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Excerpts From

The Needs of the Many: Equitable Mootness' Pernicious Effects

by

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I. INTRODUCTION

Business bankruptcies typically move fast. In many cases, this is desirable.[1] Fragile finances deteriorate quickly, reducing recoveries for creditors and eliminating value for owners. Congress thus intended chapter 11, the primary vehicle for business reorganizations, to process distressed entities quickly and decisively. Compared to routine civil litigation, chapter 11 procedures are speedy. This results from estate representatives being statutorily empowered to resuscitate the debtor by means entirely foreign to nonbankruptcy law.[2]

The reorganization process centers around a chapter 11 plan of reorgani-

[1] *See* Mark J. Roe, *Bankruptcy and Debt: A New Model for Corporate Reorganization*, 83 COLUM. L. REV. 527, 529 (1983) (identifying speed as one of "three principal characteristics desirable for a reorganization mechanism").

[2] These means include the powers (1) to transfer property free of existing liens, 11 U.S.C. § 363 (2012), (2) to disallow claims otherwise valid under state law, 11 U.S.C. § 502(b)(2), (6) (2012), (3) to discount and alter existing debt, 11 U.S.C. §§ 1123(a) & (b)(2012), (4) to recover transfers and set aside

zation, a document that adjusts and alters the rights of creditors and owners. Instead of a statutory form, Congress largely left the structure and content of such plans to the parties. As a result, creditors will enthusiastically endorse some plans and strenuously scorn others. One issue, then, is how to handle a feasible and sensible plan opposed by a minority of creditors.

Congress answered this question in part by arming plan proponents with "cramdown" powers;[3] that is, an otherwise appropriate plan that is opposed by one or more classes may be confirmed so long as it is fair and equitable and does not discriminate against a dissenting class.[4] As Congress placed the bankruptcy power in a court system rather than in an administrative process, judges rather than administrators apply the rules of cramdown. That is, judges apply the law to the facts, and in theory confirm and approve only those plans that conform to Congress' cramdown and other confirmation requirements.

Judges, however, can and do make mistakes. Congress realized as much and authorized appeals of bankruptcy court final orders.[5] These appeals correct errors in discrete cases; but they also assure the uniform implementation of bankruptcy law.[6]

A disturbing trend in bankruptcy litigation, however, challenges this notion of the proper role of appeals. The judge-made doctrine of equitable mootness allows appellate courts to dismiss meritorious appeals in order to

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liens otherwise valid under state law, 11 U.S.C. §§ 545, 547, 726(b), and (5) to accomplish as much without the unanimous consent of all creditors, 11 U.S.C. §§ 1129(a)(8), (b)(1) (2012).

[3]This is a reference to the § 1129(b)(1) power to confirm a plan over the dissent of a class of creditors or, in common parlance, to cram it down their throats. This article uses the portmanteau form "cramdown." Courts tend to use the terms "cramdown," "cram down," and "cram-down" interchangeably. Indeed, a Justice of the Supreme Court has used both "cramdown" and "cram-down" in the same sentence. Blanchette v. Conn. Gen. Ins. Corp., 419 U.S. 102, 167 (1974) (Douglas, J., dissenting).

[4]11 U.S.C. § 1129(b)(1) (2012).

[5]28 U.S.C. § 158(a) (2012); *see* ACC Bondholder Grp. v. Adelphia Commc'ns. Corp. (*In re* Adelphia Commc'ns. Corp.), 361 B.R. 337, 342 (S.D.N.Y. 2007) ("The ability to review decisions of the lower courts is the guarantee of accountability in our judicial system. In other words, no single judge or court can violate with impunity the Constitution and laws of the United States, or the rules that govern court proceedings, because nearly all decisions are subject to appellate review. At the end of the appellate process, all parties and the public accept the decision of the courts because we, as a nation, are governed by the rule of law. Thus, the ability to appeal a lower court ruling is a substantial and important right.").

[6]*See generally* Cassandra Burke Robertson, *The Right to Appeal*, 91 N.C. L. REV. 1219, 1246 (2013) (discussing generally the nature of an appeal). I acknowledge that there is no constitutional right to an appeal. The Supreme Court has stated that a right of appeal is "not essential to due process, provided that due process has already been accorded in the tribunal of first instance." Ohio *ex rel.* Bryant v. Akron Metro. Park Dist., 281 U.S. 74, 80 (1930); *see also* McKane v. Durston, 153 U.S. 684, 688 (1894).

It is of some note that, under prior bankruptcy statutes, the Supreme Court held it did not have appellate jurisdiction over "pure" bankruptcy issues such as resolution of an individual proof of claim. *See* Wiswall v. Cambell, 93 U.S. (3 Otto) 347, 348 (1876) (dismissing appeal for lack of jurisdiction with respect to order disallowing "a claim presented by a supposed creditor against the estate of a bankrupt.").

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preserve the expectations of the other participants in the reorganization.[7]

In other words, the needs of the many justify running roughshod over the rights of the few, a perverted implementation of utilitarianism.[8] Not surprisingly, especially given the previous sentence, I believe that appellate courts have used equitable mootness too broadly and in ways that undermine tenets central to our jurisprudential and bankruptcy systems.

This article explores the contours of equitable mootness to illustrate the untenable position in which it places meritorious appellants. It will then demonstrate how this process is corrosive to the role of our courts and how it can undermine the very principles it purports to protect. The article closes with some radical suggestions for reform.

II. EQUITABLE MOOTNESS[9]

As Judge Posner has put it, equitable mootness "is perhaps best described as merely an application of the age-old principle that in formulating equitable

[7]There are a host of articles devoted to the doctrine of equitable mootness, most of which attempt to describe or explain the doctrine. *See, e.g.,* Dennis J. Connolly & Sage M. Sigler, *The Issue is Moot. Or is it? Rethinking the Application of Equitable Mootness to Bankruptcy Appeals*, 2016 ANN. SURV. OF BANKR. LAW 2 (2016); Ross E. Elgart, *Bankruptcy Appeals and Equitable Mootness*, 19 CARDOZO L. REV. 2311 (1998); Katelyn Knight, *Equitable Mootness in Bankruptcy Appeals*, 49 SANTA CLARA L. REV. 253 (2009); George W. Kuney, *Understanding and Taming the Doctrine of Equitable Mootness*, 2018 NORTON ANN. SURV. OF BANKR. LAW 1 (2018); David S. Kupetz, *Equitable Mootness: Prudential Forbearance from Upsetting Successful Reorganizations or Highly Problematic Judge-Made Abstention Doctrine?*, No. 4, J. BANKR. L. & PRAC. NL Art. 2 (2016); Robert Miller, *Equitable Mootness: Ignorance is Bliss and Unconstitutional*, 107 KY. L.J. 269 (2018-19); Ryan M. Murphy, *Equitable Mootness Should Be Used as a Scalpel Rather than an Axe in Bankruptcy Appeals*, 19 J. BANKR. L. & PRAC. 1 Art. 2 (2010); Matthew D. Pechous, *Walking the Tight Rope and Not the Plank: A Proposed Standard for Second-Level Appellate Review of Equitable Mootness Determinations*, 28 EMORY BANKR. DEV. J. 547 (2012); Caroline L. Rosiek, *Making Equitable Mootness Equal: The Need for a Uniform Approach to Appeals in the Context of Bankruptcy Reorganization Plans*, 57 SYRACUSE L. REV. 685 (2007); Chad Shokrollahzadeh, *Equitable Mootness and its Discontents: The Life of the Equitable Mootness Doctrine in the Third Circuit After* In re One2One Communications L.L.C. and *In re* Tribune Media Co., 18 DUQ. BUS. L.J. 129 (2016); R. Jake Jumbeck, Comment, *"Complexity" as the Gatekeeper to Equitable Mootness*, 33 EMORY BANKR. DEV. J. 171 (2016); Paul A. Avron, *Equitable Mootness: Is it Time for the Supreme Court to Weigh in?,* AM. BANKR. INST. J., Mar. 2017, at 36; Lenard Parkins et al., *Equitable Mootness: Will Surgery Kill the Patient?*, AM. BANKR. INST. J., Sept. 2010, at 40; *see also* WILLIAM L. NORTON, 8 NORTON BANKR. L. & PRAC. 3d § 170:87 (2017); 13B CHARLES ALAN WRIGHT, ET AL., FED. PRAC. & PROC. § 3533.2.3 (3d ed. 2018 & Supp. 2019).

[8]I say "perverted" because most iterations of utilitarianism contain a version of the "harm principle," which does not permit unilateral reallocation of resources for the greater good when such reallocation harms others. As stated by John Stuart Mill: "The only purpose for which power can be rightfully exercised over any member of a civilized community, against his will, is to prevent harm to others. His own good, either physical or moral, is not sufficient warrant." JOHN STUART MILL, ON LIBERTY 21-22 (2d ed. 1859).

[9]This and the two subsequent sections are based upon, and draw heavily from, Bruce A. Markell, *Equitable Cuteness: Of Mountains and Mice*, BANKR. L. LETTER (Nov. 2015), and from 7 COLLIER ON BANKRUPTCY ¶ 1129.09 (Richard Levin & Henry J. Sommer eds., 16th ed. 2019). The author is the principal contributing author for section 1129 in *Collier on Bankruptcy*.

relief a court must consider the effects of the relief on innocent third parties."[10] The main consideration inherent in equitable mootness is the effect of the implementation of an order confirming a plan of reorganization on those not directly involved in any appeal of that order.[11]

When equitable mootness is invoked, appellate courts often reach an extraordinary conclusion: even if the appellant has a meritorious case, the court will decline to hear the appeal.[12] This leaves aggrieved appellants with no recourse for even profound errors made during the confirmation process. Especially given the Supreme Court's broad interpretation of the preclusive effect of confirmation orders,[13] this doctrine can work significant hardship on innocent creditors.

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[10]*In re* Envirodyne Indus., Inc., 29 F.3d 301, 304 (7th Cir. 1994); *see also In re* Tribune Media Co., 799 F.3d 272, 287 (3d Cir. 2015) (Ambro & Vanaskie, JJ., concurring) (collecting cases); Search Mkt. Direct, Inc. v. Jubber (*In re* Paige), 584 F.3d 1327, 1335 n.7 (10th Cir. 2009) ("[T]he doctrine of equitable mootness is rooted, at least in part, in the court's discretionary power to fashion a remedy in cases seeking equitable relief."); *In re* AOV Indus., Inc., 792 F.2d 1140, 1147–48 (D.C. Cir. 1986) ("[T]here exists . . . a melange of doctrines relating to the court's discretion in matters of remedy and judicial administration. Even when the moving party is not entitled to dismissal on [A]rticle III grounds, common sense or equitable considerations may justify a decision not to decide a case on the merits."); 13B Charles Alan Wright et al., Fed. Prac. & Proc. § 3533.1 (3d ed. 2018).

[11]Bate Land Co. LP v. Bate Land & Timber LLC (*In re* Bate Land & Timber LLC), 877 F.3d 188, 195 (4th Cir. 2017) ("Equitable mootness is a pragmatic doctrine 'grounded in the notion that, with the passage of time after a judgment in equity and implementation of that judgment, effective relief on appeal becomes impractical, imprudent, and therefore inequitable.'") (quoting Mac Panel Co. v. Va. Panel Corp., 283 F.3d 622, 625 (4th Cir. 2002)).

Courts have extended equitable mootness to appeals from cash collateral orders, sales, settlements, liquidations (both under chapter 7 and chapter 11), and equity receiverships. 7 Collier on Bankruptcy ¶ 1129.09[8] (Richard Levin & Henry J. Sommer eds., 16th ed. 2019). This article focuses only on appeals from chapter 9 and chapter 11 confirmation orders.

[12]This facet of the doctrine has not gone unnoticed. *See, e.g.*, *In re* MPM Silicones, L.L.C., 874 F.3d 787, 805 (2d Cir. 2017); *cert. denied sub nom.* BOKF, N.A. v. Momentive Performance Materials, Inc., 138 S. Ct. 2653 (2018) and *cert. denied sub nom.* Wilmington Tr., N.A. v. Momentive Performance Materials, Inc., 138 S. Ct. 2653 (2018) ("It is generally considered inappropriately harsh to deny relief to which one is entitled on the purportedly equitable ground that the unfair (or illegal) plan has been put into effect, especially where a creditor took all appropriate steps to secure judicial relief. In such a case, we have held that it is proper to 'provide relief if it is at all feasible.'") (quoting *In re* Metromedia Fiber Network, *Inc.*, 416 F.3d 136, 144 (2d Cir. 2005)).

[13]*See, e.g.*, United Student Aid Funds, Inc. v. Espinosa, 559 U.S. 260 (2010); Stoll v. Gottlieb, 305 U.S. 165 (1938).

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III. THE PERNICIOUS EFFECTS

These differences belie the uncomplicated fact that equitable mootness is an extraordinary remedy that, by design, denies review of meritorious appeals. To summarize and simplify, equitable mootness expressly provides that a meritorious individual claim of trial court error should not be heard, let alone decided, if the plan has been consummated and reversal would unsettle reasonable reliance interests of "innocent" creditors. Although the Bankruptcy Code provides for analogous treatment with respect to certain sales and loans,[94] it does so within a statutory framework established by Congress exercising its bankruptcy power.

By contrast, equitable mootness is a judge-made doctrine that cuts off appeal rights. Moreover, the doctrine is structured to be keenly sensitive to the facts in any particular case. This sensitivity leads to fine distinctions in applying precedent, which gives rise to diverging lines of cases. As shown in the last Section, these factors lead to confusion in the development of a consistent and coherent doctrine.

Finally, the doctrine also generates more work for an appellate court. Courts often choose to augment their equitable mootness dismissal with a review of the merits. The reasons are more equitable than legal; as one court put it: "The Court provides this alternative analysis because of the high burden that exists for equitable mootness, the parties have devoted a great deal of attention to these additional issues, and the appeal has been pending for quite a while."[95]

This state of affairs has led to confusion. This confusion has a cost that exceeds the benefit of insulating consummated plans from alteration after ap-

[94] 11 U.S.C. §§ 363(o), 364(m) (2012).

[95] *In re* Millennium Lab Holdings II, LLC, 591 B.R. 559, 583 n.32 (D. Del. 2018); *see also In re* Nuverra Envtl. Sols., Inc., 590 B.R. 75, 89 (D. Del. 2018) ("although I find the appeal meets the criteria for equitable mootness, the Court can 'readily resolve the merits of [the] appeal against the appealing party,' so I hold, in the alternative, that the Confirmation Order is affirmed.").

peal. In particular, there are at least eight ways in which the current application of equitable mootness has a pernicious effect. These are:

- an undermining of the standard of review regarding facts and law;
- a perversion and disruption of appellate jurisdiction;
- the placing of unfair burdens on appellants with meritorious cases;
- a destabilization of the special status Congress gave to sales and lending appeals;
- a discounting of courts' ability to fashion remedies in complex cases;
- a subversion of the ability to rely upon contracts;
- a dilution and impoverishment of the sources of interpretation of the Bankruptcy Code, and, last but not least;
- the perpetuation of a possibly unconstitutional deference by Article III courts to courts not possessed of the judicial power of the United States.

A. Undermining the Fact/Law Distinction

It is well-settled that while little deference is paid to a trial court's interpretation of law, great deference is given to its findings of fact. Factual findings made during confirmation proceedings stand unless they are "clearly erroneous."[96]

In a world without equitable mootness, an appeal from a confirmation order would be subject to these principles. Issues of fact—such as whether administrative expenses are paid at confirmation[97] or the complicated issue of feasibility[98]—would be given deference, whereas issues regarding interpretation of what, for example, section 1129(a)(10) requires if the plan contemplates substantive consolidation, would not.

This distinction permits courts to develop consistent doctrine. It allows for different interpretations to percolate up for resolution by higher courts with broader geographic jurisdiction. In a word, it prevents Balkanization.

Equitable mootness undercuts this process. If parties can block appellate review by quickly consummating a plan, then each bankruptcy district—if not each bankruptcy judge—becomes an independent fief. The judge can es-

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[96] A confirmation hearing at which an objection is heard is a contested matter under Fed. R. Bankr. P. 9014. Fed. R. Bankr. P. 3020(b). Under Rule 9014(c), Rule 7052 applies to the confirmation hearing; that rule in turn incorporates Fed. R. Civ. P. 52, which states that "Findings of fact, whether based on oral or other evidence, must not be set aside unless clearly erroneous, and the reviewing court must give due regard to the trial court's opportunity to judge the witnesses' credibility." Fed. R. Civ. P. 52(a)(6).

[97] 11 U.S.C. § 1129(a)(9) (2012).

[98] 11 U.S.C. § 1129(a)(11) (2012).

sentially create rules for his or her court that go unchallenged even if they are objectively incorrect. It thus gives trial courts' interpretations of legal rules a different standard and status than those courts' findings of fact.

One response to this might be to decline to use equitable mootness if the appeal primarily involves issues of law. One reason for this suggestion is that decisions on legal issues have far more impact and relevance nationally than do contested factual issues, and therefore there is more national interest in having appeals involving disputed legal issues heard. But the essence of many equitable mootness cases is reliance, and reliance can hinge on a conclusion of law just as much as on an issue of fact. If reliance interests are to be protected, equitable mootness must have a broad sweep. It thus lessens the doctrine's effectiveness to suggest its restriction.

B. Perverting Appellate Jurisdiction

The process of equitable mootness highlights and exacerbates a feature of normal appeals. Once a notice of appeal is filed, standard appellate doctrine is that the jurisdiction for all matters covered by the appealed order transfers to the appellate court.[99] In short, once a party appeals from a final order (and despite confusion in other areas, an order confirming a plan is about as final as an order gets in bankruptcy),[100] a trial court can no longer alter or modify the substance of its ruling.

One exception to this, however, is the determination of whether to stay the consummation of the plan pending appeal. In bankruptcy, confirmation orders are stayed for 14 days unless otherwise ordered by the court;[101]and

[99]*In re* Adams Apple, Inc., 829 F.2d 1484, 1489 (9th Cir. 1987); *In re* G-I Holdings, Inc., 568 B.R. 731, 764 (Bankr. D.N.J. 2017) (stating, "[A]n appeal of a bankruptcy order will not only divest the bankruptcy court of jurisdiction if the issues on appeal are identical to the issues presently before the bankruptcy court, but also if the bankruptcy court's determination of the issues before it would interfere with or undermine the appellate process."); *In re* Winimo Realty Corp., 270 B.R. 99, 105 (S.D.N.Y. 2001) ("It is well established that the filing of a notice of appeal 'confers jurisdiction on the [appellate court] and divests the [trial] court of control over those aspects of the case involved in the appeal.'") (quoting United States v. Rodgers, 101 F.3d 247, 251 (2d Cir.1996)); *In re* FBI Distrib. Corp., 267 B.R. 655, 656 (B.A.P. 1st Cir. 2001) ("The general rule is that once a notice of appeal has been filed, the lower court loses jurisdiction over the subject matter of the appeal. Since the filing of a notice of appeal is an event of jurisdictional significance, the bankruptcy court no longer has control over those aspects of the case involved in the appeal.").

[100]"'A confirmed reorganization plan operates as a final judgment with res judicata effect.'" *In re* City of Stockton, Calif., 909 F.3d 1256, 1263 (9th Cir. 2018) (quoting Unsecured Creditors Comm. v. Southmark Corp. (*In re* Robert L. Helms Constr. & Dev. Co.), 139 F.3d 702, 704 (9th Cir. 1998) (en banc)); *see also* United Student Aid Funds, Inc. v. Espinosa, 559 U.S. 260 (2010) (chapter 13); Chicot Cty. Drainage Dist. v. Baxter State Bank, 308 U. S. 371, 376 (1940) (Chapter IX; Court refused to permit review of a plan of debt adjustment, even though the statute upon which the adjustment was based had been held unconstitutional in another case); Stoll v. Gottlieb, 305 U. S. 165, 171–172 (1938).

[101]Fed. R. Bankr. P. 3020(e). In bankruptcy generally, there is no automatic stay of the enforcement of a bankruptcy court order. Rule 9021 clearly states that "[a] judgment or order is effective when entered . . . ." Fed. R. Bankr. P. 9021.

courts are often asked to "otherwise order," and make the plan effective immediately.[102] After that 14-day period, the confirmation order is effective, meaning that the plan can be consummated in full reliance on the effectiveness of the confirmation order. The plan proponent can cause money and property to be transferred and ownership of the debtor to change. These actions, of course, form the basis for the request for dismissal on equitable mootness grounds.

But these actions can be stayed under Rule 8007.[103] The appellant may seek to hold in abeyance the actions that might moot its appeal. The rub is the general rule that any stay should "ordinarily" be directed to the bankruptcy court first, before the appellate court reviews the matter.[104] In essence, this asks the bankruptcy judge, who has just ruled in favor of confirmation and against the appellant, if she or he "really meant it." Of course, in most cases, the judges tend to confirm that they did.

Viewed differently, this procedure asks the bankruptcy judge to review his or her order through an appellate prism, especially if denial of a stay leads to equitable mootness and absence of review. While this might not pose a practical problem with factual issues, it unduly imbues the bankruptcy judge with a sense of invulnerability on issues of law.

The confusion follows the appeal to the first appellate level, the district court. Is that court now reviewing the stay request as a new and separate matter? Or is it reviewing the bankruptcy court's initial determination to not issue a stay? Is that "review" an appeal?" If so, should the court defer to the bankruptcy court's factual findings? If not, what is the precedential or persuasive effect of the bankruptcy court's decision?

If the first level appellate court denies the stay, does the circuit court, as the next higher court, have any different issues? Is it bound by factual findings by either the bankruptcy or the district court? And what about an application to an associate justice of the Supreme Court?[105]

The argument might be made that this procedure is standard practice for all civil appeals in which a stay is sought.[106] A key difference is in the scope

[102] *See, e.g.*, Bennett v. Jefferson Cty., 899 F.3d 1240, 1244 (11th Cir. 2018), *cert. denied,* 139 S. Ct. 1305 (2019); *In re* ADPT DFW Holdings LLC, 577 B.R. 232, 243 (Bankr. N.D. Tex. 2017); *In re* Rubicon U.S. REIT, Inc., 434 B.R. 168, 191 (Bankr. D. Del. 2010).

[103] FED. R. BANKR. P. 8007.

[104] Rule 8007(a)(1) states, "*Ordinarily*, a party must move first in the bankruptcy court for the following relief: [¶] (A) a stay of a judgment, order, or decree of the bankruptcy court pending appeal; . . . ." (emphasis supplied).

[105] Recall that one of the first equitable mootness cases indicated that an aggrieved appellant would have to seek relief "even to the extent of applying to the Circuit Justice for relief." Trone v. Roberts Farms, Inc. (*In re* Roberts Farms, Inc.), 652 F.2d 793, 798 (9th Cir. 1981).

[106] Rule 8007 is an adaptation of Appeals Rule 8, which also indicates that the trial court "ordinarily" should be the first court requested to issue a stay. FED. R. APP. P. 8(a)(1)(A).

of relief that a confirmation order can effect. A confirmation order seismically impacts all debts of and claims against the debtor. In stays involving most routine civil litiation, the issues are not so much about the correctness of the rulings made, but on the amount of the bond necessary to protect the prevailing party.

C. Unfairly Burdening the Right of Appeal

The uniqueness of confirmations is in tension with the procedures in standard civil post-judgment stays pending appeal. In damage cases, an appellant obtains a stay by posting a bond, usually in the amount of 100% to 200% of the judgment, plus costs and fees.[107] The requirement protects the prevailing party's liquidated right to compensation for past damage and ensures the ability of the appellee to pay the judgment assessed if an affirming mandate issues.[108] In a chapter 11 confirmation, however, an appellant's bond flips the protection: rather than pay for its transgressions, the appellant is bound to guaranty the rights of the appellees and other creditors for the benefits that they would have received had the plan been consummated.

The general standard governing a stay pending appeal has borrowed the four-factor standard for issuing a preliminary injunction in civil cases.[109] The Third Circuit has refined this analysis in the context of an appeal from a bankruptcy court order and restated the standard as follows:

> [A]ll four stay factors are interconnected, and thus the analysis should proceed as follows. Did the applicant make a sufficient showing that (a) it can win on the merits (significantly better than negligible but not greater than 50%) and (b) will suffer irreparable harm absent a stay? If it has, we "balance the relative harms considering all four factors using a 'sliding scale' approach. However, if the movant

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[107]*See* Olcott v. Del. Flood Co., 76 F.3d 1538, 1559 (10th Cir. 1996) ("Typically, the amount of the bond matches the full amount of the judgment."); Cal. Civ. Proc. Code § 917.1(b) ("The undertaking shall be for double the amount of the judgment or order unless given by an admitted surety insurer in which event it shall be for one and one-half times the amount of the judgment or order.").

[108]Olcott v. Del. Flood Co., 76 F.3d 1538, 1559 (10th Cir. 1996) ("The purpose of requiring a supersedeas bond pending appeal 'is to secure the judgment throughout the appeal process against the possibility of the judgment debtor's insolvency.'") (quoting Grubb v. FDIC, 833 F.2d 222, 226 (10th Cir. 1987)).

[109]That standard requires a determination of "(1) whether the stay applicant has made a strong showing that he is likely to succeed on the merits; (2) whether the applicant will be irreparably injured absent a stay; (3) whether issuance of the stay will substantially injure the other parties interested in the proceeding; and (4) where the public interest lies." Nken v. Holder, 556 U.S. 418, 434 (2009) (quoting Hilton v. Braunskill, 481 U.S. 770, 776 (1987)). I note the standard for stay of an action and for a prelimimnary injunction are not entirely coextensive. *See, e.g.,* Winter v. Nat. Res. Def. Council, Inc., 555 U.S. 7, 22 (2008) ("Issuing a preliminary injunction based only on a possibility of irreparable harm is inconsistent with our characterization of injunctive relief as an extraordinary remedy that may only be awarded upon *a clear showing* that the plaintiff is entitled to such relief.") (emphasis in original).

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> does not make the requisite showings on either of these [first] two factors, the [ ] inquiry into the balance of harms [and the public interest] is unnecessary, and the stay should be denied without further analysis." . . . . But depending on how strong a case the stay movant has on the merits, a stay is permissible even if the balance of harms and public interest weigh against holding a ruling in abeyance pending appeal.[110]

While some courts indicate that a likelihood of equitable mootness equates to the irreparable harm or forfeiture of appeal rights,[111] most have not,[112] and thus the Third Circuit's formulation initially focuses on the merits. Since that question is generally posed first to the bankruptcy judge, who has already spoken on the matter, an appellant's hopes generally lie with the appellate court and, in some circuits, the bankruptcy court's determination on the matter is entitled to deference.

Although this standard does not refer to an appeal bond, bankruptcy courts nonetheless often require one in order to balance the equities. And in large cases, the bond requirement has been large: the bond in *Tribune* was set at $1.5 billion;[113] in *Adelphia* it was $1.3 billion.[114]

As these examples illustrate, the amount can often be ruinous to the point of significantly burdening—if not crushing—the ability to appeal an erroneous ruling. Even if available, at 1%[115] the cost of the bonds in *Tribune* and

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[110]Revel AC, Inc. v. IDEA Boardwalk LLC, 802 F.3d 558, 571 (3d Cir. 2015) (quoting *In re* Forty-Eight Insulations, Inc., 115 F.3d 1294, 1300-01 (7th Cir. 1997). *But see* Richard S. Kanowitz & Michael A. Klein, *The Divergent Interpretations of the Standard Governing Motions for Stay Pending Appeal of Bankruptcy Court Orders*, 17 J. BANKR. L. & PRAC. 4 (2008).

