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FIRST IMPRESSIONS: SINGAPORE INTERNATIONAL COMMERCIAL COURT APPROVES CROSS-BORDER PREPACKAGED SCHEME OF ARRANGEMENT FOR UNREGISTERED FOREIGN COMPANY

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The Singapore International Commercial Court (the "SICC"), a division of the General Division of the High Court and part of the Supreme Court of Singapore, was established in 2015 as a trusted neutral forum to meet increasing demand for effective transnational dispute resolution. It recently considered, as a matter of first impression for the SICC, whether to approve a prepackaged scheme of arrangement for a group of Vietnam-based real estate investment companies under Singapore's recently enacted Insolvency, Restructuring and Dissolution Act 2018 (the "IRDA"). In *Re No Va Land Investment Group Corp.*, [2024] SGHC(I) 17 (June 7, 2024) ("NVLIG"), the SICC sanctioned a prepackaged scheme, emphasizing that its "description of its experience with the Application constitutes useful precedent for the management and prosecution of similar restructurings that may arise in the future," including its analysis of disclosure obligations with respect to prepackaged schemes under the IRDA.

THE IRDA

The IRDA came into force on July 30, 2020. It consolidates all personal and corporate insolvency and debt restructuring legislation into a unified statutory scheme in an effort to strengthen Singapore's position as hub for international debt restructuring. Notable features of the IRDA include:

- A provision permitting a scheme of arrangement to be approved over the objection of a dissenting class of creditors that arguably does not require shareholders to give up their shares (a "cross-class cram down");
- Restrictions on the enforcement of "ipso facto" contract clauses that allow a counterparty to terminate or modify a contract or accelerate payment upon the event of the debtor's insolvency or restructuring;
- A provision permitting a company to enter "judicial management" without a court order with the approval of a majority in number and value of the creditors present and voting, thereby minimizing expense, formality, and delay, and providing distressed companies with another viable option to commence a restructuring;

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- Civil penalties for officers and directors who engage in "wrongful trading" by: (i) causing an insolvent company to incur debts or other liabilities that it has no reasonable prospect of repaying in full; or (ii) causing a company to incur debts or other liabilities that it has no reasonable prospect of repaying in full *and* that result in the company becoming insolvent; and
- A provision authorizing judicial managers and liquidators to borrow funds for the purpose of prosecuting, among other things, avoidance, wrongful trading and fraudulent trading, and wrongful trading claims, and assigning the litigation proceeds to the funders.

Section 246(1)(d) of the IRDA provides that a foreign unregistered company qualifies for winding up in Singapore provided it can demonstrate a "substantial connection" with Singapore by reason of one or more of the following factors:

- Singapore is the "center of main interests" of the company;
- The company conducts business in Singapore or has a place of business in Singapore;
- The company is a registered foreign company;
- The company has substantial assets in Singapore;
- The company has chosen Singapore law as the law governing a loan or other transaction, or the law governing the resolution of one or more disputes arising out of or in connection with a loan or other transaction; and
- The company has submitted to the jurisdiction of the High Court of Singapore for the resolution of one or more disputes relating to a loan or other transaction.

According to the High Court of Singapore, a substantial connection with Singapore can be inferred from: (i) the existence of non-transient business activities, control, and assets in Singapore; and (ii) acceptance of Singapore jurisdiction or the application of Singapore law to a dispute. *See Re PT MNC Investama TBK* [2020] SGHC 149, at [12]–[13].

Whether a scheme of arrangement should be sanctioned by a Singapore court is determined by the IRDA, but court rulings interpreting certain related legislation—the Companies Act 1967 (2020 rev. ed.) and the Companies Act (Cap 50, 2006 rev. ed.) (collectively, the "CA")—are still relevant. Precedent under the CA established that a court can sanction a scheme if:

- All of the statutory requirements for approval have been satisfied;
- The constituency of the meeting of creditors convened to solicit approval of a scheme was fairly representative of the creditor class, and minority creditors were not coerced to accept it to promote adverse interests; and
- Approval of the scheme was reasonable as a matter of honesty and sound business judgment.

See The Royal Bank of Scotland NV (formerly known as ABN Ambro Bank NV) and others v. TT Int'l Ltd and another appeal [2012] 2 SLR 213, at [70].

The IRDA includes additional requirements for approval of a scheme of arrangement that is "prepackaged" because it is approved by creditors without a meeting convened as part of restructuring proceedings. Those requirements include:

- The company must provide each creditor meant to be bound by the scheme with a statement containing specified information (IRDA ss 71(3)(a) and 71(6));
- The company must provide adequate publication notice of the application for scheme approval (IRDA s 71(3);
- The company must provide notice and a copy of the application to affected creditors (IRDA s 71(3)(c)); and

LAWYER SPOTLIGHT: DAVID HARDING

David Harding, a partner in the London Office, focuses his practice on financial restructurings, distressed acquisitions, and formal insolvency proceedings, with a particular focus on European special situations and complex cross-border restructurings, the acquisition of loan portfolios, and the implementation of "loan-to-own" strategies. David successfully transitions assets, management, and operations for a range of clients including investment banks and hedge funds holding distressed debt, corporate debtors (or their directors and shareholders), and insolvency office holders.

Among his many recent actions, David has advised AlbaCore Capital on its co-investment in a €500 million platform to acquire NPL portfolios across Europe (alongside Lindorff and Carval); the administrators of The Body Shop International on the rescue of its global retail business; and the liquidators of Value Discovery Partners in the context of a restructuring and wind-down of a US$1 billion fund. He also has advised on numerous restructuring matters and acquisitions for funds such as AlbaCore Capital, Affinity Capital, Aurelius Investments Group, Canyon Capital Advisors, Cross Ocean Partners, ESO Capital, GoldenTree, RoundShield Partners, and the Lone Star Funds.

- The court must be satisfied that, if a meeting of creditors had been convened for the purpose of seeking approval of the scheme, a majority in number of the creditors, and the holders of at least 75% in value of creditor claims, present and voting, would have approved the scheme (IRDA s 71(3)(d)).

According to the court in *Re DSG Asia Holdings Pte Ltd* [2022] 3 SLR 1250, the standard for approval of a prepackaged scheme is one of "a clear case of agreement to the scheme." Particularly, there has been proper disclosure, satisfaction of voting requirements, and proper classification of creditors. *Id.* at [31].

NVLIG

No Va Land Investment Group Corp. ("No Va") is a real estate investment holding company with more than 90 affiliates incorporated and based in Vietnam. In July 2023, severe distress affecting the real estate sector caused No Va to default on US$300 million in bond debt governed by New York law and listed on the Singapore stock exchange. Disputes regarding the terms of the bond indenture were subject to arbitration in Singapore.

After extensive negotiations with bondholders to achieve a consensual restructuring of the bonds, No Va and certain bondholders agreed on the terms of a prepackaged scheme of arrangement. Although no meeting of creditors was convened for the purpose of soliciting approval of the proposed scheme, the scheme was overwhelmingly supported by all participating bondholders (with holders of more than 95% of the outstanding bonds voting in favor of the scheme and none objecting). Before casting their votes, bondholders were provided with extensive documentation and other relevant information designed to allow them to make an informed decision regarding the benefits of the proposed scheme compared to a potential liquidation.

On April 11, 2024, No Va filed an application in the SICC seeking approval of the prepackaged scheme under the IRDA.

THE SICC'S RULING

The SICC granted the uncontested application on April 26, 2024—only 15 days after the petition date.

The court issued its "grounds of decision" on June 7, 2024. Writing for the SICC, International Justice—and former U.S. bankruptcy judge—James Michael Peck concluded that "[t]he applicable standard for approving a pre-pack was satisfied in this instance without any doubt." *NVLIG*, [2024] SGHC(I) 17, at p. 13 ¶ 29. He further noted that the scheme of arrangement "was prototypical of what could be accomplished rapidly in a pre-pack and pointed to the utility of following expedited restructuring procedures in a cross-border context." *Id.* at p. 17 ¶ 39.

Justice Peck explained that the SICC had jurisdiction to approve the scheme. As a starting point, section 18D(2)(C) of the Supreme Court of Judicature Act 1969 (2020 rev. ed.) provides that the

SICC has jurisdiction to hear any proceedings related to corporate insolvency, restructuring, or dissolution under the IRDA that are international and commercial in nature and that satisfy any other conditions specified by the rules of court. Among other things, Justice Peck noted: (i) "[t]he subject matter of the case was corporate bonds, a classic and archetypal commercial matter"; and (ii) No Va satisfied the "international" requirement as a "foreign company" because it was incorporated outside of Singapore (in Vietnam); had a place of business, property, and creditors located in a foreign country; had liabilities and contractual obligations arising in a foreign country that were subject to foreign law (including the bonds, which were governed by New York law); and was controlled from a foreign country. *Id.* at pp. 14–15 ¶¶ 31–34.

Justice Peck further explained that the uncontroverted evidence demonstrated that No Va had a "substantial connection" to Singapore, and was therefore entitled to relief under the IRDA.

Next, the SICC found that the scheme satisfied all of the disclosure requirements set forth in section 71(3) of the IRDA (the "Disclosure Requirement"), which authorizes a court to approve a prepackaged scheme only if creditors have been provided with: (i) information regarding the company's property, assets, business activities, financial condition, and prospects; (ii) information regarding the terms of the scheme and its impact on creditors; and (iii) such other information as is necessary for creditors

to make an informed decision whether to accept or reject the scheme.

According to Justice Peck, this Disclosure Requirement is not a "fixed checklist," and "what constitutes proper disclosure will depend on the particulars of each case." *Id.* at p. 18 ¶ 43. He also observed that "[a] pragmatic approach would be to look to commercial practices within the relevant restructuring market for an *ex ante* benchmark of the adequacy of disclosure." *Id.* at 19 ¶ 46. However, Justice Peck cautioned, the court "cannot solely look to the market and has a responsibility to independently find that disclosure practices followed in each case are proper and in compliance with the Disclosure Requirement." *Id.* at p. 20 ¶ 49. He also cautioned that the extensive disclosure of information does not necessarily amount to adequate disclosure, noting that "[m]ore paper does not necessarily mean better disclosure." *Id.* at p. 24 ¶ 61.

Justice Peck emphasized that, although a meeting of creditors was not formally convened in the prepackaged scheme before the court, the financial disclosures provided to creditors were "accomplished with evident care and attention to detail," in keeping with the disclosure standards governing schemes of arrangement (albeit not specifically under the IRDA) articulated by the Singapore Court of Appeal in *Pathfinder Strategic Credit LP and another v. Empire Capital Resources Pte Ltd and another appeal* [2019] 2 SLR 77. *Id.* at pp. 21–24. That guidance, he explained, which was designed to ensure that creditors are well informed, "appl[ies] with equal force in a pre-pack scheme of arrangement and should be read in conjunction with the Disclosure Requirement" of section 71(3) of the IRDA. *Id.* at p. 25 ¶ 64.

Having concluded that approval of No Va's prepackaged scheme was warranted, the SICC noted that "[t]he proceedings were entirely consensual and, in that sense, unremarkable for a judicial point of view, but the case is noteworthy, nonetheless, due to [No Va's] pioneering cross-border use of recently adopted pre-pack procedures." *Id.* at p. 28 ¶ 74.

OUTLOOK

Prepackaged restructuring plans have long been an important feature of U.S. bankruptcy law, under both chapter 11 and chapter 15, and their utility as a vehicle for accelerating reorganization proceedings and reducing administrative costs has prompted several other countries, including the United Kingdom, the Philippines, and Singapore, to incorporate pre-pack features and procedures into their restructuring laws. Singapore's regime for prepackaged schemes of arrangement is relatively recent, and the jurisprudence addressing its requirements is still evolving. The SICC's ruling in *NVLIG* is therefore notable for the guidance it provides on the IRDA's rules and procedures regarding pre-packs. Prepackaged foreign restructurings have been recognized in the United States under chapter 15—notably, the prepackaged restructuring of Diebold Nixdorf—and, all else being equal, such prepackaged restructurings taking place under the auspices of the IRDA are likely to be to be recognized under chapter 15, assuming the necessary recognition prerequisites are established.

The year 2024 has already been a year of notable developments in Singaporean bankruptcy and restructuring jurisprudence involving the SICC. In addition to its landmark ruling in *NVLIG*, the SICC on January 18, 2024, handed down its first insolvency-related ruling in *Re PT Garuda Indonesia (Persero) Tbk* [2024] SGHC(I). In that matter, the court granted recognition in Singapore of an Indonesian debtor-airline's "suspension of payments" proceeding under Singapore's version of the UNCITRAL Model Law on Cross-Border Insolvency. With both of these cases, each authored by a former U.S. bankruptcy judge—Chief Judge Sontchi (D. Del.) and Judge Peck (S.D.N.Y.), who is now a SICC Justice—Singapore and the SICC are demonstrating that the IRDA is a capable tool for complex cross-border corporate restructurings and is a viable alternative to court-supervised restructurings under U.S., UK, or other restructuring regimes.

