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COURT'S BROAD INTERPRETATION OF DEFINITION OF "SECURITIES CONTRACTS" PROMOTES EXPANSIVE SCOPE OF BANKRUPTCY CODE "SAFE HARBOR"

Daniel J. Merrett • Mark G. Douglas

Section 546(e) of the Bankruptcy Code's "safe harbor" preventing avoidance in bankruptcy of certain securities, commodity, or forward-contract payments has long been a magnet for controversy. Several noteworthy court rulings have been issued in bankruptcy cases addressing the application of the provision, including application to financial institutions, its preemptive scope, and its application to non-publicly traded securities.

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

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 transfer falling under the subsection's terms unless the transfer was made with actual intent to hinder, delay, or defraud creditors under section 548(a)(1)(A), as distinguished from constructively fraudulent transfers under

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section 548(A)(1)(B), where the debtor is insolvent at the time of the transfer (or becomes insolvent as a consequence) and receives less than reasonably equivalent value in exchange.

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

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

11 U.S.C. § 101(22). "Customer" and "securities contract" are defined broadly in sections 741(2) and 741(7) of the Bankruptcy Code, respectively. Sections 101(51A) and 741(8) define the term "settlement payment."

According to the legislative history of section 546(e), the purpose of the safe harbor 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.*

NOTABLE COURT RULINGS

Many notable court rulings have addressed: (i) whether section 546(e) preempts fraudulent transfer claims that can be asserted by or on behalf of creditors by a bankruptcy trustee under state law; (ii) whether the section 546(e) safe harbor insulates from avoidance only transactions involving publicly traded securities; and (iii) whether a "financial institution" must be the transferor or ultimate transferee, as distinguished from an intermediary or conduit, for a transaction to be insulated from avoidance under the safe harbor.

Preemption. 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 Co. ("Tribune"). According to the Second Circuit, even though section 546(e) expressly provides that "the trustee" may not avoid certain

LAWYER SPOTLIGHT: KATHRYN SUTHERLAND-SMITH

Kathryn Sutherland-Smith, of counsel in the Sydney and Melbourne offices, is an experienced insolvency and restructuring lawyer who has practiced law in Australia and in the United States. Kathryn strives to provide clients with innovative commercial solutions but is also adept working in contentious and litigious situations. Over the past decade, Kathryn has structured and implemented multibillion-dollar global reorganizations through schemes of arrangement, external administrations, and proceedings under chapters 11 and 15 of the U.S. Bankruptcy Code. She also has handled complex insolvency litigation and represented debtors and creditors in an array of out-of-court restructuring matters, including distressed M&A deals, capital markets transactions, and refinancings.

Kathryn works with private credit institutions, ad hoc creditor groups, companies experiencing financial distress, and external administrators. Her experience covers an array of industries including energy and resources, aviation, transport and logistics, real estate, financial services, and digital assets.

Highlights of Kathryn's company-side experience prior to joining Jones Day include representing: Hertz in its US$19 billion global restructuring; Swissport, the world's leading provider of airport ground services and air cargo handling, on its €1.9 billion recapitalization; and Constellation, a Brazilian offshore drilling operator, in its US$1.5 billion cross-border restructurings.

Recent creditor-side representations include advising an ad hoc group of bondholders holding more than US$630 million of unsecured bonds in the chapter 11 case of LATAM Airlines, and a U.S. private credit fund in connection with the distressed acquisition of Australian corporate and superannuation trustee Sargon Capital.

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.

Other courts have applied this rationale in finding preemption of state intentional and constructive fraudulent transfer laws by the safe harbor. *See, e.g.*, *Holliday, Liquidating Trustee of the BosGen Liq. Trust v. Credit Suisse Secs. (USA) LLC*, 2021 WL 4150523 (S.D.N.Y. Sept. 13, 2021) ("*Boston Generating*") (section 546(e) preempts intentional fraudulent transfer claims under state law because the intentional fraud exception expressly included in the provision applies only to intentional fraudulent transfer claims under federal law), *appeals filed,* Nos. 21-2543 *et al.* (2d Cir. Oct. 8, 2021) (argued on Sept. 28, 2022); *In re Nine West LBO Sec. Litig.*, 482 F. Supp. 3d 187 (S.D.N.Y. 2020) (the safe harbor preempts state law fraudulent transfer claims), *appeal filed*, No. 20-3290 (2d Cir. Sept. 25, 2020) (argued on Nov. 23, 2020).

Transactions Involving Publicly and Privately Traded Securities. Because section 546(e) is silent as to whether it applies to transactions involving publicly or privately traded securities, some courts, finding the language of the provision to be ambiguous and looking to its legislative history for guidance, have concluded that the safe harbor is limited to transactions involving publicly traded securities. *See, e.g., Kipperman v. Circle Trust F.B.O. (In re Grafton Partners, L.P.*), 321 B.R. 527, 539 (B.A.P. 9th Cir. 2005) (finding that section 546(e) places a "line between public transactions that involve the clearance and settlement process and nonpublic transactions that do not involve that process"); *Kapila v. Espirito Santo Bank (In re Bankest Capital Corp.)*, 374 B.R. 333, 346 (Bankr. S.D. Fla. 2007) (section 546(e) is inapplicable where the "case did not involve the utilization of public markets or publicly traded securities").

Other courts have disagreed, concluding that section 546(e) is not on its face limited to transactions involving publicly traded securities, and that resort to the provision's legislative history is therefore unwarranted. *See, e.g., Brandt v. B.A. Capital Co. L.P. (In re Plassein Int'l Corp.)*, 590 F.3d 252 (3d Cir. 2009) (finding that the plain meaning of section 546(e) is clear and holding that the provision is not limited to publicly traded securities but also extends to transactions involving privately held securities), *cert. denied*, 559 U.S. 1093 (2010); *In re QSI Holdings, Inc.*, 571 F.3d 545, 550 (6th Cir. 2009) ("[W]e hold that nothing in the text of § 546(e) precludes its application to settlement payments involving privately-held securities.»), abrogated in part on other grounds by *Merit Management Group, LP v. FTI Consulting, Inc.*, 138 S.Ct. 883 (2018); *Contemporary Indus. Corp. v. Frost*, 564 F.3d 981 (8th Cir. 2009) (section 546(e) is not limited to publicly traded securities transactions and protects from avoidance a debtor's payments deposited in a national bank in exchange for its shareholders' privately held stock during an LBO); *Quebecor*, 719 F.3d at 98-99 (ruling that the safe harbor applied to insulate from avoidance a repurchase transaction for private-placement notes that involved payments to a noteholder trustee that was a "financial institution"); *In re Taylor, Bean & Whitaker Mortgage Corp.*, 2017 WL 4736682, *9 (M.D. Fla. Mar. 14, 2017) ("[I]f Congress wanted § 546(e) to apply to only non-private transactions, it has the constitutional authority to rewrite the statute. The judiciary, however, does not."); *In re Lancelot Investors Fund, L.P.*, 467 B.R. 643, 655 (N.D. Ill. 2012) (section 546(e) "does not limit its protection to transactions made on public exchanges").

Financial Institution as Transferor or Transferee. Prior to the Supreme Court's 2018 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. *See generally* COLLIER ON BANKRUPTCY ¶ 546.06[2] n.16 (16th ed. 2023) (listing cases). For example, 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) did not protect a transfer made as part of a non-public stock sale transaction through a "financial institution," 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* 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. *Merit*, 138 S.Ct at 890 n.2. The selling shareholder in *Merit* was a customer of one of the conduit banks, yet never raised the argument that it therefore also qualified as a financial institution for purposes of section 546(e). For this reason, the Court did not address the possible impact of the selling shareholder's customer status on the scope of the safe harbor.

The Second Circuit quickly filled that void. In *In re Tribune Co. Fraudulent Conveyance Litig.*, 946 F.3d 66 (2d Cir. 2019), *dismissing cert. in part*, 141 S. Ct. 728 (2020), *cert. denied*, 141 S. Ct. 2552 (2021) ("*Tribune 2*"), 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." *Tribune 2*, 946 F.3d at 91; *see also Kelley as Tr. of PCI Liquidating Tr. v. Safe Harbor Managed Acct. 101, Ltd.*, 31 F.4th 1058, 1065 (8th Cir. 2022) (noting that "we do not disagree" with *Tribune 2*'s "basic assumption" that the customer of a financial institution may itself qualify as a financial institution for purposes of the section 546(e) safe harbor if it meets the definition of "financial institution" set forth in section 101(22)(A) of the Bankruptcy Code).

Several bankruptcy and district courts in the Second Circuit picked up where the Second Circuit left off in *Tribune 2*, ruling that pre-bankruptcy recapitalization or LBO transactions were safe-harbored from avoidance as fraudulent transfers because they were effected through a bank or other qualifying "financial institution." *See, e.g., Boston Generating*, 2021 WL 4150523, at *6 (payments made to the members of LLC debtors as part of a pre-bankruptcy recapitalization transaction were protected from avoidance under section 546(e) because the debtors were "financial institutions," as customers of banks that acted as their depositories and agents in connection with the transaction); *Nine West*, 482 F. Supp. 3d at 206 (dismissing fraudulent transfer and unjust enrichment claims brought by a chapter 11 plan litigation trustee and an indenture trustee seeking to avoid payments made as part of an LBO, and ruling that the payments were protected by the safe harbor because they were made by a bank acting as the debtor's agent); *SunEdison Litigation Trust v. Seller Note, LLC (In re SunEdison, Inc.)*, 620 B.R. 505, 515 (Bankr. S.D.N.Y. 2020) (noting that, under *Merit*, the "relevant transfer" was "the overarching transfer," and ruling that, because one step of an "integrated transaction" was effected through a qualified financial institution, section 546(e) shielded the "component steps" from avoidance as a constructive fraudulent transfer); *see also In re Tops Holding II Corp.*, 646 B.R. 617 (Bankr. S.D.N.Y. 2022) (the safe harbor did not insulate a transaction whereby, after encumbering the assets of a privately held chapter 11 debtor with privately issued debt, certain private equity investors took massive dividends, because, although the proceeds of the private notes were intended to be deposited into the bank accounts of the debtors and the private equity investors, the parties' banks were not agents or custodians (as was the case in *Tribune 2*), and therefore were not qualifying recipients for purposes of section 546(e)), *leave to appeal denied*, 2023 WL 119445 (S.D.N.Y. Jan. 6, 2023).

However, at least one court has criticized the *Tribune 2* "workaround" approach. *See In re Greektown Holdings, LLC*, 621 B.R. 797, 827 (Bankr. E.D. Mich. 2020) (ruling that a pre-bankruptcy recapitalization transaction fell outside the scope of the safe harbor where neither the transferor nor the transferees were financial institutions and the underwriter did not act as the transferor's agent in connection with the transaction, and noting that, under *Tribune 2*, "any intermediary hired to effectuate a transaction would qualify as its customer's agent [, which] . . . would result in a complete workaround of [*Merit*]"), *reh'g denied*, 2020 WL 6701347 (Bankr. E.D. Mich. Nov. 13, 2020).

BMO HARRIS

In March 2019, creditors filed an involuntary chapter 7 petition against BWGS, LLC (the "debtor"), a distributor of agricultural equipment and supplies, in the Southern District of Indiana. After the bankruptcy court entered an order for relief, the chapter 7 trustee filed an adversary proceeding against BMO Harris Bank, N.A. ("BMO") and Sun Capital Partners, VI, L.P. ("Sun Capital" and collectively, the "defendants"). In his complaint, the trustee sought to avoid as constructively fraudulent under Indiana law and section 544(b) of the Bankruptcy Code approximately $25 million transferred by the debtor in January 2017 to BMO to repay a bridge loan made to a Sun Capital affiliate created in 2016 to acquire the debtor's non-publicly traded stock from an employee stock ownership plan trust (the "ESOP Trust") for $37.75 million.

Although the debtor was not liable on the bridge loan, which was guaranteed by Sun Capital, the debtor borrowed funds from another bank one month after the acquisition was completed to pay off the bridge loan. The debtor pledged its assets as security for repayment of the second loan.