[111]*In re* DAEBO Int'l Shipping Co., No. 15-10616 (MEW), 2016 WL 447655, at *3, 2016 Bankr. LEXIS 356, at *8 (Bankr. S.D.N.Y. Feb. 4, 2016) ("SPV has alleged that the appeal could be rendered moot in the absence of a stay; courts have reached different conclusions as to whether such a risk amounts to irreparable injury, but this Court agrees that the 'loss of appellate rights is a 'quintessential form of prejudice' warranting a finding of irreparable harm.'") (quoting ACC Bondholder Group v. Adelphia Commc'ns Corp. (*In re* Adelphia Commc'ns Corp.), 361 B.R. 337, 347–48 (S.D.N.Y. 2007); Beeman v. BGI Creditors' Liquidating Tr. (*In re* BGI, Inc.), 504 B.R. 754, 763 (S.D.N.Y. 2014) ("In my view, 'where the denial of a stay pending appeal risks mooting any appeal of significant claims of error, the irreparable harm requirement is satisfied.' But 'the seriousness of that threat is inextricably related to the appellants' likelihood of success on the merits.'").

[112]*In re* Sports Auth. Holdings, Inc., No. 12-13262 (BLS), 2016 WL 3041846, at *1 (D. Del. May 27, 2016) (stating "[E]quitable mootness of an appeal, without more, does not constitute irreparable harm"); *In re* Sabine Oil & Gas Corp., 548 B.R. 674, 682 (Bankr. S.D.N.Y. 2016) ("A majority of courts have held that a risk of mootness, standing alone, does not constitute irreparable harm.") (quoting *In re* General Motors Corp., 409 B.R. 24, 31 (Bankr. S.D.N.Y. 2009); *In re* Sunflower Racing, Inc., 225 B.R. 225, 228 (D. Kan. 1998) (collecting cases).

[113]*In re* Tribune Co., 477 B.R. 465, 482 (Bankr. D. Del. 2012), *aff'd*, *In re* Tribune Media Co., 799 F.3d 272, 276 (3d Cir. 2015).

[114]ACC Bondholder Group v. Adelphia Commc'n. Corp. (*In re* Adelphia Commc'n. Corp.), 361 B.R. 337, 368 (S.D.N.Y. 2007).

[115]The 1% rate assumes that the bond can be fully collateralized and that discounts available to pub-

Adelphia would have been $15 million and $13 million respectively. And while winning appellants receive the cost of their bond back from the appellees as costs,[116] they do not receive the borrowing and other costs of obtaining the funds to pay for the bond, the expense of collateralizing the bond, the attorneys' fees for prosecuting the appeal, and related customary costs.[117]

Through the bonding process in equitable mootness cases, the appellant from a confirmation order is required to protect not only the plan proponent, but all the other beneficiaries of the plan (without those beneficiaries necessarily being made formal appellees). Bankruptcy courts thus impose upon appellants the protection of those who are not parties to the appeal—parties whose reliance interests often factor into the equitable mootness decision. There is irony here; if the appellant prevails, the appellate court will have no jurisdiction to disgorge from these relying parties whatever benefits they may have received from an improperly confirmed plan.

This perspective leads to requests for bonds in huge amounts, as does the fact that the plan proponent will be arguing for lightening-quick actions to forestall the debtor's financial ruin, and a court might thus err on the side of a large bond to protect the reorganization. To make matters worse, there is no concomitant upside to the appellant. If it wins, its attorneys' fees in pursuing the appeal are its own cost, as are the costs of financing its appeal bond, and cannot be shifted. The appellant gets, at best, only a shot at a different plan that better addresses its concerns.

D. Erosion of Exceptional Nature of Statutory Mootness Provisions

The urgency driving much of equitable mootness is present in other procedures under the Bankruptcy Code. In sales of assets, and in the granting of post-petition credit, Congress found a need to protect the reliance interests of those who buy and lend.

To address this need, Congress created provisions imposing statutory mootness in specific situations. Sections 363(m) and 364(o) provide that certain components of sales and loans cannot be attacked on appeal if undertaken in good faith.

Congress did not enact similar provisions with respect to confirmations of

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licly-traded companies are not available. *See* Stay Pending Appeal Bond, https://jurisco.com/what-is-surety-bond-definition/defendants-bonds/stay-pending-appeal-bond/ (last visited March 26, 2019).

[116] Fed. R. Bankr. P. 8022(c)(4).

[117] Lerman v. Flynt Distrib. Co., 789 F.2d 164, 167 (2d Cir. 1986) ("FDC's borrowing expense, sought in addition to the premium on a supersedeas bond, is not a permissible item of taxable appellate costs . . . ."); Klapmeier v. Cirrus Indus., Inc., 900 N.W.2d 386, 393–96 (Minn. 2017).

These direct costs are supplemented by the added indirect costs of expedited treatement, from the rushed briefing to the urgent demands on court time; this fire-drill process that equitable mootness creates is unparalled in other civil litigation.

chapter 11 plans. The simple argument is that this lacuna means that confirmation orders should not have the presumptions of finality without review that sale orders and lending orders enjoy. Judge Krause of the Third Circuit succinctly put forth this argument:

> But then-Judge Alito aptly explained why we should reject this argument in his *Continental Airlines* dissent: "[N]arrow provisions" such as §§ 363(m) and 364(e), "which merely prevent the upsetting of certain specific transactions if stays are not obtained," cannot support the broad doctrine of equitable mootness.[118]

Congress' omission may or may not be telling, depending on one's view of statutory interpretation.[119] What is concerning, however, is that courts, not Congress, have developed an analogous immunity for confirmation orders as exist for sales and lending appeals. While Congress, vested with its bankruptcy power, unquestionably has the ability to immunize from appeal those bankruptcy-created rights arising from sales and loans, a like authority for an Article III, not to mention an Article I, court is opaque. It may very well be that, for issues controlled by non-bankruptcy rules, the flux of events in bankruptcy cases may render the remedy of reversal useless or futile. But it is not so clear that appeals from bankruptcy court orders that restructure state law rights, and impose releases and injunctions on third parties, are subject to such common-law principles.

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[118]One2One Comm., LLC v. Quad/Graphics, Inc., 805 F.3d 428 (3d Cir. 2015) (Krause, J., concurring) (quoting *In re* Continental Airlines, 91 F.3d 553, 570 (3d Cir.1996) (en banc) (Alito, J., dissenting)).

[119]A recent example is *Mission Products Holdings, Inc. v. Tempnology, LLC,* 139 S. Ct. 1652 (2019). There the Court was asked whether the exclusion of trademarks from the definition of "intellectual property" in section 101(35A) affected rejections of trademark licenses The Court held that, given Congress' intentional omission of trademarks from section 101(35A), which definition section 365(n) incorporates to give special protections to licensees of rejected patent and copyright licenses, no special treatment should be given to the rejection of a trademark licenses. As the Court put it:

> That section's special provisions, as all agree, do not mention trademarks; and the general provisions speak, well, generally. So Tempnology is essentially arguing that distinctive features of trademarks should persuade us to adopt a construction of Section 365 that will govern not just trademark agreements, but pretty nearly every executory contract. However serious Tempnology's trademark-related concerns, that would allow the tail to wag the Doberman.

Id. at 1665. The Court thus found that trademark licenses are subject to the regular rules relating to rejection of executory contracts. *Id.* at 1666.

Were similar arguments used with respect to equitable mootness, Congress' removal of review of certain sale and lending orders from appeallate review under sections 363(o) and 364(m) would preclude extending removal of appellate review of other orders such as confirmation orders under section 1129. One main difference in extending *Tempnology's* analysis, however, would be that there is no evidence that Congress considered excluding confirmation orders from review in the same way Congress rejected inclusion of trademarks in the definition of intellectual property.

E. Improperly Discounting Courts' Ability to Fashion Remedies

A different concern is the attitude of some appellate courts that it is just too difficult to revisit plan confirmations. The analogy to unscrambling eggs comes to mind.

This is true to a point. A plan is a complex thing; so requiring the parties to reboot the process will never restore them to the exact position they occupied before the adjudicative error.

But I question if that perspective correctly frames the concern. To be sure, plans eliminate and create debt, often replacing one complex corporate financial structure with another. Then again, that is an insufficient reason to avoid hearing a meritorious appeal. As Judge Frank Easterbrook has written, "Unscrambling a transaction may be difficult, but it can be done. No one (to our knowledge) thinks that an antitrust or corporate-law challenge to a merger becomes moot as soon as the deal is consummated. Courts can and do order divestiture or damages in such situations."[120]

Judge Easterbrook has the proper view. The Clayton Antitrust Act,[121] for example, authorizes injunctive relief that can include an order obliging the acquiring company to divest the assets of the acquired firm, even when the plaintiff is a private party.[122] Indeed, although a "far-reaching and drastic remedy,"[123] the Supreme Court has described divestiture as "the most important of antitrust remedies."[124] The Department of Justice has promulgated guidelines for this remedy, which at least theoretically can "unscramble" the eggs.[125]

Courts that are, in effect, purporting to exercise the Constitution's bankruptcy power should not be restricted to remedies that are easy to implement. If an error has occurred, and relief of some type is possible, it should be no objection that the relief sought would be too difficult or complicated to

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[120] *In re* Resource Tech. Corp., 430 F.3d 884, 886–87 (7th Cir. 2005) (Easterbrook, J.); *see also In re* Kmart Corp., 359 F.3d 866 (7th Cir. 2004) (Easterbrook, J.) ("Money had changed hands and, we are told, cannot be refunded. But why not? Reversing preferential transfers is an ordinary feature of bankruptcy practice, often continuing under a confirmed plan of reorganization.") (citation omitted); *In re* Envirodyne Indus., Inc., 29 F.3d 301, 304 (7th Cir. 1994) (Posner, J.) ("We could order the bankruptcy judge to modify the plan of reorganization to reallocate $20 million worth of the stock that the 14% noteholders received to the appellants, the 13.5% noteholders. Some of the 14% noteholders, it is true, have already sold their stock, but they could be ordered to surrender some or all of the proceeds to the appellants.").

[121] Clayton Antitrust Act of 1914, 15 U.S.C. §§ 12–27, 29 U.S.C. §§ 52–53 (2012).

[122] *See* California v. Am. Stores Co., 495 U.S. 271, 295–96 (1990); Steves & Sons, Inc. v. Jeld-Wen, Inc., 292 F. Supp. 3d 656, 673–74 (E.D. Va. 2018).

[123] United States v. Coca-Cola Bottling Co., 575 F.2d 222, 229 (9th Cir. 1978).

[124] United States v. E.I. du Pont de Nemours & Co., 366 U.S. 316, 330 (1961).

[125] U.S. Dep't of Justice, *Antitrust Division Policy Guide to Merger Remedies* (June 2011), http://www.justice.gov/atr/public/guidelines/272350.pdf.

implement. The Supreme Court has invoked the All Writs Act[126] to give effect to antitrust laws;[127] courts administering the Bankruptcy Code might similarly consider the bankruptcy analogue, section 105, even as limited in recent decisions.[128]

An example of the timid and jumbled decisionmaking in this area is *Hargreaves v. Nuverra Env'tl Solutions, Inc.*[129] In *Nuverra*, the plan provided for horizontal gifting—a senior class proposed to transfer part of its plan distribution to a prechosen subset of the general class of unsecured creditors. The result was that creditors with equal priority against the debtor would have received unequal distributions depending on the whim of a senior creditor.

A non-favored creditor appealed. After failing to obtain a stay, the court found that, because the plan had been consummated, trade creditors paid, and new stock issued, the case was equitably moot as there was no longer any effective remedy.[130] Respecting the argument that recovery of the amounts paid might be ordered, the court responded:

> [D]isgorgement would require the claw back, not only of cash payments made to hundreds of individual creditors, but also . . . stock that is trading on the national stock exchange, and which now may be held by third parties who purchased those securities in the ordinary course.[131]

This view seems to adopt the perspective that the remedies could only be property based—why else would the court mention "clawing back" stock? But that ignores the fact that if the appeal were granted, the estate had non-property remedies. It could simply sue those who received distributions under the improper plan. Stock would not have to be clawed back; rather, the estate could simply seek restitution from the initial recipient and let that person worry about recovering its payments from its buyer. Similarly, the

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[126] 28 U.S.C. § 1651(a) (2012): "The Supreme Court and all courts established by Act of Congress may issue all writs necessary or appropriate in aid of their respective jurisdictions and agreeable to the usages and principles of law."

[127] In *F.T.C. v. Dean Foods Co.*, 384 U.S. 597 (1966), the Court used the All Writs Act to justify an injunction issued by the Court of Appeals to prevent a corporate combination.

[128] 11 U.S.C. § 105(a) (2012): "The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title."

The objection might be raised that a limited remedy for appellants is often worse for all other creditors, and thus should be avoided. But that argument is based upon crabbed and specious logic. It absolves the plan proponent for responsibility for promulgating a plan that should not have been confirmed. In other cases, creditors take the risk of their debtor's incompetence, see 11 U.S.C. § 1112(b)(4), and that risk should not be immunized by the bankruptcy court's error in confirming a plan that should not have been confirmed.

[129] 590 B.R. 75 (D. Del. 2018).

[130] Hargreaves v. Nuverra Env'tl Solutions, Inc. (*In re* Nuverra Env'tl Solutions, Inc.), 590 B.R. 75, 89 (D. Del. 2018).

[131] *Id.* at 88.

fact that "hundreds" of lawsuits would have to be brought should not factor into denial of the appellant's right to be heard. In any event, the estate could calculate and pursue only those recoveries that made economic sense.[132] Full and precise relief is not required.[133]

To hold otherwise is to enfeeble and erode courts' abilities to remedy wrongs. It is insufficient reason to withhold a remedy because it would be incomplete or imprecise. But that is where equitable mootness leads. Courts pervert the "irreparable injury" requirement to preclude reversals that would result in incomplete or imprecise remedies. In one respect, that is not the court's concern. If an appellant with a meritorious appeal wishes to press it, even in light of less-than-perfect remedies, it should have that choice.

F. Subversion of the Reliance on Contracts Generally

Equitable mootness also saps the sanctity of contract. Contract rights are fundamental rights. Indeed, the Constitution protects them from undue impairment by the states.[134] And many equitable mootness cases focus on third-party contractual reliance as grounds for discarding meritorious appeals.

In the long run though, the doctrine of equitable mootness will have the opposite effect. If contract rights can be ignored and countermanded by an unreviewable and erroneous trial court ruling, the ability to rely on contracts generally is lessened.

This is different than the general argument made that contracts implicitly incorporate the law in effect at the time of formation. Lenders lend knowing about cramdown and how it can alter their rights. Landlords know that ipso facto clauses will not be enforced in bankruptcy. But such risks are known and, if known, can be calculated and provided for by other terms in the contract, including price.

Equitable mootness injects terminal uncertainty into this calculus. The

[132] *Nuverra* is also notable for allowing over $7 million in unsecured claims (out of an initial indication of $12 million) to be paid before plan confirmation. Permission to pay such pre-petition claims without a plan was based solely on the testimony of the debtor's president who indicated need, but who also indicated that neither he nor his staff had contacted any prepetition creditors regarding the necessity of payment. 3 Appendix of Appellant David Hargreaves at Tab 28, pp. A1753-54, *In re* Nuverra Environmental Solutions, Inc., 590 B.R. 75 (D. Del. 2018) (reprinting Transcript of the Con?rmation Hearing held on July 21, 2017, pp. 32–33); *see* Bruce A. Markell, *The Clock Strikes Thirteen: The Blight of Horizontal Gifting*, Bankr. L. Letter 4–5 (Dec. 2018).

[133] Indeed, in the area of constitutional mootness, the Court has recently indicated that the practical aspects of recovery matter little so long as a right to recovery at least theoretically exists. *See* Mission Prod. Holdings, Inc. v. Tempnology, LLC, 139 S. Ct. 1652, 1661 (2019) ("But courts often adjudicate disputes whose "practical impact" is unsure at best, as when "a defendant is insolvent." . . . And Mission notes that if it prevails, it can seek the unwinding of prior distributions to get its fair share of the estate. . . . So although this suit "may not make [Mission] rich," or even better off, it remains a live controversy—allowing us to proceed.").

[134] U.S. Const., art. I, § 10.

doctrine basically permits a bankruptcy court to alter a non-debtor's contract rights in a manner contrary to law and then bars any appeal therefrom. Moreover, this alteration cannot be anticipated, since whether an appeal will be available at all could turn on whether third parties once or more removed will have relied on the improper alteration.

That such alterations will be the exception rather than the rule is no defense. The precautions or pricing used to protect against this unreviewable alteration risk will, almost by definition since the risk is incalculable, be noneconomic. To protect themselves, parties to the types of financial contracts capable of being restructured have to calculate the unknowable. This calculation adds (if they are risk averse) terms and pricing to such contracts likely to be out of proportion to the actual risk.

G. Diluting Sources of Interpretation and Perceptions of Justice

One by-product of equitable mootness is that the development and evolution of precedent is stunted, due to the concentration of major chapter 11 cases in New York and Delaware. Of the 6,078 business chapter 11 cases filed in the United States in 2018,[135] 626 were filed in the Southern District of New York (10.3%), and 615 were filed in the District of Delaware (10.1%).[136] These two districts have but 17 bankruptcy judges[137] out of the 354 total bankruptcy judges in the United States.[138] Accordingly, roughly 5% of the bankruptcy judges in the United States decide more than 20% of all business chapter 11 cases,[139] and those cases comprise a large majority of the chapter 11 publicly-held and mega-cases.

The limited number of bankruptcy courts is mirrored by the limited number of district court and circuit court judges. There are 673 positions for

[135]The numbers are taken from Administrative Office of the United States Courts, Table F-2 Quarterly: U.S. Bankruptcy Courts—Business and Nonbusiness Cases Commenced, by Chapter of the Bankruptcy Code, During the Three-Month Period Ending March 31, 2019, Based on Data Current as of March 31, 2019, *available at* https://www.uscourts.gov/file/26267/download.

[136]The third runner up was the Southern District of Texas with 453 cases, although that may be because that district has created a complex chapter 11 sub-group of judges, consisting of two of the six authorized judges. *See* General Order 2018-1, Order Regarding Complex Case Assignment (Bankr. S.D. Tex., Jan. 28, 2018).

[137]The Southern District of New York has nine authorized judgeships, 28 U.S.C. § 152(a)(2) (2012), and Delaware has one. *Id.* Delaware, however, has seven temporary judgeships allocated to it. *See* Bankruptcy Judgeship Act of 2005, Pub. L No. 109-8, § 1223, 119 Stat. 23, 196–98 (2005); Temporary Bankruptcy Judgeships Extension Act of 2012, Pub. L. No. 112-121 (2012); and Bankruptcy Judgeship Act of 2017, Pub. L. No. 115-72, § 1003, 131 Stat. 1224, 1231 (2017).

[138]This number includes all 38 temporary judgeships, including the seven in Delaware.

[139]If the two specialist judges of the Southern District of Texas and their case loads are considered, the comparison is that about 5.4% of judges decide 28% of all business chapter 11 cases.

district court judges; 179 authorized positions for circuit judges.[140] The Southern District of New York and the District of Delaware have 32 district court judges combined,[141] while the Second and Third Circuits account for 27 circuit judges.[142] These allocations mean that about 5% of all district court judges, and about 15% of all circuit judges, decide appeals from the 20% of bankruptcy cases mentioned above.

These imbalances reduce the number of qualified decisionmakers regarding interpretation of the Bankruptcy Code. If each of the judges has different bits of information or insight about the proper construction of the Bankruptcy Code, the best estimate of value is, other things being equal, that value estimated by the median judge. This is a standard observation from "wisdom of the crowds" literature.[143]

The narrowed and concentrated nature of the judiciary reviewing bankruptcy appeals also has an effect on perceived system fairness. As noted by Professor Melissa Jacoby:

> The prospect of appellate review by a multi-judge court fosters confidence in the system. Indeed, "the value of the appellate system's ability to increase public trust in judicial outcomes may exceed the amount of error correction actually accomplished." Judith Resnik has emphasized the importance of public participation (including observation) in adjudicatory processes as a democratic practice. As a result of equitable mootness, even fewer people get to tell their

[140] *See* Authorized Judgeships, https://www.uscourts.gov/file/document/all-authorized-judgeships-1789-present (last visited July 2, 2019).

[141] 28 U.S.C. § 133(a) (2012).

[142] 28 U.S.C. § 44.

[143] *See, e.g.*, James Surowiecki, The Wisdom Of The Crowds: Why The Many Are Smarter Than The Few And How Collective Wisdom Shapes Business, Economies, Societies, And Nations 3–22 (2005) (providing an overview of the wisdom of the crowds principle in action); *see also* Douglas G. Baird *et. al.*, *The Bankruptcy Partition*, 166 U. Pa. L. Rev. 1675, 1714 n.30 (2018). For a thoughtful consideration of the many factors involved in deferring to the "wisdom of the crowds," see Lyon Aidan & Eric Pacuit, *The Wisdom of Crowds: Methods of Human Judgement Aggregation*, *in* Handbook of Human Computation 599-614 (2018).

Recent literature indicates that it may be the case that "[w]hen expertise is not evenly spread throughout the crowd, it is better to focus on the concentration of the expertise as opposed to diluting it with experts of a lower quality. As a result, the wisdom of the experts in the crowd can beat the wisdom of the whole crowd." Daniel G. Goldstein, R. Preston McAfee & Siddharth Suri, *The Wisdom of Smaller, Smarter Crowds*, *in* Proceedings of the Fifteenth Ass'n for Computing Machinery Conference on Economics and Computation 471, 487 (2014); *see also* Clintin P. Davis-Stober, David V. Budescu, Stephen B. Broomell & Jason Dana, *The Composition of Optimally Wise Crowds*, 12 Decision Analysis 130 (2015). There is nothing in the current system, however, to indicate that the judges in this small subset of bankruptcy judges are any better (or worse) at interpreting the law than all bankruptcy judges generally.

> stories to a court of higher authority, or to observe an appellate court considering the matter.[144]

As a result, a small sample of available decision makers formulate the confirmation policies protected by equitable mootness. This weakens the long-term quality of Code interpretations while undermining public perception of bankruptcy as an objectively fair system.[145] Neither consequence is desirable.

H. Constitutional Issues?

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IV. RECONCEPTUALIZING EQUITABLE MOOTNESS

Despite these many failings, equitable mootness does have some utility. To repeat Judge Posner's characterization, equitable mootness "is perhaps best described as merely an application of the age-old principle that in formulating equitable relief a court must consider the effects of the relief on innocent third parties."[174] Aside from tinkering with how best to bestow the "innocent" label, the cynosure of many equitable mootness cases has been the need to seek a stay of the confirmation order.

A. Summary of the Issues

While this centrality may appear useful in theory, it stinks in practice. As indicated above, unlike normal civil litigation in which the damage of a stay can be localized and quantified by the money judgment appealed, confirmations in chapter 11 are different. As a condition of obtaining a stay, appellants are asked to provide possible compensation not only to the transgressors—the plan proponents—but also every interested party in the reorganization. In essence, this treats plan proponents as agents and representatives of the entire remainder of the creditor body, without those parties being named as appellees. Such reasoning leads to the exorbitant bonds mentioned earlier in *Tribune* and *Adelphia*.[175] At some point, the question needs to be raised as to whether the price of seeking an appeal should impose upon an appellant the cost of protecting absent non-appellees.[176]

The magnitude of the cost of appeal also affects other aspects. An increase in non-localized costs of appeal deters effective appeals and thus enhances the importance and immunity of the non-Article III judge's initial

[171] One2One, 805 F.3d 428, 444 (Krause, J., concurring).

[172] Sur Pet. for Reh'g, *In re* Tribune Media Co., 799 F.3d 272, ECF No. 003112071981 (3d Cir. 2015)

[173] 136 S. Ct. 1459 (2016).

[174] *In re* Envirodyne Indus., Inc., 29 F.3d 301, 304 (7th Cir. 1994).

[175] *In re* Tribune Co., 477 B.R. 465, 482 (Bankr. D. Del. 2012), *aff'd In re* Tribune Media Co., 799 F.3d 272, 276 (3d Cir. 2015); ACC Bondholder Group v. Adelphia Commc'n. Corp. (*In re* Adelphia Commc'n. Corp.), 361 B.R. 337, 368 (S.D.N.Y. 2007).

[176] This point is explored thoughtfully in Eleanor H. Gilbane, *Investing in an Appeal: The Dilemma Facing an Appellant of Confirmation Orders*, Am. Bankr. Inst. J. 38 (May 2013).

decision. Put differently, a bankruptcy judge's confirmation decision is given greater effect and authority than other orders because it is less likely to be disturbed. Given the immense effect a confirmation order has, it is perversely ironic that it cannot be reviewed, while a host of more common and mundane decisions can be. In addition, the increased costs decrease appellate decisions on the merits, which effectively decreases the effective oversight of the Article III Judiciary.

Even if these concerns can be addressed, the amassing of chapter 11 cases in a small number of jurisdictions and judges correspondingly concentrates the general interpretation process in comparatively few appellate judges and even fewer bankruptcy judges. The resulting illusion of certainty corrodes the systemic process of reaching consensus on disputed provisions of the Bankruptcy Code.

B. Radical Proposals

To redress these pernicious effects, Congress could of course amend the Bankruptcy Code to provide confirmation orders with the type of immunity conferred upon sale and financing orders. But Congress did not and has not; and only Rebecca of Sunnybrook Farm or Professor Pangloss would conceive that Congress, as currently constituted, would enact such an amendment, assuming that its members could first apprecate the need for it.

As I have argued, however, such immunity is not only unnecessary, it is dangerous to parties with meritorious arguments and to the court system in general.

So how does one approach the issue? I suggest a package of changes, phrased mainly as interpretive presumptions. These changes focus on the procedure of processing the appeal, with the intent of preserving the ability of litigants to have issues heard on the merits in a manner designed to reach the best result.

1. *Reforms Regarding Stays*

The first subset of these practices examines the stay pending appeal. The current state of the law on stays is the crux of the problem with equitable mootness; the doctrine has its strongest justification when an appellate court, regardless of the magnitude of any error that might have been made, cannot restore the parties to anything like their original positions. It is at its weakest when the appeal, if denied, will simply lead to another similar, reorganization.

Stays are governed by Rule 8007, which mirrors Rule 8 of the *Federal Rules of Appellate Procedure* and Rule 62 of the *Federal Rules of Civil Procedure*.[177] Courts approach a request for a stay pending appeal under those

[177]As stated in the Advisory Committee Notes to the Rule: "This rule is derived from former Rule

rules by noting:

> [T]he factors relevant under Civil Rule 62(c) and Appellate Rule 8 "are generally the same:" (1) whether there is a strong showing of likelihood of success on the merits; (2) whether there will be irreparable injury absent a stay; (3) whether a stay would substantially injure other interested parties; and (4) the public interest. The analysis thus somewhat resembles the test applied in the district court when evaluating a request for a preliminary injunction, though the differences in posture mean that the two tests are not identical.[178]

In an appeal from confirmation, the likelihood of success factor is odd—at most, it should be an initial test to see if the appellant has a good faith chance at reversal. The Third Circuit recognizes as much. It asks whether the "applicant ma[de] a sufficient showing that (a) it can win on the merits (significantly better than negligible but not greater than 50%). . . ."[179]

The irreparable injury inquiry cuts many different ways. The plan proponent is usually heard to argue that its plan is the only possible plan, and the only alternative is liquidation. Although such "Chicken Little" claims usually are not taken at face value, they often find their way into opinions.[180] But on the appellant's side, the loss of a meritorious right without a hearing on the merits is a concrete irreparable injury, usually subject to determination with greater certainty than claims of future illiquidity. Standard doctrine is that when considering these factors, there "should be balance[ ]; thus, for example, if the balance of harms tips heavily enough in the stay applicant's favor then the showing of likelihood of success need not be as strong, and vice versa."[181]

Against this background, I offer three suggestions regarding the granting of stays of a confirmation order entered by a bankruptcy judge:

- A stay should presumptively issue if confirmation was made possible only by adoption of a disputed rule of law;
- Given the extraordinary nature of equitable mootness, and the time pressures surrounding confirmation, appel-

8005 and F.R.App.P. 8." Advisory Comm. Notes to Rule 8007 (2014); *see also* Advisory Comm. Notes to Rule 8007 (2018) ("The amendments to subdivisions (a)(1)(B), (c), and (d) conform this rule with the amendment of Rule 62 F.R.Civ.P., which is made applicable to adversary proceedings by Rule 7062.").