This article was prepared with the assistance of Kit Shu, a foreign legal consultant in Jones Day's New York Office.

NEW YORK DISTRICT COURT: CAP ON LANDLORD CLAIMS IN BANKRUPTCY APPLIES TO CLAIMS AGAINST LEASE GUARANTORS, AND CAP SHOULD BE CALCULATED USING "TIME APPROACH"

Daniel J. Merrett

To prevent landlords under long-term real property leases from reaping a windfall for future rent claims at the expense of other creditors, the Bankruptcy Code caps the amount of a landlord's claim against a debtor-tenant for damages "resulting from the termination" of a real property lease. Unfortunately, the language of the provision of the Bankruptcy Code—section 502(b)(6)—that specifies the maximum allowed amount of a landlord's claim for lease termination damages is confusing, and it has led to a number of disagreements among bankruptcy courts regarding application of the statutory cap to claims against debtor-lease guarantors and the proper way to calculate the amount of the statutory cap.

The U.S. District Court for the Southern District of New York recently addressed both of those issues in *In re Cortlandt Liquidating LLC*, 658 B.R. 244 (S.D.N.Y. 2024). The district court affirmed bankruptcy court rulings that the statutory cap applied to a landlord's claim against a lease guarantor. It also ruled that, based on the plain language of section 502(b)(6), its legislative history, and other recent rulings considering the question, the "Time Approach," rather than the "Rent Approach," represents "the correct view" in calculating the amount of the landlord's lease termination damages.

STATUTORY CAP ON LANDLORD FUTURE RENT CLAIMS

Section 502(b)(6) of the Bankruptcy Code provides that the maximum allowable amount of the "claim of a lessor for damages resulting from the termination of a lease of real property" is limited to:

> (A) the rent reserved by such lease, without acceleration, *for the greater of one year, or 15 percent, not to exceed three years, of the remaining term of such lease*, following the earlier of—
>
> (i) the date of the filing of the petition; and
> (ii) the date on which such lessor repossessed, or the lessee surrendered, the leased property; plus
>
> (B) any unpaid rent due under such lease, without acceleration, on the earlier of such dates.

11 U.S.C. § 502(b)(6) (emphasis added). The purpose of this rent cap is to balance the interests of landlords and other unsecured creditors by allowing a landlord "to receive compensation for losses suffered from a lease termination while not permitting a claim so large as to prevent general unsecured creditors from recovering from the estate." *Solow v. PPI Enterprises, Inc. (In re PPI Enterprises (U.S.), Inc.)*, 324 F.3d 197 (3d Cir. 2003); *see generally* COLLIER ON BANKRUPTCY ("COLLIER") ¶ 502.03[7][a] (16th ed. 2024).

The scope of section 502(b)(6) is limited to lease terminations. Lease damages claims for items such as physical damages to the premises are not subject to the cap. *See Kupfer v. Salma (In re Kupfer)*, 852 F.3d 853 (9th Cir. 2016); *Saddleback Valley Cmty. Church v. El Toro Materials Co. (In re El Toro Materials Co.)*, 504 F.3d 978 (9th Cir. 2007).

APPLICATION TO CLAIMS AGAINST LEASE GUARANTORS

As noted, section 502(b)(6) provides that the "claim of a lessor for damages resulting from the termination of a lease of real property" is subject to the statutory cap. It does not state, however, that the claim must be asserted by the lessor against a debtor-lessee. For this reason, most courts have concluded that lease termination damages asserted against a debtor-lease guarantor are also capped by section 502(b)(6). *See, e.g., In re Arden*, 176 F.3d 1226 (9th Cir. 1999); *Cutler v. Lindsey (In re Lindsey)*, 1997 WL 705435 (4th Cir. Nov. 7, 1997); *In re Concepts Am., Inc.*, 621 B.R. 848 (Bankr. N.D. Ill. 2020); *Flanigan v. Samalex Trust (In re Flanigan)*, 374 B.R. 568 (Bankr. W.D. Pa. 2007); *In re Henderson*, 297 B.R. 875 (Bankr. M.D. Fla. 2003); *see generally* COLLIER at ¶ 502.03[f] ("[Section 502(b)(6)] merely results in the limitation of the allowance of damages that a lessor of real property may recover from a bankruptcy estate for termination of a lease, regardless of the identity of the entity that is the debtor. . . . [T]he cap applies in the bankruptcy of a guarantor."). *But see In re Dronebarger*, 2011 WL 350479 (Bankr. W.D. Tex. Jan. 31, 2011) (ruling that the cap did not apply to a lessor's claim for damages against the debtors as joint guarantors of a commercial real property lease due to the court's belief, based on its reading of the Fifth Circuit's decision in *In re Goforth*, 179 F.3d 390 (5th Cir. 1999), that the Fifth Circuit would have concluded that section 502(b)(6) would not apply to a debtor lease guarantor); *In re Danrik, Ltd.*, 92 B.R. 964 (Bankr. N.D. Ga. 1988) (holding that section 502(b)(6) did not limit the lessor's claim against a debtor lease guarantor given the "unusual" facts of the case, where the guarantor debtor was solvent, all other claims have been paid in full, the lessee itself had not filed for bankruptcy, and the claim was not disproportionately large).

TIME APPROACH V. RENT APPROACH IN CALCULATING STATUTORY CAP

The language of section 502(b)(6)(A) (italicized above) has long been a source of consternation among the courts, largely because its perceived ambiguity has created confusion over how it should be applied. *See* Final Report and Recommendations of the American Bankruptcy Institute Commission to Study the Reform of Chapter 11 (2014) V.A.6, p. 135 (noting that "many courts have confused or misapplied the formula and that, simply stated, the cap should be the rent reserved under the lease for the greater of (i) one year and (ii) the shorter of 15 percent of the remaining term and three years, plus unpaid rents"). Two competing approaches have been applied by courts in determining

the maximum allowable amount of a landlord's lease termination claim—the "Time Approach" and the "Rent Approach."

The focus of the Rent Approach is on the dollar amount of rent payable for the entire remaining lease term. According to the Rent Approach, section 502(b)(6) imposes a cap equal to 15% of that amount, provided that it is at least equal to the rent reserved under the lease for one year and does not exceed the rent reserved for the next three years of the lease term. *See In re Financial News Network, Inc.*, 149 B.R. 348, 351 (Bankr. S.D.N.Y. 1993) (applying the Rent Approach without any discussion of the Time Approach); *In re Andover Togs, Inc.*, 231 B.R. 521, 547 (Bankr. S.D.N.Y. 1999) (holding that the Rent Approach is the "logically sounder" approach); *In re Rock & Republic Enterprises*, 2011 WL 2471000, *20 (Bankr. S.D.N.Y. 2011) (declining to depart from the precedents set in *Financial News* and *Andover* and ruling that the Rent Approach should govern).

The Time Approach, by contrast, is anchored to the remaining term of the lease, not the remaining rent payable. According to this approach, section 502(b)(6) imposes a cap equal to the rent reserved under the lease for the time period beginning at lease termination equal to 15% of the remaining lease term, provided that time period is at least one year and no more than three years. *See In re Keane*, 2020 WL 612296, *2 (Bankr. E.D.N.C. Oct. 14, 2020); *In re Filene's Basement, LLC*, 2015 WL 1806347, *7 (Bankr. D. Del. Apr. 16, 2015); *In re Denali Family Servs.*, 506 B.R. 73, 83 (Bankr. D. Alaska 2014); *In re Shane Co.*, 464 B.R. 32, 39 (Bankr. D. Col. 2012). The Time Approach would appear to be the majority view among courts that have recently considered the question. *See* COLLIER at ¶ 502.03[7][c] (citing cases and noting that the Rent Approach "does not appear to be in accord with the language of the statute").

Because many real property leases contain rent-escalation clauses during the latter stages of the lease, the Time Approach does not take such escalations into account when computing the maximum amount of the landlord's claim, whereas the Rent Approach does, thereby resulting in a higher cap on the landlord's leasetermination claim. *See* COLLIER at ¶ 502.06[7][c] ("The choice of methodology will make a difference only where the remaining rent under the lease is not constant. If the rent is increasing over the remaining term, the latter methodology will impose a lower limit, favoring the estate. If the rent is decreasing, the latter methodology will favor the landlord. If the rent is variable, it will depend on when in the lease the termination occurs.").

CORTLANDT LIQUIDATING

In 2010, C21 1972 Broadway LLC ("C21"), an affiliate of Century 21 Department Stores LLC ("Century 21"), entered into a lease agreement (the "Lease") as tenant with Lincoln Triangle Commercial Holding Co. LLC ("Lincoln") for nonresidential real property located near Lincoln Center in New York City. Century 21 acted as guarantor under the Lease. C21's obligations under the Lease were also secured by a letter of credit ("LC") posted by C21 but funded by Century 21.

On September 10, 2020, Century 21 and certain affiliates—excluding C21 (collectively, the "debtors")—filed for chapter 11 protection in the Southern District of New York. Shortly afterward, the debtors filed a motion to reject the Lease as well as many other executory contracts and unexpired leases under section 365 of the Bankruptcy Code. Lincoln objected to rejection of the Lease. It argued that C21 did not have the power to reject the Lease because it was not a debtor in bankruptcy. The debtors responded by removing the Lease from the list of leases and contracts to be rejected.

On October 9, 2020—prior to the expiration of the stated term of the Lease—C21 breached the lease by vacating the property and delivering the keys to Lincoln. It also stopped paying rent under the Lease.

Lincoln delivered a written notice to C21 that it refused to accept termination of the Lease. Lincoln then drew down the full amount

of the LC (approximately $7.6 million) and held the proceeds as security. Thereafter, it applied those funds to satisfy C21's monthly rent and other Lease obligations.

In December 2020, Lincoln filed a proof of claim against Century 21, as guarantor, in the amount of approximately $44 million for estimated damages resulting from breach of the lease, including: (i) future rent; (ii) future real estate taxes, operating expense escalations, and utilities and repairs; and (iii) actual cleanup and repair expenses, and amounts required to discharge mechanic's liens.

The bankruptcy court confirmed a liquidating chapter 11 plan for the debtors—thereafter known as Cortlandt Liquidating, LLC—on April 26, 2021. The court-appointed administrator of the debtors' liquidating chapter 11 plan (the "administrator") objected to the claims of various real property landlords with respect to Century 21 store locations, including Lincoln, for damages arising from the termination of their leases. The administrator argued that: (i) section 502(b)(6) capped Lincoln's claim for damages; (ii) Lincoln's damages should be calculated under the Time Approach, rather than the Rent Approach; (iii) the lease termination damages should include only items properly classified as "rent reserved" and should exclude certain maintenance and repair claims; (iv) the projected future "rent reserved" used to calculate Lincoln's claim should reflect reasonable assumptions based on historical data; and (v) the LC should be applied to reduce Lincoln's capped claim for damages.

In an interim order, the bankruptcy court ruled that section 502(b)(6) caps the claims of a landlord against a debtor-guarantor under a terminated lease. It also held that the Lease was "functionally dead" and concluded that "the Court need not reach the question of whether the Lease was terminated pursuant to New York law in order to conclude that, once the Lease was 'functionally dead,' it can be considered 'terminated' for purposes of section 502(b)(6)." *In re Cortlandt Liquidating LLC*, No. 20-12097 (SCC) (Bankr. S.D.N.Y. May 20, 2022) (Doc. No. 1261) p. 8. In so ruling, the bankruptcy court noted that "termination" is not defined in section 502(b)(6) (or elsewhere in the Bankruptcy Code), and that the term "has a slightly *broader* meaning than the same term of art under [New York] landlord-tenant law," which requires that both the landlord and the tenant have taken unambiguous actions indicating that they view the lease as having been terminated.

In addition, the bankruptcy court found that "uncontroverted evidence" established that the LC was satisfied with estate assets under the debtors' liquidating chapter 11 plan and, therefore, that the amount of the LC should be deducted from Lincoln's claim for termination damages after application of the statutory cap. The bankruptcy court declined at that time to rule on the proper calculation of damages under the cap. *Id.* at p. 9.

Subsequently, the bankruptcy court ruled in favor of the administrator on the question of the proper approach for calculating the statutory cap. The court wrote that it did not "lightly depart" from precedent to the contrary in *Financial News*, *Andover* and *Rock & Republic*, but that it was "convinced that the Time Approach represents the correct view." *In re Cortlandt Liquidating LLC*, 648 B.R. 137, 141 (Bankr. S.D.N.Y. 2023), *aff'd*, 2024 WL 1301429 (S.D.N.Y. Mar. 26, 2024).