Because the transfer occurred more than two years before the bankruptcy filing, the chapter 7 trustee could not seek avoidance under section 548 of the Bankruptcy Code. Instead, the trustee invoked section 544(b) to step into the shoes of an actual creditor for the purpose of suing BMO and Sun Capital to avoid the constructively fraudulent transfer under Indiana law. The trustee alleged that the $25 million transfer to pay off the bridge loan was made "to or for the benefit" of Sun Capital and BMO and that the debtor received no consideration for encumbering its property.

The defendants moved to dismiss the trustee's complaint. They argued that the litigation was barred by the section 546(e) safe harbor because the bridge loan repayment was made in connection with several securities contracts, including the stock purchase agreement between the Sun Capital affiliate and the ESOP Trust, the bridge loan from BMO (a "financial institution"), and the Sun Capital guarantee. The trustee countered that section 546(e) applies only to transactions "that implicate systemic risks in the national clearance and settlement system for trades of publicly-held securities," not private LBO transactions.

The bankruptcy court denied the defendants' motion to dismiss. *See Petr v. BMO Harris Bank N.A. (In re BWGS LLC)*, 643 B.R. 576 (Bankr. S.D. Ind. 2022), *rev'd and remanded*, 2023 WL 3203113 (S.D. Ind. May 2, 2023). According to the bankruptcy court, the section 546(e) safe harbor did not apply because the trustee's complaint sought avoidance of the constructively fraudulent transfer under section 544(b), rather than section 548. The court also found that the safe harbor did not apply because the stock sold by the ESOP Trust was not publicly traded, so that avoiding the transfer would not pose any systemic risk to the financial markets. In addition, because there was a one-month gap between the closing of the LBO and the bridge loan repayment, the bankruptcy court concluded that the two transactions were separate for purposes of section 546(e).

The bankruptcy court authorized the defendants' interlocutory appeal to the district court.

THE DISTRICT COURT'S RULING

The district court reversed and remanded the case to the bankruptcy court.

According to U.S. District Court Judge Jane Magnus-Stinson, the bankruptcy court erred by: (i) limiting its analysis to whether the stock purchase agreement, as distinguished from all of the related agreements, was a "securities contract" for purposes of the safe harbor; and (ii) concluding that the safe harbor was not implicated because the debtor's stock was not publicly traded. Instead, she explained, the court should have examined whether all of the related agreements were securities contracts, as defined in section 741(7), in determining whether the relevant transactions were within the scope of section 546(e).

"Based on the plain and unambiguous language in Section 546(e)," Judge Magnus-Stinson concluded that the stock-purchase agreement, the bridge loan, and the Sun Capital guarantee were all covered by the safe harbor because they were entered into "in connection with a securities contract." *BMO Harris*, 2023 WL 3203113, at *5. She explained that all three agreements fell within the definition of a "securities contract" because: (i) the stock purchase agreement was the transaction by which the Sun Capital affiliate acquired the debtor's stock from the ESOP trust, and the agreement constituted "a contract for the purchase . . . of a security," as specified in section 741(7); (ii) the bridge loan was made by BMO to the Sun Capital affiliate to provide part of the $37.75 million stock purchase price, and the loan was an "extension of credit for the clearance or settlement of [a] securities transaction[ ]," or an "agreement . . . that is similar to an agreement or transaction" referred to in section 741(7); and (iii) by the Sun Capital guarantee, Sun Capital provided a credit enhancement to BMO with respect to the bridge loan, and the guarantee was accordingly an "arrangement or other credit enhancement related to any agreement or transaction referred to in [§ 741(7)], including any guarantee . . . to a . . . financial institution . . . in connection with any agreement or transaction referred to in [§ 741(7)]." *Id.*

The district court also faulted the bankruptcy court's determination that the safe harbor was inapplicable because the bridge loan was repaid one month after the LBO. According to Judge Magnus-Stinson, although the Seventh Circuit has not addressed the issue, the phrase "in connection with a securities contract" in section 546(e) should be read broadly to mean "related to" a securities contract. She wrote that "the Transfer was made in connection with the Stock Purchase Agreement because it was made to pay off the Bridge Loan that was used to close the Stock Purchase Agreement." *Id.* at *7.

The district court then ruled that the bankruptcy court erroneously concluded, based on the legislative history of section 546(e), that the safe harbor applies only to transactions involving publicly traded securities. According to Judge Magnus-Stinson:

> Nowhere in § 546(e) is a distinction drawn between a transaction that implicates publicly traded securities versus one that implicates privately held securities. Instead, as discussed above, § 546(e) refers to the definition of "securities contract" in § 741(7), which similarly does not distinguish between publicly or privately held securities. The fact that the definition of "securities contract" appears in another section of the Bankruptcy Code is of no moment—indeed statutes frequently refer to other statutes in order to define included terms.

Id. at *9. She also noted that her conclusion is consistent with the rulings of "numerous" courts, including the Sixth and Eighth Circuits in *QSI Holdings* and *Contemporary Industries*, respectively. *Id.*

Finally, citing *Tribune 1*, the district court ruled that the trustee's state constructive fraudulent transfer claims under section 544(b) and Indiana law were preempted by section 546(e).

The district court accordingly reversed the bankruptcy court's ruling and remanded the case below with instructions to dismiss the suit.

OUTLOOK

The section 546(e) safe harbor has produced a wealth of notable court rulings in recent years, and *BMO Harris* adds to that body of case law. Moreover, further developments on this issue are likely. Even though the U.S. Supreme Court declined to review *Tribune 2* in 2021, *BMO Harris* has been appealed to the Seventh Circuit, which has another opportunity (after the affirmance of its ruling in *Merit*) to weigh in on how broadly or narrowly the safe harbor should be construed. Briefing in the case was completed in September 2023. In addition, appeals of the decisions in *Boston Generating* and *Nine West* have been pending for years before the Second Circuit.

TEXAS BANKRUPTCY COURT BLESSES SERTA CHAPTER 11 PLAN OVER OBJECTIONS OF LENDERS EXCLUDED FROM "POSITION ENHANCEMENT TRANSACTION"

Oliver Zeltner • Mark G. Douglas

On June 6, 2023, the U.S. Bankruptcy Court for the Southern District of Texas confirmed the chapter 11 plan of bedding manufacturer Serta Simmons Bedding, LLC and its affiliates (collectively, "Serta"). In confirming Serta's plan, the court held that a 2020 "uptier," or "position enhancement," transaction (the "2020 Transaction") whereby Serta issued new debt secured by a priming lien on its assets and purchased its existing debt from participating lenders at a discount with a portion of the proceeds did not violate the terms of Serta's 2016 credit agreement.

The court also determined that: (i) the plan's nonconsensual exculpation provision was overly broad because it covered Serta's independent directors and managers, but was approved as amended to remedy this defect; (ii) the plan did not impermissibly indemnify lenders that participated in the 2020 Transaction; and (iii) distribution under the plan of $1.5 million to existing equity holders without paying in full the claims of non-participating lenders did not violate the "absolute priority rule" because equity provided "new value" in exchange. See *In re Serta Simmons Bedding, LLC*, 2023 WL 3855820 (Bankr. S.D. Tex. June 6, 2023), *notice of appeal filed*, No. 23-90020 (Bankr. S.D. Tex. June 6, 2023), *stay pending appeal denied*, No. 23-90020 (Bankr. S.D. Tex. June 21, 2023), *stay pending appeal denied*, No. 4:23-cv-2173 (S.D. Tex. June 29, 2023), *direct appeals certified*, No. 23-90026 (5th Cir. Sept. 18, 2023).

SERTA SIMMONS

In November 2016, Serta entered into three credit facilities providing for $1.95 billion in first-lien term loans, $450 million in second-lien term loans, and a $225 million asset-based revolving loan. The credit agreement governing the loans (the "2016 Credit Agreement"), which the court characterized as a "loose" document because it gave Serta a great deal of flexibility to engage in liability management transactions, provided as follows with respect to assignment of the debt to "Affiliated Lenders" and Serta:

> Notwithstanding anything to the contrary contained herein, any Lender may, at any time, assign all or a portion of its rights and obligations under this Agreement in respect of its Term Loans to any Affiliated Lender on a non-pro rata basis (A) ***through Dutch Auctions open to all Lenders holding the relevant Term Loans on a pro rata basis or (B) through open market purchases***, in each case with respect to clauses (A) and (B), without the consent of the Administrative Agent[.]

Serta Simmons, 2023 WL 3855820, at *2 (quoting 2016 Credit Agreement § 9.05(g)) (emphasis added). Therefore, the 2016 Credit Agreement expressly allowed Serta to repurchase its debt on a non-pro rata basis by means of open-market purchases involving fewer than all of the lenders.

Section 2.18 of the Credit Agreement provided that pro rata sharing did not apply to "any payment obtained by any Lender as consideration for the assignment of or sale of a participation in any of its Loans to any permitted assignee or participant, including any payment made or deemed made in connection with Section 2.22, 2.23, 9.02(c) and/or Section 9.05." *Id.* (quoting 2016 Credit Agreement § 2.18).

Amendments to the 2016 Credit Agreement could be freely made with the consent of only a simple majority of the lenders, unless the amendment involved a "sacred right." Sacred rights, however, were subject to an exception for any purchase of debt under section 9.05(g):

> [T]he consent of each Lender directly and adversely affected thereby (but not the consent of the Required Lenders) shall be required for any waiver, amendment or modification that: . . . waives, amends or modifies the provisions of Sections 2.18(b) or (c) of this Agreement in a manner that would by its terms alter the pro rata sharing of payments required thereby *(except in connection with any transaction permitted under Sections 2.22, 2.23, 9.02(c) and/or 9.05(g) or as otherwise provided in this Section 9.02).*

Id. (quoting 2016 Credit Agreement § 9.02(b)(A)(6)) (emphasis added).

After Serta began experiencing financial challenges (even prior to the pandemic), it began "to evaluate both liquidity enhancement alternatives and liability management alternatives designed to capture, discount, or otherwise manage [its] liabilities." *Id.* at *3. In connection with Serta's discussions with its lenders, two lender groups—the "PTL Lenders" and the "Objecting Lenders"—emerged with competing offers to address Serta's ongoing liquidity and financing problems. The Objecting Lenders, in fact, had acquired the majority of their debt holdings with the anticipation of entering into a position enhancement transaction with Serta that would exclude the PTL Lenders.

Serta ultimately elected to pursue the proposal offered by the PTL Lenders, which was consummated in the 2020 Transaction. The 2020 Transaction provided for the creation of a priority tranche of debt consisting of: (i) $200 million in new financing provided by the PTL Lenders; and (ii) $875 million in exchanged loans, with the first-lien loans exchanged at 74% and the second-lien loans exchanged at 39%. The Objecting Lenders were not invited to participate in the 2020 Transaction.

In June 2020, the Objecting Lenders, all of which were first-lien lenders, sued in New York state court to enjoin the 2020 Transaction. The state court denied the injunction based on the

plaintiffs' failure to establish a likelihood of success on the merits. The Objecting Lenders filed a second suit in New York state court in 2022, seeking the same relief.

Armed with a restructuring support agreement supported by a majority of its lenders, Serta filed for chapter 11 protection on January 23, 2023, in the Southern District of Texas. Serta proposed a chapter 11 plan that, as later amended, provided for: (i) reduction of Serta's debt from $1.9 billion to $315 million by means of a debt-for-equity swap; (ii) new exit financing to be provided by the PTL Lenders in exchange for a "basket of consideration" that included indemnification by the reorganized Serta against any liability arising from the 2020 Transaction; (iii) payment of general unsecured claims in full; (iv) partial payment of certain other unsecured claims; and (iv) a $1.5 million payment to existing equity holders as consideration for the preservation of certain tax attributes. Serta's unsecured creditors' committee supported the amended plan as part of a global settlement with Serta.

The day after Serta filed for bankruptcy, the lead debtor and the PTL Lenders commenced an adversary proceeding against the Objecting Lenders seeking a determination that the 2020 Transaction was permitted by the 2016 Credit Agreement, and that the PTL Lenders did not violate the implied covenant of good faith and fair dealing under the 2016 Credit Agreement by entering into the 2020 Transaction. The Objecting Lenders asserted counterclaims and third-party claims seeking both a determination that the 2020 Transaction violated the 2016 Credit Agreement and money damages for the plaintiffs' alleged violations of the 2016 Credit Agreement's implied covenant of good faith and fair dealing. The parties filed competing motions for summary judgment.

