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U.S. SUPREME COURT BANKRUPTCY UPDATE

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The U.S. Supreme Court handed down three bankruptcy rulings to finish the Term ended in July 2024. The decisions address the validity of nonconsensual third-party releases in chapter 11 plans, the standing of insurance companies to object to "insurance neutral" chapter 11 plans, and the remedy for overpayment of administrative fees in chapter 11 cases to the Office of the U.S. Trustee. We discuss each of them below.

U.S. SUPREME COURT BARS NONCONSENSUAL THIRD-PARTY RELEASES IN CHAPTER 11 PLANS

Some chapter 11 plans have nonconsensual third-party release provisions that limit the potential exposure of various nondebtor parties involved in the process of negotiating, implementing, and funding the plan. There has been a long-standing debate concerning the validity of such provisions when they do not provide for full payment of such third-party claims. The Supreme Court has finally addressed that debate.

On June 27, 2024, the Court handed down a long-awaited ruling regarding the validity of such releases in the chapter 11 plan of pharmaceutical company Purdue Pharma, Inc. and its affiliated debtors (collectively, "Purdue"). In *Harrington, United States Trustee, Region 2 v. Purdue Pharma L.P.*, No. 23-124, 2024 WL 3187799 (U.S. June 27, 2024), a 5–4 majority of the Court reversed and remanded a 2023 ruling by the U.S. Court of Appeals for the Second Circuit affirming the bankruptcy court confirming Purdue's chapter 11 plan. According to the majority, no provision in the Bankruptcy Code other than section 524(g) (discussed below) authorizes a chapter 11 plan to release the claims of nonconsenting creditors against nondebtor entities, including Purdue's founding Sackler family, absent full satisfaction of such claims.

In so ruling, the majority—consisting of Justices Gorsuch, Thomas, Alito, Barrett, and Jackson—reasoned that:

- The "catchall" provision in section 1123(b)(6) of the Bankruptcy Code stating that a chapter 11 plan "may" also "include any other appropriate provision not inconsistent with the applicable provisions of this title" must be construed narrowly in light of its

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surrounding context and read to "embrace only objects similar in nature," or *ejusdem generis*, to the specific examples preceding it, all of which deal with the relationship between a debtors and its creditors, rather than the "radically different" power to discharge the debts of a nondebtor without the consent of affected creditors;
- The proponents of a chapter 11 plan cannot evade the Bankruptcy Code's general limitation that a discharge applies only to debtors who place "substantially all of their assets on the table" and its exclusion from discharge of debts based on "fraud" or involving "willful and malicious injury" simply "by rebranding the discharge a 'release'"; and
- If lawmakers had intended "to reshape traditional practice so profoundly" in the Bankruptcy Code, compared to its predecessor statutes, by "extending to courts the capacious new power the plan proponents claim, one might have expected them to say so expressly somewhere" in the Bankruptcy Code itself.

The majority further noted that opioid claimants would not be left without any means of recovery from Purdue after the Sacklers, having been denied the "Sackler discharge," withdraw their commitment to provide $6 billion to fund chapter 11 plan payments to those creditors. The Court reasoned that "the potentially massive liability the Sacklers face may induce them to negotiate for consensual releases on terms more favorable to all the claimants."

The majority emphasized that nothing in its ruling should be construed to call into question consensual releases offered in connection with a bankruptcy reorganization plan. They further declined to express a view on what qualifies as a consensual release, observing that those sorts of releases pose different questions and may rest on different legal grounds. Similarly, the majority declined to pass upon a plan that provides full satisfaction of claims against a third-party nondebtor. The majority also declined to address whether its interpretation of the Bankruptcy Code would warrant unwinding already confirmed and substantially consummated chapter 11 plans.

Justice Kavanaugh, joined by Chief Justice Roberts and Justices Sotomayor and Kagan, dissented, faulting the majority opinion for being both "wrong on the law" and devastating for opioid victims. Indeed, the dissent contends that the majority ignored the reality of shared assets (e.g., insurance) and shared liability (e.g., indemnity) and disregarded a goal of bankruptcy, which is to ensure the fair and equitable recovery for creditors, instead promoting a "race to the courthouse." The dissent further suggests that dislike for the Sacklers or a sense that they did not pay enough pervades the majority opinion.

Chapter 11 Plan Releases. Section 524(e) of the Bankruptcy Code provides that, "[e]xcept as provided in subsection (a)(3) of this section [making the discharge injunction applicable to actions to collect against community property], discharge of a debt of the debtor does not affect the liability of any other entity on, or the property of any other entity for, such debt." Even so, chapter 11 plans confirmed by bankruptcy courts in certain circuits have commonly included provisions that release various nondebtors from certain debtor liabilities to third parties, including creditors or victims of the debtor.

LAWYER SPOTLIGHT: FABIENNE BEUZIT

Fabienne Beuzit is a partner in the Paris Office, where she leads the Business Restructuring & Reorganization team. Fabienne focuses on bankruptcy proceedings, court and out-of-court restructurings, distressed M&A matters, and insolvency-related litigation. She guides clients through complex restructuring situations and has represented debtors, lenders, shareholders, and investors in numerous restructurings in France and internationally. She regularly interacts with the dedicated departments of the French Ministry of Economy and Finance Affairs, particularly the Comité Interministériel de Restructuration Industrielle in charge of assisting distressed companies, and liaising with all relevant public bodies dedicated to the companies.

Fabienne's experience also includes setting up strategic carve-out, reorganization, or restructurings of groups and assisting turnaround distressed funds in the sale, acquisition, or investment of distressed equity interests.

According to *Chambers Europe*, Fabienne has "strong technical expertise coupled with business sense, and dedication at odd hours when the situation commands." *France Legal 500 EMEA*, which named her among the "Leading Individuals" in France, described Fabienne as a tough negotiator, creative in mastering all aspects of a restructuring case, and "totally dedicated to her clients."

Third-party releases can provide for the relinquishment of both prepetition and postpetition claims belonging to the debtor or nondebtor third parties (e.g., creditors) against various nondebtors. It is uncontroverted that a debtor can release its claims and other derivative claims against a nondebtor third party. As such releases have become common features of chapter 11 plans, they also have become more controversial to the extent that direct claims held by creditors against nondebtor third parties are released.

It is generally accepted that a chapter 11 plan can release nondebtors from claims of other nondebtor third parties if the release is consensual. *See generally* COLLIER ON BANKRUPTCY ("COLLIER") ¶ 524.05 (16th ed. 2024) (citing cases). What constitutes consent, however, is sometimes disputed. COLLIER at ¶ 1141.02[5](b) (discussing various opt-out and opt-in mechanisms that have been attempted as a manifestation of consent for impaired and unimpaired creditors).

In addition, a plan that establishes a trust under section 524(g) of the Bankruptcy Code to fund payments to asbestos claimants can enjoin litigation against certain third parties (e.g., entities related to the debtor or its insurers) alleged to be liable for the conduct of, claims against, or demands on the debtor. *See* 11 U.S.C. § 524(g)(4). Section 524(g) was added to the Bankruptcy Code in 1994 in the wake of the historic Johns-Manville and UNARCO Industries chapter 11 cases. It was enacted to provide explicit statutory authority for courts to issue channeling injunctions in respect of asbestos claims and demands, including those held by persons who have been exposed to asbestos but have not yet manifested any signs of illness. Significantly, all future claims are also channeled to the trust. The enactment of section 524(g) followed a 1991 study commissioned by the Supreme Court regarding the overwhelming impact of asbestos cases on the federal courts. *See* "Report of The Judicial Conference Ad Hoc Committee on Asbestos Litigation" (Mar. 1991).

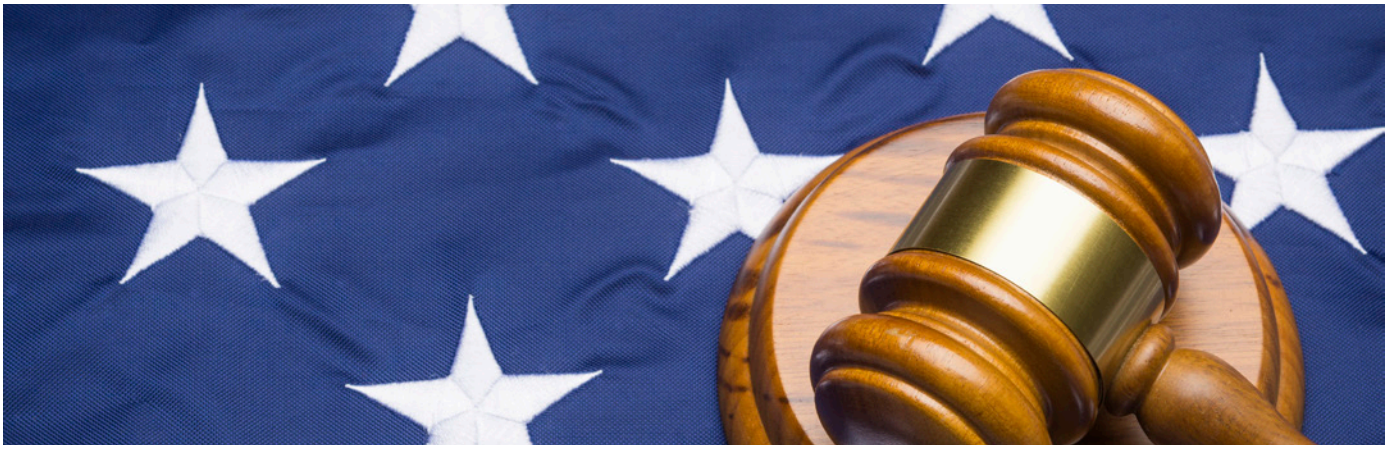
Prior to the Supreme Court's decision in *Purdue Pharma*, the circuit courts of appeal were split as to whether a bankruptcy court had the authority, other than under section 524(g), to approve chapter 11 plan provisions that, over the objection of creditors or other stakeholders, release specified nondebtors from liability or enjoin dissenting stakeholders from asserting claims against such nondebtors. The minority view, held by the Fifth and Tenth Circuits—and, until 2020, arguably the Ninth Circuit (see below)—banned such nonconsensual releases on the basis that they are prohibited by section 524(e) of the Bankruptcy Code. *See Bank of N.Y. Trust Co. v. Official Unsecured Creditors' Comm. (In re Pac. Lumber Co.)*, 584 F.3d 229 (5th Cir. 2009); *Resorts Int'l, Inc. v. Lowenschuss (In re Lowenschuss)*, 67 F.3d 1394 (9th Cir. 1995); *In re W. Real Estate Fund, Inc.*, 922 F.2d 592 (10th Cir. 1990); *see also Blixseth v. Credit Suisse*, 961 F.3d 1074, 1083-84 (9th Cir. 2020) (suggesting, contrary to *Lowenschuss* and other previous rulings, that section 524(e) does not preclude certain nondebtor plan releases of claims that are not based on the debt discharged by the plan), *cert. denied*, 141 S. Ct. 1394 (2021).

On the other hand, the majority of the circuits that have considered the issue have found such releases and injunctions permissible under certain circumstances. *See In re Purdue Pharma L.P.*, 69 F.4th 45 (2d Cir. 2023) (holding that a bankruptcy court has the power to approve third-party releases in a chapter 11 plan under sections 105(a) and 1123(b)(6) of the Bankruptcy Code in accordance with a seven-factor test), *rev'd and remanded sub nom. Harrington, United States Trustee, Region 2 v. Purdue Pharma L.P.*, 2024 WL 3187799 (U.S. June 27, 2024); *SE Prop. Holdings, LLC v. Seaside Eng'g & Surveying, Inc. (In re Seaside Eng'g & Surveying, Inc.)*, 780 F.3d 1070 (11th Cir. 2015); *In re Airadigm Commc'ns, Inc.*, 519 F.3d 640 (7th Cir. 2008); *In re Dow Corning Corp.*, 280 F.3d 648 (6th Cir. 2002); *In re Drexel Burnham Lambert Grp., Inc.,* 960 F.2d 285 (2d Cir. 1992); *In re A.H. Robins Co., Inc.*, 880 F.2d 694 (4th Cir. 1989). For authority, these courts generally relied on section 105(a) of the Bankruptcy Code, which authorizes courts to "issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of [the Bankruptcy Code]."

Moreover, as the Seventh Circuit held in *Airadigm*, the majority view was that section 524(e) does not limit a bankruptcy court's authority to grant such releases. *Airadigm*, 519 F.3d at 656 ("If Congress meant to include such a limit, it would have used the mandatory terms 'shall' or 'will' rather than the definitional term 'does.' And it would have omitted the prepositional phrase 'on, or . . . for, such debt,' ensuring that the 'discharge of a debt of the debtor shall not affect the liability of another entity'—whether related to a debt or not.").

As authority for such involuntary releases, some courts have also relied on section 1123(a)(5) or 1123(b)(6) of the Bankruptcy Code. *See, e.g., Airadigm*, 519 F.3d at 657; *In re Scrub Island Dev. Grp. Ltd.*, 523 B.R. 862, 875 (Bankr. M.D. Fla. 2015). The former states that a chapter 11 plan "shall . . . provide adequate means for the plan's implementation," including a non-exclusive list of examples. The latter provides that a chapter 11 plan may "include any other appropriate provision not inconsistent with the applicable provisions of [the Bankruptcy Code]."

The First and D.C. Circuits have suggested that they agreed with the "pro-release" majority, depending upon the specific circumstances. *See In re Monarch Life Ins. Co.*, 65 F.3d 973 (1st Cir. 1995) (a debtor's subsidiary was collaterally estopped by a plan confirmation order from belatedly challenging the jurisdiction of the bankruptcy court to permanently enjoin lawsuits against the debtor's attorneys and other nondebtors not contributing to the debtor's reorganization); *In re AOV Indus.*, 792 F.2d 1140 (D.C. Cir. 1986) (a plan provision releasing liabilities of nondebtors was unfair because the plan did not provide additional compensation to a creditor whose claim against the nondebtor was being released; adequate consideration must be provided to a creditor forced to release claims against nondebtors).



In *In re Millennium Lab Holdings II, LLC*, 945 F.3d 126 (3d Cir. 2019), the Third Circuit refrained from "broadly sanctioning the permissibility of nonconsensual third-party releases in bankruptcy reorganization plans" but, based on the "specific, exceptional facts" of the case, upheld a lower court decision confirming a chapter 11 plan containing nonconsensual third-party releases, finding that the order confirming the plan did not violate Article III of the U.S. Constitution.

Even courts in the majority camp acknowledged that nonconsensual plan releases should be approved only in rare or unusual cases. *See Seaside Eng'g*, 780 F.3d at 1078; *Nat'l Heritage Found., Inc. v. Highbourne Found.*, 760 F.3d 344, 347-50 (4th Cir. 2014); *Behrmann v. Nat'l Heritage Found.*, 663 F.3d 704, 712 (4th Cir. 2011); *In re Metromedia Fiber Network, Inc.*, 416 F.3d 136, 141–43 (2d Cir. 2005).

Recent lower court rulings also highlighted the deep division among courts on this issue. *See, e.g., In re Boy Scouts of Am. & Delaware BSA, LLC,* 650 B.R. 87 (D. Del. 2023) (ruling that the bankruptcy court had "related to" jurisdiction to confirm a chapter 11 plan providing for nonconsensual third-party releases and a channeling injunction, which were permissible under sections 105(a), 1123(a)(5), and 1123(b)(6) and necessary to ensure an equitable process by which abuse survivors' claims would be administered and paid; also finding that the plan provided for the full payment of survivors' claims), *appeal filed*, No. 23-1668 (3d Cir. Apr. 11, 2023) (held in abeyance on March 19, 2024, pending Supreme Court ruling in *Purdue Pharma*); *In re Mallinckrodt PLC*, 639 B.R. 837 (Bankr. D. Del. 2022) (concluding that bankruptcy courts have statutory and constitutional authority to approve chapter 11 plans containing nonconsensual third-party releases, albeit only in extraordinary cases, and holding that, given the extraordinary nature of the case, nonconsensual opioid releases in the plan of debtor-drug manufacturers were integral to the plan's success and would be approved as fair and reasonable), *stay pending appeal denied*, 2022 WL 1206489 (D. Del. Apr. 22, 2022); *Patterson v. Mahwah Bergen Retail Group, Inc.*, 636 B.R. 641 (E.D. Va. 2022) (vacating a bankruptcy court order confirming a retail group's chapter 11 plan and ruling that the plan impermissibly authorized nonconsensual third-party releases because the bankruptcy court lacked constitutional authority to adjudicate the released claims and failed to analyze whether the releases were justified under Fourth Circuit precedent).

Majority-view courts employed various tests to determine whether such releases are appropriate. Factors generally considered by courts evaluating third-party plan releases or injunctions included whether they are essential to the reorganization, whether the parties being released have made or are making a substantial financial contribution to the reorganization, and whether affected creditors overwhelmingly support the plan. *See Dow Corning*, 280 F.3d at 658 (listing factors).

Purdue Pharma. In September 2021, Purdue obtained confirmation of a chapter 11 plan that included nonconsensual releases of various nondebtors, including Purdue's founders the Sackler family, of liabilities associated with Purdue's sale of OxyContin, in exchange for the Sackler family's ownership interest in the companies and more than $4 billion to settle OxyContin litigation claims. At the time of Purdue's bankruptcy filing, Purdue and the Sacklers were defendants in 3,400 lawsuits seeking an estimated $40 trillion in damages, whereas the value of Purdue's assets was estimated at no more than $1.8 billion.

In December 2021, the U.S. District Court for the Southern District of New York vacated the plan confirmation order, ruling that the bankruptcy court did not have authority under the U.S. Constitution or the Bankruptcy Code to approve nonconsensual releases granted under the plan to the Sacklers. According to the district court, the released claims at issue were "non-core" under the U.S. Supreme Court's ruling in *Stern v. Marshall*, 564 U.S. 462 (2011), and the bankruptcy court could not constitutionally enter a final order that effectively finally adjudicated the released claims but, rather, should have issued proposed findings of fact and conclusions of law regarding such claims (and the releases thereof) to the district court. In addition, the district court wrote:

Contrary to the bankruptcy judge's conclusion, Sections 105(a) and 1123(a)(5) & (b)(6) [of the Bankruptcy Code], whether read individually or together, do not provide a bankruptcy court with such authority; and there is no such thing as 'equitable authority'

or 'residual authority' in a bankruptcy court untethered to some specific, substantive grant of authority in the Bankruptcy Code.

In re Purdue Pharma, L.P., 635 B.R. 26, 78 (S.D.N.Y. 2021), *rev'd and remanded*, 69 F.4th 45 (2d Cir. 2023), *rev'd and remanded sub nom. Harrington, United States Trustee, Region 2 v. Purdue Pharma L.P.*, 2024 WL 3187799 (U.S. June 27, 2024). Surprisingly, the Congressional directive found in 28 U.S.C. 157(b)(5) that "[t]he district court shall order that personal injury tort and wrongful death claims shall be tried in the district court in which the bankruptcy case is pending" was not invoked.

On January 27, 2022, the Second Circuit granted the request of Purdue, various creditor and claimant groups, and several Sackler family members for leave to appeal the district court's interlocutory order vacating the bankruptcy court's confirmation order.