"First and most importantly," the bankruptcy court explained, the plain language of section 502(b)(6) "makes clear that the Time Approach is the correct one" because the entire phrase "for the greater of one year, or 15 percent, not to exceed three years, of the remaining term of such lease" is "worded in periods of time" rather than the dollar amount of rent. If lawmakers had intended the Rent Approach to apply, the court noted, section 502(b)(6) "would have stated that the allowable rejection damages would not exceed '15 percent of the rent reserved for the remaining term of such lease, *provided* that such amount will not be less than the rent reserved for the next year of the lease term, and shall not be more than the rent reserved for the next three years of the lease term.'" *Id.* According to the bankruptcy court, those are not the words of section 502(b)(6) "and they cannot reasonably be derived from the language that does appear." *Id.*

Next, the bankruptcy court explained that the Time Approach is supported by the legislative history of section 502(b)(6), which indicates that, in enacting the provision in 1978 (then designated as section 502(b)(7)), lawmakers did not clearly express the intention to change from the Time Approach employed in cases under the former Bankruptcy Act to a "total rent"-based formula. *Id.* at 142–43 (citing *Filene's*, 2015 WL 1806347, at *6; *In re Connectix Corp.,* 372 B.R. 488, 493–94 (Bankr. N.D. Cal. 2007)).

The bankruptcy court disagreed with courts that have ruled that: (i) considerations of equity or fairness favor the Rent Approach over the Time Approach; and (ii) the former better implements lawmakers' intent or the purposes of section 502(b)(6). According to the judge, the plain intent of section 502(b)(6) was to limit landlords' claims and to "strike a balance between the interests of landlords and the interests of other creditors." However, it emphasized,"[i]dentifying that general intent is of no help in deciding whether Congress intended that the Rent Approach or the Time Approach would be used." *Id.* at 143. The bankruptcy court further noted that considerations of fairness and equity are not instructive in determining which approach should be employed.

The bankruptcy court accordingly ruled that, in accordance with the Time Approach, the section 502(b)(6) cap with respect to the landlords should be "calculated by reference to the rents reserved under the relevant leases for the first 15 percent of the remaining lease terms, *provided*, that such amounts shall not be less than the rents reserved for the first remaining year of the relevant lease terms, and shall not be greater than the rents reserved for the first three remaining years of the relevant lease terms." *Id.* at 144.

Finally, addressing the remaining disputes before it, the bankruptcy court held that: (i) because "the statutory cap applies only to damages that are attributable to the fact that the term of the

lease has come to an end," the store cleanup costs incurred by Lincoln were subject to the cap because they arose from the termination of its lease; (ii) Lincoln's claim for mechanic's liens placed on the leased premises by unpaid contractors engaged by Century 21 was not subject to the cap because "any damages associated with mechanic's liens plainly would have existed regardless of whether the lease was terminated"; (iii) Lincoln's claim for repairs required under the terms of its lease did not arise from the termination of the lease and was not subject to the cap; and (iv) although real estate taxes and certain operating expenses were properly included in calculating the "rent reserved" under Lincoln's lease as well as the amount of the section 502(b)(6) cap, the absence of certain facts regarding projected future rent assumptions precluded the court from ruling on that issue.

Lincoln appealed the bankruptcy court's rulings to the district court.

THE DISTRICT COURT'S RULING

The district court affirmed the bankruptcy court's rulings.

U.S. District Court Judge Mary Kay Vyskocil concluded that the section 502(b)(6) cap applies to a lessor's claim against a debtor-guarantor under a lease. She explained that "[b]y its terms, [section 502(b)(6)] does not explicitly address whether it applies with respect to a claim against a *guarantor*/debtor of a lease as opposed to a tenant/debtor." According to Judge Vyskocil, although the Second Circuit has not addressed the question, "by its terms, the statute simply does not distinguish among types of debtors." *Cortlandt Liquidating*, 658 B.R. at 250.

The district court noted that, to achieve section 502(b)(6)'s goal of overcompensating lessors at the expense of other general unsecured creditors, the provision "speaks not to a particular debtor entity, but rather to the amount of damages recoverable from the estate." *Id.* (citing *In re Episode USA, Inc.*, 202 B.R. 691, 695 (Bankr. S.D.N.Y. 1996)). For this reason, Judge Vyskocil wrote, "[t]he overwhelming majority of courts that have considered the issue have found" that the statutory cap applies to lease termination claims against debtor-guarantors. *Id.* at 252.

Next, the district court agreed with the bankruptcy court that the Lease was terminated for purposes of section 502(b)(6). Judge Vyskocil found no error in the bankruptcy court's conclusion that the term "termination" has a broader definition under the provision that it does under New York law, and that the Lease was "functionally dead" after the debtors intentionally abandoned the premises to the landlord, "similar to rejection." *Id.* She also agreed with the bankruptcy court's reasoning that "it would be antithetical to the purpose of Section 502(b)(6) to allow a landlord to avoid application of the damages cap by seizing on a technicality in state law to refuse to accept a surrender of the premises after the lessee has intentionally abandoned the premises." *Id.* at 253.

The district court did not fault the bankruptcy court's conclusion that the section 502(b)(6) cap should be calculated under the Time Approach. Judge Vyskocil acknowledged that "[c]ourts throughout the country uniformly recognize the two competing approaches." She also noted that the bankruptcy court and the parties acknowledged that "there is a clear divide in district court opinions on the proper approach to the 'Cap.'" *Id.* at 254.

According to Judge Vyskocil, the bankruptcy court did not lightly depart from prior Southern District of New York precedent in ruling that the Time Approach was the correct one to calculate the statutory cap, but decided to do so in part because, in the 12 years since the last district court in the Southern District of New York addressed the issue in *Rock & Republic Enterprises*, "the weight of the relevant authorities throughout the country has shifted very strongly in favor of the Time Approach." *Id.* at 255. Guided by that authority, the district court wrote, the bankruptcy court "conducted [its] own, independent analysis of Section 502(b)(6)'s statutory language and legislative history, and ultimately came to the well-reasoned decision that the Time Approach was the correct interpretation of Section 502(b)(6)." *Id*. The district court found no error with the bankruptcy court's reasoning or its conclusion.

Similarly, for the reasons articulated by the bankruptcy court, the district court ruled that the bankruptcy court correctly held that the proceeds of the LC should be applied to reduce Lincoln's claim, as capped by section 502(b)(6), and that store cleanup costs were subject to the damages cap.

OUTLOOK

In *Cortlandt Liquidating*, the district court adopted the majority position regarding both the application of the statutory cap on lease termination claims to claims against debtor-lease guarantors and the calculation of the cap in accordance with the Time Approach—the latter departing from long-standing precedent that the court viewed as outdated.

Key takeaways from the decision include:

- Section 502(b)(6) does not on its face distinguish between debtor-lessees and debtor-lease guarantors in limiting a lessor's claims for damages arising from the termination of a real property lease.
- The definition of "termination" in section 502(b)(6) may be broader than the meaning of the term under applicable state landlord-tenant law.
- Parties to real property leases should know which approach has historically been employed by the courts in a district where the debtor-tenant or guarantor files (or is likely to file) for bankruptcy.
- While bankruptcy and appellate courts sometimes disagree on the proper approach, the Time Approach is trending as the appropriate way to calculate the statutory cap. In light of that, historical practice in the jurisdiction may not guarantee future outcomes.

OHIO BANKRUPTCY COURT ADOPTS "ACTUAL TEST" TO DETERMINE WHETHER CERTAIN UNASSIGNABLE CONTRACTS CAN BE ASSUMED IN BANKRUPTCY

Oliver S. Zeltner

Disagreement regarding the interpretation of section 365(c) of the Bankruptcy Code has led to divergent rulings among the bankruptcy and federal circuit courts regarding whether a bankruptcy trustee or chapter 11 debtor can assume an executory contract or unexpired lease that is unassignable under applicable non-bankruptcy law without the counterparty's consent—even where the debtor has no intention of assigning the agreement to a third party. Some courts, including several federal circuit courts, have ruled that, absent counterparty consent, the plain language of section 365(c) prohibits a bankruptcy trustee or chapter 11 debtor from assuming an executory contract or unexpired lease if the contract or lease cannot be assigned under applicable non-bankruptcy law. This is known as the "hypothetical test."

However, one federal circuit court, and most bankruptcy courts outside of the circuits that have adopted the hypothetical test, apply what is known as the "actual test." Under the "actual test," a chapter 11 debtor, with bankruptcy court approval, can assume an executory contract or unexpired lease if the debtor intends to perform under the agreement itself, even if the agreement could not be assigned under applicable non-bankruptcy law and the counterparty does not consent to assumption.

A recent ruling by the U.S. Bankruptcy Court for the Southern District of Ohio has the potential to widen the existing circuit split if it is ultimately upheld on appeal by the U.S. Court of Appeals for the Sixth Circuit. In *In re Welcome Group 2 LLC*, No. 2:23-BK-53043, 2024 WL 3359379 (Bankr. S.D. Ohio July 10, 2024), the court concluded that the "actual test" both "comports with the plain language of the statute" and is consistent with "the overall objectives of chapter 11 relief and the purposes of the Bankruptcy Code."

LIMITATIONS ON THE ABILITY TO ASSUME OR ASSIGN CERTAIN CONTRACTS AND LEASES IN BANKRUPTCY

Section 365(a) of the Bankruptcy Code allows a trustee or chapter 11 debtor-in-possession ("DIP") (pursuant to section 1107(a)), with bankruptcy court approval, to assume or reject most kinds of executory contracts and unexpired leases. This broad power, however, is limited with respect to certain kinds of contracts. For example, section 365(c)(1)(A) of the Bankruptcy Code provides that a trustee or DIP may not "assume or assign" an executory contract or unexpired lease if "applicable law excuses a party, other than the debtor, to such contract or lease from accepting performance from or rendering performance to an entity other than the debtor or the debtor in possession" and such party does not consent to assumption or assignment. 11 U.S.C. § 365(c)(1). The provision is designed to "balance the rights of third parties who contracted with the debtor and whose rights may be prejudiced by having the contract or lease performed by an entity with which they did not enter into the agreement." *In re Lil' Things*, 220 B.R. 583, 591 (Bankr. N.D. Tex. 1998); *see generally* COLLIER ON BANKRUPTCY ("COLLIER") ¶ 365.07[1][d][i] (16th ed. 2024).

Courts have applied this provision to a wide variety of contracts. Among these are personal service contracts, including employment agreements; contracts with the U.S. government; certain kinds of franchise agreements; and licenses of intellectual property. *See id.* at ¶ 365.07[1]. Thus, many debtors (especially those in the technology industry) find that their rights with respect to certain executory contracts are significantly limited in bankruptcy.

THE STATUTORY MUDDLE

Section 365(c)(1) of the Bankruptcy Code prevents a trustee or DIP from assigning a contract without the counterparty's consent if applicable law prevents the contract from being assigned outside bankruptcy without consent. Section 365(c)(1), however, uses the distinctive phrase "assume *or* assign," as opposed to "assume *and* assign," which, at first blush, appears to mean that a trustee or DIP cannot assume such a contract and agree to perform under it, even if the trustee or DIP has no intention of assigning the contract to a third party.

Some courts construe the "assume or assign" language to mean that the statutory proscription applies to a trustee or DIP who seeks either to: (i) assume and render performance under the agreement; or (ii) assume the agreement and assign it to a third party. Under this literal interpretation, the court posits a hypothetical question: Could the debtor assign the contract to a third party under applicable non-bankruptcy law? If the answer is no, the trustee or DIP may neither assume nor assign the contract. This approach is commonly referred to as the "hypothetical test." The Third, Fourth, Ninth, and Eleventh Circuits have adopted this approach. *See In re West Elecs. Inc.*, 852 F.2d 79, 83 (3d Cir. 1988); *RCI Tech. Corp. v. Sunterra Corp. (In re Sunterra Corp.)*, 361 F.3d 257, 265–71 (4th Cir. 2004); *Perlman v. Catapult Entm't, Inc. (In re Catapult Entm't, Inc.)*, 165 F.3d 747, 749–55 (9th Cir. 1999); *City*

of Jamestown, Tenn. v. James Cable Partners, L.P. (In re James Cable Partners, L.P.), 27 F.3d 534, 537 (11th Cir. 1994).

A leading bankruptcy commentator has characterized the hypothetical test approach as "troubling, as it may prevent a debtor in possession from being able to reorganize under circumstances that do not adversely affect the other party to the contract." COLLIER at ¶ 365.07[1][d] (citation omitted). Moreover, according to the commentator, application of the hypothetical test is inconsistent with the overall objectives of chapter 11 of the Bankruptcy Code:

> As a matter of policy, a refusal to permit debtors in possession to assume otherwise nonassignable contracts would present problems for debtors whenever the debtor's business is one in which major contracts are nonassignable under non-bankruptcy law. Such debtors will not, as a practical matter, be able to avail themselves of the benefits of chapter 11 because they will not be able to perform their prebankruptcy contracts without permission from the non-debtor parties to the contracts.

Id. at ¶ 365.07[1][d][iii].