[178] 16A Charles Alan Wright, et al., Fed. Prac. & Proc. § 3954 (4th ed. 2009 & Supp. 2018).

[179] Revel AC, Inc. v. IDEA Boardwalk LLC, 802 F.3d 558, 571 (3d Cir. 2015) (quoting *In re* Forty-Eight Insulations, Inc., 115 F.3d 1294, 1300–01 (7th Cir. 1997)).

[180] *See, e.g.*, ACC Bondholder Group v. Adelphia Commc'ns Corp. (*In re* Adelphia Commc'ns Corp.), 361 B.R. 337, 350 (S.D.N.Y. 2007) (assuming, without much evidence, that amount necessary to protect a decline in property value was close to equity value under plan appealed from).

[181] 16A Charles Alan Wright, et al., Fed. Prac. & Proc. Juris. § 3954 (4th ed. 2009 & Supp. 2019).

lants should automatically be able to present their stay requests in the first instance to the reviewing court, and should not be bound by the Rules' direction that "ordinarily" such requests should go first to the trial court; and

- If the appeal is nonfrivolous and in good faith, there should be no bond imposed as a condition of a stay.

Each of these is explored in detail below.

a. Presumptive Grant of Stay If Appeal Turns on Substantial Question of Law

The first suggestion is that a stay should be presumptively granted if confirmation was made possible only by adoption of a disputed issue of law—one which I loosely define as an issue upon which courts or commentators have disagreed as to scope or content.

A current example might be a plan of a group of companies that could only be confirmed by adopting the interpretation that section 1129(a)(10) applies on a plan rather than on an entity basis.[182] Section 1129(a)(10) does not address the complex issues arising when a plan proposes to substantively consolidate several debtors into one or more reorganized debtors. The issue presented is, however, easily defined: Does section 1129(a)(10) require one consenting impaired class from each of the pre-petition debtors ("per debtor" application), or does it simply require one impaired consenting class from the classes as specified in the plan sought to be confirmed ("per plan" application)?[183]

Bankruptcy courts in the Southern District of New York, in significant and large chapter 11 cases, have adopted the "per plan" interpretation, especially in cases in which the plan proposes to substantively consolidate affiliated debtors.[184] Bankruptcy courts in Delaware, however, have not followed suit and have adopted a "per debtor" construction.[185]

[182]Another issue current in the courts might well be the proper characterization of make-whole premiums as unmatured interest or liquidated damages. *See, e.g.*, Ultra Petroleum Corp. v. Ad Hoc Comm. of Unsecured Creditors of Ultra Res., Inc. (*In re* Ultra Petroleum Corp.), 913 F.3d 533, 547-49 (5th Cir. 2019).

[183]*See In re* Tribune Co., 464 B.R. 126, 180 (Bankr. D. Del. 2011), *on reconsideration*, 464 B.R. 208 (Bankr. D. Del. 2011). These issues are explored in Suzanne T. Brindise, Note, *Choosing the "Per-Debtor" Approach to Plan Confirmation in Multi-Debtor Chapter 11 Proceedings*, 108 NW. U.L. REV. 1355 (2014).

[184]JPMorgan Chase Bank, N.A. v. Charter Communs. Operating, LLC (*In re* Charter Communs.), 419 B.R. 221, 266 (Bankr. S.D.N.Y. 2009); *In re* Enron Corp., 2004 Bankr. LEXIS 2549, *234–236 (Bankr. S.D.N.Y. July 15, 2004); *see also In re* SGPA, Inc., No. 1-01-02609, 2001 Bankr. LEXIS 2291 (Bankr. M.D. Pa. Sept. 28, 2001). The Ninth Circuit has held that there had to be at least one impaired creditor class that had accepted the plan, applied on a per-plan, rather than on a per-debtor basis. JPMCC 2007-C1 Grasslawn Lodging, LLC v. Transwest Resort Prop. Inc. (*In re* Transwest Resort Props., Inc., 881 F.3d 724 (9th Cir. 2018).

[185]*In re* JER/Jameson Mezz Borrower II, LLC (*In re* JER/Jameson), 461 B.R. 293, 300–02 (Bankr. D.

Those favoring the "per plan" interpretation point to the plain language of section 1129(a)(10) and the fact that it applies to the plan proposed by the plan proponent, not other, hypothetical, plans regarding other affiliated debts.[186] In response, those favoring the "per debtor" approach observe that in cases in which there has not been substantive consolidation before confirmation, "each joint plan actually consists of a separate plan for each debtor."[187] This view allows a plan proponent to achieve substantive consolidation through a plan only if (1) the creditors of each debtor consent to the consolidation (through voting as set forth in section 1129(a)(8)), or (2) if entity separateness would not be respected by nonbankruptcy law. In other words, the legitimate expectations of creditors regarding such separateness cannot be overcome or disturbed by those who are not creditors of their debtor.[188]

In these cases of disputed interpretation, the issue is legitimate and deserves more consideration than just the isolated bankruptcy judge relying on self-selected authorities.[189] If this type of plan is denied review due to the cost of an appeal bond, it deprives Article III courts the ability to review and develop precedent in a timely and orderly fashion.

b. Stays of Confirmation Orders Should Be Directed Initially to the Reviewing Court

A second suggestion is that the stay application not be addressed to the trial court in the first instance. This rule might work with respect to appeals in traditional civil litigation, but it is less effective when the issue affects not only parties to the appeal but also every other creditor. At this point, local lore and practice cannot be allowed to influence decision. A new perspective is needed.

Fortunately, the system already has the ability to accommodate this suggestion; the appellate court can be the first instance court. Rule 8007(a)(1) simply states that "*[o]rdinarily*, a party must move first in the bankruptcy

Del. 2011); *In re* Tribune Co., 464 B.R. 126, 180 (Bankr. D. Del. 2011), *on reconsideration*, 464 B.R. 208 (Bankr. D. Del. 2011).

[186] *See, e.g.*, JPMCC 2007-C1 Grasslawn Lodging, LLC v. Transwest Resort Props., Inc. (*In re* Transwest Resort Props., Inc.), 554 B.R. 894, 901 (D. Ariz. 2016), *aff'd*, 881 F.3d 724 (9th Cir. 2018) ("unlike the *Tribune* court, this Court finds the plain language of the statute to be dispositive.").

[187] *In re* Tribune Co., 464 B.R. 126, 182 (Bankr. D. Del. 2011), *on reconsideration*, 464 B.R. 208 (Bankr. D. Del. 2011). The court rebutted the "plain meaning" argument by noting that section 102(7) permits singular terms to be read as plural, thus the use of the singular term "plan" in section 1129(a)(10) is not to be read as applying to only one plan. *Id.*

[188] *In re* Tribune Co., 464 B.R. 126, 182–84 (Bankr. D. Del. 2011), *on reconsideration*, 464 B.R. 208 (Bankr. D. Del. 2011).

[189] Congress has acknowledged that some bankruptcy appeals present significant issues that require a prompt decision from a circuit court, with one of the grounds being that that "the judgment, order, or decree involves a question of law requiring resolution of conflicting decisions." *See, e.g.*, 28 U.S.C. § 158(d)(2)(A)(ii) (2012).

court . . . ."[190] Equitable mootness, however, is anything but ordinary. The present system's direction to apply first to the bankruptcy court will almost always lead to a second application at the reviewing court as the bankruptcy court has, as part of confirmation, already weighed and taken a considered position on the overall effect of the stay; in essence, its confirmation is its ruling that a stay is not appropriate—otherwise the court would have delayed confirmation on its own.[191]

Adoption of this suggestion may require changing existing precedent. In the Second Circuit, for example, "the applicant must first move for the stay in bankruptcy court. . . . 'If the party improperly bypasses the bankruptcy court and seeks a stay first from the district court, the district court lacks the jurisdiction to hear the matter.'"[192] Initially, this line of authority seems suspect. The applicable rule permits application to the reviewing court, and only indicates that, in the ordinary case, one seeking a stay should start at the trial court. This stated preference falls far short of a jurisdictional rule. And once that false consequence is dissolved, the argument returns to whether equitable mootness is outside of the mine run or "ordinary." As I suggest, it is.

Another concern addressed by this bypass is constitutional. As supervision is a key component to the legitimacy of the bankruptcy court system,[193] it is essential that an Article III court conduct the review.[194] In this way, a district judge or the motions panel of several circuit judges can weigh in and leave no doubt concerning *Stern* compliance.

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[190]Fed. R. Bankr. P. 8007(a)(1) (emphasis supplied).

[191]*See generally In re* Anderson, 560 B.R. 84, 89 (S.D.N.Y. 2016) ("the Court has already determined that Credit One failed to succeed on the merits. Asking the . . . court to then find that . . . Credit One is likely to succeed on the merits on appeal . . . would require the district court to find that its own order is likely to be reversed. This is a standard that is rarely going to be satisfied."). Anderson cited *In re* A2P SMS Antitrust Litig., No. 12 Cv. 2656 (AJN), 2014 WL 4247744, at *2 (S.D.N.Y. Aug. 26, 2014), which holds a similar view:

> A "serious questions" standard is particularly appropriate when a district court is asked to stay its own order; under such circumstances, the court has already determined that the applicant failed to succeed on the merits. Asking the district court to then find that the movant is likely to succeed on the merits on appeal would require the district court to find that its own order is likely to be reversed—a standard that for practical purposes is rarely going to be satisfied.

[192]*In re* Anderson, 560 B.R. 84, 90 (S.D.N.Y. 2016) (quoting *In re* BGI, Inc., 504 B.R. 754, 761 (S.D.N.Y. 2014), which in turn cited *In re* Taub, 470 B.R. 273, 276 (E.D.N.Y. 2012)).

[193]*See* Section III.H, *supra; see also* Wellness Int'l Network, Ltd. v. Sharif, 135 S. Ct. 1932, 1944 (2015) ("allowing Article I adjudicators to decide claims submitted to them by consent does not offend the separation of powers so long as Article III courts retain supervisory authority over the process."); Pacemaker Diagnostic Clinic of America, Inc. v. Instromedix, Inc., 725 F.2d 537, 544 (9th Cir. 1984) (en banc) (Kennedy, J.) (magistrate judges may adjudicate civil cases by consent because the Federal Magistrates Act "invests the Article III judiciary with extensive administrative control over the management, composition, and operation of the magistrate system").

[194]This may not be the case when the appeal is to be heard by a Bankruptcy Appellate Panel.

c. Eliminate Bonds

A third suggestion is to eliminate any rule requiring appeal bonds from confirmation orders. Typically, a bond is required to ensure that an appellant, typically found to owe money, will pay that money if the appeal is unsuccessful. In routine civil litigation, an appellant has been found to bear some blame or owe some amount, and thus is required to provide some security that it will pay or perform if it loses on appeal.[195]

But in an appeal from a confirmation order there is no blame, and typically no order to pay money by creditors. The appeal focuses not on what the appellant owes the appellee, and is delaying, but what the appellee owes the appellant. A bond under such circumstances essentially forces a party without blame to insure, at potentially great cost, the correctness of its views.

This change of circumstances should cause a similar reappraisal of the presumptive correctness of a bankruptcy court's ruling that forms the basis for bonding rules. Putting appeals involving issues of fact aside—since they will always be subject to a clearly erroneous standard of review—an appeal from a confirmation order is simply an appeal over the correct view of the law; it is not an appeal over a legal determination that the appellant owes someone else money. In short, the plan proponent as appellee is simply backing the correctness of the trial court's view.

With this change of circumstances, a bond would insure the speculative injury that might arise if the parties could not replicate a reorganization of equal value if the appellant loses. But why should the appellant insure this loss? It typically does not owe money to the estate; the reverse is true. The debtor has essentially filed a declaratory class action against all of its creditors to determine what it, the debtor, owes each of them. If the appeal is in good faith, all the appellant seeks is correction of an erroneous legal decision as to the amount owed; at the extreme, it seeks to stop the needs of the many from improperly impinging on its rights of the few.

This should cause pause in requiring a bond to insure the ability to pay damages assessed, or what might be called a supersedeas bond. Such a bond would serve no purpose, and the confirmation order does not determine that the appellant owed money or obligations to the estate that it would have to pay if it loses the appeal. *Collier* recognizes this situation when it says, "Generally courts are more inclined to consider not requiring a bond or other security when the order does not involve a monetary judgment."[196]

Courts that have visited this issue have focused on the wrong type of

[195] At least one state has capped appeal bonds to avoid ruinous costs of appeal. *See* FLA. STAT. ANN. § 45.045 (capping maximum supersedeas bond at $50 million).

[196] 10 COLLIER ON BANKRUPTCY ¶ 8007.09 (Richard Levin & Henry Sommer, eds., 16th ed., 2019).

harm. In *Tribune*, for example, the bankruptcy court stated that the test for a bond amount should be undertaken as follows:

> In determining whether a bond should be ordered, the court looks to whether the bond would be necessary to protect "against diminution in the value of property pending appeal" and to "secure the prevailing party against any loss that might be sustained as a result of an ineffectual appeal." Moreover, the posting of a bond "guarantees the costs of delay incident to the appeal."[197]

The only authority cited for this standard was *ACC Bondholder Group v. Adelphia Communications Corp.*,[198] which stated the exact same principles.[199] *Adelphia* supported these principles, however, by uncritically relying on two other district court cases, both of which denied the request for a stay,[200] and thus provided no analogous issues. *Adelphia* then conflated the loss of value of specific property (as might be the subject of adequate protection of collateral) with the loss of the debtor's entire reorganization value. This not only ignored, for example, the liquidation value of the debtor, but also made the puzzling assumption that the plan the bankruptcy court approved was the only and best possible plan—a proposition rebutted entirely if the appellant's appeal had any merit. In short, *Adelphia* assumed the lost opportunity costs for the entire bankruptcy estate to be equal to the entire value of the estate, and assumed that an appeal would wipe out the entire amount of value.

Tribune then uncritically adopted *Adelphia*'s view, and took extensive evidence as to the costs to be incurred by the debtor during the period of an appeal. But what was not considered was the cost to the appellant: the forfeiture of its rights to have its appeal heard, a concern arguably required by a faithful application of the balancing process of Rule 8007.[201]

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[197] *In re* Tribune Co., 477 B.R. 465, 478 (Bankr. D. Del. 2012) (quoting ACC Bondholder Group v. Adelphia Commc'ns Corp. (*In re* Adelphia Commc'ns Corp.), 361 B.R. 337, 350 (S.D.N.Y.2007)).

[198] 361 B.R. 337 (S.D.N.Y. 2007).

[199] *In re* Adelphia Commc'ns Corp., 361 B.R. 337, 350 (S.D.N.Y. 2007) (quoting *In re* Sphere Holding Corp., 162 B.R. 639, 644 (E.D.N.Y. 1994) and *In re* Suprema Specialties, Inc., 330 B.R. 93, 96 (S.D.N.Y. 2005)).

[200] *In re* Suprema Specialties, Inc., 330 B.R. 93, 96 (S.D.N.Y. 2005) (stating "the Court approves the stay without requiring Movants to post a bond."); *In re* Sphere Holding Corp., 162 B.R. 639, 644 (E.D.N.Y. 1994) ("This case does not require a bond (nor have any interested parties asked for one) because little or no damage will be incurred as a result of the stay.").

[201] At most, the court could request an appeal bond under Rule 7 of the Federal Rules of Appellate Procedure. Under those rules, "courts typically consider (1) the appellant's financial ability to post a bond; (2) the risk that the appellant would not pay appellee's costs if the appeal is unsuccessful, (3) the merits of the appeal, and (4) whether the appellant has shown any bad faith or vexatious conduct." *In re* Polyurethane Foam Antitrust Litig., 178 F. Supp. 3d 635, 638 (N.D. Ohio 2016) (first quoting Gemelas v.

One untenable consequence of the *Tribune/Adelphia* approach to bonds is that the successful appellant becomes surety for the consequences of an improper plan. If anything, the interest to be protected is the equity interests of the plan proponent under the plan confirmed, including the losses to any other group mismatching the harm.

Without a bond, the court must then critically examine, as would any court, the four factors traditionally associated with stays pending appeal on their own, and without introducing a "damage" element.

2. *Reforms to Type of Review*

Once a reviewing court has jurisdiction of an appeal, and a stay request is made, one of the first issues is the weight, if any, to give to the bankruptcy court's determination. This question is typically presented as either deferring to the bankruptcy court's determination under an abuse of discretion standard or by treating the stay request as a separate action and reviewing it de novo. As noted above, the circuits "are split."[202] The Second, Third, and Tenth Circuits apply an abuse-of-discretion standard,[203] while the Fifth, Sixth, Ninth, and Eleventh Circuits review equitable mootness dismissals de novo.[204]

The reason is simple. An appeal is often the first time a court vested with the Article III judicial power has looked at a case. The duty to decide cases thus compels a thorough and comprehensive review. Deference to a bankruptcy court at this point runs contrary to the supervision responsibilities assumed by Article III courts over the bankruptcy court system.

3. *Reforms Regarding Procedure — Withdrawal of the Reference*

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[202] Search Mkt. Direct, Inc. v. Jubber (*In re* Paige), 584 F.3d 1327, 1334–35 (10th Cir. 2009).

[203] *See* R2 Invs., LDC v. Charter Commc'ns, Inc. (*In re* Charter Commc'ns, Inc.), 691 F.3d 476, 483 (2d Cir. 2012); Search Mkt. Direct, Inc. v. Jubber (*In re* Paige), 584 F.3d 1327, 1335 (10th Cir. 2009)*; In re* Continental Airlines, 91 F.3d 553, 560 (3d Cir. 1996) (en banc).

[204] *See* Curreys of Nebraska, Inc. v. United Producers, Inc. (*In re* United Producers), 526 F.3d 942, 946–47 (6th Cir. 2008) (acknowledging conflict with Third Circuit); United States *ex rel.* FCC v. GWI PCS 1, Inc. (*In re* GWI PCS 1 Inc.), 230 F.3d 788, 799–800 (5th Cir. 2000); Baker & Drake, Inc. v. Pub. Serv. Comm'n of Nevada (*In re* Baker & Drake, Inc.), 35 F.3d 1348, 1351 (9th Cir. 1994); First Union Real Estate Equity & Mortg. Invs. v. Club Assocs. (*In re* Club Assocs.), 956 F.2d 1065, 1069 (11th Cir. 1992).

V. CONCLUSION

Equitable mootness arose as a response to the desire for finality in corporate reorganizations. The cost of going back and "doing it right" was perceived to exceed the cost of tolerating the loss of dissenters' rights. In some cases that calculation might prove true. But in other cases, it may not, and the nature of the beast is that we cannot truly know if and when the needs of the many justify eviscerating the rights of the few.

In this article, I have tried to show that the doctrine of equitable mootness tramples meritorious actions of the few simply to protect the needs of the many. It is thus a perverse form of utilitarianism that has long-term costs which courts have not considered.[226] For too long, we have unwittingly engaged in an experiment in which a reorganization result is given decisive weight to the detriment of holders of meritorious legal claims. Moreover, by not considering or weighing the long-term costs to the legal system, we may have incurred unknown costs to the stability of contracts, and ultimately, a legal system based on contracts.

The reaction may be to say that courts should consider reducing or eliminating equitable mootness from their reorganization tool kits. The Third and Ninth Circuits have recently made moves in this direction. The result of reducing or eliminating equitable mootness may be that some businesses do not reorganize, and that reorganization value may be lost. Some may recoil in horror at that thought. My response: so be it.

My cynical side suspects that the result of eliminating or reducing equitable mootness in most chapter 11 cases will not be the immediate liquidation of debtors or the loss of substantial reorganization value. Rather, the likely consequence will be different deals, deals made with less emphasis on expediency and more deference to dissenters' legal claims. And if that is not the consequence, the option is always open for Congress to exercise its bankruptcy powers to add confirmation orders to the list of orders statutorily immune from appeal. Until then, however, we are left with a system infested with a pernicious doctrine that, in the long run, costs more than it saves.

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[226] To repeat the "harm principle" of utilitarianism: "The only purpose for which power can be rightfully exercised over any member of a civilized community, against his will, is to prevent harm to others. His own good, either physical or moral, is not sufficient warrant." John Stuart Mill, On Liberty 21-22 (2d ed. 1859).

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Equitable Mootness Strikes Again: The Near Impossibility of Challenging a Debtor's Critical Vendor Decisions

By Norman N. Kinel on March 17, 2021
Posted in US

Although debtors who file for Chapter 11 bankruptcy generally cannot pay prepetition debts until a plan which complies with the "absolute priority rule" is confirmed, there are a number of now well-established exceptions to this rule. As noted (although not actually ruled upon) by the United States Supreme Court in its controversial "*Jevic*" decision, "[c]ourts, for example, have approved 'first-day' wage orders that allow payment of employees' prepetition wages, 'critical vendor' orders that allow payment of essential suppliers' prepetition invoices, and 'roll-ups' that allow lenders who continue financing the debtor to be paid first on their prepetition claim." *Czyzewski v. Jevic Holding Corp.*, 137 S. Ct. 973, 985 (2017).

With regard to so-called "critical vendor" orders, it has been common practice for more than two decades for debtors who commence chapter 11 bankruptcy cases immediately to seek authority to deem certain of their vendors as "critical," thereby allowing such vendors to leapfrog their prepetition and otherwise second-to-last-in-line (only above equity) claims to the top of the feeding order, resulting in the lucky creditors potentially being at least partially, if not fully, paid in the very early stages of the proceeding.

Courts have adopted a fairly uniform, yet somewhat amorphous and circular test for what type of creditor can reasonably be deemed "critical"—it is one to whom payment is "critical to the debtor's reorganization." *In re Financial News Network Inc.*, 134 B.R. 732, 736 (Bankr. S.D.N.Y. 1991). In practice, courts routinely leave the determination as to which vendors are "critical" to "the sound business judgment of the debtor." *In re United Am., Inc.*, 327 B.R. 776, 782 (Bankr. E.D. Va. 2005). This wide grant of discretion, however, often leads to disgruntled creditors who have not been designated as "critical" and other parties in interest—including creditors' committees—questioning whether the debtor's decisions in this regard are truly objective, made at arm's length and otherwise justified. However, as evidenced by the Second Circuit Court of Appeals' recent decision in GLM DFW, Inc. v. Windstream Holdings, Inc. (In re Windstream Holdings, Inc.), 2021 U.S. App. LEXIS 4630 (Feb. 18, 2021), it is nearly impossible to obtain redress in this regard, given both the wide discretion provided to debtors and other nearly impenetrable roadblocks, such as the doctrine of equitable mootness.

The *Windstream* Case

In the jointly administered bankruptcy cases styled as *In re Windstream Holdings, Inc.*, Case No. 19-22312 (the "Bankruptcy Case") filed in the United States Bankruptcy Court for the Southern District of New York, Windstream Holdings, Inc. and its debtor affiliates ("Windstream" or the "Debtors") filed a critical vendor motion [Bankruptcy Case, Docket No. 16] (the "Vendor Motion"), seeking authority to pay prepetition claims of creditors whose goods or services were claimed to be essential to the success of the incipient reorganization. Windstream alleged that "[a]ny material interruption in the provision of the Critical Vendor Products and Services – however brief – would disrupt the Debtors' operations and could cause irreparable harm to the Debtors' businesses, goodwill, employees, customer base, and market share" and a vendor would be deemed "critical" if a loss of its goods or services would "immediately and irreparably harm" the Debtors' business. Vendor Motion at ¶¶ 13, 16. As is common, however, the Vendor Motion did not name the vendors whom the Debtors believed might potentially qualify as critical, claiming that to do so would compromise the Debtors' ability to negotiate with those vendors if they knew that they were eligible for this preferred treatment.

GLM DFW, Inc. ("GLM"), a creditor holding a $2 million unsecured claim against the Debtors, filed an objection to the motion [Bankruptcy Case, Docket No. 204] (the "Objection"), on three grounds:

> (i) that it was for the Bankruptcy Court to decide who was a critical vendor . . . and not the Debtors; (ii) that the Bankruptcy Code required the disclosure of the identity of the prepetition creditors being paid and the amounts being paid, and that no grounds to seal this information existed; and (iii) that the Bankruptcy Court either failed to impose any standard, or identified an impermissible standard, on what facts and circumstances qualified a creditor to be a critical vendor.

GLM DFW, Inc. v. Windstream Holdings, Inc. (In re Windstream Holdings Inc.), 19-4854 (S.D.N.Y. April 3, 2020) (the "District Court Opinion") (citing the Objection).

On April 22, 2019, the bankruptcy court entered an order (the "Order") overruling the Objection and granting the Vendor Motion on the basis that the requested relief would "provide a material net benefit to the Debtors' estates and creditors after taking into account the Bankruptcy Code's priority scheme." Order at p.1. The Order, as is typical, was very broad, authorizing the Debtors, "***in their sole discretion***, to . . . pay any accrued but unpaid prepetition Vendor claims on a postpetition basis in the ordinary course of business or as may be necessary to secure a vendor's agreement to continue business with the Debtors on Customary Trade Terms, up to the amount set forth for each category of Vendor Claims set forth in the Motion." *Id*. The Debtors were only required to provide the full list of critical vendors to the United States Trustee, the Official Committee of Unsecured Creditors and the bankruptcy court for *in camera* review, but not to the public. *Id*.

GLM appealed to the District Court for the Southern District of New York, arguing that "[t]he most serious problem with the Order is the delegation of the judicial function to the Debtors, whereby the Bankruptcy Court has permitted the Debtors to decide questions of fact," including "who is a critical vendor." District Court Opinion at p. 14. In affirming the bankruptcy court's decision, the district court rejected GLM's "improper delegation" argument, finding that courts routinely allow payments to be made in the sound business judgment of the debtor and that determination of critical vendor status would be "impractical" and "unnecessary" in large cases, given oversight by the U.S. Trustee and the creditors' committee. *Id*. at p. 15. The district court also rejected GLM's argument that it was error to allow the Debtors to keep secret the identities of the proposed critical vendors. *Id*. at pp. 17-18. According to the court, because a list of critical vendors had never been publically filed, Section 107(b)(1) of the Bankruptcy Code—which permits redaction of protected commercial information in public filings—was inapplicable. *Id*. at p. 19. Moreover, even if Section 107 did apply, the court pointed to decisions of other courts holding that the names of critical vendors could be redacted in public filings under Section 107(b)(1). *Id*. at pp. 20-21.

On the merits, the district court held that under Section 363(b) of the Bankruptcy Code, a debtor has "broad flexibility" to make payments outside of the ordinary course of business after articulating "some business justification, other than mere appeasement of major creditors." *Id*. at p. 23. The court listed three requirements for invoking the "doctrine of necessity" under Section 105(a), which is often relied upon as the basis upon which a debtor may pay prepetition claims: "(1) the vendor must be necessary for the successful reorganization of the debtor; (2) the transaction must be in the sound business judgment of the debtor; and (3) the favorable treatment of the critical vendor must not prejudice other unsecured creditors." *Id*. (quoting *In re United*, 327 B.R. at 782). The district court rejected GLM's contention that there needed to be "a formal refusal to provide services," and "while the existence (or not) of such a refusal is a factor to be considered, [the objector] has failed to support its contention that it alone is dispositive." *Id*. at p. 26. Accordingly, the district court affirmed, holding that the bankruptcy court "appropriately applied the doctrine of necessity in this case." *Id*. at p. 28.

GLM appealed the district court's affirmance to the Second Circuit Court of Appeals, but did not seek a stay pending appeal. However, while the appeal was pending, the bankruptcy court confirmed Windstream's chapter 11 plan.