In February 2022, the Sacklers agreed to add more than $1.6 billion to the $4.3 billion settlement that they would have paid under Purdue's original chapter 11 plan. Pending the Second Circuit's hearing and deliberations on the dispute, a court-appointed mediator explored a possible global settlement between Purdue and parties opposing the plan. As a result of these negotiations, many parties agreed to the terms of a revised plan, reflecting, among other things, the Sackler family's increased financial contribution. By the time the Second Circuit handed down its ruling on the appeal, the remaining appellees consisted of the U.S. Trustee, several Canadian municipalities and indigenous nations, and several individual *pro se* plaintiffs. The revised plan was overwhelmingly supported by opioid claimants and was endorsed by all 50 states (in addition to thousands of state instrumentalities and health care providers).

A divided three-judge panel of the Second Circuit reversed the district court's order holding that the Bankruptcy Code does not permit nonconsensual releases of third-party direct claims against nondebtors, affirmed the bankruptcy court's confirmation of Purdue's chapter 11 plan, and remanded the case below for further proceedings.

The Second Circuit panel concluded that the bankruptcy court had both jurisdiction and statutory authority to approve the third-party releases in Purdue's chapter 11 plan.

According to the Second Circuit, a bankruptcy court's "ability to release claims at all derives from its power of discharge" under section 524(a), which provides that a bankruptcy discharge, among other things, releases a debtor from personal liability for any debt by enjoining creditors from attempting to collect on it. Although section 524(e) of the Bankruptcy Code provides that a debtor's discharge "does not affect the liability of any other entity on … such debt," the court emphasized that the releases in Purdue's chapter 11 plan "do not constitute a discharge of debt for the Sacklers because the releases neither offer umbrella protection against liability nor extinguish all claims." *Purdue Pharma*, 69 F.4th at 70.

The Second Circuit panel agreed with the lower courts that the bankruptcy court had statutory jurisdiction to approve the releases "because it is conceivable, indeed likely, that the resolution of the released claims would directly impact" Purdue's bankruptcy estate even though many of the claims were asserted directly against the Sackler officers and directors, who were indemnified by Purdue for liabilities that did not arise from bad-faith conduct. *Id.* at 71.

The Second Circuit panel also concluded that nonconsensual third-party releases may be approved as part of a chapter 11 plan under sections 105(a) and 1123(b)(6) of the Bankruptcy Code. Although section 105(a) alone cannot provide authority to approve such releases, the court explained, section 1123(b)(6) fills the gap consistent with the Supreme Court's conclusion in *United States v. Energy Resources Co.*, 495 U.S. 545 (1990), that section 1123(b)(6)—"acting in tandem with § 105(a)—grants bankruptcy courts a 'residual authority' consistent with 'the traditional understanding that bankruptcy courts, as courts of equity, have broad authority to modify creditor-debtor relationships.'" *Id.* at 73 (quoting *Energy Resources*, 495 U.S. at 549). The Second Circuit panel found the Seventh Circuit's reasoning in *Airadigm* and the Sixth Circuit's rationale in *Dow Corning* to be convincing on this point.

The Second Circuit panel distanced itself from courts that have ruled that section 524(e) precludes such releases, emphasizing, as the Seventh Circuit explained in *Airadigm*, that the language of section 524(e) is not mandatory and does not expressly manifest lawmakers' intent to limit the bankruptcy court's power to release nondebtors. The panel also found ample Second Circuit precedent "support[ing] the approval of a plan containing nonconsensual third-party releases" in non-asbestos liability cases, provided the bankruptcy court makes adequate factual findings and satisfies certain equitable considerations. *Id.* at 75–77 (citing *In re Metromedia Fiber Network, Inc.*, 416 F.3d 136 (2d Cir. 2005); *Drexel*, 960 F.2d at 293; *MacArthur Co. v. Johns-Manville Corp.*, 837 F.2d 89, 91 (2d Cir. 1988)).

On August 10, 2023, the Supreme Court granted a stay of the mandate as well as an informal petition filed by the U.S. Trustee for a writ of *certiorari* with respect to the Second Circuit's ruling. *See Harrington v. Purdue Pharma L.P.*, 144 S. Ct. 44 (Aug. 10, 2023).

The Supreme Court's Ruling. The Supreme Court reversed the Second Circuit's ruling and remanded the case below for further proceedings.

Writing for the 5–4 majority, Justice Gorsuch repeatedly observed that "[t]he Sacklers have not filed for bankruptcy and have not placed virtually all their assets on the table for distribution to creditors, yet they seek what essentially amounts to a discharge" of all existing and future claims against them for opioid liability. *Purdue Pharma*, 2024 WL 3187799, at *5.

According to the majority, section 1123(b)(6) of the Bankruptcy Code does not provide authority for nonconsensual third-party chapter 11 plan releases because the "catchall" provision must be read narrowly "in light of its surrounding context . . . to 'embrace only objects similar in nature' to the specific examples preceding it," none of which refer in any way to discharge or release of claims asserted by nonconsenting creditors against nondebtors, but instead, "concern the debtor—its rights and responsibilities, and its relationship with its creditors." *Id.* at *7 (citations omitted). "Doubtless," Justice Gorsuch wrote, "paragraph (6) operates to confer additional authorities on a bankruptcy court. . . . [b]ut the catchall cannot be fairly read to endow a bankruptcy court with the 'radically different' power to discharge the debts of a nondebtor without the consent of affected nondebtor claimants." *Id.*

The majority also emphasized that the Bankruptcy Code "does authorize courts to enjoin claims against third parties without their consent, but does so in only one context"—section 524(g), governing asbestos cases. According to Justice Gorsuch, this "makes it all the more unlikely that § 1123(b)(6) is best read to afford courts that same authority in every context." *Id.* at *9.

In addition to the text and context of the Bankruptcy Code, the majority reasoned that limiting a bankruptcy discharge to claims against a debtor that offered a "fair and full surrender of [its] property" is consistent with pre-Bankruptcy Code law and practice. *Id.* at *10. Justice Gorsuch explained that:

> No one has directed us to a statute or case suggesting American courts in the past enjoyed the power in bankruptcy to discharge claims brought by nondebtors against other nondebtors, all without the consent of those affected. Surely, if Congress had meant to reshape traditional practice so profoundly in the present bankruptcy code, extending to courts the capacious new power the plan proponents claim, one might have expected it to say so expressly "somewhere in the [c]ode itself."

Id. (citation omitted).

The majority rejected the argument that invalidating the "Sackler discharge" would leave opioid victims with little recourse for meaningful recovery and that the chapter 11 plan releases of the Sacklers should be upheld in the interests of public policy. According to Justice Gorsuch, the Court is "the wrong audience" for such a public policy debate, which only Congress can address by amending the Bankruptcy Code to expressly authorize such releases in non-asbestos cases. *Id.* at *11.

Finally, the 5–4 majority emphasized that nothing in its decision should be interpreted to call into question *consensual* chapter 11 plan releases, declining to express a view on what qualifies as a consensual release or a release in a plan that provides for full satisfaction of such third-party claims against the released party. Similarly, it did not address whether its interpretation of the Bankruptcy Code would justify unwinding already confirmed and substantially consummated chapter 11 plans. *Id.*

In his dissent, Justice Kavanaugh, joined by joined by Chief Justice Roberts and Justices Sotomayor and Kagan, wrote that "[t]oday's decision is wrong on the law and devastating for more than 100,000 opioid victims and their families." *Id.* at *12 (dissenting opinion). According to the dissent, the majority's decision "rewrites the text of the U.S. Bankruptcy Code and restricts the long-established authority of bankruptcy courts to fashion fair and equitable relief for mass-tort victims." *Id.* The dissent further notes that bankruptcy and appellate courts, based principally on section 1123(b)(6), "have determined that nondebtor releases can be appropriate and essential in mass-tort cases like this one." *Id.* at *13.

Outlook. Third-party releases in non-asbestos chapter 11 plans have long been controversial. Because such releases are commonly the linchpin of heavily negotiated chapter 11 plans involving tens of thousands of creditors, the Supreme Court's ruling in *Purdue Pharma* is a discouraging development for companies that file for chapter 11 protection in an effort to manage mass tort and other liabilities. Without Congressional action to authorize nonconsensual third-party releases in non-asbestos cases, the sea change wrought by *Purdue Pharma* may have significant consequences in many chapter 11 cases, mass tort and otherwise.

It may also result, like the asbestos suits of the 1990s, with the federal courts being overwhelmed by having all mass tort cases naming the debtor as a defendant being transferred to the district court where the bankruptcy case is pending, as provided by Congress in 28 U.S.C. § 157(b)(5). That statutory authority may give rise to a settlement process in federal courts that one could hope has similarly successful results as those achieved by the federal bench in multidistrict litigation (with 98% of cases settled). After all, many of the plaintiffs' attorneys in mass tort bankruptcy cases are already participants and often act as lead counsel in many multidistrict litigations.

The Court's ruling in *Purdue Pharma* may have sounded the death knell for nonconsensual third-party releases in non-asbestos chapter 11 cases that are not full-pay cases, but it does not necessarily prohibit such releases in all bankruptcy cases. The prospect for full payment plans and potentially complex "opt out" arrangements being viewed as consensual remains and may be a viable response.

Additionally, if a multinational company or enterprise has the option of filing a restructuring proceeding in a foreign tribunal that approves a restructuring plan (such as a "scheme of arrangement" under UK or Singapore law or a *wet homologatie onderhands akkoord* (or WHOA) in the Netherlands) containing third-party releases, the debtor's foreign representative can file a chapter 15 case in the United States—provided it has U.S. assets—seeking recognition of the foreign restructuring proceeding and enforcement of the debtor's restructuring plan in the United States.

Many U.S. bankruptcy courts have recognized and enforced foreign restructuring plans providing for third-party releases in chapter 15 cases. *See, e.g., In re Vitro S.A.B. de CV*, 701 F.3d 1031, 1062 (5th Cir. 2012) ("We conclude that, although our court has firmly pronounced its opposition to [nondebtor] releases, relief is not thereby precluded under § 1507, which was intended to provide relief not otherwise available under the Bankruptcy Code or United States law."); *In re Agrokor d.d.*, 591 B.R. 163 (Bankr. S.D.N.Y. 2018); *In re Sino-Forest Corp.*, 501 B.R. 655 (Bankr. S.D.N.Y. 2013); *In re Metcalfe & Mansfield Alternative Investments*, 421 B.R. 685 (Bankr. S.D.N.Y. 2010).

Given the Supreme Court's disinclination in *Purdue Pharma* to weigh in on the litigants' public policy arguments, it seems unlikely that a U.S. bankruptcy court would conclude—at least based on *Purdue Pharma*—that enforcement in the United States of third-party releases in a foreign restructuring plan would be "manifestly contrary" to U.S. public policy within the meaning of section 1506 of the Bankruptcy Code, thereby giving the court the discretion to refuse a request for recognition.

Jones Day filed amici curiae *briefs in support of Purdue's chapter 11 plan on behalf of an Ad Hoc Group of Local Councils of the Boy Scouts of America, the U.S. Conference of Catholic Bishops, and Aldrich Pump LLC, Murray Boiler LLC, and Bestwall LLC.*

U.S. SUPREME COURT HOLDS THAT INSURER HAS STANDING AS "PARTY IN INTEREST" TO OBJECT TO CHAPTER 11 PLAN

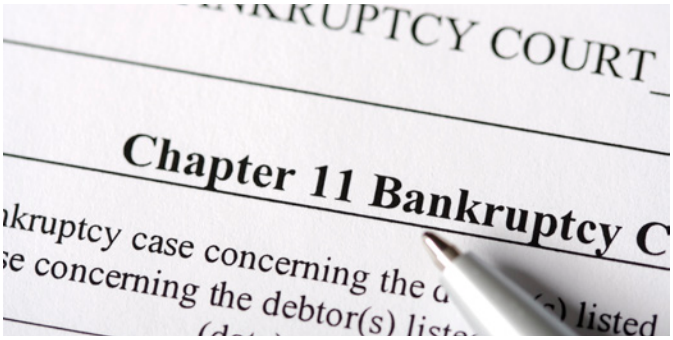
On June 6, 2024, the U.S. Supreme Court ruled in *Truck Insurance Exchange v. Kaiser Gypsum Co.*, ____ U.S. ____, 144 S. Ct. 1414 (2024), that an insurer with "financial responsibility for bankruptcy claims" is a "party in interest" that can raise objections to its insureds' chapter 11 plan, because the insurer "can be directly affected by the reorganization proceedings in myriad ways." According to the unanimous Court, the Bankruptcy Code provision—11 U.S.C. § 1109(b)—that gives every "party in interest" the right to be heard "on any issue" in a chapter 11 case "asks whether the reorganization proceedings might directly affect a prospective party, not how a particular reorganization plan actually affects that party." Section 1109(b) of the Bankruptcy Code, the Court wrote, "grants insurers neither a vote nor a veto; it simply provides them a voice in the proceedings."

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. *E.g., TransUnion LLC v. Ramirez*, 594 U.S. 413, 422–30 (2021).

In addition, it is generally necessary that some statutory authority provide a would-be party the right to be in court. Various provisions of the Bankruptcy Code confer this "statutory" 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, section 1109 of the Bankruptcy Code provides that "[a] party in interest, including the debtor, the trustee, a creditors committee, an equity security holders' committee, a creditor, an equity security holder, or any indenture trustee may raise and may appear and be heard on any issue" in a 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.



Truck Insurance. Kaiser Gypsum Company, Inc. and Hanson Permanente Cement Inc. (collectively, the "debtors") manufactured and sold products that contained asbestos. Facing tens of thousands of asbestos-related lawsuits, the debtors filed for chapter 11 protection on September 30, 2016, in the Western District of North Carolina. After extensive negotiations with representatives of asbestos claimants as well as various other unsecured creditors, the debtors proposed a chapter 11 plan that, among other things, would create a trust under section 524(g) of the Bankruptcy Code funded by the debtors and their parent company to deal with present and future asbestos claims, which were to be channeled to the trust. The plan would transfer all of the debtors' rights under their insurance policies to the trust.

The debtors' primary insurer was Truck Insurance Exchange ("Truck"). Under the insurance policies (the "policies"), Truck was obligated to pay up to $500,000 per claim, with a $5,000 deductible per claim. Truck was required to defend and indemnify the debtors even if a claim was false or fraudulent. The policies had no maximum aggregate limit, and they were non-eroding (i.e., defense costs were not counted against the policy limit for each claim). The policies provided that the debtors were required to assist and cooperate with Truck in defending against claims.

The plan's provisions for asbestos claims depended on whether the claims were or were not covered by the policies. Covered claims were to continue to be litigated in the tort system—subject to the $500,000 per-claim coverage limit—with the trust picking up the deductibles. Any uninsured claims would be paid by the trust alone, subject to its administrative procedures. For either sort of claim, punitive damages would not be available.

Covered claims remained subject to Truck's prepetition coverage defenses and its rights in the tort system, including the debtors' continuing obligation to assist and cooperate. Uninsured claims were governed by trust distribution procedures. For certain claims under these procedures (known as "extraordinary" claims), there were special disclosure requirements, common for trusts created in the last decade or so, designed to prevent fraudulent and duplicate claims.

All claims of non-asbestos unsecured creditors were settled. The debtors' excess insurers also dropped their objections to the plan. The only class entitled to vote on the plan—asbestos claimants—voted unanimously to accept it.

Only Truck opposed confirmation of the debtors' chapter 11 plan. It argued that: (i) the plan was not "proposed in good faith," as required by section 1129(a)(3) of the Bankruptcy Code, because it was allegedly the result of "collusion" between debtors and asbestos claimants and the anti-fraud provisions for certain claims resolved under the trust distribution procedures did not apply to insured claims resolved in the tort system, thereby exposing Truck to millions of dollars in fraudulent tort claims; (ii) funding for the plan impermissibly impaired Truck's rights under the policies by relieving the debtors of their assistance and cooperation obligations, and by precluding Truck from invoking the debtors' conduct in bankruptcy as a defense in future coverage disputes; and (iii) the trust violated section 524(g) of the Bankruptcy Code because, among other things, it did not "deal equitably with claims and future demands."

The bankruptcy court recommended that the district court approve the chapter 11 plan, finding that it was proposed in good faith and "insurance neutral" because the plan did not increase Truck's obligations or impair its contractual rights under the policies. Based on its finding of insurance neutrality, the bankruptcy court concluded that Truck was not a party in interest under section 1109(b) and therefore lacked standing to challenge the plan. That court also went on to reject Truck's objections on the merits, including finding that the plan was the result of arm's-length negotiation and did not violate the Truck policies.

After the district court confirmed the plan and adopted all of the bankruptcy court's findings, Truck appealed the confirmation order to the U.S. Court of Appeals for the Fourth Circuit.

The Fourth Circuit affirmed, agreeing with the lower courts that Truck was not a party in interest under section 1109(b). Among other things, the court of appeals concluded that the plan was insurance neutral. It did not alter Truck's pre-bankruptcy contractual rights or "quantum of liability" because Truck was not entitled when litigating claims before the bankruptcy to the anti-fraud measures it requested for litigating claims after the bankruptcy. Nor had the debtors' conduct in bankruptcy violated their assistance and cooperation obligations. Truck also sought party-in-interest status as a creditor, because it had claims for unpaid deductibles. But because the plan paid those claims in full, the Fourth Circuit ruled that Truck had no injury in fact as a creditor and thus lacked Article III standing "to object to aspects of a reorganization plan that in no way relate to its status as a creditor but instead implicate only the rights of third parties (who actually support the Plan)."

The Supreme Court agreed to review the Fourth Circuit's ruling on October 13, 2023, to resolve a claimed split among the federal circuit courts of appeals. Although they all applied some form of the doctrine of "insurance neutrality," they had used different language to describe the interplay of section 1109(b) and Article III in bankruptcy cases. *See In re Global Industrial Technologies, Inc.*, 645 F.3d 201, 211 (3d Cir. 2011) (*en banc*) (concluding that section 1109(b) is coextensive with the right of any party with Article III standing to appear and be heard in a chapter 11 case); *In re Tower Park Properties, LLC*, 803 F.3d 450, 457 n.6 (9th Cir. 2015) (determining that Article III and section 1109(b) are not "coextensive"); *In re Thorpe Insulation Co.*, 677 F.3d 869, 885 (9th Cir. 2012) (looking to "the real-world impacts of the [chapter 11] plan to see if it increases insurance exposure and likely liabilities of [the insurers]," and ruling that an insurer would have standing to object to the plan provided there were "a substantial economic impact" on the insurer); *In re James Wilson Associates*, 965 F.2d 160, 169 (7th Cir. 1992) (holding that section 1109(b) preserves background "limitations on standing, such as that the claimant be within the class of intended beneficiaries of the statute that he is relying on for his claim"); *In re C.P. Hall Co.*, 750 F.3d 659, 661–62 (7th Cir. 2014) (stating rule for section 1109(b) statutory standing based on *James Wilson* and other circuit-court cases, and rejecting argument that *Global* and *Thorpe* were in conflict with them).

The Supreme Court's Ruling. The Supreme Court reversed the Fourth Circuit's ruling.