Other courts, having determined that the phrase "may not assume *or* assign" should be read to mean "may not assume *and* assign," apply the statutory proscription only when the trustee or DIP actually intends to assign the contract to a third party. This approach is commonly referred to as the "actual test." Its adherents include the First Circuit and the vast majority of lower courts considering the issue. *See Institut Pasteur v. Cambridge Biotech Corp.*, 104 F.3d 489, 493–94 (1st Cir. 1997), *abrogated on other grounds by Hardemon v. City of Boston*, No. 97-2010, 1998 WL 148382 (1st Cir. Apr. 6, 1998), *superseded by* 144 F.3d 24 (1st Cir. 1998); *Summit Inv. & Dev. Corp. v. Leroux (In re Leroux)*, 69 F.3d 608, 612–14 (1st Cir. 1995); *In re Jacobsen*, 465 B.R. 102, 105–06 (Bankr. N.D. Miss. 2011) (collecting cases).

In addition, the Fifth Circuit has applied the actual test in construing section 365(e)(2)—the Bankruptcy Code's exception to the prohibition against enforcement of "ipso facto" clauses that act to terminate or modify a contract as a consequence of a bankruptcy filing. *See Bonneville Power Admin. v. Mirant Corp. (In re Mirant Corp.)*, 440 F.3d 238, 248–51 (5th Cir. 2006). Many "actual test" courts have reasoned that a literal interpretation of section 365(c)(1) could defeat the policy considerations and underlying purposes of the Bankruptcy Code. *See, e.g., In re Edison Mission Energy*, No. 12-49219, 2013 WL 5220139, at *10 (Bankr. N.D. Ill. Sept. 16, 2013) ("The Court also finds that the actual test is more congruous with fundamental bankruptcy policy: the maximization of the value of the debtor's estate."); *In re Mirant Corp.*, 303 B.R. 319, 334 (Bankr. N.D. Tex. 2003) (ruling that section 365(c)(1) is "not meant to aid creditors in penalizing an estate"); *In re Cumberland Corral, LLC*, No. 313-06325, 2014 WL 948473, at *10 (Bankr. M.D. Tenn. March 11, 2014) (concluding that a literal interpretation of section 365(c)(1) would produce an "outcome [that is] contrary to the purposes of the Bankruptcy Code").

In *In re Footstar, Inc.*, 323 B.R. 566 (Bankr. S.D.N.Y. 2005), the court agreed with the ultimate conclusion reached by the "actual test" courts but adopted a different reading of section 365(c)(1) that, in the court's view, harmonized the plain meaning of the statute with the result obtained via application of the actual test. Expanding its analysis of section 365(c) beyond the phrase "assume or assign," the *Footstar* court reasoned that the term "trustee" in section 365(c) should not automatically be read (as it is in many other provisions "as a matter of simple logic and common sense") to be synonymous with the term "debtor-in-possession." *Id.* at 570, 573.

Instead, the proscription of assumption and assignment is limited to situations where a trustee, rather than a DIP, seeks to assume an executory contract. *Id.* at 573–74. Under the *Footstar* approach, the DIP would be permitted to assume the contract because, unlike a bankruptcy trustee, the DIP is not "an entity other than" itself; nevertheless, the DIP would be precluded from assigning a qualifying contract because assignment would force the non-debtor contracting party to accept performance from or render performance to an entity other than the debtor. *Id.; accord In re Adelphia Comms. Corp.*, 359 B.R. 65, 72 n.13 (Bankr. S.D.N.Y. 2007) (noting that *Footstar* is "plainly correct"); *In re Aerobox Composite Structures*, LLC, 373 B.R. 135, 141–42 (Bankr. D.N.M. 2007). *Footstar* thus articulated a rationale for the actual test that relies on the text of the statute itself rather than considerations of bankruptcy policy.

The U.S. Supreme Court declined to address the dispute regarding the proper interpretation of section 365(c)(1) when it denied a petition for *certiorari* in *N.C.P. Mktg. Grp., Inc. v. BG Star Prods.*, 556 U.S. 1145 (2009). In a statement accompanying the order, Justice Kennedy, joined by Justice Breyer, noted that even though the case before it was not an appropriate vehicle for review, "[t]he division in the courts over the meaning of § 365(c)(1) is an important one to resolve for bankruptcy courts and for businesses that seek reorganization." The Justices also emphasized that neither test is entirely satisfactory:

> The hypothetical test is not . . . without its detractors. One arguable criticism of the hypothetical approach is that it purchases fidelity to the Bankruptcy Code's text by sacrificing sound bankruptcy policy. For one thing, the hypothetical test may prevent debtors-in-possession from continuing to exercise their rights under nonassignable contracts, such as patent and copyright licenses. Without these contracts, some debtors-in-possession may be unable to effect the successful reorganization that Chapter 11 was designed to promote. For another thing, the hypothetical test provides a windfall to nondebtor parties to valuable executory contracts: If the debtor is outside of bankruptcy, then the nondebtor does not have the option to renege on its agreement; but if the debtor seeks bankruptcy protection, then the nondebtor obtains the power to reclaim—and resell at the prevailing, potentially higher market rate—the rights it sold to the debtor. . .. Of course, the actual test may present problems of its own. It may be argued, for instance, that the

> actual test aligns § 365(c) with sound bankruptcy policy only at the cost of departing from at least one interpretation of the plain text of the law.

Id. at 1146–47.

WELCOME GROUP

Hilliard Hotels, LLC (the "Debtor"), an affiliate of Welcome Group 2, LLC, operated a 94-room inn in Ohio pursuant to a 2017 franchise agreement with a major hotel chain (the "Chain"). *Welcome Grp.*, 2024 WL 3359379, at *1. The franchise agreement authorized the Debtor to use trademarks and operational systems owned by the Chain and obligated the Debtor to comply with certain "brand standards." *Id.* The agreement also required the Debtor to make certain repairs and improvements to the hotel property no later than March 2023 in accordance with a "property improvement plan" (the "PIP"). *Id.* The Debtor expended more than $1.5 million to comply with the PIP, but the renovations were not done to the Chain's satisfaction, leading the Chain to notify the Debtor that it was in default of the franchise agreement. *Id.* The Debtor responded by filing for chapter 11 protection on September 1, 2023, in the Southern District of Ohio with the intention of assuming (but not assigning) the franchise agreement. *Id.*

In February 2024, the Chain filed a motion for relief from the automatic stay to terminate the franchise agreement. *Welcome Grp.*, 2024 WL 3359379, at *1. As grounds for relief from the stay, the Chain argued that: (i) the Debtor's failure to complete the PIP was an incurable default under the franchise agreement; (ii) section 365(c)(1) of the Bankruptcy Code precluded the Debtor from assuming the franchise agreement; (iii) the Chain's interest in the franchised hotel property was not adequately protected due to the Debtor's failure to comply with the brand standards while operating the hotel; and (iv) the Debtor had defaulted on its obligation to pay postpetition fees under the franchise agreement. *Id.* at *2.

The Debtor agreed that the franchise agreement was an executory contract that could be assumed or rejected under section 365. *Id.* The parties disagreed, however, as to whether section 365(c)(1) of the Bankruptcy Code prohibited assumption of the agreement. *Id.* According to the Chain, the plain language of the provision required the bankruptcy court to apply the hypothetical test to determine whether the franchise agreement could be assumed without the Chain's consent because applicable law (i.e., the Lanham Act, 15 U.S.C. §§ 1051-1141(n), which prohibits assignment of a franchise agreement without a franchisor's consent) precluded assumption of the agreement, even if the Debtor had no intention of assigning it. *Id.*

The Debtor countered that the court should apply the actual test to section 365(c)(1) and hold that the Debtor could assume the franchise agreement despite the prohibition of assignment under applicable non-bankruptcy law because it had no actual intention of assigning it. *Id.* The Debtor also argued that it would suffer a significant financial burden if it were not able to continue operating the hotel as a branded inn under the franchise agreement. *Id.*

The court confined its ruling on the motion to the section 365(c)(1) dispute, leaving for another day the other grounds for automatic stay relief cited by the Chain.

THE BANKRUPTCY COURT'S RULING

At the outset of her analysis, U.S. Bankruptcy Judge Mina Nami Khorrami noted that, if the Debtor were prohibited from assuming the franchise agreement as a matter of law under section 365(c)(1) of the Bankruptcy Code, the Chain would be entitled to relief from the automatic stay to terminate the agreement. *Welcome Grp.*, 2024 WL 3359379, at *3. She also observed that the U.S. Court of Appeals for the Sixth Circuit has not weighed in on the application of either the actual test or the hypothetical test. *Id.* at *3 n.3.

The bankruptcy court concluded that the actual test, as articulated by *Footstar*, *Adelphia*, and *Aerobox*, "is the most faithful interpretation of the language in § 365(c)(1) . . . [and] preserves the evident purpose of § 365(c)(1), which is to protect a counterparty from being forced to do business with someone other than the debtor." *Welcome Grp.*, 2024 WL 3359379, at *8. According to the Judge Khorrami, the actual test is both the "better policy" and the "most faithful interpretation of the statutory language." *Id.* By contrast, she wrote, as explained by the court in *Footstar*, "the plain meaning analysis of the 'hypothetical test' is itself flawed and leads to a contradictory, if not oxymoronic, result." *Id.*

Judge Khorrami elaborated as follows:

> Without assignment of the contract by the Debtor, there can be no entity other than the Debtor that will be accepting performance or rendering performance under the Franchise Agreement. It is a legal impossibility unless the executory contract is assigned. Based on the plain language of § 365(c)(1), the statutory condition that the creditor must be forced to accept performance from or render performance to an entity other than the debtor can only be triggered and thus make the limitation in § 365(c)(1) applicable if the debtor assigns the contract, because the debtor can never be an entity other than itself. Therefore, based on the plain language of the statute, a debtor is not prohibited from assuming an executory contract if it does not intend on assigning it. Interpreting § 365(c)(1) in this manner not only comports with the plain language of the statute, but it also is consistent with the overall objectives of chapter 11 relief and the purposes of the Bankruptcy Code.

Id.

Moreover, the bankruptcy court emphasized, adoption of the hypothetical test would render section 365(f)(1) of the Bankruptcy Code—which makes provisions in an executory contract that prohibit assignment, except as provided in sections 365(b)

and 365(c), unenforceable—superfluous because, if a contract could never even be assumed under the hypothetical test under section 365(c)(1), there would be no need to provide an exception to the unenforceability of a prohibition of assignment in section 365(f)(1). *Id.*

Judge Khorrami also emphasized that barring the Debtor from assuming the franchise agreement would permit the Chain to obtain a windfall by relieving the Chain of its obligations under the agreement "simply by withholding its consent, as opposed to complying with the terms and conditions for termination of the Franchise Agreement which the Chain would be required to do if the Debtor has not filed for bankruptcy protection," thereby essentially giving the Chain "veto power over the Debtor's ability to reorganize." *Id.* at *9. According to Judge Khorrami, because the Debtor had no intention of assigning the franchise agreement, the protections provided to non-debtor contracting parties like the Chain in section 365(c)(1) were neither necessary nor warranted. *Id.*

The bankruptcy court accordingly denied the Chain's request for stay relief on the basis of section 365(c)(1).

OUTLOOK

The ruling in *Welcome Group* is consistent with the approach adopted by the majority of lower courts—but only a single circuit court of appeals—concluding that the actual test should determine whether a trustee or DIP may assume or assign a contract that cannot be assigned under applicable law without the non-debtor counterparty's consent in accordance with section 365(c)(1) of the Bankruptcy Code. The ruling is a positive development for debtors whose post-reorganization business is dependent upon the preservation for contract rights that are not assignable under applicable non-bankruptcy law.

Even so, the longstanding divide among bankruptcy and appellate courts on this issue highlights the need for clarification of the meaning of the statute by either Congress or the Supreme Court. Neither has acted so far to resolve an interpretive conflict that has existed for more than 30 years.

If the Sixth Circuit ultimately affirms the bankruptcy court's ruling in *Welcome Group*, the widening circuit split may once again be an invitation for review by the U.S. Supreme Court, which, as noted, has yet to agree to hear a case on whether the hypothetical, the actual, or some other test is the proper one. With no resolution of this matter on the horizon, the practical challenges confronting parties to these kinds of contracts can only be accurately assessed on a case-by-case basis by reference to the particular court presiding over the debtor's bankruptcy case.

OWNERSHIP DISPUTE REGARDING FOREIGN DEBTOR'S U.S. ASSETS MUST BE RESOLVED BEFORE A U.S. BANKRUPTCY COURT CAN APPROVE SALE UNDER SECTION 363 IN CHAPTER 15 CASE

Corinne Ball • Dan T. Moss • Randi C. Lesnick

As the enactment of chapter 15 of the Bankruptcy Code approaches its 20-year anniversary, U.S. bankruptcy courts are still grappling with some unresolved issues concerning how its provisions should be applied to best harmonize cross-border bankruptcy cases. One of those issues was the subject of a bench ruling handed down by the U.S. Bankruptcy Court for the District of Delaware.