On appeal, GLM raised two alleged errors in the decisions below: (1) that the bankruptcy court improperly delegated its judicial authority to the Debtors to decide who should be paid, such that "the bankruptcy court essentially rubber-stamped Windstream's proposed list of creditors, and should have instead conducted a creditor-by-creditor analysis before allowing Windstream to offer any creditor preferential treatment, and (2) the bankruptcy court erred by not requiring the debtors to publically disclose the identities of those creditors being paid." *GLM DFW*, 2021 U.S. App. LEXIS at *1-2.

In a non-precedential summary order, the Second Circuit dismissed the appeal as equitably moot. According to the circuit court,

> [T]he primary purpose of equitable mootness is to give courts a tool "to avoid disturbing a reorganization plan once implemented." As a result, where, as here, such a plan has already been substantially consummated, we presume that an appeal is equitably moot.

Id. at *3 (internal citations omitted). According to the court, a party seeking to overcome the presumption of equitable mootness may do so only by demonstrating that five factors—referred to as the *Chateaugay* factors—are met:

> (1) the court can still order some effective relief; (2) such relief will not affect the re-emergence of the debtor as a revitalized corporate entity; (3) such relief will not unravel intricate transactions so as to knock the props out from under the authorization for every transaction that has taken place and create an unmanageable, uncontrollable situation for the [b]ankruptcy [c]ourt; (4) the parties who would be adversely affected by the modification have notice of the appeal and an opportunity to participate in the proceedings; and (5) the appellant pursued with diligence all available remedies to obtain a stay of execution of the objectionable order if the failure to do so creates a situation rendering it inequitable to reverse the orders appealed from.

Id. (internal quotations omitted). The court also noted that "it is the appellant's burden to show that all five of these factors are satisfied." *Id.*

GLM took the position that the equitable mootness doctrine was inapplicable because it *was not* appealing the bankruptcy court's confirmation order, an argument rejected by the Second Circuit:

> Our precedent is clear that equitable mootness can be applied 'in a range of contexts,' including appeals involving all manner of bankruptcy court orders.

Id. at *4.

According to the Second Circuit, the creditor's argument "makes little sense," because it "overlooks the important interest of finality that attaches once a reorganization plan is approved and consummated." *Id*. The court decided that equitable mootness applied, "even though [the appellant] has not expressly asked us to reject the bankruptcy court's approval of [the Debtors'] plan of reorganization." *Id*. at *5. The court ruled that GLM had "clearly failed" to satisfy the five *Chateaugay* factors, including by failing to seek a stay or an expedited appeal. *Id*. The court also found that granting the relief sought on appeal "could cause tens of millions of dollars in previously satisfied claims to spring back to life, thereby potentially requiring the bankruptcy court to reopen the plan of reorganization," and that "it would likely be highly disruptive for the creditors that received these funds to return them more than a year later." *Id*. at *6. Finally, the court ruled that even if the court could provide GLM with relief that did not unwind Windstream's plan of reorganization, GLM had "no cognizable interest" in finding out which critical vendors were paid, because "it lacks the ability to parlay them into a possible financial recovery." *Id*. at *6 n.1.

Implications of *Windstream*

For those who regularly represent individual creditors or unsecured creditors' committees, *Windstream* is emblematic of *critical* concerns about the critical vendor process, including: (a) the difficulty of challenging the debtor's determination as to the *criticality* of a particular vendor to a successful reorganization; (b) the degree to which pre-filing and likely potential post-emergence relationships—both good and bad—might influence the "business judgment" being exercised in making the decision; and (c) the degree to which enticing individual creditors with the possibility of receiving critical vendor status may influence their behavior in the case, including for those creditors who sit in a fiduciary capacity as members of a creditors' committee.

At bottom, however, as can be seen in the *Windstream* trio of rulings, critical vendor motions are (i) routinely granted, (ii) left almost entirely to a debtor's discretion to determine who is "critical," and (iii) extremely difficult to challenge—either when the relief is initially sought (typically within days of the chapter 11 filing, at least on an interim basis), or on appeal as a result of, among other things, the ever increasing breadth and application of the equitable mootness doctrine. While critical vendor orders can often serve a useful or even *critical* purpose, more transparency, real accountability and a meaningful opportunity to challenge a debtor's determinations in that regard would promote much needed confidence in the fairness of the process.

Chapter 11 Plans, Due Process Concerns, Jurisdiction & Appeals, Litigation Issues, Post-Confirmation Issues

What's Done is Done: Third Circuit Upholds Equitable Mootness and Rules Out Possibility of Individualized Relief for Timely Objecting Party

Mar 29, 2021

Contributor(s)
Robert Lemons

Bankruptcy courts often dismiss appeals of chapter 11 plans when granting the relief requested in the appeal would undermine the finality and reliability of the corresponding plans, a doctrine known as Equitable Mootness. Over the past several years, certain circuits criticized the doctrine for its lack of statutory basis and effect of avoiding review on the merits. [1]

A recent Third Circuit decision indicated that, despite these concerns, Equitable Mootness is still alive and well, and rejected an argument that an appellate court can avoid Equitable Mootness by allowing "individualized relief" (*i.e.*, where the appellate court allows an appellant recoveries in excess of other creditors in the same class under a chapter 11 plan). However, a concurring opinion by one of the Third Circuit judges highlights continuing concerns regarding the effect of the doctrine on individual appellants and the more general development of bankruptcy jurisprudence.

Nuverra

In *In re Nuverra Environmental Solutions, Inc. v. Hargreaves*, Case No. 18-3084, 834 Fed. Appx. 729 (3d Cir. Jan. 6, 2021), Nuverra Environmental Solutions, Inc. and its affiliated debtors (collectively, "Nuverra" or the "Debtors") confirmed a chapter 11 plan over the objection of David Hargreaves, a holder of unsecured notes. The Debtors' enterprise value was calculated at $302.5 million at plan confirmation, while the Debtors' total prepetition and postpetition secured debt totaled approximately $500 million, entitling the Debtors' unsecured claims to no recoveries under the Bankruptcy Code.

As required by the Bankruptcy Code, the Debtors' plan created classes of claims for plan voting and distribution purposes. Class A6, which Hargreaves belonged to, received securities and cash equal to 6% of the face value of their notes. Meanwhile, Class A7, comprised of trade creditors with debts arising from the Debtors' day-to-day operations, received payment in full. The payment in full was characterized by the parties as a "gift" to be paid by the Debtors' secured creditors, who would own the Debtors post –emergence and accordingly sought to maintain ongoing business relationships with the Debtors' trade creditors.

Class A6 voted to reject the plan and Hargreaves filed an objection, claiming improper classification of claims and unfair discrimination in the treatment of Class A6 compared to the treatment of Class A7. The Bankruptcy Court confirmed the plan over Hargreaves' objection, finding that Class A6 was out of the money no matter what treatment Class A7 received, and that Class A7's claims arose out of the day-to-day operations of the Debtors.

Hargreaves filed his notice of appeal to the District Court on July 25, 2017, the same day that the Bankruptcy Court confirmed the plan. He filed an emergency motion for stay of the confirmation order the next day. The District Court denied the stay request on August 3, 2017, and the plan went effective on August 7, 2017. Two months later, the Reorganized Debtors filed a motion to dismiss Hargreaves' appeal as equitably moot. The District Court agreed and dismissed Hargreaves' appeal on August 21, 2018. Hargreaves timely appealed the District Court's dismissal to the Third Circuit.

At this point, the plan was already substantially consummated and practically could not be unwound. Hargreaves argued, however, that the Third Circuit could grant him a full individual recovery while leaving the plan in place, and while all other members of Class A6 received no additional recoveries because they did not exercise their rights to object to the plan or appeal entry of the confirmation order. The Reorganized Debtors argued that individualized relief would be contrary to the Bankruptcy Code and that Hargreaves could not obtain any relief because his appeal was equitably moot.

Majority Opinion

In its majority opinion, the Third Circuit affirmed the District Court's decision. The Third Circuit restated the basic elements of Equitable Mootness analysis: (1) whether the confirmed plan has been substantially consummated, and (2) if granting the relief requested in the appeal would "fatally scramble the plan" or significantly harm those who relied on the plan.

The Court recognized that the plan had been substantially consummated, and noted that both parties agreed that granting relief for Hargreaves would fatally scramble the plan unless Hargreaves could receive an enhanced individual recovery. The Court's analysis therefore focused on whether such individual recovery was permissible under the Bankruptcy Code.

The Court first dismissed as irrelevant Hargreaves' argument that the relatively "small" sum of his individual recovery justified relief. In doing so, the Court noted that the key question is whether the Bankruptcy Code permits *any* enhanced payments, regardless of their amount, to an appellant.

Turning to that question, the Court held that Hargreaves' individual recovery at a rate higher than recoveries of other creditors in Class A6 was not permitted by the Bankruptcy Code. In particular, the Court found that enhanced recoveries for an appellant (a) would violate Bankruptcy Code § 1123(a)(4)'s restriction on preferential treatment of members *within a class* and (b) is inconsistent with Bankruptcy Code § 1129(b)(1)'s prohibition on unfair discrimination *between classes* under a plan. As noted by the Court, a creditor's objection under § 1129(b)(1) to treatment of other classes' claims under a plan is inherently an objection that would benefit and apply to all other creditors in the same plan class as the objecting creditor because § 1129(b)(1) only relates to treatment between entire classes of creditors. The Court further noted that Hargreaves could not have requested individualized relief at the confirmation hearing due to § 1123(a)(4)'s prohibition on disparate treatment of members within the same plan class, and that allowing Hargreaves on appeal to seek different relief would encourage parties to take inconsistent positions in the bankruptcy court and later on appeal. [2]

Concurring Opinion

Judge Krause concurred with the denial of the appeal, but on different grounds. In her concurring opinion, Judge Krause rejected the application of the Equitable Mootness doctrine to the case, calling it an "ill-advised expansion" of a doctrine that, if used at all, should be used narrowly. She instead held that the Debtors would win the appeal even if the Court rejected

Equitable Mootness arguments to instead analyze other substantive legal questions posed by the appeal.

In so holding, Judge Krause questioned the majority's conclusion that the Bankruptcy Code prohibits individualized plan treatment for an appellant creditor. While Judge Krause agreed with the majority's holding that the Bankruptcy Code does not generally permit disparate treatment of creditors within a plan class, she contended that the majority did not sufficiently analyze Hargreaves' contention that disparate treatment is permissible in an appeal because non-appealing class members effectively agreed to potentially disparate recoveries when they chose not to object to, or appeal the confirmation of, the plan.

Judge Krause further noted that the majority's denial of the appeal on Equitable Mootness grounds precluded the Court from considering other substantive arguments—such as whether senior creditors may gift recoveries to a subset of junior claims with the same priority as other junior claims, whether unfair discrimination objections should focus on the process or the outcome of a plan, and what are the limits on separately classifying similarly ranked claims—and developing bankruptcy jurisprudence accordingly in derogation of the Court's duty to promote its development.

Finally, in a footnote, Judge Krause criticized the lower courts' refusal to stay implementation of the Debtors' plan pending appeal and asserted that predicating appellate review on a lower court's willingness to issue a stay pending appeal raises "serious constitutional and practical concerns."

Conclusion

This was not the first time that Judge Krause took issue with the existence and application of the Equitable Mootness doctrine. In 2015, Judge Krause drafted the concurrence in *In re One2One Communications, LLC*, in which she argued the time had come to reconsider whether Equitable Mootness should exist at all or should be substantially reformed.

However, Judge Krause's concurrence in *Nuverra* highlights the difficulty plan objectors face when appealing plan confirmation. As a litigant before the bankruptcy court, Hargreaves appears to have done everything he needed to do procedurally by filing his objection, appeal, and motion for stay in a timely manner. By the District Court's denial of his motion for stay, the Reorganized Debtors' plan was permitted to move forward to substantial consummation, and Hargreaves' appeal was, for all intents and purposes, lost to Equitable Mootness at that moment.

Notwithstanding Judge Krause's concerns, Equitable Mootness is still a healthy doctrine in the Third Circuit, as evidenced by the majority opinion. This appears consistent with recent decisions of other circuit courts, such as *René Pinto-Lugo, et al. v. Financial Oversight and Management Board of Puerto Rico, et al.*, Case No. 19-1181 (1st Cir. Feb. 8, 2021) (dismissing appeal of plan of adjustment confirmation in Puerto Rico bankruptcy) and *In re Windstream Holdings, Inc.*, Case No. 20-1275-bk (2d Cir. Feb. 18, 2021) (dismissing unsecured creditors' appeal of order permitting payment of debtors' critical vendors).

Footnotes

1. *See* Charles Persons, Equitable Mootness on Life Support: the Third Circuit Further Pares Back the Abstention Doctrine in One2One Communications, Weil Restructuring (Aug. 3, 2015).
2. Hargreaves did not appeal the Third Circuit's decision, which is now final and non-appealable.

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INSIGHTS

Third Circuit Invokes Equitable Mootness to Bar Appeal of Gifting Chapter 11 Plan

MARCH 2021 | NEWSLETTERS

In *In re Nuverra Environmental Solutions, Inc.*, 834 Fed. App'x 729 (3d Cir. 2021), the U.S. Court of Appeals for the Third Circuit handed down a long-awaited ruling that could have addressed, but ultimately did not address, the validity of "gifting" chapter 11 plans under which a senior creditor class gives a portion of its statutorily entitled recovery to one or more junior classes as a means of achieving consensual confirmation. By avoiding the merits and holding that an appeal of an order confirming a "horizontal gifting" plan was equitably moot, the Third Circuit skirted a question that continues to linger in the aftermath of the U.S. Supreme Court decision in *Czyzewski v. Jevic Holding Corp.*, __ U.S. __, 137 S. Ct. 973 (2017). In that case, the Supreme Court invalidated final distributions to creditors departing from the Bankruptcy Code's priority scheme as part of a nonconsensual "structured dismissal" of a chapter 11 case.

Equitable Mootness

The court-fashioned remedy of "equitable mootness" bars adjudication of an appeal when a comprehensive change of circumstances has occurred such that it would be inequitable for a reviewing court to address the merits of the appeal. In bankruptcy cases, appellees often invoke equitable mootness as a basis for precluding appellate review of an order confirming a chapter 11 plan. *See, e.g., In re LCI Holding Company, Inc.*, 802 F.3d 547, 554 (3d Cir. 2015) (stating that the doctrine "comes into play in bankruptcy (so far as we know, its only playground) after a plan of reorganization is approved" and ruling that equitable mootness would not cut off the authority to hear an appeal outside the plan context).

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

Substantially similar tests have been applied by most circuit courts of appeals in assessing whether an appeal of a chapter 11 confirmation order should be dismissed under the doctrine. Those tests generally focus on whether the appellate court can fashion effective and equitable relief. *See, e.g., PPUC Pa. Pub. Util. Comm'n v. Gangi*, 874 F.3d 33, 37 (1st Cir. 2017) (considering whether: (i) the appellant diligently pursued all available remedies to obtain a stay of the confirmation order; (ii) the challenged chapter 11 plan had progressed "to a point well beyond any practicable appellate annulment"; and (iii) providing relief would harm innocent third parties); *JPMCC 2007-C1 Grasslawn Lodging, LLC v. Transwest Resort Props., Inc. (In re Transwest Resort Props., Inc.)*, 801 F.3d 1161, 1167–68 (9th Cir. 2015) (applying a four-factor test, including whether the court "can fashion effective and equitable relief without completely knocking the props out from under the plan and thereby creating an uncontrollable situation for the bankruptcy court"); *Tribune*, 799 F.3d at 278 (considering "(1) whether a confirmed plan has been substantially consummated; and (2) if so, whether granting the relief requested in the appeal will (a) fatally scramble the plan and/or (b) significantly harm third parties who have justifiably relied on plan confirmation"); *Search Market Direct, Inc. v. Jubber (In re Paige)*, 584 F.3d 1327, 1339 (10th Cir. 2009) (applying a six-factor test, including the likely impact upon a successful reorganization of the debtor if the appellant's challenge is successful); *In re United Producers, Inc.*, 526 F.3d 942, 947–48 (6th Cir. 2008) (three-factor test); *TNB Fin., Inc. v. James F. Parker Interests (In re Grimland, Inc.)*, 243 F.3d 228, 231 (5th Cir. 2001) (three-factor test); *see also In re Fin. Oversight & Mgmt. Bd. for Puerto Rico*, 2021 WL 438891, **6-7 (1st Cir. Feb. 8, 2021) (holding that the doctrine of equitable mootness was not abrogated by the U.S. Supreme Court's ruling in *Mission Product Holdings, Inc. v. Tempnology, LLC*, 139 S. Ct. 1652 (2019), and that the doctrine applied to dismiss an appeal of an order approving a plan in a proceeding under the Puerto Rico Oversight, Management, and Economic Stability Act).

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

Nuverra

Nuverra Environmental Solutions, Inc. ("NES") filed a prepackaged chapter 11 case in May 2017 with $500 million in secured debt and a value of approximately $300 million. NES proposed a chapter 11 plan under which: (i) secured noteholders received new stock, representing an estimated 55% recovery, but forfeited $190 million in deficiency claims; (ii) unsecured noteholders received a combination of new stock and cash amounting to a 4–6% recovery; and (iii) trade and certain other business-related unsecured claims (collectively, "trade claims") were paid in full. Secured noteholders agreed to fund payments to holders of unsecured noteholder and trade claims, which otherwise would have received nothing under the plan.

The unsecured noteholder class voted to reject the plan. One unsecured noteholder ("Hargreaves") objected to confirmation, arguing that: (i) the plan's proposed treatment of the dissenting unsecured noteholder class was not "fair and equitable," a requirement for cram-down confirmation under section 1129(b)(1) of the Bankruptcy Code, because the plan distributed less value to that class than to the trade claim class; and (ii) the plan's classification scheme was improper because unsecured noteholder claims and trade claims should not have been separately classified because they were "substantially similar" within the meaning of section 1122(a) of the Bankruptcy Code.

The bankruptcy court overruled the objection and confirmed the plan. The court determined that separate classification of the unsecured noteholder claims and the trade claims was reasonable because trade creditors were critical to the success of reorganized NES.

The bankruptcy court also considered whether the plan satisfied section 1129(b)(1)'s mandate that a chapter 11 plan cannot "discriminate unfairly" with respect to rejecting classes of creditors and shareholders. Applying a test (the Markell test) used by many courts in determining whether a plan "discriminates unfairly," the court found that the disparate treatment of the unsecured noteholder and trade creditor classes gave rise to a rebuttable presumption of unfair discrimination. However, it determined that the presumption had been rebutted because the unsecured noteholder class was "indisputably out of the money and not, otherwise, entitled to any distribution under the [B]ankruptcy [C]ode's priority scheme[,] and … the proposed classification and treatment of the unsecured creditors fosters a reorganization of these debtors."

The court also held that, because the plan distributions to unsecured creditors were "gifted" by the secured creditors from property to which they otherwise would have been entitled, rather than property of the estate—sometimes referred to as "horizontal gifting"—the plan satisfied the "absolute priority rule," which, broadly stated, precludes any distribution to junior creditors unless more senior creditors are paid in full or agree otherwise.

Hargreaves appealed the confirmation order to the district court. The district court denied his emergency request to stay the confirmation order beyond the 10-day period specified in the order.

The district court affirmed. As an initial matter, the court ruled that the appeal was equitably moot. In particular, the district court concluded that NES had "substantially consummated" its chapter 11 plan and that the relief sought by Hargreaves—equal distributions to unsecured noteholders and trade creditors—would "require undoing the [p]lan" and necessarily result in harm to third parties. Specifically, the court noted, "disgorgement would require the clawback, not only of cash payments made to hundreds of individual creditors, but also the clawback of stock that is trading on the national stock exchange, and may now be held by third parties who purchased these securities in the ordinary course."

Nevertheless, the district court addressed the merits of the appeal. It found no fault with the bankruptcy court's conclusions. Among other things, the district court explained that, although "vertical gifting"—gifting in a manner that skips over an intermediate junior class of dissenting creditors—violates the absolute priority rule under Third Circuit precedent, horizontal gifting does not. We provide a more detailed discussion of the bankruptcy and district court rulings and the legal concepts involved.

Hargreaves appealed the ruling to the Third Circuit.

The Third Circuit's Ruling

A divided three-judge panel of the Third Circuit affirmed, but skirted the merits. Instead, the majority ruled that the district court correctly held that the appeal was equitably moot.

Initially, the court explained that Hargreaves, who was the only creditor in the unsecured noteholder class to appeal the confirmation order, sought as a remedy for the alleged unfair discrimination an individual payout of $450,000, equal to a 100% recovery on his claim, but only 0.45% of NES's $173 million enterprise value.

Applying the *Tribune* test for equitable mootness, the Third Circuit concluded that NES's chapter 11 plan had been substantially consummated, but acknowledged that the relief sought, "an individual payout of a relatively small sum," might not "fatally scramble the plan." However, the court held that such relief "is not permitted by the Bankruptcy Code" because it would: (i) violate section 1123(a)(4), which states that a chapter 11 plan must "provide the same treatment for each claim or interest of a particular class, unless the holder of a particular claim or interest agrees to a less favorable treatment"; and (ii) contravene the purpose of the prohibition of unfair discrimination, which "applies only to classes of creditors *(not the individual creditors that comprise them)*, and then only to classes that dissent" (citations and internal quotation marks omitted).

According to the Third Circuit, Hargreaves could not "properly … propose that the appropriate remedy is to pay him only and no one else in his class." It also explained that, if every creditor in the unsecured noteholder class were to be paid in full, the $40 million payment would drain 23.3% of the value of reorganized NES—thus scrambling the plan. The Third Circuit accordingly ruled that Hargreaves's appeal was equitably moot.

In a concurring opinion, Circuit Judge Cheryl Ann Krause sided with NES, but not for the reason cited by the majority. She criticized the majority for "abdicating our jurisdiction" on the basis of equitable mootness—a "narrow" doctrine she has previously decried as "legally ungrounded and practically unadministrable."

According to Judge Krause, because the relief requested by Hargreaves did not threaten to fatally scramble the chapter 11 plan or significantly harm the interest of reliant third parties, the appeal was not equitably moot, and the court should have considered the merits of the appeal. Important issues that should have been addressed, she explained, include: (i) whether "individualized relief" is permitted by section 1123(a)(4) when one member of a class objects to a less-favorable treatment under a plan, but others do not; (ii) whether the Supreme Court's ruling in *Jevic* "foreclose[s] preferential treatment of a sub-class through horizontal gifting"; (iii) whether the unfair discrimination test "focus[es] on the plan's results or the process" that produced them; and (iv) the limits of chapter 11 plan classification schemes. Judge Krause then summarily stated that she would have upheld confirmation of NES's plan on the merits.

Outlook

Senior-class gifting is an important tool for building consensus on the terms of a confirmable chapter 11 plan. The district court's ruling in *Nuverra* dispelled speculation that *Jevic* might presage an end to all kinds of gifting chapter 11 plans, but many anticipated that the Third Circuit would provide additional circuit-level guidance on the issue. It elected not to do so. Thus, courts in that circuit will continue to grapple with an issue that is increasingly a common feature of many chapter 11 plans.

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IN RE: EXIDE HOLDINGS, INC., et al., Debtors.
CALIFORNIA DEPARTMENT OF TOXIC SUBSTANCES CONTROL, Appellant,
v.
EXIDE HOLDINGS, INC., et al., Appellees.

Case No. 20-11157-CSS
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Civ. No. 20-1402-RGA
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OPINION

ANDREWS, UNITED STATES DISTRICT JUDGE:

Chapter 11

(Jointly Administered)

***1** Before the Court is an appeal (D.I. 1) by the California Department of Toxic Substances Control ("DTSC") with respect to the Bankruptcy Court's *Order Confirming Fourth Amended Joint Chapter 11 Plan of Exide Holdings, Inc. and its Affiliated Debtors* ("Exide" or "Debtors"), dated October 16, 2020 (B.D.I. 998) (A-1217)[1] ("Confirmation Order"). The merits of the appeal are fully briefed. (D.I. 45, 54, 59, 62).[2] Both the Debtors and the United States on behalf of the U.S. Environmental Protection Agency ("EPA," and together with the Debtors, "Appellees") assert that the appeal must be dismissed on the basis of equitable mootness and that DTSC's additional arguments are without merit. For the reasons set forth below, while the appeal meets the criteria for equitable mootness, I can readily resolve the merits of the appeal against the appealing party, so the Confirmation Order is affirmed.

I. BACKGROUND

A. The Parties and the Chapter 11 Cases

Exide owned and operated a battery recycling facility in Vernon, California. Although the Vernon plant ceased operations in 2015, the site remains highly contaminated, requiring constant monitoring and containment to assure that hazardous substances are not released into the environment. DTSC is a California regulatory agency with authority to protect California's people and environment from harmful effects of toxic substances by restoring contaminated resources, enforcing hazardous waste laws, reducing hazardous waste generation, and encouraging the manufacture of chemically safer products. Cal. Health & Safety Code §§ 25100 *et seq.*, 25300 *et seq.*, 58000 *et seq.* DTSC implements and enforces these laws, as well as laws concerning the cleanup of releases or threatened releases of hazardous substance.

By early 2020, Exide's business was in jeopardy and facing mounting environmental remediation expenses, rising costs, and operational inefficiencies, which were exacerbated by the COVID-19 pandemic. (B.D.I. 14 ¶¶ 11, 30). On May 19, 2020, Exide commenced a chapter 11 case. (*Id.* ¶ 3). Prior to the bankruptcy filing, Exide conducted a marketing and sale process for substantially all of its Americas and Europe and rest-of-world ("Europe/ROW") businesses, with remaining assets that Exide was unable to sell to be either liquidated or abandoned. (*Id.* ¶¶ 12–13; B.D.I. 948 ("Peluchiwski Confirmation Decl.") ¶¶ 8, 9). Debtors sold their Americas business to an affiliate of Atlas Capital Resources III LP ("Americas Buyer"), and the Bankruptcy Court approved the sale. (B.D.I. 690). An ad hoc group of noteholders ("Consenting Creditors") submitted a credit bid for the Europe/ROW business for $559.4 million. (D.I. 17-1 ("Peluchiwski Stay Decl.") ¶ 7). Debtors did not receive any other qualified bids despite their efforts to obtain them. (Peluchiwski Confirmation Decl. ¶ 17). A special committee reviewed and accepted the bid, determining that it would generate the most value for Debtors' stakeholders and was a better option than liquidation. (*Id.* ¶ 18).

B. Global Settlement and Plan

***2** On a parallel track, and to reduce the risk that sixteen other contaminated sites in ten states would be abandoned in the course of the bankruptcy proceedings, Debtors sought authorization to engage in negotiations, including mediation, with various environmental agencies to achieve a consensual solution for the orderly transition of these non-performing properties ("NPPs") and to proceed on an expedited timeline for the contested abandonment of the NPPs if negotiations were unsuccessful. (B.D.I. 37 ("Settlement Procedures Motion") ¶ 3). Debtors' motion emphasized, "at the end of these chapter 11 cases, the Debtors will not be in business, and as such, they will no longer be able to retain and support the ongoing maintenance and remediation of [the NPPs]." (*Id.* ¶ 2). On June 9, 2020, the Bankruptcy Court entered a Settlement Procedures Order (B.D.I. 242) appointing five mediators.

On July 28, 2020, after nearly two months of negotiations, the parties achieved preliminary acceptance of the mediators' proposal for a global settlement that would be part of a plan of liquidation. All government agencies, including DTSC, agreed to recommend and pursue approval of the global settlement. (*See* B.D.I. 622, 636). The global settlement provided, among other things, for the creation of an environmental remediation trust ("ERT"). The Consenting Creditors and certain Exide entities that would be transferred in the Europe/ROW sale ("Transferred Entities") would then fund the ERT with settlement payments of approximately $10 million. (B.D.I. 942 ¶ 19). Based on an allocation structure, approximately $2.6 million of settlement payments would be allocable to the Vernon site, in addition to more than $26 million in available financial assurances that Debtors put into place long before the settlement. (*Id.* ¶¶ 21, 200; *see* B.D.I. 973 ¶¶ 24, 34). On August 14, 2020, the Debtors filed their proposed plan and disclosure statement (B.D.I. 742, 743), and a confirmation hearing was set for September 25, 2020 (B.D.I. 745 at 11).

