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CRAM-DOWN CHAPTER 11 PLAN NEED NOT STRICTLY ENFORCE SUBORDINATION AGREEMENT

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In the latest chapter of more than a decade of contentious litigation surrounding the 2007 leveraged buyout ("LBO") and ensuing bankruptcy of media conglomerate Tribune Co. ("Tribune"), the U.S. Court of Appeals for the Third Circuit affirmed lower court rulings that Tribune's 2012 chapter 11 plan did not unfairly discriminate against senior noteholders who contended that their distributions were reduced because the plan improperly failed to strictly enforce pre-bankruptcy subordination agreements. In *In re Tribune Co.*, 972 F.3d 228 (3d Cir. 2020), the Third Circuit held that, according to a plain reading of the relevant provisions of the Bankruptcy Code, a nonconsensual chapter 11 plan that does not strictly enforce a subordination agreement does not necessarily discriminate unfairly against a class of creditors that would otherwise benefit from subordination. In this case, the Third Circuit agreed with the lower courts that the "immaterial" reduction in the senior noteholders' recovery did not rise to the level of unfair discrimination. In reaching this conclusion, the Third Circuit appears to have become the first court of appeals in a published ruling to adopt the "Markell test" for assessing unfair discrimination.

CRAMDOWN CONFIRMATION OF A CHAPTER 11 PLAN

Section 1129(a)(8) of the Bankruptcy Code requires that, for a chapter 11 plan to be confirmable, each class of claims or interests must either accept the plan or not be "impaired." However, "cramdown" confirmation is possible in the absence of plan acceptance by impaired classes under section 1129(b)(1), which provides as follows:

> *Notwithstanding section 510(a) of this title*, if all of the applicable requirements of subsection (a) of this section other than paragraph (8) are met with respect to a plan, the court, on request of the proponent under the plan, shall confirm the plan notwithstanding the requirements of such paragraph if the plan *does not discriminate unfairly*, and is fair and equitable, with respect to each class of claims or interests that is impaired under, and has not accepted, the plan.

11 U.S.C. § 1129(b)(1) (emphasis added).

The Bankruptcy Code does not define "unfair discrimination." As noted by a leading commentator, "Courts have struggled to give the unfair discrimination test an objective

IN THIS ISSUE

standard." COLLIER ON BANKRUPTCY ("COLLIER") at ¶ 1129.03[a] (16th ed. 2020). Nevertheless, most courts agree that the purpose underlying the requirement is "to ensure that a dissenting class will receive relative value equal to the value given to all other similarly situated classes." *In re LightSquared Inc.*, 513 B.R. 56, 99 (Bankr. S.D.N.Y. 2014); *accord In re SunEdison, Inc.*, 575 B.R. 220 (Bankr. S.D.N.Y. 2017); *In re 20 Bayard Views, LLC*, 445 B.R. 83 (Bankr. E.D.N.Y. 2011); *In re Johns-Manville Corp.*, 68 B.R. 618, 636 (Bankr. S.D.N.Y. 1986), *aff'd*, 78 B.R. 407 (S.D.N.Y. 1987), *aff'd*, 843 F.2d 636 (2d Cir. 1988).

Courts historically have relied on a number of tests to determine whether a plan discriminates unfairly. These include: (i) the "mechanical" test, which prohibits all discrimination and requires that the recoveries of similarly situated creditors be identical; (ii) the "restrictive" approach, which narrowly defines unfair discrimination to mean that, absent subordination, disparate treatment of similarly situated creditors is not permitted; and (iii) the "broad" approach, which considers whether (1) a reasonable basis for discrimination exists, (2) the debtor can consummate a plan without discrimination, (3) the discrimination is proposed in good faith, and (4) the extent of discrimination is directly proportional to its rationale. *See generally* Denise R. Polivy, *Unfair Discrimination in Chapter 11: A Comprehensive Compilation of Current Case Law*, 72 AM. BANKR. L.J. 191, 196-208 (1998) (discussing cases applying the various tests).

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

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

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

ENFORCEABILITY OF SUBORDINATION AGREEMENTS IN BANKRUPTCY

As noted previously, even if not all classes vote to accept a plan, section 1129(b)(1) states that it can be confirmed "notwithstanding section 510(a)" of the Bankruptcy Code, provided the plan complies with all of the other confirmation requirements, does not discriminate unfairly, and is fair and equitable with respect to impaired dissenting classes. Section 510(a) deals with contractual subordination agreements. It provides that, if the claims of one creditor or group of creditors are subordinated in accordance with the provisions of a valid and enforceable agreement, the subordination agreement is enforceable in a bankruptcy case "to the same extent that such agreement is enforceable under applicable nonbankruptcy law."

Thus, in construing the enforceability of a subordination agreement in bankruptcy, section 510(a) directs the bankruptcy court to look to applicable nonbankruptcy law—generally state law—as well as the terms of the agreement itself. *See* COLLIER at ¶ 510.03. If there is ambiguity in the agreement concerning the terms or extent of the subordination, a bankruptcy court may refuse to enforce it. *See In re Bank of New England Corp.*, 364 F.3d 355, 367 (1st Cir. 2004) (remanding case to bankruptcy court to determine under New York law whether subordination agreement actually provided for payment of postpetition interest on senior debt prior to any payment on junior debt), *on remand*, 404 B.R. 17 (Bankr. D. Mass. 2009) (finding that parties did not intend to subordinate claims for postpetition interest), *aff'd*, 426 B.R. 1 (D. Mass. 2010), *aff'd*, 646 F.3d 90 (1st Cir. 2011).

However, because section 1129(b)(1) would appear to remove section 510(a) from the playing field when determining whether a chapter 11 plan can be confirmed over the objection of a dissenting impaired class, it is unclear whether a chapter 11 plan must give effect to the explicit terms of a subordination agreement in providing for the treatment of creditor claims. This was the thorny question addressed by the Third Circuit in *Tribune*.

TRIBUNE

In 2007, Tribune was the target of an LBO that paid its shareholders more than $8 billion in exchange for their shares in the company and saddled Tribune with nearly $13 billion in debt. Shortly after the LBO was completed in December 2007, Tribune experienced financial difficulties due to declining advertising revenues and its failure to meet projections. The company filed for chapter 11 protection in December 2008 in the District of Delaware.

At the time of the bankruptcy filing, Tribune's complex capital structure included, among other obligations: (i) approximately $1.28 billion in senior unsecured notes ("senior notes"); (ii) approximately $759 million in unsecured debentures ("sub debentures"); and (iii) $225 million in unsecured notes ("sub notes"). The sub debentures and the sub notes were contractually subordinated to the senior notes in their respective indentures, which limited repayment of the instruments until all "Senior Obligations" were paid in full. Tribune's other debts included an unsecured $150.9 million claim under an interest rate swap agreement ("swap claim"), $105 million in unsecured retiree claims ("retiree claims"), and $8.8 million in unsecured trade claims ("trade claims").

Under Tribune' proposed chapter 11 plan, creditors in the class comprising the swap claim, the retiree claims, and the trade claims—Class 1F—and creditors in the separate class comprising the senior notes—Class 1E—would each receive 33.6% of their outstanding claims. These payments included distributions that would otherwise have been made in respect of the contractually subordinated sub debentures and sub notes.

The senior noteholders objected to the plan, arguing that it violated section 510(a) because it allocated more than $30 million to which they said they were entitled under the contractual subordination provisions to Class 1F, which did not contain claims qualifying as "Senior Obligations." In the alternative, the senior noteholders argued that the plan unfairly discriminated against their class (Class 1E).

The bankruptcy court ruled that section 1129(b)(1) does not require that a subordination agreement be strictly enforced for a plan to be confirmed. The court also rejected the senior noteholders' unfair discrimination argument, even though the court assumed (without deciding) that, except for the swap claim, none of the claims in Class 1F were Senior Obligations entitled to the benefit of the subordination provisions. By eliminating the swap claim from the calculus of the senior noteholders' $30 million complaint, the court found that only $13 million was in dispute, compared to the senior noteholders' $1.28 billion claim. Thus, the court reasoned that, if it ruled in the senior noteholders' favor, their recovery would increase by only 0.9% (from 33.6% to 34.5%). Applying the Markell test, the bankruptcy court concluded that "[t]he discriminatory effect on the dissenting class is immaterial and, therefore, no rebuttable presumption of unfair discrimination arises here." *In re Tribune Co.*, 472 B.R. 223, 244 (Bankr. D. Del. 2012), *aff'd in part, vacated in part,* 2014 WL 2797042 (D. Del. June 18, 2014), *aff'd in part, rev'd in part*, 799 F.3d 272 (3d Cir. 2015), *aff'd after remand*, 587 B.R. 606 (D. Del. 2018), *aff'd*, 972 F.3d 228 (3d Cir. 2020). The bankruptcy court accordingly confirmed Tribune's chapter 11 plan in July 2012.

The senior noteholders appealed the confirmation order to the district court, which dismissed their appeal as being "equitably moot" because Tribune's plan had been substantially consummated. According to the district court, it could not "practically or equitably" order disgorgement from Class 1F creditors because the class consisted of more than 700 members, the majority of which were individuals and small-business trade creditors. Also, disgorgement would be "difficult to implement uniformly," as only 16% of the class creditors received cash distributions, while the remaining creditors received part of their distributions from interests in a litigation trust.

The Third Circuit reversed on appeal and remanded the case to the district court. It ruled that forcing Class 1F creditors to repay the distributions they received under the plan would not "unravel" the plan, noting that "the dispute is about whether one of two classes of creditors is entitled to $30 million in the context of a $7.5 billion reorganization."

On remand, the district court upheld the plan confirmation order. It rejected the senior noteholders' contention that the plan discriminated unfairly because it did not strictly enforce the subordination provisions. Among other things, the district court found that the bankruptcy court did not err in concluding that the swap claims were Senior Obligations. According to the district court, "[m]inor or immaterial differences . . . do not rise to the level of unfair discrimination." The plan did not unfairly discriminate, it explained, because the dissenting class (Class 1E) would receive "a percentage recovery that was, at most, 2.3 percentage points lower than the recovery to which they claim they were entitled," meaning there was no presumption of unfair discrimination under the Markell test.

The senior noteholders appealed to the Third Circuit.

THE THIRD CIRCUIT'S RULING

A three-judge panel of the Third Circuit affirmed. Writing for the panel, Circuit Judge Thomas L. Ambro held at the outset that "§ 1129(b)(1) overrides § 510(a) because that is the plain meaning of ‹[n]otwithstanding.›" According to Judge Ambro, the purpose and the legislative history of section 1129(b)(1) support this interpretation, as does the only published court ruling that has directly addressed the question. *See In re TCI 2 Holdings*, 428 B.R. 117, 141 (Bankr. D.N.J. 2010).

He explained that both section 510(b) and section 1129(b)(1)'s unfair discrimination test are concerned with distributions among creditors—the former, by agreement, and the latter, as a gauge of "whether involuntary reallocations of subordinated sums under a plan unfairly discriminate against the dissenting class." However, Judge Ambro noted, "Only one can supersede, and that is the cramdown provision," which "provides the flexibility to negotiate a confirmable plan even when decades of accumulated debt and private ordering of payment priority have led to a complex web of intercreditor rights." At the same time, he wrote, section 1129(b)(1) "attempts to ensure that debtors and courts do not have *carte blanche* to disregard pre-bankruptcy contractual arrangements, while leaving play in the joints."

Next, Judge Ambro noted that, by mentioning only cases involving the relative treatment of like-kind creditors affected by subordination agreements, the scant and sometimes confusing legislative history of section 1129(b)(1) suggests that lawmakers intended to "rely on that discrimination principle, and not on § 510(a), to enforce subordination agreements" in a cramdown chapter 11 plan. *See* H.R. Rep. No. 95-595, at 416-17 (1977).

He rejected the noteholders' argument that lawmakers' intent to favor section 510(a) can be inferred from a 1995 recommendation that removal of the reference to section 510(a) in section 1129(b)(1) was warranted to "prevent the anomalous result of overriding § 510(a) and eliminating the enforcement of subordination agreements in cases in which the class rejects the plan." *See* Kenneth N. Klee, *Adjusting Chapter 11: Fine Tuning the Plan Process*, 69 Am. Bankr. L.J. 551, 561 (1995). According to Judge Ambro, that recommendation is not evidence of legislative intent and Congress never amended the provision to reflect it.

Finally, the Third Circuit ruled that the plan's allocation of a small portion of subordinated sums to the Class 1F creditors did not unfairly discriminate against the senior noteholder class even if the Class 1F creditors were not entitled to them under the subordination agreement. In doing so, it "distill[ed]" several principles from various unfair-discrimination analyses. These included, among other things:

- A "pure *pro rata* division of plan distributions among like-priority creditors . . . runs counter to the text" of section 1129(b)(1). Thus, a subordination agreement need not be "enforced to the letter" in the case of a cramdown, and subordinated amounts may be allocated to other classes not entitled to benefit from subordination outside of bankruptcy.
- Although one approach in assessing unfair discrimination is to compare the proposed plan distributions to the allegedly preferred class and the dissenting class, a court may instead consider—as in this case—the difference between the amount to which the dissenting class argues it is entitled and what it actually received under the plan.
- To presume unfair discrimination, there must be either a materially lower percentage recovery for the dissenting class or a materially greater risk to the dissenting class in connection with its proposed distribution. The definition of "material," however, must be left to the courts on a case-by-case basis. The presumption can be rebutted, but the determination of what qualifies as an adequate rebuttal must be left to the courts.

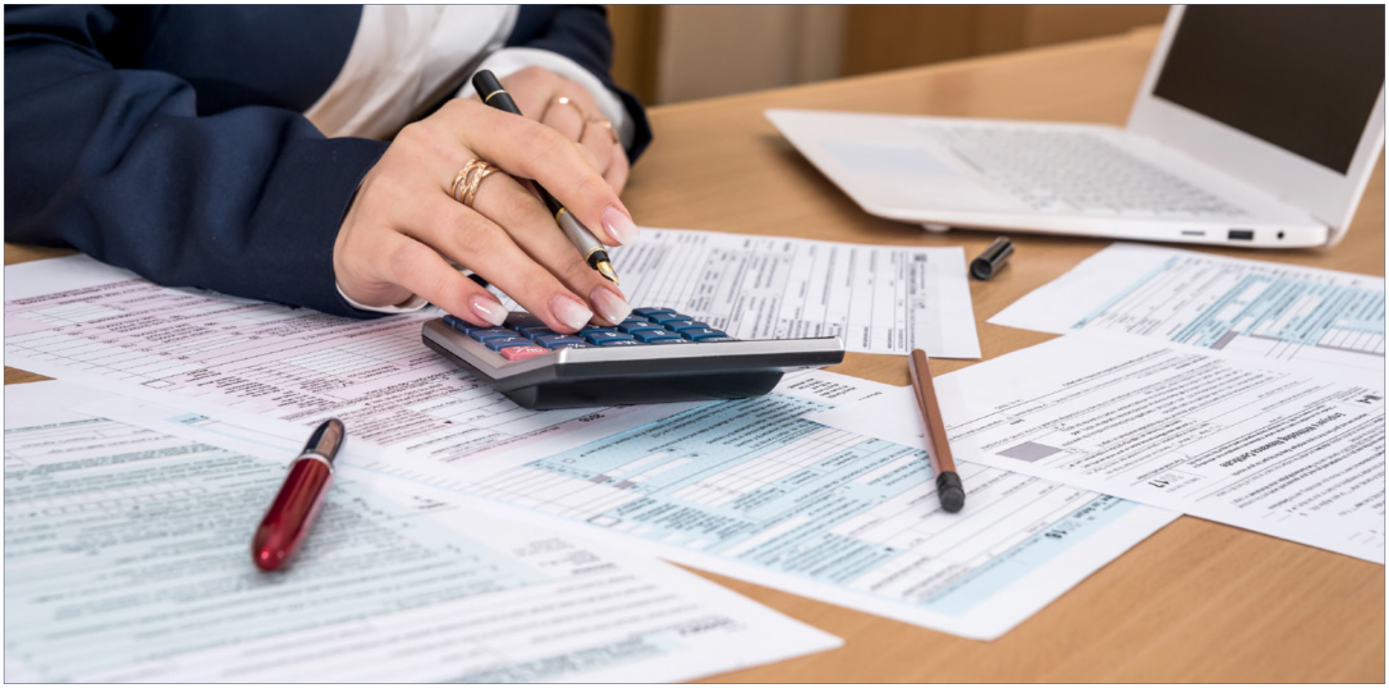
Applying these principles, the Third Circuit affirmed the lower courts' ruling that there was no unfair discrimination. It stated that the bankruptcy court "did not necessarily err" by comparing the senior noteholders' desired recovery (34.5%) with their actual recovery under Tribune's plan (33.6%) because the comparison was "an appropriate metric (or cross-check)" under the circumstances. Judge Ambro explained that, because the claims of the retirees and trade creditors were substantially smaller than the senior noteholder claims ($114 million compared to $1.28 billion), "the increases in the recovery percentage for the [retirees and the trade creditors] from reallocated subordinated amounts results in only a minimal reduction of the recovery percentage for the Senior Noteholders." He therefore agreed with the lower courts' decision to apply a "pragmatic approach" in concluding that the 0.9% difference was "not material." "Although the Plan discriminates," Judge Ambro wrote, "it is not presumptively unfair when understood . . . that a cramdown plan may reallocate some of the subordinated sums."