Writing for the unanimous Court, Justice Sonia Sotomayor noted at the outset of her opinion that "Section 1109(b)'s text, context, and history confirm that an insurer such as Truck with financial responsibility for a bankruptcy claim is a 'party in interest' because it may be directly and adversely affected by the reorganization plan." *Truck Insurance*, 144 S. Ct. at 1423.

Justice Sotomayor explained that a "common thread uniting the seven listed parties" in the "illustrative but not exhaustive list of parties in interest" in section 1109(b) "is that each may be directly affected by a reorganization plan either because they *have a financial interest in the estate's assets* (the debtor, creditor, and equity security holder) or because they *represent parties that do* (a creditors' committee, an equity security holders' committee, a trustee, and an indenture trustee)." *Id.* at 1424 (*emphases added*). But she did not limit party-in-interest status to those

falling in one of these two categories. According to Justice Sotomayor, lawmakers use the phrase "party in interest" in provisions of the Bankruptcy Code "when it intends that provision to apply 'broadly.'" *Id.* (citing *Hartford Underwriters Ins. Co. v. Union Planters Bank, N. A.*, 530 U.S. 1, 7 (2000)).

The broad scope of the term, she noted, is consistent with the ordinary meanings of the terms "party" and "interest," and supported by section 1109(b)'s historical context and purpose in promoting broad participation in bankruptcy cases. *Id.* at 1424–25. When Congress enacted section 1109(b) as part of the Bankruptcy Code in 1978, Justice Sotomayor explained, it opted for a "capacious" and "nonexhaustive" list of entities qualifying as parties in interests in lieu of the exclusive list applied in cases under the former Bankruptcy Act of 1898. *Id.* at 1425.

Applying these principles to the case at hand, the Court ruled that "insurers such as Truck with financial responsibility for bankruptcy claims are parties in interest." According to Justice Sotomayor, an insurer's interests can be affected by a chapter 11 case in "myriad ways." *Id.* at 1426. For example, a chapter 11 plan could: (i) impair an insurer's contractual rights to control settlements or defend claims; (ii) abrogate an insurer's right to contribution from other insurers; or (iii) "be collusive, in violation of the debtor's duty to cooperate and assist, and impair the insurer's financial interests by inviting fraudulent claims." *Id.*

In the case before the Court, Justice Sotomayor explained, Truck was responsible for "the vast majority" of the liability of the trust established under chapter 11 plan, and "§ 524(g)'s channeling injunction, which stays any action against the Debtors, means that Truck would stand alone in carrying that financial burden." *Id.* at 1426.

The Court faulted the lower courts' reliance on the "insurance neutrality" doctrine, which Justice Sotomayor stated is "conceptually wrong and makes little practical sense." *Id.* at 1427. She explained that the doctrine "conflates the merits of an objection with the threshold party in interest inquiry," and "is too limited in its scope" because, by focusing on the insurer's pre-bankruptcy obligations and property rights, "it wrongly ignores all the other ways in which bankruptcy proceedings and reorganization plans can alter and impose obligations on insurers." *Id*.

The Court rejected the debtors' contention based on lower-court decisions that reading the text of section 1109(b) to give insurers like Truck party in interest status would allow "'peripheral parties' to derail a reorganization." According to Justice Sotomayor, a "'parade of horribles' argument generally cannot 'surmount the plain language of the statute,'" and section 1109(b) "provides parties in interest only an opportunity to be heard—not a vote or a veto in the proceedings." *Id.* (citation and footnote omitted). Moreover, she noted, a bankruptcy court has the equitable power under section 105(a) of the Bankruptcy Code "to control participation in a [bankruptcy case]" where "necessary or appropriate to enforce or implement court orders or rules, or to prevent an abuse of process." *Id.* at 1427 n.5 (quoting 11 U.S.C. § 105(a)).

She acknowledged that the term "party in interest" is not intended to include every entity that might be involved in or affected by a chapter 11 case, and that there might be difficult cases requiring courts "to evaluate whether truly peripheral parties have a sufficiently direct interest." This case, Justice Sotomayor concluded, "is not one of them." *Id.* at 1428.

In light of the Court's conclusion that Truck was a party in interest under section 1109(b) based on its insurer status, the Court declined to address whether Truck could be a party in interest to object to the debtors' chapter 11 plan based on its status as a creditor. The Court did not reach the merits of the plan, and remanded for further proceedings.

Justice Samuel Alito did not participate in the case.

Outlook. The Supreme Court's ruling in *Truck Insurance* is noteworthy for a number of reasons. Most significantly, by rejecting the long-standing consensus of the circuit courts that an insurer was not a party in interest able to challenge an "insurance neutral" plan, the decision establishes the proposition that chapter 11's non-exclusive catalog of "parties in interest" encompasses a wide variety of persons or entities potentially impacted by a chapter 11 case, but with the caveat that the term "party in interest" is not so broad as to give parties only peripherally affected by the bankruptcy a voice in the case. Although much of its opinion focused on insurers, and it will have the most immediate effect in that area, the Court was interpreting section 1109(b) generally, and thus arguably broadening it—to any "prospective party" whom "the reorganization proceedings might directly affect." The Court provided little guidance on the outer boundary of that concept.

Truck Insurance is also notable for what it does not say: It did not get into the interplay of constitutional standing and bankruptcy statutory standing that was the basis for the claimed circuit split underlying the petition for certiorari. Although Truck had argued in its merits brief that section 1109(b) should be read as going to the limits of Article III, the Court in its opinion never mentioned constitutional standing. Guidance on this point would have been useful, as the tension between bankruptcy standing and Article III standing has long been a source of confusion and disagreement among the courts. *See In re Wilton Armetale, Inc.*, 968 F.3d 273 (3d Cir. 2020) (examining the distinction between constitutional and bankruptcy standing and holding 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); *In re Pettine*, 655 B.R. 196, 206 (B.A.P. 10th Cir. 2023) (stating that "[t]he caselaw is unsettled regarding whether the Article III case-or-controversy requirement that imposes Article III jurisdictional constraints apply to non-Article III bankruptcy courts," and noting that there is a split in the circuits on the issue).

Jones Day represented debtors Kaiser Gypsum Company, Inc. and Hanson Permanente Cement Inc. in the proceedings before the Supreme Court.

U.S. SUPREME COURT RULES THAT NO REFUNDS FOR OVERPAYMENT OF U.S. TRUSTEE ADMINISTRATIVE FEE IN CHAPTER 11 CASES

On June 14, 2024, the U.S. Supreme Court issued its opinion in *Office of United States Trustee v. John Q. Hammons Fall 2006, LLC*, No. 22-1238, — U.S. —, 144 S. Ct. 1588 (2024). The Court held that debtors who paid disuniform bankruptcy fees paid under a 2017 amendment to 28 U.S.C. § 1930(a)(6) (the "2017 Amendment") that was later determined to be unconstitutional were entitled to prospective relief only, and were not entitled to a refund of the unconstitutional fees. *Id.* at 1596. This decision answers the remedy question the Court explicitly left unresolved when it unanimously found the 2017 Amendment unconstitutional in *Siegel v. Fitzgerald*, 596 U.S. 464, 481 (2022).

Background. In 2017, Congress amended 28 U.S.C. § 1930(a)(6) to drastically increase the quarterly fees payable to the U.S. Trustee in chapter 11 cases, raising the fees from a maximum of $30,000 per quarter per debtor to a maximum of $250,000 per quarter per debtor. These increased fees, however, were not immediately applied to chapter 11 cases pending in districts operating under the Bankruptcy Administrator ("BA") program instead of the U.S. Trustee program.

In response, multiple debtors challenged the constitutionality of the law, arguing that it impermissibly allowed the government to charge higher fees in districts overseen by the U.S. Trustee ("UST") system compared to those charged in BA districts. In *Siegel*, the Court held that the U.S. Constitution's "Bankruptcy Clause affords Congress flexibility to fashion legislation to resolve geographically isolated problems, but . . . the Clause does not permit Congress to treat identical debtors differently based on an artificial funding distinction that Congress itself created." *Siegel*, 596 U.S. at 479–80. The Court remanded *Siegel* and the related cases raising similar challenges to the 2017 Amendment back to the Circuit courts to decide the proper remedy. *Id.* at 481.

Following *Siegel*, all circuit courts to consider the issue on remand found that the proper remedy for the constitutional violation found in *Siegel* was a refund of the disuniform fees paid by the affected debtors. *See USA Sales, Inc. v. Office of United States Trustee*, 76 F.4th 1248 (9th Cir. 2023); *U.S. Trustee Region 21 v. Bast Amron LLP* (*In re Mosaic Management Inc.*), 71 F.4th 1341 (11th Cir. 2023) (petition for cert. filed Sept. 22, 2023); *In re Clinton Nurseries, Inc.*, 53 F.4th 15 (2d Cir. 2022) (petition for cert. filed July 17, 2023).

After the Tenth Circuit reaffirmed its prior decision in *Hammons*, ordering a refund of the debtors' quarterly fees paid under the 2017 Amendment so that the fees paid would equal the amount the debtors would have paid in a BA district, *In re John Q. Hammons Fall 2006, LLC*, 2022 WL 3354682, *1 (Aug. 15, 2022), the government timely sought *certiorari*, teeing up the issue for the Supreme Court. *See Off. of United States Tr. v. John Q. Hammons Fall 2006, LLC*, 600 U. S. ____, 144 S. Ct. 480 (2023).

In its petition and briefing to the Court, the U.S. Trustee argued that no refund was necessary because Congress had already amended § 1930(a)(6) in 2021 to eliminate the nonuniformity. *See* Pet., 17, *Office of United States Tr. v. John Q. Hammons Fall 2006, LLC*, No. 22-1238, 2023 WL 4201139 (filed Jun. 23, 2023). The government argued that this prospective relief was sufficient to remedy the constitutional problem. Moreover, the government cautioned, should the Court require the UST to pay back affected debtors, those refunds could cost the U.S. Trustee Fund as much as $326 million, assuming refunds were actually sought and paid to all debtors who had paid the increased fees. *See Hammons*, 144 S. Ct. at 1597.

Majority Decision. Writing for a sixJustice majority, Justice Jackson largely agreed with the government's arguments, holding that prospective relief was the proper remedy for the nonuniformity violation and that the other two remedies contemplated by *Siegel*—refunds to UST debtors or retroactive fee increases on BA debtors—were both untenable. As a preface to the remedy consideration, the Court summarized the 2017 Amendment's constitutional defect by explaining that "the violation . . . was nonuniformity, not high fees," *id.* at 1595, and that the problem was thus "short lived and small"—"short lived" because it existed only from January 2018 to April 2021 and "small" because 98% of debtors (those in UST districts) paid the higher fees that Congress intended them to pay, while only 2% of debtors (those in BA districts) paid lower fees. *Id.*

The majority then explained that in such a situation, "the key question" for the Court was "what the legislature would have willed had it been apprised of the constitutional infirmity." *Id.* (citations omitted). And in "cases involving unequal treatment," that question turns on two considerations: "Congress's 'intensity of commitment' to the more broadly applicable rule, and 'the degree of potential disruption of the statutory scheme that would occur' if we were to extend the exception." *Id.* (citations omitted).

The Court concluded that Congress's decision not to lower UST fees to BA levels when it amended the law in 2021 "removed any doubts about its commitment to raising fees[.]" *Id.* at 1596. And, if the government's estimate of $326 million owed to UST debtors was "even close to correct," *id.*, a refund would work a significant disruption to the bankruptcy system by "transform[ing] a program Congress designed to be self-funding into an enormous bill for taxpayers." *Id.* at 1597. Without acknowledging the apparent contradiction with the government's dire refund estimates, the majority next reasoned that refunding all UST debtors "blinks reality" because the vast majority of those cases have closed "and some of those debtors have been liquidated or otherwise ceased to exist." *Id.*

The majority also rejected raising fees on BA debtors because retroactively imposing such fees would "raise serious practical challenges," *id.*, noting that the "Government would be forced to extract fees from funds that might already be disbursed, inevitably prompting additional litigation and even the unwinding of closed cases." *Id.* at 1598.

The majority rejected the debtors' and dissent's arguments that "due process requires meaningful backward-looking relief unless an exclusive predeprivation remedy is both clear and certain," *id.* at 1599, because, it reasoned, debtors "had the opportunity to challenge their fees before they paid them." *Id.* at 1600. And because the debtors here had the option of both pre and post-deprivation challenges, the majority found that due process does not require a refund as the sole remedy. *See id.* at 1599. Rather, it said, the remedy here must address the constitutional violation (non-uniformity); it need not award the challengers' preferred relief (money damages). *Id.* at 1598. The majority likewise rejected the dissent's claims that congressional intent favored refunds, noting that, in 2021, "'Congress . . . address[ed] this very issue' and mandated prospective equalization of fees," not refunds. *See id.* at 1598 (citations omitted).

REMAINING QUESTIONS

Although *Hammons* closes the door on prospective refunds for debtors who paid unconstitutionally disuniform fees under the 2017 Amendment, the majority opinion did not directly address debtors who do not require affirmative relief. In a dissent joined by Justices Thomas and Barrett, Justice Gorsuch concluded that even "under the majority's logic, debtors who did choose to 'withhold the unconstitutional fees' and brought prepayment challenges may not now be ordered to hand over that money." *Id.* at 1609 n.6 (Gorsuch, J., dissenting) (citations omitted). Nor did the Court pass on other challenges to the 2017 Amendment or the quarterly fee system more broadly. Thus, for debtors who do not require a refund to recover any unconstitutional fees (and also for debtors who timely preserved challenges to the 2017 Amendment that were not presented in *Siegel* or *Hammons*), the Supreme Court's decision in *Hammons* does not foreclose relief.

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

On June 24, 2024, the Court agreed to hear the U.S. government's case challenging a chapter 7 trustee's lawsuit seeking to avoid and recover a payment to the Internal Revenue Service (the "IRS") as a fraudulent transfer. In *Miller v. U.S.*, 71 F.4th 1247 (10th Cir. 2023), *cert. granted sub. nom. U.S. v. Miller*, No. 23-824 (U.S. June 24, 2024), the U.S. Court of Appeals for the Tenth Circuit ruled that the trustee could recover a $145,000 payment made by the debtor to the IRS for "personal tax debts" of its principals under section 544(b) of the Bankruptcy Code and applicable state fraudulent transfer law, reasoning that section 106(a) of the Bankruptcy Code waives the IRS's immunity from suit.

In so ruling, the Tenth Circuit sided with the Ninth and Fourth Circuits, both of which have ruled that the waiver of immunity in section 106(a) allows claims against the government under state law. *See In re DBSI, Inc.*, 869 F.3d 1004 (9th Cir. 2017); *Cook v. U.S. (In re Yahweh Center Inc.)*, 27 F.4th 960 (4th Cir. 2022). However, that approach is at odds with the Seventh Circuit's decision in *In re Equip. Acquisition Res. Inc.*, 742 F.3d 743 (7th Cir. 2014), where the court held that the immunity waiver in section 106(a) did not allow suit, reasoning that section 106(a) did not alter the requirement in section 544(b) that an actual unsecured creditor—a "triggering creditor"—exists with standing to prosecute the claim.

OHIO BANKRUPTCY COURT OFFERS GUIDANCE ON (THE AMENDED) ORDINARY COURSE PAYMENT PREFERENCE DEFENSE

Jane Rue Wittstein

To encourage vendors and other creditors to continue doing business with financially distressed entities, the Bankruptcy Code includes various defenses to litigation brought by a bankruptcy trustee or chapter 11 debtor-in-possession ("DIP") seeking to avoid pre-bankruptcy payments to such entities. One of these defenses shields from avoidance transfers made to pay debts incurred in the ordinary course of business of the debtor and the transferee. Until lawmakers amended the Bankruptcy Code in 2005 as part of the Bankruptcy Abuse Prevention and Consumer Protection Act ("BAPCPA"), transferees seeking to invoke the ordinary course payment defense bore a heavier evidentiary burden because the statutory provision—section 547(c)(2)—required that the transferee prove both that the payment was made in the ordinary course of business of the debtor and the transferee (the "subjective test"), and that the payment was made according to ordinary business terms (the "objective test").

The U.S. Bankruptcy Court for the Southern District of Ohio addressed a preference defendant's burden of proof under amended section 547(c)(2) in *In re ASPC Corp.*, 658 B.R. 455 (Bankr. S.D. Ohio 2024). The court granted summary judgment to a creditor in avoidance litigation, ruling that the defendant need only demonstrate that the payment satisfied one—but not both—of the tests stated in section 547(c)(2). According to the bankruptcy court, "[t]his case illustrates the importance of [the 2005 amendment's] replacement of the conjunctive 'and' with the disjunctive 'or' between the subjective and objective tests for the ordinary course of business defense."

THE ORDINARY COURSE OF BUSINESS PAYMENT DEFENSE TO PREFERENTIAL TRANSFER AVOIDANCE

Section 547(b) of the Bankruptcy Code provides that a trustee or DIP, "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)," may avoid any transfer made by an insolvent debtor within 90 days of a bankruptcy petition filing (or up to one year, if the transferee is an insider) "to or for the benefit of a creditor . . . for or on account of an antecedent debt," if the creditor, by reason of the transfer, receives more than it would have received in a chapter 7 liquidation and the transfer had not been made. 11 U.S.C. § 547(b).

Section 547(c) sets forth nine defenses or exceptions to preference avoidance. One of those is the "ordinary course payment" defense in section 547(c)(2), which provides as follows:

> The trustee may not avoid under this section a transfer . . . to the extent that such transfer was in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee, and such transfer was—(A) made in the ordinary course of business or financial affairs of the debtor and the transferee; or (B) made according to ordinary business terms. . . .

11 U.S.C. § 547(c)(2).

The ordinary course payment defense was intended to "leave undisturbed normal commercial and financial relationships and protect recurring, customary credit transactions which are incurred and paid in the ordinary course of business of both the debtor and the debtor's transferee." *Comm. of Unsecured Creditors of Gregg Appliances v. Curtis Int'l Ltd. (In re hhgregg, Inc.)*, 636 B.R. 545, 549 (Bankr. S.D. Ind. 2022) (quoting *Kleven v. Household Bank, F.S.B.*, 334 F.3d 638, 642 (7th Cir. 2003)); *accord Desmond v. Northern Ocean Liquidating Corp.* (*In re Nat'l Fish and Seafood, Inc.)*, 2024 WL 1422665 (Bankr. D. Mass. Apr. 1, 2024); *In re Liquidating Est. of H&P, Inc.*, 648 B.R. 767 (Bankr. W.D. Pa. 2023).

The defense "is formulated to induce creditors to continue dealing with a distressed debtor so as to kindle its chances of survival without a costly detour through, or a humbling ending in, the sticky web of bankruptcy." *Fiber Lite Corp. v. Molded Acoustical Prods. (In re Molded Acoustical Prods.)*, 18 F.3d 217, 219–220 (3d Cir. 1994) (citations omitted); *accord Auriga Polymers Inc. v. PMCM2, LLC as Tr. for Beaulieu Liquidating Tr.*, 40 F.4th 1273, 1288 (11th Cir. 2022) (citing *In re BFW Liquidation, LLC*, 899 F.3d 1178, 1193 (11th Cir. 2018)). Section 547(c)(2)'s legislative history indicates that its purpose is "to leave undisturbed normal financial relations." H.R. Rep. No. 95-595, at 373 (1977)); *see generally* COLLIER ON BANKRUPTCY ("COLLIER") ¶ 547.04 [2] (16th ed. 2024) ("This section is intended to protect recurring, customary credit transactions that are incurred and paid in the ordinary course of business of the debtor and the debtor's transferee.").