In March 2023, the bankruptcy court awarded partial summary judgment to the PTL Lenders, holding that the term "open market purchase" in section 9.05(g) of the 2016 Credit Agreement was unambiguous, and that the 2020 Transaction constituted a permitted "open market purchase" under that section. The Fifth Circuit granted the Objecting Lenders' motion for a direct appeal of that order. *See Excluded Lenders v. Serta Simmons Bedding, L.L.C.*, No. 23-90012 (5th Cir. Apr. 26, 2023). Briefing on the appeal had not been completed as of September 1, 2023.

While the appeal was pending, the bankruptcy court consolidated its consideration of confirmation of Serta's plan with the disposition of certain issues remaining in the adversary proceeding.

THE BANKRUPTCY COURT'S RULING

U.S. Bankruptcy Judge David R. Jones confirmed Serta's chapter 11 plan and overruled any objections that had not been resolved.

The Objecting Lenders opposed the plan and raised two objections. First, the Objecting Lenders argued that, by including an indemnity by the debtors in favor of the PTL Lenders for any liability related to the 2020 Transaction, the plan violated sections 502(e)(1)(B) and 509(c) of the Bankruptcy Code. *Serta Simmons*, 2023 WL 3855820, at *10. This argument was based on the Objecting Lenders' contention that the indemnity provision was a continuation of a substantially similar indemnity the debtors granted to the PTL lenders prepetition, rather than a new indemnity arising from a settlement in bankruptcy between the debtors and the PTL Lenders. *Id.* Second, the Objecting Lenders argued that the plan violated the absolute priority rule by providing for a $1.5 million payment to holders of equity interests while the Objecting Lenders' claims were not being paid in full. *Id.*

Judge Jones began his opinion by noting that the Objecting Lenders misconstrued Serta's plan in arguing that the plan violated sections 502(e)(1)(B) and 509(c) of the Bankruptcy Code by allowing Serta's prepetition indemnity of the PTL Lenders "to pass through the Plan unaffected." *Id.* He explained that the indemnification provision in the plan was new—it replaced a previous indemnification provision that expired upon Serta's bankruptcy filing. Moreover, Judge Jones emphasized, given the PTL Lenders' agreement to equitize nearly $1 billion in debt and provide exit financing, the new indemnity was a sound exercise of Serta's business judgment and represented a settlement that was fair, equitable and in the best interests of Serta's estate. He characterized as "irrelevant" the fact that Serta's decision "interfere[d] with the Objecting Lender's litigation strategy." *Id.*

Next, the bankruptcy court ruled that the $1.5 million to be paid under the plan to existing equity holders did not violate the absolute priority rule because Serta agreed to make the payment in exchange for "new value" in the form of a $54 million tax benefit held by equity. This decision too, Judge Jones noted, was a decision "in the range of reasonable business judgment." *Id.* at *11.

Addressing the adversary proceeding, the bankruptcy court stated that "based on the overwhelming evidence adduced at trial, the 2020 Transaction was the result of good-faith, arm's length negotiations by economic actors acting in accordance with the duties owed to their respective creditors, investors and owners." In addition, Judge Jones determined, "the 2020 Transaction is binding and enforceable in all respects." *Id.* at *12.

According to Judge Jones, the evidence adduced at the trial undeniably demonstrated that: (i) the parties were "keenly" aware that the 2016 Agreement was a "loose document," and the Objecting Lenders understood what that entailed when they acquired the majority of their claims long after the debt was originally issued; (ii) there was no evidence of an improper motive on the part of Serta or the PTL Lenders, which, unlike the Objecting Lenders, acted "defensively and in good faith"; and (iii) neither Serta nor the PTL Lenders breached the 2016 Credit Agreement by entering into the 2020 Transaction. *Id.* at *13.

According to the bankruptcy court, the harsh result for the Objecting Lenders was entirely foreseeable and avoidable:

> The parties could have easily avoided this entire situation with the addition of a sentence or two to the 2016 Credit Agreement. They did not. And this litigation ends with each party receiving the bargain they struck—not the one they hoped to get. . . .
>
> [Position enhancement transactions] may or may not be a good thing. Lender exposure to these types of transactions can be easily minimized with careful drafting of lending documents. While the result may seem harsh, there is no equity to achieve in this case. Sophisticated financial titans engaged in a winner-take-all battle. There was a winner and a loser. Such an outcome was not only foreseeable, it is the only correct result. The risk of loss is a check on unrestrained behavior.

Id. at **13-14.

Because the Objecting Lenders questioned the bankruptcy court's constitutional authority to enter either a final order on plan confirmation or a final judgment in the adversary proceeding, the court directed the parties to submit proposed findings of fact and conclusions of law that could be recommended to the district court in the event of an appeal.

Finally, Judge Jones found that "cause" existed to shorten the 14-day stay of the confirmation order specified in Fed. R. Bankr. P. 3020(e) to seven days, and stated that he was prepared to conduct an expedited hearing to consider any motion to stay the confirmation order pending an appeal and establish an appropriate bond.

OUTLOOK

Shortly after the bankruptcy court confirmed Serta's plan, the Objecting Lenders and creditor Citadel Equity Fund Ltd. ("Citadel") (collectively, the "Appellants") appealed the confirmation order to the district court and sought a stay of effectiveness of the plan. On June 21, 2023, the bankruptcy court denied the Appellants' motion for an emergency stay of the confirmation order pending appeal. On June 29, 2023, the U.S. District Court for the Southern District of Texas denied substantially similar motions for a stay pending appeal filed by the Objecting Lenders and Citadel. Immediately afterward, Serta announced that its chapter 11 plan had become effective, bolstering its argument that any appeal of the confirmation order will be equitably moot. As noted previously, the Fifth Circuit has already agreed to hear an appeal of the bankruptcy court's partial summary judgment ruling issued in the adversary proceeding. In addition, on September 18, 2023, the Fifth Circuit agreed to hear direct appeals of the confirmation order. As such, there are likely to be additional developments regarding this issue.

"Creditor on creditor violence" in the form of uptier transactions, whereby a borrower and certain of its existing lenders alter the repayment or lien priority of a portion of an existing loan to the detriment of other lenders, have featured prominently in recent headlines. Further developments regarding this contentious issue are likely, both from the appellate court(s) in *Serta* and from other courts, principally because the exponential growth of the $1.3 trillion leveraged U.S. loan market during the last decade has coincided with the loosening of loan covenants, including financial covenants and typical contract provisions obligating lenders to be repaid and otherwise treated on a pro-rata basis.

CIRCUIT SPLIT WIDENS ON EXTENT OF ABROGATION OF SOVEREIGN IMMUNITY FOR GOVERNMENTAL UNITS IN BANKRUPTCY AVOIDANCE LITIGATION

Dan B. Prieto • Mark G. Douglas

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

The federal circuit courts of appeals (and many lower courts) are split regarding whether the abrogation of sovereign immunity by governmental units with respect to avoidance actions commenced under section 544(b) also extends to the causes of action arising under applicable nonbankruptcy law that a "triggering" or "predicate" creditor would be precluded from asserting outside of bankruptcy due to sovereign immunity. The U.S. Court of Appeals for the Tenth Circuit weighed in on this debate as a matter of first impression in *U.S. v. Miller*, 71 F.4th 1247 (10th Cir. 2023). Expanding what had been a 2–1 majority in the circuit courts on this issue, the Tenth Circuit ruled that the abrogation of sovereign immunity in section 106(a) permitted a chapter 7 trustee to sue the Internal Revenue Service to avoid and recover a fraudulent transfer under section 544(b)(1), even though an eligible existing creditor could not have sued the IRS outside of bankruptcy.

WAIVER OF SOVEREIGN IMMUNITY IN THE BANKRUPTCY CODE

Pursuant to the federal system created by the U.S. Constitution, each state is a sovereign entity. In addition, both federal and state governmental bodies have sovereign immunity from suit unless that immunity has been abrogated by Congress, waived by the governmental body, or eliminated by a specific provision of the Constitution itself. *See generally* COLLIER ON BANKRUPTCY ("COLLIER") ¶ 1.06.01 (6th ed. 2023).

Abrogation of sovereign immunity by Congress requires that: (i) Congress has "unequivocally expressed its intent to abrogate the immunity"; and (ii) lawmakers have acted "pursuant to a valid exercise of power." *Id.* (quoting *Seminole Tribe v. Florida*, 517 U.S. 44, 56 (1996); *In re LTV Steel Co., Inc.*, 264 B.R. 455, 464 (Bankr. N.D. Ohio 2001)); *accord LAC du Flambeau Bank of Lake Superior Chippewa Indians v. Coughlin*, 143 S. Ct. 1689, 1695 (2023). The sovereign immunity of a litigant deprives a court of subject matter jurisdiction to adjudicate a dispute. *See FDIC v. Meyer*, 510 U.S.

471, 475 (1995) ("Sovereign immunity is jurisdictional in nature."). A waiver or abrogation of immunity must be strictly construed in favor of the sovereign, with any ambiguities to be resolved in favor of sovereign immunity. *See Orff v. United States*, 545 U.S. 596, 601–602 (2005).

The doctrine of sovereign immunity has been applied in bankruptcy cases to shield state and federal governments from claims asserted against them by bankruptcy trustees or DIPs. However, the Bankruptcy Code provides for a broad-ranging abrogation of such sovereign immunity. In particular, section 106(a) of the Bankruptcy Code provides that, "[n]otwithstanding an assertion of sovereign immunity, sovereign immunity is abrogated as to a governmental unit . . . with respect to" nearly 60 provisions of the Bankruptcy Code specified in section 106(a)(1), including actions to enforce the automatic stay, preference and fraudulent transfer avoidance actions, and proceedings seeking to establish the dischargeability of a debt.

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

Section 101(27) of the Bankruptcy Code defines the term "governmental unit" as:

> United States; State; Commonwealth; District; Territory; municipality; foreign state; department, agency, or instrumentality of the United States (but not a United States trustee while serving as a trustee in a case under this title), a State, a Commonwealth, a District, a Territory, a municipality, or a foreign state; or other foreign or domestic government.

11 U.S.C. § 101(27).

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

Other subsections of section 106 address a bankruptcy court's power to issue process, orders, or judgments against governmental units (sections 106(a)(3) and (a)(4)), a governmental unit's deemed waiver of sovereign immunity with respect to certain counterclaims by filing a proof of claim (section 106(b)), and permitted setoffs, despite any assertion of sovereign immunity, of claims owned by the bankruptcy estate against claims asserted by governmental units (section 106(c)).

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

CONTROVERSY IN THE COURTS

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

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

The Ninth and Fourth Circuits have staked out a different approach. In *In re DBSI, Inc.*, 869 F.3d 1004 (9th Cir. 2017), the Ninth Circuit held that "[s]ection 106(a)(1)'s abrogation of sovereign immunity is absolute with respect to Section 544(b)(1) and thus necessarily includes the derivative state law claim on which a Section 544(b)(1) claim is based." *Id.* at 1010. Examining the

language of section 106(a) in the framework of the Bankruptcy Code as a whole, the Ninth Circuit concluded that "we cannot read the plain text of Section 544(b)(1)—i.e., the triggering creditor requirement—devoid of the declaration in Section 106(a)(1) that 'sovereign immunity is abrogated as to a governmental unit . . . with respect to [Section 544].'" *Id.*

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

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

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

The Tenth Circuit weighed in on this debate as a matter of first impression in *Miller*.

MILLER

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

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

The bankruptcy court ruled in favor of the trustee, concluding that "§ 106(a)(1) unequivocally waives the federal government's sovereign immunity with respect to the underlying state law cause of action incorporated through § 544(b)." *In re All Resort Group*, 617 B.R. 375, 394 (Bankr. D. Utah 2020), *aff'd*, 2021 WL 5194698 (D. Utah. Sept. 8, 2021), *aff'd*, 2023 WL 4190456 (10th Cir. June 27, 2023). It accordingly avoided the transfers and entered a judgment against the IRS in the amount of approximately $145,000. The district court affirmed the ruling on appeal, and the IRS appealed to the Tenth Circuit.