In *In re Goli Nutrition Inc.*, 2024 WL 1748460 (Bankr. D. Del. Apr. 23, 2024), the bankruptcy court: (i) denied a foreign representative's motion under section 363(b) of the Bankruptcy Code to approve a "reverse vesting transaction" authorized by a Canadian bankruptcy court involving a transfer of the foreign debtor's stock to a successor entity because the transaction did not involve a use, sale, or lease of the debtor's property; and (ii) held in abeyance the foreign representative's companion motion to approve a non-ordinary course "free and clear" sale of certain equipment located in California pending resolution of a dispute over the ownership of the equipment.

In so ruling, the U.S. bankruptcy court concluded that the propriety of a sale of a foreign debtor's U.S. assets in a chapter 15 case must be assessed according to the standard applied to such sales under section 363(b) of the Bankruptcy Code. The court also determined that the ownership dispute had to be resolved before it could approve the sale, but not necessarily by a U.S. bankruptcy court, and it was appropriate in this case to allow the Canadian court to determine the owner of the assets.

PROCEDURES, RECOGNITION, AND RELIEF UNDER CHAPTER 15

Chapter 15 was enacted in 2005 to govern cross-border bankruptcy and insolvency proceedings. It is patterned on the 1997 UNCITRAL Model Law on Cross-Border Insolvency (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.

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

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

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."

Section 1507(a) of the Bankruptcy Code provides that, upon recognition of a main or nonmain proceeding, the bankruptcy court may provide "additional assistance" to a foreign representative

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

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

Section 1520(a)(2) provides that "sections 363, 549, and 552 apply to a transfer of an interest of the debtor in property that is within the territorial jurisdiction of the United States to the same extent that the sections would apply to property of an estate." In addition, section 1520(a)(3) gives a foreign representative in a recognized chapter 15 case the power, unless the court orders otherwise, to "exercise the rights and powers of a [bankruptcy] trustee under and to the extent provided by sections 363 and 552."

Section 363(b) of the Bankruptcy Code provides that a bankruptcy trustee, after notice and a hearing, may use, sell, or lease property of the estate outside the ordinary course of the debtor's business. Most courts apply a "business judgment" standard to a proposed use, sale, or lease of property under section 363(b), whereby "the bankruptcy court reviews the business judgment of a trustee (or a chapter 11 debtor-in-possession ("DIP")) to determine independently whether the judgment is a reasonable one." COLLIER ON BANKRUPTCY ("COLLIER") ¶ 363.02[4] (16th ed. 2024) (citing and discussing cases). Under section 363(f), the trustee or DIP may sell property pursuant to section 363(b) "free and clear of any interest in such property of an entity other than the estate" under certain specified circumstances, including when "such interest is in bona fide dispute." 11 U.S.C. § 363(f)(4).

Following recognition of a foreign main or nonmain proceeding, section 1521(a) provides that, to the extent not already in effect, and "where necessary to effectuate the purpose of [chapter 15] and to protect the assets of the debtor or the interests of the creditors," the bankruptcy court may also "grant[] any additional relief that may be available to a trustee, except for relief available under sections 522, 544, 545, 547, 548, 550, and 724(a)." These provisions authorize a bankruptcy trustee to, among other things, avoid and recover transfers that are fraudulent under the Bankruptcy Code.

However, these avoidance powers are only available to a foreign representative if a proceeding under another chapter of the Bankruptcy Code is commenced with respect to the debtor. *See* 11 U.S.C. §§ 1520(c) and 1528 (providing that a foreign representative can also commence a full-fledged bankruptcy case under any other chapter of the Bankruptcy Code as long as the foreign debtor is eligible to file for bankruptcy in the United States under that chapter).

SOME NOTABLE COURT RULINGS REGARDING CHAPTER 15 ASSET SALES

Asset sales under section 363(b) in chapter 15 cases have been the focus of some notable bankruptcy court rulings. For example, in *In re Elpida Memory, Inc.*, 2012 WL 6090194 (Bankr. D. Del. Nov. 20, 2012), the U.S. Bankruptcy Court for the District of Delaware ruled as an apparent matter of first impression that both the express language of chapter 15 and its legislative intent permit the representative of a foreign debtor to use chapter 15 and section 363 to sell assets located in the United States free and clear of all claims, liens, and other competing interests. *Id.* at *1.

In *Elpida*, the Delaware bankruptcy court recognized a Japanese reorganization proceeding under chapter 15. The Japanese debtor's foreign representative filed motions seeking court approval under sections 1520 and 363 to sell certain of the debtor's U.S. assets free and clear of competing interests. The sale had previously been authorized by the Japanese court overseeing the debtor's reorganization proceeding. A group of the debtor's bondholders objected.

All parties agreed that section 363 was available as a means of effecting a sale of the debtor's U.S. assets. However, it was unclear how the provision should be applied and, in particular, what standard should be employed by the bankruptcy court in ruling on the request. Therefore, the court considered whether it should decide the issue on the basis of principles of comity (i.e., by deferring to the Japanese court's approval of the transaction) or instead independently review the sale transaction under the "business judgment" standard applied under section 363(b) to a proposed use, sale, or lease of property outside the ordinary course of business.

The bankruptcy court noted that section 1520(a) unequivocally states that section 363 applies to transfers of a foreign debtor's U.S. assets and ruled that the business judgment standard applied to section 363(b) sales must also apply in chapter 15 cases. *Id.* at *5.

The court also examined the legislative history of section 1520, observing that the provision is adopted from Article 20 of the Model Law, which adopts an *in rem* division of labor between U.S. and foreign courts—i.e., by giving domestic courts responsibility for the assets located within their borders and by imposing "the laws of the ancillary forum—not those of the foreign main proceedings—on the debtor with respect to transfers of assets located in such ancillary jurisdiction." *Id.* at *7. The court was

mindful of the important role that comity plays in chapter 15 cases but cautioned that "it is not the end all be all of the statute. "To require this Court to defer in all instances to foreign court decision[s]," the court wrote, "would gut section 1520," which itself is mandatory. *Id.* at *8.

By contrast, in *In re Fairfield Sentry Ltd.*, 484 B.R. 615 (Bankr. S.D.N.Y. 2013), *aff'd*, 2013 BL 370732 (S.D.N.Y. July 3, 2013), *vacated and remanded*, 768 F.3d 239 (2d Cir. 2014), *on remand*, 539 B.R. 658 (Bankr. S.D.N.Y. 2015), *aff'd*, No. 15 Civ. 9474 (AKH) (S.D.N.Y. June 2, 2016), *aff'd*, 690 F. App'x 691 (2d Cir. 2017), the U.S. Bankruptcy Court for the Southern District of New York held that a chapter 15 debtor's sale of claims asserted by a British Virgin Island ("BVI") "feeder fund" against Bernard Madoff's defunct brokerage company was not subject to independent review as an asset sale under section 363(b) of the Bankruptcy Code. After the debtor's foreign representative agreed to sell the claims, subject to approval by both the BVI court overseeing the debtor's liquidation and the New York bankruptcy court that granted chapter 15 recognition of the BVI liquidation, the claims increased substantially in value. This prompted the foreign representative to attempt to scuttle the sale (which had been approved by the BVI court), by filing a motion in the New York bankruptcy court to disapprove it under sections 363(b) and 1520(a)(2) as not being in the best interests of the debtor or an exercise of sound business judgment.

The bankruptcy court denied the motion, noting that "[t]his is a pure and simple case of seller's remorse." *Fairfield Sentry*, 484 B.R. at 617. The court also concluded that plenary review of the claims sale was not warranted under section 1520(a)(2) (and section 363) because the property was not "within the territorial jurisdiction" of the United States. The court determined that the debtor's claims were "located" in the BVI and that, as a matter of comity, the BVI court had the paramount interest in the sale of the claims, whereas the New York bankruptcy court lacked any meaningful interest at all.

After a district court affirmed the ruling on appeal, the U.S. Court of Appeals Second Circuit vacated the orders below and remanded the case to the bankruptcy court, ruling that the claims, which could be attached under New York law, were located in the United States by operation of section 1502(8) of the Bankruptcy Code (providing that property located in the United States includes "any property subject to attachment or garnishment that may be properly seized or garnished by an action" in a U.S. court), and pursuant to section 1520(a)(2), the bankruptcy court must apply section 363 to the sale.

In so ruling, the Second Circuit concluded that the bankruptcy court erred in using principles of comity to defer to the BVI court's approval of the transfer of the claims. According to the Second Circuit, "[T]he language of section 1520(a)(2) is plain; the bankruptcy court is required to conduct a section 363 review when the debtor seeks a transfer of an interest in property within the territorial jurisdiction of the United States." *Fairfield Sentry*, 768 F.3d at 246. According to the Second Circuit, although comity is a "central[]" component of chapter 15, section 1520(a)(2)'s requirement for section 363(b) review operates as a "brake or limitation on comity." *Id.* at 246 n.1.

Upon remand, the bankruptcy court ruled that the foreign representative demonstrated a sound business reason for abandoning the sale and should be permitted either to retain the claims and receive recoveries for the debtor's creditors or to sell the claims at a much higher price. The Second Circuit ultimately affirmed that decision in a summary order.

In *Crystallex Int'l Corp.*, 2022 WL 17254660 (Bankr. D. Del. Nov. 28, 2022), the foreign representative of a Canadian company in a reorganization proceeding in Canada sought an order from the U.S. Bankruptcy Court for the District of Delaware enforcing under chapter 15 a mechanism approved by the Canadian court that included a sale of certain stock in a U.S. company attached to satisfy an arbitration award. Relying on *Elpida* and *Fairfield Sentry*, the bankruptcy court held that, pursuant to section 1520 of the Bankruptcy Code, the court presiding over a chapter 15 case has *in rem* jurisdiction over the foreign debtor's U.S. assets and that the U.S. bankruptcy court, rather than the foreign court, must decide whether a request to sell such assets should be approved under section 363(b). As in *Fairfield Sentry*, the court in *Crystallex* concluded that the stock was located in the United States pursuant to section 1502(8) of the Bankruptcy Code because it was subject to garnishment or attachment by an action in a U.S. court.

Many other bankruptcy courts have also approved the use, sale, or lease of a foreign debtor's U.S. assets under section 363(b) in a chapter 15 case, albeit most in unpublished orders or opinions. *See, e.g., In re Markus,* No. 19-10096 (MG) (Bankr. S.D.N.Y. Apr. 27, 2022) (Doc. No. 421) (approving the sale of a foreign debtor's U.S. condominium and a related settlement); *In re CDS U.S. Holdings, Inc.*, No. 20-11719 (CSS) (Bankr. D. Del. Oct. 29, 2020) (Doc. No. 112) (applying the business judgment standard in approving a sale of substantially all of a foreign debtor's U.S. assets free and clear of liens); *In re Veris Gold Corp.*, Nos. 14-51015-gwc *et al.* (Bankr. D. Nev. June 4, 2015) (Doc. No. 318) (order recognizing and enforcing a Canadian court's order approving a sale of the debtor's assets and related relief, and approving the sale free and clear of liens applying the business judgment standard under section 363(b)); *In re Irish Bank Resol. Corp. Ltd.*, 2014 WL 1759609, at *2 (Bankr. D. Del. Feb. 14, 2014) (approving a free and clear sale of a foreign debtor's assets and related assignments under section 363(b)'s business judgment standard); *see also In re Ace Track Co., Ltd.*, 556 B.R. 887, 913 (Bankr. N.D. Ill. 2016) (section 1520 authorizes a foreign representative to operate the debtor's business within the United States and to dispose of its U.S. assets under section 363, but it does give such authority to the foreign debtor).

GOLI NUTRITION

Quebec-based nutritional gummi producer Goli Nutrition Inc. ("Goli Canada") is a Canadian corporation with various affiliates, including a U.S. subsidiary incorporated in Delaware ("Goli US,"

and together with Goli Canada, the "debtors")). On March 18, 2024, both companies obtained protection in a proceeding under the Canadian Companies' Creditors Arrangement Act (the "CCAA").

Shortly afterward, a foreign representative appointed for the debtors by a Canadian court filed a motion in the U.S. Bankruptcy Court for the District of Delaware for recognition of the CCAA proceeding under chapter 15 as a foreign main proceeding. The foreign representative also sought an order pursuant to section 1529, 363(b), and 363(f) of the Bankruptcy Code recognizing and enforcing orders issued by the Canadian court approving two transactions: (i) a "reverse vesting transaction" involving a sale of Goli Canada stock and the creation of a new entity to hold Goli Canada's remaining assets, including certain equipment located in California; and (ii) a related sale of the equipment (the "equipment sale"). In approving the equipment sale, the Canadian court directed that part of the proceeds of the sale should be set aside pending the resolution of a dispute over ownership of the equipment with a creditor ("Hoffman") that had commenced litigation in the United States against the debtors' officers and directors and certain non-debtor affiliates. The Canadian court scheduled a hearing to settle the ownership dispute.

Hoffman objected to chapter 15 recognition to the extent that it would stay the litigation. After that objection was resolved, the recognition petition was unopposed. However, Hoffman objected to the equipment sale based on its competing ownership claim.

