of [the Bankruptcy Code]." SIPA § 78fff(b).

SIPA affords limited financial protection to the customers of registered broker-dealers. SIPC advances funds to the SIPA trustee as necessary to satisfy customer claims but limits them to $500,000 per customer, of which no more than $250,000 may be based on a customer claim for cash. SIPC is subrogated to customer claims paid to the extent of such advances. Those advances are repaid from funds in the general estate prior to payments on account of general unsecured claims.

The SIPA trustee has substantially all of a bankruptcy trustee's powers, including the avoidance powers. Thus, if property in the customer estate is not sufficient to pay customer net equity claims in full, "the [SIPA] trustee may recover any property transferred by the debtor which, except for such transfer, would have been customer property if and to the extent that such transfer is voidable or void under the provisions of [the Bankruptcy Code]." SIPA § 78fff-2(c)(3). However, neither a SIPA trustee nor a bankruptcy trustee may avoid certain transfers made by, to, or for the benefit of stockbrokers, repurchase agreement participants, swap agreement participants, and certain other entities, unless the transfer was made with actual intent to hinder, delay, or defraud creditors in accordance with section 548(a)(1)(A). See 11 U.S.C. §§ 546(e), (f), and (g).

MADOFF

Bernard L. Madoff Investment Securities LLC ("MIS") was the brokerage firm that carried out Bernard Madoff's infamous Ponzi scheme by collecting customer funds that it never invested and making distributions of principal and fictitious "profits" to old customers with funds it received from new customers. After the scheme collapsed in December 2008, the U.S. District Court for the Southern District of New York issued a protective decree for MIS under SIPA.

Because the customer property held by MIS was inadequate to pay customer net equity claims, the SIPA trustee sought to recover funds that would have been customer property had MIS not transferred them to others. Certain customers had "net equity" claims, because they had withdrawn less than the full amount of their investments from their MIS accounts before entry of the protective decree. Other customers had no net equity claims, because they withdrew more money from their accounts than they had deposited. These customers received not only a return of their principal investment but also fictitious "profits" that were actually other customers' money.

In 2010, the SIPA trustee commenced hundreds of adversary proceedings in the bankruptcy court against former MIS customers and third parties seeking, among other things, to avoid and recover many payments as actual and constructive fraudulent transfers under federal law (see SIPA § 78fff-2(c)(3); 11 U.S.C. §§ 548(a)(1)(A) and 548(a)(1)(B)) as well as state fraudulent transfer laws (as made applicable in a SIPA proceeding under SIPA § 78fff-2(c)(3) and section 544 of the Bankruptcy Code).

That litigation included an adversary proceeding against ABN AMRO Bank N.V. (presently known as Royal Bank of Scotland, N.V.) ("AMRO"), a Dutch financial institution that maintained offices in the United States. The proceeding sought to recover pursuant to sections 105(a) and 550(a) of the Bankruptcy Code approximately $308 million that AMRO received as a "subsequent transferee" from two "feeder funds" that invested with MIS in accordance with 2006 and 2008 swap agreements between AMRO and the feeder funds as well as related transactions. The SIPA trustee alleged that the payments were made with the actual intent to defraud MIS's customers and creditors and could therefore be recovered from AMRO as a subsequent transferee.

The AMRO adversary proceeding was dismissed, together with avoidance litigation involving hundreds of other defendants, after the U.S. District Court for the Southern District of New York held on April 28, 2014, that: (i) contrary to normal practice, a SIPA

trustee bears the burden of pleading the affirmative defense of lack of good faith in connection with litigation seeking to recover a fraudulent transfer from a subsequent transferee under section 550(a)(2); and (ii) because SIPA is part of federal securities law, the trustee must plead the "willful blindness" standard applied to some securities law claims. That standard requires "a showing that the defendant acted with willful blindness to the truth, that is, he intentionally chose to blind himself to the red flags that suggest a high probability of fraud," rather than the "inquiry notice" standard, "under which a transferee may be found to lack good faith when the information the transferee learned would have caused a reasonable person in the transferee's position to investigate the matter further." *Sec. Inv. Prot. Corp. v. Bernard L. Madoff Inv. Sec. LLC*, 516 B.R. 18, 21 (S.D.N.Y. 2014) (citations and internal quotation marks omitted), *vacated and remanded sub nom. In re Bernard L. Madoff Investment Securities LLC*, 12 F.4th 171 (2d Cir. 2021), *cert. denied*, No. 21-1059 (U.S. Feb. 28, 2022).

On August 31, 2021, however, the U.S. Court of Appeals for the Second Circuit reversed the 2014 district court decision, ruling 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 SIPA stockbroker liquidation case; and (ii) the defendants, rather than the SIPA trustee, bear the burden of pleading on the issue of good faith under section 550 of the Bankruptcy Code. *See In re Bernard L. Madoff Investment Securities LLC*, 12 F.4th 171 (2d Cir. 2021), *cert. denied*, No. 21-1059 (U.S. Feb. 28, 2022). The decision, 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.

Pursuant to a stipulated order dated November 12, 2021, the bankruptcy court, in accordance with the Second Circuit's August 2021 decision, reopened the AMRO adversary proceeding and vacated its order dismissing the proceeding.

On March 22, 2022, the SIPA trustee filed a motion for leave to amend his complaint against AMRO, which opposed the motion on the grounds of futility and moved to dismiss.

The bankruptcy court denied AMRO's motion to dismiss on March 3, 2023. Among other things, the bankruptcy court concluded that the trustee's amended complaint adequately pleaded a cause of action for recovery of a fraudulent transfer under section 550.

AMRO filed an answer to the trustee's complaint in which it denied most of the substantive allegations and asserted 34 affirmative defenses and two counterclaims against the SIPA trustee for unjust enrichment. The trustee moved to dismiss the counterclaims on July 17, 2023.

On August 24, 2023, AMRO moved to amend its answer to assert eight additional affirmative defenses and supplement its counterclaims, arguing that the trustee would not be prejudiced by the proposed amendments. The SIPA trustee opposed the motion insofar as it sought leave to amend two affirmative defenses (numbers 31 and 42) alleging that AMRO was entitled to the affirmative defenses of setoff, recoupment, and unjust enrichment. In the alternative, the trustee asked the court to hold the proposed amendments in abeyance until the court resolved the trustee's motion to dismiss the amended counterclaims.

THE BANKRUPTCY COURT'S RULING

The bankruptcy court denied AMRO's motion to amend its answer in part and granted it in part.

U.S. Bankruptcy Judge Cecilia G. Morris explained that a court will deny a motion to amend a pleading if the proposed amendment is futile because "the proposed amendments would fail to cure prior deficiencies or to state a claim under Rule 12(b)(6) of the Federal Rules of Civil Procedure." *Madoff*, 654 B.R. at 233 (quoting *Panther Partners Inc. v. Ikanos Commc'ns, Inc.*, 681 F.3d 114, 119 (2d Cir. 2012)). According to Judge Morris, AMRO's motion to amend its affirmative defenses to assert claims of setoff and unjust enrichment must be denied on the basis of futility, but it was premature to deny AMRO's request to amend its recoupment affirmative defense.