OUTLOOK

The Third Circuit's ruling in *Tribune* is notable for at least two reasons. First, although many lower courts (within and outside of the Third Circuit) have adopted the Markell test in examining whether a plan unfairly discriminates against a dissenting class, the Third Circuit appears to be the first circuit court of appeals to endorse that approach in a published opinion. In doing so, it acknowledged that chapter 11 balances competing interests with the goal of achieving an outcome that is fair (albeit imperfectly) to all stakeholders. Discrimination between similarly situated classes is permitted under a chapter 11 plan, as long as it not unfair and is supported by a reasonable justification. What constitutes unfair discrimination will depend on the circumstances of each case. However, the Third Circuit clarified in *Tribune* that immaterial disparities in recoveries do not qualify, writing that "[w]hat constitutes a material difference in recovery when analyzing the effect of a plan on the dissenting class is a distinct and context-specific inquiry." The court cautioned that it did not "address the outer boundary of that inquiry here."

Second, *Tribune* is important because the Third Circuit, construing the plain language of section 1129(b)(1), held that a chapter 11 plan that does not strictly enforce a contractual subordination agreement does not necessarily discriminate unfairly against classes that would otherwise benefit from subordination.

Jones Day represented Tribune Co. in the litigation before the Third Circuit.



NEW APPELLATE COURT RULING ON PRIORITY OF STRADDLE-YEAR TAXES IN BANKRUPTCY

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A basic tenet of bankruptcy law, premised on the legal separateness of a debtor prior to filing for bankruptcy and the estate created upon a bankruptcy filing, is that prepetition debts are generally treated differently than debts incurred by the estate, which are generally treated as priority administrative expenses. However, this seemingly straightforward principle is sometimes difficult to apply in cases where a debt technically "arose" or "was incurred" prepetition, but does not become payable until sometime during the bankruptcy case.

A ruling recently handed down by the U.S. District Court for the District of Delaware highlights this issue. In *In re Affirmative Ins. Holdings, Inc.*, 620 B.R. 73 (D. Del. 2020), the court ruled as a matter of apparent first impression at the appellate level that "straddle-year" corporate income taxes that become due during a bankruptcy case are entitled to administrative expense priority. In so ruling, the court reversed a bankruptcy court's adoption of the "bifurcation" approach to this issue, which can have a major impact on a company's chances for a successful reorganization.

PRIORITY OF INCOME TAX CLAIMS

Section 507(a)(2) of the Bankruptcy Code provides that "administrative expenses allowed under section 503(b)," among other types of claims, have second priority of payment. Section 503(b)(1)(B) provides that an administrative expense shall be allowed for, among other items, "any tax . . . *incurred by the estate*, whether secured or unsecured, . . . except a tax of a kind specified in section 507(a)(8)" (emphasis added).

Section 541(a)(1) of the Bankruptcy Code provides that an "estate" is created upon the commencement of a bankruptcy case; however, the Bankruptcy Code does not define the term "incurred" as it is used in section 503(b)(1). Finding that the phrase "incurred by the estate" is "facially ambiguous," some courts have looked to the legislative history of the enactment of the Bankruptcy Code and concluded that Congress "intended for a tax on income to be considered 'incurred' on the last day of the income period." *In re Pac.-Atl. Trading Co.*, 64 F.3d 1292, 1300 (9th Cir. 1995) (noting that compromise language proposed by the Senate Finance Committee providing that "a tax on or measured by income or gross receipts for a taxable period shall be considered incurred on the last day of the taxable period" was omitted from the final bill due to concerns over the impact of the definition of the term "incurred" upon the rule for preferences, but nevertheless indicated lawmakers' intent that income taxes due postpetition are "incurred by the estate").

Other courts have ruled that certain types of taxes are incurred as they accrue and become a fixed liability. *See, e.g.*, *In re Columbia Gas Transmission Corp.*, 37 F.3d 982 (3d Cir. 1994) (public utility taxes were incurred prepetition when the debtor filed its tax return, even though the assessment occurred postpetition; thus, taxes were not entitled to administrative expense priority); *In re O.P.M. Leasing Servs., Inc.*, 68 B.R. 979, 983–84 (Bankr. S.D.N.Y. 1987) (concluding, without reference to the Senate Finance Committee's proposed language, that corporate income taxes are incurred as they accrue rather than on the day they are assessed).

Section 507(a)(8) provides in relevant part that certain allowed unsecured claims of "governmental units" (such as taxing authorities) for taxes are entitled to eighth priority of payment, including claims for:

> a tax on or measured by income or gross receipts *for a taxable year ending on or before the date of the filing of the petition* . . . (i) for which a return, if required, is last due, including extensions, after three years before the date of the filing of the petition; (ii) assessed within 240 days before the date of the filing of the petition . . .; or (iii) . . . not assessed before, but assessable, under applicable law or by agreement, after, the commencement of the case (emphasis added).

The Bankruptcy Code does not define "assessment." For federal income tax purposes, courts have almost uniformly adopted the Internal Revenue Code ("IRC") definition, under which "[t]he date of the assessment is the date the summary record is signed by the assessment officer" following the taxpayer's receipt of a notice of deficiency and the expiration of any period to respond. *See* COLLIER ON BANKRUPTCY ("COLLIER") ¶ 507.11[2][b][i] (16th ed. 2020) (citing cases and 26 C.F.R. § 301.6203-1; 26 U.S.C. § 6203). For state or local tax purposes, most courts have used the date of assessment under relevant state or local law, which varies from state to state, but generally depends on the date on which formal tax liability is finally fixed. *Id.* (citing cases).

Thus, certain income taxes for taxable years ending on or before the petition date are given eighth priority, whereas taxes incurred by the estate (i.e., postpetition taxes) are afforded second priority as administrative expenses. *See generally id.* (noting that section 507(a)(8) "applies only to taxable years ending on or before the petition date").

Section 502(i) provides that a tax claim entitled to priority under section 507(a)(8) that "arise[s]" postpetition shall be allowed or disallowed "the same as if such claim had arisen before the date of the filing of the petition." Section 502(i) was "intended to deal with situations where a tax is incurred prior to the filing of the petition but is not assessed or payable until after the petition has been filed." *In re Hotel Nevada Corp.*, 75 B.R. 174, 176 (Bankr. D. Nev. 1987); *see generally* COLLIER at ¶ 502.10 ("Properly interpreted, section 502(i) makes clear that only taxes incurred by the debtor prepetition but not becoming due and payable until after the petition is filed are allowed under section 502 just as any other prepetition claim. The allocation of such status as a prepetition claim denies administrative status.").

Sections 502(i) and 503(b) both expressly refer to section 507(a)(8) to distinguish between taxes that should be prepetition liabilities and taxes that should be postpetition liabilities. Because tax obligations are generally determined in arrears, the existence and amount of a tax liability may be unknown until after the petition date. "If a tax claim is asserted after the commencement of the case for a time period encompassing both before and during the case, it is necessary to apply the test set forth in section 507(a)(8) to determine whether and how much of the claim should be a prepetition claim." COLLIER at ¶ 507.11.

The priority status of qualifying prepetition tax claims was included in the Bankruptcy Code from previous law as part of the Bankruptcy Act of 1978, although the provision was originally designated as section 507(a)(6) and was renumbered as section 507(a)(7) in 1985 and as section 507(a)(8) in 1994.

Section 507(a)(8) was later amended in 2005 as part of the Bankruptcy Abuse Prevention and Consumer Protection Act. Prior to 2005, it provided as follows with respect to income tax claims:

> Eighth, allowed unsecured claims of governmental units, only to the extent that such claims are for—
>
> (A) a tax on or measured by income or gross receipts—
>
> (i) for a taxable year ending on or before the date of the filing of the petition for which a return, if required, is last due, including extensions, after three years before the date of the filing of the petition;
> (ii) assessed within 240 days, plus any time plus 30 days during which an offer in compromise with respect to such tax that was made within 240 days after such assessment was pending, before the date of the filing of the petition; or
> (iii) other than a tax of a kind specified in section 523(a)(1)(B) or 523(a)(1)(C) of this title, not assessed before, but assessable, under applicable law or by agreement, after, the commencement of the case.

Prior to 2005, it was unclear whether the income tax liability of a corporate debtor for the year of its bankruptcy filing ("straddle year") was entitled to priority as a prepetition unsecured claim or as an administrative expense claim. *See O.P.M.*, 68 B.R. at 983 (ruling that a claim for taxes allocable to prepetition business activities but not due until postpetition was of the kind specified in section 507(a)(7) (now 507(a)(8)) because it was for a tax "not assessed before, but assessable, under applicable law or by agreement, after, the commencement of the case," and that the claim was not entitled to administrative expense priority because it was not incurred by the estate).

Moreover, several federal courts of appeals held before 2005 that the income tax liability of a corporate debtor for the straddle year must be bifurcated into a prepetition component and an administrative expense component, even though the filing of a bankruptcy petition does not terminate the corporate debtor's taxable year. *See In re Hillsborough Holdings Corp.*, 116 F.3d 1391 (11th Cir. 1997); *In re L.J. O'Neill Shoe Co.*, 64 F.3d 1146 (8th Cir. 1995); *Pacific-Atlantic*, 64 F.3d at 1292. Bifurcation of corporate straddle-year taxes arguably conflicts with certain provisions of the IRC. Although IRC § 1398 permits individual debtors in chapter 7 and chapter 11 cases to elect to bifurcate their taxable years into pre- and postpetition periods, corporate and partnership debtors are prohibited from doing so under IRC § 1399. In addition, section 346(d) of the Bankruptcy Code provides that "[f]or purposes of any State or local law imposing a tax on or measured by income, the taxable period of a debtor in a case under this title shall terminate only if and to the extent that the taxable period of such debtor terminates under the [IRC]."

In its October 20, 1997, final report entitled "Bankruptcy: the Next Twenty Years" ("NBRC Report"), the National Bankruptcy Review Commission ("NBRC") recommended to Congress that straddle-year tax claims be treated as administrative expenses, unless a corporate debtor elected to bifurcate its straddle tax year. The NBRC Report notes that at least three proposals had been made for the treatment of corporate straddle-year tax claims: (i) the decisions in *O'Neill* and *Pacific-Atlantic* could be codified, "establishing the rule that the tax liability is apportioned between prepetition eighth priority and postpetition first priority administrative expense"; (ii) as proposed by the Internal Revenue Service ("IRS") and the U.S. Department of Justice, the entire straddle tax year's liability could be treated as an administrative expense, thereby overruling *O'Neill* and *Pacific-Atlantic*; and (iii) the entire straddle tax year's liability could be treated as an administrative expense, except that corporations could be granted the same election to bifurcate the straddle tax year that is available to individuals in chapter 7 and chapter 11 cases under the IRC. The NBRC adopted the third proposal in its final report, noting that "payment of priority taxes might be a critical element in proposing a successful reorganization." *See* NBRC Report, Ch. 4—Other Recommendations and Issues: Taxation and the Bankruptcy Code § 4.2.33 pp. 975-77.

In discussing *O'Neill* and *Pacific-Atlantic*, the NBRC Report stated that "[t]he legislative history indicates that Congress intended straddle tax year income taxes to be considered 'incurred' on the last day of the taxable period of a corporate debtor for purposes of §§ 503 and 507, the same as under the Internal Revenue Code." However, the NBRC Report notes, the Eighth and Ninth Circuits in *O'Neill* and *Pacific-Atlantic* held that the straddle-year corporate income tax may also be "a tax of a kind specified in § 507(a)(8)," and thereby be excluded from administrative priority treatment, even though the tax is not "incurred" until after the petition date.

According to some courts and commentators, under section 507(a)(8) as amended in 2005, Congress resolved this issue by providing that income and gross receipt taxes for straddle years would be treated as postpetition administrative expense claims for the entire tax year, unless the debtor filed for bankruptcy on the last day of its taxable year. *See In re Earl Gaudio & Son, Inc.*, 2017 WL 377918, at *5 (Bankr. C.D. Ill. Jan. 25, 2017) ("Where a Chapter 11 petition is filed during a taxable year, the tax on all income for that taxable year—without regard to whether the income was earned before or after the petition date—is considered a post-petition tax debt that is incurred by the estate"); *In re FR & S Corp.*, 2011 WL 1261329, at *4 (Bankr. D.P.R. Mar. 30, 2011); COLLIER at ¶ TX4.03 ("[I]ncome and gross receipt taxes for the year of the bankruptcy filing are postpetition administrative expense claims that must be paid in full in the ordinary course, rather than prepetition priority claims that are not payable until emergence from bankruptcy"); Ginsberg, Martin and Furay, GINSBERG & MARTIN ON BANKRUPTCY § 18.07 (2019) ("under new § 507(a)(8), taxes for straddle years (the year of the Chapter 11 petition for a corporate debtor) will be treated as post-petition administrative claims, not bifurcated into pre-petition and post-petition claims as was common under [pre-2005] practice"); Carl M. Jenks, *The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005: Summary of Tax Provisions*, 79 AM. BANKR. L.J. 893, 898 (2005) (noting that, in amending section 507(a)(8) in 2005, Congress, contrary to the recommendation of the NBRC, apparently adopted the government's argument that the bifurcation cases should be overruled, "although the technical draftsmanship of the amendment may have left something to be desired").

AFFIRMATIVE INSURANCE

Automobile insurer Affirmative Insurance Holdings, Inc. and its affiliates (collectively, "AIH") filed for chapter 11 protection on October 14, 2015, in the District of Delaware after selling or otherwise disposing of their assets and discontinuing operations. On March 10, 2016, the bankruptcy court entered an order converting AIH's jointly administered chapter 11 cases to chapter 7 liquidations.

The IRS filed an administrative expense claim for corporate income tax, interest, and penalties in the amount of approximately $857,000 for the tax period ending December 31, 2015.

The trustee objected to the IRS's claim, asserting that it was a prepetition unsecured claim because all events that gave rise to the tax arose prior to the petition date. The IRS countered that the claim was an administrative expense claim because, although the tax year straddled the petition date, the tax year in which the taxes were incurred concluded and the tax was assessed in the ordinary course after the petition date.

THE BANKRUPTCY COURT'S RULING

The bankruptcy court undertook a two part inquiry—namely: (i) whether the IRS's claim was a priority unsecured claim under section 507(a)(8); and (ii) if not, whether the claim was an administrative expense claim based on when the tax was incurred and by which entity.

The court concluded that the tax claim did not qualify for priority treatment under section 507(a)(8) because, in accordance with the plain meaning of that provision as amended in 2005, the tax year covered by the claim did not end on or before the bankruptcy petition date, but instead straddled the petition date.

Next, the bankruptcy court ruled that the entire tax claim was not entitled to administrative expense status under section 503(b)(1), but instead must be bifurcated into pre- and postpetition components. It explained that, in order to qualify for administrative expense priority, a tax liability must have been "incurred by the estate." The court further noted that, although the Bankruptcy

Code does not provide a definition for that concept, most courts considering the issue, including the U.S. Court of Appeals for the Third Circuit, have determined that a tax is incurred when it accrues and becomes a fixed liability, and that state law determines when a tax is incurred. *See Affirmative Insurance*, 607 B.R. at 182 (citing *In re Barnhill's Buffet, Inc.*, 2010 WL 703088, *1 (Bankr. M.D. Tenn. Feb. 24, 2010); *Columbia Gas*, 37 F.3d at 985-86; *In re Federated Dep't Stores, Inc.*, 270 F.3d 994, 1000-01 (6th Cir. 2001); *Gaudio*, 2017 WL 377918, at *3).