On September 15, 2020, DTSC notified Exide that the California Governor's office had rejected the global settlement. (B.D.I. 942 ¶ 22). To avoid widespread abandonment of the NPPs, the parties worked to amend the global settlement and plan in a way that would achieve the same results, albeit without requiring (but leaving the option open for) DTSC's participation.

On September 23, 2020, Exide filed an amended version of the plan, which provided, among other things, that: (a) if certain non-consensual releases were approved, DTSC would still receive the benefit of the $2.6 million that otherwise would have been provided to the Vernon site under the global settlement, regardless of whether the Vernon site was abandoned or transferred to a trust; (b) DTSC could enter into an agreement with the environmental trustee providing covenants not to sue, and if it did so, in addition to the $2.6 million, Exide would transfer the Vernon property to an environmental remediation trust ("Vernon ERT") and the property would be managed by a trustee; and (c) if DTSC did not sign the agreement with the environmental trustee, or if the non-consensual releases were not approved by the Bankruptcy Court, Exide would abandon the Vernon property pursuant to § 554(a) of the Bankruptcy Code. (*See* B.D.I. 871; B.D.I. 944 ¶ 20). Regardless of which option it chose, DTSC would also receive the $26 million in financial assurances that had been funded in advance. (*Id.*; 10/16/20 Tr. 174:14–18; B.D.I. 973 ¶ 46). The Bankruptcy Court adjourned the confirmation hearing from September 25, 2020 to October 15, 2020 to allow DTSC additional time to take discovery. On October 7, 2020, DTSC objected to the plan on the basis that abandonment of the Vernon site and the non-consensual third-party releases were impermissible. (B.D.I. 917).

C. Confirmation Hearing

On October 15 and 16, 2020, the Bankruptcy Court held a confirmation hearing, including live witness testimony and several hours of oral argument. Among the witnesses presented, Eric Fraske, an experienced on-site engineer, testified that the main industrial building on the Vernon site—the portion with the most elevated lead and arsenic levels—was fully contained by a tent-like structure called a Full Enclosure Unit ("FEU"), and that Exide's on-site contractors "maintained and inspected" the structure "daily." (10/15/20 Tr. at 125:15–126:4, 137:22–139:20; B.D.I. 952 ("Fraske Decl.") ¶ 11). Mr. Fraske further testified that he "intend[ed] to continue [his] job and care for the Vernon site" while the site transitioned to the Vernon ERT or to DTSC, and he explained that the site would pose no "threat to health and safety" even if "nobody was able to go to the site for two weeks" to perform maintenance and inspections. (10/15/20 Tr. 131:7–14, 132:13–134:10; *see also* Fraske Decl. ¶¶ 11–13, 17). The Bankruptcy Court found Mr. Fraske to be "extremely competent, very persuasive, and a very honest and forthright witness." (10/16/20 Tr. 176:5–7). The Debtors' CRO, Roy Messing, testified that "over $26 million [in financial assurances] would be made available to DTSC to continue maintenance efforts and restart the remediation efforts at the [Vernon] site." (*See* B.D.I. 950 ("Messing Abandonment Decl.") ¶ 30).

***3** DTSC's witness, Grant Cope, conceded during cross-examination that $26 million would "allow [DTSC] to continue to maintain the current activities at the site" at least until the agency was able to develop a long-term remediation plan. (10/15/20 Tr. 216:13–18). Dr. Gina Solomon of the Public Health Institute testified about lead's toxicity and effects on human health, but offered no opinions specific to the Vernon site. (*Id.* at 232:12–249:8).

D. Confirmation Order and Supplemental Letter Ruling

The Bankruptcy Court confirmed the plan. (10/16/20 Tr. 170:16–19; A1217). First, the Bankruptcy Court approved abandonment of the Vernon site as an alternative and found that abandonment posed "no identifiable imminent threat to the public's safety or to health or humans' general safety." (*Id.* at 179:18–23). The Bankruptcy Court noted that the high concentrations of lead on the Vernon site are contained to areas that are secure and "[o]therwise, people are walking the exterior of the site without respirators." (*Id.* at 177:19–178:5). The Bankruptcy Court further noted, "there are funds available immediately under the plan and under the preexisting set-asides [via $26 million in financial assurances] to fund remediation, or at least preservation of safety at the site for quite some time." (*Id.* at 174:14–18). The Bankruptcy Court also adopted Debtors' voluntary proposal that the property would not be abandoned for two weeks (*i.e.*, no sooner than October 30, 2020) to provide time to transition responsibility to DTSC without any gap in oversight. (*Id.* at 179:2–23, 184:5–20). On October 19, 2020, the Bankruptcy Court issued a supplemental letter (B.D.I. 1003) (A1363) ("Supplemental Ruling") clarifying the gravity and difficulty of the situation:

> The issue is not whether the lead at Vernon is dangerous—it is. The question is whether abandonment of the site presents an imminent danger—it does not. The evidence overwhelmingly established that the site is constantly monitored, and the dangerous polluted areas are contained. The evidence also established that the contractors currently in place are ready, willing, and able to continue their work, provided they are paid.

The Bankruptcy Court also recognized that although "Exide should pay its debts ... it cannot. There is simply no available money to do so." (*Id.*) The Bankruptcy Court further observed that "the abandonment would occur, if at all, on October 30, 2020," which gave DTSC "ample time to arrange for the orderly transfer of responsibility over the site." (*Id.*) The Bankruptcy Court also emphasized that Vernon "is not the Debtors' only environmental site. There are sites in 9 other states and the state and federal agencies responsible for those sites support the settlement contained in the 4th Amended Plan as the best, realistic alternative." (*Id.*)

Regarding the non-consensual third-party releases, the Bankruptcy Court explained that (i) this is an "unprecedented" and "extraordinary case" that "requires extraordinary measures"; (ii) the releases are a "sine qua non of the plan"; and (iii) the releases are "fair, equitable, and reasonable." (10/16/20 Tr. 181:9–182:1; Confirmation Order ¶ I (iii)–(iv)). The Bankruptcy Court further explained that there is "a lot of value being provided in exchange for receipt of the releases." (10/16/20 Tr. 181:18–20). Specifically, the Consenting Creditors and Transferred Entities—who will receive the protections afforded by the non-consensual third-party releases—made critical and substantial contributions to the plan, which were contingent upon the continued effectiveness of those benefits and the finality afforded by the plan and Confirmation Order. (Confirmation Order ¶ I(iii)–(iv)). Accordingly, the plan (B.D.I. 998-2) (A126) was confirmed, and the Bankruptcy Court granted a seven-day stay to allow DTSC to appeal and to seek a stay of the Confirmation Order. (10/16/20 Tr. 185:4–7).

G. Appeal and Denial of Stay Pending Appeal

***4** On October 18, 2020, DTSC filed a notice of appeal. (D.I. 1). On October 19, 2020, DTSC filed an emergency motion for a stay pending the appeal. (D.I. 4). Following oral argument on October 22, 2020 (D.I. 32), I denied the request for stay pending appeal (*id.* at 66:4-14; D.I. 30). Thereafter, DTSC provided the trustee with covenants not to sue, the Vernon ERT was established, and abandonment of the Vernon site was completely avoided. (*See* D.I. 55 ("Singh Decl.") ¶¶ 2-3). Nevertheless, DTSC has filed this appeal because it argues that the plan presented it with a "Hobson's choice" —either accept the intolerable abandonment of the Vernon site or agree to the Vernon site's transfer to the underfunded Vernon ERT—and such a plan should not have been confirmed.

II. JURISDICTION AND STANDARD OF REVIEW

The Court has jurisdiction to hear an appeal from a final judgment of the Bankruptcy Court pursuant to 28 U.S.C. § 158(a)(1). In reviewing the bankruptcy court's determinations, this Court "review[s] the bankruptcy court's legal determinations *de novo*, its factual findings for clear error and its exercise of discretion for abuse thereof." *See* *In re Trans World Airlines, Inc.*, 145 F.3d 124, 130 (3d Cir. 1998).

III. PARTIES' CONTENTIONS

Exide argues that the appeal should be dismissed on the basis of equitable mootness. Acting in reliance on the Confirmation Order, Exide and its stakeholders substantially consummated the plan. Unwinding confirmation, Exide argues, would significantly increase environmental risks at the Vernon site and other contaminated sites nationwide by transferring title to those properties back to an entity on the brink of liquidation. Exide further asserts that it would be impractical and inequitable to undermine the settled expectations of every party in the bankruptcy proceeding and their counterparties, including the environmental regulators in ten states and the United States government, especially when DTSC's primary objection is to abandonment that will never happen anyway. EPA agrees that remanding this case for further proceedings would fatally scramble the plan and threatens the global settlement that protects against the potential abandonment of the NPPs.

DTSC does not dispute that the plan has been substantially consummated, but argues that modifying the Confirmation Order would not "fatally scramble" the plan or harm third parties who justifiably relied on it. Because the plan is a liquidation of Exide's assets, as opposed to a reorganization, DTSC argues, there have been no dramatic changes to the lender or equity base that cannot be "undone after the Effective Date." The plan transactions—such as the Europe/ROW Sale Transaction and funding of various trusts related to the global settlement—could remain intact, DTSC further argues, because narrower relief is possible including: (a) narrowing/eliminating the plan's releases and injunction as they apply to DTSC, and (b) allocating additional funding to "clean up" the Vernon site.

With respect to the merits, DTSC's core contention is that the Bankruptcy Court improperly authorized abandonment of the Vernon site as one possible outcome under the plan. DTSC argues that, despite an identifiable threat to public health and safety, the Bankruptcy Court authorized abandonment of the Vernon site as an option rather than requiring Exide to first remedy the threat. (*See* 10/16/20 Tr. 179:18–23) (A-1833). In doing so, DTSC argues, the Bankruptcy Court misinterpreted and misapplied the Supreme Court's holding in *Midlantic Nat'l Bank v. New Jersey Dep't of Envtl. Prot.*, 474 U.S. 494 (1986). According to DTSC, the Bankruptcy Court further erred in approving the plan because it: (i) improperly approved non-consensual releases; (ii) improperly approved releases by Exide in favor of parties that provided little or no contribution to the plan; (iii) included improper and overly broad injunctions and discharges; and (iv) did not provide equal treatment for each claim in its class.

***5** Having chosen the plan's other option and avoided abandonment of the Vernon site, Exide argues, DTSC's challenge to the plan no longer presents a live case or controversy. If I do reach the merits of the appeal, Exide argues that I should affirm the Confirmation Order in its entirety as the Bankruptcy Court properly authorized abandonment as an alternative. EPA agrees. According to EPA, DTSC's argument that the plan is inconsistent with governing precedent is without merit, and the appeal should be denied. Both Appellees contend that the evidentiary record provides ample support for the Bankruptcy Court's determinations that the releases and injunctions in the plan were necessary, fair, and satisfied the standard for approval. The Bankruptcy Court did not clearly err in finding that Debtors proposed the plan in good faith, Exide argues, as extensive evidence showed that the plan was premised on the court-appointed mediators' settlement proposal after extensive arm's length negotiations in a global settlement overwhelmingly supported by all key stakeholders. The Bankruptcy Court correctly concluded that the plan does not unfairly discriminate against DTSC, Appellees assert, because the plan treated DTSC no better and no worse than other holders of environmental claims.

IV. ANALYSIS

A. The Appeal Meets the Criteria for Equitable Mootness

" 'Equitable mootness' is a narrow doctrine by which an appellate court deems it prudent for practical reasons to forbear deciding an appeal when to grant the relief requested will undermine the finality and reliability of consummated plans of reorganization." *In re Tribune Media Co.*, 799 F.3d 272, 277 (3d Cir. 2015). A court assesses equitable mootness through the application of "prudential" considerations that address "concerns unique to bankruptcy proceedings." *In re Philadelphia Newspapers, LLC*, 690 F.3d 161, 168 (3d Cir. 2012). The Third Circuit has described the analytical steps under the doctrine as asking: "(1) whether a confirmed plan has been substantially consummated; and (2) if so, whether granting the relief requested in the appeal will (a) fatally scramble the plan and/or (b) significantly harm third parties who have justifiably relied on plan confirmation." *In re Nuverra Environmental Solutions, Inc.*, 834 F. App'x 729, 733 (3d Cir. 2021) (quoting *In re Tribune Media Co.*, 799 F.3d 272, 278 (3d Cir. 2015)). Appellees "bear[ ] the burden of overcoming the strong presumption that appeals from confirmation orders of reorganization plans – even those not only approved by confirmation but implemented thereafter (called 'substantial consummation' or simply 'consummation') – need to be decided." *Tribune Media*, 799 F.3d at 278.

1. The Plan Has Been Substantially Consummated

The Bankruptcy Code defines "substantial consummation" to mean:

(A) transfer of all or substantially all of the property proposed by the plan to be transferred;

(B) assumption by the debtor or by the successor to the debtor under the plan of the business or of the management of all or substantially all of the property dealt with by the plan; and

(C) commencement of distribution under the plan.

11 U.S.C. § 1101(2). DTSC does not dispute that the plan has been substantially consummated (D.I. 45 at 5). The record supports a finding that all of the relevant property has been transferred, Exide's successors have assumed management of the businesses and other property, and distributions have begun. [3] 11 U.S.C. § 1101. The "foremost consideration" under the equitable mootness doctrine has been satisfied. *In re Cont'l Airlines*, 91 F.3d 553, 561 (3d Cir. 1996).

2. Modifying the Plan (i) to Narrow/Eliminate DTSC Release and (ii) to Allocate Additional Consideration to the Vernon Site

***6** Once it is established that substantial consummation has occurred, the next step is to "look to whether granting relief will require undoing the plan as opposed to modifying it in a manner that does not cause its collapse." *In re SemCrude L.P.*, 728 F.3d 314, 321 (3d Cir. 2013). A court "should also consider the extent that a successful appeal, by altering the plan or otherwise, will harm third parties who have acted reasonably in reliance on the finality of plan confirmation." *Id.* The Third Circuit instructs that the "starting point is the relief an appellant specifically asks for." *Tribune*, 799 F.3d at 278. According to DTSC, relief on appeal does not require wholesale reversal of the Confirmation Order; rather, narrower relief may "redress DTSC's concerns." (D.I. 45 at 5, 64). In considering available relief, my "starting point" is DTSC's specific request to modify the plan (i) to narrow or eliminate the releases and injunction applicable to DTSC, and (ii) to direct allocation of an "additional $43 million," which DTSC argues is required under *Midlantic* "to mitigate the imminent risk of harm at and from the Vernon Plant." (D.I. 62 at 31).

As to DTSC's request that I modify the plan to narrow or eliminate the releases and injunction which apply to DTSC, Exide argues that this Court cannot pick and choose by altering just those aspects of the plan while leaving everything else unchanged. (D.I. 54 at 28). In this particular case, I agree. The Bankruptcy Court determined that the trust conditions and the third-party releases are the "sine qua non of the plan." (10/16/20 Hr'g Tr. 181:9–182:1). The Consenting Creditors' agreement to pay $12.5 million for the NPPs and general unsecured claims was conditioned on receiving full releases from the beneficiaries. Without that $12.5 million and the Consenting Creditors' credit bid for the Europe/ROW business, the global settlement and plan would have fallen apart. I agree that narrowing or eliminating the releases and injunctions would upend the global settlement that was "a central issue in the formulation of a plan of reorganization." *Tribune*, 799 F.3d at 280.

As to DTSC's request that I modify the plan to allocate an "additional $43 million" in order "to mitigate the imminent risk of harm at and from the Vernon Plant" (D.I. 62 at 31), DTSC posits that "there are numerous ways this could happen," but, in terms of real options, suggests only that I might "fashion a remedy that reallocates value from the Transferred Entities or Consenting Creditors to the satisfaction of environmental claims." (D.I. 45 at 64; D.I. 62 at 31). The Consenting Creditors, however, had no obligation to put ***any*** money into the settlement, as Exide points out, and the Bankruptcy Court could not force third-party creditors to make settlement payments over their objections. *See, e.g., Coca-Cola Bottling Co. of Shreveport, Inc. v. The Coca-Cola Co.*, 769 F. Supp. 671, 707 (D. Del. 1991) ("Courts do not rewrite contracts to include terms not assented to by the parties") *aff'd*, 988 F.2d 414 (3d Cir. 1992); *id.* citing *Glantz Contracting Co. v. General Electric Co.*, 379 So.2d 912, 916 (Miss. 1980) ("Courts do not have the power to make contracts where none exist, nor to modify, add to, or subtract from the terms of one in existence"); *Adelphia Commc'ns*, 367 B.R. at 97 (relief requested "would rewrite the terms of the bargain, which is beyond the power of the Court"). Moreover, the Consenting Creditors have not received any cash distributions under the plan, and Exide does not anticipate having any funds left to make distributions to the Consenting Creditors after satisfying administrative, secured, and priority claims. (Rinaldi Decl. ¶ 8). Even if the entire plan were unwound, the Bankruptcy Court could not force the Consenting Creditors to disgorge distributions and give those funds to DTSC because the Consenting Creditors have not received any distributions. Requiring the Consenting Creditors or Transferred Entities to make additional payments to DTSC would "circumvent the bankruptcy process and give [DTSC] by judicial fiat what it could not achieve by consensus within Chapter 11 proceedings." *Tribune*, 799 F.3d at 281.

***7** The Third Circuit further instructs that "even when a court applies the doctrine of equitable mootness, it does so with a scalpel rather than an axe. To that end, a court may fashion whatever relief is practicable instead of declining review simply because full relief is not available." *Tribune*, 799 F.3d at 278 (internal citations and quotations omitted). As Exide correctly points out, the Court is not able to provide more funding for the Vernon site as a precondition to abandonment because abandonment is not going to occur. And as to other possible sources of funding, I see none. I cannot order Debtors to provide the additional funding when they have no funds to spare. (D.I. 54 at 29). Debtors project to have adequate funds to satisfy only allowed administrative, secured, and priority claims and wind-down expenses as required under the plan. (Rinaldi Decl. ¶¶ 8–10). If Debtors were required to provide additional funding for the Vernon site, they would need to divert funds reserved for administrative, secured, and priority creditors (whose claims must be satisfied in full under the plan and the Bankruptcy Code). I agree that, "Reallocating those funds to keep them in reserve for the no-longer-existent possibility that the Vernon property might be abandoned would pointlessly leave Debtors unable to satisfy their obligations under the Plan to pay administrative, other secured, and priority claims, to the detriment of approximately 280 administrative, secured, and priority creditors who relied on such treatment in supporting or not opposing the Plan." (*Id.* ¶ 9).[4] EPA agrees, adding that no evidence was adduced to contradict Debtors' position that they "simply do not have the financial or human resources to pivot to anything but a chapter 7 liquidation if the amended plan is not confirmed." (B.D.I. 871 ¶ 15). It seems a foregone conclusion that any remand of this case would result in a conversion to chapter 7, and conversion would threaten the protections to public health and safety accomplished through the plan, including those provided to DTSC to date. Even assuming DTSC is successful on appeal, it is unclear what other practicable relief I may grant at this point.

B. The Confirmation Order Is Affirmed

I find the appeal meets the criteria for equitable mootness, but I can "readily resolve the merits of [the] appeal against the appealing party." *Tribune*, 799 F.3d at 278. So I hold that the Confirmation Order is affirmed.

1. The Abandonment Issue Does Not Present a Live Case or Controversy

Exide argues that while abandonment previously was a possibility under the plan, there is no longer any possibility that Debtors will abandon the site. The plan provided that the Vernon site would be transferred to the Vernon ERT—and would not be abandoned—if DTSC executed the agreement with the environmental trustee providing covenants not to sue, which DTSC did immediately after I denied the stay. Thus, DTSC's challenge to something that will never occur—and thus cannot injure it—no longer presents a live case or controversy. I agree.

Under Article III, " 'an actual controversy' must exist ... through 'all stages' of the litigation," *Already, LLC v. Nike, Inc.*, 568 U.S. 85, 90-91 (2013), and the alleged injury must be "actual or imminent; fairly traceable to the challenged action; and redressable by a favorable ruling," *Clapper v. Amnesty Int'l USA*, 568 U.S. 398, 409 (2013) (citation omitted). Developments that "eliminate a plaintiff's personal stake in the outcome of a suit or prevent a court from being able to grant the requested relief" render a case moot. *Donovan ex rel. Donovan v. Punxsutawney Area Sch. Bd.*, 336 F.3d 211, 216 (3d Cir. 2003) (citation omitted). DTSC's challenge to the possibility of abandonment is now moot because there is no actual or imminent possibility that the Debtors will abandon the Vernon site. DTSC signed the agreement providing covenants not to sue the environmental trustee, allowing Debtors to transfer the site to the Vernon ERT. (*See* Puga Decl. ¶ 6). Debtors thus did not abandon the Vernon site and will not abandon it in the future (much less imminently). Because the Vernon ERT now owns and maintains the site, the alleged harm DTSC warned could occur upon abandonment never happened. Pursuant to the trustee's plan, contractors have continued to perform safety measures that DTSC claimed would "cease immediately upon abandonment," such as "dust suppression and air monitoring," "water treatment," and daily inspections. (D.I. 45 at 33–34; Puga Decl. ¶ 15). There has been "no stoppage of containment efforts." (D.I. 45 at 33; Puga Decl. ¶ 7). Government regulators did not have to "assume management responsibilities" over the Vernon site (D.I. 45 at 31) as the Vernon ERT is managing the property using funds from the settlement and financial assurances. (Puga Decl. ¶¶ 7, 16–18). DTSC identifies no concrete injury to it arising from the fact that the Vernon ERT (rather than Exide) is now managing the property. DTSC's objection is that DTSC itself might have had to take over responsibility for the site upon abandonment, but that possibility is no longer actual or imminent.

***8** As the EPA correctly points out, DTSC fares no better by seeking to characterize the plan as presenting it with a "Hobson's choice." (D.I. 45 at 4). Having agreed to participate in the Vernon ERT, DTSC can no longer complain that it would have been injured if it had selected the abandonment option instead. That possibility is in the past and will never recur, DTSC has identified no ongoing harm that it suffers because it was once presented with that choice, and an order from this Court reversing confirmation of the plan could not provide DTSC any redress.

2. The Conditions Contained in the Plan Satisfy the *Midlantic* Standard for Abandonment

Even assuming abandonment issue was not mooted, [5] the conditions contained in the plan satisfy the standard for abandonment under *Midlantic.* Under § 554 of the Bankruptcy Code, a court ordinarily can authorize the abandonment of property that is "burdensome to the estate." 11 U.S.C. § 554. The Supreme Court has recognized a "narrow" exception to that power, concluding that a bankruptcy court cannot "authorize an abandonment without formulating conditions that will adequately protect the public's health and safety." *Midlantic*, 474 U.S. at 502, 507 & n.9. That exception "does not encompass a speculative or indeterminate future violation of [health or safety] laws that may stem from abandonment." *Id.* at 507 n.9. It is only limited by "laws or regulations" that are "reasonably calculated to protect the public health or safety from imminent and identifiable harm." *Id.* Thus, courts disallow abandonment only where both (i) the abandonment itself poses "an imminent and identifiable harm to the public health or safety" and (ii) the debtor is "attempting to abandon property in contravention of state or local laws or regulations designed to protect the public." *In re Unidigital, Inc.*, 262 B.R. 283, 286–87 (Bankr. D. Del. 2001) (citing numerous cases).

DTSC argues that absent authorization to abandon the Vernon site, the plan was not confirmable, and the Bankruptcy Court erred in authorizing abandonment based on a misapplication of *Midlantic.* According to DTSC, the undisputed record demonstrates that the Vernon site posed an imminent and identifiable harm to the public health and safety, and, under *Midlantic*, "a trustee may not abandon property in contravention of a state statute or regulation that is reasonably designed to protect the public health or safety from identified hazards." 474 U.S. at 507. Debtors agree that the Vernon site is contaminated and that, without appropriate safeguards, it poses imminent and identifiable threats to human health and safety. However, in challenging the Bankruptcy Court's confirmation of the plan, Debtors argue, DTSC has ignored the protections and conditions the plan placed on the abandonment option, "conditions that will adequately protect the public's health and safety." *Midlantic*, 474 U.S. at 506-07. I agree.

a. Determination that the Vernon Site Unlikely Posed Imminent Threat to Public Health and Safety Is Not Clearly Erroneous

A bankruptcy court's determination of whether there is an "imminent threat" is a case-specific factual inquiry reviewed for clear error. *See In re Smith-Douglass, Inc.*, 856 F.2d 12, 16 (4th Cir. 1988). Based on the record, I see no clear error. The resident engineer at the Vernon site testified during his live direct and cross-examinations at the confirmation hearing that the site was secure and unlikely to pose an imminent threat to the public. (*See* 10/16/20 Tr. 176:5–7; 10/15/20 Tr. 120:18–121:23, 126:21–127:5, 131:7–14, 133:12–134:13). Evidence established that the contractors currently in place were able to continue their work, provided they were paid. (*See* Suppl. Ruling at 2). Mr. Fraske testified that, if abandonment occurred, he would continue to maintain the site while the parties "worked something out." (10/15/20 Tr. 132:13–133:10). DTSC's own witness, Mr. Cope, testified that DTSC was already in communication with various vendors, including the operator of the FEU, about continuing work, had obtained estimates from certain vendors, had conducted preliminary contract negotiations, and was "doing everything we can, 100 percent, everything that we can to protect [the people of California]." (*Id.* at 182:11–184:3, 211:16–20). The plan provided $29 million [6] in immediately available funding, which would pay for onsite or offsite remediation efforts and enable contractors to continue working. (10/16/20 Tr. 174:14–18). DTSC's own evidence showed that completing "phase one" closure without removing buildings and installing a cover would cost $27,325,298—less than the funds available to DTSC under the plan. (*See* Exh. 1 (B.D.I. 917-9) to B.D.I. 917-8 ("Myers Decl.")). The Confirmation Order extended Debtors' contractual obligations with a critical vendor through October 30, 2020 (Suppl. Ruling at 2), and this extension allowed for the orderly transfer of responsibility and continuation of protections for the public's health and safety at the Vernon site. I find no clear error in the Bankruptcy Court's determination that, based on these conditions, the Vernon site posed no imminent threat to public health and safety.