First, Judge Morris noted that a defendant in fraudulent transfer litigation in bankruptcy cannot assert a right of setoff because the required mutuality between the potential avoidance liability and the defendant's prepetition claim against the debtor is absent. *Id.* at 234 (citing *Try the World*, 2023 WL 5537564, at *13; *Singh*, 434 B.R. at 308). In this case, she explained, AMRO did not dispute that the claim upon which its alleged setoff right was based arose prepetition in connection with its investments in the Madoff feeder funds. Having concluded that there was no mutuality, the bankruptcy court accordingly denied AMRO's motion to amend its affirmative setoff defense.

Next, the bankruptcy court concluded that allowing AMRO to amend its recoupment affirmative defense *might* similarly be futile because AMRO did not allege that there was a "single unified transaction" involved in the 2006 and 2008 swap agreements between AMRO and the Madoff feeder funds. According to Judge Morris, for there to be a single unified transaction—and therefore a recoupment right under non-bankruptcy law—the opposing claims must "result from a set of reciprocal contractual obligations from the same set of facts." *Id.* at 235 (quoting *Pereira v. Equitable Life Ins. Soc'y of the U.S. (In re Trace Int'l Holdings, Inc.)*, 289 B.R. 548, 562 (Bankr. S.D.N.Y. 2003)). However, because the availability of a recoupment defense depends in part on the equities of the case, which had not been adequately developed at this stage of the litigation, the bankruptcy court allowed AMRO to amend its recoupment affirmative defense.

Finally, the bankruptcy court denied AMRO's motion to amend its unjust enrichment affirmative defense. Judge Morris explained that, to state a claim for unjust enrichment under New York law,

a plaintiff must plead that the defendant was enriched at the plaintiff's expense and that "equity and good conscience require the plaintiff to recover the enrichment from the defendant." *Id.* at 236 (quoting *Moshik Nadav Typography LLC v. Banana Republic, LLC*, 2021 WL 2403724, at *2 (S.D.N.Y. June 10, 2021)). However, she noted, unjust enrichment is typically asserted as a claim, rather than a defense. Moreover, Judge Morris emphasized, the enforcement of an unjust enrichment claim in bankruptcy could "wreak … havoc" on the Bankruptcy Code's priority scheme by allowing "a separate allocation mechanism" favoring a single creditor in the form of a constructive trust as a remedy for unjust enrichment. *Id.* at 237 (*quoting In re Commodore Bus. Machs., Inc.*, 180 B.R. 72, 83 (Bankr. S.D.N.Y. 1995)).

According to the bankruptcy court:

> There is nothing inequitable, in bad conscience, or unjust in allowing the Trustee to proceed in marshalling and preserving the assets of the estate. [AMRO] has not presented a substantial reason to do so and risk[s] disrupting the priority system ordained by the Bankruptcy Code. The Court will not allow [AMRO] to amend the affirmative defenses in so far as [it] seek[s] to add a defense of unjust enrichment.

Id. at 238.

OUTLOOK

Madoff represents one of the latest chapters in the protracted saga regarding the Madoff Ponzi scheme and the SIPA trustee's more than decade-long efforts to recover customer funds transferred to various parties as part of the fraudulent enterprise. Key takeaways from the ruling include: (i) a trustee's claim arising from a prepetition fraudulent transfer involving the debtor is considered a postpetition claim of an entity other than the debtor such that a defendant cannot offset that liability against a prepetition claim the creditor asserts against the debtor because the claims lack the required mutuality; (ii) depending on the specific facts and equities of the case, recoupment may be asserted as an affirmative defense in avoidance litigation; and (iii) unjust enrichment cannot ordinarily be raised as an affirmative defense and is particularly disfavored in bankruptcy because it undermines the Bankruptcy Code's priority scheme.

As a postscript, shortly after the bankruptcy court handed down its decision in *Madoff*, AMRO voluntarily dismissed its counterclaims—thereby resolving the trustee's pending motion to dismiss—noting that, in light of the court's decision, the counterclaims, which mirror AMRO's affirmative defenses, are no longer necessary. Even so, with the bankruptcy court's permission to amend AMRO's affirmative defenses other than setoff and unjust enrichment, the litigation would appear far from over.

DELAWARE BANKRUPTCY COURT IMPUTES OFFICER'S FRAUDULENT INTENT TO CORPORATION IN AVOIDANCE LITIGATION

S. Christopher Cundra IV

A powerful tool afforded to a bankruptcy trustee or a chapter 11 debtor-in-possession ("DIP") is the power to recover pre-bankruptcy transfers that are avoidable under federal bankruptcy law (or sometimes state law) because they were either made with the intent to defraud creditors or are constructively fraudulent because the debtor-transferor received less than reasonably equivalent value in exchange and was insolvent at the time, or was rendered insolvent as a consequence of the transfer. To avoid an intentionally fraudulent transfer, a trustee or DIP must show that the debtor transferred its property with the intent to hinder, delay, or defraud its creditors. When the debtor-transferor is an entity rather than an individual, the entity's intent to defraud is typically derived from the intent of individuals or a governing body acting on its behalf (e.g., a board of directors). But if, unbeknownst to the debtor's board, its members approve a transfer based on fraudulent information provided by an officer, has the entity acted with fraudulent intent for purposes of avoidance?

The U.S. Bankruptcy Court for the District of Delaware recently addressed this issue in *In re Cyber Litigation Inc.*, 2023 WL 6938144 (Bankr. D. Del. Oct. 19, 2023). In granting summary judgment in favor of a trustee seeking to avoid payments made as part of a pre-bankruptcy tender offer as a fraudulent transfer, the court held that the intent of a fraudster-officer can be imputed to the board and, in turn, the debtor, where the fraudster manipulated the board through deceit. The court also considered, and rejected, application of the "earmarking" defense to avoidance.

AVOIDANCE OF FRAUDULENT TRANSFERS IN BANKRUPTCY

As noted, fraudulent transfers that can be avoided by a trustee or DIP include: (i) actual fraudulent transfers, which are transfers made with "actual intent to hinder, delay, or defraud" creditors (see 11 U.S.C. § 548(a)(1)(A)); and (ii) constructive fraudulent transfers, which are "transactions that may be free of actual fraud, but which are deemed to diminish unfairly a debtor's assets in derogation of creditors." Collier on Bankruptcy ("Collier") ¶ 548.05 (16th ed. 2023); 11 U.S.C. § 548(a)(1)(B).

Due to the difficulty in proving actual fraud based on an avoidance defendant's subjective state of mind, some courts consider "badges of fraud" in assessing whether a transfer or obligation was made or incurred with intent to defraud, including, among other things, the adequacy of the consideration involved, the relationships between the parties, whether the transferor continued to use the property even after the transfer, and the transferor's financial condition at the time of and after the transfer. *See, e.g.*, *In re TransCare Corp.*, 81 F.4th 37 (2d Cir. 2023); *see generally* Collier at ¶ 548.04[1][b][i] (citing cases); *see also* Section 4(b) of the Uniform Fraudulent Transfer Act (the "UFTA") and its successor, the Uniform Voidable Transfer Act (the "UVTA") (listing 11 separate badges of fraud to be applied in determining whether an actual fraudulent transfer should be avoided under state law) (discussed below).