Section 547(c)(2) is an affirmative defense, meaning that the preference defendant bears the burden of proof. *See* 11 U.S.C. § 547(g); *Gulf City Seafoods, Inc. v. Ludwig Shrimp Co., Inc. (In re Gulf City Seafoods, Inc.)*, 296 F.3d 363, 367 (5th Cir. 2002); *In re Liquidating Est. of H&P, Inc.*, 648 B.R. 767, 790 (Bankr. W.D. Pa. 2023).

Section 547(c)(2) was amended in 2005 as part of BAPCPA. It previously provided as follows:

The trustee may not avoid under this section a transfer . . . to the extent that such transfer was—(A) in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee; (B) made in the ordinary course of business or financial affairs of the debtor and the transferee; *and* (C) made according to ordinary business terms.

11 U.S.C. § 547(c)(2) (amended in 2005) (emphasis added).

The 2005 amendments made successful invocation of the ordinary course payment defense considerably easier. A transferee still must demonstrate that a challenged transfer was "in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee." However, under amended section 547(c)(2), a transferee's additional evidentiary burden is limited to proving *either*: (i) that the transfer was made "in the ordinary course of business or financial affairs of the debtor and the transferee"; *or* (ii) that the transfer was made according to "ordinary business terms." *See Baumgart v. Savani Props. (In re Murphy)*, 2021 WL 2524946 at *2 (Bankr. N.D. Ohio Apr. 19, 2021).

Prior to the 2005 amendments, a preference defendant was required to prove *both* (i) and (ii) to successfully invoke the defense. Because the language of those alternatives remains unchanged, pre-2005 amendment case law interpreting the meaning of the provisions is still relevant. *See generally* COLLIER at ¶ 547.04 [2] (citing cases); *see Pirinate Consulting Group. v. Maryland Dep't of Env't (In re Newpage Corp.),* 555 B.R. 444, 452 (Bankr. D. Del. 2016); *Pereira v. United Parcel Serv. Of Am., Inc. (In re Waterford Wedgewood USA, Inc.)*, 508 B.R, 821, 827 (Bankr. S.D.N.Y. 2014).

The initial element of the ordinary course payment defense requires that the transfer be made to pay a debt incurred by the debtor in the ordinary course of business or financial affairs of *both* the debtor and the transferee. There is relatively little case law addressing this element of section 547(c)(2), and it is frequently undisputed. *See PMC Mktg. Corp.*, 543 B.R. 345, 357 (B.A.P. 1st Cir. 2016) ("There is no precise legal test to determine whether a preferential transfer was made in the ordinary course of business between the debtor and the creditor.") (citations and internal quotation marks omitted); COLLIER at ¶ 547.04 [2][i] (noting that "[m]ost courts assume this requirement is met by inferring from the evidence that there was nothing 'unusual' about the transactions underlying the preferential payment").

Section 547(c)(2)(A) creates a "subjective test," whereas section 547(c)(2)(B) establishes an "objective test." The former is an "inherently fact-intensive inquiry, aimed at determining whether the transfer at issue conformed with the 'normal payment practice between the parties.'" *In re Diversified Mercury Commc'ns, LLC*, 646 B.R. 403, 412 (Bankr. D. Del. 2022) (citing *In re Am. Home Mortg. Holdings, Inc.*, 476 B.R. 124, 135 (Bankr. D. Del. 2012); *Stanziale v. Superior Tech. Res., Inc. (In re Powerwave Techs., Inc.)*, 2017 WL 1373252, at *4 (Bankr. D. Del. Apr. 13, 2017)); *accord Faulkner v. Broadway Festivals, Inc. (In re Reagor-Dykes Motors, LP)*, 2022 WL 120199, at *5 (Bankr. N.D. Tex. Jan. 12, 2022).

In applying the subjective test, some courts consider the following factors:

> (1) the length of time the parties engaged in the type of dealings at issue; (2) whether the subject transfers were in an amount more than usually paid; (3) whether payments at issue were tendered in a manner different from previous payments; (4) whether there appears to have been an unusual action by the debtor or creditor to collect on or pay the debt; and (5) whether the creditor did anything to gain an advantage (such as additional security) in light of the debtor's deteriorating condition.

Diversified Mercury, 646 B.R. at 412 (citing *FBI Wind Down, Inc. v. Careers USA, Inc. (In re FBI Wind Down, Inc.)*, 614 B.R. 460, 487 (Bankr. D. Del. 2020); *accord Hechinger Inv. Co. v. Universal Forest Prods., Inc. (In re Hechinger Inv. Co.)*, 489 F.3d 568, 578 (3d Cir. 2007); *In re Gaines*, 502 B.R. 633, 641 (Bankr. N.D. Ga. 2013).

By contrast, the objective test examines whether a challenged transfer was "ordinary in the industry." *Reagor-Dykes*, 2022 WL 2046144, at *14; *accord H&P*, 648 B.R. at 790; *In re Whistler Energy II, LLC*, 608 B.R. 655, 662 (Bankr. E.D. La. 2019). For example, the U.S. Court of Appeals for the Sixth Circuit has held that, for purposes of the objective test, "'ordinary business terms' means that the transaction was not so unusual as to render it an aberration in the relevant industry." *Luper v. Columbia Gas of Ohio, Inc. (In re Carled, Inc.)*, 91 F.3d 811. 818 (6th Cir. 1996).

In applying the objective test, every federal circuit court that has addressed the issue has concluded that the phrase "ordinary business terms" in section 547(c)(2)(B) refers to the practices in the preference defendant's industry. *See Miller v. Fla. Mining & Materials (In re A.W. & Associates, Inc.)*, 136 F.3d 1439, 1443 (11th Cir. 1998); *Fiber Lite Corp. v. Molded Acoustical Prods., Inc. (In re Molded Acoustical Prods., Inc.)*, 18 F.3d 217, 220 (3d Cir. 1994); *In re Tolona Pizza Prods. Corp.*, 3 F.3d 1029, 1033 (7th Cir. 1993).

ASPC

Before it filed for chapter 11 protection on May 1, 2018, in the Southern District of Ohio, ASPC Corp., formerly known as AcuSport Corp. ("AcuSport"), was an authorized distributer of firearms manufactured by Sturm Ruger & Co., Inc. ("Ruger"). During

the 90-day period preceding its bankruptcy filing, AcuSport made several wire transfers to Ruger totaling more than $3 million for firearms shipped to AcuSport under distribution agreements.

In 2020, the trustee of a creditor trust established under AcuSport's liquidating chapter 11 plan sued Ruger seeking, among other things, to avoid the payments as preferential transfers.

Ruger moved for summary judgment in the avoidance litigation, arguing that AcuSport made the payments according to ordinary business terms and that the challenged transfers were shielded from avoidance under section 547(c)(2). Both parties agreed that the transfers were made in the ordinary course of business. Ruger's motion for summary judgment relied only on the objective test, contending that the transfers were "made according to ordinary business terms."

To support its affirmative defense, Ruger presented expert testimony regarding payment practices from both retailers and wholesalers like AcuSport to manufacturers in Ruger's small firearms manufacturing industry. It also claimed that the bankruptcy court should determine whether the challenged transfers were made according to ordinary business terms based on the number of days AcuSport's invoices remained unpaid compared to a range of days that invoices were typically outstanding in the relevant industry.

According to Ruger, with one exception, AcuSport paid Ruger's invoices within 42–56 days after their issuance, which was well within ordinary payment ranges in the small firearms manufacturing industry. AcuSport made only one payment outside the range—approximately $3,500—which AcuSport paid 74 days after its receipt of the invoice.

In opposing summary judgment, the trustee did not produce his own expert, but instead countered that Ruger should also have presented evidence of payments made by companies in AcuSport's durable goods wholesalers industry. He also argued that the court should focus on evidence other than the duration of outstanding invoices, including how other firearms manufacturers adjust credit limits, as compared to how Ruger adjusted AcuSport's credit limit during the 90-day preference period.

THE BANKRUPTCY COURT'S RULING

The bankruptcy court awarded summary judgment in favor of Ruger.

At the outset of his analysis, Chief U.S. Bankruptcy Judge John E. Hoffman, Jr. examined the history and purpose of section 547(c)(2), explaining that "[the 2005 amendment] did not change the subjective or objective tests themselves, but made it so a preference defendant need only prove that a transfer satisfies either of the two tests—not both." *ASPC*, 658 B.R. at 465.

Judge Hoffman emphasized that the Sixth Circuit gives preference defendants "considerable latitude" in defining the relevant industry for purposes of section 547(c)(2), and agreed with Ruger that its industry, as the recipient of the allegedly preferential transfer, was the relevant industry. He characterized the trustee's contention to the contrary as "a non-starter" because, among other things, the cases relied on by the trustee—two Sixth Circuit (and therefore precedential) rulings—did not support using the debtor-transferor's industry to assess ordinariness. *Id.* (citing *Logan v. Basic Distrib. Corp. (In re Fred Hawes Org., Inc.)*, 957 F.2d 239 (6th Cir. 1992); *First Fed. of Mich. v. Barrow*, 878 F.2d 912 (6th Cir. 1989)).

Moreover, Judge Hoffman noted, the one decision relied on by the trustee that did hold that the debtor's industry is the touchstone of ordinariness under section 547(c)(2)—*Shodeen v. Airline Software, Inc. (In re Access Air, Inc.)*, 314 B.R. 386 (B.A.P. 8th Cir. 2004)—had already been rejected by a bankruptcy court in a neighboring circuit and would not be followed by his court. *Id.* (citing *US Bank Nat'l Ass'n (In re Interstate Bakeries Corp.)*, 499 B.R. 376, 388 n.7 (Bankr. W.D. Mo. 2013) (disagreeing with *Access Air*).

Instead, Judge Hoffman explained, "Sixth Circuit law is consistent with selecting Ruger's (i.e., the defendant/transferee's) industry as the relevant industry for assessing whether the Transfers satisfy the objective test for the ordinary course of business defense." *Id.* at 466. Specifically, he noted, the Sixth Circuit in *Fred Hawes* stated that the transferor's "payment practices were in accordance with those of the [the defendant's] overall customer base," indicating that ordinariness should be determined by reference to the preference defendant's industry. *Id.* (citing *Fred Hawes*, 957 F.2d at 246) (internal quotation marks omitted). He further noted that every other circuit to consider the question has reached the same conclusion. *Id.* (citing *Tolona Pizza*, 3 F.3d at 1033; *A.W. & Associates*, 136 F.3d 1441; *Molded Acoustical*, 18 F.3d at 220).

Judge Hoffman found no fault with Ruger's analysis concerning the timing of payments in assessing the ordinariness of the transfers made by AcuSport. He also noted that the information regarding whether changes to AcuSport's credit limits by Ruger during the preference period were ordinary course (and clearly relevant to the *subjective* test) was not readily available and "would saddle Ruger (and any other creditor defending a preference action) with the burden of producing 'information that the competitors oft will be reluctant to yield and that frequently the creditor will find difficult to obtain.'" *Id.* at 468 (quoting *Molded Acoustical*, 18 F.3d at 224).

The bankruptcy court accordingly ruled that the trustee failed to raise any genuine issues of material fact that would preclude summary judgment in favor of Ruger on its preference defense claim under section 547(c)(2)(B) with respect to all transfers other than the $3,500 paid by AcuSport 74 days after its receipt of an invoice from Ruger. Most of the trustee's evidence, he

explained, was directed to the subjective test for ordinariness under section 547(c)((2)(A) rather than the objective test under section 547(c)(2)(B)—only one of which Ruger needed to satisfy to escape preference liability.

According to Judge Hoffman, "[t]his case illustrates the importance of [the 2005 amendment's] replacement of the conjunctive 'and' with the disjunctive 'or' between the subjective and objective tests for the ordinary course of business defense." *Id.* at 470. He also noted in *dicta* that, because there appeared to have been a change in the way that Ruger dealt with AcuSport before and during the preference period regarding credit limits, Ruger likely would not have been able to satisfy the pre-2005 version of section 547(c)(2).

OUTLOOK

Congress eased preference transferees' evidentiary burden considerably under the ordinary course payment defense when it amended section 547(c)(2) in 2005. As illustrated by *ASPC*, a transferee now need satisfy only one of the alternative tests stated in the provision to shield payments made during the preference period from avoidance. To be sure, because section 547(c)(2) is an affirmative defense, it is still incumbent on a preference defendant to introduce evidence sufficient to establish that either the subjective test or the objective defense has been satisfied. In addition, the trustee or DIP should be prepared to counter the transferee's evidence concerning the course of dealing between the parties and ordinary industry standards with its own evidence and expert testimony—a deficiency that was highlighted repeatedly by the bankruptcy court in *ASPC*. Another key takeaway from the ruling is that, at least in the Sixth Circuit, preference defendants are given considerable latitude in defining the "relevant industry" for purposes of the ordinary course payment defense.

FIRST IMPRESSIONS: SEVENTH CIRCUIT RULES THAT THE BANKRUPTCY CODE'S "SAFE HARBOR" FOR SECURITIES CONTRACTS TRANSFERS APPLIES TO NON-PUBLIC SECURITIES

Daniel J. Merrett

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 scope of the provision, including its limitation to transactions involving "financial institutions" as transferors or transferees, its preemption of avoidance litigation that could have been commenced by or on behalf of creditors under applicable non-bankruptcy law, and its application to non-public transactions.

One of the latest chapters in the ongoing debate was written by the U.S. Court of Appeals for the Seventh Circuit in *Petr v. BMO Harris Bank N.A.*, 95 F.4th 1090 (7th Cir. 2024) ("*BMO Harris 2*"). The Seventh Circuit affirmed a district court ruling broadly construing the section 546(e) safe harbor to bar a chapter 7 trustee from suing under state law and section 544 of the Bankruptcy Code to avoid an alleged constructively fraudulent transfer made by the debtor shortly after it had been acquired in a leveraged buy-out ("LBO"). Among other things, the Seventh Circuit agreed with the district court's conclusions that: (i) the safe harbor is not limited to transfers involving publicly traded securities; and (ii) section 546(e) preempted the trustee's claim to recover the value of the transfer under section 544 and state law.

THE SECTION 546(e) SAFE HARBOR

Section 546 of the Bankruptcy Code imposes a number of limitations on a bankruptcy trustee's avoidance powers, which include the power to avoid certain preferential and fraudulent transfers. Section 546(e) provides that the trustee may not avoid, among other things, a pre-bankruptcy transfer that is a settlement payment "made by or to (or for the benefit of) a . . . financial institution [or a] financial participant. . ., or that is a transfer made by or to (or for the benefit of)" any such entity "in connection with a securities contract," except under section 548(a)(1)(A) of the Bankruptcy Code. Thus, the section 546(e) "safe harbor" bars avoidance claims challenging a qualifying transfer unless the transfer was made with actual intent to hinder, delay, or defraud creditors under section 548(a)(1)(A), as distinguished from constructively fraudulent transfers under 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. For example, 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 I*"), 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 Company ("Tribune"). According to the Second Circuit, even though section 546(e) expressly provides that "the trustee" may not avoid certain payments under securities contracts unless such payments were made with the *actual* intent to defraud, section 546(e)'s language, its history, its purposes, and the policies embedded in the securities laws and elsewhere lead to the conclusion that the safe harbor was intended to preempt *constructive* fraudulent transfer claims asserted by creditors under state law.

The Second Circuit recently reaffirmed this approach in *In re Nine W. LBO Sec. Litig.*, 87 F.4th 130 (2d Cir. 2023), *reh'g denied*, Nos. 20-3257-cv (L) *et al.* (2d Cir. Jan. 3, 2024), where the court adopted a "transfer-by-transfer" rather than a "contract-by-contract" approach to the safe harbor in affirming in part and reversing in part a district court ruling that section 546(e) preempted a litigation trustee's fraudulent transfer and unjust enrichment claims seeking avoidance of payments made to public and non-public shareholders as part of an LBO because only the public shareholder payments involved a "financial institution."

Previously, in *Holliday, Liquidating Trustee of the BosGen Liq. Trust v. Credit Suisse Secs. (USA) LLC*, 2021 WL 4150523 (S.D.N.Y. Sept. 13, 2021) ("*Boston Generating*"), *appeal filed*, No. 21-2543 (2d Cir. Oct. 8, 2021), *appeal stayed*, No. 21-2543 (2d Cir. Oct. 3, 2022), the U.S. District Court for the Southern District of New York held that 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.

Public v. Private Transactions. Because section 546(e) is silent as to whether it applies to both public and private transactions, 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., In re Quebecor World (USA)*

Inc., 719 F.3d 94 (2d Cir. 2013) (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"); *overruled in part on other grounds by Merit Mgmt. Grp., LP v. FTI Consulting, Inc.*, 583 U.S. 366 (2018) ("*Merit*"); *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"), *overruled in part on other grounds by Merit Mgmt. Grp., LP v. FTI Consulting, Inc.*, 583 U.S. 366 (2018); *Contemporary Indus. Corp. v. Frost*, 564 F.3d 981 (8th Cir. 2009) (section 546(e) is not limited to public securities transactions and protects from avoidance a debtor's payments deposited in national bank in exchange for its shareholders' privately held stock during an LBO); *In re Olympic Nat. Gas Co.*, 294 F.3d 737, 742 n.5 (5th Cir. 2002) (by including references to both the commodities and securities markets, lawmakers meant to exclude from the automatic stay and avoidance as a constructively fraudulent transfer "both on-market, and the corresponding off-market, transactions"); *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 (listing cases) (16th ed. 2023). 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*, 583 U.S. at 373 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 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); *In re Nine W. LBO Sec. Litig.*, 482 F. Supp. 3d 187 (S.D.N.Y. 2020) (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), *aff'd in part, rev'd in part and remanded*, 87 F.4th 130 (2d Cir. 2023); *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).

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 stock from a non-publicly traded 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's version of the Uniform Voidable Transactions Act (the "UVTA"). 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 trustee also sought to recover the value of the transfer from either BMO—the original transferee—of the beneficiary of the transfer—Sun Capital—under section 550(a) of the Bankruptcy Code and the UVTA.

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) ("*BMO Harris 1*"), *aff'd*, 95 F.4th 1090 (7th Cir. 2024). 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, hence 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). Finally, the court held (*sua sponte*) that the trustee's claim to avoid the value of the transfer from Sun Capital under the UVTA via the "strong arm" powers in section 544(b) did not implicate the section 546(e) safe harbor because the UVTA provides that a creditor may recover the value of a transfer to the extent that the is *avoidable* rather than *avoided*.

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

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

According to the district court, 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, the district court explained, the bankruptcy 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)," the district court 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 1*, 2023 WL 3203113, at *5.