The bankruptcy court acknowledged that the 2005 amendments "had a real and substantial effect of creating a priority claim for tax years that ended on or before the petition date." However, it wrote, "[i]n no way would this Court's refusal to accept that the pre-petition portion of the Straddle Tax as an administrative claim, create an ambiguity with Congress' intention in [the 2005 amendments] regarding priority claims for tax years ending on or before the petition date."

The court explained that, in conferring administrative expense priority on certain tax claims, sections 503(b)(1)(B)(i) and 503(b)(1)(B)(ii) distinguish between "any tax . . . incurred by the estate" and certain tax adjustments, "whether the taxable year to which such adjustment relates ended before or after the commencement of the case." According to the court, although these provisions are not directly relevant to this case, Congress could have used similar language in section 507(a)(8) if it had intended "to grant administrative expense priority to *all* straddle year taxes."

The bankruptcy court distinguished *Gaudio* and *FR & S*—the only reported decisions addressing this issue—"based on the plain meaning of § 503(b)(1)(B) and the cannons [sic] of statutory construction." It faulted *Gaudio* for focusing on the amount of taxes due in determining whether such taxes had been "incurred by the estate," rather than on "the priority based on whether the tax was incurred, administrative priority or general unsecured as the case may be." Instead, the court in *Affirmative Insurance* quoted *O'Neill* for the proposition that "there is nothing in either the bankruptcy or tax laws which prevents us from allowing different treatment during distribution for different portions" of the tax claims. In addition, the bankruptcy court found *FR & S* to be flawed because that court "could not find any legislative history or statutory language allowing for the Straddle Tax Year to be an administrative claim." The *Affirmative Insurance* court also wrote that "although Congress could have expressly written such, it did not."

The bankruptcy court ruled that "pre-petition events that incur tax liability" during straddle tax years have general unsecured status, whereas "post-petition events that incur tax liability" during the same straddle tax years have administrative priority, "in effect, bifurcating the straddle tax years into two distinct treatments under the Bankruptcy Code."

The IRS appealed the ruling.

THE DISTRICT COURT'S RULING

In what it characterized as a matter of apparent first impression in the appellate courts, the district court reversed.

Noting that the sole issue on appeal was whether the taxes at issue were "incurred by the estate," Judge Richard G. Andrews explained that, in accordance with the Supreme Court's decision in *Hall v. U.S.*, 566 U.S. 506, 511 (2012), "[t]he phrase 'incurred by the estate' bears a plain and natural reading." Judge Andrews then concluded that underlying substantive tax law—in this case, federal tax law—determines when a tax is incurred. Because the IRC provides that a federal income tax does not become a fixed liability until the last day of the applicable tax period, Judge Andrews held that the estate incurred AIH's tax liability when AIH's taxable year ended postpetition. He rejected the trustee's argument that, consistent with the principles governing when a claim "arises" under federal bankruptcy law, "corporate income taxes 'accrue'—and thus are 'incurred'—on a daily basis as events giving rise to tax liability is incurred." Judge Andrews explained:

> Importing the traditional bankruptcy claims analysis won't work for purposes of § 503(b)(1)(B)(i), as identifying when the action which underlies a "right to payment" occurred will not necessarily comport with a determination of when the tax "accrues and becomes a fixed liability" in accordance with the relevant substantive tax law.

Citing *Columbia Gas*, *Gaudio*, and other similar cases, the district court concluded that: (i) a tax is incurred when it accrues and becomes a fixed liability; and (ii) when a federal income tax has been incurred must be determined in accordance with applicable substantive law. *See In re Dawes*, 652 F.3d 1236, 1239-40 (10th Cir. 2011); *Columbia Gas*, 37 F.3d at 985; *Marion County Treas. v. Blue Lustre Prods., Inc.*, 214 B.R. 188 (S.D. Ind. 1997); *Gaudio*, 2017 WL 377918, *3; *FR & S Corp.*, 2011 WL 1261329, at *1.

Next, the district court, applying the underlying substantive law in the case before it (the IRC), stated that corporate income tax accrues and becomes a fixed ability on the last day of the tax year because it is only then "that all events giving rise to an income tax have occurred (both those creating income and those creating deductions)." Thus, the court ruled, AIH's 2015 taxable income could be calculated only at the end of its taxable year on December 31, 2015—which was postpetition.

Notwithstanding this conclusion, the district court rejected the argument that Congress intended to make straddle-year taxes entirely postpetition administrative claims when it amended section 507(a)(8) in 2005. According to the court, the scant legislative history of the 2005 amendments does not explain why the provision was amended.

The district court accordingly reversed the bankruptcy court's decision, ruling that "the tax at issue in the IRS Claim was incurred by the estate post-petition and should be entitled to priority as an administrative expense."

OUTLOOK

Although the bankruptcy and district courts in *Affirmative Insurance* reached different conclusions, they agreed that the scant legislative history of the 2005 amendments does not support the position that lawmakers intended to confer administrative expense priority on straddle-year corporate income tax claims. The district court, however, viewed the absence of any such guidance as irrelevant based on its conclusion that, in accordance with applicable substantive law, the plain meaning of the phrase "incurred by the estate" in section 503(b)(1)(B)(i) was dispositive of the issue.

Notably, the district court observed that its conclusion might have been different in a case involving taxes fundamentally different from income taxes, such as employment or excise taxes, which accrue "upon the occurrence of certain transactions or events and generally are reported on periodic (*i.e.* quarterly) returns."

The debate on this issue is far from over. The chapter 7 trustee appealed the ruling to the Third Circuit on September 25, 2020. In addition, shortly before the district court issued its ruling, a Massachusetts bankruptcy court adopted the approach to straddle-year corporate income taxes applied by the *Affirmative Insurance* bankruptcy court. *See In re Telexfree, LLC*, 615 B.R. 362, 373 (Bankr. D. Mass. 2020). In that case, the court observed that "[t]he Bankruptcy Code, despite its panoply of provisions classifying all manner of tax claims, offers no precise statutory hole in which to slide the peg of straddle-year taxes." It held that, because "federal income taxes are incurred at the time they accrue as opposed to the time payment is due for section 503(b)(1)(B) purposes," the IRS's claim for corporate income taxes due postpetition but based on prepetition income was not entitled to administrative expense priority, but would be treated as a nonpriority general unsecured claim.

DIP FINANCING AGREEMENT INITIALLY REJECTED AS *SUB ROSA* CHAPTER 11 PLAN

Mark G. Douglas

Postpetition financing provided by pre-bankruptcy shareholders or other "insiders" is not uncommon in chapter 11 cases as a way to fund a plan of reorganization and allow old shareholders to retain an ownership interest in the reorganized entity. The practice is typically sanctioned by bankruptcy courts under an exception—the "new value" exception—to the "absolute priority rule," which prohibits shareholders and junior creditors from receiving any distribution under a plan on account of their interests or claims unless senior creditors are paid in full or agree otherwise.

Such a proposed financing arrangement was the subject of a ruling recently handed down by the U.S. Bankruptcy Court for the Southern District of New York. In *In re LATAM Airlines Grp. S.A.*, 2020 WL 5506407 (Bankr. S.D.N.Y. Sept. 10, 2020), the court held that the debtor demonstrated that secured financing provided by its existing shareholders was necessary, that the terms of the loan were fair, and that the lenders were acting in good faith. However, the court initially refused to approve the proposed financing agreement, finding that the agreement was a prohibited "*sub rosa*" chapter 11 plan because it provided that the debtor could elect to repay the shareholder loan with discounted stock in lieu of cash and effectively prevented confirmation of any plan other than the debtor's. However, after the parties modified the financing agreement to remove the equity election feature, the bankruptcy court approved the financing.

LATAM

In May 2020, LATAM Airlines Group S.A. and certain affiliates (collectively, "LATAM"), Latin America's leading airline group, filed for chapter 11 protection in the Southern District of New York after losing 95% of its passenger business due to travel restrictions imposed during the COVID-19 pandemic.

LATAM's prepetition efforts to secure government financial assistance were unsuccessful. Accordingly, upon the filing of its chapter 11 case, LATAM sought bankruptcy court approval of a $2.45 billion debtor-in-possession ("DIP") financing agreement with Oaktree Capital Management Inc. ("Oaktree"), as Tranche A lender, and two of its existing shareholders—Qatar Airways Investments (U.K.) Ltd ("Qatar") and Costa Verde Aeronautica S.A. ("Costa Verda")—as Tranche C lenders (an alternative super-priority DIP loan facility proposal with a Tranche B loan was abandoned). Oaktree had no relationship with LATAM prior to the bankruptcy cases. Together, Qatar, Costa Verda, and their affiliates held approximately 32% of LATAM's common stock. Delta Airlines, Inc. ("Delta") acquired approximately 20% of the common stock of LATAM's parent corporation in connection with a 2019 tender offer and an ensuing joint venture agreement.

The Tranche A loan ($1.3 billion) was to bear interest at an adjusted LIBOR rate plus an applicable margin and would be secured by a senior lien on LATAM's unencumbered assets and a junior lien on its encumbered assets. The delayed-draw Tranche C loan (up to $900 million plus an additional $250 million increase commitment) was to bear payment-in-kind interest at the initial rate of 14.5% and was to be secured by a lien junior to the lien of the Tranche A lender. Both loans were to be conferred with super-priority administrative expense status. LATAM had the right to prepay the Tranche A loan, but not the Tranche C loan.

The Tranche C loan facility provided that, in lieu of repaying the loan in cash, LATAM had the option to repay the loan by giving the Tranche C lenders restricted equity in the reorganized company at a 20% discount to plan value (a discount valued at approximately $283 million). According to LATAM, this "modified equity subscription election" was a valuable asset, particularly if it did not have sufficient cash to pay off the Tranche C loan at the end of the case. The proposed DIP financing agreement further provided that confirmation of a non-LATAM-approved chapter 11 plan was an event of default.

LATAM's official unsecured creditors' committee, an ad hoc bondholder group, and Knighthead Capital Management LLC ("Knighthead" and collectively, the "objectors"), the last of which was a bondholder and a jilted competing DIP lender, objected to the Tranche C loan. They argued that the shareholders were getting a "sweet" deal because they were LATAM's largest shareholders and that the court should deny the motion because LATAM failed to demonstrate the "entire fairness" of the "insider" loan. They also argued that the loan was both overpriced and not the product of good faith, arm's-length negotiations.

In addition, the objectors contended that the equity election was really a means for LATAM's major shareholders to ensure that they would retain their equity interests in the reorganized company at the potential expense of unsecured creditors. They also argued that the credit agreement violated the "absolute priority rule" because old shareholders would receive stock while unsecured creditors would not be paid in full under any plan proposed by LATAM. Finally, the objectors claimed that the Tranche C loan facility amounted to a prohibited *sub rosa* chapter 11 plan.

THE BANKRUPTCY COURT'S RULING

The bankruptcy court initially denied the DIP financing motion.

At the outset of its opinion, the court concluded that, as required by section 364(c) of the Bankruptcy Code, LATAM demonstrated that it: (i) was unable to obtain unsecured credit allowable as an administrative expense; (ii) had an urgent need for financing; and (iii) was appropriate for LATAM to seek approval of the full $2.45 billion DIP loan facility.

Whether the Financing Was Fair and Reasonable. However, in examining whether the proposed financing was "fair and reasonable," the bankruptcy court concluded that the business judgment standard customarily used in this context did not apply. The court explained that, when a proposed transaction with a debtor involves "insiders," courts apply "heightened" or "rigorous" scrutiny in assessing the bona fides of the transaction. *LATAM*, 2020 WL 5506407, at *27 (citing *Citicorp Venture Capital, Ltd. v. Comm. of Creditors Holdings Unsecured Claims (In re Papercraft Corp.)*, 211 B.R. 813, 823 (W.D. Pa. 1997), *aff'd*, 160 F.3d 982 (3rd Cir. 1998); *In re MSR Hotels & Resorts, Inc.*, 2013 WL 5716897, at *1 (Bankr. S.D.N.Y. Oct. 1, 2013)). Although the term "insider" is defined in section 101(31) of the Bankruptcy Code, the court noted, the statutory definition is not exclusive and has been interpreted broadly to include anyone "who has a sufficiently close relationship with the debtor that his conduct is made subject to closer scrutiny than those dealing at arm's length with the debtor." *Id.* at *28 (citations and internal quotation marks omitted).

If a transaction involves an insider, the court explained, the insider bears the burden of showing the "entire" or "inherent" fairness of the transaction at issue. *Id.* at *27 (citing *WHBA Real Estate Ltd. P'ship v. Lafayette Hotel P'ship (In re Lafayette Hotel P'ship)*, 227 B.R. 445, 454 (S.D.N.Y. 1998); *In re L.A. Dodgers LLC*, 457 B.R. 308, 313 (Bankr. D. Del. 2011); *Papercraft*, 211 B.R. at 823). Even a minority shareholder can be considered an insider in this context if it exercises influence and control over the corporation through other means, including board seats or exclusive access to confidential information. *Id.* (citing *Nisselson v. Softbank AM Corp. (In re Marketxt Holdings Corp.)*, 361 B.R. 369, 387-88 (S.D.N.Y. 2007)).

According to the bankruptcy court, the Tranche C lenders and Delta—which was "instrumental" in negotiating the terms of the transaction—were "insiders" of LATAM. These shareholders collectively owned or controlled 51% of LATAM's common stock and designated six of LATAM's nine board members. Moreover, although it was undisputed that Oaktree was not a LATAM insider, the court applied heightened scrutiny to the proposed Tranche A loan as well, reasoning that the two loan facilities were "intertwined" and the "terms of the Tranche C Facility were essential in raising the Tranche A DIP Facility."

To demonstrate that LATAM satisfied the "entire fairness" standard, the court noted, LATAM had to show that the proposed financing agreement, including the Tranche A facility and the Tranche C facility, "results from fair dealing and reflects a fair price." Initially, the court rejected the objectors' argument that LATAM lacked good faith in seeking approval of the financing. According to the court, the evidence showed that LATAM made an informed judgment in rejecting financing from other sources and had "good reasons" for approaching its major shareholders for a DIP loan.

Next, the court concluded that the terms of the proposed financing amounted to a "fair price" under the circumstances and that LATAM's efforts to obtain DIP financing amounted to a "fair process" that included extensive due diligence and negotiations, extensive marketing procedures, and the consideration of multiple competing offers. The court rejected the objectors' argument that LATAM's admitted failure to market the Tranche C facility prepetition precluded a finding that the process was entirely fair. According to the court, LATAM engaged in a robust marketing process *postpetition* and demonstrated that there were good reasons for it not to go to the market with the DIP financing proposal prior to filing for bankruptcy, including: (i) "a DIP underwritten by its major shareholders would enhance the potential for governmental support and send a strong signal to the market that their equity holders had confidence in the [LATAM's] business"; and (ii) it was impractical to go to the market because LATAM did not have adequate collateral to fully secure a $2 billion loan.

The court also rejected the objectors' argument that the price and terms of the Tranche C facility were not "entirely fair" because the pricing was excessive, and the terms, including the lack of any prepayment right, broadly deviated from market standards, in an attempt to entrench management, impair creditor protections, and impinge on the court's authority. According to the court, because LATAM was not obligated to draw down the full amount of the delayed-draw Tranche C facility, a prepayment right was of "diminished" importance. Moreover, the court explained, even after thoroughly testing the market postpetition, LATAM was unable to secure alternative financing on more favorable terms (either by increasing the Tranche A facility or otherwise) to address its liquidity needs in the current crisis. In addition, the bankruptcy court found that the pricing of the Tranche C loan was "negotiated to incorporate the respective parties' risks and rewards" and accordingly found that the DIP financing agreement, including the Tranche A loan and the Tranche C loan, resulted "from fair dealing and reflects a fair price."