A transfer is constructively fraudulent if the debtor received "less than a reasonably equivalent value in exchange for such transfer or obligation" and was, among other things, insolvent, undercapitalized, or unable to pay its debts as such debts matured. Collier at ¶ 548.05; 11 U.S.C. § 548(a)(1)(B).

Fraudulent transfers may also be avoided by a trustee or DIP under section 544(b) of the Bankruptcy Code, which provides that, with certain exceptions, "the trustee may avoid any transfer of an interest of the debtor in property or any obligation incurred by the debtor by a creditor holding an unsecured claim that is allowable under section 502 of [the Bankruptcy Code] or that is not allowable only under section 502(e) of [the Bankruptcy Code]." 11 U.S.C. § 544(b)(1). This provision permits a trustee to step into the shoes of a "triggering" unsecured creditor that could have sought avoidance of a transfer under applicable non-bankruptcy law (e.g., the UFTA or its successor, the UVTA). *See generally* Collier at ¶ 544.06. Section 544(b) is an important tool, principally because the reach-back period for avoidance of fraudulent transfers under state fraudulent conveyance laws (or even non-bankruptcy federal laws, such as the Internal Revenue Code) is typically longer than the two-year period for avoidance under section 548. *Id.*

If a transfer is avoided under either section 548 or 544(b), section 550 of the Bankruptcy Code authorizes the trustee or DIP to recover the property transferred or its value from the initial or subsequent transferees, with certain exceptions.

FRAUDULENT INTENT OF BUSINESS ENTITIES

If a debtor-transferor is a legal entity, as opposed to an individual, the question of intent can be complex. For example, as a threshold matter, in the Third Circuit, courts construe federal statutes in which an entity's mental state is an element by looking to the law of the state in which the entity is incorporated. *Belmont v. MB Inv. Partners, Inc.*, 708 F.3d 470, 494 (3d Cir. 2013).

For a business entity in Delaware (which lies within the Third Circuit), "a basic tenet of [Delaware] corporate law, derived from principles of agency law, is that the knowledge and actions of the corporation's officers and directors, acting within the scope of their authority, are imputed to the corporation itself." *Stewart v. Wilmington Trust SP Servs., Inc.*, 112 A.3d 271, 302–03 (Del. Ch. 2015). If an action is subject to the approval of a board of directors, the intent of the majority of the board is imputed to the corporation. *Dieckman v. Regency GP LP*, 2021 WL 537325, at *36 (Del. Ch. Feb. 15, 2021) (because "it is the Board that governs and manages" the entity in question, the relevant intent was that of a majority of the board).

DEFENSE TO FRAUDULENT TRANSFER CLAIM: THE EARMARKING DOCTRINE

For a trustee to avoid a transfer made by a debtor, the debtor must have an interest in the property transferred. See 11 U.S.C. § 548(a)(1)(B) (providing in relevant part that the trustee may avoid "any transfer of an interest of the debtor in property" if the transfer is actually or constructively fraudulent). One instance where courts have held that a debtor lacks a sufficient interest in transferred property is where the property is said to have been "earmarked" for transfer to another party, such as where the debtor incurs new debt specifically for the purpose of repaying existing debt. See *In re Chuza Oil Co.*, 88 F.4th 849, 855 (10th Cir. 2023) ("The earmarking doctrine is a judicially created mechanism to determine whether the debtor had an interest in transferred property. It allows a debtor to borrow money to pay an existing creditor without the payments being avoided and the money becoming part of the bankruptcy estate, but only if the borrowed money was 'earmarked' for that purpose.") (citation omitted).

For example, in the Third Circuit, the "earmarking" defense applies if:

(1) An agreement exists between the new lender and the debtor that the funds will be used to pay a specific antecedent debt;
(2) That agreement is performed according to its terms; and
(3) The transaction viewed as a whole does not result in any diminution of the debtor's estate.

In re Winstar Commc'ns, *Inc.*, 554 F.3d 382, 400 (3d Cir. 2009) (citing *In re Bohlen Enters.*, *Ltd.*, 859 F.2d 561, 565 (8th Cir. 1988)). In other words, the debtor must act as a mere conduit through which the funds are transferred and not have the ability to exercise discretion over how to use the funds. *See In re USA United Fleet*, *Inc.*, 559 B.R. 41, 65 (Bankr. E.D.N.Y. 2016); *see also Chuza*, 88 F.4th at 856–57 (earmarking applies if the debtor does not exercise dominion or control over the property transferred and the transfer does not diminish the estate).

CYBER LITIGATION

NS8, Inc. ("NS8"), cofounded by Adam Rogas in 2016, purported to be a fraud prevention service company that would help consumers avoid risks associated with online transactions. The company was instead a fraudulent scheme perpetrated by Rogas, who ultimately pled guilty to federal securities fraud charges.

Rogas's scheme was to create the appearance of a successful business by fabricating NS8's bank statements and other business records showing grossly inflated annual revenue and an exaggerated customer base. Rogas maintained the scheme through his exclusive control of the company's operating account and the data and metrics underlying NS8's purported sales revenue and customer counts.

Relying on these falsified business records, NS8 obtained capital from outside investors through several securities offerings. These included an offering whereby $123 million was raised in 2019 and early 2020 through the sale of preferred shares (the "Series A Financing"). The Series A Financing comprised two separate tranches: $50 million in September 2019 and $73 million in April 2020 (the "April 2020 SPA").

On account of their investment in the initial $50 million tranche, the three lead investors in the Series A Financing each had representatives who served on the NS8's board. The other two seats were held by cofounder and CEO Rogas and an executive vice president.

In April 2020, the company sought to consummate a tender offer whereby it would use the proceeds of the April 2020 SPA to purchase its own shares from earlier investors, including Rogas, who would receive $17 million in exchange for his shares. While negotiations over the April 2020 SPA were ongoing, however, the company disclosed to the three board members appointed by the Series A Financing investors that certain of the company's employees had received subpoenas from the Securities Exchange Commission in connection with a 2019 whistleblower complaint.

The board, in light of this development, elected to delay the April 2020 SPA to permit an independent party to determine whether the company had engaged in any wrongdoing. To investigate the whistleblower complaint, the board retained an accountant, a forensic investigator, and attorneys (collectively, the "advisors"). The advisors, apparently deceived by Rogas's scheme, reported no instances of fraud or wrongdoing.

Satisfied with the advisors' findings, NS8's board decided to go forward with the April 2020 SPA. On April 15, 2020, the board formally approved the transaction following a presentation by Rogas on the company's growth and financial performance, the substance of which would later be determined to be entirely false.