THE BANKRUPTCY COURT'S RULING

In a bench ruling, the bankruptcy court granted the petition for chapter 15 recognition of the CCAA proceeding as a foreign main proceeding. Explaining that CCAA proceedings are consistently recognized by U.S. bankruptcy courts under chapter 15, U.S. Bankruptcy Judge Laurie Selber Silverstein saw no reason not to do so in this case, particularly in the absence of any opposition to recognition. She did note that, although no one challenged designation of the CCAA proceeding as a "foreign main proceeding," Goli US is a Delaware, rather than a Canadian, corporation. Even so, Judge Silverstein wrote, "I do not perceive a difference in how I would rule on the [sale] motions before me if recognition were as a foreign non-main proceeding." *Goli Nutrition*, 2024 WL 1748460, at *2.

Judge Silverstein refused to approve the reverse vesting transaction under section 363. First, she explained, the issuance of stock in a debtor company is not a sale transaction under section 363. Second, the court noted, even if it were, the new stock—in a Canadian company—was not an asset of the debtor in the territorial jurisdiction of the United States, meaning that section 1520(a)(2) did not apply. However, she reasoned, to the extent that a transfer of the equipment to the new Canadian entity was part of the reverse vesting transaction, bankruptcy court approval of this non-ordinary course "use" of Goli Canada's U.S. property—which Judge Silverstein analogized to a "quitclaim deed"—was required under section 363. *Id.* at *3.

Examining her previous decision in *Crystallex* as well as the ruling in *Fairfield Sentry*, Judge Silverstein concluded that: (i) a bankruptcy court is obligated to apply section 363 to a proposed sale of a foreign debtor's U.S. assets in a chapter 15 case; and (ii) "Comity does not require me to defer to the Canadian Court on approval." *Id.* at *5.

The bankruptcy court found that the proposed equipment sale readily satisfied the standard for approval of a non-ordinary course asset sale under section 363(b). However, Judge Silverstein was uncertain whether the ownership dispute had to be decided before approval of the sale under section 363, and if so, by which court.

Judge Silverstein concluded that the ownership dispute had to be resolved before she could authorize the equipment sale. She rejected the foreign representative's argument that the transaction could be approved, with the proviso that Hoffman would be entitled to whatever portion of the proceeds related to its property upon adjudication of the ownership dispute. According to Judge Silverstein, there is nothing in section 363 "that permits me to authorize the sale of property that is not property of the estate—in other words that the debtor has no interest in at all." *Id.* (citing and discussing *Worcester Country Club Acres, LLC*, 655 B.R. 41 (Bankr. D. Mass. 2023)).

The bankruptcy court also held that section 363(f) of the Bankruptcy Code "does not provide independent authority for a trustee to sell assets." Instead, Judge Silverstein explained, section 363(f) authorizes a free and clear sale of property that can be sold under sections 363(b) or section 363(c). She wrote that, accordingly, "in order to invoke the 'free and clear' sale, the trustee must first own the property . . . [and] [d]isputes envisioned by section 363(f)(4) [authorizing a free and clear sale when "such interest is in bona fide dispute"] therefore, are not ownership disputes." *Id.* at *6 (citing *Worcester*, 655 B.R. at 46).

"With one exception," the bankruptcy court concluded that the ownership dispute had to be resolved before it could authorize the equipment sale. That exception, Judge Silverstein noted, would apply if the debtor were selling its disputed interest in the property:

> If a purchaser is willing to buy whatever interest the debtor has in property—in essence, take a quitclaim deed—that could be permissible. The dispute would survive the sale, to be fought now by the purchaser, not the debtor.

Id. However, in this case, the foreign representative did not seek approval of such a sale.

Finally, after examining relevant decisions (some of which dealt with free and clear sales under repealed section 304 of the Bankruptcy Code), the bankruptcy court concluded that "no clear guidance is given on which court must decide the ownership issue." *Id.* at *7 (discussing *JP Morgan Chase Bank v. Altos Hornos de Mexico, S.A. DE C.V.*, 412 F.3d 418 (2d Cir. 2005); *In re*

Koreag, Controle et Revision, S.A. v. Refco F/X Assocs., Inc., 961 F.2d 341 (2d Cir. 1992); *CT Inv. Mgmt. Co. LLC v. Cozumel Caribe, S.A. de C.V. (In re Cozumel Caribe, S.A. de C.V.)*, 482 B.R. 96 (Bankr. S.D.N.Y. 2012)). In this case, however, Judge Silverstein concluded that the Canadian court, which had already scheduled a hearing on the ownership dispute, was in the best position to decide it. She accordingly held the foreign representative's equipment sale motion in abeyance to give the Canadian court an opportunity to do so.

OUTLOOK

Nearly two decades after chapter 15 implemented the Model Law in the United States, section 363 asset sales of a foreign debtor's U.S. assets are increasingly common in chapter 15 cases. *Goli Nutrition* is emblematic of some important issues faced by U.S. bankruptcy courts in assessing the propriety of such sales. Key takeaways from the ruling include:

- Consistent with previous court decisions addressing the question and the plain language of section 1520(a)(2) of the Bankruptcy Code, a U.S. bankruptcy court must independently examine a proposed sale of a chapter 15 debtor's assets pursuant to the standard applied to such sales under section 363 of the Bankruptcy Code, rather than deferring as a matter of comity to a foreign court order approving the sale.
- Disputes regarding the ownership of property to be sold under section 363 must be resolved before a U.S. bankruptcy court can approve the sale, but the U.S. bankruptcy court need not necessarily adjudicate the dispute.
- Section 363 transactions in a chapter 15 case must involve a use, sale, or lease of the foreign debtor's property (as distinguished from "property of the estate," as there is no estate in a chapter 15 case).
- Section 363(f) of the Bankruptcy Code does not provide independent authority for a use, sale, or lease of property. Rather, the sale must be authorized under sections 363(b) or 363(c).

Interestingly, the bankruptcy court's statement in *dicta* that there would be no difference in how it would rule on the motions if the CCAA proceeding had been recognized as a foreign non-main proceeding does not explain that section 1520(a) makes section 363 applicable in a chapter 15 case "[u]pon recognition of a foreign main bankruptcy proceeding." A bankruptcy court could conceivably exercise its power under section 1521(7) or section 1507(a) to make section 363 applicable after recognizing a foreign non-main proceeding, but the analysis might be more nuanced.

On April 30, 2024, the Canadian court entered an order terminating the debtors' CCAA proceeding at the debtors' request after they were unable to obtain financing to proceed with their restructuring and the equipment sale. On June 12, 2024, the U.S. bankruptcy court entered an order recognizing the termination order and closing the debtors' chapter 15 case.

DELAWARE BANKRUPTCY COURT REINFORCES THE HIGH BAR FOR REVOCATION OF A CHAPTER 11 PLAN CONFIRMATION ORDER

Dan B. Prieto

Confirmation of a chapter 11 plan providing for the reorganization or liquidation of a debtor is the culmination of the chapter 11 process. To promote the fundamental policy of finality in that process, the general rule is that a final confirmation order is inviolable. The absence of certainty that the transactions effectuated under a plan are valid and permanent would undermine chapter 11's fundamental purpose as a vehicle for rehabilitating ailing enterprises and providing debtors with a fresh start.

The importance of finality in this context was the subject of a ruling handed down by the U.S. Bankruptcy Court for the District of Delaware. In *In re Virgin Orbit, L.L.C.*, 659 B.R. 36 (Bankr. D. Del. 2024), the court denied a request by certain equity holders to revoke an order confirming a chapter 11 plan that canceled their equity interests while allocating nearly all of the proceeds generated from a bankruptcy auction sale of the debtors' assets to an insider prepetition and postpetition secured lender as part of a global settlement. According to the court, absent any evidence that the debtors made materially false statements or otherwise procured the confirmation order by fraud, the equity holders failed to satisfy the high bar for revocation.

REVOCATION OF AN ORDER CONFIRMING A CHAPTER 11 PLAN

A limited exception to the rule of finality of the confirmation of a chapter 11 plan can be found in section 1144 of the Bankruptcy Code. Section 1144 provides that, on the request of a party-in-interest made any time before 180 days after the entry of an order of confirmation, the bankruptcy court "may revoke such order if and only if such order was procured by fraud." If the court exercises its discretion to revoke a confirmation order, the statute further provides that the revocation order "shall—(1) contain such provisions as are necessary to protect any entity acquiring rights in good faith reliance on the order of confirmation; and (2) revoke the discharge of the debtor."

Section 1144 is designed to restore the parties to their pre-confirmation positions, as long as the rights of third parties who relied on the plan in good faith are protected. The extreme difficulty of doing so in most cases means that revocation is generally regarded as a drastic remedy for the bankruptcy court to employ. *See generally* COLLIER ON BANKRUPTCY ("COLLIER") ¶ 1144.04[2] (16th ed. 2024) ("Many courts have stressed the need for parties to be able to rely on the finality of plans in conducting business and in dealing with the reorganized debtor. . . . If plans could be overturned or rescinded except in the most extreme of circumstances, the reliability of the plan process would be undermined.") (footnote omitted).

Section 1144 is the sole mechanism for revoking a chapter 11 plan confirmation order. *See Acquisition Co. of Am. V, LLC v. Leonard (In re Asset Resolution, LLC)*, 542 Fed. Appx. 578, 579 (9th Cir. 2013) ("Section 1144 of the Bankruptcy Code is the only avenue for revoking a confirmed Chapter 11 plan. . . . Creditors may not collaterally attack a confirmed plan, even where the plan contains illegal provisions."); *SC SJ Holdings, LLC v. Pillsbury Winthrop Shaw Pittman LLP (In re SC SJ Holdings, LLC)*, 2023 WL 2598842, at *7 (D. Del. 2023) (section 1144 is the "only means by which a confirmation order may be … revoked."); *In re Saberioon*, 2024 WL 1134579, at *9 & n.106 (Bankr. S.D. Tex. Mar. 15, 2024) ("This Court agrees that a consensual individual Chapter 11 plan is binding, with section 1144 being the exclusive avenue for revoking confirmation of a Chapter 11 plan."); *In re Logan Place Props., Ltd.*, 327 B.R. 811, 815 (Bankr. S.D. Tex. 2005) (The language "if and only if was added to § 1144 in 1984 to emphasize fraud as the exclusive means for revocation"); *In re Clev. Imaging & Surgical Hosp.*, L.L.C., 2022 WL 677459, *3 (Bankr. S.D. Tex. 2022) (under Fed. R. Bankr. P. 9024, Fed. R. Civ. P. Rule 60 may only be used to "revoke an order confirming a plan … within the time allowed by § 1144").

The court must specifically find that the order was procured by fraud before revoking a confirmation order, but neither the Bankruptcy Code nor the Federal Rules of Bankruptcy Procedure define "fraud." Some courts have concluded that the term has its ordinary meaning under common law, whereas other have construed the term to mean "fraud on the court." For example, in *In re Tenn-Fla Partners*, 226 F.3d 746 (6th Cir. 2000), the U.S. Court of Appeals for the Sixth Circuit ruled that fraud exists to revoke a chapter 11 plan confirmation order if the court finds:

(1) that the debtor made a representation regarding … compliance with Code § [1129] which was materially false;
(2) that the representation was either known by the debtor to be false, or was made without belief in its truth, or was made with reckless disregard for the truth;
(3) that the representation was made to induce the court to rely upon it;
(4) [that] the court did rely upon it; and
(5) that as a consequence of such reliance, the court entered the confirmation order.

Id. at 750; *accord In re Celsius Network LLC,* 2024 WL 2952943, at *5 (Bankr. S.D.N.Y. June 12, 2024); *In re Melinta Therapeutics, Inc.*, 623 B.R. 257, 263 (Bankr. D. Del. 2020); *In re Cuzco Dev. U.S.A., LLC*, 585 B.R. 870, 876 (Bankr. D. Haw. 2018); *see also In re Michelson*, 141 B.R. 715, 725 (Bankr. E.D. Cal. 1992) ("Regardless of whether section 1144 sweeps broad or narrow with respect to other species of fraud, fraud on the court is one species that unquestionably is a basis for revoking the order confirming a plan of reorganization.").

The fraud need not have been committed by the debtor or any other proponent of the plan. Fraud committed during a chapter 11 case that is unrelated to plan confirmation is not a basis for revocation—the bankruptcy court can implement other remedies designed to punish the malefactor or remedy any resulting harm, such as the entry of a judgment against the perpetrator. COLLIER at ¶ 1144.03.

On its face, section 1144, unlike its predecessor provision under the former Bankruptcy Act, does not require the party seeking revocation to have been unaware of the fraud at the time the plan was confirmed. *Id.* at ¶ 1144.LH ("Section 1144 was derived from section 386 of the Bankruptcy Act and Chapter XI Rule 11-41.1 Those provisions also provided that an order of confirmation could only be revoked if the confirmation order was procured by fraud. Under Section 386 of the Act, the fraud must have been perpetrated by the debtor or perpetrated by a third party with the knowledge of the debtor. In contrast, section 1144 contains no such explicit requirement.").