It 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 the court, although the Seventh Circuit had not then 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. It 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 the district court:

> 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. The district court also noted that its conclusion is consistent with the rulings of "numerous" courts, including the Sixth and Eighth Circuits in *QSI Holdings* and *Contemporary Industries*, respectively. *Id.*

The district court rejected the trustee's argument that he could recover the value of the property transferred for the benefit of Sun Capital, which was not a transferee, under section 544(a) of the Bankruptcy Code, which allows a trustee to "avoid any transfer of property of the debtor or any obligation incurred by the debtor that is voidable by" certain creditors that extend credit to the debtor, and the UVTA. According to the district court, "[b]ecause the Trustee did not assert a claim under § 544(a) in the Amended Complaint in the adversary proceeding, nor did he rely upon that provision in opposing the Motions to Dismiss, the Court will not consider any arguments under § 544(a) in this appeal." *Id.* at *11.

Finally, citing *Tribune 1*, the district court ruled that the trustee's state constructive fraudulent transfer claims under section 544(b) and the UVTA 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.

The trustee appealed the district court's ruling to the Seventh Circuit.

THE SEVENTH CIRCUIT'S RULING

A three-judge panel of the Seventh Circuit affirmed.

Writing for the panel, U.S. Circuit Court Judge Amy J. St. Eve explained that the appeal raised two issues of first impression in the Seventh Circuit: (i) whether the section 546(e) safe harbor "extends to transactions involving private securities that do not implicate the national securities market"; and (ii) if so, whether the safe harbor provision "also preempts state law claims seeking similar relief such that a bankruptcy trustee may not bring them under § 544(a) of the Bankruptcy Code." "We hold today," Judge St. Eve wrote, "that the answer to each of these questions is 'yes.'" *BMO Harris 2*, 95 F.4th at 1094.

The Seventh Circuit panel rejected the trustee's argument that reference to section 546(e)'s legislative history was warranted to determine whether lawmakers intended the provision to apply to private securities transactions because the court had previously found section 546(e) to be ambiguous in *FTI Consulting, Inc. v. Merit Mgmt. Grp.*, 880 F.3d 690 (7th Cir. 2016), *aff'd and remanded*, 583 U.S. 366 (2018). According to Judge St. Eve, "we held no such thing" in *FTI Consulting*. *BMO Harris 2*, 95 F.4th at 1098. Rather, she explained, the discrete issue in that case was whether the safe harbor protects transfers conducted through financial institutions as mere conduits, as distinguished from the transferor or the ultimate transferee.

Judge St. Eve further noted that there was no question that the transfer involved in *FTI Consulting* was a "settlement payment" or a payment made "in connection with a securities contract" for purposes of section 546(e). Therefore, she emphasized, the court did not previously hold that the provision "as a whole is ambiguous," and its conclusion that certain parts of section 546(e) were ambiguous—thereby warranting reference to its legislative history—was limited to the meaning of the phrases "by or to" and "for the benefit of" a financial institution in connection with a securities contract. *Id.* Even after consulting the legislative history regarding the meaning of these terms, Judge St. Eve wrote, "we did not come close to holding that § 546(e), or any portion thereof, applies only to securities transactions implicating the national securities clearance system." *Id.*

Because the parties did not dispute that the transfer to BMO was made to a "financial institution," the Seventh Circuit panel considered whether the term "securities contract" in section 546(e) is ambiguous. It concluded that it was not, and that "nothing in the plain language of § 546(e) excludes private contracts not implicating the national securities clearance system from the definition of 'securities contract.'" *Id.* at 1099.

Judge St. Eve explained that section 741(7) defines the term "very broadly," and none of section 741(7)'s "eleven sub-definitions contains any indication that it is limited to contracts implicating only publicly held securities." *Id.* Moreover, she noted: (i) section 741(7)(a)(i) states that "securities contract" includes "a contract for the purchase, sale, or loan of a security"; (ii) "security" is defined in section 101(49)(A)(ii) of the Bankruptcy Code to include "stock"; and (iii) "stock" is commonly understood to include shares in private and public companies. *Id.*

The Seventh Circuit panel rejected the argument that, because the definition of "securities contract" is located in the subchapter of the Bankruptcy Code governing stockbroker liquidations (subchapter III of chapter 7, §§ 741-753), Congress intended to "somehow graft[ ] a public-securities requirement onto the otherwise-clear meaning of the term." *Id.* Judge St. Eve noted that section 102(8) of the Bankruptcy Code instead states that "a definition, contained in a section of [the Bankruptcy Code] that refers to another section of [the Bankruptcy Code], does not for the purpose of such reference, affect the meaning of a term used in such other section." *Id.* Thus, she wrote, "Congress … made it clear that it did not intend cross-references between sections of the Code to impact the meaning of terms used in those other sections." *Id.*

The Seventh Circuit panel noted that its conclusion that the section 546(e) safe harbor is not restricted to public securities comports with the rulings of its sister circuits in *Plassein*, *Frost*, *QSI Holdings*, and *Olympic*. "Accordingly," the Seventh Circuit panel wrote, "we hold that the term 'securities contract' as used in § 546(e) unambiguously includes contracts involving privately held securities." *Id.* at 1100.

Applying the "unambiguous definition" in section 741(7), the Seventh Circuit panel agreed with the district court that the stock purchase agreement, the bridge loan, and the Sun Capital guarantee were all securities contracts for the reasons articulated by the district court. The Seventh Circuit panel also found no error in the district court's conclusion and reasoning that the challenged transfers were made "in connection with" those securities contracts, although it declined to define the "outer limits" of the "in connection with" requirement. *Id.* at 1101. Because the relevant agreements were securities contracts, the Seventh Circuit panel ruled that the challenged transfers could not be avoided by the trustee under section 544(b) of the Bankruptcy Code.

Finally, the Seventh Circuit panel denied the trustee's request to amend his complaint to add a claim for recovery of the value of the challenged transfer from Sun Capital under section 544(a) and the UVTA. According to the trustee, section 546(e)'s ban on *avoidance* of a constructively fraudulent transfer did not prohibit him from seeking a judgment for the value of the transfer because a transfer need only be *avoidable* under section 544(a) and the UVTA. The Seventh Circuit rejected this argument, ruling that amendment of the complaint would be futile. According to Judge St. Eve, the trustee's claim sought to invoke the UVTA under section 544(a) "to obtain the same relief that § 546(e) otherwise precludes," and that section 546(e) accordingly precluded the claim. The Seventh Circuit panel noted that this conclusion is consistent with decisions by two other circuits holding that section 546(e) preempts state law claims seeking recovery of the value of transfers protected from avoidance under the safe harbor. *Id.* at 1103 (citing *Tribune 2*, 946 F.3d at 90-92; *Frost*, 564 F.3d at 988). "To hold differently," Judge St. Eve wrote, "would render § 546(e) meaningless." *Id.* at 1104.

OUTLOOK

The section 546(e) safe harbor has produced a wealth of notable court rulings in recent years, and *BMO Harris 2* is no exception. Moreover, further developments on this issue are likely. Even though the U.S. Supreme Court declined to review *Tribune 2* in 2021, an appeal of the decisions in *Boston Generating* has been pending for years before the Second Circuit.

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

Key takeaways from the Seventh Circuit's decision include: (i) five circuit courts of appeal have now concluded that the section 546(e) safe harbor is not limited to transactions involving transfers of publicly traded securities; and (ii) three circuits have now ruled that section 546(e) preempts state law claims seeking recovery of the value of transfers protected from avoidance under the safe harbor.

This article was prepared with the assistance of Nathaniel J. Parr.

THIRD CIRCUIT: UNSECURED CLAIM FOR ROYALTIES FROM INTELLECTUAL PROPERTY PURCHASED BY DEBTOR DISCHARGED UNDER CHAPTER 11 PLAN

Oliver S. Zeltner

Mitigating risk of loss associated with a bankruptcy filing should be an element of any commercial transaction, especially if it involves a sale or license of intellectual property rights. A ruling recently handed down by the U.S. Court of Appeals for the Third Circuit provides a stark reminder of the consequences of when it is not. In *In re Mallinckrodt PLC*, 99 F.4th 617 (3d Cir. 2024), the Third Circuit ruled that, in the absence of any security, a claim asserted by the seller of intellectual property rights for contingent royalties payable under the sale agreement was a prepetition unsecured claim that was discharged when the bankruptcy court confirmed the debtor-buyer's chapter 11 plan.

BANKRUPTCY CODE'S BROAD DEFINITION OF "CLAIM"

As part of the overhaul of bankruptcy laws in 1978, Congress for the first time included the definition of "claim" as part of the Bankruptcy Code. Specifically, section 101(5) of the Bankruptcy Code provides that the term "claim" means:

> (A) right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured; or
> (B) right to an equitable remedy for breach of performance if such breach gives rise to a right to payment, whether or not such right to an equitable remedy is reduced to judgment, fixed, contingent, matured, unmatured, disputed, undisputed, secured, or unsecured.

11 U.S.C. § 101(5). "By fashioning a single definition of 'claim' in the Code, Congress intended to adopt the broadest available definition of that term." COLLIER ON BANKRUPTCY ¶ 101.05 (16th ed. 2024).

Section 101(12) of the Bankruptcy Code, in turn, provides that a "debt" means "liability on a claim."

When a debt or claim "arises" is of crucial significance in bankruptcy. In a chapter 11 case, section 1141(d) of the Bankruptcy Code provides in relevant part that, except for debts of individual debtors excepted from discharge under section 523 or debts of liquidating corporations, and except as otherwise provided in a chapter 11 plan or the order confirming it, "the confirmation of a plan . . . discharges the debtor from *any debt that arose before the date of such confirmation*," whether or not the claimant has filed a proof of claim, the claim has been allowed, or the claimant voted to accept the chapter 11 plan. 11 U.S.C. § 1141(d) (emphasis added).

In 1984, the Third Circuit was the first court of appeals to examine the Bankruptcy Code's new definition of "claim" in *Avellino & Bienes v. M. Frenville Co. (In re M. Frenville Co.)*, 744 F.2d 332 (3d Cir. 1984). Focusing on the "right to payment" language in that definition, the court decided that a claim arises when a claimant's right to payment accrues under applicable non-bankruptcy law. *Id.* at 337. Thus, because a claim for indemnification or contribution under New York law did not arise until asserted, the Third Circuit held that the automatic stay did not preclude a chapter 7 debtor's accountant from filing a third-party complaint against the debtor for indemnification or contribution in state court litigation commenced by a bank against the accountant seeking damages for its prepetition preparation of the debtor's financial statements. *Id.*

This "accrual" test was widely criticized by other circuit courts as contradicting the broad definition of "claim" envisioned by Congress and the Bankruptcy Code. *See, e.g., Cadleway Props., Inc. v. Andrews (In re Andrews)*, 239 F.3d 708, 710 n.7 (5th Cir. 2001) (stating that the *Frenville* "accrual test" has been "universally rejected"); *Grady v. A.H. Robins Co.*, 839 F.2d 198, 201 (4th Cir. 1988) ("We have found no court outside the Third Circuit which has followed the reasoning and holding of *Frenville*. All of the cases coming to our attention which have considered the issue have declined to follow *Frenville*'s limiting definition of claim.").

In 2010, the Third Circuit decided *JELD-WEN, Inc. v. Van Brunt (In re Grossman's Inc.)*, 607 F.3d 114 (3d Cir. 2010), and expressly overruled *Frenville* (as well as the 26 intervening years of precedent). In its *en banc* decision, the court adopted the "exposure" test, a version of the "conduct" test used by other courts. *Id.* at 125. It held that an asbestos claim is presumptively discharged under a confirmed chapter 11 plan if exposure occurred before bankruptcy, even though the injury was not manifested until years afterward. *Id.*

However, the court stressed that regardless of the applicable definition of "claim," due process considerations remained an important part of the determination of whether a claim had been discharged, and consequently it remanded the due process analysis to the bankruptcy court. *Id.* at 125–26. The applicability of *Grossman*'s outside of the asbestos (or tort) context initially was uncertain. In *Mallinckrodt*, however, the Third Circuit rejected a contract counterparty's attempt to extend the "exposure" test announced in *Grossman's* to contingent, unliquidated royalty claims payable under a prepetition contract.

MALLINCKRODT

In 2001, pharmaceutical company Sanofi-Aventis U.S. LLC ("Sanofi") sold certain intellectual property ("IP"), including trademarks and regulatory rights, relating to Acthar Gel, a drug that relieves chronic inflammation and treats autoimmune diseases, to Mallinckrodt plc (the "debtor"). *Sanofi-Aventis U.S. LLC v. Mallinckrodt plc (In re Mallinckrodt plc)*, 646 F. Supp. 3d 565, 567 (D. Del. 2022), *aff'd*, 99 F.4th 617 (3d Cir. 2024). Under the sale agreement, the debtor paid Sanofi $100,000 in cash and promised a perpetual royalty of 1% of all annual net sales exceeding $10 million. *Id.* The debtor granted Sanofi a purchase-money security interest in the Acthar Gel IP to secure the debtor's obligation for the upfront payment, but not the royalty. *Id.* For many years, the annual royalty was substantial, with annual sales of Acthar Gel in 2019 amounting to nearly $1 billion. *Mallinckrodt*, 99 F.4th at 620.

In October 2020, the debtor filed for chapter 11 protection in the District of Delaware. As of the filing date, the debtor faced several billion dollars of legal liabilities related to the opioid epidemic and Acthar Gel rebates. Although the debtor continued to manufacture and sell Acthar Gel postpetition, it breached the sale agreement with Sanofi by, among other things, failing to pay royalties. *Mallinckrodt*, 646 F. Supp. 3d at 566–67.

In 2021, Sanofi filed a motion seeking a determination that the sale agreement was not an executory contract and that its claim for postpetition royalty payments was not dischargeable or, in the alternative, that the sale agreement was executory and the debtor could not continue to sell Acthar Gel if it rejected the sale agreement. *Id.* at 566.

The bankruptcy court ruled that that the sale agreement was not executory because Sanofi had fully performed its obligations under the agreement by transferring its ownership rights in Acthar Gel to the debtor two decades earlier. *Id.* at 566–67. The bankruptcy court further concluded that Sanofi's claims for breach of the sale agreement were unsecured claims that would be discharged by operation of section 1141(d) of the Bankruptcy Code upon confirmation of the debtor's chapter 11 plan.

The district court affirmed on appeal, reasoning that Sanofi's contingent claim for future royalties arose at the time of the sale, and because Sanofi did not retain a property interest in the Acthar Gel IP, Sanofi held only an unsecured claim for breach of the agreement that would be discharged upon plan confirmation. *Id.* at 569–70. Sanofi appealed to the Third Circuit.

THE THIRD CIRCUIT'S RULING

A three-judge panel of the Third Circuit affirmed the district court's decision.

Writing for the panel, U.S. Circuit Court Judge Stephanos Bibas explained that, because Sanofi's right to payment of royalties under the sale agreement was a "claim" under section 101(5)(A) of the Bankruptcy Code, and because that right to payment arose pre-bankruptcy, Sanofi's claim for royalties was dischargeable in bankruptcy pursuant to section 1141(d)(1)(A) of the Bankruptcy Code. *Mallinckrodt*, 99 F.4th at 621.

The Third Circuit panel rejected Sanofi's argument that the future royalties from Acthar Gel were too indefinite to be a "claim." Judge Bibas explained that Sanofi's "argument fails because the Bankruptcy Code allows for claims that are both contingent and unliquidated." *Id.* at 620 (citing 11 U.S.C. § 101(5)(A)). According to Judge Bibas, Sanofi held a contingent claim for future royalties because its right to payment was not fixed until triggered in accordance with the express terms of the sale agreement—i.e., by the debtor's sale of more than $10 million of Acthar Gel in any given year. *Id.* at 621. Sanofi's contingent claim was also unliquidated because the amount of the royalties payable in any given year would not be ascertained or determined until the end of the year. *Id.*

The Third Circuit distinguished *Grossman's* and concluded that Sanofi's contingent and unliquidated claim for royalties arose at the time that Sanofi and the debtor signed the sale agreement. *Id*. Judge Bibas rejected Sanofi's argument that, like a tort claim, its claims for royalties would not arise until Sanofi was harmed by the debtor's "injurious conduct" at the time that the debtor met the sales trigger and refused to pay royalties. *Id.* "[T]he tort analogy is inapt," Judge Bibas wrote, because the "regular rule" applies: "most contract claims arise when the parties sign the contract." *Id.* (citations omitted).

According to the Third Circuit panel, "once the parties agree to a contingent right to payment, the claim exists," and even the Third Circuit's overruled decision in *Frenville* correctly concluded in *dicta* that, "once the claim exists, bankruptcy can reach it." *Id.*

Judge Bibas noted that certain contract claims might be exceptions to the general rule if, for example, "fairness might compel special treatment" where: (i) the debtor's postpetition "conduct is so unexpected that the contract could not give the creditor notice"; or (ii) "a debtor games bankruptcy, wielding it as both a sword and a shield." *Id.* (citations omitted). Sanofi confused these exceptions to the general rule, Judge Bibas explained, because nothing in the language of sections 101(5)(A) or 1141(d)(1)(A) or the out-of-circuit decisions it relied on support the contention that a claim does not exist in bankruptcy until it is triggered by a debtor's postpetition conduct, as distinguished from an "extrinsic

event." *Id.* at 621. Moreover, he noted, the facts in *Mallinckrodt* "d[id] not involve lack of notice or games-manship" justifying an equitable exception. *Id.* at 621–22.

Finally, the Third Circuit panel faulted Sanofi, a sophisticated party, for agreeing to a deal that left it unprotected in the event the debtor filed for bankruptcy:

> To protect itself, Sanofi could have structured the deal differently. It could have licensed the rights to the drug, kept a security interest in the intellectual property, or set up a joint venture to keep part ownership. But it chose not to do so. Instead, it sold its rights outright, leaving itself with only a contingent, unsecured claim for money. And under the Bankruptcy Code, that claim is dischargeable.

Id. at 622.

OUTLOOK

Mallinckrodt is a cautionary tale, especially for owners of IP. Selling IP outright in exchange for an upfront cash payment and a contractual obligation to pay royalties without taking a security interest in the property or future royalties may expose the seller to considerable risk in the event that the buyer later files for bankruptcy. The seller in *Mallinckrodt* could have mitigated its risk by licensing the IP rather than selling it, or by insisting on a deal that secured its right to future royalties, yet it chose not to do so. Instead, the seller was left with a general unsecured claim that, under Mallinckrodt's confirmed plan, likely will receive a pro rata distribution amounting to a small fraction of the future royalties it would have been paid but for the buyer's bankruptcy filing.

Mallinckrodt also reaffirmed the general rule in bankruptcy that a claim "arises" under a contract at the time that the contract is signed, rather than when a payment obligation under the contract is triggered or matures.

CIRCUIT SPLIT: ELEVENTH CIRCUIT AND SECOND CIRCUIT DISAGREE ON ELIGIBILITY REQUIREMENTS FOR CHAPTER 15 DEBTORS

Corinne Ball • Dan T. Moss • Nicholas J. Morin • David S. Torborg

Courts disagree over whether a foreign bankruptcy case can be recognized under chapter 15 of the Bankruptcy Code if the foreign debtor does not reside or have assets or a place of business in the United States. In 2013, the U.S. Court of Appeals for the Second Circuit staked out its position on this issue in *Drawbridge Special Opportunities Fund LP v. Barnet (In re Barnet)*, 737 F.3d 238 (2d Cir. 2013), ruling that the provision of the Bankruptcy Code requiring U.S. residency, assets, or a place of business applies in chapter 15 cases as well as cases filed under other chapters.