Following approval of the April 2020 SPA, the board, relying again on a fraudulent presentation from Rogas, unanimously voted to approve the tender offer. On June 23, 2020, NS8 funded $72 million of payments to the shareholders, including $17 million paid to Rogas.

Shortly after the tender offer, Rogas's fraud unraveled when NS8's new president sought access to the company's bank accounts. Rogas abruptly resigned as CEO and, on September 17, 2020, was arrested and charged with securities and wire fraud.

On October 27, 2020, the debtor filed a chapter 11 petition in the District of Delaware. In April 2022, the bankruptcy court confirmed a liquidating chapter 11 plan creating a litigation trust empowered with investigating and pursuing estate causes of action for the benefit of creditors. In May 2023, the litigation trustee brought an adversary proceeding against former NS8 shareholders to avoid, under section 548 of the Bankruptcy Code, the 2020 tender offer payments made to them by NS8 as actual and constructive fraudulent transfers. The trustee moved for summary judgment on the claims.

The defendants cross-moved for summary judgment. They argued, among other things, that: (i) the payments were unavoidable under the earmarking doctrine; and (ii) although Rogas may have engaged in fraudulent conduct, NS8's board of directors had the authority to approve the transaction and a majority of the board of directors lacked fraudulent intent, such that Rogas's fraud could not be imputed to the board or the company for purposes of section 548.

THE BANKRUPTCY COURT'S RULING

The bankruptcy court granted the trustee's motion for summary judgment on its actual fraudulent conveyance claim and denied the defendants' cross motion. The court did not consider the constructive fraudulent transfer claim (or a related unjust enrichment claim) as those claims sought recovery of the same damages as the actual fraudulent conveyance claim.

U.S. Bankruptcy Judge Craig T. Goldblatt first considered the earmarking defense to the litigation trustee's actual fraudulent conveyance claim. The defendants argued that the April 2020 SPA proceeds were "earmarked" for use in the tender offer because the April 2020 SPA required "[NS8] to use its proceeds to purchase and redeem up to approximately 4,292,525 shares" in a subsequent tender offer, and NS8 did, in fact, use these funds in the tender offer. The defendants further argued that NS8 lacked discretion to use the proceeds for any other purpose.

The bankruptcy court rejected this argument. It found that NS8 retained discretion on how to use the funds under the April 2020 SPA. Judge Goldblatt explained that the agreement required NS8 to repurchase "up to approximately 4,292,525 shares," but did not obligate the company to repurchase any *minimum* number of shares. Thus, under the April 2020 SPA, the court determined that NS8 had the discretion to purchase anywhere from one to the 4,292,525 shares. Cyber Litigation, 2023 WL 6938144, at *6. The court also pointed to a provision in the agreement that permitted NS8 to use proceeds left over from the tender offer "for general corporate purposes, in accordance with the directions of the Company's Board of Directors." *Id.* Because NS8 had the discretion to determine how many shares to purchase and how to use the balance of the proceeds, the bankruptcy court held that the funds were not "earmarked" for use in the tender offer and thus were property of the debtor's estate that could be fraudulently transferred. *Id.* at *7.

The bankruptcy court then turned to the merits of the litigation trustee's actual fraudulent conveyance claim. At the outset, Judge Goldblatt found, and no party disputed, that Rogas actually intended to defraud NS8's creditors by raising money through fabricated financial statements and then transferring that money beyond the reach of creditors through the tender offer in exchange for shares he knew to be worthless.

Next, the court considered whether Rogas's fraudulent intent could be imputed to NS8. In construing the intent element with reference to Delaware state law, the court determined that, because the decision-making body was the board of directors, the relevant inquiry was the intent of the majority of the board. But after surveying relevant Delaware case law, the court concluded that an officer's malintent can be imputed to a board (and thus to the corporation) where the officer controlled the board through deception. *Id.* at **9–13. To determine whether an officer controlled the board through deception, Judge Goldblatt explained that the "touchstone of the analysis" is whether the deception caused the board to make the decision. *Id.* at *12.

Judge Goldblatt rejected the defendants' argument that the majority of NS8's board did not have fraudulent intent that could be imputed to the company because, although Rogas clearly had fraudulent intent, the rest of the board was ignorant of Rogas's fraud and had validly relied on the advisors' reports. The bankruptcy court focused on the cause of NS8's decision, i.e., whether the tender offer was approved because of Rogas's fraud or because of the independent board members' uncorrupted view of the transaction and reliance on the advisors' reports. The court reasoned that the cause was necessarily Rogas's fraud, because NS8 was deeply insolvent and the only way the board or its advisors could conclude otherwise was by relying on Rogas's fraudulent financial statements. As such, the court wrote, "[b]ecause Rogas' fraud was the *sine qua non* of the tender offer, his intent to hinder, delay or defraud creditors is imputed to the debtor." *Id.* at *13.

OUTLOOK

Cyber Litigation is an unusual case. First, the malfeasance giving rise to events that led to the avoidance litigation was extreme and undisputed. This meant that the bankruptcy trustee did not bear the onerous burden of proving actual intent to defraud. Other actual fraud cases are unlikely to be so uncomplicated on this point.

Other key takeaways from the ruling include: (i) if a debtor has the discretion to determine how funds it receives from a third party are to be disbursed, the recipient of the funds cannot rely on the earmarking doctrine as a defense to avoidance of the transfer; (ii) the court looks to applicable non-bankruptcy law (usually state law) to determine whether fraudulent intent can be imputed from the governing body of a business entity to the entity itself; and (iii) under certain circumstances, such as those presented by *Cyber Litigation*, fraud may be imputed even if that governing body is unaware of the fraud, but is deceived by someone in a position to influence the governing body's decisions.

SECOND CIRCUIT: BANKRUPTCY COURTS HAVE INHERENT AUTHORITY TO IMPOSE CIVIL CONTEMPT SANCTIONS

Because bankruptcy courts were created by Congress rather than under Article III of the U.S. Constitution, there is a disagreement over whether bankruptcy courts, like other federal courts, have "inherent authority" to impose sanctions for civil contempt on parties that refuse to comply with their orders. The U.S. Court of Appeals for the Second Circuit revisited this debate in *In re Markus*, 78 F.4th 554 (2nd Cir. 2023). The court of appeals affirmed a bankruptcy court decision imposing sanctions on a chapter 15 debtor's lawyer who repeatedly flouted the court's discovery orders and awarding attorneys' fees to the debtor's foreign representative incurred in bringing a motion for sanctions.

In so ruling, the Second Circuit reaffirmed its earlier decisions concluding that a bankruptcy court has the inherent authority to impose civil sanctions for contempt. However, the Second Circuit expanded the scope of that inherent authority to include punitive civil contempt sanctions in an amount greater than it had approved in its previous rulings. According to the Second Circuit, "we hold that a bankruptcy court's inherent sanctioning authority includes the power to impose civil contempt sanctions in non-nominal amounts to compensate an injured party and coerce future compliance with the court's orders."

CONTEMPT POWER OF FEDERAL COURTS

U.S. federal courts have "contempt power" to ensure that litigants comply with laws and respect the courts. When parties refuse to comply with court orders or disrespect the judicial process, courts have long used punishment (and the threat of punishment) in the form of contempt to compel compliance.