THE TENTH CIRCUIT'S RULING

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

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

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

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

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

Finally, the Tenth Circuit rejected the IRS's argument that the Internal Revenue Code (the "IRC") trumps the Bankruptcy Code under the doctrine of "field preemption." According to Judge Baldock, field preemption does not apply because the Bankruptcy Code (including section 544(b)(1)), like the IRC, is a federal statute, and Congress has demonstrated its ability to harmonize federal statutes in cases of conflict. In this case, he noted, lawmakers could have done so by adding an express provision to section 544(b) exempting the government from its operation (as lawmakers did in section 544(b)(2) by excepting transfers involving charitable contributions). Moreover, the Tenth Circuit panel explained, "[t]he argument for field preemption based on federal tax collection policy is surely rather weak where Congress is aware of the operation of state law in a field of federal interest, i.e., bankruptcy law, and has decided to place the policy of equal distribution and fairness among creditors on equal footing and tolerate whatever tension exists between the two policies." *Id.* at 1256.

OUTLOOK

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

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

The Tenth Circuit's decision in *Miller* is significant for several reasons. First, the ruling widens a split among the circuits on the interaction between sections 106(a) and 544(b). Second, the (growing) majority approach on this important issue is that Congress abrogated sovereign immunity for purposes of both section 544(b) and causes of action under applicable nonbankruptcy laws that could have been asserted outside of bankruptcy by a triggering creditor. This is a positive development for trustees and DIPs seeking to add value to the bankruptcy estate. However, until the circuit split has been resolved, awareness of the approach adopted by the courts in any particular jurisdiction will be vital.

SIXTH CIRCUIT: EQUITABLE MOOTNESS DOES NOT BAR AN APPEAL IN A CHAPTER 7 CASE

Charles M. Oellermann • Mark G. Douglas

The court-fashioned doctrine of "equitable mootness" has frequently been applied to bar appeals of bankruptcy court orders under circumstances where reversal or modification of an order could jeopardize, for example, the implementation of a negotiated chapter 11 plan or related agreements and upset the expectations of third parties who have relied on the order. The doctrine has figured prominently in recent bankruptcy headlines because it arguably contravenes the principle that federal courts have an obligation to address the merits of controversies that fall within their appellate jurisdiction.

The U.S. Court of Appeals for the Sixth Circuit recently weighed in on one aspect of the equitable mootness debate. In *In re Kramer*, 71 F.4th 428 (6th Cir. 2023), a divided Sixth Circuit panel ruled that equitable mootness does not apply in a chapter 7 liquidation. The panel accordingly reversed a district court decision finding that appeals of bankruptcy court orders approving the fees of chapter 7 trustees and their attorneys were constitutionally or equitably moot and must be dismissed because the appellant failed to obtain a stay pending appeal.

EQUITABLE MOOTNESS

"Mootness" is a doctrine that precludes a reviewing court from reaching the underlying merits of a controversy. An appeal can be either constitutionally, statutorily, or equitably moot. Constitutional mootness is derived from Article III of the U.S. Constitution, which limits the jurisdiction of federal courts to actual cases or controversies and, in furtherance of the goal of conserving judicial resources, precludes adjudication of cases that are hypothetical or merely advisory.

An appeal can also be rendered moot (or otherwise foreclosed) by statute. For example, section 363(m) of the Bankruptcy Code provides that, absent a stay pending appeal, "[t]he reversal or modification on appeal of an authorization . . . of a sale or lease of property does not affect the validity of a sale or lease under such authorization to an entity that purchased or leased such property in good faith."

The court-fashioned remedy of "equitable mootness" bars adjudication of an appeal when a comprehensive change of circumstances has occurred such that it would be inequitable for a reviewing court to address the merits of the appeal. In bankruptcy cases, appellees often invoke equitable mootness as a basis for precluding appellate review of an order confirming a chapter 11 plan.

The doctrine of equitable mootness is sometimes criticized as an abrogation of federal courts' "virtually unflagging obligation" to hear appeals within their jurisdiction. *See In re One2One Commc'ns, LLC*, 805 F.3d 428, 433 (3d Cir. 2015); *In re Charter Commc'ns, Inc.*, 691 F.3d 476, 481 (2d Cir. 2012). According to this view, dismissing an appeal on equitable mootness grounds "should be the rare exception." *In re Tribune Media Co.*, 799 F.3d 272, 288 (3d Cir. 2015); *accord In re Pac. Lumber Co.*, 584 F.3d 229, 240 (5th Cir. 2009) (equitable mootness should be applied "with a scalpel rather than an axe").

Moreover, although the U.S. Supreme Court has declined on several occasions to weigh in on the propriety of the equitable mootness doctrine, it recently expressed skepticism regarding the concept of mootness generally as a bar to a federal court's consideration of the merits of any appeal. *See MOAC Mall Holdings LLC v. Transform Holdco LLC*, 143 S. Ct. 927, 935 (2023) (in ruling that an order approving a lease assignment as a part of a bankruptcy sale transaction was not statutorily moot under section 363(m) of the Bankruptcy Code, the Court noted that "[o]ur cases disfavor these kinds of mootness arguments").

Substantially similar tests have been applied by most circuit courts in assessing whether an appeal of a chapter 11 confirmation order should be dismissed under equitable mootness. Those tests generally focus on whether the appellate court can fashion effective and equitable relief. *See, e.g., PPUC Pa. Pub. Util. Comm'n v. Gangi*, 874 F.3d 33, 37 (1st Cir. 2017) (considering whether: (i) the appellant diligently pursued all available remedies to obtain a stay of the confirmation order; (ii) the challenged chapter 11 plan had progressed "to a point well beyond any practicable appellate annulment"; and (iii) providing relief would harm innocent third parties); *JPMCC 2007-C1 Grasslawn Lodging, LLC v. Transwest Resort Props., Inc. (In re Transwest Resort Props., Inc.)*, 801 F.3d 1161, 1167–68 (9th Cir. 2015) (applying a four-factor test, including whether the court "can fashion effective and equitable relief without completely knocking the props out from under the plan and thereby creating an uncontrollable situation for the bankruptcy court"); *In re Tribune Media Co.,* 799 F.3d 272, 278 (3d Cir. 2015) (considering "(1) whether a confirmed plan has been substantially consummated; and (2) if so, whether granting

the relief requested in the appeal will (a) fatally scramble the plan and / or (b) significantly harm third parties who have justifiably relied on plan confirmation"); *Search Market Direct, Inc. v. Jubber (In re Paige)*, 584 F.3d 1327, 1339 (10th Cir. 2009) (applying a six-factor test, including the likely impact upon a successful reorganization of the debtor if the appellant's challenge is successful); *In re United Producers, Inc.*, 526 F.3d 942, 947–48 (6th Cir. 2008) (three-factor test); *TNB Fin., Inc. v. James F. Parker Interests (In re Grimland, Inc.)*, 243 F.3d 228, 231 (5th Cir. 2001) (considering "(1) whether the complaining party has failed to obtain a stay, (2) whether the plan (here, the liquidation) has been substantially consummated, and (3) whether the relief requested would affect the rights of parties not before the court or the success of the plan").

A common element of almost all of these tests is whether the chapter 11 plan has been substantially consummated. Section 1101(2) of the Bankruptcy Code provides that "substantial consummation" of a chapter 11 plan occurs when substantially all property transfers proposed by the plan have been completed, the debtor or its successor has assumed control of the business and property dealt with by the plan, and plan distributions have commenced.

DOES EQUITABLE MOOTNESS APPLY IN CHAPTER 7 CASES?

The doctrine of equitable mootness has generally been applied to bar appeals in complex chapter 11 reorganization cases, in keeping with its underlying purpose in preventing disruption to confirmed and substantially consummated chapter 11 plans involving agreements entered into with the debtor by third parties in reliance on the finality of the debtor's emergence from bankruptcy and continued operation. *See generally* Collier on Bankruptcy ¶ 1129.09[3][a] (16th ed. 2023) (citing and discussing cases).

Some courts, however, have ruled that the doctrine of equitable mootness applies in chapter 7 cases, even though the rationales warranting its application in a chapter 11 reorganization are not present. *See, e.g.*, *Hoa Dao v. Sommers*, 2018 WL 1139157, *2 (S.D. Tex. Mar. 1, 2018) (noting that although "[c]ourts do not normally apply equitable mootness to Chapter 7 proceedings," the court was persuaded that it should apply in a chapter 7 case); *ANR Co. v. Rushton*, 2012 WL 1556236, *4 (D. Utah May 2, 2012) ("After thorough review of the relevant case law, the Court is persuaded that equitable mootness should apply. . . . In keeping with those circuits that have applied equitable mootness to Chapter 7 proceedings, the Court will adopt the same approach taken when applying equitable mootness to Chapter 11 proceedings."), *aff'd*, 740 F.3d 548 (10th Cir. 2014); *In re Carr*, 321 B.R. 702, 707 (E.D. Va. 2005) (holding that "the equitable mootness doctrine's principles counseling pragmatism in the exercise of equity apply with equal force to the Chapter 7 liquidation of a bankruptcy estate").

Other courts, including several circuits courts of appeals, have either assumed that the doctrine applies in chapter 7 cases or avoided deciding the issue based on the facts. *See, e.g., Ordonez v. ABM Aviation, Inc.,* 787 F. App'x 533, 539–40 (10th Cir. 2019) (assuming that equitable mootness applies in chapter 7 and holding that appeals from a bankruptcy court order relating to a chapter 7 trustee's settlement of the debtor's employment discrimination claims were equitably moot under the factors traditionally applied to the analysis); *Myers v. Offit Kurman, P.A.,* 773 F. App'x 161, 162 (4th Cir. 2019) (finding that an appeal from a bankruptcy court order granting a chapter 7 trustee's motion for approval of a settlement agreement was equitably moot given that the agreement had been fully consummated and funds had been distributed accordingly); *In re JMC Memphis, LLC*, 655 F. App'x 802, 805 (11th Cir. 2016) (assuming that equitable mootness applies in chapter 7 and dismissing as equitably moot an appeal from an unstayed order approving a settlement between the chapter 7 trustee and the debtor's property insurer); *In re Nica Holdings, Inc.*, 810 F.3d 781, 786 (11th Cir. 2015) ("We assume without deciding that equitable mootness applies in the Chapter 7 context, because even if it does, the Appellees have not shown this appeal is equitably moot."); *In re BGI, Inc.*, 772 F.3d 102, 109 n.13 (2d Cir. 2014) ("As noted above, the instant appeal arises in the context of a Chapter 11 liquidation. Consequently, we leave to a future panel of our Court the question whether a district court may also invoke equitable mootness in the context of a Chapter 7 liquidation."); *Stokes v. Gardner*, 483 F. App'x 345, 346 (9th Cir. 2012) (assuming that equitable mootness applies in a chapter 7 case and finding that an appeal of an order approving a settlement agreement in a chapter 7 case was equitably moot); *Tech. Lending Partners, LLC v. San Patricio Cnty. Cmty. Action Agency (In re San Patricio Cnty. Cmty. Action Agency)*, 575 F.3d 553, 558 (5th Cir. 2009) ("It is certainly arguable that equitable mootness has no application to an appeal in a Chapter 7 liquidation. Yet, there is no reason to make such a comprehensive statement here. Instead, we find that under traditional equitable mootness analysis, this case is not moot."); *Drawbridge Special Opportunities Fund, L.P. v. Shawnee Hills, Inc. (In re Shawnee Hills, Inc.)*, 125 F. App'x 466, 469–70 (4th Cir. 2005) (holding, without discussing whether equitable mootness applies in a chapter 7 case, that a district court's ruling on appeal that a bank was obligated to honor a chapter 7 debtor-employer's prepetition payroll checks was equitably moot); *In re Grimland, Inc.*, 243 F.3d 228, 231 n.4 (5th Cir. 2001) ("Equitable mootness normally arises where a Chapter 11 reorganization plan is at issue. Because we find the doctrine inapplicable on other grounds, we need not resolve whether or not the doctrine may be applied in a liquidation under Chapter 7."); *Hicks, Muse & Co., Inc. v. Brandt (In re Healthco Int'l, Inc.)*, 136 F.3d 45, 48–49 (1st Cir. 1998) (without discussing whether equitable mootness applies in a chapter 7 case, holding that an appeal from a district court's affirmance of a bankruptcy court order approving a settlement between a chapter 7 trustee and a codefendant was not equitably moot); *Fitzgerald v. Ninn Worx Sr., Inc. (In re Fitzgerald)*, 428 B.R. 872, 881–82 (B.A.P. 9th Cir. 2010) (assuming that equitable mootness applies in a chapter 7 case but ruling that an appeal of a bankruptcy court order approving a chapter 7 asset sale was not equitably moot).