The U.S. Court of Appeals for the Eleventh Circuit split with the Second Circuit on this controversial issue in *In re Al Zawawi,* 97 F.4th 1244 (11th Cir. 2024). Distancing itself from *Barnet* based on Eleventh Circuit precedent predating the enactment of chapter 15, the Eleventh Circuit affirmed a district court ruling that chapter 15 has its own eligibility requirements, and that the eligibility requirements for debtors in cases under other chapters of the Bankruptcy Code do not apply in chapter 15 cases. The resulting circuit split may be an invitation to a petition for rehearing *en banc*, U.S. Supreme Court review, or congressional action.

PROCEDURES, RECOGNITION, RELIEF, AND ELIGIBILITY UNDER CHAPTER 15

Chapter 15 was enacted in 2005 to govern cross-border bankruptcy and insolvency proceedings. It is patterned on the 1997 UNCITRAL Model Law on Cross-Border Insolvency (the "Model Law"), which has been enacted in some form by nearly 60 nations or territories.

Both chapter 15 and the Model Law are premised upon the principle of international comity, or "the recognition which one nation allows within its territory to the legislative, executive or judicial acts of another nation, having due regard both to international duty and convenience, and to the rights of its own citizens or of other persons who are under the protection of its laws." *Hilton v. Guyot*, 159 U.S. 113, 164 (1895). Chapter 15's stated purpose is "to provide effective mechanisms for dealing with cases of cross-border insolvency" with the objective of, among other things, cooperation between U.S. and non-U.S. courts.

Chapter 15 replaced section 304 of the Bankruptcy Code. Section 304 allowed an accredited representative of a debtor in a foreign bankruptcy proceeding to commence a limited "ancillary" bankruptcy case in the United States for the purpose of enjoining actions against the foreign debtor or its assets located

in the United States or, in some cases, repatriating such assets or their proceeds abroad for administration in the debtor's foreign bankruptcy.

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

Section 1501(a) of the Bankruptcy Code similarly states that the purpose of chapter 15 is to "incorporate the [Model Law] so as to provide effective mechanisms for dealing with cases of cross-border insolvency with the objectives of," among other things, cooperation between U.S. and foreign courts, greater legal certainty for trade and investment, fair and efficient administration of cross-border cases to protect the interests of all stakeholders, protection and maximization of the value of a debtor's assets, and the rehabilitation of financially troubled businesses.

Section 1508 requires U.S. courts interpreting chapter 15 to "consider its international origin, and the need to promote an application of this chapter that is consistent with the application of similar statutes adopted by foreign jurisdictions."

Under section 1515, the "foreign representative" of a foreign "debtor" may file a petition in a U.S. bankruptcy court seeking "recognition" of a "foreign proceeding."

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

However, section 101 of the Bankruptcy Code also includes a definition of the term "debtor," and section 109 limits the entities that can qualify as a debtor. Section 101(13) provides that "debtor" means "person or municipality concerning which a case under this title has been commenced." Section 109(a) states that, "[n]otwithstanding any other provision of this section, only a person that resides or has a domicile, a place of business, or property in the United States, or a municipality, may be a debtor under this title." Section 103(a) provides that "this chapter"—i.e., chapter 1, including section 109(a)—"appl[ies] in a case under chapter 15."

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

Section 1506 sets forth a public policy exception to any of the relief otherwise authorized in chapter 15, providing that "[n]othing in this chapter prevents the court from refusing to take an action governed by this chapter if the action would be manifestly contrary to the public policy of the United States."

Section 101(24) defines "foreign representative" as "a person or body, including a person or body appointed on an interim basis, authorized in a foreign proceeding to administer the reorganization or the liquidation of the debtor's assets or affairs or to act as a representative of such foreign proceeding."

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

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

More than one bankruptcy or insolvency proceeding may be pending with respect to the same foreign debtor in different countries. Chapter 15 therefore contemplates recognition in the United States of both a foreign "main" proceeding—a case pending in the country where the debtor's center of main interests ("COMI") is located (*see* 11 U.S.C. §§ 1502(4) and 1517(b)(1))—and foreign "nonmain" proceedings, which may be pending in countries where the debtor merely has an "establishment" (*see* 11 U.S.C. §§ 1502(5) and 1517(b)(2)). A debtor's COMI is presumed to be the location of the debtor's registered office, or habitual residence in the case of an individual. *See* 11 U.S.C. § 1516(c). An establishment is defined by section 1502(2) as "any place of operations where the debtor carries out a nontransitory economic activity."

DISPUTE OVER ELIGIBILITY FOR CHAPTER 15 RELIEF

Despite the express language of section 103(a), courts disagree over whether a foreign debtor must satisfy both sections 109 and 1502 to be eligible for chapter 15 relief.

In *Barnet*, the Second Circuit ruled that section 109(a) applies in a chapter 15 case on the basis of a "straightforward" interpretation of the statutory provisions.

The Second Circuit rejected the foreign representatives' argument that section 109(a) does not apply because the Australian company in the case was a "debtor" under the Australian Corporations Act (rather than under the Bankruptcy Code) and the foreign representatives (rather than the debtor) were seeking recognition of the foreign proceeding. According to the court:

> [T]he presence of a debtor is inextricably intertwined with the very nature of a Chapter 15 proceeding . . . [and] [i]t stretches credulity to argue that the ubiquitous references to a debtor in both Chapter 15 and the relevant definitions of Chapter 1 do not refer to a debtor under the title [title 11] that contains both chapters.

Barnet, 737 F.3d at 248. In addition to the statutory definitions of "foreign representative," "foreign main proceeding," "debtor," and "foreign proceeding," the court noted, the automatic and discretionary relief provisions that accompany recognition of a foreign main proceeding (*see* sections 1520 and 1521) are similarly "directed towards debtors." *Barnet*, 737 F.3d at 248.

The Second Circuit flatly rejected the foreign representatives' argument that a foreign debtor need satisfy only the chapter 15-specific definition of "debtor" in section 1502(1), and not the section 109 requirements. "This argument also fails," the court wrote, "as we cannot see how such a preclusive reading of Section 1502 is reconcilable with the explicit instruction in Section 103(a) to apply Chapter 1 to Chapter 15." *Id.* at 249.

According to the Second Circuit, not only a "plain meaning" analysis but also the context and purpose of chapter 15 support the application of section 109(a) to chapter 15. The court explained that Congress amended section 103 to state that chapter 1 applies in cases under chapter 15 at the same time it enacted chapter 15, which strongly supports the conclusion that lawmakers intended section 103(a) to mean what it says—namely, that chapter 1 applies in cases under chapter 15.

The court acknowledged that the strongest support for the foreign representatives' arguments lies in 28 U.S.C. § 1410, which provides a U.S. venue for chapter 15 cases even when "the debtor does not have a place of business or assets in the United States." However, the Second Circuit explained that this venue statute "is purely procedural" and that, "[g]iven the unambiguous nature of the substantive and restrictive language used in Sections 103 and 109 of Chapter 15, to allow the venue statute to control the outcome would be to allow the tail to wag the dog." *Id.* at 250.

Finally, the Second Circuit found that the purpose of chapter 15 would not be undermined by making section 109(a) applicable in chapter 15 cases. As noted above, section 1501(a) of the Bankruptcy Code provides that the purpose of chapter 15 "is to incorporate the Model Law . . . so as to provide effective mechanisms for dealing with cases of cross-border insolvency." Although section 109(a), or its equivalent, is not included in the Model Law, the Second Circuit emphasized, the Model Law allows a country enacting it to "modify or leave out some of its provisions." In any case, the court concluded, the omission of a provision similar to section 109(a) from the Model Law does not suffice to outweigh the express language Congress used in adopting sections 103(a) and 109(a). *Id.* at 251.

The Second Circuit accordingly vacated the recognition order and remanded the case to the bankruptcy court for further proceedings consistent with its ruling.

The Second Circuit did not provide any guidance as to how extensive a foreign debtor's property holdings in the United States must be to qualify for chapter 15 relief. On remand, the bankruptcy court answered that question in *In re Octaviar Administration Pty Ltd.*, 511 B.R. 361 (Bankr. S.D.N.Y. 2014). It ruled that, consistent with case law analyzing the scope of section 109 for the purpose of determining who is eligible to commence a case under chapter 11, the requirement of property in the United States should be interpreted broadly. Because the Australian debtor had causes of action governed under U.S. law against parties in the United States and also had an undrawn retainer maintained in the United States, the bankruptcy court held that the requirement for the debtor to have property located in the United States was satisfied.

Guided by *Barnet*, other bankruptcy courts within the Second Circuit have similarly concluded that section 109 applies in chapter 15 cases and that satisfying its U.S. asset requirement is not difficult. *See, e.g., In re Agro Santino, OOD,* 653 B.R. 79 (Bankr. S.D.N.Y. 2023) (unused attorney retainers deposited by the debtor in a New York bank account and a $1.5 million counterclaim in pending N.Y. litigation); *In re Olinda Star Ltd.*, 614 B.R. 28 (Bankr. S.D.N.Y. 2020) (small retainer and rights under New York law debt instruments); *In re Serviços de Petróleo Constellation*, 613 B.R. 497 (Bankr. S.D.N.Y. 2019) (rights under New York law-governed debt and retainer); *In re Ascot Fund Ltd.*, 603 B.R. 271 (Bankr. S.D.N.Y. 2019) (retainer, interest in a New York partnership, and contract rights); *In re P.T. Bakrie Telecom TBK*, 601 B.R. 707 (Bankr. S.D.N.Y. 2019) (rights under a New York law indenture and New York law-governed notes); *In re B.C.I. Fins. Pty Ltd.*, 583 B.R. 288 (Bankr. S.D.N.Y. 2018) (attorney retainers deposited by foreign debtors in the United States for the sole purpose of satisfying section 109(a) and obtaining discovery adequate).

Barnet has received a considerable amount of criticism. For example, a leading commentator noted that the decision:

> clearly misconstrues the intent of the statute to focus on eligibility of the foreign proceeding, not of the debtor, never mentions the direction of section 1508 to consider the international origin of chapter 15 and does not follow the suggestion of the legislative history of section 1508 to consult the Guide to Enactment . . . [which] makes clear that "the Model Law was formulated to apply to any proceeding that meets the requirements of article 2, subparagraph (a) [definition of foreign proceeding], independently of the nature of the debtor or its particular status under national law."

COLLIER ON BANKRUPTCY ¶ 1517.01 (16th ed. 2024) (citing H.R. Rep. No. 109-31, p. 109 (2005); Guide to Enactment and Interpretation of the Model Law (the "Guide to Enactment"), ¶ 47); *see also* Glosband and Westbrook, "Chapter 15 Recognition in the U.S.: Is a Debtor 'Presence' Required?," 24 Int. Insolv. Rev. 28–56 (2015)

(noting that the Second Circuit "confuse[d] the foreign debtor with the foreign insolvency representative" and explaining that section 109(a) does apply in chapter 15 cases, but only in limited circumstances, including: (i) the requirement that a foreign debtor have a presence in the United States when a foreign representative use its power under section 1511 to file a "full" case under another chapter; and (ii) when a foreign debtor files a bankruptcy case in the United States to enforce a foreign discharge); *In re Avanti Commc'ns Grp. PLC*, 582 B.R. 603, 612 (Bankr. S.D.N.Y. 2018) (describing *Barnet* as a "controversial ruling").

Several bankruptcy courts outside of the Second Circuit have disagreed with *Barnet*. For example, in *In re Bemarmara Consulting A.S.*, No. 13-13037(KG) (Bankr. D. Del. Dec. 17, 2013), the U.S. Bankruptcy Court for the District of Delaware ruled that section 109(a) does not apply in chapter 15 because it is the foreign representative, and not the debtor in the foreign proceeding, who petitions the court. Moreover, the court wrote, "there is nothing in [the] definition [of 'debtor'] in Section 1502 which reflects upon a requirement that [a] Debtor have assets." *See* Transcript of Hearing at 9, l. 11–18, *In re Bemarmara Consulting A.S.*, No. 13-13037(KG) (Bankr. D. Del. Dec. 17, 2013) [Document No. 39]. "A Debtor," the court noted, "is an entity that is involved in a foreign proceeding."

A Florida bankruptcy court similarly refused to apply section 109(a) in a chapter 15 case in *In re MMX Sudeste Minercao S.A.*, No. 17-16113-RAM (Bankr. S.D. Fla. 2017) (Order Granting Recognition, Docket No. 9, June 12, 2017; Transcript of Nov. 1, 2017, Hearing Denying Motion to Dismiss Ch. 15 Case at 5-6, Docket No. 51). An attempted appeal of the recognition order was dismissed for lack of jurisdiction. *See Batista v. Alvarenga Mendes (In re MMX Sudeste Minercao S.A.)*, No. 17-24038-RNS (S.D. Fla. Apr. 20, 2018).

Apparently, only one court outside of the Second Circuit has relied on *Barnet* in a published opinion in finding that section 109(a) applies in a chapter 15 case. *See In re Forge Grp. Power Pty Ltd.*, 2018 WL 827913, at *13 (N.D. Cal. Feb. 12, 2018) (vacating a bankruptcy court order denying chapter 15 recognition on the basis of *Barnet*, but noting that "the debtor eligibility requirements of 11 U.S.C. § 109(a) apply in Chapter 15 cases" and "the requirement of 'property in the United States' is satisfied by a security retainer that remains the property of the debtor until the funds are applied by the attorney for services actually rendered").

It should be noted that chapter 15's predecessor—section 304 of the Bankruptcy Code—did not require a foreign debtor to qualify as a "debtor" under section 109(a) as a condition to relief. *See, e.g., Goerg v. Parungao (In re Goerg)*, 844 F.2d 1562 (11th Cir. 1988); *Saleh v. Triton Container Intl., Ltd. (In re Saleh)*, 175 B.R. 422 (Bankr. S.D. Fla. 1994).

For example, in *Goerg*, the Eleventh Circuit considered whether an individual debtor in a German bankruptcy case could qualify as a "debtor" for purposes of granting comity to the German bankruptcy case in an "ancillary proceeding" under section 304. The court of appeals ruled as a matter of first impression that the individual was not required to meet the Bankruptcy Code's definition of "debtor" (then contained in section 101(12)) to be eligible for relief under section 304. In so ruling, the court identified an incongruity between the definition of "debtor" in section 101(12) as a "person or municipality concerning which a case under [the Bankruptcy Code] has been commenced" and the term "foreign proceeding" in section 101(22), which at that time provided that the term meant:

> [A] proceeding[,] *whether judicial or administrative and whether or not under bankruptcy law*, in a foreign country in which the debtor's domicile, residence, principal place of business, or principal assets were located at the commencement of such proceeding, for the purpose of liquidating an estate, adjusting debts by composition, extension, or discharge, or effecting a reorganization.

11 U.S.C. § 101(22) (emphasis added) (repealed in 2005 and superseded by 11 U.S.C. § 1502(4), (5)). According to the Eleventh Circuit, "although the inclusion of the term 'debtor' in the definition of 'foreign proceeding' suggests that the subject of the foreign proceeding must qualify as a 'debtor' under United States bankruptcy law, the [Bankruptcy] Code expressly provides that the foreign proceeding need not even be a bankruptcy proceeding, whether under foreign or United States law." *Goerg*, 844 F.2d at 1566–67.

After weighing possible solutions to resolve this anomaly, the Eleventh Circuit ruled that a debtor in an ancillary proceeding under section 304 "need only be properly subject" to a "foreign proceeding" and that "'debtor' eligibility under the [Bankruptcy] Code was not a prerequisite to section 304 ancillary assistance." *Id.* at 1568. This conclusion, the Eleventh Circuit reasoned, was consistent with the purpose of section 304 in "prevent[ing] dismemberment by local creditors of assets located in [the United States] that are involved in a foreign bankruptcy proceeding" and "to help further the efficiency of foreign insolvency proceedings involving worldwide assets." *Id.* (citation and internal quotation marks omitted). It also explained that "it would make little sense to require that the subject of the foreign proceeding qualify as a 'debtor' under United States bankruptcy law," and that, instead, it "would make eminent sense for Congress to define expansively the class of foreign insolvency proceedings for which ancillary assistance is available." *Id.*

In *Al Zawawi*, the Eleventh Circuit revisited this issue in the context of eligibility for chapter 15 relief.

AL ZAWAWI

Talal Qais Abdulmunem Al Zawawi (the "debtor") was a debtor in a bankruptcy case filed in a UK court in March 2020. He did not reside in the United States but had indirect ownership interests in several Florida-based companies that owned residential and office buildings in Florida and was listed as a director of each of the companies. Prior to 2020, the debtor also had a 60% ownership interest in a Florida corporation that owned real estate leased to a chain of restaurants. In February 2020, the debtor sold his ownership interest in the corporation to his brother, the only other shareholder, but continued to be listed as a director.

In March 2021, the UK court-appointed trustees of the debtor's bankruptcy estate filed a petition with the U.S. Bankruptcy Court for the Middle District of Florida seeking recognition of the UK bankruptcy case under chapter 15 as a foreign main proceeding for the purpose of investigating the debtor's affairs, recovering U.S.-based assets and potentially asserting claims against third parties for the benefit of creditors, including the debtor's former spouse, who held a judgment claim for more than £24 million.

The debtor opposed recognition. He conceded that the foreign representatives met all the requirements for recognition set forth in section 1517, but argued, relying on *Barnet*, that he did not satisfy the definition of "debtor" in section 109(a). The foreign representatives countered that *Barnet* has been discredited and that the court should instead follow the Eleventh Circuit's rationale in *Goerg*, even though it involved an ancillary case filed under repealed section 304 of the Bankruptcy Code. Alternatively, the foreign representatives argued that, if section 109(a) did apply, the court should grant recognition because the debtor was a director and beneficial owner of the Florida-based companies, and the foreign representatives' U.S. counsel held a retainer provided on the debtor's behalf and had possession of the debtor's wallet.

The bankruptcy court granted the petition for recognition. Section 1517(a), it explained, is "unambiguous" and, subject to the public policy exception stated in section 1506, "'chapter 15 recognition must be ordered when a court finds the requisite criteria are met.'" *In re*

Talas Qais Abdulmunem Al Zawawi, 634 B.R. 11, 18 (Bankr. S.D. Fla. 2021) (quoting *In re ABC Learning Centres, Ltd.*, 728 F.3d 301, 308 (3d Cir. 2013)), *aff'd*, 637 B.R. 663 (M.D. Fla. 2022), *aff'd*, 2024 WL 1423871 (11th Cir. Apr. 3, 2024).

According to the bankruptcy court, a "debtor" under chapter 15 is not the same as a "debtor" under chapter 1 of the Bankruptcy Code. "If the § 101 definition included the subject of a foreign proceeding," it wrote, "then this special definition [in section 1502(1)] would be unnecessary—§ 1502(1) would be superfluous." *Id.*

The bankruptcy court explained that, although section 103 makes chapter 1 applicable in chapter 15, "it does not graft those provisions into chapter 15—meaning the limited definition would not apply when interpreting § 109." *Id.* at 19. Any other interpretation, it noted, would not give effect to the other provisions of chapter 15 and the purpose of the chapter, which is international uniformity and cooperation in cross-border bankruptcy cases.