Good Faith Lenders? Next, the bankruptcy court found that both the Tranche A lender and the Tranche C lenders were entitled to the protections of section 364(e) of the Bankruptcy Code, which moots any appeal of an unstayed order approving financing from a good faith lender. The court rejected the objectors' argument that the Tranche C lenders did not act in good faith because: (i) they were LATAM insiders; and (ii) they "intentionally pursued a transaction . . . that, on its face, subverts the principles of absolute priority and constitutes a sub rosa plan." The court dismissed the insider argument as meritless. Also, it explained that, because LATAM maintained that the Tranche C loan represented an investment of new money, was not a *sub rosa* plan and did not violate the absolute priority rule, the Tranche C lenders were "not seeking relief that is improper under settled law." Finally, given the absence of any evidence indicating that the Tranche C lenders misused their status as shareholders, engaged in fraud or collusion, or tried to take gross advantage of other bidders, the court ruled that the Tranche C lenders were entitled to a good faith lender designation under section 364(e).

The Absolute Priority Rule and the New Value Exception. According to the objectors, the proposed DIP financing violated the "absolute priority rule" codified in section 1129(b)(2) of the Bankruptcy Code because, "on account of their status as shareholder," the proposed financing: (i) gave existing shareholders—the Tranche C lenders—the exclusive option to acquire the equity of the reorganized LATAM at a discount; and (ii) extended to all other shareholders the option to acquire all of the new equity in the reorganized LATAM at plan value. The bankruptcy court acknowledged that, even though the proposed DIP financing was not part of a chapter 11 plan, the absolute priority rule was "triggered" because the "Tranche C DIP Facility is at least partly being extended and repaid to the Tranche C Lenders (and other shareholders) on account of their pre-existing equity holdings."

However, the court concluded that the financing transaction satisfied the "new value" exception to the rule, which permits a shareholder to retain equity, or a junior creditor to receive a distribution under a plan, despite less than full payment of senior creditors, provided the shareholder or junior creditor contributes new capital to the restructured enterprise. First, the court noted, there was no dispute that the up to $1.15 billion to be loaned by the Tranche C lenders was “new, substantial money.” Next, the court found that the $1.15 billion Tranche C facility was “reasonably equivalent” to the value retained and “necessary” because: (i) the loan was negotiated at arm’s length and underwent an extensive postpetition market test without producing any viable competing offers; and (ii) the total pricing of the loan, including the equity conversion feature, reflected the value of the risk undertaken by the Tranche C lenders.

Undone by a *Sub Rosa* Plan? Despite all its prior findings, the court ultimately denied the financing motion because it concluded that the equity subscription provision in the Tranche C facility represented a prohibited *sub rosa* chapter 11 plan. It explained that certain events that precede (or supersede) confirmation of chapter 11 plan, such as a global settlement among major stakeholders, a sale of substantially all of the debtors assets, or a comprehensive agreement in anticipation of a “structured dismissal,” may be a de facto chapter 11 plan without providing all parties with the same protections as the plan confirmation process. Such *sub rosa* plans are prohibited “based on a fear that a debtor-in-possession will enter into transactions that will, in effect, ‘short circuit the requirements of Chapter 11 for confirmation of a reorganization plan.’” *LATAM*, 2020 WL 5506407, at *54 (citing *Motorola, Inc. v. Official Comm. of Unsecured Creditors (In re Iridium Operating LLC)*, 478 F.3d 452, 466 (2d Cir. 2007); *Pension Benefit Guar. Corp. v. Braniff Airways, Inc. (In re Braniff Airways, Inc.)*, 700 F.2d 935, 940 (5th Cir. 1983)); *accord In re Miami Metals I, Inc.*, 603 B.R. 531, 536 (Bankr. S.D.N.Y. 2019). According to the court, a proposed DIP loan may be rejected as a *sub rosa* plan “if the terms of the loan include concessions to creditors or parties in interest that are unauthorized under, or in conflict with, provisions under the Bankruptcy Code.” *LATAM*, 2020 WL 5506407, at *56 (citing *Resolution Tr. Corp. v. Official Unsecured Creditors Comm. (In re Def. Drug Stores, Inc.)*, 145 B.R. 312, 317 (B.A.P. 9th Cir. 1992); *In re Belk Props., LLC*, 421 B.R. 221, 225-26 (Bankr. N.D. Miss. 2009); *In re Chevy Devco*, 78 B.R. 585, 589 (Bankr. C.D. Cal. 1987)).

In this case, the court found, LATAM was not asking the court to approve a transaction that would merely bring it one step closer to plan confirmation but “to approve a transaction that will fix now, some of the terms of a plan yet to be filed.” If approved, the court noted, the Tranche C facility would lock into place the 20% discount to plan value on the stock to be issued at LATAM’s option to the Tranche C lenders in satisfaction of the loan. The court wrote that, because it was not market tested, “[t]here is no way of knowing now whether that discount is appropriate . . . [and] neither the Debtors’ decision to make that election, nor the 20% discount, will be subject to creditor comment or Court review.” For this reason, the court initially denied approval of the Tranche C loan because it “short circuit[ed]” the chapter 11 plan review process “by establishing plan terms sub rosa.”

In addition, the bankruptcy court ruled that the DIP financing agreement “establishe[d] plan terms sub rosa” by providing for the distribution of stock in the reorganized LATAM to existing equity holders “on account of” their status as shareholders without market testing.

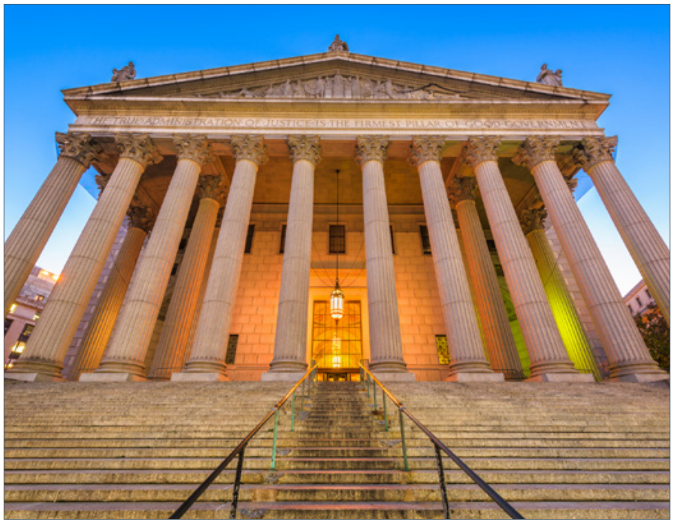
Finally, the court found that the provision in the DIP financing agreement providing that the confirmation of a non-LATAM-approved chapter 11 plan was an event of default was further evidence that the agreement was a *sub rosa* plan. According to the court, the DIP financing agreement “effectively lock[ed] up any future plan of reorganization to be only the Debtors’ plan providing for the equity conversion.”

POSTSCRIPT

Shortly after the bankruptcy court handed down its ruling, the lenders and LATAM submitted a revised DIP financing agreement without the equity subscription election and with terms modified to remedy the concerns expressed by the court in its decision. In addition, Knighthead affiliates were permitted to subscribe up to $425 million to the Tranche A and Tranche C loans. The court approved the revised DIP financing agreement on September 19, 2020. *See In re LATAM Airlines Grp. S.A.*, No. 20-11254 (JLG) (Bankr. S.D.N.Y. Sept. 19, 2020) (Doc. No. 1091).

OUTLOOK

LATAM is a cautionary tale for shareholders or other insiders attempting to parlay chapter 11 plan financing into a continuing ownership interest in a reorganized company. According to the bankruptcy court, even if such financing is necessary to the success of the case and on otherwise fair terms, it cannot dictate the terms of a chapter 11 plan or otherwise subvert the plan confirmation process.



NEW YORK'S HIGHEST COURT UPHOLDS MINORITY NOTEHOLDERS' RIGHTS UNDER TRUST INDENTURE ACT

Bruce Bennett ■ Jane Rue Wittstein ■ George J. Cahill
Michael C. Schneidereit ■ Jayant W. Tambe

In a sharply divided 4–3 decision, *CNH Diversified Opportunities Master Account, L.P. v. Cleveland Unlimited, Inc.*, 2020 WL 6163305 (N.Y. Oct. 22, 2020), the New York Court of Appeals reversed the courts below to rule that the actions of majority noteholders and an indenture trustee ("Trustee") to foreclose on collateral, as expressly authorized under the indenture ("Indenture") and a Collateral Trust Agreement ("CTA"), did not override the individual noteholder's legal right to payment or suit under the "consent" provision of the Indenture based on section 316(b) of the Trustee Indenture Act of 1939 ("TIA").

For indentures governed by New York law, *CNH* breathes new life into the standard indenture provision—prevalent in corporate bonds and structured finance transactions—requiring that, notwithstanding remedy provisions that permit actions against collateral at the direction of a majority of noteholders, an individual noteholder's rights to receive "payment of principal . . . and interest and . . . on or after the respective due dates expressed in such Note, or to bring suit for the enforcement of any such payment on or after such respective dates, shall not be impaired or affected without the consent of such Holder." *CNH*, 2020 WL 6163305, at *1.

Whether this decision "needlessly injects uncertainty into a multi-trillion dollar corporate debt market" as the dissent claims is yet to be seen, but it is fair to say that the pendulum has swung back in favor of dissenting noteholders and a broader interpretation of section 316(b) of the TIA. Minority noteholders will likely be emboldened to take actions seeking to preserve their rights to demand payment or the right to sue in connection with out-of-court collateral dispositions, even when the Trustee's actions are contractually authorized and implemented at the direction of the majority of noteholders.

BACKGROUND

In 2005, Cleveland Unlimited, Inc. ("CU") issued $150 million of five-year senior secured notes ("Notes") guaranteed by subsidiaries under an indenture. Although the indenture was not qualified under the TIA, it included provisions tracking sections 316(a) (section 6.05 Control by Majority) and 316(b) (section 6.07 Rights of Holders To Receive Payment) of the TIA, and expressly incorporated by reference "[a]ny provision of the TIA which is required to be included in a qualified indenture."

When CU defaulted on the Notes' December 15, 2010, maturity date, the parties entered into a forbearance agreement pursuant to which CUI Holdings, LLC ("CUI Holdings"), an affiliate of CU that owned 100% of CU's stock, became a guarantor and pledged 100% of CU's stock. After a plan to have the noteholders purchase 100% of CU equity in exchange for a release under the Notes was rejected by holders of 3% of the Notes ("plaintiffs"), the holders of 97% of the Notes directed the Trustee to commence a "strict foreclosure" on the CU equity, pursuant to which the Notes were cancelled, and the Trustee complied. The plaintiffs brought breach of contract and breach of guaranty actions against CU and the guarantors (including CUI Holdings).

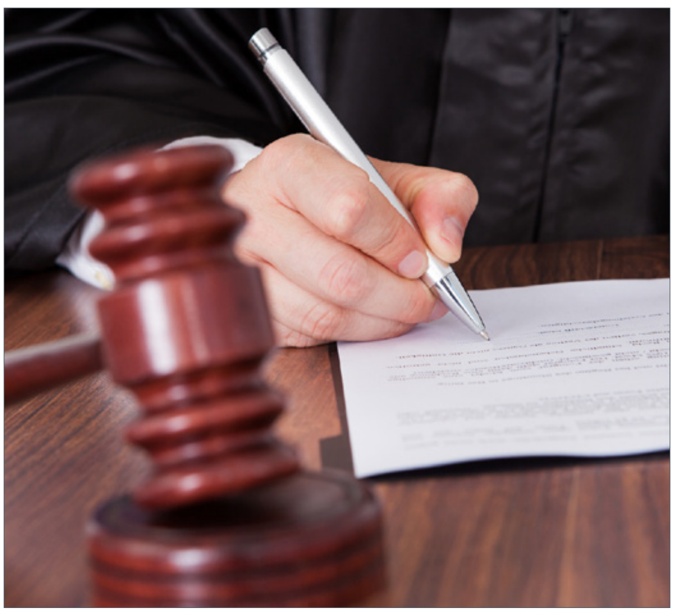
THE DECISIONS

The N.Y. Supreme Court entered summary judgment for the defendants, and the Appellate Division affirmed, ruling that the strict foreclosure did not violate section 316(b) of the TIA—or the equivalent language of section 6.07 of the indenture—because the transaction neither formally "amend[ed] any terms of the Indenture" nor "prevent[ed the Minority Noteholders] from bringing an action to collect payments due on the dates indicated in the Indenture." The lower courts relied on the Court of Appeals' prior decision in *Beal Sav. Bank v Sommer*, 8 N.Y.3d 318 (2007), and the decision by the U.S. Court of Appeals for the Second Circuit in *Marblegate Asset Mgt., LLC v Education Mgt. Fin. Corp.*, 846 F.3d 1 (2d Cir. 2017).

In the N.Y. Court of Appeals, the majority reversed the grant of summary judgment to the defendants and granted partial summary judgment to the plaintiffs. Although the plaintiffs argued they were entitled to an award equal to the face value of the Notes plus unpaid interest, the court determined the amount of damages and other factual issues preserved by the parties should be addressed in the first instance by the Supreme Court upon remittal. On the key legal issue presented, the majority determined that the dissenting noteholders' right to sue, and right to payment, survived the purported cancellation of the Notes under the strict foreclosure.

Unlike in *Beal*, where the agreements as a whole bound all holders to "collective" action in the event of a default, "the Indenture in this case contained a specific provision, section 6.07, that affords each individual Noteholder the absolute legal right to bring suit on its own behalf for payment of principal or interest, despite any 'no-action clause' to the contrary." *CNH*, 2020 WL 6163305, at *9.

The majority was careful to distinguish the rights of the dissenting senior secured noteholders here from the minority junior unsecured noteholders in the Second Circuit's *Marblegate* decision (whose right to sue was not extinguished). They noted that while the TIA provides a simple majority in the principal amount of the securities to authorize the Trustee to pursue an available remedy, "the same section of the TIA [protects] certain core rights of minority bondholders." *Id.* at *6 (citing *Marblegate*, 846 F3d at 15 n.15 ("while the 1938 version of the bill vested discretion in the SEC to regulate indenture provisions, the 1939 version of the bill was altered to mandate that all qualified indenture contain certain provisions")). The majority also found that the aftermarket noteholders were not parties to the CTA, and thus rejected the dissent's argument construing the CTA to provide the requisite consent.



The dissenting opinion concluded that the majority ignored the CTA and mistakenly applied (and misapplied) the TIA in what should have been a contractual analysis reading all the indenture documents as a whole. Viewing this case as controlled by the reasoning in the Second Circuit's *Marblegate* decision, the dissent argued that the foreclosure did not violate section 316(b) of the TIA because it did not amend an indenture's "core payment terms" and, reading the Indenture together with the CTA, the noteholders consented to the remedy chosen by the controlling noteholders to have the Trustee foreclose on the collateral. Warning that the "decision needlessly disconnects the law of the two courts most relevant to the markets in which these securities are traded" and that "[c]onfusion will surely follow," the dissent concluded that the majority's recognition that dissenting noteholders' rights survive an authorized foreclosure "needlessly injects uncertainty into a multi-trillion-dollar corporate debt market . . . [and] ultimately strikes a chord of disharmony in undermining what should be the prevailing rule in both this Court and the Second Circuit that agreements of collective design should be read as one." *Id.* at **9, 17.

The majority opinion disputed the dissent's assertion that this decision conflicts with *Marblegate*, noting that the transaction in question in that case interfered only with the dissenting noteholders' "practical ability" to recover payment, while CU's note cancellation eliminated the dissenting noteholders' legal rights to payment in full, and to sue the issuer and guarantors after default.

THREE KEY TAKEAWAYS

1. Following a string of district court decisions regarding the scope of section 316(b) of the TIA, the Second Circuit's 2017 *Marblegate* decision was viewed to have provided financial markets with judicial certainty on the subject. Time will tell whether the rationale behind the *CNH* decision will be embraced by the Second Circuit or whether the dissent's dire predictions of discord and confusion will prove accurate.
2. The *Marblegate* decision was widely viewed as substantially narrowing the grounds for dissenting noteholders to attack out-of-court restructurings based on section 316(b) of the TIA in the absence of an amendment to an indenture's "core payment terms." The *CNH* decision now provides leverage to minority noteholders protected by section 316(b) in the context of out-of-court restructurings. Those seeking certainty in restructuring debt governed by New York law may need to resort to the bankruptcy process to bind an objecting minority.
3. Although the *CNH* decision is likely to embolden minority noteholders, the distinction drawn by the majority between impairment of the practical ability and the legal right to recover payment should not be overlooked. If anything has been made clear by the series of non-pro rata refinancing transactions implemented recently, it is that there are countless ways to impair a party's practical ability to be repaid without eliminating its legal right to repayment.