KRAMER

In March 2015, Said Taleb ("Taleb") received an arbitration award imposing joint and several liability on both his former employer—a real estate business named Kay Bee Kay Properties ("KBK")—and KBK's owner Keith B. Kramer ("Kramer") in the amount of nearly $800,000. A state court confirmed the arbitration award in April 2015. However, before Taleb could collect on the judgment, Kramer and KBK separately filed for chapter 11 protection in the Eastern District of Michigan. The bankruptcy court converted both cases to chapter 7 liquidations in August 2015.

Taleb filed an unsecured claim in Kramer's chapter 7 case based on the arbitration judgment. Two law firms that had represented Taleb in the arbitration, the state court litigation, and the chapter 7 cases filed attorneys' liens after Taleb refused to pay their fees. They also obtained a state court order directing that any distributions made to Taleb from the chapter 7 estates were to be paid directly to the law firms until their fee claims were paid in full.

In accordance with that order, the chapter 7 trustees for Kramer and KBK distributed the approximately $240,000 that would otherwise have been paid to Taleb directly to the law firms. Taleb later objected to the both the chapter 7 trustees' final reports and the fee applications of both trustees and their lawyers. However, the bankruptcy court overruled his objections and approved in separate orders the trustees' final reports and fee applications as well as the distributions to the law firms.

Taleb appealed these orders to the district court but did not obtain a stay pending appeal. While the appeals were pending, the bankruptcy court discharged the trustees and closed the chapter 7 cases. The district court dismissed the appeals, ruling that they were either constitutionally or equitably moot because Taleb failed to obtain a stay pending the appeals.

Taleb appealed to the Sixth Circuit.

THE SIXTH CIRCUIT'S RULING

A three-judge panel of the Sixth Circuit reversed and remanded the case below.

Two judges wrote separate opinions, in which both majorities concluded that the appeals were not moot, but for different reasons.

In the first majority opinion, U.S. Circuit Judge John B. Nalbandian made separate determinations regarding constitutional and equitable mootness. First, he determined that the appeal of the orders approving the KBK chapter 7 trustee's final report and fees as well as the fees of his counsel was not constitutionally moot, even though Taleb had not obtained a stay pending appeal, because the district court could have fashioned a remedy by granting Taleb's requested relief. *Kramer,* 71 F.4th at 440–41.

In reaching his second determination on equitable mootness, Judge Nalbandian acknowledged that the Sixth Circuit had previously expanded the scope of equitable mootness beyond chapter 11 plan confirmation orders to an appeal of an order confirming a chapter 9 municipal debt adjustment plan in *In re City of Detroit, Michigan,* 838 F.3d 792 (6th Cir. 2016). Moreover, he noted that "[o]ur sister circuits who have opined on this issue have universally extended equitable mootness to Chapter 7 cases." *Kramer,* 71 F.4th at 443. Judge Nalbandian concluded that, even if equitable mootness applies in a chapter 7 case, Taleb's appeal of the bankruptcy court's fee orders in Kramer's chapter 7 case was not equitably moot because: (i) other circuits applying the equitable mootness test "have invariably found that, regardless of the type of bankruptcy at issue, challenges to professional fees are not equitably moot on appeal," *id.*; and (ii) the appeal did not satisfy the three-factor equitable mootness test applied in the Fifth Circuit and elsewhere because "any redistribution of [the Kramer chapter 7 trustee's] fee award could only help and not hurt the other creditors in the bankruptcy case." *Id.* at 444.

Judge Moore wrote the second opinion, in which she was joined by Judge Clay regarding the issue of equitable mootness.

After examining the equitable mootness doctrine at length, Judge Moore concluded that it simply does not apply in a chapter 7 case.

Judge Moore explained that courts have been reluctant to expand the scope of the doctrine beyond appeals of chapter 11 plan confirmation orders, which "makes sense given the different concerns that arise" in connection with appeals from a bankruptcy court's orders in a chapter 7 liquidation. *Id.* at 450. She noted that chapter 7 cases almost always entail the simple liquidation of estate assets and the distribution of proceeds to creditors, rather than "intricate transactions that need to be unraveled." *Id.* at 451 (citation omitted). Judge Moore further observed that, in a simple chapter 7 liquidation, the debtor does not emerge from bankruptcy as a reorganized entity conducting business and triggering the reliance of third parties.

According to Judge Moore, "no other circuit court has affirmatively embraced the equitable-mootness doctrine in Chapter 7 liquidations." *Id.* at 452. Instead, she explained, in the handful of cases in which sister circuits have addressed the doctrine in connection with chapter 7 appeals, the courts have skirted the threshold issue by ruling that the doctrine did not apply on the facts of the case.

Judge Moore noted that, "consistent with the doctrine's underlying purpose and its aims," the Sixth Circuit's previous rulings confined the doctrine of equitable mootness to appeals of plan confirmation orders (albeit in the context of both chapter 9 and chapter 11). *Id.* at 448. Judge Moore saw no reason to depart from those precedents or their rationale:

> Ultimately, we must decline the request to expand broadly an already questionable doctrine. Having started with the presumption that we "should hear and decide on the merits cases properly before [us]," . . . and finding the characteristics of a Chapter 7 liquidation far too distinct from the doctrine's rationale and its scope as delineated by our precedent, we hold that the doctrine of equitable mootness has no place in Chapter 7 liquidations.

Id. at 452 (citations omitted).

The Sixth Circuit accordingly reversed the district court's ruling that Taleb's appeal of the bankruptcy court's fee orders was constitutionally or equitably moot and remanded the case below for the district court to consider the merits of Taleb's claims.

OUTLOOK

Because it involved appeals of several orders in two separate but related bankruptcy cases, *Kramer*'s facts are relatively confusing. Moreover, the message sent by the Sixth Circuit was muddied somewhat by two separate majority opinions. One of those opinions, however, very clearly concludes that the doctrine of equitable mootness should be applied sparingly to bar consideration of the merits of an appeal and simply does not apply in a chapter 7 case. It remains to be seen whether other courts will embrace this rationale.

Meanwhile, having addressed statutory mootness under section 363(m) of the Bankruptcy Code in *Transform HoldCo*, the Supreme Court may now have an opportunity to weigh in on the doctrine of equitable mootness, including the role that a stay pending appeal plays in the analysis and the burden of proof. In a petition for *certiorari* filed on March 24, 2023, the indenture trustee for unsecured noteholders of Windstream Holdings, Inc. ("Windstream") asked the Court to review an October 2022 decision by the U.S. Court of Appeals for the Second Circuit dismissing on equitable mootness grounds the indenture trustee's appeal of an order confirming Windstream's chapter 11 plan and a related settlement. *See U.S. Bank. Nat'l Assoc. v. Windstream Holdings, Inc.*, No. 22-926 (U.S. Mar. 24, 2023). According to the indenture trustee, the doctrine is a "scourge on the proper functioning of the constitutionally mandated court system in bankruptcy cases," it "wrongfully and unevenly deprives bankruptcy litigants of their constitutional and statutory rights to Article III court review," and lacks a basis in the Bankruptcy Code or the U.S. Constitution. That petition was distributed for conference scheduled for September 26, 2023. The Court has recently denied other petitions seeking review of lower court rulings applying the doctrine. *See, e.g., KK-PB Financial LLC v. 160 Royal Palm LLC*, 142 S. Ct. 2778 (2022); *GLM DFW, Inc. v. Windstream Holdings, Inc.*, 142 S. Ct. 226 (2021).

NINTH CIRCUIT: STANDARD FOR CONSTITUTIONAL STANDING APPLIES TO BANKRUPTCY APPEALS

Jane Rue Wittstein • Mark G. Douglas

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

The U.S. Court of Appeals for the Ninth Circuit addressed the interplay between these standards in *Clifton Capital Group LLC v. Sharp (In re East Coast Foods Inc.)*, 66 F.4th 1214 (9th Cir. 2023), *as amended and rehearing denied,* 2023 WL 5965812 (9th Cir. Sept. 14, 2023). The Ninth Circuit reversed a district court ruling affirming a bankruptcy court order approving an award of enhanced fees to a chapter 11 trustee, concluding that the appellant lacked constitutional standing to appeal the fee order because any injury to the appellant was "too conjectural and hypothetical." In so ruling, the Ninth Circuit held that an appellant must satisfy the requirements for constitutional standing in the first instance rather than the more exacting "person aggrieved" standard.

STANDING

"Standing" is the legal capacity 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 order to establish "constitutional" or "Article III" standing, a plaintiff must have a personal stake in litigation sufficient to make out a concrete "case" or "controversy" to which the federal judicial power may extend under Article III, section 2, of the U.S. Constitution. *See Pershing Park Villas Homeowners Ass'n v. United Pac. Ins. Co.*, 219 F.3d 895, 899 (9th Cir. 2000).

In bankruptcy cases, various provisions of the Bankruptcy Code confer another type of standing on various entities (e.g., the debtor, the debtor-in-possession, a bankruptcy trustee, creditors, equity interest holders, official committees, or indenture trustees), among other things, to participate generally in a bankruptcy case or commence litigation involving causes of action or claims that either belonged to the debtor prior to filing for bankruptcy or are created by the Bankruptcy Code. For example, in a chapter 11 case, section 1109 of the Bankruptcy Code provides that any "party in interest," including the debtor, the trustee, a committee of creditors or equity interest holders, a creditor, an equity

security holder, or an indenture trustee "may raise and may appear and be heard on any issue" in a chapter 11 case.

This "bankruptcy" or "statutory" standing is distinct from constitutional standing, which is jurisdictional—if a potential litigant lacks constitutional standing, the court lacks jurisdiction to adjudicate the dispute. The distinction between constitutional and bankruptcy standing was examined by the U.S. Court of Appeals for the Third Circuit in *In re Wilton Armetale, Inc.*, 968 F.3d 273 (3d Cir. 2020), in which the court of appeals held that the ability of a creditor to sue in bankruptcy is not a question of constitutional standing (because the risk of loss creates standing) but, rather, an issue of statutory authority because creditors may lose authority to pursue claims under the Bankruptcy Code.

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. 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.* The party invoking the jurisdiction of a federal court bears the burden of establishing the elements of Article III standing. *Lujan v. Defs. of Wildlife*, 504 U.S. 555, 561 (1992).

Finally, the judicially created concept of "prudential" or "zone of interests" standing examines whether: (i) the plaintiff's grievance falls within the zone of interests protected by a statute; (ii) the complaint raises abstract questions or a generalized grievance more properly addressed by the legislature; and (iii) the plaintiff is asserting his legal rights and interests or those of third parties. However, Congress can modify or even abrogate prudential standing requirements by statute. *St. Paul Fire & Marine Ins. Co. v. Labuzan*, 579 F.3d 533, 539 (5th Cir. 2009) (considering whether lawmakers intended to abrogate prudential standing requirements in section 362(k) of the Bankruptcy Code, which authorizes the recovery of damages for a willful violation of the automatic stay). In *Susan B. Anthony List v. Driehaus*, 573 U.S. 149 (2014), the U.S. Supreme Court questioned the concept of prudential standing, finding tension with the "virtually unflagging" obligation of federal courts to hear cases within their jurisdiction. *Id.* at 167 (citing *Lexmark*, 572 U.S. at 126; *Sprint Communications, Inc. v. Jacobs*, 571 U.S. 69, 77 (2013)).