***9** According to DTSC, the Bankruptcy Court's analysis misconstrues *Midlantic's* first factor, which addresses whether the property itself—in a static state—presents an imminent and identifiable risk of harm to public health and safety. According to DTSC, "[a]llowing a debtor to abandon property because government agencies exist and will take action to address threats to public health and safety is contrary to the Supreme Court's clear directive," and "*Midlantic* requires additional funding to clean up the Vernon Plant before abandonment would be appropriate." (D.I. 45 at 6, 25). I agree with Exide that DTSC is attacking a strawman. The Bankruptcy Court did not authorize abandonment and simply leave DTSC to pick up the pieces with nothing more than $2.6 million. DTSC fails to mention the ongoing efforts to maintain the site, the additional $26 million in financial assurances available to DTSC, the two-week transition period, and DTSC's ability to avoid abandonment entirely by participating in the Vernon ERT. (10/16/20 Tr. 179:2–7). The Bankruptcy Court only allowed abandonment as an alternative after finding no threat of "imminent and identifiable harm" to the public and "formulating conditions that will adequately protect the public's health and safety." *Midlantic*, 474 U.S. at 507 & n.9. Moreover, the Bankruptcy Court's conclusion that governments may sometimes have to step in where there is no identifiable imminent danger to the public is not inconsistent with *Midlantic.* DTSC's position—that abandonment is impermissible if it requires a government to take any action in response—would replace *Midlantic*'s narrow exception with a requirement that bankrupt parties must assume "long-term obligations" and eliminate all long-term risks before abandonment. This is not the standard set forth in *Midlantic.*

The plan provides for: (i) the unimpeded access to $26.5 million in financial assurances available to the DTSC; (ii) contribution of another $2,587,523 by the Consenting Creditors for the exclusive benefit of the Vernon site; (iii) the possibility of the establishment of the Vernon ERT; and (iv) the grant of a first-position lien on the Vernon site in favor of DTSC. (*See* B.D.I. 869-1 at Section XII; B.D.I. 998-2 at Section 5.2(e) and Sch. 1). These protections stand in stark contrast to the facts in *Midlantic* where the trustee "was not required to take even relatively minor steps to reduce imminent danger," and whose conduct "aggravated already existing dangers." *Midlantic*, 474 U.S. at 499 n.3. I find no clear error in the Bankruptcy Court's determination that plan conditions would avoid a chaotic abandonment and will adequately protect the public's health and safety.

b. The Record Supports the Bankruptcy Court's Findings

DTSC argues that the Bankruptcy Court made factual findings unsupported or contradicted by the evidence and takes issue with observations made in the Bankruptcy Court's bench ruling. (*See* D.I. 45 at 31-35). According to DTSC, the evidentiary record did not establish that the existing containment efforts eliminated the risk of exposure of surrounding communities. (D.I. 45 a 21). Rather, DTSC argues, the record shows that (i) even lead contamination "contained" at low levels poses serious adverse health effects, (ii) the Vernon site's most highly polluted areas were only contained by a temporary structure that experienced several failures during the chapter 11 cases, and (iii) the areas outside of the FEU contained high concentrations of lead and required daily maintenance to prevent further migration of those chemicals into the neighborhood and water supplies.

Mr. Fraske, the only witness with first-hand knowledge about the Vernon site, testified, “the Site is stable and secured, and nothing on the Site presents any imminent threat to public health and safety.” (Fraske Decl. ¶ 17; *see also* 10/15/20 Tr. 120:18–121:23, 126:21–127:5, 131:7–14, 133:12–134:13). Mr. Fraske further testified that the property would remain stable and secured “even if there were a several-week time gap between Exide's abandonment and the DTSC's takeover of closure operation oversight.” (Fraske Decl. ¶ 17; *see also* 10/15/20 Tr. 133:12–134:13). The Bankruptcy Court's analysis took into account the credibility of the witnesses. Specifically, the Bankruptcy Court found that Mr. Fraske had credibly testified at the confirmation hearing that the site was secure and unlikely to pose an imminent threat to the public. (*See* 10/16/20 Tr. 176:5–7; 10/15/20 Tr. 120:18–121:23, 126:21–127:5, 131:7–14, 133:12–134:13). By contrast, the Bankruptcy Court found that the testimony DTSC offered on the issue was “not ... particularly persuasive” because DTSC's principal witness, Mr. Cope, was “evasive” and “doesn't have any real insight” into “the actual facts on the ground.” (10/16/20 Tr. 176:12–19.9).

***10** DTSC notes that Dr. Solomon testified that “even low levels of lead exposure have serious health effects,” and argues that “the lead at present levels at the site poses major health risks.” (D.I. 45 at 31). But that testimony ignores that the lead at the Vernon site is contained, maintained, and managed. *Midlantic* does not impose “a *per se* principle” that “*any* detectable amount of ... contamination, no matter its intensity, ... poses an imminent threat to public health and safety.” *In re Guterl Special Steel Corp.*, 316 B.R. 843, 858–59 (Bankr. W.D. Pa. 2004) (permitting abandonment of site containing radioactive waste). If that were the rule, “virtually every site in our environment would pose an imminent threat to public health and safety.” *Id.* The Bankruptcy Court acknowledged that “the Vernon site is dangerous and exposure to lead is highly dangerous,” but found that abandonment as an option under the proposed plan would not pose an imminent threat of public harm because “[t]he evidence overwhelmingly established that the site is constantly monitored, and the dangerous polluted areas are contained.” (Suppl. Ruling at 2). Those findings are consistent with *Midlantic* and supported by the record.

DTSC asks me to second-guess the Bankruptcy Court's factual findings that “the polluted areas are contained” and that “areas outside the FEU are safe.” (D.I. 45 at 32–35). The evidence presented at the confirmation hearing, however, supports the Bankruptcy Court's determinations that the Vernon site is constantly monitored and that dangerous polluted areas are contained. Mr. Fraske testified that the portions of the site with high lead levels were “fully secured,” on-site contractors “maintained and inspected” the FEU “daily,” DTSC's own inspectors did not wear respirators outside the FEU, and daily perimeter air samples had not shown lead above permissible levels since closure activities commenced in 2017, even when there were tears in the FEU that required repair. (Fraske Decl. ¶¶ 11–13, 15, 17; 10/15/20 Tr. 120:4–134:13). DTSC points out that Mr. Fraske testified that the FEU needs to be reinforced regularly, there are sometimes tears in the FEU that need repair, and surface dust has to be sprayed down. (D.I. 45 at 33–34). The Bankruptcy Court, however, weighed that testimony against all of the other record evidence and ultimately found that the lead was fully contained. These findings are not clearly erroneous.

Finally, DTSC relies on the Myers Declaration in support of its argument that it would take $72 million to mitigate the imminent risk of harm at and from the Vernon site, which in DTSC's view, should have been required under the plan to satisfy the requirements of *Midlantic* and in order to complete actions prior to abandonment such as building removal, foundation removal, and an asphalt cap. DTSC introduced evidence of an approved “closure plan” for the Vernon site. (*See* B.D.I. 917-5). An approved closure plan establishes the process for closure of “any hazardous waste management unit, for example a surface impoundment or containment building that the facility used to treat, store, or dispose of hazardous waste.” (*See* B.D.I. 917-1 (“Cope Decl.”) at ¶ 41). DTSC also introduced evidence that the cost to complete “Phase I” closure and complete corrective actions, which are an essential part of mitigating the imminent risk of harm at and from the Vernon site, is less than $29 million. (Myers Decl. Ex. 1 at Lines 1.0, 6A, and 6B). According to DTSC's own testimony, the Closure Plan has three stages:

> (1) “Phase One” closure work to remove all hazardous waste from all regulated hazardous waste units, to remove all such units and to demolish to grade all buildings related to such hazardous waste units;

> (2) "Phase Two" contingent closure work to address unforeseen circumstances that arise during closure or additional activities that are required to complete or certify final facility closure, including removal of contaminated soil beneath the equipment, buildings, structures and pavement; and (3) "Phase Three" post-closure and contingent post-closure work to implement long-term inspections, monitoring and maintenance.

***11** (B.D.I. 917-1 at ¶ 12). Mr. Myers opines that "[c]ompleting Phase 1 closure and certain corrective action tasks are an essential part of mitigating the imminent risk of harm at and from the [Vernon] Plant." (*See* B.D.I. 917-9 at ¶ 2). Based on the evidence presented by DTSC, completing Phase 1 of the closure plan and mitigating the imminent risk of harm at and from the Vernon site will cost $27,325,298—which is less than the amount of funds available to DTSC under the plan following entry of the Confirmation Order.[7] Whereas Mr. Myers estimates additional costs of $44.7 million meant to sustain the Vernon site on a long term basis, he does not explain how these expenses are connected to imminent and identifiable harms (*see* B.D.I. 917-9 at Ex. 1, Line 3), and *Midlantic* does not reach "speculative or indeterminate future" violations. *Midlantic*, 474 U.S. at 507 n.9.

DTSC's litigation position supplants the requirements of *Midlantic* with long-term obligations. Although the evidence establishes that the Vernon site is highly contaminated and requires appropriate safeguards to protect against imminent and identifiable threats to health and the environment, it also establishes support for the Bankruptcy Court's conclusion that the plan meets *Midlantic*'s requirements by establishing conditions that would adequately protect the public's health and safety—including the unimpeded access of up to $29 million to use towards completing Phase 1 of the DTSC-approved closure plan. I find no clear error in the Bankruptcy Court's authorization of abandonment as an option under the plan based on the specific facts and circumstances of this case.

3. The Good Faith Finding Is Supported by the Record

The Bankruptcy Court found that the plan had been "proposed in good faith" and was "the result of extensive, good faith, arm's length negotiations among the Debtors and their principal constituencies." (Confirmation Order ¶ F). DTSC argues that the Bankruptcy Court erred in holding that the plan was proposed in good faith pursuant to § 1129(a)(3). (*See* D.I. 45 at 35-38). According to DTSC, the proposal and solicitation of the initial version of the plan was premised on all parties agreeing to the proposed settlement. Following DTSC's rejection of the settlement, however, the plan was intentionally restructured to force the settlement on DTSC.

As DTSC correctly points out, § 1129(a)(3) of the Bankruptcy Code requires a debtor to show that the plan has been proposed in good faith and not by any means forbidden by law. The good-faith determination is "a factual inquiry into a totality of the circumstances surrounding the plan's proposal," and "bankruptcy courts are in the best position to ascertain the good faith of the parties' proposals." *In re W.R. Grace & Co.*, 475 B.R. 34, 87 (D. Del. 2012), *aff'd*, 532 F. App'x 264, 729 F.3d 311, 729 F.3d 332 (3d Cir. 2013). "[D]eterminations of fact pertaining to good faith are reviewed for clear error." *In re PWS Holding Corp.*, 228 F.3d 224, 242 (3d Cir. 2000).

A plan is proposed in good faith only if it will "fairly achieve a result consistent with the objectives and purposes of the Bankruptcy Code." *In re Combustion Eng'g, Inc.*, 391 F.3d 190, 247 (3d Cir. 2004) (citation omitted). "[T]he Bankruptcy Code's objectives include: giving debtors a fresh start in life, discouraging debtor misconduct, the expeditious liquidation and distribution of the bankruptcy estate to its creditors, and achieving fundamental fairness and justice." *In re Am. Capital Equip., LLC*, 688 F.3d 145, 157 (3d Cir. 2012) (internal citations and quotations omitted). Courts have also considered whether the plan "(1) fosters a result consistent with the Code's objectives, (2) the plan has been proposed with honesty and good intentions ... and (3) there was fundamental fairness in dealing with the creditors." *In re Genesis Health Ventures, Inc.*, 266 B.R. 591, 609 (Bankr. D. Del. 2001).

***12** According to DTSC, Exide's lack of good faith is evidenced by the plan's "coercive provisions," which were engineered "to compel DTSC to elect treatment under the plan identical to the terms of a settlement DTSC previously rejected." (D.I. 45 at 36). "Exide's hurried proposal of a plan contingent on the abandonment of a property that presented clear imminent and identifiable threats to the public safety and designed to coerce action from DTSC is not a plan proposed in good faith." *Id.* DTSC asserts that Exide "engineered" a Plan "to force DTSC to accept the very settlement it rejected" and "ramm[ed] an unlawful Plan through the confirmation process." (D.I. 45 at 38, 61). But DTSC cites no evidence from the record, and its argument gives short shrift to the entirely consensual settlement and plan process as a whole which preceded DTSC's decision to reject the very settlement it negotiated.

To address the threats posed by the Debtors' contaminated properties, the plan avoids a contested abandonment process by incorporating the global settlement, which establishes an ERT for the sixteen NPPs and a separate ERT for the Vernon site. Extensive evidence showed that the plan was premised on the court-appointed mediators' settlement proposal after lengthy arm's length negotiations. The global settlement was overwhelmingly supported by all key stakeholders—including the creditors' committee, ten state environmental regulators, and the U.S. government—and was fully consistent with the objectives of chapter 11. (*See* B.D.I. 973 ¶ 1). DTSC itself participated throughout the mediation process, agreed to recommend the settlement to those with authority, and participated in drafting the settlement documents—until just ten days before the original confirmation hearing date. (B.D.I. 944 ¶¶ 18, 21, 22, 50, 140). When DTSC pulled its support, Exide and the other key stakeholders scrambled to save the global settlement, ultimately adjusting the proposed plan to account for DTSC's withdrawal while still giving DTSC the option to opt back into the global settlement.

Moreover, the amended proposed plan allowed DTSC to receive the same settlement payment it would have received under the initial plan, provided that the Bankruptcy Court approved the consideration for the settlement payment (*i.e.*, the third-party releases). DTSC's contention that this structure was meant "to force DTSC to accept (or at least not contest) the Non-consensual Releases" (D.I. 45 at 38), is not supported by the record. Unsurprisingly, the third parties were unwilling to make settlement payments to DTSC unless they received some assurance that DTSC would not sue them afterwards. And DTSC's contention that the plan conditioned DTSC's treatment on "a condition outside DTSC's control"— *i.e.*, the Bankruptcy Court's approval of the non-consensual third-party releases—misses the mark. As Exide points out, non-consensual releases are by definition always outside a non-consenting party's control. The Third Circuit, however, has instructed that third-party releases may be permissible when they are "integral to the restructuring" and fair. *In re Millennium Lab Holdings II, LLC*, 945 F.3d 126, 137–40 (3d Cir. 2019). The plan's inclusion of such releases alone does not undermine a finding of good faith.

The record demonstrates that the plan was proposed in good faith as a way to preserve the proposal made by the mediators, and I see no error in the Bankruptcy Court's finding.

4. The Plan Releases and Injunction Are Proper

DTSC appeals three plan provisions that Exide asserts are central to the global settlement and implementing the plan: (a) the non-consensual third-party releases; (b) the releases granted by the Debtors in Section 10.5 of the Plan (the "Debtor Release"); and (c) the injunction provisions in Section 10.3 of the Plan. "Determining the fairness of a plan which includes the release of non-debtors requires the consideration of numerous factors and the conclusion is often dictated by the specific facts of the case." *In re Wash. Mut., Inc.*, 442 B.R. 314, 345 (Bankr. D. Del. 2011). Courts review the approval of releases and injunctions for clear error. *Cf. In re Cont'l Airlines*, 203 F.3d 203, 217 (3d Cir. 2000) (conducting detailed case-specific factual inquiry).

***13** As an initial matter, as Exide correctly points out, DTSC has misapprehended the scope of the third-party releases and the Debtor Release. First, the non-consensual third-party releases that bar DTSC from bringing suit only protect the Consenting Creditors and a subset of their related parties (*i.e.*, the Transferred Entities, the Europe/ROW Purchaser, and the indenture trustee for the notes). (Plan § 10.6(f)).[8] These parties made various contributions to enable DTSC to benefit from the plan and the Vernon ERT, including contributing $18.5 million in settlements, consenting to use of cash collateral and debtor-in-possession financing, purchasing the Europe/ROW business and canceling debt in connection therewith, waiving deficiency claims, and releasing liens on NPPs. (*See* Confirmation Order ¶ I(iii)–(iv)). Second, the Debtor Release only applies to estate claims held by the Debtors, not direct claims held by DTSC or claims against the Debtors. (Plan § 10.5). DTSC suggests that the Debtor Release somehow prevents it from "pursu[ing] environmental claims against the Released Parties." (D.I. 45 at 47). While the Debtor Release applies to a broader group of released parties than the third-party releases, it does not prevent DTSC from bringing any direct claims it may have against those additional parties.

a. Third Party Releases

To grant non-consensual releases, a court must assess "fairness, necessity to the reorganization, and [make] specific factual findings to support these conclusions." *Cont'l Airlines*, 203 F.3d at 214. These considerations might include whether: "(i) the non-consensual release is necessary to the success of the reorganization; (ii) the releasees have provided a critical financial contribution to the debtor's plan; (iii) the releasees' financial contribution is necessary to make the plan feasible; and (iv) the release is fair to the non-consenting creditors, *i.e.* whether the non-consenting creditors received reasonable compensation in exchange for the release." *In re Spansion, Inc.*, 426 B.R. 114, 144 (Bankr. D. Del. 2010).

The finding that the Consenting Creditors and Transferred Entities—who will receive the protections afforded by the non-consensual third-party releases—made critical and substantial contributions to the plan is supported by the record. (Confirmation Order ¶ I(iii)–(iv)). Those contributions included: (a) funding $18.5 million in settlement payments; (b) consenting to the use of cash collateral; (c) contributing a significant portion of the debtor-in-possession financing capital; (d) purchasing Debtors' Europe/ROW business when there were no other qualified bidders; (e) waiving deficiency claims against Debtors; (f) releasing their liens on Debtors' NPPs to facilitate the global settlement and provide additional value to the environmental agencies, including DTSC; and (g) canceling Debtors' guarantee of $155.9 million of principal obligations under a superpriority notes indenture. (B.D.I. 944 ¶ 32).

DTSC acknowledges that the settlement payments were "consideration" for the third-party releases, but dismisses the payments as "inadequate." (D.I. 45 at 42). The mere fact that DTSC believes the consideration too low does not meet the exacting standard for reversing the Bankruptcy Court's finding of fact on the clear error standard. *See* *Anderson v. City of Bessemer City, N.C.*, 470 U.S. 564, 573–74 (1985). And, as the record demonstrates, $12.5 million was the amount that the five mediators recommended and that the parties agree to in the global settlement. (*See* B.D.I. 944 ¶ 23; B.D.I. 636 ¶ 4).

DTSC further contends that "non-consensual third-party releases are, by definition, not necessary for reorganization" when there is a liquidation. (D.I. 45 at 41). This case was not a chapter 7 liquidation, and a traditional reorganization of a going-concern business is not a mandatory precondition for non-consensual releases; chapter 11 liquidation plans may also qualify for such relief. *See* *In re Medford Crossings N., LLC*, 2011 WL 182815, at *18 (Bankr. D.N.J. Jan. 20, 2011) (rejecting argument that a liquidating plan is *per se* ineligible for third-party releases and injunctions); *In re U.S. Fidelis, Inc.*, 481 B.R. 503, 520 (Bankr. E.D. Mo. 2012) (similar). Here, the plan involved a combination of a reorganization through the Europe/ROW sale, transfers of the NPPs to ERTs, and a liquidation of Debtors' remaining assets. The released parties' contributions (and third-party releases) were necessary to the process.

***14** DTSC further asserts that this was not an "extraordinary case" that justifies the grant of third-party releases. (D.I. 45 at 44). The Bankruptcy Court found that this case was "really ... unprecedented" because of the complex environmental issues and the limited financial resources available for remediation. (10/16/20 Tr. 181:9–17 (crediting Mr. Tenenbaum's analysis of why this case was extraordinary); *id.* 120:20–121:4 (Mr. Tenenbaum explaining that "in my 32 years at the Department of Justice, this is about the most unusual circumstance I've ever encountered")). DTSC has failed to show that the Court's conclusion was clearly erroneous. Finally, I agree with Exide that DTSC's argument that Debtors' investigation "did not include environmental claims" is a red herring. (D.I. 45 at 45). Debtors had no obligation to investigate claims that third parties might have against other third parties, and DTSC cites no authority supporting this argument.

The unique facts and circumstance of this case support the Bankruptcy Court's finding that a third party release was sine qua non for the Consenting Creditors to voluntarily contribute funds necessary for the consummation of the plan. The Bankruptcy Court used the appropriate standard for determining that the third-party releases were justified, and the Bankruptcy Court's findings are not clearly erroneous.

b. Debtor Release

Section 10.5 of the plan released estate claims held by the Debtors. Under Bankruptcy Code § 1123(b)(3)(A), a debtor acting as debtor-in-possession may release its own claims against third parties "if the release is a valid exercise of the debtor's business judgment, is fair, reasonable, arid in the best interests of the estate." *Spansion*, 426 B.R. at 143. When evaluating a debtor's release of claims, bankruptcy courts sometimes consider the factors listed in *In re Zenith Elecs. Corp.*, 241 B.R. 92, 110 (Bankr. D. Del. 1999), including: (i) an identity of interest between the debtor and non-debtor such that a suit against the non-debtor will deplete the estate's resources; (ii) a substantial contribution to the plan by the non-debtor; (iii) the necessity of the release to the reorganization; (iv) the overwhelming acceptance of the plan and release by creditors and interest holders; and (v) the payment of all or substantially all of the claims of the creditors and interest holders under the plan. The factors "are neither exclusive nor conjunctive requirements, but simply provide guidance in the Court's determination of fairness." *Wash. Mut.*, 442 B.R. at 346. According to DTSC, approval of the Debtor Release was an abuse of discretion because it does not satisfy any of the *Zenith* factors. (D.I. 45 at 46–47).

Exide argues that such a release is appropriate where a debtor concludes in its business judgment that any claims it might have against third parties are only marginally viable and unlikely to have significant value. *See PWS Holding*, 228 F.3d at 242 (approving release by debtor of potential claims where claims were "of only marginal viability" and not worth pursuing). Applying the *Zenith* factors, Exide argues, ample evidence shows that the Debtor Release was fair, reasonable, and in the best interests of the estate. *See Zenith*, 241 B.R. at 110.

I agree with Exide. The Bankruptcy Court found that the Debtor Release was "an essential component of the Plan and appropriate" because, among other things, (i) an independent subcommittee investigated potential claims and "properly concluded that the Debtor Release is appropriate and supported by adequate consideration provided by the Consenting Creditors and the Transferred Entities," (ii) no "party in interest, other than the California DTSC, has opposed the Debtor Release," (iii) the Debtor Release was "integral to the agreements among the various parties in interest," and (iv) "the failure to implement the Debtor Release would seriously jeopardize the Debtors' ability to confirm and implement the Plan, including consummation of the Global Settlement." (Confirmation Order ¶ I(i)). DTSC argues that released parties provided only a "de minimis" contribution, the plan was not "overwhelmingly" accepted, and the contribution to general unsecured creditors was "meager." DTSC essentially asks me to reweigh the record evidence (*id.* at 45-48), but review on appeal is limited to determining whether the Bankruptcy Court's findings were clearly erroneous. *See Anderson*, 470 U.S. at 573–74.

***15** Moreover, undisputed evidence shows that the Debtor Release was a valid exercise of the Debtors' business judgment. An independent subcommittee of the board oversaw a nearly four-month investigation into the Debtors' potential claims against third parties. (B.D.I. 946 ¶ 10). The creditors' committee also conducted its own investigation. (*Id.* ¶ 12). After their investigations, neither the subcommittee nor the creditors' committee identified any valuable, colorable claims. (*Id.* ¶¶ 15–16). The subcommittee also considered the significant value that the Debtors would receive under the global settlement and, against that backdrop, concluded that the Debtor Release was appropriate and fair. (*Id.* ¶¶ 18–19).

c. Plan Injunction

I find DTSC's arguments regarding the injunction contained in Section 10.3 of the plan unavailing. The injunction is a standard provision enjoining the parties from commencing litigation against the released parties with respect to claims or causes of action addressed by the plan. The injunction simply implements the release and exculpation provisions by preventing parties from bringing claims that have already been released. (*See* B.D.I. 998-2 at § 10.3). The injunction also permits parties to return to the Bankruptcy Court and seek permission to pursue claims that might otherwise be barred by the plan. (*Id.* (enjoining suits "[e]xcept as expressly provided in ... a separate order of the Bankruptcy Court")). Without this injunction, DTSC or some other third party could circumvent the releases and the extensively negotiated structure of the plan. Creditors would not have been willing to purchase the Europe/ROW business, allow Exide to access cash collateral and debtor-in-possession financing, and contribute $18.5 million without knowing that they would not later be sued. (*See* Confirmation Order ¶ I(iii)–(iv)). The injunction provision was necessary to the plan and provided fair protection in exchange for significant contributions by the released parties.

5. The Bankruptcy Court Properly Found that the Plan Does Not Discriminate

Section 1123(a)(4) of the Bankruptcy Code requires that a chapter 11 plan "provide the same treatment for each claim or interest of a particular class, unless the holder of a particular claim or interest agrees to a less favorable treatment of such particular claim or interest." 11 U.S.C. § 1123(a)(4). DTSC relies on an estimate for remediation costs over the next five years that was included in Debtors' first day declaration as evidence that DTSC was unfairly treated in the allocation of Class 8 claims. DTSC contends it should have received a pro rata distribution based on the estimate. (*See* D.I. 45 at 54 n.10). EPA counters that the allocation of consideration among the government agencies was based on several relevant factors, not just total estimated remediation costs. Exide argues that treatment the Bankruptcy Code "does not require precise equality, only approximate equality," *W.R. Grace*, 729 F.3d at 327, and that the proposed allocation was fair and not discriminatory. (D.I. 54 at 59-62). I agree with Appellees.

The plan offered the same opportunity to all holders of Class 8 claims: accept the global settlement or reject it and face the prospect of abandonment. "[C]ourts have interpreted the 'same treatment' requirement to mean that all claimants in a class must have 'the same opportunity' for recovery." *W.R. Grace*, 729 F.3d at 327. "What matters, then, is not that claimants recover the same amount but that they have equal opportunity to recover on their claims." *Id.* Accordingly, "[p]roviding different treatment to a creditor who agrees to settle instead of litigating is permitted by section 1123(a)(4)." *Wash. Mut.*, 442 B.R. at 355–56; *accord, In re Dana Corp.*, 412 B.R. 53, 62 (S.D.N.Y. 2008) ("[T]he fact that some claimants have settled while others have not does not, by itself, indicate unequal treatment."). DTSC is correct that "creditors of equal priority should receive pro rata shares of the debtor's property" under the Bankruptcy Code. *Begier v. IRS*, 496 U.S. 53, 58 (1990). Here, however, the $10 million payments transferred to the ERTs were not the Debtors' property. Rather, they were settlement payments (or in the case of the Vernon site, a substantial contribution) by the Consenting Creditors and Transferred Entities. Nothing in the Bankruptcy Code requires a third party to make settlement payments or provide substantial contributions to similarly situated creditors in equal or prorated amounts.

***16** The record supports a finding that the proposed allocation of the $10 million was fair and not discriminatory. The NPPs were in various stages of investigation and cleanup of environmental contamination caused by the former operations of the Debtors, and the record supports that allocation among the government agencies was based on several relevant factors, not just total estimated remediation costs. (*See* B.D.I. 973 ¶¶ 17, 20, 46). The allocation considered the availability of approximately $24 million in surety bond or other financial assurance proceeds under the global settlement that was incorporated into the plan, as available surety funding varied among the individual sites. The allocation also considered the value of the NPPs free and clear of liens from other creditors of the Debtors—given the Consenting Creditors' waiver of their liens on these properties, the individual value reduced the allocation to each respective site. Another factor considered was the degree of litigation risk to avoid abandonment on account of imminent and identifiable harms—an important consideration for the payments provided by the Consenting Creditors in order to have a confirmable plan. Recognizing these complexities, the environmental agencies, including DTSC, devised a method of allocating the $10 million settlement that would better account for the various factors involved. (*See* 10/16/20 Tr. 107:22–108:18 (for each of the NPPs, the allocation took into account: (1) the estimated total cleanup costs; (2) the availability of financial assurances; (3) the estimated value of the property after cleanup; and (4) the degree of litigation risk for the property under *Midlantic*); B.D.I. 942 ¶¶ 21, 201; B.D.I. 973 ¶ 34). DTSC relies on Mr. Cope's testimony to assert that its claim is "worth in excess of $100 million." (D.I. 54 at 43). Other government agencies did not file their claims until after the plan was confirmed, so the record does not include any evidence regarding the size of DTSC's claim relative to other class members.

Finally, DTSC argues that the releases contained in the plan treat California differently. The non-consensual releases apply to "all California state governmental agencies that ... have jurisdiction regarding the enforcement of Environmental Laws" (B.D.I. 998-2 § 10.6(f)) but only to other state agencies that identified themselves as the agencies with the principal responsibility for regulating the NPPs. (D.I. 45 at 55-56). According to Exide, the point of this provision was to ensure that the releases were equal *in effect.* I agree. In California, unlike other states involved in the settlement, environmental authority is dispersed across multiple state agencies. Moreover, every other state regulator involved in the global settlement—except DTSC—represented that it is "the primary state governmental agency in its state with responsibility for enforcing Environmental Laws applicable to the [NPPs] located within its jurisdiction." (B.D.I. 998-2 § 5.2(j)(v)). If the releases applied only to DTSC, their effect would be *narrower* in California because any other California agency could bring the very actions that the releases were meant to prohibit. DTSC has failed to carry its burden of establishing that it was unfairly discriminated against.