The source of a federal court's power to punish for contempt is uncertain. Some courts and commentators have found the power to be implied from the "judicial Power of the United States," which Section 1 of Article III of the U.S. Constitution vests in the U.S. Supreme Court and lower courts created by Congress. *See Ex parte Robinson*, 86 U.S. (19 Wall.) 505, 510 (1874) ("The power to punish for contempts is inherent in all courts…."); *Gompers v. Bucks Stove & Range Co.*, 221 U.S. 418, 450 (1911) ("[T]he power of courts to punish for contempts is a necessary and integral part of the independence of the judiciary, and is absolutely essential to the performance of the duties imposed on them by law…. If a party can make himself a judge of the validity of orders which have been issued, and by his own act of disobedience set them aside, then are the courts impotent, and what the Constitution now fittingly calls the 'judicial power of the United States' would be a mere mockery."); Robert J. Pushaw, Jr., *The Inherent Powers of Federal Courts and the Structural Constitution*, 86 Iowa L. Rev. 735, 741–42 (2001) (stating that the power to sanction is an "implied indispensable power" of courts under Article III).

Others have expressed the view that contempt power was not intended to be encompassed in the "judicial Power" vested in federal courts by the Constitution. *See*, *e.g.*, *Green v. United States*, 356 U.S. 165, 193 (1958) (Black, J., dissenting) (characterizing summary contempt as "an anomaly in the law"); Ronald Goldfarb, *The History of the Contempt Power*, 1961 Wash. U. L.Q. 1, 2 (arguing that contempt power appears to be "violative of basic philosophical approaches to the relations between government bodies and people").

Contempt can be either criminal or civil. Criminal contempt is designed to vindicate the authority of the court by punishing a litigant who has defied the court, whereas civil contempt is designed to preserve and enforce compliance with court orders and to compensate injured parties for losses sustained from noncompliance. See *Downey v. Clauder*, 30 F.3d 681, 685 (6th Cir. 1994).

Addressing "contempts," 18 U.S.C. § 401 of the U.S. Code (Title Eighteen governs "Crimes and Criminal Procedure") provides as follows:

> A court of the United States shall have power to punish by fine or imprisonment, or both, at its discretion, such contempt of its authority, and none other, as—
>
> (1) Misbehavior of any person in its presence or so near thereto as to obstruct the administration of justice;
> (2) Misbehavior of any of its officers in their official transactions;
> (3) Disobedience or resistance to its lawful writ, process, order, rule, decree, or command.

18 U.S.C. § 401. In addition, Rule 42 of the Federal Rules of Criminal Procedure provides that "[a]ny person who commits criminal contempt may be punished for that contempt after prosecution on notice." Fed. R. Crim. P. 42.

With respect to civil contempt, Rule 70 of the Federal Rules of Civil Procedure states that if a party refuses "to perform any … specific act [directed by the court] … within the time specified," the court "may also hold the disobedient party in contempt." Fed. R. Civ. P. 70.

In addition, if a party fails to comply with a subpoena issued in connection with discovery, Rule 45 of the Federal Rules of Civil Procedure provides that "[t]he court for the district where compliance is required—and also, after a motion is transferred, the issuing court—may hold in contempt a person who, having been served, fails without adequate excuse to obey the subpoena or an order related to it. Fed. R. Civ. P. 45(g).

Aside from constitutional, statutory, or regulatory authority, federal courts also have "inherent authority" to enforce compliance with their directives by means of civil contempt. *See Int'l Union, United Mine Workers of Am. v. Bagwell*, 512 U.S. 821, 831 (1994); *Fuery v. City of Chicago*, 900 F.3d 450, 463 (7th Cir. 2018); *EEOC v. Guardian Pools, Inc.*, 828 F.2d 1507, 1516 (11th Cir. 1987).

Until the U.S. Supreme Court's ruling in *Taggart v. Lorenzen*, 139 S. Ct. 1795 (2019) (discussed below), it was generally recognized that a federal court's inherent power to hold a litigant in civil contempt could be exercised only if: (i) the order with which the litigant allegedly failed to comply is clear and unambiguous; (ii) proof of noncompliance is clear and convincing; and (iii) the litigant fails to attempt compliance diligently and in a reasonable way. *See King v. Allied Vision, Ltd.*, 65 F.3d 1051, 1058 (2d Cir. 1995); *Monsanto Co. v. Haskel Trading, Inc.*, 13 F. Supp.2d 349, 363 (E.D.N.Y. 1998). "Clear and unambiguous" means that the court's order or directive must enable the litigant "to ascertain from the four corners of the order precisely what acts are forbidden." *Monsanto*, 13 F. Supp. 2d at 363. "In the context of civil contempt, the clear and convincing standard requires a quantum of proof adequate to demonstrate 'reasonable certainty' that a violation occurred." *Levin v. Tiber Holding Corp.*, 277 F.3d 243, 250 (2d Cir. 2002) (citation omitted).

DO BANKRUPTCY COURTS HAVE CONTEMPT POWER?

Even though bankruptcy courts were created by Congress under Article I of the Constitution (and are now "units" of federal district courts), rather than as part of the judiciary branch under Article III, most courts have determined that bankruptcy courts, like other federal courts, have inherent civil contempt power. *See In re Sanchez*, 941 F.3d 625, 627–28 (2d Cir. 2019) ("As our sister circuits have explained, inherent sanctioning powers are not contingent on Article III, but rather are, as their name suggests, inherent in the nature of federal courts as institutions charged with judicial functions. We therefore hold that bankruptcy courts, like Article III courts, possess inherent sanctioning powers."); *Alderwoods Grp., Inc. v. Garcia*, 682 F.3d 958, 966 n.18 (11th Cir. 2012); *see generally* Collier on Bankruptcy ("Collier") ¶ 105.02[1][a] (16th ed. 2023) (stating that "[t]he majority of cases conclude that all courts, whether created pursuant to Article I or Article III of the Constitution, have inherent civil contempt power to enforce compliance with their lawful judicial orders, and no specific statute is required to invest a court with civil contempt power.").

Many courts have reasoned that bankruptcy courts have civil contempt power flowing not only from "the inherent power of a court to enforce compliance with its lawful orders," but also from section 105(a) of the Bankruptcy Code, which provides that:

> [A bankruptcy] court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of [the Bankruptcy Code]…. *No provision of [the Bankruptcy Code] providing for the raising of an issue by a party in interest shall be construed to preclude the court from*, *sua sponte*, *taking any action or making any determination necessary or appropriate to enforce or implement court orders or rules*, *or to prevent any abuse of process.*

11 U.S.C. § 105(a) (emphasis added). *See In re Walker*, 257 B.R. 493, 496 (Bankr. N.D. Ohio 2001) (citations omitted); *accord In re Roman Cath. Church of Archdiocese of New Orleans*, 2023 WL 4105655, *16 (E.D. La. June 21, 2023); *In re City of Detroit*, 653 B.R. 874, 892 (Bankr. E.D. Mich. 2023); *In re Kwok*, 653 B.R. 480, 489 (Bankr. D. Conn. 2023); *In re Brown*, 2023 WL 4496925, *4 (Bankr. N.D. Ga. July 12, 2023).