STANDING TO APPEAL BANKRUPTCY COURT ORDERS OR JUDGMENTS

In determining whether a party has standing to appeal a bankruptcy court order or judgment, courts have generally applied a "person aggrieved" standard instead of examining whether the potential appellant has Article III standing. The "person aggrieved" standard is more exacting than traditional constitutional standing because it requires that an appellant demonstrate that it was "directly, adversely, and financially impacted by a bankruptcy order." *See Matter of Highland Cap. Mgmt., L.P.*, 57 F.4th 494, 501 (5th Cir. 2023) (citations and internal quotation marks omitted); *accord Brown v. Ellmann (In re Brown)*, 851 F.3d 619, 623 (6th Cir. 2017); *In re Ernie Haire Ford, Inc.*, 764 F.3d 1321, 1325 (11th Cir. 2014).

A party does not have standing to appeal a bankruptcy court's order or judgment merely by participating in a bankruptcy case as a party-in-interest or if the order or judgment causes only indirect harm to the party's asserted interest. *See In re Bay Circle Prop., LLC*, 2022 WL 16002916, *2–3 (11th Cir. Oct. 28, 2022). Furthermore, "for a person to be aggrieved, the interest they seek to vindicate on appeal must be one that is protected or regulated by the Bankruptcy Code." *See Ernie Haire Ford*, 764 F.3d at 1325–26.

The "person aggrieved" standard is a "prudential" requirement initially found within the Bankruptcy Act of 1898, which permitted an appeal by any "person aggrieved by an order of a referee." 11 U.S.C. § 67(c) (1976) (repealed 1978). It was designed to limit appeals in bankruptcy cases because bankruptcies invariably implicate the interests of various stakeholders, including those that may qualify as parties-in-interest in the bankruptcy case, but are not formally litigants in a particular contested matter or adversary proceeding. *See Matter of Fondiller*, 707 F.2d 441, 443 (9th Cir. 1983); *accord In re Imerys Talc Am., Inc.*, 38 F.4th 361, 370–71 (3d Cir. 2022); *Kane v. Johns-Manville Corp.*, 843 F.2d 636, 642 (2d Cir. 1988).

Even though lawmakers did not include the "person aggrieved" standard for appellate standing in the Bankruptcy Code in 1978 (or afterward), courts continue to apply the standard to this day. *See generally* COLLIER ON BANKRUPTCY ¶ 5.07 (16th ed. 2023) (citing and discussing cases).

The Ninth Circuit addressed the "person aggrieved" standard and constitutional standing in *East Coast Foods*.

EAST COAST FOODS

On March 25, 2012, East Coast Foods, Inc., manager of four locations of the landmark Los Angeles restaurant chain Roscoe's House of Chicken & Waffles (the "debtor"), filed for chapter 11 protection in the Central District of California. Shortly afterward, the bankruptcy court supplanted the debtor-in-possession with a chapter 11 trustee.

In July 2018, the court confirmed a chapter 11 plan of reorganization proposed for the debtor by its unsecured creditors' committee and principal. The plan provided that the allowed claims of all unsecured creditors, including subordinated creditors, were to be paid in full with interest over no more than four years from funds generated by the debtor's ongoing operations and non-estate sources. Under the plan, subordinated claims, including the

consensually subordinated claim of Clifton Capital Group, LLC ("Clifton") in the amount of approximately $4.2 million, would be paid in full with interest after payment of all other unsecured claims and certain other claims.

The plan's commitment to pay all unsecured claims in full was to be funded by: (i) the reorganized debtor's commitment to pay $110,000 per month plus any excess monthly free cash flow from operations; (ii) an up to $10 million backstop commitment by the debtor's principal; and (iii) $130,000 per month to be contributed by nondebtor affiliates. In addition, the plan payments were secured by a lien on substantially all of the debtor's assets, which were valued at more than $39 million, leaving the reorganized debtor with $23.4 million in "net equity."

The plan provided that the debtor's principal would retain his equity interests in the debtor in exchange for his backstop commitment. All but two secured classes were identified as "impaired" by the plan.

Two impaired classes (class 1, a secured class, and class 9, the general unsecured trade claims class) voted to accept the plan. Clifton agreed to the treatment of its claim under the plan, which provided that Clifton's consensually subordinated claim and the claims of other class 11 creditors were impaired, but it is not clear whether Clifton voted to accept the plan. All other classes either rejected the plan or were deemed to reject it. In confirming the plan, the bankruptcy court held that the plan satisfied that Bankruptcy Code's cram-down confirmation requirements with respect to all dissenting impaired classes.

After the effective date of the plan, the reorganized debtor fell behind in making certain plan payments to unsecured creditors, due in part to liquidity problems resulting from the pandemic.

In his October 2018 final fee application, the trustee requested approximately $1.2 million, consisting of a "lodestar" amount of approximately $760,000 based on the hours worked, plus a 65% enhancement ($400,000) for exceptional services. Clifton objected to the application, arguing that the amount was unreasonable. The bankruptcy court approved the application, and Clifton appealed to the district court.

The trustee argued before the district court that Clifton lacked standing to appeal the fee order because it was not a "person aggrieved." The district court disagreed, ruling that Clifton satisfied that standard "[b]ecause the increased compensation to the Trustee will further subordinate [Clifton's] claim" and Clifton was therefore "directly and adversely affected" by the fee order. *See In re East Coast Foods, Inc.*, 2019 WL 6893015, *3 (C.D. Cal. Dec. 18, 2019). The district court then vacated the bankruptcy court's fee order and remanded the case below with instructions either to apply the lodestar amount or to make detailed findings justifying a higher amount.

On remand, the bankruptcy court found that the full amount of the fee request was warranted due to the exceptional results in the case. After the district court affirmed on appeal, Clifton appealed to the Ninth Circuit.

THE NINTH CIRCUIT'S RULING

A three-judge panel of the Ninth Circuit reversed the ruling and remanded the case with instructions to the court below to dismiss the appeal.

Writing for the panel, Circuit Judge Ryan D. Nelson explained that it is unclear why courts continue to apply the pre-Bankruptcy Code "person aggrieved" rule "with little attention to Article III standing" in the absence of any statute providing authority to do so. Courts in the Ninth Circuit, he noted, "appear to have recast the pre-1978 statutory standard and applied it as a principle of prudential standing," which the Supreme Court questioned in *Driehaus*. *East Coast Foods*, 66 F.4th at 1218. After *Driehaus*, Judge Nelson wrote, "we have returned emphasis to Article III standing," which must be satisfied before examining whether an appellant has prudential standing under the "person aggrieved" standard. *Id.*

According to the Ninth Circuit panel, the rulings below had to be reversed because Clifton lacked Article III standing to appeal the bankruptcy court's fee order. First, Judge Nelson explained, Clifton could not demonstrate that it had suffered an "injury in fact." He rejected Clifton's argument that it was harmed because it had not yet received any payment of its subordinated claim under the plan and the bankruptcy court's approval of a $400,000 fee enhancement to the trustee impaired "both the likelihood and timing of any payment by further subordinating it." *Id.* at 1219.

The Ninth Circuit panel held that Clifton's alleged injury was "too conjectural and hypothetical to establish an injury in fact for Article III standing" and that the district court erred when it concluded that the fee award would further subordinate Clifton's claim. *Id.* In particular, Judge Nelson explained, the district court erroneously determined that the debtor's chapter 11 plan created a "limited fund" for the payment of creditor claims.

According to Judge Nelson, under Ninth Circuit precedent, the existence of a finite pool of assets to pay claims under a chapter 11 plan has been held to confer appellate standing on a party whose share of the asset pool is under threat. However, he emphasized, the debtor's chapter 11 plan did not establish such a limited fund but provided for the payment in full of all unsecured claims, including Clifton's claim, with interest, from the reorganized debtor's future income and outside sources of funding. *Id.* at 1219–20. In addition, Judge Nelson noted, the debtor's obligation to make plan distributions was secured by collateral of sufficient value to create a 35% "equity cushion." "[E]ven if [the trustee] receives the contested $400,000 bonus," he wrote, "this will not impact Clifton's ability to be paid because there are other sources from which to make Clifton's payment at the appropriate time." *Id.* at 1221.

The Ninth Circuit panel also rejected Clifton's argument that it was harmed because the fee award would prolong payment of its subordinated claim. According to Judge Nelson, the plan expressly provided, and Clifton clearly understood, that the payout term could be longer or shorter based on the amount of allowed claims and estimated that distributions on subordinated claims would be completed sometime between 2022 and 2024. "Ultimately," he wrote, "the Plan's guarantee that Clifton will be paid with interest precludes a finding of an injury in fact now even though these estimates thus far have proven inaccurate." *Id.* at 1222. The Ninth Circuit panel concluded that, given the possibility that the debtor might yet complete all distributions within the estimated timeframe, "Clifton has failed to establish the negative impact of any delayed payment not already addressed by the Plan." *Id.*

Finally, the Ninth Circuit panel emphasized that Clifton was not left without a remedy—it could sue to enforce the terms of the plan if the debtor defaulted. At that juncture, Judge Nelson noted, "there may be an actual injury that is both fairly traceable and would be easily redressable by ordering additional money deposited into the estate to pay Clifton's claims." *Id.*

Because the Ninth Circuit panel concluded that Clifton lacked Article III standing to appeal the fee order, it declined to address whether Clifton satisfied the prudential "person aggrieved" standard. *Id.* at 1222 n.11.

The Ninth Circuit panel accordingly reversed the district court's order and remanded the case to the court below with instructions to dismiss Clifton's appeal for lack of Article III standing.

OUTLOOK

On September 14, 2023, the Ninth Circuit issued an amended opinion and denied Clifton's motion for rehearing *en banc*. A key takeaway from *East Coast Foods* is that, in the Ninth Circuit, Article III standing, as distinguished from prudential standing under the "person aggrieved" standard, is the gatekeeper (at least in the first instance) to appellate review of bankruptcy court orders or judgments. This means that in cases where a potential appellant lacks such standing, the appellate court does not have jurisdiction to hear the appeal.

The Ninth Circuit's ruling leaves certain important questions unanswered. For example, because the panel declined to address whether the appellant satisfied the more exacting "person aggrieved" standard, it is unclear whether an appellant that (unlike Clifton) satisfies the requirements for Article III standing must then also satisfy the "person aggrieved" standard to have standing to appeal. On the facts of *East Coast Foods*, Clifton likely would not have satisfied either standard, but other cases might be different.

Shortly after the Ninth Circuit handed down its ruling in *East Coast Foods*, the Fifth Circuit reaffirmed its commitment to the "person aggrieved" standard for bankruptcy appellant standing in bankruptcy in two separate decisions in the same chapter 11 case. *See Dugaboy Investment Trust v. Highland Capital Management LP (In re Highland Capital Management LP)*, 2023 WL 4861770 (5th Cir. July 31, 2023) (dismissing for lack of standing an appeal of an order approving a settlement filed by a family trust controlled by the debtor's former chief executive holding an approximately 0.2% limited partnership interest in the debtor because the trust was not "directly affected" by the settlement and was therefore not a "person aggrieved," and rejecting the trust's argument that it had standing to appeal as an equity security holder pursuant to section 1109(b) and based on withdrawn claims filed in the case); *NexPoint Advisors, L.P. v. Pachulski Sting Ziehl & Jones, L.L.P. (In re Highland Capital Management, L.P.)*, 74 F.4th 361 (5th Cir. 2023) (affirming a district court order dismissing for lack of standing an appeal filed by an administrative claimant and adversary proceeding defendant of bankruptcy court orders awarding professional fees and expenses because any harm to the appellant was too speculative). In so ruling, the Fifth Circuit held that the more exacting "person aggrieved" standard—as distinguished from Article III standing—is the more appropriate standard, and that the Supreme Court's decision in *Lexmark* did not invalidate the "person aggrieved" standard for bankruptcy appeals.

Given the disagreement among courts on the appropriate standard for bankruptcy appellate standing, knowledge of the approach applied by the appellate courts in any particular jurisdiction is important.

SEVENTH CIRCUIT: NO AVOIDANCE OF PREFERENTIAL OR FRAUDULENT TRANSFER ABSENT DIMINUTION OF THE ESTATE

Patrick Lombardi

In *Mann v. LSQ Funding Group, L.C.*, 71 F.4th 640 (7th Cir. 2023), *reh'g denied*, 2023 WL 4684702 (7th Cir. July 21, 2023), the U.S. Court of Appeals for the Seventh Circuit affirmed the entry of summary judgment by a Wisconsin bankruptcy court dismissing litigation commenced by a chapter 7 trustee seeking to avoid as a fraudulent and preferential transfer a pre-bankruptcy payment made by a third party to satisfy the debtor's obligation under a factoring agreement because the transferred funds were never "an interest of the debtor in property." The Seventh Circuit reasoned that the transferred funds did not diminish the amount available for distribution to the debtor's creditors because the funds were not estate property.