TENTH CIRCUIT BAP: BANKRUPTCY COURTS HAVE EXCLUSIVE JURISDICTION TO DETERMINE WHETHER CLAIMS ARE ESTATE PROPERTY

Timothy W. Hoffmann ■ **Mark G. Douglas**

In *Hafen v. Adams (In re Hafen)*, 616 B.R. 570 (B.A.P. 10th Cir. 2020), a bankruptcy appellate panel from the Tenth Circuit ("BAP") held that the bankruptcy court is the only court with subject-matter jurisdiction to decide whether a claim or cause of action is property of a debtors' bankruptcy estate. As a consequence, the BAP held that the bankruptcy court abused its discretion by permitting a state court to determine whether creditors had "standing" to sue third-party recipients of allegedly fraudulent transfers. The decision illustrates the distinction between "bankruptcy standing" and "constitutional standing" to sue in federal courts.

JURISDICTION OVER ESTATE PROPERTY IN BANKRUPTCY

Federal district courts have "original and exclusive jurisdiction" of all "cases" under the Bankruptcy Code. 28 U.S.C. § 1334(a). District courts also have "original but not exclusive jurisdiction of all civil proceedings arising under" the Bankruptcy Code, "or arising in or related to cases" under the Bankruptcy Code. 28 U.S.C. § 1334(b). District courts may (and do), however, refer these cases and proceedings to the bankruptcy courts in their districts, which are constituted as "units" of the district courts. 28 U.S.C. § 157(a).

A federal district court in which a bankruptcy case is commenced or pending also has exclusive jurisdiction over all of the debtor's property, wherever located, property of the debtor's bankruptcy estate (as defined in section 541(a) of the Bankruptcy Code), and all claims or causes of action involving the retention of bankruptcy professionals. 28 U.S.C. § 1334(e). Under section 541(a)(1), the estate includes "all legal or equitable interests of the debtor in property as of the commencement of the case." Accordingly, claims and causes of action belonging to the debtor on the petition date are estate property. *See In re Wilton Armetale, Inc.*, 968 F.3d 273, 280 (3d Cir. Aug. 4, 2020) (citing 11 U.S.C. § 541(a)(1); *U.S. v. Whiting Pools, Inc.*, 462 U.S. 198, 205 n.9 (1983); *Bd. of Trs. of Teamsters Local 863 Pension Fund v. Foodtown, Inc.*, 296 F.3d 164, 169 (3d Cir. 2002)).

As the "representative of the estate" with the "capacity to sue and be sued" on its behalf (*see* 11 U.S.C. § 323(a), (b)), the bankruptcy trustee or, by operation of section 1107(a) of the Bankruptcy Code, a chapter 11 debtor-in-possession ("DIP"), has the exclusive authority to assert estate claims and causes of action. *Armetale*, 968 F.3d at 280. Thus, after a debtor files a bankruptcy petition, the debtor's creditors lack authority—sometimes referred to as "standing"—to assert claims that are estate property. *Id.; accord In re Emoral, Inc.*, 740 F.3d 875, 879 (3d Cir. 2014); *Highland Capital Mgmt. LP v. Chesapeake Energy Corp. (In re Seven Seas Petrol., Inc.)*, 522 F.3d 575, 584 (5th Cir. 2008); *Logan v. JKV Real Estate Servs. (In re Bogdan)*, 414 F.3d 507, 511–12 (4th Cir. 2005).

In keeping with 28 U.S.C. § 1334(e), nearly all courts that have considered the question have concluded that the jurisdiction to determine what qualifies as estate property lies exclusively with the bankruptcy court. *See, e.g.*, *Brown v. Fox Broad. Co. (In re Cox)*, 433 B.R. 911, 920 (Bankr. N.D. Ga. 2010) ("It is generally recognized that '[a] proceeding to determine what constitutes property of the estate pursuant to 11 U.S.C. § 541 is a core proceeding under 28 U.S.C. § 157(b)(2)(A) and (E),' and that, '[w]henever there is a dispute regarding whether property is property of the bankruptcy estate, exclusive jurisdiction is in the bankruptcy court.'" (citations omitted)); *accord Gardner v. U.S. (In re Gardner)*, 913 F.2d 1515, 1518 (10th Cir. 1990); *Brown v. Dellinger (In re Brown)*, 734 F.2d 119, 124 (2d Cir. 1984); *Montoya v. Curtis (In re Cashco, Inc.)*, 614 B.R. 715, 722 (Bankr. D.N.M. 2020); *In re DeFlora Lake Dev. Assocs., Inc.*, 571 B.R. 587, 593 (Bankr. S.D.N.Y. 2017); *In re Brown*, 484 B.R. 322, 332 n.2 (Bankr. E.D. Ky. 2012); *Mata v. Eclipse Aerospace, Inc. (In re AE Liquidation, Inc.)*, 435 B.R. 894, 904–05 (Bankr. D. Del. 2010); *Heolena Chem. Co. v. True (In re True)*, 285 B.R. 405, 412 (Bankr. W.D. Mo. 2002); *Manges v. Atlas (In re Duval Cty. Ranch Co.)*, 167 B.R. 848, 849 (Bankr. S.D. Tex. 1994).

However, in the interests of justice or comity with state courts, a bankruptcy court may relinquish its exclusive jurisdiction to make that determination by abstaining under 28 U.S.C. § 1334(c)(1) in deference to another tribunal better suited to adjudicate the issue. *See In re Ament*, 2020 WL 354888, at *4 (Bankr. D.N.M. Jan. 21, 2020) ("Construing § 1334(c)(1) and § 1334(e) together, it is clear that, although the bankruptcy court has exclusive jurisdiction over property of the estate once a petition is filed, the bankruptcy court may choose to abstain from exercising its jurisdiction and modify the stay to allow a state court to divide community property."); *accord In re Maxus Energy Corp.,* 560 B.R. 111, 120 (Bankr. D. Del. 2016); *In re Thorpe*, 546 B.R. 172, 177 (Bankr. C.D. Ill. 2016), *aff'd*, 569 B.R. 310 (C.D. Ill. 2017), *aff'd*, 881 F.3d 536 (7th Cir. 2018).

HAFEN

Several years before filing a chapter 7 case in 2004 in the District of Utah, securities broker-dealer Roy Nielson Hafen ("debtor") operated a Ponzi scheme that defrauded investors. Although the debtor's chapter 7 schedules listed the defrauded investors as creditors and the creditors were notified of the bankruptcy filing, the investors did not file proofs of claim or otherwise participate in the bankruptcy case. The debtor received a bankruptcy discharge in 2004.

Alleging that the debtor had concealed assets, several investors sought to reopen the case 13 years later. Without seeking bankruptcy court authority, the investors also sued the debtor, his wife, and several related entitles in state court seeking to avoid and recover fraudulent transfers and undisclosed assets under state law.

The debtor argued that the causes of action in the state court complaint belonged to his bankruptcy estate and filed a motion in the bankruptcy court to sanction the investors for violating

the discharge injunction under section 524(a) of the Bankruptcy Code. In connection with the hearing on the motion, the debtor and the investors agreed that the state court could decide whether the investors had standing to sue. The debtor's newly appointed chapter 7 trustee did not weigh in on the matter.

The bankruptcy court denied the motion for sanctions and ruled that whether the investors had standing to sue could be decided by the state court. In so ruling, the bankruptcy court relied on the investors' representation that they did not intend to collect any judgment from the debtor but from third parties, which is permitted under section 524(e). The debtor appealed to the BAP.

THE BAP'S RULING

A three-judge panel of the BAP reversed the ruling and remanded the case below.

Writing for the panel, Judge Terrence L. Michael held that the bankruptcy court erred by not deciding whether the investors had "standing" to assert the claims asserted in their complaint. Judge Michael looked to 28 U.S.C. § 1334(e)(1) and the Tenth Circuit's determination in *Gardner* that lawmakers intended "to grant comprehensive jurisdiction to the bankruptcy courts so that they might deal efficiently and expeditiously with all matters connected with the bankruptcy estate" (internal quotation marks and citations omitted). On the basis of these authorities, he wrote that "[t]he jurisdiction to determine what is property of the estate lies exclusively with the bankruptcy court."

Judge Michael explained that the investors' standing to assert fraudulent transfer claims totally depended on whether such claims constituted property of the bankruptcy estate, "an issue over which the Bankruptcy Court has exclusive jurisdiction." If the fraudulent transfer claims were estate property, he wrote, "only the chapter 7 trustee has standing to pursue those claims." According to Judge Michael, standing to pursue assets that were not disclosed in the debtor's bankruptcy filing also hinged on whether the claims belonged to the estate. In both instances, he ruled, the bankruptcy court did not have discretion to allow the state court to resolve the standing question.

The BAP also faulted the bankruptcy court's denial of the debtor's motion to sanction the investors. The bankruptcy court found no violation of the discharge injunction because the investors sought to establish the debtor's liability only so that they could recover any judgment from third parties. According to Judge Michael, if the claims were property of the estate—meaning that the investors lacked standing—"the § 524(e) safe harbor applicable to claims against entities separate from the Debtor may not apply." However, because the evidence did not establish whether the claims were estate property, the BAP remanded the case to the bankruptcy court to "determine whether the causes of action . . . are property of the bankruptcy estate, and, after making that determination, determine whether the Investors had standing to bring those claims."

OUTLOOK

The BAP's analysis of the issues in *Hafen* in terms of "standing" to assert claims belonging to the bankruptcy estate raises an interesting question regarding the confusing nature of "standing" in bankruptcy. "Standing" is the ability to commence litigation in a court of law. It is a threshold issue—a court must determine whether a litigant has the legal capacity to pursue claims before the court can adjudicate the dispute. In bankruptcy cases, the concept most commonly arises in connection with: (i) the right of parties-in-interest (e.g., creditors, shareholders, and committees) to participate in chapter 11 cases; and (ii) the ability of parties other than a bankruptcy trustee or DIP to assert claims or causes of action that may be property of the debtor's bankruptcy estate. This "bankruptcy" or "statutory" standing is distinct from the "constitutional standing" to sue, which is jurisdictional—if a potential litigant lacks constitutional stating, the court lacks jurisdiction to adjudicate the dispute.

The distinction between constitutional and bankruptcy standing was recently examined by the U.S. Court of Appeals for the Third Circuit in *Armetale*, in which the court of appeals held that the ability of a creditor to sue in bankruptcy is not a question of standing but, rather, an issue of statutory authority. The Third Circuit explained that, in accordance with the U.S. Supreme Court's decision in *Lexmark Int'l, Inc. v. Static Control Components, Inc.*, 572 U.S. 118, 125 (2014), constitutional standing has only three elements: (i) there must be "a concrete and particularized injury in fact"; (ii) the injury must be "fairly traceable" to the defendant's conduct; and (iii) "a favorable judicial decision" would likely redress the injury. *Armetale*, 968 F.3d at 291 (citing *Lexmark*, 572 U.S. at 125). Once a plaintiff satisfies those elements, the action "presents a case or controversy that is properly within federal courts' Article III jurisdiction." *Id.*

Guided by *Lexmark* and the Seventh Circuit's ruling in *Grede v. Bank of N.Y. Mellon*, 598 F.3d 899, 900 (7th Cir. 2010), where the court observed that bankruptcy "standing" is doctrinally "abnormal," the Third Circuit concluded in *Armetale* that "a litigant's 'standing' to pursue causes of action that become the estate's property means its statutory authority under the Bankruptcy Code, not its constitutional standing to invoke the federal judicial power." It accordingly ruled that, although a creditor ordinarily would have constitutional standing to pursue a claim belonging to a bankruptcy estate, it may lack statutory authority to assert the claim unless the trustee or DIP has abandoned the claim or the creditor has suffered a direct, particularized injury.

The U.S. Court of Appeals for the Sixth Circuit also recently examined bankruptcy standing in *In re Capital Contracting Co.*, 924 F.3d 890 (6th Cir. 2019). In that case, a law firm withdrew its claim for fees owed by a chapter 7 debtor it had represented in pre-bankruptcy state court litigation as part of a settlement of the chapter 7 trustee's legal malpractice claims against the law firm. After discussing the distinction between bankruptcy and constitutional standing, the Sixth Circuit ruled that the law firm did not have Article III standing to appeal the bankruptcy court's order approving the trustee's final report, based on the report's failure to list the debtor's appellate rights in the state court lawsuit as an asset. According to the Sixth Circuit, the failure to list those rights as an asset could not financially harm the law firm because it had settled with the trustee and withdrawn its fee claim.

NEW YORK DISTRICT COURT EXPANDS THE SCOPE OF THE BANKRUPTCY SAFE HARBOR FOR LBO PAYMENTS

Charles M. Oellermann ■ Mark G. Douglas

In 2019, the U.S. Court of Appeals for the Second Circuit made headlines when it ruled that creditors' state law fraudulent transfer claims arising from the 2007 leveraged buyout ("LBO") of Tribune Co. ("Tribune") were preempted by the safe harbor for certain securities, commodity or forward contract payments set forth in section 546(e) of the Bankruptcy Code. In *In re Tribune Co. Fraudulent Conveyance Litig.*, 946 F.3d 66 (2d Cir. 2019), *petition for cert. filed*, No. 20-8-07102020, 2020 WL 3891501 (U.S. July 6, 2020) ("*Tribune 2*"), the Second Circuit concluded that a debtor may itself qualify as a "financial institution" covered by the safe harbor, and thus avoid the implications of the U.S. Supreme Court's decision in *Merit Mgmt. Grp., LP v. FTI Consulting, Inc.*, 138 S. Ct. 883 (2018), by retaining a bank or trust company as an agent to handle LBO payments, redemptions, and cancellations.

Picking up where the Second Circuit left off, the U.S. Bankruptcy Court for the Southern District of New York held in *Holliday v. K Road Power Management, LLC (In re Boston Generating LLC)*, 617 B.R. 442 (Bankr. S.D.N.Y. 2020), that: (i) section 546(e) preempts intentional fraudulent transfer claims under state law because the intentional fraud exception expressly included in section 546(e) provision applies only to intentional fraudulent transfer claims under federal law; and (ii) 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.

The U.S. District Court for the Southern District of New York joined the *Tribune 2* bandwagon in *In re Nine W. LBO Sec. Litig.*, 2020 WL 5049621 (S.D.N.Y. Aug. 27, 2020), *appeal filed*, 20-3290 (2d Cir. Sept. 25, 2020). The court dismissed $1.1 billion in fraudulent transfer and unjust enrichment claims brought by a chapter 11 plan litigation trustee and an indenture trustee against shareholders, officers, and directors of women's clothing retailer Nine West Holding Inc. ("Nine West"). Citing *Tribune 2*, 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 Nine West's agent. According to the court, "When, as here, a bank is acting as an agent in connection with a securities contract, the customer qualifies as a financial institution with respect to that contract, and all payments in connection with that contract are therefore safe harbored under Section 546(e)."

Further developments on this issue are likely—the U.S. Supreme Court has been asked to review *Tribune 2*, and *Nine West* has been appealed to the Second Circuit.

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, as distinguished from being constructively fraudulent 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:

> [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) (emphasis added). "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.*

In *Deutsche Bank Trust Co. Ams. v. Large Private Beneficial Owners (In re Tribune Co. Fraudulent Conveyance Litig.)*, 818 F.3d 98 (2d Cir. 2016) ("*Tribune 1*"), the U.S. Court of Appeals for the Second Circuit affirmed lower court decisions dismissing creditors' state law constructive fraudulent transfer claims arising from the 2007 LBO of Tribune. According to the Second Circuit, even though section 546(e) expressly provides that "the trustee" may not avoid certain payments under securities contracts unless such payments were made with the actual intent to defraud, section 546(e)'s language, its history, its purposes, and the policies embedded in the securities laws and elsewhere lead to the conclusion that the safe harbor was intended to preempt constructive fraudulent transfer claims asserted by creditors under state law.

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 ruled that the safe harbor applied under those circumstances in *In re Quebecor World (USA) Inc.*, 719 F.3d 94 (2d Cir. 2013). The Supreme Court resolved the circuit split in *Merit*.

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 relevant inquiry is whether the transferor or the transferee in the transaction sought to be avoided overall is itself a financial institution. Because the selling shareholder in the LBO transaction that was challenged in *Merit* as a constructive fraudulent transfer was not 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 shareholder transferee's customer status on the scope of the safe harbor.