V. CONCLUSION

I will affirm the Confirmation Order for the reasons set forth herein. In my opinion, the appeal meets the criteria for equitable mootness, but I do not rely on that theory. A separate order will be entered.

All Citations

Slip Copy, 2021 WL 3145612

Footnotes

1 The docket of the Chapter 11 cases, captioned *In re Exide Holdings, Inc., et al.*, No. 20-11157 (CSS) (Bankr. D. Del.), is cited herein as "B.D.I. __." The appendix (D.I. 46-51) filed in support of DTSC's amended opening brief is cited herein as "A __." Transcripts of the confirmation hearing held before the Bankruptcy Court on October 15, 2020 (A1365) and October 16, 2020 (A1654) are cited herein as "10/15/20 Tr. __" and "10/16/20 Tr. __," respectively.

2 I did not hear oral argument because the facts and legal arguments are adequately presented in the briefs and record, and the decisional process would not be significantly aided by oral argument.

3 Following denial of the motion for stay pending appeal, DTSC executed the agreement providing the Vernon ERT with covenants not to sue. (*See* Singh Decl. ¶¶ 2-3). On October 26, 2020 ("Effective Date"), Exide transferred title, ownership, and environmental obligations for the Vernon site directly to the Vernon ERT and thereby avoided abandonment. (*See* D.I. 56 ("Puga Decl.") ¶ 6). The Vernon ERT has worked to maintain and remediate it, including consulting with regulators to develop a 14-month plan and budget for decontaminating the site. (*Id.* ¶ 10). The trustee estimates that the $29 million currently available to the Vernon ERT will allow it to complete a 14-month plan and maintain the site through the end of 2022. (*Id.* ¶ 19). The trustee has a plan to obtain additional funds, including through a potential sale of the property, which would enable the Vernon ERT to deconstruct all the ancillary buildings on the site. (*Id*). Remediation restarted in mid-November and the Vernon ERT continues to perform maintenance, including daily inspections, dust monitoring, sample collection, spraying down the site, and collecting and treating wash water. (*Id.* ¶¶ 12, 15). The Vernon ERT received the $2.6 million payment allocated under the plan, and DTSC has transferred to the Vernon ERT approximately $6 million of the $26 million in financial assurances for the site. (*Id.* ¶¶ 16–18). Based on the current pace, decontamination of the Vernon site and deconstruction of the industrial structures are expected to be completed by the end of 2021. (*Id.* ¶ 14).

On the Effective Date, Exide transferred all sixteen NPPs to the ERT. (*Id.* ¶ 21; D.I. 57 ("Messing Decl.") ¶ 6). Since then, the ERT performed significant work at the sites, including negotiating/assuming contracts to maintain/service the sites, creating plans/budgets to remediate/transition them, and continuing regular maintenance to ensure safety. (Puga Decl. ¶¶ 22–24). On the Effective Date, the ERT received the $7.4 million settlement allocated to NPPs outside California and $23.6 million in financial assurances. (*Id.* ¶¶ 30–31).

In consultation with the ERT's advisors and applicable regulators, the trustee determined that the best strategy for safely and efficiently transitioning the NPPs is selling them to buyers willing to assume the environmental liabilities. (*Id.* ¶ 25). The ERT has been marketing and selling those properties. As of January 2021, the ERT has closed the sale of at least one NPP, with the buyer assuming all environmental liabilities and remediation efforts for that properly (*id.* ¶¶ 25–26) and has begun negotiating the sale of ten more NPPs (*id.* ¶¶ 26–29).

Following the Effective Date, Exide implemented various other transactions in reliance on the plan. The Consenting Creditors issued $36 million in bridge financing notes to the Europe/ROW business to support its continued operations and provide funding for the settlements (Messing Decl. ¶ 5), and using the proceeds of the bridge financing, the Transferred Entities made approximately $18.5 million in settlement payments, including (a) the above-mentioned $2.6 million to the Vernon ERT and $7.4 million to the ERT, (b) $100,000 to the Texas Commission on Environmental Quality, (c) $2.4 million to the general unsecured creditors trust ("GUC Trust"), and (d) $6 million to the Pension Benefit Guaranty Corporation. (*Id*). Exide has transferred causes of action to the GUC Trust. (*Id.* ¶ 7). Exide has consummated the sale of the Europe/ROW business and transferred the business. (*Id.* ¶ 8). In exchange, Consenting Creditors forgave $70 million of priority notes and canceled Exide's $155.9 million guarantee of superpriority notes. (*Id.* ¶ 9). The Consenting Creditors released liens on the NPPs and any sale proceeds thereof. (*Id*). The Europe/ROW Purchaser took over management of the former Europe/ROW business and remaining Exide employees. (*Id.* ¶ 10).

Finally, the plan administrator is managing the sale or liquidation of the estates' remaining assets and the distribution process for holders of administrative expense, secured, and priority claims. (D.I. 58 ("Rinaldi Decl.") ¶ 2). The plan administrator is reconciling administrative, secured, and priority claims. (*Id.* ¶ 6). On January 21, 2021, the estates made a payment of approximately $8.1 million to the Americas Buyer regarding a working capital adjustment. (*Id.* ¶ 7). The wind-down estates are implementing other wind-down activities in reliance on the Confirmation Order.

4 As Exide points out, it has no ability to "reallocate" funds by taking funds from administrative, secured, and priority creditors and allocating them to DTSC. *See* *In re Paragon Offshore plc*, 597 B.R. 748, 762 (D. Del. 2019) (holding disgorgement would "violat[e] the absolute priority rule" and be "inequitable and not practicable" because there was "no relief that could be layered onto the existing Plan consistent with governing law"); *In re Adelphia Commc'ns Corp.*, 367 B.R. 84, 97 (S.D.N.Y. 2007) (finding "selective disgorgement from cherry-picked creditors as opposed to ordering disgorgement from all creditors ... is inequitable").

5 If abandonment were the only issue in this appeal, I would dismiss the appeal as moot. But there are numerous other issues, and I have appellate jurisdiction over the case. I expect DTSC will exercise its right to appeal to the Third Circuit. Since the Third Circuit might not agree with the mootness ruling, I also consider the abandonment issue on the merits.

6 That is, the $26 million in financial assurances and the $2.6 million provided by the global settlement.

7 The cost estimate attached as Exhibit 1 to the Myers Declaration identifies the cost to complete "Phase 1 Closure – Complete Segments 2, 3 and remainder of tasks in 12/8/2016 Closure Plan and Phase 2 Elements as needed for Stable Config. Scenario" as $12,907,568. (*See* B.D.I. 917-9 at Ex. 1, Line 1.0). Site operations for the estimated time necessary to complete the Phase 1 implementation amount to another $14,417,730.13. (*See* B.D.I. 917-9 at Ex. 1, Lines 6A and 6B).

8 DTSC released a smaller group of parties than the other governmental regulators, who also provided covenants not to sue Debtors, their related parties, and a broader group of the Consenting Creditors' related parties.

2021 WL 3411834
Only the Westlaw citation is currently available.
United States Court of Appeals, Eighth Circuit.

IN RE: VEROBLUE FARMS USA, INC., Debtor
FishDish, LLP, Appellant/Cross-Appellee
v.
VeroBlue Farms USA, Inc.; Alder Aqua, LTD., Appellees
Broadmoor Financial, L.P., Appellee/Cross-Appellant

No. 19-3413, No. 19-3487
|
Submitted: January 12, 2021
|
Filed: August 5, 2021

Synopsis
Background: Preferred shareholder of corporate debtor appealed certain pre-confirmation orders as well as order entered by the United States Bankruptcy Court for the Northern District of Iowa, Thad J. Collins, Chief Judge, confirming, over shareholder's objections, debtors' Chapter 11 plan of reorganization. Plan sponsor moved to dismiss appeal based on, inter alia, the doctrine of "equitable mootness," and senior secured creditor filed partial motion to dismiss appeal of claim objection order. The District Court, C.J. Williams, J., 2019 WL 4918758, granted motions and dismissed appeal as "equitably moot," ruling in the alternative that it had jurisdiction over the untimely appeal from the bankruptcy court's pre-confirmation claim objection order. Shareholder appealed, and creditor cross-appealed.

Holdings: Addressing issues of apparent first impression for the court, the Court of Appeals, Loken, Circuit Judge, held that:

pursuant to the so-called equitable mootness doctrine, "equitable," "prudential," or "pragmatic" considerations may render an appeal of a bankruptcy court decision moot even when the appeal is not constitutionally moot;

the 14-day deadline for filing appeals from bankruptcy court decisions set forth in the bankruptcy rule governing time for filing notice of appeal is mandatory but not jurisdictional;

the 14-day deadline for filing appeals from bankruptcy court decisions set forth in the bankruptcy rule governing time for filing notice of appeal is not limited to final orders of the bankruptcy court, but also applies to interlocutory orders and decrees; and

the district court did not apply a sufficiently rigorous test to determine when, pursuant to the so-called equitable mootness doctrine, bankruptcy equities and pragmatics justify foregoing Article III judicial review of a bankruptcy court order confirming a Chapter 11 plan.

Affirmed in part, reversed in part, and remanded.

Procedural Posture(s): On Appeal; Motion to Dismiss; Objection to Confirmation of Plan.

Appeals from United States District Court for the Northern District of Iowa - Ft. Dodge

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Before LOKEN, GRASZ, and KOBES, Circuit Judges.

Opinion

LOKEN, Circuit Judge.

***1** Debtors in this Chapter 11 bankruptcy proceeding are VeroBlue Farms USA, Inc., and affiliated entities ("Debtors"). A VeroBlue preferred shareholder, FishDish, LLP ("FishDish"), appeals the district court's order granting appellees' motions to dismiss FishDish's appeal of the bankruptcy court order confirming Debtors' Chapter 11 plan of reorganization over FishDish's objections, and certain pre-confirmation orders. Appellees are VeroBlue Farms, the reorganized debtor; Alder Aqua, Ltd. ("Alder Aqua"), Debtors' plan of reorganization sponsor; and senior secured creditor Broadmoor Financial, L.P. ("Broadmoor"). In dismissing the appeal, the district court invoked equitable mootness, a bankruptcy doctrine adopted by our sister circuits (though not uniformly), and by the Eighth Circuit Bankruptcy Appellate Panel and Eighth Circuit district courts. We have never expressly adopted the doctrine, [1] nor has the Supreme Court. Alternatively, the court considered appellees' jurisdictional defenses, including timeliness, and concluded it did have subject matter jurisdiction. Broadmoor cross appeals the district court's ruling that FishDish's appeal from one order, the "Claim Objection Order," though untimely under Rule 8002(a)(1) of the Federal Rules of Bankruptcy Procedure, was not subject to dismissal under 28 U.S.C. § 158(c)(2) because the statute only applies to appeals from the "final judgments, orders, and decrees" referred to in § 158(a)(1).

We agree that the district court and this court have statutory subject matter jurisdiction. However, we conclude the district court erred in limiting *the mandatory but non-jurisdictional* timeliness requirements of Rule 8002 to appeals from final bankruptcy court orders. As FishDish has conceded its appeal from the pre-confirmation Claim Objection Order was untimely under Rule 8002, we affirm the grant of appellees' Partial Motion to Dismiss Appeal on this alternative ground.

Regarding the central issue on appeal, what has misleadingly come to be known as "equitable mootness," like the Tenth Circuit we agree with "[e]very other circuit to consider the issue ... that 'equitable,' 'prudential,' or 'pragmatic' considerations can render an appeal of a bankruptcy court decision moot even when the appeal is not constitutionally moot." In re Paige, 584 F.3d 1327, 1337 (10th Cir. 2009). However, invoking this doctrine often results in "the refusal of the Article III courts to entertain a live appeal over which they indisputably possess statutory jurisdiction and in which meaningful relief can be awarded." In re Cont'l Airlines, 91 F.3d 553, 571 (3d Cir. 1996) (Alito, J., dissenting), cert. denied sub nom. Bank of N.Y. v. Cont'l Airlines, Inc., 519 U.S. 1057, 117 S.Ct. 686, 136 L.Ed.2d 610 (1997). An Article III appellate court has a "virtually unflagging obligation" to exercise its subject matter jurisdiction. In re Semcrude, L.P., 728 F.3d 314, 320 (3d Cir. 2013) (quotation omitted). Therefore, as in Paige, Semcrude, and numerous other circuit court decisions, we conclude that the district court did not apply a sufficiently rigorous test to determine when bankruptcy equities and pragmatics justify foregoing Article III judicial review of a bankruptcy court order confirming a Chapter 11 plan. Accordingly, we remand for further district court proceedings.

I. Background.

***2** Founded in 2014, Debtors were in the aquaculture business -- farming fish and selling those fish through wholesalers to restaurants and grocery chains. Kenneth Lockard, an Iowa businessman, formed FishDish to invest in the Debtors. In the summer of 2016, Debtors sold $6 million in preferred shares to FishDish and $28 million to Alder Aqua, a British Virgin Islands entity allegedly owned and controlled by Dr. Otto Happel and his family. In addition, certain Debtors borrowed $29 million from Amstar Group, LLC (the "Credit Facility"), also allegedly owned and controlled by Dr. Happel, a loan secured by substantially all of Debtors' assets. As a result, Lockard and Alder Aqua representatives sat on the Debtors' board. Lockard often voted en bloc with the founders. In December 2017, Amstar transferred its rights under the Credit Facility to Broadmoor. Alder Aqua loaned Debtors additional funds in 2018 and acquired a participation interest in the Credit Facility. By early 2018, Alder Aqua had taken control of the Debtors, terminating the founders and installing their appointees to the board and causing Lockard to resign from the board.

The Debtors filed a voluntary Chapter 11 bankruptcy petition on September 21, 2018, listing an undisputed obligation to the Credit Facility as approximately $54 million -- well in excess of Debtors' assets. On motion of the Debtors, the bankruptcy court promptly entered an interim post-petition financing order authorizing Debtors to borrow $2 million from Alder Aqua as Lender to finance post-petition obligations and to grant Lender a "first priority priming lien" under 11 U.S.C. § 364(d) on its business assets, and granting Broadmoor an Adequate Protection Lien equal to the diminution in value of any valid pre-petition lien.

No interested party objected to the interim order. On October 17, the bankruptcy court entered a final debtor-in-possession financing order (the "DIP Order"). The DIP Order provided that "the Broadmoor Secured Debt and Broadmoor Lien shall be deemed to be allowed for all purposes in the Chapter 11 Cases ... and shall not be subject to challenge by any party in interest as to extent, validity, priority, or otherwise" unless "(i) the Debtors receive notice of a potential Challenge during the Investigation Period from the Committee and (ii) the Court rules in favor of the plaintiff in any timely and properly filed Challenge resulting therefrom." The DIP Order defined "Committee" as an "official committee in the Chapter 11 case." See 11 U.S.C. § 1102. Section 8(a) defined the Challenge Procedure. Section 8(b) provided that if "a Challenge is not timely commenced," the Broadmoor Secured Debt and Lien "shall be deemed to be allowed for all purposes ... and shall not be subject to challenge by any party in interest." No party appealed the DIP Order.

On October 24, the United States Trustee appointed the Official Committee of Unsecured Creditors ("Creditors Committee") under 11 U.S.C. § 1102. The Creditors Committee investigated the Broadmoor claim and on December 19 sent Debtors a lengthy and timely challenge notice under Section 8(a) of the DIP Order demanding that Debtors initiate an adversary proceeding against Broadmoor, Aqua Alder, Amstar, and others, or consent to the Creditors Committee's standing to prosecute an adversary proceeding, for breaches of fiduciary duty, corporate waste and usurpation of corporate opportunities, equitable subordination or recharacterization of Broadmoor's claim under the Credit Facility, and fraud (the "Challenge Notice"). The next day, an unofficial Ad Hoc Committee of Equity Security Holders ("AHC") -- consisting of FishDish and certain common shareholders of the Debtors -- sent Debtors a letter joining the Creditors Committee Challenge Notice. The AHC also filed an Objection to approval of Debtors' Disclosure Statement for the plan. See 11 U.S.C. § 1125(b).

On January 14, 2019, the bankruptcy court held a hearing limited to the Debtors' disclosures. Debtors filed a Modified Chapter 11 Plan and Modified Disclosure Statement on February 16. The bankruptcy court approved the amended disclosure statement and scheduled a preliminary confirmation hearing on March 20 (the "Disclosure Order").

***3** On January 13, the AHC moved for an order "extending the procedural protections of paragraph 8 of the Final DIP Order" to the AHC. In early February, the AHC moved for an order "confirming" its derivative standing to pursue the claims demanded in the Challenge Notice (the "Standing Motion"). See generally In re Racing Servs., Inc., 540 F.3d 892, 904-05 (8th Cir. 2008). After a hearing on February 4, the bankruptcy court entered an order deferring ruling on AHC's Standing Motion pending plan confirmation proceedings.

On March 5, the Creditors Committee notified the bankruptcy court it had settled its claims against Debtors in return for proposed plan amendment providing relief for the unsecured creditors. Broadmoor moved to enforce the DIP Order's Section 8 claim bar against the AHC, and Debtors moved to bar AHC from further participation under Bankruptcy Rule 2019. After hearings, the bankruptcy court issued an order on April 3, 2019 (the "AHC Standing Order") stating in relevant part:

> IT IS FURTHER ORDERED THAT, for all parties in interest, objections to the Broadmoor Secured Debt ... as well as any and all claims held by debtor, or derivative of Debtor's rights, for the recharacterization or equitable subordination of the Broadmoor Secured Debt, are barred, because no timely challenge was made pursuant to the DIP Order and for other reasons set forth on the record.
>
> IT IS FURTHER ORDERED THAT, for all parties in interest, any objections relating to the allegations and claims set forth in the Challenge Notice attached as an exhibit to the Motion are barred, as those claims are not colorable and for other reasons set forth on the record. [2]

FishDish then 1) objected to Broadmoor's claim, 2) moved for leave to initiate discovery, and 3) objected to the amended disclosure statement. After a pre-confirmation hearing, the bankruptcy court denied FishDish's motion for discovery. (the "Discovery Order"). It clarified at the April 17 confirmation hearing that FishDish's objections to the Broadmoor claim were barred but offered FishDish an opportunity to make an offer of proof to bolster the record on appeal. After the confirmation hearing concluded on April 18, the court entered a text order denying the FishDish's claim objection (the "Claim Objection Order"). On April 22 the bankruptcy court approved the Plan of reorganization ("Plan Confirmation Order").

On May 6, FishDish filed a notice of appeal identifying as the matters being appealed the Plan Confirmation Order, the Disclosure Order, the AHC Standing Order, the Discovery Order, and the Claim Objection Order. FishDish elected an appeal to the Bankruptcy Appellate Panel, but Alder Aqua timely transferred the appeal to the District Court for the Northern District of Iowa. See 28 U.S.C. § 158(c)(1)(B); Bankruptcy Rule 8005. The bankruptcy court entered an order confirming the Plan, as amended, on May 7, 2019.

The limited record on appeal reveals that, after confirmation of the Plan: (1) Alder Aqua funded the Plan with $13.5 million; (2) Debtors cancelled all the outstanding common and preferred stock and re-issued stock to Alder Aqua; (3) the Class 3 claimants received $294,700; (4) the Class 5 creditor trust received $620,000, which has since paid or settled claims in the amount of $272,000; (5) Broadmoor received $6,000,000; and (6) Alder Aqua released its $5,025,000 claim under the credit facility, as well as its $2,000,000 claim for the DIP bridge financing. Alder Aqua, as plan sponsor and sole shareholder of the reorganized Debtors, assumed management, and deferred its commitment to invest $21,400,000 "for capital investments for the Debtors retrofit and additional working capital." The bankruptcy court closed the case. See Fed. R. Bankr. P. 3022; 11 U.S.C. § 350. [3]

***4** In its appeal of the Plan Confirmation Order, FishDish argued the Plan (1) unfairly discriminates between members of the same class of shareholders; (2) violates the absolute priority rule; (3) was proposed in bad faith; (4) is not in the best interests of the creditors for failure to investigate and value the Challenge Notice claims; and (5) is not feasible for want of funding. Alder Aqua moved to dismiss based on the "doctrine of equitable mootness," bankruptcy standing, and waiver. Broadmoor filed a partial motion to dismiss the appeal of the Claim Objection Order as untimely. Without reaching the merits, the district court dismissed FishDish's appeal as "equitably moot." It further ruled FishDish as a "person aggrieved" has standing to appeal the Plan's confirmation, and that FishDish's appeal of the Claim Objection Order is timely because it was not a final order. FishDish appeals the equitable mootness dismissal; Broadmoor cross-appeals the timeliness issue.

II. Timeliness, a Potential Jurisdictional Issue.

Bankruptcy Rule 8002(a)(1) provides: "Except as provided in subdivisions (b) and (c) [which are not at issue], a notice of appeal must be filed with the bankruptcy clerk within 14 days after entry of the judgment, order, or decree being appealed." "Bankruptcy Rules prescribed by [the Supreme Court] for the practice and procedure in cases under title 11 ... do not create or withdraw federal jurisdiction." Kontrick v. Ryan, 540 U.S. 443, 453, 124 S.Ct. 906, 157 L.Ed.2d 867 (2004). But "a rule is jurisdictional if the legislature clearly states that a threshold limitation on a statute's scope shall count as jurisdictional." Gonzalez v. Thaler, 565 U.S. 134, 141, 132 S.Ct. 641, 181 L.Ed.2d 619 (2012).

The appellate jurisdiction of a district court, a court of appeals, or a bankruptcy appellate panel ("BAP") to review a bankruptcy court order is governed by 28 U.S.C. § 158. Subsection § 158(a) provides:

> (a) The district courts of the United States shall have jurisdiction to hear appeals
>
> (1) from final judgments, orders, and decrees;
>
> (2) from interlocutory orders and decrees issued under section 1121(d) of title 11 increasing or reducing the time periods referred to in section 1121 ...; and
>
> (3) with leave of court, from other interlocutory orders and decrees;
>
> of bankruptcy judges ....

Subsection § 158(c)(2) provides: "An appeal under subsection[ ] (a) ... shall be taken in the same manner as appeals in civil proceedings generally are taken to the courts of appeals from the district courts, and in the time provided by Rule 8002 of the Bankruptcy Rules." The jurisdictional issue is whether the incorporation of Rule 8002(a)(1)'s time-limit in 28 U.S.C. § 158(c)(2) creates a statutory limitation on federal district courts' subject-matter jurisdiction. See Kontrick, 540 U.S. at 453, 124 S.Ct. 906. If it does, then the district court should have addressed this issue before the non-jurisdictional issue of equitable mootness because "a court cannot issue a ruling on the merits when it has no jurisdiction because to do so is, by very definition, for a court to act ultra vires." Brownback v. King, ––– U.S. ––––, 141 S. Ct. 740, 749, 209 L.Ed.2d 33 (2021) (cleaned up); see In re AFY, 734 F.3d 810, 816 (8th Cir. 2013), cert. denied sub. nom Sears v. Badami, 572 U.S. 1117, 134 S.Ct. 2315, 189 L.Ed.2d 177 (2014). Therefore, we address this issue -- the crux of Broadmoor's cross appeal regarding the Claim Objection Order -- before addressing equitable mootness.

We upheld the dismissal of a bankruptcy appeal for failure to comply with Rule 8002 in In re Delta Engineering Intern., Inc., 270 F.3d 584, 586 (8th Cir. 2001). But we have not held that Rule 8002's 14-day deadline for filing appeals from bankruptcy court decisions is jurisdictional. (The Eighth Circuit BAP has, but its rulings are not controlling on this Article III issue.) A number of our sister circuits have concluded that Rule 8002 is jurisdictional, like Rule 4(a)(6) of the Federal Rules of Appellate Procedure. See the cases cited in In re Tennial, 978 F.3d 1022, 1026-27 (6th Cir. 2020). But after careful consideration of these contrary cases, we agree with the careful analysis in Tennial and conclude that Rule 8002's 14-day deadline is *mandatory but not jurisdictional*. Judge Sutton explained in Tennial, 978 F.3d at 1025-26, 1028:

> ***5** In [28 U.S.C. § 158(c)(2)], Congress merely referred to any appeal deadlines created by the Bankruptcy Rules. Nothing about that reference indicates that Congress meant to attach subject matter jurisdiction consequences to deadlines established by the Bankruptcy Rules. Much less did it do so "clearly" with that modest reference.
>
> * * * * *
>
> [I]f deadlines established by the rules process alone created jurisdictional limits, that would mean the rules committee could change the scope of federal court subject matter jurisdiction on its own. ... But the Constitution gives that power to Congress alone. ... The rules committees, as it happens, have changed the bankruptcy appeal deadline since 28 U.S.C. § 158 was enacted -- from 10 to 14 days. ... How, then, can we say that Congress "specified" [that] deadline ....?
>
> * * * * *

> Bankruptcy Rule 8002(a)(1)-s 14-day time limit for filing a notice of appeal does not create a jurisdictional imperative.
>
> Even so, the deadline remains mandatory. ...
>
> Because the appeal deadline is mandatory, because Tennial missed it, and because REI raised the issue in its motion to dismiss, the appeal must be dismissed as dilatory.

As in Tennial, FishDish missed the mandatory 14-day time limit in appealing the Claim Objection Order, and appellees' Partial Motion to Dismiss raised the issue. The district court denied that motion because " 'An appeal [from final judgments, orders, and decrees] shall be taken ... in the time provided by Rule 8002,' " and the Claim Objection Order was not a final order. The bracketed limitation inserted by the court in quoting § 158(c)(2) was an error of law. The statute applies to appeals "under subsections (a) and (b)." Those appeals include appeals to district courts "from other interlocutory orders and decrees." § 158(a)(3). Rule 8002(a)(1) mandates filing a notice of appeal "within 14 days after entry of the judgment, order, or decree being appealed." Thus, it is not limited to *final* orders, and rightly so, because the need for expedited appellate processing in bankruptcy applies to appeals of interlocutory orders to the district court or to the BAP, as well as to final orders that can then be appealed to the court of appeals under § 158(d). Cf. In re Farmland Indus., Inc., 397 F.3d 647, 649-50 (8th Cir. 2005).

For this reason, we need not decide whether the Claim Objection Order was a "final judgment, order, [or] decree[ ]" under § 158(a)(1). See generally Ritzen Grp., Inc., v. Jackson Masonry, LLC, ––– U.S. ––––, 140 S. Ct. 582, 205 L.Ed.2d 419 (2020); Bullard v. Blue Hills Bank 575 U.S. 496, 135 S.Ct. 1686, 191 L.Ed.2d 621 (2015). As it is undisputed that FishDish missed the mandatory 14-day time limit, the district court's order dismissing the appeal of the Claim Objection Order is affirmed.