AVOIDANCE OF PREFERENTIAL AND FRAUDULENT TRANSFERS

In bankruptcy cases, a trustee has the "paramount duty . . . to act on behalf of the bankruptcy estate, that is, for the benefit of the creditors." *In re Cybergenics Corp.*, 226 F.3d 237, 243 (3d Cir. 2000). In furtherance of this duty, the Bankruptcy Code provides trustees with an array of tools that they can wield to fulfill this mandate. Among these tools are the "statutorily created powers, known as avoidance powers, which enable trustees to recover property on behalf of the bankruptcy estate." *Id.* Each avoidance power has a specific application. Two of the most commonly invoked avoidance powers are the ability to avoid preferential and fraudulent transfers made (or obligations incurred) by debtors prior to filing for bankruptcy.

Preferential Transfers. A preference generally "exists when a debtor makes a payment or other transfer to a certain creditor or creditors and not others." *Kenan v. Fort Worth Pipe Co. (In re George Rodman, Inc.)*, 792 F.2d 125, 127 (10th Cir. 1986). Section 547(b) of the Bankruptcy Code establishes the trustee's power to avoid preferential transfers, providing in part:

> Except as provided in subsections (c) and (i) of this section, the trustee may, based on reasonable due diligence in the circumstances of the case and taking into account a party's known or reasonably knowable affirmative defenses under subsection (c), avoid any transfer *of an interest of the debtor in property* . . . .

11 U.S.C. § 547(b) (emphasis added). A preferential transfer may be avoided under section 547(b) only if:

1. The transfer was made to or for the benefit of a creditor (§ 547(b)(1));
2. The transfer was for or on account of an antecedent debt owed by the debtor (§ 547(b)(2));
3. The transfer was made while the debtor was insolvent (§ 547(b)(3));
4. The transfer was made either: (i) on or within 90 days before the date of filing of the petition; or (ii) between 90 days and one year before the filing of the petition if the creditor at the time of the transfer was an insider (§ 547(b)(4)); and
5. The transfer enables the transferee to receive more than it would have received in a chapter 7 liquidation had it not received the transfer (§ 547(b)(5)).

Section 547(c) contains nine defenses or exceptions to avoidance. These include, among other things, contemporaneous exchanges for new value, ordinary course business transfers, transfers involving purchase-money security interests, and transfers after which the transferor subsequently provides new value to the debtor.

There are also certain other nonstatutory defenses to preference liability. One of these is the judge-fashioned "earmarking doctrine," which provides that the debtor's new borrowing of funds to satisfy a preexisting debt is not deemed a transfer of property of the debtor and therefore is not avoidable as a preference. That is, if a third party provides funds for the specific purpose of paying a creditor of the debtor, hence "earmarking" them for that purpose, the transfer of the funds to the creditor may not be recoverable as preference. The doctrine rests on the idea that the funds are not within the control of the debtor, and because one debt effectively is exchanged for another, there is no diminution of the debtor's bankruptcy estate. *See generally* COLLIER ON BANKRUPTCY ("COLLIER") ¶547.03[2][a] (16th ed. 2023).

Fraudulent Transfers. Section 548(a)(1) of the Bankruptcy Code empowers a bankruptcy trustee to avoid pre-bankruptcy fraudulent transfers. It provides in part that:

> The trustee may avoid any transfer (including any transfer to or for the benefit of an insider under an employment contract) *of an interest of the debtor in property*, or any obligation (including any obligation to or for the benefit of an insider under an employment contract) incurred by the debtor, that was made or incurred on or within 2 years before the date of the filing of the petition . . . .

11 U.S.C. § 548(a)(1) (emphasis added). Fraudulent transfers that can be avoided include both: (i) actual fraudulent transfers, which are transfers made with "actual intent to hinder, delay, or defraud" creditors (*see* 11 U.S.C. § 548(a)(1)(A)); and (ii) constructive fraudulent transfers, which are "transactions that may be free of actual fraud, but which are deemed to diminish unfairly a debtor's assets in derogation of creditors." COLLIER at ¶ 548.05; *see* 11 U.S.C. § 548(a)(1)(B). Under section 548(A)(1)(B), a transfer is constructively fraudulent if the debtor received "less than a reasonably equivalent value in exchange for such transfer or obligation" and was, among other things, insolvent, undercapitalized, or unable to pay its debts as such debts matured. *Id.*

Section 548(c) provides a defense to avoidance of a fraudulent transfer for a "good faith" transferee who gives value in exchange for the transfer involved.

Fraudulent transfers may also be avoided by a trustee under section 544(b) of the Bankruptcy Code, which provides that, with certain exceptions, "the trustee may avoid any transfer *of an interest of the debtor in property* or any obligation incurred by the debtor that is voidable under applicable law by a creditor holding an unsecured claim that is allowable under section 502 of [the Bankruptcy Code] or that is not allowable only under section 502(e) of [the Bankruptcy Code]." 11 U.S.C. § 544(b)(1) (emphasis added). This provision permits a trustee to step into the shoes of a "triggering" unsecured creditor that could have sought avoidance of a transfer under applicable bankruptcy law (e.g., the Uniform Voidable Transfer Act enacted in many states). *See generally* COLLIER at ¶ 544.06.

WHAT IS AN INTEREST OF THE DEBTOR IN PROPERTY?

Notably, the plain language of sections 544(b), 547(b), and 548(a)(1) contains a fundamental limitation on their application: Only a transfer "of an interest of the debtor in property" is avoidable. The Bankruptcy Code does not define the phrase "an interest of the debtor in property." The U.S. Supreme Court, however, provided guidance on this point, concluding that "an interest of a debtor in property" is "best understood as that property that would have been part of the estate had it not been transferred before the commencement of bankruptcy proceedings." *Begier v. IRS*, 496 U.S. 53, 58 (1990). Thus, the Court viewed "property of the estate" as an appropriate postpetition analog to "interest of the debtor in property." *Id.* at 59. Consistent with the Supreme Court's analysis, courts have construed "an interest of the debtor in property" very broadly, mirroring the reach of property of the estate to "all legal and equitable interests of property." *See In re Moses*, 256 B.R. 641, 645 (B.A.P. 10th Cir. 2000).

Courts have developed two tests to analyze whether a transfer is avoidable as an interest of the debtor in property. The first test focuses on a debtor's dominion/control over the property prior to the transfer. *See In re Marshall*, 550 F.3d 1251, 1255 (10th Cir. 2008) ("Under [the dominion/control test], a transfer of property will be a transfer of 'an interest of the debtor in property' if the debtor exercised dominion or control over the transferred property."); *accord In re Clink*, 643 B.R. 522, 526 (Bankr. D. Mass. 2022). The dominion/control tests is grounded in the concept that a debtor's "right to use an item or control its use" is a property interest. *Marshall*, 550 F.3d at 1255. Therefore, courts find that sufficient dominion or control over an item is all that is required to establish a property interest in the item. *See, e.g., Gladstone v. U.S. Bancorp.*, 811 F.3d 1133, 1139 (9th Cir. 2016); *Riley v. Nat. Lumber Co. (In re Reale)*, 584 F.3d 27, 31 (1st Cir. 2009); *MBNA Am. Bank, N.A. v. Meoli (In re Wells)*, 561 F.3d 633, 635 (6th Cir. 2009).

A second test, the diminution of the estate test, states that a transfer is of "an interest of the debtor in property" where the transfer "diminished the resources from which the debtor's creditors could have sought payment." *Southmark Corp. v. Grosz (In re Southmark Corp.)*, 49 F.3d 1111, 1116–17 (5th Cir. 1995); *Moses*, 256 B.R. at 645. The diminution of the estate test seeks to ensure that certain creditors do not obtain a windfall from funds that otherwise would have been available to other creditors. *See Adams v. Anderson (In re Superior Stamp & Coin Co.)*, 233 F.3d 1004, 1007 (9th Cir. 2000).

Although some courts assert that only one of the two tests needs to be satisfied, other courts often apply both tests in their analysis. *See, e.g., Walters v. Stevens, Littman, Biddison, Tharp & Weinberg, LLC (In re Wagenknecht)*, 971 F.3d 1209, 1214 (10th Cir. 2020) ("We apply *Marshall*'s dominion/control and diminution of the estate tests to determine whether [the debtor] had a legal or equitable interest in the payment to the law firm . . . [and] we conclude that neither the dominion/control test nor the diminution of

the estate test is satisfied here."); *In re Smith*, 966 F.2d 1527, 1531–35 (7th Cir. 1992) ("The real question here is whether the Debtor was actually able to exercise sufficient dominion and control over the funds . . . . We conclude in the present case that the Debtor's estate was diminished by the transfer."); *Gray v. Travelers Ins. Co. (In re Neponset River Paper Co.)*, 231 B.R. 829, 833–34 (B.A.P. 1st Cir. 1999) (concluding that, under either test, transfers of funds that a lender deposited into the account of the debtor's attorneys in order to pay the debtor's antecedent debt to its insurer were transfers of an "interest of the debtor in property"). The majority of courts appear to support this two-factor analysis.

LSQ FUNDING

Engstrom, Inc. (the "debtor") was an agency that provided temporary staffing services to its clients. Throughout its history, the debtor relied upon accounts receivable factoring agreements under which it obtained financing for operations by collateralizing future funds anticipated from operations. The debtor and one of its factors—LSQ Funding Group, L.C. ("LSQ")—entered into factoring agreements beginning as early as December 2014.

In 2018, LSQ and the debtor entered into a new invoice factoring agreement. This agreement was supposed to work as a typical factoring agreement: The debtor would issue invoices to customers, after which it would submit the receivables to LSQ for purchase; LSQ would pay the debtor some portion of the face value of the invoices, and LSQ would pay the debtor the outstanding balance, less agreed-upon fees, when LSQ collected from the customer.

Unbeknownst to LSQ, the agreement was all part of a Ponzi scheme devised by the debtor's CEO, Cheri Campion ("Campion"). Rather than submit legitimate invoices to LSQ, the debtor created sham invoices in the name of real customers that were sent to LSQ for payment. The debtor would then funnel some of the funds it received from LSQ to pay LSQ on account of old invoices.

Eventually, LSQ learned of the debtor's scheme. It then terminated the factoring agreement and demanded that the debtor pay $10.3 million to repurchase all unpaid invoices that LSQ had purchased. To address this, Campion and the debtor sought out another victim. This role fell to Millennium Funding ("Millennium"), another factoring company that the debtor selected to replace LSQ. The debtor convinced Millennium to enter into a factoring agreement and buy out the $10.3 million in unpaid invoices that LSQ had previously purchased. LSQ, at the debtor's request, provided Millennium with a pay-off letter for all unpaid invoices and accrued fees but made no efforts to alert Millennium to the underlying scheme.

Millennium wire-transferred $10.3 million to LSQ in January 2020. The debtor had agreed with Millennium that the funds transferred would be used only to pay the debtor's obligation to LSQ. After the transfer, the debtor was indebted to Millennium in the amount of $10.3 million, which debt was secured by the same collateral that previously secured the debt to LSQ.

Shortly after entering into the factoring agreement, Millennium discovered that the invoices were worthless. Millennium confronted the debtor and learned of LSQ's participation in the scheme.

In April 2020, the debtor filed a chapter 11 petition in the Eastern District of Wisconsin. The debtor then commenced an adversary proceeding to avoid the $10.3 million payment by Millennium to LSQ as a preferential and/or fraudulent transfer.

The bankruptcy court converted the case to a chapter 7 liquidation and substituted the chapter 7 trustee as the plaintiff in the avoidance litigation. LSQ moved for summary judgment, arguing that the trustee could not establish that "any transfer of an interest of the debtor in property" occurred.