In April 2018, the Supreme Court issued an order that, in light of its ruling in *Merit*, the Court would defer consideration of a petition seeking review of *Tribune 1*. The Second Circuit later suspended the effectiveness of *Tribune 1* "in anticipation of further panel review." In a revised opinion issued in

December 2019—*Tribune 2*—the Second Circuit reaffirmed the court's previous decision that the creditors' state law constructive fraudulent transfer claims in that case were preempted by the section 546(e) safe harbor.

The Second Circuit acknowledged that one of the holdings in *Tribune 1* (as well as its previous ruling in *Quebecor*) was abrogated by *Merit*'s pronouncement that the section 546(e) safe harbor does not apply if a financial institution is a mere conduit. However, the court again concluded that section 546(e) barred the creditors' state law avoidance claims, but for a different reason.

The Second Circuit explained that, under *Merit*, the payments to Tribune's shareholders were shielded from avoidance under section 546(e) only if either Tribune, which made the payments, or the shareholders who received them were "covered entities." It then concluded that Tribune was a "financial institution," as defined by section 101(22) of the Bankruptcy Code, and "therefore a covered entity."

According to the Second Circuit, the entity Tribune retained to act as depository in connection with the LBO was a "financial institution" for purposes of section 546(e) because it was a trust company and a bank. Therefore, the court reasoned, Tribune was likewise a financial institution because, under the ordinary meaning of the term as defined by section 101(22), Tribune was the bank's "customer" with respect to the LBO payments, and the bank was Tribune's agent according to the common-law definition of "agency." "Section 546(e)'s language is broad enough under certain circumstances," the Second Circuit wrote, "to cover a bankrupt firm's LBO payments even where, as here, that firm's business was primarily commercial in nature."

In *Boston Generating*, the bankruptcy court dismissed state law intentional and constructive fraudulent transfer claims asserted by a liquidating chapter 11 plan trustee seeking to avoid and recover $1 billion paid to the members of the debtors' holding company as part of a 2006 leveraged recapitalization transaction in the form of unit redemptions, warrant redemptions, and other distributions. The court held that: (i) section 546(e) preempted the state law intentional fraudulent transfer claims because the plain language of the provision excepts only intentional fraudulent transfer claims under federal law; and (ii) the payments were protected from avoidance by the section 546(e) safe harbor because the debtors were "financial institutions," as customers of the banks that acted as the debtors' agents in connection with the recapitalization.

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. The transaction involved the merger of Jones into a new Sycamore subsidiary that was ultimately renamed Nine West Holdings, Inc. ("Nine West"). Transfers made to Jones shareholders, directors, and officers as part of the LBO included: (i) $1.1 billion paid to public shareholders by canceling and converting each share of common stock to the right to receive $15 in cash; (ii) $78 million paid to directors and officers by canceling and converting each of their restricted stock and stock equivalent units to the right to receive $15 in cash; and (iii) $71 million in "change in control" payments to certain directors and officers.

Payments with respect to common stock were made by a paying agent "pursuant to a paying agent agreement in customary form" that empowered the paying agent, among other things, to "act as [Nine West's] special agent for the purpose of distributing the Merger Consideration." Payments with respect to restricted stock, stock equivalent units, and unpaid dividends as well as change-in-control payments "were processed through the payroll and by other means."

Nine West 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 Nine West 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 Nine West noteholders to prosecute state law fraudulent transfer claims.

The litigation trustee sued the public shareholders ("shareholder defendants") and the directors and officers ("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'S RULING

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 Nine West 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).

He rejected the trustees' efforts to distinguish *Tribune 2* on the basis that *Tribune 2* involved payments to public shareholders for the redemption of stock, whereas Nine West's LBO involved the cancellation and conversion of common stock to the right to receive cash. According to Judge Rakoff, the two-step LBO transaction in *Tribune 2* involved the redemption of common stock followed by post-merger cancellation and conversion of the remaining shares to the right to receive cash. Moreover, he explained, 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."

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

Next, guided by *Tribune 2*, Judge Rakoff determined that Nine West's shareholder payments involved a "qualifying participant" because Nine West qualified as a "financial institution" under section 546(e) as a "customer" of an agent bank that was also a financial institution. In addition, he noted that at least 82 of the shareholder defendants independently qualified as "financial institutions" because they were either registered investment companies or commercial banks.

Also in accordance with *Tribune 2*, where the Second Circuit held that section 546(e) impliedly preempts state law fraudulent transfer claims by individual creditors that would be barred by the provision if asserted by a bankruptcy trustee, the *Nine West* district court ruled that the safe harbor preempts both trustees' state law fraudulent transfer claims against the defendants.

Judge Rakoff also concluded that the payments (other than the change-in-control 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 Nine West's agent bank. He reasoned that, because Nine West was a financial institution as a customer of the agent bank, section 546(e) safe-harbors 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) of the Bankruptcy Code. Instead, he opted for the more comprehensive "contract-by-contract" approach, which views the transaction as a whole. This approach, he explained, 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."

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.

OUTLOOK

Several Second Circuit bankruptcy and appellate courts, including the court of appeals, have now ruled that the results of *Merit* might be avoided by structuring transactions so that the target or recapitalized entity is a "customer" of the financial intermediaries involved. Whether this approach holds up to further appellate scrutiny remains to be seen. Both the U.S. Supreme Court and the Second Circuit (again) now have an opportunity to weigh in on the issue.

Two months after the district court handed down its decision in *Nine West*, the U.S. Bankruptcy Court for the Southern District of New York invoked section 546(e) to dismiss a chapter 11 plan litigation trustee's complaint seeking to avoid and recover alleged constructive fraudulent transfers made in 2015 by SunEdison Holdings ("Holdings"), a subsidiary of renewable-energy development company SunEdison, Inc. ("SunEdison"), in connection with the acquisition of a wind and solar power generation project ("project").

Funding for the $350 million project involved: (i) Holdings' formation of a special purpose entity subsidiary ("SPE") that issued secured notes under an indenture among the SPE, SunEdison, as guarantor, and Wilmington Trust, N.A. ("Wilmington"), as collateral agent; (ii) the transfer by Holdings of stock ("Step One Transfer") to the SPE to facilitate the acquisition under a 2014 purchase and sale agreement ("PSA"); and (iii) the SPE's pledge of the stock ("Step Two Transfer") to Wilmington, as collateral agent for the noteholders under a pledge agreement.

Beginning on April 2016, SunEdison, Holdings, and various affiliates filed for chapter 11 protection in the Southern District of New York (the SPE did not file for bankruptcy). In 2017, the bankruptcy court confirmed a chapter 11 plan in for SunEdison, Holdings, and various affiliates. In 2018, the liquidating trustee ("trustee") under the plan sued the SPE and the noteholders (collectively, "defendants") to avoid and recover the Step One Transfer (but not the Step Two Transfer) as a constructive fraudulent transfer under sections 544, 548(a)(1)(B), and 550 of the Bankruptcy Code and New York law. The defendants moved to dismiss, arguing that the section 546(e) safe harbor barred the trustee's constructive fraudulent transfer claims because the transaction included the Step Two Transfer, which was made to a "financial institution" (Wilmington). The trustee responded that he did not seek avoidance of the Step Two Transfer and that, even if Wilmington was a "financial institution," it did not act as the SPE's agent in connection with the Step One Transfer because it did not facilitate the actual transfer of the stock to the SPE.

The court ruled that the safe harbor barred the trustee's constructive fraudulent transfer claims. *See SunEdison Litigation Trust v. Seller Note, LLC (In re SunEdison, Inc.)*, 2020 WL 6395497 (Bankr. S.D.N.Y. Nov. 2, 2020). Under *Merit* and *Boston Generating*, the court explained, the "relevant transfer" in this case was "the overarching transfer"—namely, both the Step One Transfer, which did not involve a "qualifying participant," and the Step Two Transfer, which did, because Wilmington received the pledged stock as collateral for the notes. According to the court, "[t]his was an integrated transaction" because the "Step One Transfer would not have occurred without agreement on the Step Two Transfer as well as the other components of the purchase and sale." Because the 2015 transaction was made to Wilmington, a qualified "financial institution," in connection with the 2014 PSA, a "securities contract," the court ruled that section 546(e) shielded the "component steps" from avoidance as a constructive fraudulent transfer.

Moreover, recent rulings regarding the impact of *Merit* on the scope of section 546(e) safe harbor are not confined to the Second Circuit, and at least one has rejected the *Tribune* "workaround" approach. In *In re Greektown Holdings, LLC,* 2020 WL 6218655 (Bankr. E.D. Mich. Oct. 21, 2020), *reh'g denied*, 2020 WL 6701347 (Bankr. E.D. Mich. Nov. 13, 2020), the U.S. Bankruptcy Court for the Eastern District of Michigan denied a motion for summary judgment filed in avoidance litigation by the recipients of payments made in connection with a pre-bankruptcy recapitalization transaction that involved the issuance of unsecured notes underwritten by a financial institution and payment of a portion of the proceeds to the defendants. Citing *Merit*, the defendants argued that the transfer was safe-harbored because the transaction was undertaken "for the benefit of" the underwriter, which acted as the debtor-transferor's agent, thereby making the transferor a financial institution as the underwriter's customer.

The court rejected this argument, ruling that the transaction fell outside the section 546(e) safe harbor because: (i) neither the transferor nor the transferees were financial institutions in their own right; (ii) the defendants failed to establish that the transaction was "for the benefit" of the underwriter financial institution by showing that it "received a direct, ascertainable, and quantifiable benefit corresponding in value to the payments"; and (iii) the evidence did not show that the underwriter was acting as either the transferor's agent or custodian in connection with the transaction, such that the transferor itself could be deemed a financial institution. Notably, the court was "not persuaded by the agency analysis in [*Tribune 2*] as it does not distinguish between mere intermediaries contracted for the purpose of effectuating a transaction and agents who are authorized to act on behalf of their customers in such transactions." Under *Tribune 2*, the court wrote, "any intermediary hired to effectuate a transaction would qualify as its customer's agent [, which] . . . would result in a complete workaround of [*Merit*]."

FIRST IMPRESSIONS: TENTH CIRCUIT BAP RULES THAT SECTION 364 OF THE BANKRUPTCY CODE DOES NOT APPLY TO CHAPTER 11 EXIT FINANCING

Daniel J. Merrett ■ Mark G. Douglas

The ability of a bankruptcy trustee or chapter 11 debtor-in-possession ("DIP") to obtain credit or financing during the course of a bankruptcy case is often crucial to the debtor's prospects for either maintaining operations pending the development of a confirmable plan of reorganization or facilitating an orderly liquidation designed to maximize asset values for the benefit of all stakeholders. In a chapter 11 case, financing (and/or cash infusions through recapitalization) also is often a key component of the reorganized debtor's ability to operate post-bankruptcy. Section 364 of the Bankruptcy Code includes provisions specifically governing the circumstances under which a trustee or DIP can obtain credit or financing, including secured financing that primes existing secured creditors' liens, during a bankruptcy case. It is unclear, however, whether those provisions apply to post-confirmation exit financing.

A Tenth Circuit bankruptcy appellate panel ("BAP") recently addressed this question as a matter of first impression in *GPIF Aspen Club LLC v. Aspen Club Spa LLC (In re Aspen Club Spa LLC)*, 2020 WL 4251761 (B.A.P. 10th Cir. July 24, 2020). The divided panel ruled that section 364(d)(1) of the Bankruptcy Code could not be used to approve chapter 11 plan exit financing that primed the liens of an existing secured lender and remanded the case to the bankruptcy court to determine whether the cram-down plan provided the primed lender with the "indubitable equivalent" of its secured claim. The majority also held that, in a single asset real estate ("SARE") case, a bankruptcy court must always decide whether a plan has a reasonable possibility of confirmation within a reasonable time when ruling on a motion to modify the automatic stay if the debtor is not making payments to the creditor seeking stay relief.

OBTAINING CREDIT AND FINANCING IN BANKRUPTCY

Section 364(a) of the Bankruptcy Code provides that a "trustee . . . authorized to operate the business of the debtor" may obtain unsecured credit or incur unsecured debt in the ordinary course of business and that the resulting claims will be treated as administrative expenses. In addition, the bankruptcy court may authorize the trustee to obtain non-ordinary course unsecured credit or financing with administrative expense priority. *See* 11 U.S.C. § 364(b).

If unsecured credit or financing is unavailable, the court, after notice and a hearing, may authorize the trustee to obtain: (i) unsecured credit or financing with "super-priority" over other administrative expenses; or (ii) credit or financing secured by a lien on unencumbered "property of the estate," a junior lien on already encumbered estate property, a lien on already encumbered estate property equal in priority to existing liens, or a "priming" lien on already encumbered estate property, as long as the existing lien holder is provided with "adequate protection." *See* 11 U.S.C. § 364(c) and (d). A DIP is granted the same ability to obtain credit or financing in accordance with section 1107(a) of the Bankruptcy Code.

CRAM-DOWN OF SECURED CLAIMS IN BANKRUPTCY

Section 1129(a) of the Bankruptcy Code requires, among other things, that for a chapter 11 plan to be confirmable, each class of claims or interests must either accept the plan or not be impaired. *See* 11 U.S.C. § 1129(a)(8). However, confirmation is possible in the absence of acceptance by impaired classes under section 1129(b) if all of the other plan requirements are satisfied and the plan "does not discriminate unfairly" and is "fair and equitable" with respect to each class of claims or interests that is impaired under, and has not accepted, the plan.

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

The Bankruptcy Code does not define the term "indubitable equivalent," which, in addition to section 1129(b)(2)(iii), appears in section 361(3) of the Bankruptcy Code as an alternative form of "adequate protection" of a creditor's interest in property ("adequate protection may be provided by . . . granting such other relief . . . as will result in the realization by such entity of the indubitable equivalent of such entity's interest in such property"). It has been defined as "the unquestionable value of a lender's secured interest in the collateral." *In re Philadelphia Newspapers, LLC*, 599 F.3d 298, 310 (3d Cir. 2010); *accord In re Sparks*, 171 B.R. 860, 866 (Bankr. N.D. Ill. 1994) (a plan provides the indubitable equivalent of a claim to the creditor where it "(1) provides the creditor with the present value of its claim, and (2) insures the safety of its principle [sic]"); *see generally* COLLIER ON BANKRUPTCY ("COLLIER") ¶¶ 361.03[4] and 1129.04[2][c][i] (16th ed. 2020) (discussing the derivation of the concept from *In re Murel Holding Corp.*, 75 F.2d 941 (2d Cir. 1935), and explaining that "abandonment, or unqualified transfer of the collateral, to the secured creditor," substitute collateral, and the retention of liens with modified loan terms have been deemed to provide the "indubitable equivalent").

ASPEN CLUB

Aspen Club & Spa, LLC and Aspen Redevelopment Company, LLC (collectively, "debtors") own real property in downtown Aspen, Colorado, on which they have been developing luxury residential condominiums and a fitness club and spa since 2015. Construction halted after the lender that provided $30 million in construction financing refused to make additional advances. The original lender then assigned the loan, which was secured by the real property and had increased to $34 million, to GPIF Aspen Club, LLC ("GPIF"). The debtors filed SARE chapter 11 cases in the District of Colorado in May 2019.

The bankruptcy court authorized the debtors to obtain up to $4.2 million in DIP financing from EFO Financial Group, LLC ("EFO"), secured by a priming lien on the property senior to approximately $25 million in mechanics' liens and the lien securing GPIF's $34 million claim. In approving the financing, the court found that, solely for the purpose of the financing motion, the property was worth no less than "the ninety to one hundred million-dollar range," compared to estimated prepetition secured claims totaling approximately $67 million.

The debtors filed a joint chapter 11 plan shortly before the expiration of the 90-day period applicable to SARE debtors under section 362(d)(3). One of the plan's stated conditions to confirmation was that the court shall have entered an order under sections 364(c) and 364(d)(1) approving $140 million in super-priority exit financing provided by EFO to the "Debtors and Reorganized Debtors" secured by a lien senior to all existing liens other than mechanics' liens. The plan proposed to pay all mechanics' lien claims in full. It provided that GPIF's secured claim would be paid over a period of years from a certain portion of the anticipated sale proceeds of living units constructed on the property.