The second sentence of section 105(a) (italicized above) was added in 1986 as part of the Bankruptcy Judges, United States Trustees, and Family Farmer Bankruptcy Act (Pub. L. No. 99-554). Some courts have determined that the addition indicates that Congress meant section 105 to serve as the statutory basis for a bankruptcy court's civil contempt power. *See, e.g., Stephen W. Grosse, P.C.*, 84 B.R. 377, 386 (Bankr. E.D. Pa. 1988); *In re Miller*, 81 B.R. 669, 676-78 (Bankr. M.D. Fla. 1988); *In re Haddad*, 68 B.R. 944, 948 (Bankr. D. Mass. 1987).

A bankruptcy court's inherent contempt powers are also indicated by Rule 9020 of the Federal Rules of Bankruptcy Procedure (the "Bankruptcy Rules"), which provides that "Rule 9014 [governing "contested matters" in bankruptcy] governs a motion for an order of contempt made by the United States trustee or a party in interest." In addition, Rule 70 of the Federal Rules of Civil Procedure, which, as noted previously, authorizes a federal court to "hold [a] disobedient party in contempt," applies in bankruptcy "adversary proceedings" pursuant to Bankruptcy Rule 7070.

In *Taggart*, the U.S. Supreme Court held that, based on traditional standards in equity practice, a creditor may be held in civil contempt for violation of the bankruptcy discharge injunction, but only "if there is no fair ground of doubt as to whether the order barred the creditor's conduct." *Taggart*, 139 S. Ct. at 1799. According to the Court in *Taggart*, "civil contempt may be appropriate if there is no objectively reasonable basis for concluding that the creditor's conduct might be lawful." *Id.* Stated differently, there is no fair ground of doubt when the creditor violates a discharge injunction "based on an objectively unreasonable understanding of the discharge order or the statutes that govern its scope." *Id.* at 1802. A "creditor's good faith belief" that the discharge injunction does not apply to an act in violation of the discharge injunction does not by itself preclude a civil contempt sanction. *Id.* However, a creditor may not be held in civil contempt merely because "the creditor was aware of the discharge order and intended the actions that violated the order." *Id.* at 1803.

According to the bankruptcy court in *In re City of Detroit, Michigan*, 614 B.R. 255 (Bankr. E.D. Mich. 2020), after *Taggart*, the elements that must be proven for a court to find a party in civil contempt are that: (i) the party violated a definite and specific court order obligating it to perform or to refrain from performing a particular act; (ii) the party acted with knowledge of the court order; and (iii) there is no fair ground of doubt as to whether the order precluded the party's conduct (or stated differently, there was no objectively reasonable basis to conclude that the party's conduct might be lawful). *Id.* at 265–66.

Courts disagree as to whether a bankruptcy court's contempt powers extend to criminal contempt. See Collier at ¶ 9020.01[2] (citing cases and noting that "[t]here may be a split developing among the circuits as to whether a bankruptcy court can punish criminal contempt."); *id.* at ¶ 105.02[1][a] (stating that "[s]ome courts have held that this inherent power extends to all contempts, be they civil or criminal, … while others hold that it applies only to civil contempt and some forms of criminal contempt (such as contempt committed in the presence of the court.").

The Bankruptcy Code, the Bankruptcy Rules, and the Federal Rules of Civil Procedure also give bankruptcy courts the power to sanction disobedient litigants (and their lawyers). For example, section 363(k) of the Bankruptcy Code provides that, with certain exceptions, an individual injured by any willful violation of the automatic stay "shall recover actual damages, including costs and attorneys' fees, and, in an appropriate case, may recover punitive damages." In addition, if the court dismisses an involuntary bankruptcy petition, it may grant judgment against the petitioning creditors for costs and attorneys' fees, or even punitive damages if a creditor files an involuntary case in bad faith. See 11 U.S.C. § 303(i).

Bankruptcy Rule 3002.1(i) authorizes a bankruptcy court to award reasonable expenses and attorneys' fees caused by the failure of home mortgagees to provide certain required notices to the debtor mortgagor.

Under Bankruptcy Rule 9011, an attorney or unrepresented litigant who signs any court pleading or other document certifies that, "to the best of the person's knowledge, information, and belief, formed after an inquiry reasonable under the circumstances," the document does not contain, among other things, false, misleading, frivolous, or legally unsupported allegations. Fed. R. Bankr. P. 9011(a) and (b).

Bankruptcy Rule 9011(c) provides that "[i]f, after notice and a reasonable opportunity to respond, the court determines that subdivision (b) has been violated, the court may, subject to the conditions stated below, impose an appropriate sanction upon the attorneys, law firms, or parties that have violated subdivision (b) or are responsible for the violation." Pursuant to Bankruptcy Rule 9011(c)(2), "[a] sanction imposed for violation of this rule shall be limited to what is sufficient to deter repetition of such conduct or comparable conduct by others similarly situated." Sanctions may include "directives of a nonmonetary nature, an order to pay a penalty into court, or, if imposed on motion and warranted for effective deterrence, an order directing payment to the movant of some or all of the reasonable attorneys' fees and other expenses incurred as a direct result of the violation." Fed. R. Bankr. P. 9011(c)(2).

Sanctions are not available under Rule 9011 in connection with "disclosures and discovery requests, responses, objections, and motions that are subject to the provisions of [Bankruptcy] Rules 7026 through 7037." Fed. R. Bankr. P. 9011(d). The discovery rules set forth in Bankruptcy Rules 7026 through 7037 authorize the bankruptcy court in an adversary proceeding (and, unless the court orders otherwise, contested matters in a bankruptcy case) to impose sanctions on a litigant or its attorney in connection with discovery abuses under circumstances similar to those described in Bankruptcy Rule 9011. See Fed. R. Civ. P. 7026(g)(3); Fed. R. Bankr. P. 9014(c).

In addition, Rule 37 of the Federal Rules of Civil Procedure, which is made applicable to bankruptcy adversary proceedings and contested matters by Bankruptcy Rules 7037 and 9014(c), provides that the bankruptcy court may impose sanctions for a litigant's failure to comply with discovery requests or court discovery orders, including an award of fees and expenses or orders compromising the noncompliant litigant's ability to effectively prosecute the litigation (e.g., dismissal of the action or the entry of a default judgment in the action), or "treating as contempt of court the failure to obey any [discovery] order except an order to submit to a physical or mental examination." Fed. R. Civ. P. 37(b)(2). Rule 45(g) of the Federal Rules of Civil Procedure (authorizing a federal court to hold a party refusing to comply with a subpoena in contempt) also applies in bankruptcy cases pursuant to Bankruptcy Rule 9016.