The bankruptcy court found that the debtor did not exercise dominion and control over the funds transferred from Millennium to LSQ and that the payment did not diminish the estate. The court also concluded that, although most of the case law on the earmarking doctrine arises in the context of preference claims, the doctrine also may be applied to a fraudulent transfer claim. It accordingly ruled that the earmarking doctrine applied, and that the payment from Millennium to LSQ was not avoidable because it did not represent a transfer of "an interest of the debtor in property." The district court affirmed, and the chapter 7 trustee appealed to the Seventh Circuit. *See In re Engstrom, Inc.*, 648 B.R. 617 (Bankr. E.D. Wis. 2021), *aff'd*, 2022 WL 2788437 (E.D. Wis. July 15, 2022), *aff'd*, 71 F.4th 640 (7th Cir. 2023).

THE SEVENTH CIRCUIT'S RULING

A three-judge panel of the Seventh Circuit affirmed.

Writing for the panel, U.S. Circuit Judge Amy St. Eve noted that, unlike the courts below, the Seventh Circuit "need not focus on the 'earmarking doctrine' because a careful reading of the Bankruptcy Code's text and the application of our precedent resolve this case." *LSQ Funding*, 71 F.4th at 645. Starting with the avoidance of preferential transfers under section 547, Judge St. Eve closely examined section 547's plain language, noting that it only allows "the trustee . . . [to] avoid . . . transfer[s] of *an interest of the debtor in* property." *Id.* According to Judge St. Eve, this phrase was the key to the resolution of the case. *Id.*

The Seventh Circuit panel emphasized that, in interpreting this phrase, the Supreme Court, in *Begier*, had explained that "the purpose of the avoidance provision is to preserve the property includable within the bankruptcy estate—the property available for distribution to creditors." *Id.* Thus, Judge St. Eve noted, an "interest of the debtor in property is 'best understood as that

property that would have been part of the estate had it not been transferred before the commencement of the bankruptcy proceedings.'" *Id.* (quoting *Warsco v. Preferred Tech. Grp.*, 258 F.3d 557, 564 (7th Cir. 2001)).

According to the Seventh Circuit panel, whether a transfer affects "an interest of the debtor in property" requires either that the debtor exercise dominion/control over the transferred funds, or that the transfer diminished the property of the estate. *Id.* Judge St. Eve explained that a debtor exercises dominion/control over transferred funds where the debtor can "determine the disposition of the funds and designate the creditor to whom payment is made." *Id.* (quoting *Matter of Smith*, 966 F.2d at 1535). Under this framework, the Seventh Circuit panel found that, in this case, although a reasonable jury could find that the debtor could designate to whom payment was made, there was "scant evidence in the record" to find that the debtor could "determine the disposition of the funds or accounts themselves." *Id.*

Next, the Seventh Circuit panel concluded that the "diminution of the estate analysis shows plainly that the transaction at issue here did not involve 'an interest of the debtor in property.'" *Id.* at 646. Importantly, the panel highlighted that the parties agreed that "neither the $10.3 million nor the accounts sold would have been part of the Debtor's estate." *Id.* The panel further noted that the debtor never possessed the funds, the funds never passed through its accounts, and that creditors were substituted instantaneously. The Seventh Circuit panel accordingly determined that the transfer between Millennium and LSQ could not be avoided as a preference because it did not involve "an interest of the debtor in property." *Id.*

Like the lower courts, Judge St. Eve rejected the trustee's argument that the dominion/control and diminution of the estate analyses apply only to avoidance of preferences and not the avoidance of fraudulent transfers. Drawing on the parallel use of "an interest of the debtor in property" in sections 547 and 548, Judge St. Eve explained that avoidance of fraudulent transfers turns on the same question: "whether the payoff agreement constituted an interest of the debtor in property." *Id.* at 646. She also pointed to the presumption in statutory construction that "identical words used in different parts of the same act are intended to have the same meaning." *Id.* at 646–47 (quoting *White v. United Airlines, Inc*., 987 F.3d 616, 623 (7th Cir. 2021)).

The Seventh Circuit panel also rejected the trustee's contention that avoiding the transfer would somehow bring the transferred funds into the debtor's estate, finding instead that avoidance of the transfer would benefit only one creditor, Millennium, by providing it with the full $10.3 million that it paid to LSQ. That "perverse result," Judge St. Eve reasoned, "further assures us that § 548's use of 'interest of the debtor in property' is identical to its use in § 547." *Id.* at 647–48.

Finally, the Seventh Circuit panel noted that its decision comports with the approach of other circuits, which have concluded that, even in the Ponzi scheme context, "outright fraud alone cannot bring a transaction within the avoiding powers of the Bankruptcy Code—the baseline avoiding requirements of the statute must still be met." *Id.* at 648. Accordingly, because the transfer at issue did not diminish the debtor's estate, the Seventh Circuit affirmed the ruling below.

OUTLOOK

The Seventh Circuit denied the chapter 7 trustee's motion for rehearing in a summary order. *See Mann v. LSQ Funding Grp., L.C.*, 2023 WL 4684702 (7th Cir. July 21, 2023).

The Seventh Circuit's decision is consistent with the approach adopted by most courts considering whether a debtor must have an interest in property for a transfer of such property to be subject to avoidance in bankruptcy as a preferential or fraudulent transfer.

NEWSWORTHY

Jeffrey B. Ellman ***(Atlanta)***, ***Thomas M. Wearsch*** ***(New York/Cleveland)***, ***Caitlin K. Cahow*** ***(Atlanta/Chicago)***, ***Gary L. Kaplan*** ***(Miami)***, ***Ryan Sims*** ***(Washington)***, ***Heather Lennox*** ***(Cleveland/New York)***, ***Daniel J. Merrett*** ***(Atlanta)***, ***Gregory M. Gordon*** ***(Dallas)***, ***Corinne Ball*** ***(New York)***, ***Hannah Rozow Owolabi*** ***(San Diego)***, ***T. Daniel Reynolds*** ***(Cleveland)***, ***Kevyn D. Orr*** ***(Washington)***, ***Aldo L. LaFiandra*** ***(Atlanta)***, ***Carl E. Black*** ***(Cleveland)***, ***Bruce Bennett*** ***(Los Angeles)***, ***Brad B. Erens*** ***(Chicago)***, ***Amanda S. Rush*** ***(Dallas)***, ***Genna Ghaul*** ***(New York)***, and ***Nicholas J. Morin*** ***(New York)*** were recognized in the 2024 edition of *Best Lawyers*™ in the field of "Bankruptcy and Creditor Debtor Rights/Insolvency and Reorganization Law."

Bruce Bennett ***(Los Angeles)***, ***Heather Lennox*** ***(Cleveland/New York)***, ***Corinne Ball*** ***(New York)***, ***Jeffrey B. Ellman*** ***(Atlanta)***, ***Caitlin K. Cahow*** ***(Atlanta/Chicago)***, ***Gary L. Kaplan*** ***(Miami)***, and ***Carl E. Black*** ***(Cleveland)*** were recognized in the 2024 edition of *Best Lawyers*™ in the field of "Litigation-Bankruptcy."

Fabienne Beuzit ***(Paris)***, ***Rodolphe Carrière*** ***(Paris)***, ***Elodie Fabre*** ***(Paris)***, and ***Isabelle Maury*** ***(Paris)*** were recognized in the 2024 edition of *Best Lawyers in France*™ in the practice area "Insolvency and Reorganization Law" and/or "Insolvency and Reorganization Law/Distressed Investing and Debt Trading."

Katie Higgins ***(Sydney)*** was included in the 2024 edition of *Best Lawyers*™ in the practice area "Insolvency and Reorganization Law/Distressed Investing and Debt Trading."

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

Roger Dobson ***(Sydney)*** was included in the 2024 edition of *Best Lawyers*™ in the practice area "Banking and Finance Law."

Ben Larkin ***(London)*** and ***Sion Richards*** ***(London)*** were included in the 2024 edition of *Best Lawyers*™ in the practice area "Insolvency and Restructuring Law."

Olaf Benning ***(Frankfurt)*** was recognized in the 2024 edition of *Best Lawyers*™ in the practice area "Restructuring and Insolvency Law."

In the first-ever combined utilization of the U.S. Bankruptcy Code and the recently enacted Dutch restructuring law, automatic teller machine manufacturer Diebold Nixdorf, Incorporated and certain of its U.S., Canadian, and European subsidiaries (collectively, "Diebold") restructured more than $2.7 billion in debt through coordinated cross-border restructuring proceedings in just 71 days. ***Jones Day*** used all of its resources to achieve this monumental and historic outcome for its long-time client. Cross-practice and cross-office teams based throughout the United States and Europe guided Diebold through each step of the negotiations with creditors and dual court proceedings in the United States and the Netherlands. Members of the Jones Day team in the Business Reorganization & Restructuring Practice included ***Heather Lennox*** ***(Cleveland/New York)***, ***Jasper Berkenbosch*** ***(Amsterdam)***, ***Nicolas J. Morin*** ***(New York)***, ***Dan T. Moss*** ***(New York/Washington)***, ***Sid Pepels*** ***(Amsterdam)***, ***T. Daniel Reynolds*** ***(Cleveland)***, ***Matthew C. Corcoran*** ***(Columbus)***, ***Erik Schuurs*** ***(Amsterdam)***, and ***Ryan Sims*** ***(Washington)***.

Kevyn Orr ***(Washington)*** was featured in news coverage of the 10th anniversary of the Detroit bankruptcy filing and his role as Emergency Manager.

An article written by ***Corinne Ball*** ***(New York)*** titled "PETs, Winner Take All and New Protections for Independent Directors/Serta Confirms Plan" was published in the August 23, 2023, edition of the *New York Law Journal*.

Corinne Ball ***(New York)*** and ***Bruce Bennett*** ***(Los Angeles)*** were named to the "Hall of Fame" in the practice area "Finance: Restructuring (including bankruptcy): corporate" in the 2023 edition of *The Legal 500 United States*. Bruce was also named to the *Legal 500* Hall of Fame in the practice area "Finance: Restructuring (including bankruptcy): municipal."

Heather Lennox ***(Cleveland/New York)*** was designated a "Leading Individual" in the 2023 edition of *The Legal 500 United States* in the practice area "Finance: Restructuring (including bankruptcy): corporate." She was also named a "Next Generation Partner" in the practice area "Finance: Restructuring (including bankruptcy): municipal."

Genna Ghaul ***(New York)*** is one of the lawyers named by the *New York Law Journal* as a "Rising Star," an award recognizing the New York legal community's emerging leaders.

An article written by ***Christopher DiPompeo*** ***(Washington)*** and ***Mark G. Douglas*** ***(New York)*** and titled "Supreme Court Roundup" was published on July 25, 2023, in *Lexis Practical Guidance*.

An article written by ***Daniel J. Merrett*** ***(Atlanta)*** and ***Mark G. Douglas*** ***(New York)*** titled "Delaware Bankruptcy Court Rules that Due Diligence Is Element of Preference Claim Rather Than Basis for Affirmative Defense" was published on July 25, 2023, in *Lexis Practical Guidance*.

Ben Larkin ***(London)*** and ***Hannah Plumb*** ***(London)*** recently coauthored a Jones Day *Alert* titled "Clintons Puts Its Cards on the Table: Part 26A Restructuring Plan Sanctioned," which discusses an August 24, 2023, ruling by an English court approving a restructuring plan for Esquire Retail Limited, trading as Clintons, with distinctive treatment of business rates. Clintons is one of the first mid-market companies to successfully achieve a cross-class cramdown through the use of a restructuring plan.

An article written by ***Oliver S. Zeltner*** ***(Cleveland)*** and ***Mark G. Douglas*** ***(New York)*** titled "'Straight' Dismissal of Chapter 11 Case Did Not Violate *Jevic*'s Prohibition of 'Structured Dismissals' That Do Not Conform with Bankruptcy Code's Priority Scheme" was published on July 25, 2023, in *Lexis Practical Guidance*.

An article written by ***Charles M. Oellermann*** ***(Columbus)*** and ***Mark G. Douglas*** ***(New York)*** titled "Liquidating Chapter 11 Plan Confirmed Despite Provision Temporarily Enjoining Litigation Against Corporate Debtors" was published on July 25, 2023, in *Lexis Practical Guidance*.

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