The debtors separately filed a motion seeking approval of the exit financing, to which GPIF objected. GPIF also filed a motion for relief from the automatic stay, arguing that: (i) as specified in section 362(d)(3), the plan "did not have a reasonable possibility of being confirmed with a reasonable time" and was patently unconfirmable because it was based on nonconsensual priming-lien exit financing, which cannot be approved under section 364 or state law; and (ii) "the proposed exit financing could not be crammed down" because the plan did not provide either that GPIF would retain its lien under section 1129(b)(2)(a)(i) or that GPIF would receive the indubitable equivalent of its secured claim under section 1129(b)(a)(iii).

The bankruptcy court acknowledged that whether the proposed exit financing could be approved was a "threshold issue" because the debtors' plan would fail without it. The court also noted that there is no binding precedent from either the U.S. Supreme Court or the Tenth Circuit Court of Appeals regarding whether exit financing can be approved under section 364(d)(1). For that reason, the bankruptcy court determined that it was not yet prepared to decide the issue and concluded that the debtors therefore were not, "as a matter of law, precluded from seeking an exit financing facility . . . pursuant to 11 U.S.C. § 364(d)(1).»

The court then denied GPIF's stay relief motion, finding that: (i) the debtors had equity in the property exceeding the

$95 million in debt secured by it; and (ii) foreclosure by GPIF would benefit only itself and the mechanics' lienors rather than the entire creditor body. The court also suggested that GPIF's secured claim could be crammed down by providing GPIF with adequate protection amounting to the indubitable equivalent of its claim. Finally, the bankruptcy court extended the periods during which the debtors had the exclusive right to propose and seek acceptances for a plan.

GPIF appealed the ruling to the BAP.

THE BANKRUPTCY APPELLATE PANEL'S DECISION

A divided BAP reversed. According to the majority, the bankruptcy court erred by basing its denial of stay relief on the existence of equity in the property, rather than a finding that the debtors had a reasonable possibility of confirming a plan within a reasonable time, as required by section 362(d)(3) in a SARE bankruptcy case. To make that finding, the majority explained, the bankruptcy court was obligated to rule on the debtors' motion to approve the priming-lien exit financing.

Instead of remanding the case below for the bankruptcy court to make this determination, however, the BAP majority "exercised its discretion to consider" the issue because it had been fully briefed and argued by the parties, the issue was one of law impacting confirmation, "and plan confirmation potentially could moot a later appeal of whether exit priming lien financing is permitted under § 364, §§ 1123 and 1129, or both.»

It was not clear from the record whether the exit financing would take effect before or after the effective date of the debtors' plan, and the court addressed both possibilities. Because section 364 uses the terms "trustee" and "property of the estate," the BAP majority reasoned that any exit financing incurred by the reorganized debtors after the collateral was no longer estate property could not be approved under the provision as a matter of law. For support, it cited three bankruptcy court rulings that purportedly reached the same conclusion. *See In re SAI Holdings, Ltd.*, 2012 WL 3201893 (Bankr. N.D. Ohio Aug. 3 , 2012); *In re Les Ruggles & Sons, Inc.*, 222 B.R. 344 (Bankr. D. Neb. 1998); *In re Hickey Props., Ltd.*, 181 B.R. 173 (Bankr. D. Vt. 1995); *see generally* COLLIER at ¶ 364.05[3] (discussing cases).

The BAP majority characterized as "less clear" whether section 364(d) would apply if the bankruptcy court granted the debtors' exit financing motion prior to confirmation of the plan (while the collateral securing the priming liens was still estate property) and the exit loan was funded after confirmation—i.e., "hybrid" exit financing that "straddles confirmation." The majority concluded, however, that the debtors could not rely on the provision to obtain priming-lien exit financing under these circumstances either:

> Section 364 is designed to provide a mechanism for the trustee or debtor-in-possession to obtain credit to finance the operation of the business or to fund the cost of administering the bankruptcy case, not to finance post-confirmation operations after the property of the estate has vested in the reorganized debtor.

But this did not end the analysis. The BAP majority went on to hold that the debtors could obtain priming lien exit financing: (i) as a means of implementing their chapter 11 plan by satisfying or modifying a lien pursuant to section 1123(a)(5)(E) of the Bankruptcy Code; and (ii) by providing the dissenting secured creditor whose lien was being modified—GPIF—with the indubitable equivalent of its claim under section 1129(b)(2)(A)(iii).

The bankruptcy court had not determined the value of GPIF's collateral for purposes of anything other than the initial DIP loan. For this reason, the BAP majority held that it could not determine whether the plan (including the proposed priming-lien exit financing) provided GPIF with the indubitable equivalent of its claim. It accordingly remanded the case to the bankruptcy court to make this determination as part of its finding under section 362(d)(3) that, in the absence of a final determination of the section 364(d) issue, there was a reasonable possibility that the debtors' plan could be confirmed within a reasonable time.

In a "vehement" dissent, Bankruptcy Judge Terrence L. Michael stated that he would have affirmed the bankruptcy court's decision. In his view, the bankruptcy court "acted reasonably and prudently" by moving the case toward confirmation and making a decision about indubitable equivalence at the confirmation hearing. "That's what we do," he wrote.

According to Judge Michael, the bankruptcy court appropriately exercised its discretion not to decide the 364(d) issue in the context of the stay relief motion, and the BAP majority consequently abused its own discretion by deciding the question as a matter of first impression even though it had not been ruled on by the bankruptcy court or in any decision at the circuit court level. He also noted that a close reading of the cases cited by the BAP majority for the proposition that section 364 cannot be used to obtain financing that survives confirmation reveals that they are conclusory, distinguishable, and establish no "bright-line rule" against exit financing.

OUTLOOK

Exit financing is a routine feature of chapter 11 plans, and many courts have approved such financing under section 364 without actually ruling on whether the provision applies in that context.

See, e.g., *In re XS Ranch Fund VI, L.P.*, 2018 WL 2448084, at *2 (Bankr. N.D. Cal. Mar. 26, 2018) (noting that "[t]he Debtor and Crestline have negotiated the terms and conditions of Exit Financing loan documents and this Order in good faith and at arm's-length, and any loans made to the Debtor pursuant to the Plan or this Order shall be, and hereby are, deemed to have been made in 'good faith' within the meaning of Section 364(e) of the Bankruptcy Code"); *In re Starbrite Properties Corp.*, 2012 WL 2050745, at *2 (Bankr. E.D.N.Y. June 5, 2012) ("The Debtor also secured, with the Court's authorization, exit financing in the amount of $3,850,000 (the "Exit Loan") from Madison Acquisition Group II LLC ("Madison"). The Confirmation Order specifically approved the Exit Loan under section 364(e) of the Bankruptcy Code."); *In re Panolam Holdings Co.*, 2009 WL 7226968, at *5 (Bankr. D. Del. Dec. 10, 2009) (approving exit financing under sections 364 and 1123(a)(5) as a necessary means of implementing a chapter 11 plan and finding that lender was entitled to the protections of section 364(e) as a good faith lender); *In re U.S. Mineral Prod. Co.*, 2005 WL 5887218, at *2 (Bankr. D. Del. Nov. 29, 2005) (approving secured exit loan financing provided by a DIP lender to consummate a chapter 11 plan and "for general working capital purposes of the Reorganized Debtor").

Given the uncertainty highlighted by the courts in *Aspen Club* as to whether section 364 governs post-reorganization exit financing, however, the better approach may be to rely on a bankruptcy court's power to approve a chapter 11 plan that includes exit financing as a permitted means of implementation. *See In re City of Detroit*, 524 B.R. 147, 276 (Bankr. E.D. Mich. 2014) (ruling that, although section 364 does not apply to post-confirmation exit financing, such financing was, among other things, necessary and appropriate to implement a chapter 9 plan under section 1123(a)(5) (made applicable to chapter 9 cases under section 901(a)), and the financing was not inconsistent with any other provisions of the Bankruptcy Code under section 1123(b)(6)). This approach obviates the need to obtain approval of exit financing prior to confirmation when there is still a DIP or trustee and while any collateral securing such financing is still property of the estate.

Finally, it should be noted that, in discussing "hybrid" exit financing that "straddles confirmation," the BAP in *Aspen Club* referred to "confirmation" consistent with section 1141(b) of the Bankruptcy Code, which provides that confirmation of a chapter 11 plan vests property of the estate in the debtor "[e]xcept as otherwise provided in the plan or the order confirming the plan." However, chapter 11 plans and confirmation orders commonly provide that such plans take effect in the future in accordance with their terms. In such a case, the court presumably would intend for its analysis to reference hybrid exit financing that straddles the effective date of any such plan, not its mere confirmation.

TENTH CIRCUIT: BANKRUPTCY TRUSTEE MAY RECOVER ONLY THE ACTUAL PROPERTY (NOT PROCEEDS) FRAUDULENTLY TRANSFERRED TO SUBSEQUENT TRANSFEREES

Dan T. Moss ▪ Mark G. Douglas

The ability of a bankruptcy trustee to avoid certain transfers of a debtor's property and to recover the property or its value from the transferees is an essential tool in maximizing the value of a bankruptcy estate for the benefit of all stakeholders. However, a ruling recently handed down by the U.S. Court of Appeals for the Tenth Circuit could, if followed by other courts, curtail a trustee's avoidance and recovery powers. In *Rajala v. Spencer Fane LLP (In re Generation Resources Holding Co.)*, 964 F.3d 958 (10th Cir. 2020), *reh'g denied*, No. 19-3226 (10th Cir. Aug. 24, 2020), the Tenth Circuit held that, according to the plain language of section 550(a) of the Bankruptcy Code, a recipient of proceeds traceable to fraudulently transferred property does not qualify as a "transferee" because the recipient does not possess the fraudulently transferred property itself.

POST-AVOIDANCE RECOVERY OF PROPERTY OR ITS VALUE IN BANKRUPTCY

If a bankruptcy trustee, a chapter 11 debtor-in-possession ("DIP"), or, in some cases, an individual debtor (*see* 11 U.S.C. § 522(i)) avoids a transfer of the debtor's property under any of the avoidance provisions of the Bankruptcy Code, section 550 provides that, with certain restrictions, the trustee, DIP, or debtor may recover the transferred property or its value from the initial transferee, and from any subsequent transferee that does not take the transfer for value, in good faith and without knowledge of the transfer's voidability. It states in part as follows:

(a) Except as otherwise provided in this section, to the extent that a transfer is avoided under section 544, 545, 547, 548, 549, 553(b), or 724(a) of this title, the trustee may recover, for the benefit of the estate, the property transferred, or, if the court so orders, the value of such property, from—
  (1) the initial transferee of such transfer or the entity for whose benefit such transfer was made; or
  (2) any immediate or mediate transferee of such initial transferee.

(b) The trustee may not recover under section (a)(2) . . . from—
  (1) a transferee that takes for value, including satisfaction or securing of a present or antecedent debt, in good faith, and without knowledge of the voidability of the transfer avoided; or
  (2) any immediate or mediate good faith transferee of such transferee.

11 U.S.C. § 550.

The Bankruptcy Code does not define the terms "initial transferee," "immediate transferee," and "mediate transferee." Any entity that receives a transfer of property directly from the debtor is generally deemed to be the initial transferee. However, many courts have concluded that a party acting as a mere conduit in connection with a transfer from the debtor to a third party is not a "transferee" and, therefore, not the initial transferee. *See, e.g., Lamonica v. Harrah's Atlantic City Operating Co., LLC (In re JVJ Pharmacy Inc.)*, 2020 WL 4251666, at *9 (Bankr. S.D.N.Y. July 24, 2020) (citing and discussing cases); *see generally* COLLIER ON BANKRUPTCY ("COLLIER") ¶ 550.02[4][a] (16th ed. 2020) (same). Section 550(a)'s distinction between initial transferees and immediate and mediate transferees of the initial transferee is important. The protections of section 550(b) are given only to those subsequent transferees. *Id.*

Finally, the court may authorize recovery of the value of property transferred rather than the property itself. The Bankruptcy Code is silent as to the circumstances under which this may be warranted. In keeping with the intent of section 550 to restore the estate to the financial condition it would have enjoyed if the transfer had not occurred, courts exercising their broad discretion in this context consider several factors, including whether the property can be recovered, whether it has diminished in value due to depreciation or conversion, whether the value of the property is disputed, and whether a monetary award would result in a savings to the estate. *See* COLLIER at ¶ 550.02[3].

GENERATION RESOURCES

Generation Resources Holding Company, LLC ("GR") developed three wind power projects in Pennsylvania. The projects were to be sold to Edison Capital ("Edison"), which agreed to construct the projects pursuant to a memorandum of understanding. After it became clear that GR was on the brink of insolvency, GR insiders created two other companies—Lookout Windpower Holding Company, LLC ("Lookout") and Forward Windpower Holding Company, LLC ("Forward")—to assume GR's development rights for the wind projects. Edison later agreed to pay $13 million for the projects to Lookout and Forward instead of GR.

After defaulting on its debts, GR filed a chapter 7 petition in the District of Kansas on April 28, 2008.

In December 2008, Lookout hired the law firm Husch Blackwell LLP ("Husch") to sue Edison for the balance due on the wind power projects. In April 2009, GR's chapter 7 trustee informed Husch that the claims against Edison involved funds that belonged to GR's estate. Shortly afterward, Husch sued Edison on Lookout's behalf in federal district court.

After denying the trustee's motion to enjoin the litigation, the district court entered a $9 million judgment in May 2011 against Edison in Lookout's favor. The district court then transferred enforcement of the judgment to the bankruptcy court to determine whether the judgment was property of GR's bankruptcy estate. Edison deposited funds to cover the judgment in the bankruptcy court's registry.

Another law firm—Spencer Fane LLP ("Spencer")—appeared on behalf of Lookout and Forward in GR's bankruptcy case and successfully petitioned the court for an order determining that the $9 million judgment was not property of GR's bankruptcy estate because the trustee had not yet commenced litigation on his fraudulent transfer claims. The court distributed the proceeds of the judgment to Lookout in May 2012. After the trustee unsuccessfully attempted to enjoin dissipation of the funds, Lookout ultimately distributed the proceeds during the next four years to several different recipients, including Spencer, which received approximately $723,000 in legal fees, and Husch, which received approximately $1.3 million in fees.

The trustee subsequently brought fraudulent transfer claims against the GR insiders, Lookout, and Forward. The bankruptcy court entered summary judgment in favor of the defendants, but the Tenth Circuit reversed on appeal (in a separate case). In May 2017, the chapter 7 trustee settled the fraudulent transfer litigation against the GR insiders, Lookout, and Forward. The bankruptcy court entered a consent judgment avoiding the transfers of GR's development rights and empowering the trustee to recover approximately $11.5 million from Lookout and Forward.

Unable to collect from Lookout and Forward, the trustee commenced an adversary proceeding in March 2018 against Spencer and Husch, seeking to recover under section 550 the more than $2 million in fees paid to the two law firms. The bankruptcy court denied the firms' motion to dismiss the complaint, holding that the defendants were transferees of proceeds derived from the fraudulent transfer claims. The bankruptcy court certified a direct appeal of its ruling to the Tenth Circuit.

THE TENTH CIRCUIT'S RULING

The Tenth Circuit reversed, ruling that the trustee could not recover the fees paid to Spencer and Husch because they were not "transferees" within the meaning of section 550(a). Examining the plain language of section 550(a), the Tenth Circuit concluded that the law firms were not transferees of the fraudulently transferred property—GR's contractual right to receive the sale proceeds from Edison—and consequently did not fall within the ambit of section 550(a). The Tenth Circuit explained that there was no evidence that GR transferred the right to receive sale proceeds to Spencer and Husch. Therefore, the court wrote, "neither firm is a transferee of the property that was set aside as fraudulently transferred."

The Tenth Circuit rejected the chapter 7 trustee's argument that, because section 550(a) permits recovery of "the property transferred, or, if the court so orders, the value of such property," he had the right to recover proceeds from the fraudulent transfer as the "value" of the fraudulently transferred property. Even if the bankruptcy court had ordered recovery of the value of the

transferred property, the Tenth Circuit reasoned, the chapter 7 trustee could not recover under section 550(a) because "the firms [were] not transferees" of the property that was fraudulently transferred.