The bankruptcy court further explained that several provisions of the Bankruptcy Code indicate that lawmakers did not intend section 109 to apply in chapter 15 cases, including:

(i) Section 1528, which provides that "[a]fter recognition of a foreign main proceeding, a case under another chapter of this title may be commenced only if the debtor has assets in the United States" and would be superfluous if section 109 applied to recognition.
(ii) 28 U.S.C. § 1410, governing venue of chapter 15 cases, which provides that "if the debtor does not have a place of business or assets in the United States, [venue is proper in the district] in which there is pending against the debtor an action or proceeding in a Federal or State court . . . or in which venue will be consistent with the interests of justice and the convenience of the parties, having regard to the relief sought by the foreign representative."

(iii) Section 109, which in subsections (b) through (g) specifies the persons or entities that may be debtors in every chapter of the Bankruptcy Code other than chapter 15, and in subsection (h) requires an individual debtor, absent a court waiver or a specified exception, to obtain credit counseling 180 days to a bankruptcy filing—a requirement that could not be satisfied without a waiver in every case because a foreign bankruptcy case has already been filed by or against a foreign debtor.

Id. at 19–20.

Finally, the court noted that *Barnet* is neither controlling precedent nor persuasive. Moreover, it stated that the Eleventh Circuit would likely disagree with the ruling based upon its previous decision in *Goerg*. Although section 304 has been repealed, the court wrote, "chapter 15 has a similar purpose and given this similar issue—whether a foreign debtor must qualify as a debtor under the Bankruptcy Code—this court finds *Goerg* persuasive, and declines to follow [*Barnet*]." *Id.* at 20.

Even so, the bankruptcy court found that the debtor satisfied the eligibility requirements of section 109(a) because he had interests in the Florida companies, he was listed as a director of those companies, and the foreign representatives had potential claims against third parties with respect to the debtor's transfer of its interest in one of the companies prior to the commencement of his UK bankruptcy case. The debtor appealed the recognition order to the district court.

The district court affirmed the bankruptcy court's decision, ruling that "compliance with Section 109(a) is not a prerequisite to obtaining recognition under Chapter 15."

The district court agreed with the bankruptcy court that section 1517(a) sets forth just three conditions for recognition, "none of which involve an assessment of the foreign debtor's contacts with the United States." *See In re Zawawi*, 637 B.R. 663, 667 (M.D. Fla. 2022), *aff'd*, 2024 WL 1423871 (11th Cir. Apr. 3, 2024). It also noted that, although section 101(13) contains a definition of "debtor," chapter 15 "provides its own, alternate definition" of the term, and "[t]hat definition controls and is plainly consistent with the purposes of Chapter 15." *Id.* at 668 (footnote omitted).

The district court determined that it need not look beyond section 1517 to answer the questions posed in the case before it. Even so, it agreed with the bankruptcy court's analysis that other provisions of the Bankruptcy Code—section 109 itself, as well as section 1528—and the chapter 15 venue provision in 28 U.S.C. § 1410, support the conclusion that chapter 15 recognition is not predicated on section 109(a). In addition, the district court concluded that both the legislative history of chapter 15 and the Guide to Enactment of the Model Law on which chapter 15 was patterned indicate that, provided the requirements for recognition set forth in section 1517(a) have been met, "recognition is not tethered to Section 109(a)." *Id.* at 669.

Barnet did not alter the district court's conclusion. It noted that courts outside of the Second Circuit have rejected the reasoning in *Barnet*, and courts in the Second Circuit obligated to follow it "do not require much to satisfy Section 109(b)." *Id.* at 670.

Finally, the district court concluded that, based on its reasoning in *Goerg*, the Eleventh Circuit would decline to follow *Barnet*. "Limiting recognition to proceedings involving foreign debtors that qualify as 'debtors' under the Bankruptcy Code," the district court wrote, "is simply inconsistent with the express language and fundamental purpose of Chapter 15." *Id.* at 670.

The debtor appealed to the Eleventh Circuit.

THE ELEVENTH CIRCUIT'S RULING

A three-judge panel of the Eleventh Circuit affirmed the district court's ruling in a unanimous decision with two concurrences.

Writing for the unanimous panel, U.S. Circuit Court Judge Barbara Lagoa acknowledged that a plain reading of section 103(a) of the Bankruptcy Code indicates that section 109(a) applies in chapter 15 cases—an interpretation she noted that that the Second Circuit "correctly" characterized as "straightforward" in *Barnet*. *Al Zawawi*, 97 F.4th at 1252. However, Judge Lagoa explained, the Eleventh Circuit is bound to follow *Goerg*'s ruling that "Chapter 1's debtor eligibility language does not apply to cases ancillary to a foreign proceeding." *Id.*

Judge Lagoa noted that the Bankruptcy Code's current definitions of "debtor" and "foreign proceeding" create an "anomaly" similar to that confronted by the court in *Goerg* because: (i) like repealed section 304, chapter 15 provides ancillary assistance to "foreign proceedings"; and (ii) the definition of "debtor" has remained unchanged since *Goerg*, and the definition of "foreign proceeding" has "changed only somewhat." As a consequence, the Eleventh Circuit panel reasoned that the rule laid down in *Goerg* should continue to apply in chapter 15 cases "if the purpose of Chapter 15 sufficiently tracks that of former § 304." *Id.* at 1253.

Judge Lagoa conceded that there are differences between repealed section 304 and chapter 15. Even so, she explained, despite those differences, "we believe that the former § 304 and Chapter 15 are sufficiently similar in terms of their purposes such that our decision in *Goerg* controls our analysis in this case." Due to the similar definitions of "foreign proceeding" under both statutory schemes (both of which require a "debtor"), "and wary of slicing our binding precedent too thin," the Eleventh Circuit panel "follow[ed] the logic of *Goerg*" in ruling that, "based on the definition of 'foreign proceeding' in § 101(12), as informed by the purpose of Chapter 15, debtor eligibility under Chapter 1 is not a prerequisite for the recognition of a foreign proceeding under Chapter 15." *Id.* at 1255. Accordingly, the Eleventh Circuit panel held that the debtor was properly subject to a "foreign

proceeding" and that the debtor's German bankruptcy case satisfied section 1517's requirements for chapter 15 recognition.

CONCURRING OPINIONS

Two judges, including Judge Lagoa, filed concurring opinions. Judge Lagoa stated that she agreed with the conclusion reached by the majority. However, she wrote, "if we were writing on a clean slate," she would reverse the bankruptcy court's ruling that section 109(a) does not apply in chapter 15 cases. Judge Lagoa then explained why she was unpersuaded by the foreign representatives' argument supporting the application of *Goerg* to the present case.

First, Judge Lagoa rejected the contention that because section 1517(a) of the Bankruptcy Code, which states that recognition "shall" be granted upon satisfaction of its requirements, does not refer to section 109(a) as one of those prerequisites, a foreign entity need not be a "debtor" under section 109 to be eligible for chapter 15 relief. According to Judge Lagoa, this argument "overlooks that debtor eligibility is baked into the requirements of section 1517(a)," which expressly and impliedly depends on the existence of a "foreign proceeding" involving "some related 'debtor.'" *Id.* at 1256 (concurring opinion).

Next, Judge Lagoa found no traction in the argument that section 1502(1)'s definition of "debtor" as "an *entity* that is the subject of a foreign proceeding" conflicts with section 109(a), which states that bankruptcy eligibility is limited to "a person that resides or has a domicile, a place of business, or property in the United States, or a municipality." According to the foreign representatives, by using the term "entity," section 1502(1) apparently permits estates, trusts, and certain government units to be chapter 15 debtors, whereas section 109(a) expressly excludes such entities from bankruptcy relief. Judge Lagoa rejected this argument, noting that: "as far as this case is concerned," the two provision can "easily be read in harmony: § 1502(1) recognizes that persons can be debtors in Chapter 15 cases, and § 109(a) imposes a residency/property requirement that must be satisfied for a person to qualify as a debtor." *Id.*

Judge Lagoa was similarly unconvinced by the argument that applying section 109(a) in chapter 15 cases would render a portion of section 1528 of the Bankruptcy Code superfluous because the latter also states that, post-recognition, a chapter 15 debtor must have U.S. assets to file a case under another chapter of the Bankruptcy Code. According to Judge Lagoa, "this argument rests on the faulty assumption that any debtor who satisfies § 109(a) necessarily 'has assets in the United States.'" It is possible, she explained, that an individual debtor might be a U.S. resident without having any U.S. assets or that a municipal debtor might not have any assets at all. Therefore, in cases where a debtor satisfies section 109(a) but not section 1528, if the debtor's foreign proceeding is recognized under chapter 15, "§ 1528's asset requirement certainly has an effect: it prohibits the commencement of a case under any other Chapter of [the Bankruptcy Code]." *Id.*

Finally, Judge Lagoa rejected the argument that applying section 109(a) in chapter 15 cases would render parts of 28 U.S.C. § 1410 superfluous. As noted previously, that provision governs the venue of chapter 15 cases, stating that a chapter 15 case may be commenced in: (i) the district in which "the debtor has its principal place of business or principal assets" in the United States; (ii) absent principal assets or a principal place of business in the United States, the district in which litigation is pending against the debtor; or (iii) any other district "consistent with the interests of justice and the convenience of the parties, having regard to the relief sought by the foreign representative."

According to the foreign representatives, if every chapter 15 were required to satisfy section 109(a)'s requirement for assets or a principal place of business in the United States, the alternative venue provisions in 28 U.S.C. § 1410 would be "meaningless." This argument, Judge Lagoa explained, "rests on a faulty assumption"—a chapter 15 debtor might satisfy section 109(a) by being a U.S. resident or domiciliary without having a "principal place of business or principal assets" in the United States, thereby bringing into play the alternative venue options in 28 U.S.C § 1410. *Id.* at 1257.

U.S. Circuit Judge Gerald Bard Tjoflat also filed a concurring opinion in which he agreed that the court was bound to follow *Goerg* (in which Judge Tjoflat wrote the opinion more than 35 years earlier), but disagreed with the majority's interpretation of the ruling "as abstract positivism." Instead, Judge Tjoflat stated that the court was bound by *Goerg* because the Bankruptcy Code's current definition of "foreign proceeding" is substantially the same as it was when *Goerg* was decided, and "the current statute contains additional support for the conclusion that American courts can recognize foreign proceedings regardless of whether the debtor subject to the foreign proceeding is eligible to commence a United States bankruptcy proceeding." *Id.* at 1258 (concurring opinion). He then examined, among other things, the differences between chapter 15 cases and cases under other chapters of the Bankruptcy Code, chapter 15's origins in the Model Law, and the Eleventh Circuit's decision in *Goerg*.

According to Judge Tjoflat, recognizing a foreign bankruptcy proceeding under chapter 15 "occurs in a very different context" than granting an order for relief in a case under another chapter. "By the time a petition for recognition arrives on our shores," he wrote, the foreign court has already determined the debtor's eligibility under its own law, and the debtor's assets are already under the control of the foreign proceeding." *Id.* at 1262. Judge Tjoflat also noted that "[u]nlike the procedures that begin a full bankruptcy case under [the Bankruptcy Code], the procedures

for recognizing and assisting a foreign proceeding do not naturally involve consideration of the debtor's eligibility to commence a full case under § 109(a)." *Id.* at 1267 (citation omitted).

Judge Tjoflat further noted that section 1508 of the Bankruptcy Code expressly directs courts to consider chapter 15's "international origin" in interpreting its provisions "to promote an application . . . that is consistent with the application of similar statutes adopted by foreign jurisdictions." Notably, he explained, the Model Law upon which chapter 15 is based does not define the term "debtor" because it is not an element of recognition. Instead, the Model Law was created to apply to any proceeding that satisfies the Model Law's definition of foreign proceeding "'*independently of the nature of the debtor or its particular status under national law.*'" *Id.* at 1273 (quoting Guide to Enactment at ¶ 55, and discussing Digest of Case Law on the UNCITRAL Model Law on Cross-Border Insolvency (2021) ¶ 43).

Judge Tjoflat also noted that, if section 109(a)'s U.S. asset requirement were applied to chapter 15, a "successfully executed" fraudulent transfer of a debtor's U.S. assets outside of the United States could defeat a petition for chapter 15 recognition, which would be inconsistent with one of chapter 15's primary purposes in promoting "fair and efficient administration of cross-border insolvencies that protects the interests of all creditors," and defy both common sense and lawmakers intent in enacting the chapter. *Id.* at 1277.

OUTLOOK

With *Al Zawawi*, the issue has now been joined (with fully developed arguments) by two circuits on the proper standard for a foreign debtor's eligibility for chapter 15 relief, creating a split that could be an invitation to U.S. Supreme Court review or congressional clarification of the statutory requirements.

Thus, the debate continues over chapter 15 eligibility. As applied by many bankruptcy courts, the Second Circuit's approach to the issue in *Barnet* does not act as a serious impediment to chapter 15 recognition. This is particularly true where the alleged property in the United States could be a law firm retainer, debt document governed by a particular state's law, potential causes of action against a U.S. entity or person, or possibly recoverable property situated in the United States. Nonetheless, the conflict in the courts and uncertainty regarding the proper interpretation of the statutory framework is unsettling.

NEW YORK BANKRUPTCY COURT: LOCKUP PROVISION IN PROPOSED SETTLEMENT AGREEMENT VIOLATED BANKRUPTCY CODE'S DISCLOSURE AND SOLICITATION REQUIREMENTS

Brad B. Erens

A bedrock principle underlying chapter 11 of the Bankruptcy Code is that creditors, shareholders, and other stakeholders should be provided with adequate information to make an informed decision to either accept or reject a chapter 11 plan. For this reason, the Bankruptcy Code provides that any "solicitation" of votes for or against a plan must be preceded or accompanied by stakeholders' receipt of a "disclosure statement" approved by the bankruptcy court explaining the background of the case as well as the key provisions of the chapter 11 plan. The votes of stakeholders whose votes are solicited outside of this process, and therefore improperly, may be disallowed.

However, to promote communication and negotiation among the debtor and other stakeholders throughout the course of a chapter 11 case, courts generally construe the term "solicitation"—and the remedies for improper solicitation—narrowly. In some cases, courts have even permitted debtors and certain stakeholders to enter into agreements prior to the approval of a disclosure statement in which the signatories agree to support a plan under certain specified conditions.

The U.S. Bankruptcy Court for the Southern District of New York recently addressed the propriety of such agreements in *In re GOL Linhas Aéreas Inteligentes S.A.*, 2024 WL 1716490 (Bankr. S.D.N.Y. Apr. 22, 2024). The court approved a global settlement among the chapter 11 debtors and various aircraft lessors, but denied approval of an impermissible "lockup" provision in the settlement agreements obligating the counterparties to support any chapter 11 plan later filed by the debtors, provided the plan embodied the terms of the settlement. Although the bankruptcy court declined to adopt a "bright-line" prohibition of such agreements in all cases, it emphasized that the Bankruptcy Code's disclosure and vote solicitation requirements are paramount, and concluded that the lockup provision before it failed to pass muster. The court came to this conclusion because, unlike most typical lockup or "plan support agreements" ("PSAs") or "restructuring support agreements" ("RSAs"), the provision did not specify the terms of a proposed chapter 11 plan, but merely the terms of the proposed settlement, together with a requirement that any plan could not be inconsistent with those settlement terms.

SOLICITATION AND DISQUALIFICATION OF VOTES ON A CHAPTER 11 PLAN

Section 1125(b) of the Bankruptcy Code provides that votes in favor of a chapter 11 plan can be solicited postpetition only after the creditor or shareholder receives a court-approved disclosure document containing "adequate information," a concept defined

in section 1125(a). The provision is "designed to 'discourage the undesirable practice of soliciting acceptance or rejection at a time when creditors and stockholders were too ill-informed to act capably in their own interests.'" *In re Heritage Org., LLC*, 376 B.R. 783, 794 (Bankr. N.D. Tex. 2007) (quoting *In re Clamp-All Corp.*, 233 B.R. 198, 208 (Bankr. D. Mass. 1999)).

In cases where section 1125(b) has been violated, section 1126(e) provides a remedy:

> On request of a party in interest, and after notice and a hearing, the court may designate any entity whose acceptance or rejection of such plan was not in good faith, *or was not solicited or procured in good faith or in accordance with the provisions of this title*.

11 U.S.C. § 1126(e) (emphasis added). "Designation" of an entity under section 1126(e) means that it is disqualified from voting or its vote is disallowed. *See* COLLIER ON BANKRUPTCY ¶ 1126.06 (16th ed. 2024). Votes cast by any creditor or interest holder designated under the provision are not counted for the purpose of determining whether the plan has been accepted by a class of creditors or interest holders under sections 1126(c) and 1126(d). *See In re DBSD N. Am., Inc.*, 634 F.3d 79, 106 (2d Cir. 2011).

Designation of a vote under section 1126(e) "is a drastic remedy, and, as a result, designation of votes is the exception, not the rule. The party seeking to have a ballot disallowed has a heavy burden of proof." *In re Adelphia Commc'ns Corp.*, 359 B.R. 54, 61 (Bankr. S.D.N.Y. 2006).

What constitutes "solicitation" of a vote on a plan is unclear. Most courts agree that the term "solicitation" "must be read narrowly . . . because [a] broad reading of § 1125 can seriously inhibit free creditor negotiations." *Century Glove, Inc. v. First Am. Bank of New York*, 860 F.2d 94, 101 (3d Cir. 1988); *accord In re Heritage Org., L.L.C.*, 376 B.R. 783 (Bankr. N.D. Tex. 2007) (holding that certain plan-proponent creditors that negotiated a term sheet for a liquidating chapter 11 plan containing a plan support provision and later jointly filed a disclosure statement for the plan did not violate section 1125(b)). Relevant case law suggests that the term "should relate to the formal polling process in which the ballot and disclosure statement are actually presented to creditors with respect to a specific plan, and the term should not be read so broadly as to chill the debtor's postpetition negotiations with its creditors." *In re Residential Capital, LLC*, 2013 WL 3286198, *19 (Bankr. S.D.N.Y. June 27, 2013) ("*ResCap*") (quotations and citations omitted).

RSAS, PSAS AND LOCKUP AGREEMENTS

In keeping with a series of court decisions beginning with the bankruptcy court's ruling in *Trans World Airlines, Inc. v. Texaco, Inc. (In re Texaco, Inc.)*, 81 B.R. 813 (Bankr. S.D.N.Y. 1988), RSAs and PSAs have generally been deemed not to run afoul of the Bankruptcy Code's solicitation requirements. *See*, *e.g., Heritage Org.*, 376 B.R. at 792; *In re Kellogg Square Partnership*, 160 B.R. 336 (Bankr. D. Minn. 1993). Among other reasons, courts have noted that such agreements, which outline the basic elements of a chapter 11 plan and provide a roadmap for confirmation, typically contain provisions allowing signatories to back out of their commitments where: (i) their fiduciary obligations require it; or (ii) the plan actually proposed by the debtor is materially different from what was agreed upon. *See Kellogg Square*, 160 B.R. at 340.