The 180-day period specified in section 1144 is absolute. Unlike certain other deadlines contained in the Bankruptcy Code, it may not be extended by the court, even if fraud in procuring a confirmation order is not discovered until after the 180-day period expires. *See Anti-Lothian Bankr. Fraud Comm. v. Lothian Oil, Inc. (In re Lothian Oil, Inc.)*, 508 F. App'x 352, 357 (5th Cir. 2013); *In re Beyha*, 637 B.R. 430, 440 (Bankr. E.D. Pa. 2022); *see also In re Calpine Corp.*, 389 B.R. 323, 324 (S.D.N.Y. 2008) (the time limit for filing an adversary proceeding seeking revocation of chapter 11 plan confirmation order was not equitably tolled, where the movant failed to show that he had pursued his rights diligently, and that extraordinary circumstances prevented him from filing a timely adversary proceeding in the bankruptcy court); *see generally* COLLIER at ¶ 1144.04[2].

Many court orders tainted by fraud can also be set aside under Rule 9024 of the Federal Rules of Bankruptcy Procedure. With certain exceptions, that rule makes Fed. R. Civ. P. 60 applicable in bankruptcy cases. Civil Rule 60 provides that the court may relieve a party from an order or judgment due to, among other things, "mistake, inadvertence, surprise, or excusable neglect," "newly discovered evidence," fraud, or "any other reason that justifies relief." A request for relief under Rule 9024 and Civil Rule 60 must be made no later than one year following entry of the challenged order or judgment. However, Rule 9024(3) makes an exception to the application of Civil Rule 60, providing that "a complaint to revoke an order confirming a plan may be filed only within the time allowed by § 1144 [of the Bankruptcy Code]."

Fed. R. Bankr. P. 7001(5) provides that "a proceeding to revoke an order of confirmation of a chapter 11, chapter 12, or chapter 13 plan" is an "adversary proceeding," which must be commenced by the filing of a complaint.

VIRGIN ORBIT

Virgin Orbit Holdings, Inc. and two affiliates (collectively, the "debtors") provided satellite launch systems to domestic and international commercial and government customers. After unsuccessful efforts to sell the company in 2022, a liquidity crisis prompted the debtors to seek chapter 11 protection in April 2023 with the intention of selling the business under section 363 of the Bankruptcy Code.

After approving bidding and notice procedures, the bankruptcy court authorized the debtors to designate a non-insider stalking horse purchaser for certain key assets. The selection was made after the debtors' aggressively marketed the companies to approximately 200 potential bidders, more than 30 of which expressed interest in acquiring the debtors as a going concern. In consultation with the official unsecured creditors' committee (the "committee"), the debtors later declared four non-insider winning bidders for four separate assets groups.

Based on evidence of the marketing efforts, competitive bidding process, terms of the auction, sale prices, and good faith, non-collusive conduct of the debtors and the purchasers, the bankruptcy court approved the four asset sales. It later made similar findings in approving a sale of the debtors remaining assets to a fifth non-insider buyer.

The debtors did not receive enough from the sales to repay approximately $28 million in debtor-in-possession financing provided by Virgin Investments Limited ("VIL"), the debtors' indirect parent and prepetition lender. They accordingly reached a global settlement with VIL and the committee whereby VIL agreed to take a substantial haircut on its secured claim and waived its unsecured deficiency claim in exchange for a cash payment, an interest in a post-confirmation litigation trust, and the debtors' remaining intellectual property (pertaining to rocket engine and avionics systems). The settlement allowed the debtors to satisfy all administrative expenses and other priority claims under a plan that would make a small distribution to general unsecured creditors (approximately 1%–5%). The plan canceled the debtors' equity interests.

The debtors' equity holders did not object to the plan (or withdrew objections before confirmation) but were deemed to reject it due to the cancellation of their interests (*see* 11 U.S.C. § 1126(g)). The bankruptcy court confirmed the debtors' chapter 11 plan on July 31, 2023, and the plan became effective two days later. The confirmation order was not appealed.

Approximately five months after confirmation, a group of equity holders (the "equity group") filed a motion that the court deemed to request revocation of the confirmation order. The equity group argued that: (i) the debtors' assets were worth approximately $3.7 billion as a going concern but were improperly marketed and sold in piecemeal fire sales; and (ii) this unfair sales process allowed the debtors to misrepresent the value of their remaining intellectual property assets, which were then distributed to VIL to the detriment of other creditors and equity holders. According to the equity group, this intentional lack of honesty and transparency amounted to fraud and the illegal cancellation of their equity interests, and warranted revocation of the confirmation order.

THE BANKRUPTCY COURT'S RULING

The bankruptcy court denied the equity group's request to revoke the confirmation order.

Initially, U.S. Bankruptcy Judge Karen B. Owens noted that the equity group's challenge to the integrity of the sale process was barred by the doctrine of *res judicata* because the equity group had an opportunity to object and be heard at the bidding procedures and sale hearings as parties in interest but did not object or participate when the court approved the sales. *Virgin Orbit*, 659 B.R. at 42.

In addition, Judge Owens explained, the pre-confirmation sale transactions were not relevant to the inquiry under section 1144 in accordance with the five elements articulated in *Melinta Therapeutics* (and *Tenn-Fla Partners*, discussed previously), which establish a high standard to protect the finality of confirmation orders. She concluded that the equity group failed to satisfy the "high bar set for revocation." *Id.*

In particular, Judge Owens noted, the equity group did "not identify with precision any alleged false representations regarding the requirements of section 1129 that the Debtors made to obtain confirmation of the Plan," but merely "minimally challenge[d]" representations made by the debtors to support a finding that the chapter 11 plan was proposed in good faith, as required by section 1129(a)(3), that the plan satisfied the "best interests" of creditors test in section 1129(a)(7), and that the plan was both "fair and equitable" and did not "discriminate unfairly" with respect to the class of equity, as required under section 1129(b)(1). *Id.* According to Judge Owens, the lack of any evidence of materially false statements by the debtors or any evidence proving that the debtors' remaining intellectual property assets were undervalued was fatal to the equity group's revocation bid.

Judge Owens emphasized that the value of the debtors' assets "was determined by the marketplace after an open and fair sale process overseen by the Court"—the "gold standard" valuation method." It was unfortunate that the sale proceeds were less than stakeholders anticipated—"a typical result in bankruptcy cases"—but not a basis for revocation of the confirmation order. *Id.*

OUTLOOK

Virgin Orbit reinforces the importance of the concept of finality with respect to orders confirming chapter 11 plans. The limited 180-day time frame for a request to revoke such an order procured by fraud gives stakeholders a reasonable period of time to root out fraud, yet cuts off challenges filed outside of that period to preserve the reasonable expectations of all stakeholders that the terms of a confirmed chapter 11 plan will be binding.

Virgin Orbit also illustrates that the standard for revoking a chapter 11 plan confirmation order is a high one that can be satisfied only with concrete evidence of conduct that amounts to fraud on the court. The equity group's failure to produce such evidence proved fatal to their request for revocation.

TENTH CIRCUIT: BANKRUPTCY COURT DID NOT RELINQUISH ITS JURISDICTION BY GRANTING RELIEF FROM AUTOMATIC STAY

Patrick Lombardi

Ever since Congress amended the Bankruptcy Code in 1984 to remedy the U.S. Supreme Court's 1982 ruling declaring the jurisdictional groundwork of title 11 unconstitutional, there have been lingering questions regarding the scope of a bankruptcy court's jurisdiction to rule on the many matters and proceedings that must typically be resolved in a bankruptcy case. One of those questions—namely, whether the bankruptcy court retains jurisdiction over claims and assets with respect to which the court has granted relief from the Bankruptcy Code's "automatic stay"—was addressed by the U.S. Court of Appeals for the Tenth Circuit in *In Summit Inv. Mgmt. LLC v. Connolly (In re Fog Cap Retail Invs.)*, 2024 WL 659559 (10th Cir. Feb. 16, 2024). The Tenth Circuit affirmed lower court rulings concluding that a bankruptcy court does not relinquish its "related to" jurisdiction by granting a motion for relief from the automatic stay to permit the continuation of state court litigation against a debtor over environmental remediation liabilities.

BANKRUPTCY COURT JURISDICTION

Bankruptcy courts, like all federal courts, are courts of limited jurisdiction. *In re Hamilton*, 282 B.R. 22, 25 (Bankr. W.D. Okla. 2002). Indeed, "[t]he jurisdiction of bankruptcy courts, like that of other federal courts, is grounded in, and limited by statute." *Celotex Corp. v. Edwards*, 514 U.S. 300, 307 (1995).

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

A federal district court in which a bankruptcy case is commenced or pending also has exclusive jurisdiction over all of the debtor's property, wherever located, "property of the estate" (as defined in section 541(a) of the Bankruptcy Code), and all claims or causes of action involving the retention of bankruptcy professionals. 28 U.S.C. § 1334(e).

A bankruptcy "case" is the umbrella under which all of the proceedings that follow the filing of a bankruptcy petition take place. The filing of a voluntary or involuntary petition for relief commences a bankruptcy case. After an order for relief is entered (on the petition date, in a voluntary case, and after a trial on the petition, in an involuntary case), the bankruptcy case may involve

many civil proceedings, whether denominated administrative matters, controversies, adversary proceedings, contested matters, suits, actions, or disputes.

Matters "arising under" and "arising in" bankruptcy cases are generally referred to as "core" proceedings. *In re Southmark Corp.*, 163 F.3d 925, 930 (5th Cir. 1999). Twenty-eight U.S.C. § 157(b)(2) contains a non-exclusive catalog of "core" proceedings, including, among other things, matters concerning the administration of the bankruptcy estate; the allowance, disallowance, or estimation of claims; counterclaims by the estate against persons filing claims against the estate; orders to turn over property of the estate; motions to modify or terminate the automatic stay; and proceedings to avoid and recover preferential or fraudulent transfers.

A matter "arises under" the Bankruptcy Code "if it invokes a substantive right provided by title 11," *Southmark*, 163 F.3d at 930. In other words, when a cause of action is created by title 11, that civil proceeding is one "arising under" the Bankruptcy Code. *See generally* COLLIER ON BANKRUPTCY ¶ 3.01[3][e][i] (16th ed. 2024).

Similarly, claims that "arise in" a bankruptcy case are claims that by their nature, rather than their particular factual circumstances, could arise only in the context of a bankruptcy case. *Stoe v. Flaherty*, 436 F.3d 209, 218 (3rd Cir. 2006).

Clams or causes of action arising under state law are not "core proceedings" because they do not invoke "a substantive right provided by title 11 or a proceeding that, by its nature, could arise only in the context of a bankruptcy case." *In re Seven Fields Dev. Corp.*, 505 F.3d 237, 256 (3d Cir. 2007).

A civil proceeding is "related" to a bankruptcy case when "the outcome of that proceeding could conceivably have any effect on the estate being administered in bankruptcy." *Pacor, Inc. v. Higgins*, 743 F.2d 984 (3d Cir. 1985); *accord Celotex Corp. v. Edwards*, 514 U.S. 300 (1995).

In addition to statutory authority, a bankruptcy judge must have *constitutional* authority to hear and determine a matter. *Stern v. Marshall*, 564 U.S. 462 (2011). Constitutional authority exists when a matter originates under the Bankruptcy Code or, in non-core matters, where the matter is either one that falls within the "public rights exception," (i.e., cases involving "public rights" that Congress could constitutionally assign to "legislative" courts for resolution), or where the parties have consented, either expressly or impliedly, to the bankruptcy court hearing and determining the matter. *See, e.g., Wellness Int'l Network, Ltd. v. Sharif*, 135 S. Ct. 1932 (2015) (parties may consent to a bankruptcy court's jurisdiction); *Richer v. Morehead*, 798 F.3d 487, 490 (7th Cir. 2015) (noting that "implied consent is good enough").

ESTATE PROPERTY AND THE AUTOMATIC STAY

"Property of the estate," as referenced in 28 U.S.C. 1334(e), is defined in section 541(a) of the Bankruptcy Code, which provides

that the filing of a bankruptcy petition creates an estate comprising an extensive list of property, "wherever located and by whomever held," including, among other things, "all legal or equitable interests of the debtor in property" as of the petition date.

The debtor and property of its bankruptcy estate are protected by the automatic stay in section 362 of the Bankruptcy Code from creditor collection efforts during a bankruptcy case, including litigation, enforcement of judgments, and acts "to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate."

Under section 362(d), a bankruptcy court can modify or grant relief from the automatic stay upon a showing of: (i) "cause," including the lack of "adequate protection" of an interest in property of the party seeking stay relief; (ii) the debtor's lack of equity in property that is not necessary for an effective reorganization; (iii) a "single asset real estate" debtor's failure within 90 days of the petition date (with certain exceptions) either to file "a plan of reorganization that has a reasonable possibility of being confirmed within a reasonable time," or to commence monthly interest payments to any mortgagee. Under the conditions specified in section 362(e), the automatic stay terminates 30 days after a stay relief motion is filed under section 362(d), unless the court orders otherwise. The bankruptcy court "shall" also grant stay relief under section 362(f) if "necessary to prevent irreparable damage" to a third party's interest in estate property before there is an opportunity for notice and a hearing on its stay relief motion.