MARKUS

Larisa Ivanova Markus (the "debtor") is a Russian citizen who founded Vneshprombank, Ltd. ("VB"), one of Russia's largest banks. In March 2016, a Russian court commenced a bankruptcy proceeding against VB. Shortly afterward, the Russian court granted a petition filed by one of the debtor's creditors to commence a bankruptcy proceeding against her personally. The court appointed Yuri Vladimirovich Rozhkov ("Rozhkov") to preside over the liquidation of the debtor's assets and to pursue litigation against any entities that contributed to the debtor's bankruptcy. In 2017, the debtor was imprisoned in Russia after being convicted for embezzling $2 billion from VB.

In January 2019, Rozhkov, as the debtor's "foreign representative," filed a petition in the U.S. Bankruptcy Court for the Southern District of New York seeking recognition of the debtor's Russian bankruptcy proceeding under chapter 15 of the Bankruptcy Code. According to the petition, Rozhkov sought recognition of debtor's Russian bankruptcy for the purpose of obtaining discovery concerning the debtor's U.S. assets (including at least 10 companies and apartments valued at more than $10 million). The U.S. bankruptcy court granted the chapter 15 petition in April 2019.

Heated discovery disputes ensued almost immediately between Rozhkov and the debtor's attorney, Victor A. Worms. Among other things, despite repeated discovery requests, Worms made no effort to obtain responsive documents, arguing that he did not need to comply because the U.S. bankruptcy court improperly recognized the debtor's Russian bankruptcy (Worms filed a motion to vacate the recognition order in June 2019).

The U.S. bankruptcy court overruled Worms's objections, and directed him to comply immediately with Rozhkov's discovery requests. The court also informed Worms that failure to comply could result in the imposition of sanctions. After Worms failed to produce any discovery before the court-imposed deadline, he argued in a written response to a subpoena that the requested discovery "exceed[ed] the limited scope of discovery provided for under Chapter 15." Worms also stated that, because the debtor was in prison, she had no documents responsive to the discovery requests in her possession, and neither he nor his client had any duty to obtain and produce responsive documents in the possession of the debtor's agents because such documents were not in the United States.

In September, 2019, Rozhkov filed a motion for sanctions against Worms and the debtor under Rules 37 and 45(g) of the Federal Rules of Civil Procedure (as made applicable in bankruptcy cases by Bankruptcy Rules 7037 and 9016). In seeking a civil contempt sanction against Worms in the amount of $1,000 per day until compliance, Rozhkov submitted evidence of the identities and contact information of more than 30 known agents of Worms, 14 of whom were in the United States.

After a hearing during which the U.S. bankruptcy court again warned Worms that he would be sanctioned for noncompliance, the court found that Worms's violations of the court's discovery orders were knowing, willful, and intentional, and entered an order (the "sanctions order") imposing the requested monetary sanctions (amounting to $34,000 for the days since the discovery deadline and $1,000 per day until compliance) pursuant to Rule 37 of the Federal Rules of Civil Procedure and "the court's inherent power to hold a party in civil contempt." The U.S. bankruptcy court later awarded $60,000 in attorneys' fees (the "fee order") against Worms personally to compensate Rozhkov for costs incurred in connection with the sanctions motion. The court did not state in the fee order the source of its authority to do so, but referenced its previous opinion granting the sanctions motion.

On appeal of both the sanctions and fee orders, a U.S. district court affirmed the bankruptcy court's imposition of civil contempt sanctions under its "inherent authority," which Worms acknowledged existed, but remanded the case below for determination of the appropriate amount, and vacated the $34,000 in "lump-sum sanctions" as an improper criminal sanction. Because the bankruptcy court had not specified the source of its authority to award attorneys' fees to Rozhkov, the district court vacated the fee order and remanded the case below for clarification.

On remand, the U.S. bankruptcy court held that Worms's contempt was cured as of November 27, 2019, when a U.S.-based agent of the debtor contacted the debtor's other agents to obtain the requested discovery. Based on the 55 days that Worms was in contempt, the court imposed a total of $55,000 in sanctions. The bankruptcy court also held that the fee award was based on its inherent authority, but reduced the amount of the fees to $36,600. However, it also awarded Rozhkov $63,500 in fees incurred in defending the district court appeal.

Worms appealed again to the district court, which affirmed the sanctions award but vacated the award of attorneys' fees for defending the initial district court appeal, reasoning that a bankruptcy court generally does not have the power under its inherent sanctioning power to award fees incurred in connection with an appeal before another court.

Worms appealed the ruling upholding the sanctions order and the fee order to the Second Circuit.

THE SECOND CIRCUIT'S RULING

A three-judge panel of the Second Circuit affirmed the district court's ruling.

Writing for the panel, U.S. Circuit Judge Denny Chin noted that the issue of whether a bankruptcy court has inherent authority to impose "non-nominal civil contempt sanctions" was one of first impression before the Second Circuit.

He explained that, in *Sanchez*, the Second Circuit, guided by the U.S. Supreme Court's ruling in *Chambers v. NASCO, Inc.*, 501 U.S. 32 (1991), unequivocally held that bankruptcy courts, like other federal courts, have "inherent sanctioning power." *Markus*, 78 F.4th at 565 (citing *Sanchez*, 941 F.3d at 628). In addition, Judge Chin noted, in a previous decision, *In re Kalikow*, 602 F.2d 82 (2d Cir. 2010), the Second Circuit concluded that "[t]he statutory powers given to a bankruptcy court under § 105(a) complement the inherent powers of a federal court to enforce its own orders … [and] [t]hese powers are in addition to whatever inherent contempt powers the court may have." *Id.* at 96-97 (citation and internal quotation marks omitted).

He further noted that in *Law v. Siegel*, 571 U.S. 415, 420-21 (2014), the Supreme Court wrote that "[a] bankruptcy court … may also possess 'inherent power … to sanction abusive litigation practices.'"

However, Judge Chin emphasized, its previous rulings, including *In re Gravel*, 6 F4th 503 (2d. Cir. 2021), where the Second Circuit suggested that the imposition of non-nominal punitive sanctions pursuant to a bankruptcy court's inherent authority requires a finding of bad faith, dealt only with "relatively minor non-compensatory [i.e., punitive] sanctions," unlike the "substantial, compensatory, and coercive sanctions imposed against Worms here." *Markus*, 78 F.4th at 564-65.

The Second Circuit panel concluded that a bankruptcy court's inherent authority "extends beyond" the power to impose minor punitive sanctions, but "is by no means unlimited" and requires "caution and notice before use." *Id.* at 565 (internal quotation marks and citation omitted). Judge Chin explained such limitations as follows:

(i) A bankruptcy court's invocation of its inherent authority to sanction abuse "is a last resort for when an express authority is not up to the task," and the court "may not contravene valid statutory directives and prohibitions."
(ii) A bankruptcy court must expressly invoke its inherent sanctioning powers for its order to withstand appellate scrutiny.
(iii) A bankruptcy court must comply with the mandates of due process when deploying its inherent powers.
(iv) Although a bankruptcy court need not always find bad faith before invoking its inherent sanction power, the imposition of such sanctions may require an express finding that a lawyer (acting as an advocate rather than an officer of the court) acted in bad faith supported by clear evidence that the lawyer's conduct was "entirely without color" and "motivated by improper purposes."
(v) A bankruptcy court may impose a civil contempt sanction that is compensatory or coercive, not punitive.
(vi) A contempt order is justified only where the movant establishes by clear and convincing evidence that the contemnor violated the court's order.