According to the chapter 7 trustee, because section 541(a)(6) of the Bankruptcy Code provides that property of the estate includes the "proceeds" of estate property, the "property transferred" under section 550(a) should similarly include the proceeds of that property. The Tenth Circuit rejected this argument as being contrary to the plain language of section 550(a), "which permits the trustee to recover certain property from a limited group of persons." Because Spencer and Husch were not transferees of the fraudulently transferred property (i.e., the right to proceeds from the wind projects sale), "nothing about § 541›s definition of property expands the trustee›s powers under § 550 to recover from persons who are not transferees.»

The Tenth Circuit further noted that the chapter 7 trustee's argument was inconsistent with the "structure" of section 541. Although section 541(a)(6) provides that proceeds of estate property are property of the estate, section 541(a)(3) provides that "[a]ny interest in property that the trustee recovers under section . . . 550" is estate property. The Tenth Circuit noted that "if proceeds were available under § 550, there would be no reason to list them separately in § 541.» And, «[t]he fact that the Code treats ‹[p]roceeds› as distinct from ‹property that the trustee recovers› under § 550 is strong evidence that the two species of property are different, at least in some respects.»

Finally, the Tenth Circuit observed that lawmakers evidently knew how to include proceeds in the scope of section 550(a), yet declined to do so:

> § 541 demonstrates that when Congress intended to include proceeds, it knew how to do so. Section 550 allows the trustee to follow the property fraudulently transferred and recover it, or its value. And it permits the trustee to recover only from transferees of the property. If its intent was to provide the trustee the power to trace proceeds derived from the property against any person who received those proceeds as payment for goods or services, Congress could have said so.

POSSIBLE IMPLICATIONS

According to the Tenth Circuit's interpretation of section 550(a), if a debtor fraudulently transfers a contract claim to an entity that converts the contract claim to cash and thereafter transfers the cash to a subsequent transferee, the trustee cannot recover the payments to the subsequent transferee because it did not receive the fraudulently transferred property (i.e., the contract claim). This could be the case even if the subsequent transferee knew that the initial transfer was fraudulent.

Whether or not this is an accurate construction of section 550(a) is an open question. Although the Tenth Circuit did not cite any authority in support of its decision, such cases exist, including one discussed by the bankruptcy court in *Generation Resources*. In *Lassman v. Santosuosso (In re Ruthaford)*, 2015 WL 1510566, at *12 (Bankr. D. Mass. Mar. 30, 2015), a chapter 7 trustee argued that transfers of real property from debtor to a person who subsequently sold the property to a good faith buyer were avoidable under section 544 and state fraudulent transfer law. The trustee sought to recover some of the proceeds of the real property under section 550(a)(2) from two defendants—an attorney and a law firm—to whom the real property itself had never been transferred. The court held that the defendants were entitled to summary judgment, reasoning:

> Section 550(a) does not extend the right of recovery to the proceeds of the property transferred. Where the drafters of the Bankruptcy Code meant to include proceeds, they were clear about it. *See* 11 U.S.C. §§ 541(a)(6) (property of the estate includes proceeds of property of the estate) and 552(b)(1) (extending certain prepetition security interests to postpetition proceeds). I conclude . . . that § 550(a) permits a trustee to recover that property, or its value, only from transferees of that property.

2015 WL 1510566, at *12; *see also In re Air Conditioning, Inc. of Stuart*, 845 F.2d 293, 299 (11th Cir. 1988) ("The district court, in fact, did not allow the trustee to recover the proceeds of the letter of credit (as LSC characterizes the district court's judgment). Instead, the district court correctly allowed the trustee to recover from LSC the property transferred: the certificate of deposit.").

However, this view is at odds with the approach applied by courts in a number of other cases. *See, e.g.*, *In re Wolf*, 595 B.R. 735, 788 (Bankr. N.D. Ill. 2018) ("Scott Wolf, SHBM, Hound Ventures, and Michael Wolf, as alleged, are subsequent (mediate or immediate) transferees of the proceeds, products, or profits of the allegedly fraudulently transferred property (the MMQB business). The value of the MMQB business may be recovered from ZZC as an initial transferee and from Scott Wolf and MMQB, Inc. as subsequent transferees."); *In re Fehrs*, 391 B.R. 53, 76 (Bankr. D. Idaho 2008) ("The initial transferee, Jae, sold the Terrill

Loop Property to the Johansens, converting that real property interest to cash. He then allowed all the cash proceeds (with the exception of $200.00) to be retained by Debtor, who became an 'immediate or mediate' transferee. . . . Trustee adequately traced the proceeds of sale into her hands, and established that the same represented 'the value of such property' under § 550(a)."); *see also In re Richmond Produce Co., Inc.*, 118 B.R. 753, 756–57 (Bankr. N.D. Cal. 1990) ("To be an ultimate transferee [for purposes of section 550(a)], one must receive the fraudulently transferred property or, at a minimum, its proceeds."); *In re Morris Commc'ns NC Inc.*, 75 B.R. 619, 629 (Bankr. W.D.N.C. 1987) ("The clear legislative intent of [sections 548 and 550] is that the fraudulently transferred property and all proceeds and profits derived therefrom should be returned to the trustee subject only to certain specific liens in favor of a good faith transferee."), *rev'd on other grounds*, 914 F.2d 458 (4th Cir. 1990).

The Tenth Circuit's ruling has also been criticized by leading commentators. *See, e.g.*, Bruce A. Markell, *Where Does the Flame Go When the Candle Is Blown Out, or Why Can't Courts Grasp the Concept of Intangibles?*, 40 BANKR. L. LETTER 1 (2020) (contending that the Tenth Circuit "got it wrong" in *Generation Resources*).

Moreover, the Tenth Circuit's approach is arguably inconsistent with the purpose of section 550. *See In re Fabric Buys of Jericho, Inc.*, 33 B.R. 334, 336–37 (Bankr. S.D.N.Y. 1983) ("Section 550 provides the Trustee with greater flexibility to recover preferences when the actual transferee of its assets may have disappeared at the direction of another entity. . . . By passing section 550, Congress hoped to preclude multiple transfers or convoluted business transactions from frustrating the recovery of avoidable transfers."). Indeed, it is logical that section 550 brings all of the debtor's property—including the proceeds thereof—into the estate because, "'property of the debtor' is best understood to mean property that would have been part of the estate had it not been transferred." *Begier v. IRS*, 496 U.S. 53, 59 (1990).

While superficially appealing—and textually precise—the holding in *Generation Resources* may severely impair the ability of bankruptcy trustees in avoidance litigation to recover property or its value from subsequent transferees. Indeed, nefarious parties could immunize a transferee from liability by orchestrating a conversion of the fraudulently transferred property to cash that is then transferred to the intended recipient. To the extent this is the case, the Tenth Circuit's ruling is a startling development in fraudulent transfer law, which generally recognizes that property of the debtor subject to avoidance is property that would have been property of the estate had it not been transferred, which includes the proceeds of such property. This approach is in keeping with the court's power to authorize recovery of the "value" of the property. Further, the defenses available under section 550(b) to subsequent transferees—i.e., good faith recipients—should be adequate to maintain the balance between the estate's recovery of fraudulently transferred property and a good faith subsequent transferee's right to retain such property.

POSTSCRIPT

One bankruptcy court in another circuit already also parted ways with the Tenth Circuit's approach in *Generation Resources*, writing that the decision creates "perverse incentives" for the initial transferee to liquidate the property to make the proceeds "unrecoverable." In *In re Giant Gray, Inc.*, 2020 WL 6226298 (Bankr. S.D. Tex. Oct. 22, 2020), the CEO of a financially distressed software company secretly arranged for the company to issue to him convertible preferred stock, which he sold for $15 million that otherwise would have been paid to the company. He claimed that he gave adequate consideration for the stock by agreeing to take on the additional role of chairman. The CEO transferred approximately $5 million of the proceeds to subsequent transferees.

After creditors filed an involuntary chapter 7 case against the company, the chapter 7 trustee sued the subsequent transferees to avoid and recover the $5 million as a fraudulent transfer under the Texas Uniform Fraudulent Transfer Act and sections 544 and 550(a)(2) of the Bankruptcy Code. The defendants moved to dismiss. They argued that, in accordance with *Generation Resources*, they were not subsequent transferees subject to avoidance liability because they received proceeds from the preferred stock, not the stock itself.

The bankruptcy court acknowledged that *Generation Resources* "is the only circuit-level case directly on point." Even so, after examining the language of section 550, the court concluded that, although the initial transferee must have received a transfer of the property, "that same restriction is not placed on immediate and mediate transferees." If *Generation Resources* were correct, the court explained, a subsequent transferee could take proceeds with knowledge of the fraud and still escape liability. "That result," it wrote, "fails to consider Section 550(a) in context . . . [and] [t]he complete defense set forth in Section 550(b) adequately protects those who were not privy to the initial transferee's wrongdoing." The court ultimately denied the motion to dismiss, observing that the approach taken in *Generation Resources* does not "square with the Bankruptcy Code's policy of maximizing the estate for all creditors."

LEGISLATIVE UPDATE: NEW DUTCH RESTRUCTURING LAW ENACTED

Jasper Berkenbosch ▪ Erik Schuurs ▪ Sid Pepels

On October 6, 2020, the Dutch Senate approved long-anticipated restructuring legislation allowing for court confirmation of extrajudicial restructuring plans (*Wet Homologatie Onderhands Akkoord*, or "WHOA").

The legislation combines features of the U.S. chapter 11 procedure and the English Scheme of Arrangement. With its broad range of jurisdiction and flexibility, the "Dutch Scheme" should prove to be an effective addition to the restructuring toolbox for both Dutch and non-Dutch entities and for groups of companies, with the possibility of automatic recognition throughout the European Union. The new proceeding can be used to restructure both Dutch companies with a "center of main interest" in the Netherlands as well as non-Dutch companies with a sufficient nexus with the Netherlands (e.g., by means of significant group activities in the country). It is considered a last-resort pre-insolvency restructuring tool with limited court supervision.

Previously, Dutch law did not provide a mechanism for imposing a restructuring plan on dissenting creditors outside of formal insolvency proceedings. As a result, a restructuring plan required the consent of all creditors and shareholders whose rights were affected by the plan. This made restructurings outside of formal insolvency proceedings very difficult and provided stakeholders with ample opportunity to monetize on nuisance value.

With the enactment of the Dutch Scheme, the Dutch legislature's intent is to allow debtors to propose restructuring plans to their creditors and shareholders outside of formal insolvency proceedings, with the prospect of the debtor being preserved on a going-concern basis. The Dutch Scheme is also intended to (partially) implement the EU-wide initiative to promote "debtor-in-possession" restructuring, as recently formalized in the EU Harmonisation Directive (EU 2019/1023), which requires EU Member States to include such proceedings in the their national legislation.

Key features of the Dutch Scheme include:

- **Restructuring Plan**: Debtors or a court-appointed restructuring expert will be permitted to propose a restructuring plan for approval by creditors (secured, preferential, and unsecured) and shareholders.
- **Voting Threshold**: Stakeholders may be split into voting classes divided on the basis of the similarity of their rights vis-à-vis the debtor. The restructuring plan must be approved by a two-thirds majority of each voting class, with the possibility of requesting a cross-class "cram down" under certain circumstances.
- **Debtor-in-Possession Proceeding**: The debtor remains in control of the company's affairs throughout a Dutch Scheme proceeding.
- **Stay of Individual Enforcement Actions**: Debtors will be permitted to apply for a stay of individual enforcement actions (including bankruptcy petitions) for a period of four months (extendable to a total of eight months in certain cases).
- **Broad Basis for Jurisdiction and Group Restructurings**: Subject to certain qualifying criteria, the Dutch courts will have jurisdiction to confirm restructuring plans for both Dutch and non-Dutch companies, allowing for cross-border group restructurings to be centralized in the Netherlands.
- **Trade Creditor Protections**: Dissenting trade creditors of small enterprises can prevent the adoption of a restructuring plan if they do not receive a distribution under the plan equal to at least 20% of their claims.
- **Treatment of Secured Creditors**: A secured creditor's claim will be bifurcated into a secured claim, to the extent of the value of any collateral, and an unsecured claim for the deficiency, and the secured and unsecured claims must be classified separately in a plan for voting purposes. Secured financial creditors are excepted from the obligation to offer dissenting creditors that are part of a dissenting class a cash distribution under the plan that is equal to the amount that they would have received in a bankruptcy scenario. Instead, it is sufficient to offer such a secured financial creditor any distribution other than stock.

NEWSWORTHY

Jones Day received a National Tier 1 ranking for its "Bankruptcy and Creditor Debtor Rights/Insolvency and Reorganization Law" and "Litigation-Bankruptcy" practices in the 2021 *U.S. News–Best Lawyers®* "Best Law Firms" list published jointly by *U.S. News and World Report* and *Best Lawyers®*.

Ben Larkin ***(London)***, ***Kay Morley*** ***(London)***, and ***Sion Richards*** ***(London)*** were named "Leaders in Their Field" for Restructuring/Insolvency by *Chambers UK* 2021.

Corinne Ball ***(New York)*** received the 2020 Lifetime Achievement Award from the *New York Law Journal* for making "an impact on the legal community and the practice of law over an entire career." The *NYLJ* featured the 2020 recipients in its *Professional Excellence Magazine*. Ms. Ball has nearly 40 years of experience in business finance and restructuring, with a focus on complex corporate reorganizations and distressed acquisitions. She co-leads the New York Office of Jones Day's Business Restructuring & Reorganization Practice and leads the Firm's European Distress Investing and Alternative Capital Initiatives. She also leads the Firm's distressed M&A efforts and is the featured "Distress M&A" columnist for the *NYLJ*.

Ben Larkin ***(London)*** was named to the *Legal 500* Hall of Fame in the 2021 edition of *The Legal 500 United Kingdom* guide in the practice area "Finance–Corporate restructuring and insolvency."

Corinne Ball ***(New York)***, ***Todd R. Geremia*** ***(New York; Issues & Appeals)***, ***Ben Rosenblum*** ***(New York)***, ***Andrew M. Butler*** ***(New York)***, and ***Benjamin J. Thomson*** ***(New York)*** are representing the Roman Catholic Diocese of Rockville Centre, New York, in connection with its October 1, 2020, chapter 11 filing in the U.S. Bankruptcy Court for the Southern District of New York.

An article written by ***Mark G. Douglas*** ***(New York)*** titled "Oversecured Creditor's Right to Contractual Default-Rate Interest Allowed Under State Law" was posted on the September 29, 2020, *Harvard Law School Bankruptcy Roundtable*.

An article written by ***Daniel J. Merrett*** ***(Atlanta)*** and ***Mark G. Douglas*** ***(New York)*** titled "Another Bankruptcy Court Rules that a Traded Claim Can Be Disallowed if the Seller Received a Voidable Transfer" was published in the November 6, 2020, edition of the *International Law Office Newsletter*.

An article written by ***Mark G. Douglas*** ***(New York)*** titled "Cram-Up Chapter 11 Plans: Reinstatement and Indubitable Equivalence" was published in the October 23, 2020, edition of the *International Law Office Newsletter*.

An article written by ***Dan T. Moss*** ***(Washington)*** and ***Mark G. Douglas*** ***(New York)*** titled "Creditors' Committee Denied Standing to Bring Derivative Claims on Behalf of LLC Debtor in Bankruptcy" was published in the October 30, 2020, edition of the *International Law Office Newsletter*.

An article written by ***Paul M. Green*** ***(Houston)*** and ***Mark G. Douglas*** ***(New York)*** titled "Secured Creditor's 'Net Economic Damages' Estimate of Disputed Claims 'Plainly Insufficient' to Establish Collateral Value" was posted on the September 8, 2020, *Harvard Law School Bankruptcy Roundtable*.

An article written by ***Corinne Ball*** ***(New York)*** titled "Bankruptcy Court Denies Proposed DIP Financing Despite Entire Fairness of Process and Price" was published in the October 21, 2020, edition of the *New York Law Journal*.

An article written by ***Charles M. Oellermann*** ***(Columbus)*** and ***Mark G. Douglas*** ***(New York)*** titled "Flip-Clause Payments to Lehman Brothers Noteholders After Termination of Swap Agreement Safe Harboured in Bankruptcy" was published in the October 16, 2020, edition of the *International Law Office Newsletter*.

An article written by ***Timothy Hoffmann*** ***(Chicago)*** and ***Mark G. Douglas*** ***(New York)*** titled "Assets May Be Sold in Bankruptcy Free and Clear of Successor Liability" was published in the September 4, 2020, edition of the *International Law Office Newsletter*.

BUSINESS RESTRUCTURING REVIEW

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