Notably, relief from the automatic stay does not remove an asset from the debtors' estate, and the bankruptcy court retains jurisdiction over the property. *See In re Brook Valley VII, J.V.*, 496 F.3d 892, 899 (8th Cir. 2007); *In re Merriman*, 616 B.R. 381, 394 (B.A.P.

9th Cir. 2020); *accord Catalano v. CIR*, 279 F.3d 682, 687 (9th Cir. 2002) ("an order lifting the automatic stay by itself does not release the estate's interest in the property"); *Loken-Flack, LLC v. Stoner*, 2014 WL 3562792, at *7 (D. Colo. July 17, 2014) ("Although Adams Bank was granted relief from the automatic stay, the bankruptcy court's order cannot be construed as relinquishing all jurisdiction to property pledged in the security agreement. Rather, Adams Bank was merely given permission to take whatever action it deemed necessary to foreclose and/or take possession of whatever subject property it wished."); *In re Cordry*, 149 B.R. 970, 973–74 (D. Kan. 1993) ("Relief from the stay simply removes the bankruptcy restraints on a claimant's right to pursue contractual and non-bankruptcy remedies as to the matter in question," and a bankruptcy court's jurisdiction over the property "is considered to be continuing until some action is taken which would necessitate the relinquishment of jurisdiction"); *In re Forrest Marbury House Assocs Ltd. P'ship*, 137 B.R. 554, 556 (Bankr. D.D.C. 1992) ("Until the real property was sold at foreclosure sale, the real property remained property of the estate."); *In re Fricker*, 113 B.R. 856, 864 (Bankr. E.D. Pa. 1990) ("we do not believe that granting relief from the stay deprives a bankruptcy court of jurisdiction over that property").

The Tenth Circuit considered this question in *Fog Cap Retail*.

FOG CAP RETAIL

Fog Cap Retail Investments (the "debtor") was formed in 2002 to hold commercial leasehold interests for investment purposes. The debtor was owned by SBN FCCG, LLC ("SBNF"). SBNF and two affiliates—Summit Investment Management ("Summit") and SBN Edge LLC ("SBN Edge" and collectively with SBNF and Summit, the "related parties")—were also creditors.

The debtor's leasehold interests included a lease of commercial property in Oklahoma (the "property") owned by Stratford Holding, LLC ("Stratford"). The property was previously leased by Foot Locker Retail, Inc. ("Foot Locker"), which operated a shoe store from the premises. After subletting the property to a dry cleaning business, Foot Locker assigned the lease to the debtor, which assumed all of the obligations to Stratford under the lease.

Six years after assuming the lease, the debtor evicted the dry cleaning business and the property sat vacant for several years until the debtor surrendered its leasehold interest to Stratford. The property, however, was contaminated with hazardous dry-cleaning chemicals, prompting the State of Oklahoma to commence an environmental enforcement action against Stratford and the former dry-cleaning tenant.

Stratford sued both Foot Locker and the debtor in federal district court to recover its remediation liabilities under state and federal environmental laws, as well as related damages (the "Oklahoma litigation"). That litigation was stayed when the debtor filed for chapter 11 protection in the District of Colorado in 2016. Stratford and Foot Locker moved for relief from the automatic stay to continue with the Oklahoma litigation and liquidate their claims against the debtor. The bankruptcy court granted the motion. The court later converted the debtor's chapter 11 case to a chapter 7 liquidation.

Because the Oklahoma litigation was not progressing, the chapter 7 trustee later sought bankruptcy court approval to enter into separate settlement agreements with the related parties, Foot Locker, and Stratford regarding the treatment of their claims against the debtor based on the Oklahoma litigation and the remediation liabilities. Under the proposed settlement agreements: (i) the related parties stipulated that their claims against the debtor were contingent and unliquidated claims for contribution that would be estimated at $0.00; (ii) Foot Locker agreed to subordinate its claim to all allowed claims and costs of administration, except for the related parties' claims, and to the estimation of its claim at $0.00; and (iii) Stratford agreed that its allowed claim would be reduced from $20 million to $6.5 million, its claim arising from future remediation costs would be disallowed, and its deposit as part of a prepetition failed asset purchase agreement would be refunded. In his motion to approve the settlement agreements, the trustee also sought authority to make an interim distribution to creditors.

The related parties objected to the trustee's motion seeking approval of the settlements with Foot Locker and Stratford as well as the interim distributions. The bankruptcy court, however, approved the settlements as well as the interim distributions as being in the best interests of the debtor's estate.

The related parties appealed to the district court, arguing, among other things, that, having granted relief from the automatic stay to continue the Oklahoma litigation, the bankruptcy court erred by: (i) exercising jurisdiction over the claims that were being litigated in the Oklahoma litigation; and (ii) exercising jurisdiction over certain federal and state environmental remediation claims as well as other non-core claims. The trustee countered that the bankruptcy court had jurisdiction over the settlement motion because it "related to" the bankruptcy case, and resolution in the Oklahoma litigation of all the claims covered by the settlements would not be possible because many of the claimants were not parties in the litigation.

The district court affirmed the bankruptcy court's orders approving the settlements, ruling, among other things, that: (i) "if the bankruptcy court grants relief from the stay with respect to certain property or claims, . . . the bankruptcy court retains jurisdiction over those matters, although its jurisdiction is concurrent with that of other courts of competent jurisdiction"; and (ii) the bankruptcy court had jurisdiction over the settlements because they could conceivably have an effect on the estate and were therefore "related to" the bankruptcy case. Finally, the district court rejected as unfounded the related parties' argument that the bankruptcy court effectively reimposed the automatic stay by authorizing the settlement without applying the standard for issuing an injunction. *See In re Fog Cap Retail Invs., LLC*, 2022

WL 3443685, at *7 (D. Colo. Aug. 17, 2022), *aff'd*, 2024 WL 659559 (10th Cir. Feb. 16, 2024). The related parties appealed to the Tenth Circuit.

THE TENTH CIRCUIT'S RULING

A three-judge panel of the Tenth Circuit affirmed.

Writing for the panel, U.S. Circuit Judge Paul J. Kelly, Jr. explained that the automatic stay "partially strips the concurrent jurisdiction of other courts," but the bankruptcy court's exclusive jurisdiction only extends as far as section 362 of the Bankruptcy Code permits. *Fog Cap*, 2024 WL 659559, at *3. Thus, Judge Kelly reasoned, the language of section 362 instructs whether a bankruptcy court forfeits its jurisdiction upon granting relief from the stay.

Examining the plain language of the relevant subsections of section 362—i.e., subsections 362(d), (e), and (f)—Judge Kelly concluded that these provisions "say nothing about the bankruptcy court relinquishing jurisdiction" by granting relief from the automatic stay. Accordingly, the Tenth Circuit panel held that when stay relief is granted, "the bankruptcy court retains jurisdiction over those matters, although its jurisdiction is concurrent with that of other courts of competent jurisdiction." *Id.* (quoting *Chao v. Hosp. Staffing Servs., Inc.*, 270 F.3d 374, 383 (6th Cir. 2001)).

According to the Tenth Circuit panel, all of the decisions relied on by the related parties were distinguishable because, among other things, the bankruptcy court in this case was not adjudicating the merits of the claims being settled and the court in the Oklahoma litigation had not taken any action after relief from the stay that would have divested the bankruptcy court of jurisdiction over the claims. *Id.* at *4. The panel accordingly concluded that the bankruptcy court retained "related to" jurisdiction over the claims, such that it could grant the settlement motion because it affected the administration of the bankruptcy estate.

The Tenth Circuit panel rejected the argument that the bankruptcy court improperly resolved state and federal law environmental remediation claims that it did not have subject matter jurisdiction to adjudicate. According to Judge Kelly, the Foot Locker and Stratford settlements did not involve such claims but, rather, merely established their allowed amounts, and in no way resolved or capped the debtor's liability under state and federal environmental laws, which would still be determined in the Oklahoma litigation. *Id.* at *5. Because nothing in the settlements decided any aspect of the claims or restricted the related parties' ability to defend against them, the Tenth Circuit panel concluded that the bankruptcy court did not err in approving them.

OUTLOOK

Although the Fifth Circuit did not break new ground with its ruling in *Fog Cap* concerning the scope of a bankruptcy court's "related to" jurisdiction in cases over claims or assets where the court has granted relief from the automatic stay, the decision is notable for a number of reasons. Most significantly, the Fifth Circuit reaffirmed the well-established principle that a bankruptcy court's exclusive jurisdiction over property of a bankruptcy estate is not relinquished at the moment the court modifies the stay. That jurisdiction becomes concurrent until such time that it is extinguished by subsequent actions or events, such as the issuance of a judgment by another court of competent jurisdiction or the sale of property. Notably, the Fifth Circuit concluded that the plain language of section 362 of the Bankruptcy Code does not divest a bankruptcy court of jurisdiction once the court modifies the automatic stay. Another takeaway from *Fog Capital* is that the bankruptcy court's approval of a settlement does not constitute an adjudication of the underlying claims.

NEWSWORTHY

***Heather Lennox* (Cleveland and New York)** and ***Bruce Bennett* (Los Angeles)** were named "Lawyers of the Year" in the 2025 edition of *The Best Lawyers in America*® in the fields, respectively, of "Bankruptcy and Creditor Debtor Right/Insolvency and Reorganization Law; Litigation" and "Litigation-Bankruptcy." ***Caitlin K. Cahow* (Atlanta and Chicago)**, ***Amanda S. Rush* (Dallas)**, ***Genna Ghaul* (New York)**, ***Nicholas J. Morin* (New York)**, and ***Ryan Sims* (Washington)** were named "Ones to Watch," and ***Jeffrey B. Ellman* (Atlanta)**, ***Aldo L. LaFiandra* (Atlanta)**, ***Daniel J. Merrett* (Atlanta)**, ***Brad B. Erens* (Chicago)**, ***Carl E. Black* (Cleveland)**, ***T. Daniel Reynolds* (Cleveland)**, ***Thomas W. Wearsch* (New York and Cleveland)**, ***Gregory M. Gordon* (Dallas)**, ***Gary L. Kaplan* (Miami)**, ***Corinne Ball* (New York)**, ***Dan T. Moss* (Washington and New York)**, and ***Kevyn D. Orr* (Washington)** were recognized in one or both practice areas.

***Corinne Ball* (New York)** (Hall of Fame), ***Bruce Bennett* (Los Angeles)**, ***Carl E. Black* (Cleveland)**, ***Jeffrey B. Ellman* (Atlanta)**, ***Brad B. Erens* (Chicago)**, ***Gregory M. Gordon* (Dallas)**, ***Heather Lennox* (Cleveland and New York)**, ***Joshua M. Mester* (Los Angeles)**, and ***Kevyn D. Orr* (Washington)** were included in the 2024 edition of *Lawdragon 500 Leading Bankruptcy and Restructuring Lawyers*.

A team led by ***Alexander Ballmann* (Munich)** and ***Anna Geissler* (Munich)** advised German construction and agricultural Group BayWa on a standstill agreement and a new financing package with its core lenders and largest shareholders that will allow it to finalize a final restructuring solution to deal with its €6.5 billion in debt.

***Ben Larkin* (London)** and ***Sion Richards* (London)** were recognized in the 2025 edition of *The Best Lawyers in the United Kingdom*™ in the practice area "Insolvency and Restructuring Law."

***Fabienne Beuzit* (Paris)**, ***Rodolphe Carrière* (Paris)**, and ***Isabelle Maury* (Paris)** were recognized in the 2025 edition of *The Best Lawyers in France*™ in the practice area "Insolvency and Reorganization Law."

***Corinne Ball* (New York)** and ***Bruce Bennett* (Los Angeles)** were designated "Hall of Fame" attorneys in the field "Restructuring (Including Bankruptcy): Corporate" in the 2024 edition of *Legal 500 United States*. ***Heather Lennox* (Cleveland and New York)** received a "Leading Lawyer" designation.

An article written by ***Corinne Ball* (New York)** titled "Distressed M&A: Surprises All Around Following a Creditor's Enforcement of a Pledge to Effect Change of Control" was published in the August 21, 2024, edition of the *New York Law Journal*.

An article written by ***Heather Lennox* (Cleveland and New York)**, ***Dan T. Moss* (Washington and New York)**, ***Ben Larkin* (London)**, ***David Harding* (London)**, ***Jasper Berkenbosch* (Amsterdam)**, ***Alexander Ballmann* (Munich)**, and ***Olaf Benning* (Frankfurt)** titled "Cross-Border Restructurings and the New Jurisdictional Chessboard" was published by Reorg Research on July 22, 2024.

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