Id. (internal quotation marks and citations omitted). Therefore, Judge Chin emphasized, to demonstrate contempt justifying the imposition of sanctions, the party seeking a contempt order must establish that: (i) the order with which the contemnor failed to comply is clear and unambiguous; (ii) proof of noncompliance is clear and convincing; and (iii) the contemnor failed to diligently attempt to comply in a reasonable manner (the "King factors"). *Id.* at 566 (citing *King v. Allied Vision*, Ltd., 65 F.3d 1051, 1058 (2d Cir. 1995)).

Applying these principles, the Second Circuit panel ruled that the bankruptcy court did not abuse its discretion in sanctioning Worms.

First, Judge Chin explained, because it is unclear whether the bankruptcy court could have relied on its express power in section 105(a) of the Bankruptcy Code to enforce compliance with a subpoena issued under Rule 45 of the Federal Rules of Civil Procedure, "the bankruptcy court was right to consider its inherent contempt authority." *Id.* at 567.

According to Judge Chin, "most importantly," the bankruptcy court, in ordering contempt sanctions, found that all of the King factors had been satisfied and that Worms had acted in bad faith. Specifically, he wrote, the record clearly established that the bankruptcy court's order was unambiguous, proof of Worms's failure to comply was clear and convincing, Worms failed even to attempt compliance, and the record "firmly support[ed] the bankruptcy court's finding that Worms 'knowingly and intentionally' engaged in a 'continuous pattern of obstructing legitimate discovery.'" *Id.* In addition, Judge Chin noted, because Worms had "abundant" notice of the consequences of his refusal to comply with the bankruptcy court's discovery orders pursuant to the court's inherent authority, Worms was afforded due process.

Finally, the Second Circuit panel noted that, although the fee order did not expressly state that the bankruptcy court was exercising its inherent authority in awarding attorneys' fees to Rozhkov, the order specifically incorporated the sanction order, which did include an express reference, and Worms was clearly aware that that "the bankruptcy court rested the civil contempt sanctions against him on its inherent authority." *Id.* at 569.

OUTLOOK

There are several key takeaways from the Second Circuit's ruling in *Markus*. First, the decision clarifies that, in addition to a bankruptcy court's statutory powers under section 105(a) of the Bankruptcy Code, and whatever powers the court may have to sanction for contempt under applicable procedural rules, a bankruptcy court, like other federal courts, has inherent authority to sanction a party for civil contempt under appropriate circumstances. Second, if a bankruptcy court is relying on its inherent authority to sanction a party for civil contempt, it must state so explicitly. Third, although the Second Circuit has previously concluded that a bankruptcy court has the inherent power to impose civil contempt sanctions in nominal amounts, the court of appeals has now ruled as a matter of first impression that such punitive sanctions may also be imposed in non-nominal amounts.

Markus is an unusual case because it involved civil contempt sanctions in connection with a discovery dispute in a chapter 15 case (discovery may generally be obtained in a chapter 15 case in the same way that it is available in cases under other chapters of the Bankruptcy Code). Moreover, the sanctions were levied against an attorney rather than his client because the client was unable to respond to the discovery obligations. Recognizing that the client's compliance was not possible, the bankruptcy court afforded the attorney multiple opportunities to respond by taking reasonable steps to comply, such as contacting entities that could provide the requested discovery. The court sanctioned the attorney only after he failed to make any effort to do so, resulting in the required finding of bad faith. The ruling is therefore also a cautionary tale.

NEWSWORTHY

***Dan T. Moss* (Washington/New York), *Olaf Benning* (Frankfurt), *David S. Torborg* (Washington), *Colleen E. Laduzinski* (Boston/New York), *Ryan Sims* (Washington), *S. Christopher Cundra IV* (Washington), *Nick Buchta* (Cleveland), *Richard H. Howell* (Washington), *Elizabeth A. Dengler* (Boston),** and **Alexandra Levay (Boston)** are part of a team of Jones Day attorneys advising Spark Networks SE ("Spark"), a Germany-based leading social dating platform, in connection with a cross-border restructuring under the recently enacted German Act on the Stabilization and Restructuring Framework for Companies (*Gesetz über den Stabilisierungs und Restrukturierungsrahmen für Unternehmen* ("StaRUG")) and chapter 15 of the U.S. Bankruptcy Code. Introduced in January 2021 after a 2019 EU Directive to Member States to implement preventative restructuring frameworks, StaRUG allows German companies to impose an arrangement on their creditors, including a restructuring of liabilities, subject to a vote and court approval. Spark's StaRUG proceeding involved restructuring more than $100 million in secured debt held by MGG Investment Group LP, a U.S.-based credit fund. Spark's StaRUG proceeding also restructured more than $13 million of Spark's unsecured debt. The StaRUG restructuring plan was approved by Spark's creditors in December 2023 and confirmed by the German Restructuring Court on January 4, 2024. On December 14, 2023, the U.S. Bankruptcy Court for the District of Delaware recognized the StaRUG proceeding of Spark and its two U.S. subsidiaries under chapter 15 of the Bankruptcy Code. Spark intends to seek recognition of the restructuring plan in the chapter 15 proceedings in the coming weeks.

An article written by ***Corinne Ball* (New York)** titled "Texas Bankruptcy Court Holds Code Overrides State Law on Expulsion" was published in the December 27, 2023, edition of the *New York Law Journal.*

An article written by ***Heather Lennox* (Cleveland/New York), *Jasper Berkenbosch* (Amsterdam), *Nicholas J. Morin* (New York), *Dan T. Moss* (Washington/New York),** and ***Sid Pepels* (Amsterdam)** titled "Historic Outcome for Diebold Nixdorf" was published in *INSOL World Q4 2023*.

An article written by ***Mark A. Cody* (Chicago)** titled "Health Care Provider Bankruptcy Update: Patient Care Ombudsman Not Necessary in Every Health Care Business Bankruptcy Case" was published on December 16, 2023, in *Lexis Practical Guidance*.

An article written by ***Daniel J. Merrett* (Atlanta)** titled "Court's Broad Interpretation of Definition of 'Securities Contracts' Promotes Expansive Scope of Bankruptcy Code 'Safe Harbour'" was published in the November 2023 *INSOL International Restructuring Alert*.

An article written by ***Oliver S. Zeltner* (Cleveland)** titled "Cure and Reinstatement of Defaulted Loan Under Chapter 11 Plan Requires Payment of Default-Rate Interest" was published on November 14, 2023, by *Lexis Practical Guidance*.

***Juan Ferré* (Madrid)** was recognized in the practice area "Insolvency and Reorganization Law" in the 2024 edition of *The Best Lawyers in Spain*.™

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