However, in a pair of unpublished bench rulings handed down in 2002, U.S. Bankruptcy Judge Mary F. Walrath held that postpetition lockup agreements violate section 1125(b), and she consequently disallowed the votes of the signatories under section 1126(e). *See In re Station Holdings Company, Inc.*, No. 02-10882 (MFW) (Bankr. D. Del. 2002) (transcript of Sept. 30, 2002, hearing) (Doc. No. 177); *In re NII Holdings, Inc.*, No. 02-11505 (MFW) (Bankr. D. Del. 2002) (transcript of Oct. 22, 2002, hearing) (Doc. No. 367). Both cases involved prepackaged chapter 11 plans, but certain supporting creditors signed lockup agreements after the petition date but before the court approved a chapter 11 plan disclosure statement. The transcripts of the proceedings indicate that Judge Walrath laid particular emphasis on the absence of any provision in the lockup agreements permitting the signatories to change their votes if the information contained in the disclosure statement turned out to be different from what they had received previously. In *NII Holdings*, Judge Walrath even announced a "bright line" rule prohibiting postpetition lockup agreements in cases before her. (*Id.* at 62:1–6.)

Another Delaware bankruptcy judge, Brendan L. Shannon, revisited this issue in *In re Indianapolis Downs, LLC*, 486 B.R. 286 (Bankr. D. Del. 2013). In that case, the court rejected arguments that a postpetition RSA was impermissible, adopting a narrow interpretation of "solicitation" in section 1125(b) in accordance with the Third Circuit's ruling in *Century Glove*. *Id.* at 294. The court rejected the argument that provisions in the RSA requiring the signatories to vote in favor of a conforming plan and providing for the remedy of specific performance amounted to solicitation. According to the court, the specific performance provision in the RSA was appropriate because the parties "were entitled to demand and rely upon assurances that accepting votes would be cast." *Id.* at 297.

Many other courts have similarly concluded that the negotiation of postpetition RSAs or PSAs prior to approval of a disclosure statement does not amount to improper solicitation under section 1125. *See In re Fin. Oversight & Mgmt. Bd. for Puerto Rico*, 637 B.R. 223, 284 (D.P.R. 2022) ("The process of negotiation and solicitation of assent to the plan support agreements prior to the approval and distribution of the disclosure statement did not constitute improper solicitation of votes with respect to the Plan."); *COMM 2013 CCRE12 Crossings Mall Rd., LLC v. Tara Retail Grp., LLC*, 591 B.R. 640, 651 (N.D.W. Va. 2018) (drawing the distinction between plan support agreements that permit a signatory to change its vote under appropriate circumstances and prohibited lockup agreements that do not and therefore violate section 1125); *In re Grupo Aeroméxico*, S.A.B. de C.V., No. 20-11563 (Bankr. S.D.N.Y. 2021) (transcript of Nov. 16, 2021, hearing at 39:22-25; 36-18; 36:15-16; 53-17-22) (approving plan support provisions in claim settlement agreements because the counterparties were sophisticated, the court had already approved similar agreements without objection, and not all agreements included the provision, cutting against any indication of coercion or that the debtors had conditioned the settlement on the inclusion of the provision); *ResCap* 2013 WL 3286198, at *20 (ruling that a complex and highly negotiated RSA embodying numerous settlements and resolving complicated legal and factual disputes necessary to formulate a confirmable chapter 11 plan did not amount to improper solicitation because there were "numerous termination events that allow a party to withdraw" and the agreement to vote was conditioned on the approval of a disclosure statement); *see also In re LATAM Airlines Grp. S.A.*, 2022 WL 2206829 (Bankr. S.D.N.Y. June 18, 2022) (unpublished opinion) (overruling an objection to confirmation of a chapter 11 plan based on the debtors' alleged violation of the plan solicitation requirements by entering into PSAs with certain creditors, prior to the court's approval of a disclosure statement, that obligated them to vote in favor of a plan in exchange for allowance of their claims, and holding that, even if those PSAs were improper (and the court did not reach that question), the only remedy for the violation was disallowance of the creditors' votes, which would not change the outcome of the voting process), *as amended*, 2022 WL 2541298 (Bankr. S.D.N.Y. July 7, 2022), *aff'd*, 643 B.R. 756 (S.D.N.Y. 2022). *But see In re SAS AB*, No. 22-10925 (Bankr. S.D.N.Y. 2022) (transcript of Sept. 28, 2022, hearing at 10:5-9; 18:1-5; 19:25) (Doc. No. 434) (ruling that a lockup provision denominated as an RSA contained in a lease assumption agreement obligating creditors to vote for *any* plan that the debtors might propose violated section 1125(b), and rejecting the "naked voting requirement" as an attempt to use "the claims process to buy a vote with no particular plan terms and without regard to whether there might be aspect[s] of the plan that the claimant might legitimately have other opinions about").

GOL LINHAS

Brazilian low-cost airline GOL Linhas Aéreas Inteligentes S.A. and its affiliates (collectively, the "debtors") filed for chapter 11 protection on January 25, 2024, in the Southern District of New York with the intention of achieving a consensual restructuring of its fleet obligations with aircraft lessors. To that end, in March 2024, the debtors filed several motions seeking court approval of agreements and stipulations (the "stipulations") with various aircraft lessors resolving certain disputes relating to, among other things, unpaid rent, maintenance reserves, security deposits, and the amendment and assumption of various aircraft and engine leases.

Each of the stipulations included the following provision (the "lockup provision") stating that the lessors would support any chapter 11 plan later proposed by the debtors as long as the plan embodied the terms of the stipulations:

> If a disclosure statement for a Chapter 11 Plan is approved by the Bankruptcy Court, [the lessor] agrees that, after its vote has been properly solicited, it shall vote (a) to accept the Chapter 11 Plan so long as (i) the Chapter 11 Plan, and a disclosure statement filed by the Debtors (the "Disclosure Statement") (A) is not inconsistent with the terms contained in the Term Sheet, the Definitive Documentation or the Approval Order; (B) no Events of default have occurred and are continuing in respect of any postpetition obligations of the applicable Debtor under the Leases (as amended herein, as applicable), the Definitive Documentation or any other lease ("Other Lease") entered into by Debtors and [the lessor]; (C) the Chapter 11 Plan provides for the vesting of the Definitive Documentation, including each of the Leases and guarantees, and any Other Lease or other agreement or guarantee in the applicable reorganized Debtor; and (D) the Chapter 11 Plan provides for the exculpation of [the lessor]; and (ii) (x) as of the effective date of the Chapter 11 Plan, the Debtors' Liquidity shall be no less than US$500,000,000 and (y) as of the effective date of the Chapter 11 Plan, the Projected Leverage Ratio for the calendar year ending 2026 shall be equal to or less than 3.5:1; and (b) against any other plan of reorganization filed by any party other than the Debtors, and shall not, in any material fashion, directly or indirectly support the filing of any such plan of reorganization by any party other than the Debtors. . . .
>
> This Term Sheet is not intended, and shall not be deemed or construed to be, a solicitation for votes in favor of the Chapter 11 Plan for purposes of sections 1125 and 1126 of the Bankruptcy Code or otherwise. The votes of holders of claims and interests in the Chapter 11 Cases will not be solicited until such holders who are entitled to vote on the Chapter 11 Plan have received the Chapter 11 Plan, the Disclosure Statement and related ballots, and other solicitation materials or the equivalent. For the avoidance of doubt, [the lessor] shall not be obligated to support any Chapter 11 Plan filed by the Debtors if such plan, related Disclosure Statement, proposed confirmation order, or other related document (by amendment or otherwise) is not consistent with the terms of the Term Sheet, the leases (as amended herein, as applicable) or the other Definitive Documentation. . . . [T]he foregoing provision shall not be enforceable if the Court determines at the hearing to

approve the motion in respect of this Term Sheet that such provision violates applicable law, or declines to approve the motion because of this provision.

The debtors' official unsecured creditors' committee objected to approval of the lockup provision. The committee argued that the provision, which obligated lessors to support any chapter 11 plan before a plan term sheet or disclosure statement had been filed, was an improper vote solicitation designed to thwart a potential bid from a competitor. The committee also argued that the debtors' motion to approve the settlements in the stipulations should be evaluated by a stricter standard than the deferential "business judgment" standard traditionally applied to a proposed use of estate property outside the ordinary course of a debtor's business under section 363(b) of the Bankruptcy Code.

According to the committee, the court should instead evaluate whether the inclusion of the lockup provision in the stipulations was reasonable under the circumstances—an "entire fairness" standard. The committee argued that it was not, and should be stricken from the agreements, because: (i) it improperly transferred the lessors' right to vote to the debtors, thereby impairing the rights of other unsecured creditors; (ii) the terms of the stipulations, which provided that the settlements could be approved even if the lockup provision were stricken by the court, indicated that the lockup provision was not a critical component of the agreements; and (iii) the debtors' efforts to buy votes in support of a nonexistent plan constituted a bad faith solicitation of votes in violation of section 1126(e).

The Office of the U.S. Trustee largely echoed these objections, adding that unlike permissible PSAs or RSAs in other cases, the lockup provision in this case lacked a "meaningful out" and "offer[ed] no protection at all" to the lessors.

THE BANKRUPTCY COURT'S RULING

The bankruptcy court approved the stipulations, but without the lockup provision.

Initially, because the stipulations were settlements, Chief U.S. Bankruptcy Judge Martin Glenn considered whether the stipulation satisfied the standard applied to proposed settlements under Rule 9019(a) of the Federal Rules of Bankruptcy Procedure in accordance with the seven-factor test articulated in *In re Iridium Operating LLC*, 478 F.3d 452 (2d Cir. 2007). In that case, the Second Circuit considered:

> (1) the balance between the litigation's possibility of success and the settlement's future benefits; (2) the likelihood of complex and protracted litigation, "with its attendant expense, inconvenience, and delay," including the difficulty in collecting on the judgment; (3) "the paramount interests of the creditors," including each affected class's relative benefits "and the degree to which creditors either do not object to or affirmatively support the proposed settlement"; (4) whether other parties in interest support the settlement; (5) the "competency and experience of counsel" supporting, and "[t]he experience and knowledge of the bankruptcy court judge" reviewing, the settlement; (6) "the nature and breadth of releases to be obtained by officers and directors"; and (7) "the extent to which the settlement is the product of arm's length bargaining."

GOL Linhas, 2024 WL 1716490, at **5-6 (quoting *Iridium*, 478 F.3d at 462). According to Judge Glenn, although a debtor's business judgment should not be ignored in assessing the propriety of a proposed settlement, "settlements cannot be allowed to trample on the rights and protections expressly created by section 1125 of the Bankruptcy Code." *Id.* at *6.

Turning to the requirements of section 1125, Judge Glenn carefully examined decisions addressing whether postpetition PSA, RSA, or lockup agreements violated the Bankruptcy Code's vote solicitation requirements. He concluded that the hallmarks of permissible PSAs, such as those approved as part of settlement agreements in *Kellogg Square* and *Grupo Aeroméxico*, included: (i) creditors' receipt of "meaningful *information*"; and (ii) a "*meaningful choice*" to rescind the agreement if the actual plan terms were materially different. *Id.* at **9-10.

Judge Glenn ruled that the economic terms of the stipulations satisfied the *Iridium* factors because they were reasonable, did not generate any objections, and "resolve a host of issues with critical counterparties and move the Debtors towards their DIP milestones." *Id.* at *11. However, he concluded that the lockup provision contained "neither (1) adequate (or any) information about the plan terms, nor (2) any evidence of meaningful choice." *Id.* at *10. In so ruling, Judge Glenn noted that the court need not decide whether the stipulations should be evaluated under the business judgment rule or the heightened entire fairness standard.

According to Judge Glenn, the lockup provision was clearly not a garden-variety RSA of the sort approved in cases like *Heritage*, *Indianapolis Downs*, or *ResCap* because it did not outline the broad features of a chapter 11 plan around which creditors could rally or facilitate the flow of information. Instead, he characterized the provision as a "bonus feature, affixed to unrelated stipulations regarding aircraft and engine leases, of the type that reach mixed results under judicial scrutiny." *Id.* at *11. Because the aircraft lessors had neither adequate information about the terms of a chapter 11 plan nor meaningful "outs," Judge Glenn concluded that the lockup provision "undoes the Bankruptcy Code's careful allocations of creditor rights and ultimately constitutes an improper solicitation in violation of section 1125(b)." He declined, however, to adopt the same bright-line prohibition of post-petition PSAs adopted by the court in *NII Holdings*. *Id.* at *8 n.11.

In particular, Judge Glenn explained, the debtors' chapter 11 cases were in their infancy, and the debtors were months away from filing a disclosure statement. He further noted that the court would not opine at that stage of the case on the amount of information necessary to qualify as meaningful disclosure. "[T]he lack

of *any* adequate information about plan terms," he wrote, "clearly runs head-on into the purpose and goals of section 1125(b)." *Id.*

The bankruptcy court found that the lockup provision had no meaningful "outs" for the lessors "to void the blank check they are writing." Among other things, Judge Glenn noted: (i) the requirement in the lockup provision that the debtors satisfy certain liquidity and leverage ratios was to be measured as of the effective date of a chapter 11 plan, after the plan had been solicited, confirmed, and implemented; (ii) the stipulation only required the debtor to list the ratios in the disclosure statement as targets or projections, but there was "no way to unscramble the egg" if those projections were not met; and (iii) even though the lessors might have objections on grounds other than liquidity and leverage, the lockup provision "snuffs out the ability to vote accordingly." *Id.* at *12.

According to the bankruptcy court, although the sophistication of the aircraft lessors was relevant in assessing whether the lockup provision was permissible, the level of their sophistication did not allow the debtors to circumvent the Bankruptcy Code's solicitation requirements or "use its provisions as bargaining chips," particularly when it might "trample the statutory rights of *other* creditors." *Id.* Finally, the court dismissed as speculative the debtors' concerns that, without the certainty of the lockup provision, the lessors might demand additional concessions in exchange for their votes. "These speculative concerns," Judge Glenn wrote, can be addressed in other ways, and in any event, "do not trump the statute." *Id.* at *13.

OUTLOOK

GOL Linhas is a significant development in the evolving jurisprudence regarding the permissibility of RSAs, PSAs, and lockup agreements in chapter 11 cases. Whatever denominated, such agreements are generally regarded by bankruptcy courts as a violation of the Bankruptcy Code's disclosure and vote solicitation requirements if they skirt those rules by failing either to impart adequate information to the affected signatories or to give such parties an opportunity to withdraw their support of a chapter 11 plan that fails to reflect their reasonable expectations. As indicated in *GOL Linhas*, the utility of PSAs, RSAs, and lockups in advancing a chapter 11 case to confirmation of a plan and the sophistication of the parties involved are relevant considerations in the analysis, but they do not trump the Bankruptcy Code's disclosure and vote solicitation requirements.

NEWSWORTHY

***Heather Lennox* (Cleveland/New York)**, ***Bruce Bennett* (Los Angeles)**, ***Kevyn D. Orr* (Washington)**, ***Gregory M. Gordon* (Dallas)**, ***Carl E. Black* (Cleveland)**, ***Daniel J. Merrett* (Atlanta)**, ***Robert W. Hamilton* (Columbus)**, ***Corinne Ball* (New York)**, ***Gary L. Kaplan* (Miami)**, ***Thomas M. Wearsch* (New York/Cleveland)**, ***Brad B. Erens* (Chicago)**, ***Jeffrey B. Ellman* (Atlanta)**, and ***Dan T. Moss* (Washington/New York)** were recognized as leading lawyers in the area of Bankruptcy/Restructuring in the 2024 edition of *Chambers USA*. Bruce Bennett and Gregory M. Gordon received a "Band 1" designation. Heather Lennox was ranked as a "Star Individual." Corinne Ball was designated a "Senior Statesperson." ***Thomas M. Wearsch* (New York/Cleveland)** spoke on a panel discussing "International Restructuring in the Automotive Sector" on June 4, 2024, at the International Bar Association Annual Meeting in Zurich, Switzerland.

***Dr. Olaf Benning* (Frankfurt)**, ***Markus Ledwina* (Frankfurt)**, and ***Alexander Ballmann* (Munich)** were recognized as leading lawyers by *The Best Lawyers in Germany*™ 2025 in the practice area Restructuring and Insolvency Law.

On June 10, 2024, ***Dan T. Moss* (Washington/New York)** was on a panel discussing "Insolvency Proceedings Without Solvency?" at the 24th Annual International Insolvency Conference in Singapore.

An article written by ***Daniel J. Merrett* (Atlanta)** titled "New York Bankruptcy Court: Setoff and Unjust Enrichment Cannot Be Asserted as Affirmative Defenses in Bankruptcy Avoidance Litigation" was posted on June 11, 2024, on the *Harvard Law School Bankruptcy Roundtable*.

On May 17, 2024, the U.S. Bankruptcy Court for the District of Delaware recognized and enforced a restructuring plan for Spark Networks SE ("Spark") under chapter 15 of the Bankruptcy Code, marking the first such order for a plan formulated under Germany's Corporate Stabilization and Restructuring Act ("StaRUG"). Dating platformer provider Spark received approval for its StaRUG plan from a German court in January and successfully defended an appeal by certain shareholders in April. Introduced in January 2021, StaRUG allows companies to impose a compromise or arrangement, including a restructuring of liabilities, upon all or a subset of the creditors. The plan waives more than $30 million of secured debt and $13 million of unsecured debt, and provides approximately $24 million in liquidity support. The Jones Day professionals advising Spark included ***Dan T. Moss* (Washington/New York)**, ***Olaf Benning* (Frankfurt)**, ***David S. Torborg* (Washington)**, ***Colleen E. Laduzinski* (Boston/New York)**, ***Ryan Sims* (Washington)**, ***S. Christopher Cundra IV* (Washington)**, ***Nick Buchta* (Cleveland)**, ***Richard H. Howell* (Washington)**, ***Elizabeth A. Dengler* (Boston)**, and ***Alexandra Levay* (Boston)**.

An article written by ***T. Daniel Reynolds* (Cleveland)** titled "Fifth Circuit: Recent U.S. Supreme Court Ruling Did Not Alter Mootness Requirements for Unstayed Bankruptcy Sale Orders" was published on June 4, 2024, by *Lexis Practical Guidance*.

An article written by ***Dan T. Moss* (Washington/New York)**, ***Heather Lennox* (Cleveland/New York)**, ***David S. Torborg* (Washington)**, and ***Vinay Kurien* (Singapore)** titled "Third Circuit Updates Its Standard for Granting Comity to Foreign Bankruptcy Proceedings" was published on June 9, 2024, by *Lexis Practical Guidance*.

An article written by ***Corinne Ball* (New York)**, ***David S. Torborg* (Washington)**, and ***Dan T. Moss* (Washington/New York)** titled "Delaware Bankruptcy Court: 'Center of Main Interests' for Purposes of Chapter 15 Recognition Must Be Determined on Debtor-by-Debtor Rather than Enterprise Group Basis was published on June 9, 2024, by *Lexis Practical Guidance*.

An article written by ***T. Daniel Reynolds* (Cleveland)** titled "Ability of Creditors' Committees to Prosecute Estate Claims Given a Boost in Delaware Bankruptcy Courts" was published on June 4, 2024, by *Lexis Practical Guidance*.

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