III. Equitable Dismissal Issues.

The district court declined to address the merits of FishDish's appeal, invoking the "doctrine of equitable mootness." The doctrine's name is misleading. A case is moot, that is, beyond a federal court's Article III jurisdiction, only if "it is impossible for a court to grant any effectual relief whatsoever." Mission Prod. Holdings, Inc. v. Tempnology, LLC, ––– U.S. ––––, 139 S. Ct. 1652, 1660, 203 L.Ed.2d 876 (2019) (quotation omitted). "There is a big difference between *inability* to alter the outcome (real mootness) and *unwillingness* to alter the outcome ('equitable mootness'). Using one word for two different concepts breeds confusion. Accordingly, we banish 'equitable mootness' from the (local) lexicon." In re UNR Indus., Inc., 20 F.3d 766, 769 (7th Cir.) (emphasis in original), cert. denied sub nom. UNARCO Bloomington Factory Workers v. UNR Indus., Inc., 513 U.S. 999, 115 S.Ct. 509, 130 L.Ed.2d 416 (1994). But the name lives on elsewhere. [4]

***6** The equitable mootness doctrine is based on a recognition that "even when the moving party is not entitled to dismissal on Article III grounds, common sense or equitable considerations may justify a decision not to decide a case on the merits." In re Manges, 29 F.3d 1034, 1039 (5th Cir. 1994) (quotation omitted; cleaned up), cert. denied sub nom. Manges v. Seattle-First Nat. Bank, 513 U.S. 1152, 115 S.Ct. 1105, 130 L.Ed.2d 1071 (1995). Numerous Chapter 11 plan confirmation appeals have been dismissed "when, even though effective relief could conceivably be fashioned, implementation of that relief would be inequitable." In re Chateaugay Corp., 988 F.2d 322, 325 (2d Cir. 1993). "If limited in scope and cautiously applied, this doctrine provides a vehicle whereby the court can prevent substantial harm to numerous parties." Cont'l Airlines, 91 F.3d at 559.

As with any equitable determination, a variety of factors may be relevant in a particular case. Our sister circuits have fashioned many different routes to answer the ultimate question. [5] Most have adopted either the two-factor analysis in In re Tribune Media Co., 799 F.3d 272, 277 (3d Cir. 2015), cert. denied sub nom. Aurelius Cap. Mgmt., L.P. v. Tribune Media Co., 577 U.S. 1230, 136 S. Ct. 1459, 194 L.Ed.2d 575 (2016), or a variation of the five-factor analysis adopted by the Eighth Circuit BAP in In re Williams, 256 B.R. 885, 896 n.11 (8th Cir. B.A.P. 2001). We decline the parties' invitation to adopt a specific multi-factor test. "The ultimate question to be decided is whether the Court can grant relief without undermining the plan and, thereby, affecting third parties." In re SI Restructuring, Inc., 542 F.3d 131, 136 (5th Cir. 2008). The most important factors are whether the confirmed plan has been substantially consummated and, if so, what effects reversal of the plan would likely have on third parties." Paige, 584 F.3d at 1339. Whether appellant sought or obtained a stay pending appeal is relevant but not determinative. See, e.g., Manges, 29 F.3d at 1039-40.

The equitable mootness doctrine as frequently applied has been thoughtfully criticized by many circuit judges. Perhaps the most thorough survey of the subject is the concurring opinion of Third Circuit Judge Cheryl Krause in In re One2One, 805 F.3d at 438-54, where the Third Circuit reversed the district court's equitable mootness dismissal and remanded for consideration of a bankruptcy appeal on the merits. After discussing at length issues regarding the judge-made doctrine's legitimacy, Judge Krause turned to the doctrine's efficacy, id. at 446-47:

> The doctrine was intended to promote finality, but it has proven far more likely to promote uncertainty and delay. Ironically ... a motion to dismiss an appeal as equitably moot has become "part of the Plan." Proponents of reorganization plans now rush to implement them so they may avail themselves of an equitable mootness defense, much like Appellees did here. Rather than litigate the merits of an appeal, parties then litigate equitable mootness. And even if an appeal is dismissed as equitably moot by a district court, that dismissal is appealed to our Court, often resulting, in turn, in a remand and further proceedings.
>
> * * * * *
>
> Even if we were affirming the District Court's finding of equitable mootness, there would not have been finality until this point .... Without the equitable mootness doctrine, on the other hand, the District Court would have ruled on the merits long ago.

***7** The record on appeal suggests that the Chapter 11 proceedings in this case may have followed that pattern, yet the district court made no such inquiry. Of the $12 million paid under the Plan to creditors, presumably from the $13.5 million in funding provided by Alder, one half was paid to Broadmoor, and Alder Aqua as plan sponsor assumed management of the reorganized Debtors. These appellees are not third parties that the equitable mootness doctrine is intended to protect. Moreover, the only transfer that did not take place was Alder Aqua's commitment to invest substantial working capital. If that did not take place because the reorganized Debtors were preparing for a quick asset sale instead of resuming operations, the case takes on the look of the type of Chapter 11 plan that Judge Krause defined as one needing review on the merits by an Article III appellate court. And if the confirmed plan must be set aside on the merits, the district court may be able to fashion effective relief for those whose rights were impaired by the plan even if the business assets have been sold to a third party purchaser relying on the confirmed plan, such as disgorgement of the proceeds. We do not assume how these factual inquiries may be resolved. We decide only that the inquiry must be made.

The panel in One2One was bound to apply the equitable mootness doctrine as adopted by the Third Circuit's 7-6 en banc decision in Continental Airlines. Writing on a clean Eighth Circuit slate, we conclude that an inquiry into these issues is required before equitable mootness may be invoked in this case. This means that, on remand, the district court must make at least a preliminary review of the merits of FishDish's appeal to determine the strength of FishDish's claims, the amount of time that would likely be required to resolve the merits of those claims on an expedited basis, and the equitable remedies available -- including possible dismissal -- to avoid undermining the plan and thereby harming *third parties*. See Abengoa Bioenergy Biomass of Kan., LLC, 958 F.3d 949, 960 (10th Cir. 2020); In re Charter Commc'ns Inc., 691 F.3d 476, 482 (2d Cir. 2012), cert. denied sub nom Law Debenture Tr. Co. v. Charter Commc'ns, Inc., 569 U.S. 968, 133 S.Ct. 2021, 185 L.Ed.2d 905 (2013). [6]

"In many cases," Judge Krause observed, "district courts may conclude that all or substantially all of the relief requested is feasible despite the plan's consummation." One2One, 805 F.3d at 450; see Paige, 584 F.3d at 1339; SI Restructuring, 542 F.3d at 136 (appellants "do not seek any return of money ... from third party creditors"); In re Envirodyne Inds., Inc., 29 F.3d 301, 304 (7th Cir. 1994). A "quick look at the merits of an appellant's challenge" is also important, Judge Krause urged, because "[m]erits review is particularly important for complex questions, like whether a plan comports with the Bankruptcy Code's cram down provisions, an issue that often cries out for appellate review ... or claims involving conflicts of interest or preferential treatment that go to the very integrity of the bankruptcy process." 805 F.3d at 454 (cleaned up). We agree. Those are precisely the kinds of issues FishDish raises in this appeal.

In resolving a different but somewhat analogous issue, the Supreme Court recently held that "allowing Article I adjudicators to decide claims submitted to them by consent does not offend the separation of powers *so long as Article III courts retain supervisory authority over the process*." Wellness Int'l Network, Ltd. v. Sharif, 575 U.S. 665, 135 S. Ct. 1932, 1944, 191 L.Ed.2d 911 (2015) (emphasis added). When a district court (or a court of appeals reviewing a BAP decision) is asked to invoke equitable mootness to preclude a party whose rights have been impaired by a Chapter 11 confirmation order from obtaining supervisory review of the merits of the plan by an Article III court that has an "unflagging obligation" to exercise its appellate jurisdiction, the request should be granted only in extremely rare circumstances. "The presumptive position remains that federal courts should hear and decide on the merits cases properly before them." Semcrude, 728 F.3d at 326. If equitable mootness instead becomes the rule of appellate bankruptcy jurisprudence, rather than an exception to the Article III-based rule that jurisdiction should be exercised, we predict the Supreme Court, having up to now denied petitions for certiorari to review the doctrine, will step in and severely curtail -- perhaps even abolish -- its use, just as the Court curtailed lower courts' excessive use of the "Rooker-Feldman doctrine" to avoid difficult claim and issue preclusion analysis in Exxon Mobil Corp. v. Saudi Basic Indus., Corp., 544 U.S. 280, 283-84, 125 S.Ct. 1517, 161 L.Ed.2d 454 (2005).

IV. Conclusion.

***8** In summary, we affirm the decision of the district court dismissing FishDish's appeal of the Claim Objection Order. We reverse and remand for reconsideration the district court's dismissal of FishDish's appeal of the Plan Confirmation Order on the ground of equitable mootness. We conclude that appellees' contention that FishDish lacks bankruptcy case standing to appeal because it is not a "person aggrieved," see Opportunity Fin., LLC, v. Kelley, 822 F.3d 451, 457-58 (8th Cir. 2016), should not be decided on this record. Accordingly, we remand the case to the district court for further proceedings not inconsistent with this opinion.

All Citations

--- F.4th ----, 2021 WL 3411834

Footnotes

1 We upheld the district court's invocation of "equitable mootness" without discussion in In re President Casinos, Inc., 409 F. App'x. 31, 31-32 (8th Cir. 2010), an unpublished, non-precedential opinion. In In re Nevel Props. Corp., 765 F.3d 846 (8th Cir. 2014), we affirmed on the merits and denied as moot a motion to dismiss the appeal under the equitable mootness doctrine. As we will explain, this should almost always be the preferred disposition.

2 The order also granted the Debtors' motion under Rule 2019. The AHC's separate appeal of that order is pending in the United States District Court for the Northern District of Iowa.

3 We grant the motion to supplement the record with the closure order.

4 FishDish contends the doctrine is constitutionally infirm, a contention some circuits have addressed but none has adopted. See In re One2One Comm'cns, LLC, 805 F.3d 428, 432-33 (3d Cir. 2015). FishDish did not make this argument to the district court, and we decline to consider it for the first time on appeal.

5 There is a conflict among the circuits whether a district court decision to invoke equitable mootness is reviewed *de novo* or for abuse of discretion, an issue the parties debate on appeal. We apparently applied the *de novo* standard of review

in In re President Casinos, 409 F. App'x at 31, a non-binding opinion. Given our decision that a remand is required, we need not decide this issue.

6 For example, in Manges, a Chapter 11 proceeding where the debtors' principal assets were a large Texas ranch and mineral rights under the ranch, the district court affirmed the bankruptcy court's confirmation of the principal creditors' proposed plan. 29 F.3d at 1036. Debtors appealed, and the Fifth Circuit granted appellees' motion to dismiss based on equitable mootness because the relief sought by debtors was "nothing less than a wholesale annihilation of the Plan," and the ranch had been sold to third party purchasers. Id. at 1043.

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3 F.4th 229
United States Court of Appeals, Fifth Circuit.

In the MATTER OF: WALKER COUNTY HOSPITAL CORPORATION Debtor,
The Official Committee of Unsecured Creditors of Walker County Hospital Corporation, doing business as Huntsville Memorial Hospital, Appellant,
v.
Walker County Hospital District; Huntsville Community Hospital, Incorporated, Appellees.

No. 20-20572
|
FILED July 12, 2021

Synopsis
Background: Order was entered by the United States Bankruptcy Court for the Southern District of Texas authorizing sale of Chapter 11 debtor-hospital's assets to stalking horse bidder, and unsecured creditors' committee appealed. The United States District Court for the Southern District of Texas, No. 4:20-CV-911, Andrew S. Hanen, J., 2020 WL 6482016, entered order dismissing appeal as statutorily moot, and committee appealed.

The Court of Appeals, Jolly, Circuit Judge, held that unsecured creditors' committee failure to seek a stay prevented it, on statutory mootness grounds, from later challenging the terms of sale of debtor-hospital's assets to stalking horse bidder, as those terms were amended to compensate stalking horse bidder for delayed closing.

Affirmed.

Procedural Posture(s): On Appeal; Motion to Dismiss; Motion to Use, Sell, or Lease Property Outside the Ordinary Course of Business.

***231** Appeal from the United States District Court for the Southern District of Texas, USDC No. 4:20-CV-911, Andrew S. Hanen, U.S. District Judge

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Before Jolly, Duncan, and Oldham, Circuit Judges.

Opinion

E. Grady Jolly, Circuit Judge:

A creditor disputes last-minute modifications to the terms of a bankruptcy sale. Because it failed to seek a stay, its appeal fails.

I.

Walker County Hospital Corporation (the "Hospital" or the "Debtor") operated a not-for-profit community hospital in Huntsville, Texas.[1] It is the county's largest healthcare provider; to be sure, few other options exist for residents in this rural area. The Hospital had financial troubles and was on the brink of closing, a matter of great concern to the citizens of Walker County. On November 11, 2019, the Hospital filed for Chapter 11 bankruptcy and made an effort to auction off its assets and operations. But none of the thirty-six parties that received the Hospital's offering memorandum submitted a bid.

But the Hospital did have some hope: a "stalking horse bid"[2] from Huntsville Community Hospital, a joint venture between Walker County Hospital District (the "District") and Community Hospital Corporation (collectively, the "Buyers"). At approximately the same time that the Buyers' bid was being organized and considered, a committee was appointed to represent the interests of the Debtor's unsecured creditors (the "Committee" or the "Creditors"). The Committee believed the Buyers' bid undervalued what the Hospital was worth and would have left little for the Creditors (i.e., the Committee). After weeks of negotiation, the Debtor, the Buyers, and the Committee reached a Settlement that would govern the sale of all of the Hospital's assets and operations to the Buyers. In exchange, the Committee agreed not to bring its objections. This Settlement was memorialized in an email exchange between the parties on December 18, 2019. Two days later, the bankruptcy court held a hearing to approve the sale on the agreed terms and subsequently entered a Sale Order pursuant to 11 U.S.C. § 363(b), which attached and referenced the Settlement ***232** reached among the parties as well as a Purchase Agreement between only the Debtor and the Buyers.

Key features of these documents would later form the basis for this dispute. As noted above, the Committee agreed to waive its objections to the sale based on the terms agreed to in the Settlement. In exchange, the Committee received more favorable terms of sale for the Debtor than originally contemplated by the transaction. This would, of course, translate into more funds being available to flow from the Debtor to the Committee—i.e., to pay off unsecured creditors.

In exchange for less favorable terms, the Buyers retained certain rights. First, the Buyers' bid was conditioned on raising financing from a third-party lender (the "Lender"); without such financing, the Buyers were not obligated to consummate the transaction. Second, the Hospital was slated to receive a large future payment associated with a certain Medicaid program; the Buyers scheduled the transaction's closing date such that that payment was supposed to be received after they owned all of the Hospital's assets—including its accounts receivable—meaning that the Buyers would be entitled to receive that payment. However, if the sale closed after the Hospital received the payment from Medicaid, the payment would be included in an "Accounts Receivable Sharing Waterfall," a complex formula devised to divide the Hospital's accounts receivable between the Buyers and the Debtor's estate (that would eventually flow to the Committee). In short, if the payment reached the Hospital before the sale closed, the Buyers would receive substantially less than expected.

After the Sale Order was entered, the Lender began its due diligence process, reviewing the Hospital's records to determine if it was willing to finance the Buyers' acquisition of the Hospital. The process was slow, issues were found, and closing was delayed past the date originally planned. During this period of delay, the Buyers and the Hospital negotiated some side agreements to keep the Hospital running, since it was very close to shutting its doors due to financial difficulties. As part of these side agreements, the Buyers conditioned their ability and willingness to close the transaction on the Hospital's having not yet received the Medicaid payment; the Buyers did not want to lose that asset because of the delay.

The Lender remained unwilling to finalize financing for the Buyers' acquisition before finishing its diligence on the Hospital—when on or about February 25, 2020, the Hospital received the Medicaid payment. The sale had not yet closed. The Buyer informed the Debtor that losing the Medicaid payment would sink its ability to receive financing to close the transaction.

On February 26, 2020, the Debtor filed an emergency motion in bankruptcy court seeking to amend the Sale Order. In it, the Debtor noted the side deals that had been reached between the Debtor and the Buyers to keep the hospital running and also explained about the delayed closing, the Medicaid payment, and the need for financing. The Debtor asked the court to adjust downward the purchase price the Buyers would be paying and also grant the Buyers an administrative expense claim (which would, in effect, also decrease the sale price for the Buyers). According to the Debtor, this compromise constituted the agreement the Debtor and the Buyers had reached to allow the transaction to still go forward. Without it, there would be no deal, and the hospital would have to cease operations. The Debtor thus claimed that the relief it sought was "in the best interests of the Debtor, its estate, creditors, ***233** and all parties in interest."[3] Because "timely consummation of the sale" was of "critical importance," the Debtor also asked the court to waive the standard fourteen-day stay usually required by Federal Rule of Bankruptcy Procedure 6004(h). FED. R. BANKR. P. 6004(h) ("An order authorizing the use, sale, or lease of property ... is stayed until the expiration of 14 days after entry of the order, *unless the court orders otherwise*.") (emphasis added).

The Debtor filed its motion on February 26, 2020, at 8:42 a.m., and the Committee acknowledges receiving notice "shortly after." Indeed, the Committee says that its counsel called the bankruptcy court to inform the court that it objected to the motion and wanted time to confer with the Debtor and the Buyers, but this evidence does not appear in the record. What is in the record is that one of the Buyers filed a joinder to the Debtor's motion the next day, stating that the "Buyers will not be able to close this transaction without the relief sought in the Debtor's Emergency Motion." And that same day, February 27, 2020, at 9:20 a.m.—about twenty-four hours after the Debtor's motion was filed—the bankruptcy court entered an order amending the Sale Order (the "Amendment Order") and granted the Debtor and the Buyers the relief they had requested.

The Amendment Order was "effective immediately upon its entry," and it authorized the Debtor and the Buyers to "close the sale of the Purchased Assets immediately." It also was explicit that "[a]ny party objecting to this order must exercise due diligence in filing an appeal and pursuing a stay within the time prescribed by law and prior to the Closing Date, [sic] or risk its appeal will be foreclosed as moot." That did not leave much time, because less than twenty-four hours later, the sale of the Hospital's assets closed—at 12:01 a.m. on February 28, 2020.

The Committee did not seek a stay at any point, but about two weeks later, on March 11, 2020, it did appeal the bankruptcy court's Amendment Order to the district court, claiming various bankruptcy rules were not followed and that its procedural due process rights were violated. The Buyers moved to dismiss the Committee's appeal. They argued it was mooted by 11 U.S.C. § 363(m), which provides that the "modification on appeal" of certain authorized bankruptcy sales "does not affect the validity of" such a sale "to an entity that purchased ... such property in good faith ... unless" that sale was "stayed pending appeal." 11 U.S.C. § 363(m). Since the Committee did not even seek a stay, the Buyers argued that the sale could not be modified.

The District Court ruled that the Committee's appeal was statutorily moot.[4] It did not address the Committee's due process arguments.

This appeal by the Committee followed.

II.

"In reviewing the rulings of ... the district court sitting in bankruptcy, we ***234** review findings of fact for clear error and conclusions of law de novo." *In re TMT Procurement Corp.*, 764 F.3d 512, 519 (5th Cir. 2014). "We review mixed questions of law and fact de novo." *Id.*

III.

The district court held that the Committee's appeal was statutorily moot under 11 U.S.C. § 363(m), which provides that the "modification on appeal" of a "sale ... of property" authorized under § 363(b) "does not affect the validity of" such a sale "to an entity that purchased ... such property in good faith ... unless" that sale was "stayed pending appeal." 11 U.S.C. § 363(m). The purpose of § 363 is to "promote the finality of bankruptcy sales[,] thereby maximizing the purchase price of estate assets." NORTON § 44:37. "Without this protection, potential appeals would create such uncertainty that it could chill bidding on the debtor's assets." *Id.* And ultimately, maximizing bidding on and the purchase price for a debtor's assets benefits a debtor's creditors. As this court noted in *Bleaufontaine*:

> If deference were not paid to the policy of speedy and final bankruptcy sales, potential buyers would not even consider purchasing any bankrupt's property. As a result, the bankrupt's creditors would be the ones most injured thereby. The public has a keen interest in protecting such creditors. Otherwise, financing might become a thing of the past.

In re Bleaufontaine, Inc., 634 F.2d 1383, 1389 n.10 (5th Cir. 1981). "The cost, of course, is disposing of ... full judicial review for legal accuracy that typically follows a trial court's ruling. But Congress thought that trade was worth making to encourage buyers to come to the table." *Sneed Shipbuilding*, 916 F.3d at 409–10.

This court's interpretation of § 363(m)—which follows directly from the text of the statute—is clear: "[A] failure to obtain a stay is *fatal* to a challenge of a bankruptcy court's authorization of the sale of property." *In re Ginther Trusts*, 238 F.3d 686, 689 (5th Cir. 2001) (emphasis added). And fatal means fatal: challenges to authorized bankruptcy sales are dismissed when the party challenging the sale has not sought a stay. This result is made unmistakable by our precedent.

For example, four decades ago, a debtor wanted to make a deal to lease property to provide crucial finances as it went through a Chapter 11 bankruptcy. *Am. Grain Ass'n v. Lee-Vac, Ltd.*, 630 F.2d 245, 247 (5th Cir. 1980). "[T]ime was of the essence" to close the leasing transaction. *Id.* A creditor objected to the lease, but the bankruptcy court approved it over the objection, and the lease agreement was consummated. *Id.* The creditor appealed the bankruptcy court's order to this court. *Id.* It did not, however, seek a stay. *Id.* This court held that "[i]n the absence of a stay of a bankruptcy court's order ... a party appealing the order will not be heard to affect the rights of a third party" who acquired the property through the lease. *Id.* at 248. "Under such circumstances, the appeal will be dismissed as moot." *Id.* at 247.

A few years later, a creditor attempted to assert ownership of property that was part of a bankruptcy proceeding; the bankrupt wanted to sell the property to a buyer. *Fabrique, Inc. v. Corman*, 813 F.2d 725, 725 (5th Cir. 1987). The bankruptcy judge allowed the sale. *Id.* The creditor appealed that decision but failed to seek a stay. *Id.* The appeal was "dismissed as moot, as 11 U.S.C. § 363(m) ... placed [the buyer's] purchase beyond challenge." *Id.*

Just three years after *Fabrique*, a bankruptcy court "entered an order approving ***235** the sale of certain assets," which a party "did not obtain a stay [of] pending appeal to the district court." *In re Gilchrist*, 891 F.2d 559, 560 (5th Cir. 1990). When the appeal reached this court, the panel was resolute: "Section 363(m) patently protects, from later modification on appeal, an authorized sale where the purchaser acted in good faith and the sale was not stayed pending appeal." *Id.* As such, "in the absence of a stay," the appeal is moot, and a party "cannot be heard to complain at this late date." *Id.* at 560–61.

Only two years ago in *Sneed Shipbuilding*, a trustee attempted to block a bankruptcy court's approval of a sale of key estate assets, and we "conclude[d] that section 363(m) made the bankruptcy court's approval the final word on the subject when the objector did not obtain a stay of that ruling." *Sneed Shipbuilding*, 916 F.3d at 407. We reasoned that since "Congress ha[d] ordered [it] not to review such decisions by the bankruptcy court when they are not stayed," the case was moot. *Id.* at 410.

IV.

The Committee, however, makes two interrelated arguments in an attempt to skirt § 363(m)'s bar. First, it notes that it only appealed the Amendment Order, not the Sale Order. Second, although the Sale Order was rendered pursuant to § 363(b), the Amendment Order did not mention that subsection or § 363(c), which are the only two subsections that authorize sales to which § 363(m) applies. Because the Committee did not appeal the Sale Order, and because the Amendment Order was not pursuant to § 363(b), the Committee argues that the lower court erred in applying § 363(m).

The Committee is correct when it asserts that the Amendment Order did not mention § 363(b). But the Amendment Order never purported to authorize a new or different sale; it only amended the Sale Order based "upon all of the proceedings had" before that court. One can clearly see this from looking at the titles of the two orders, which are nearly identical—the Amendment Order merely adds "Order Amending" to the title of the Sale Order. The Amendment Order, rather than being a discrete decree, was integrally linked to, and indeed, inseparable from, the Sale Order.

What's more, this court previously has encountered these sorts of arguments in this same context. For example, in *American Grain*, the creditor argued that § 363(m) should not apply because it contested an order about a lease, not a sale of property. *Am. Grain Ass'n*, 630 F.2d at 248. The panel held that "such a strict reading of the rule would ... undermine the important policy of affording finality to lower court judgments in bankruptcy proceedings." *Id.* A creditor made a similar argument in *Sneed Shipbuilding*, saying that it did not challenge the sale of the property but rather the cash disbursement that happened as part of that sale and a related settlement. *Sneed Shipbuilding, Inc.*, 916 F.3d at 410. In response, this court stated that it could not perform an "isolated analysis," given that the payment was an "essential feature of the sale." *Id.* The court went on to note that because the arrangements were "mutually dependent" and could not be "sever[ed]," the creditor's argument was unavailing. *Id.*

Thus, *American Grain* and *Sneed Shipbuilding* control here.[5] The Amendment ***236** Order does just that—it amends the Sale Order—and therefore cannot be separated from it, just as the lease in *American Grain* and the cash disbursement in *Sneed Shipbuilding*. The Committee's contentions are therefore unavailing.[6]

V.

In this opinion, we have held that § 363(m) forecloses the creditor's appeal because it failed to seek the required stay of the Sale Order. Established precedent leads us to this conclusion, and the Committee's argument that it appealed an order not subject to § 363(m) is unpersuasive. In short: no stay, no pay.

AFFIRMED.

All Citations

3 F.4th 229, 70 Bankr.Ct.Dec. 124

Footnotes

1 As the facts are not in dispute, the factual discussion in the district court's order is relied on here.

2 "[A]n initial bidder" in a bankruptcy proceeding may "serve as a so-called 'stalking horse,' whose initial research, due diligence, and ... bid may encourage later bidders." *In re ASARCO, L.L.C.*, 650 F.3d 593, 602 (5th Cir. 2011). "[T]he initial offeror provides a valuable service by establishing a minimum price for the assets to be sold and in creating a market for the assets." WILLIAM L. NORTON, 2 NORTON BANKR. L. & PRAC. § 44:28 (3d ed. 2021) [hereinafter "NORTON"].

3 The Debtor also noted, however, that it "sought the Committee's consent to the relief sought in this Motion prior to filing this Motion, but such consent was not obtained."

4 The district court also found that the Creditors' appeal was equitably moot. Equitable mootness is a judge-created bankruptcy doctrine that "allows courts to abstain from appeals" of orders confirming bankruptcy plans. *In re Sneed Shipbuilding, Inc.*, 916 F.3d 405, 408 (5th Cir. 2019). But there was no bankruptcy plan ever proposed in this case, let alone a plan confirmation order, so the doctrine of equitable mootness cannot apply. *Id.* at 409.

5 We note one case that appears, at first glance, to support the Committee's position: *In re Energytec, Inc.*, 739 F.3d 215 (5th Cir. 2013). But in that case, the bankruptcy court specifically reserved for later determination an issue that arose as part of a sale; this court found a later ruling on that issue to be separately appealable from the sale order and not moot. *Id.* at 219 & nn.2–3, 221. Here, the bankruptcy court did not reserve any questions for later determination: the Amendment Order's sole purpose was to modify the Sale Order so that the parties would fully consummate the sale. Nothing was left on the table. *Energytec* is thus inapposite.

6 The Committee also argues that its procedural due process rights were violated by the manner in which the bankruptcy court handled the Debtor's motion to amend and the Amendment Order; that is, the short time frame in which the Committee had to seek a stay. Having decided this appeal on statutory mootness grounds, we will not address these arguments. *Cf. TMT Procurement Corp.*, 764 F.3d at 520 (noting that "[c]onsistent with our precedent" the court "d[id] not reach" another issue in a bankruptcy appeal "before deciding the statutory mootness issue" because of the party's "failure to obtain a stay pending appeal"). Nor will we pass on the Committee's contentions regarding the other parties' good faith or the awarding of damages, as the Committee did not make these arguments until its district court appeal reply brief. Since "arguments raised for the first time in a reply brief are waived," *United States v. Gas Pipe, Inc.*, 997 F.3d 231, 242 (5th Cir. 2021), the district court—as an appellate court, in this bankruptcy case—rightfully did not consider these arguments.

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Bankruptcy Law Letter

MAY 2019 | VOLUME 39 | ISSUE 5

ON CONSTRUCTIVELY FRAUDULENT TRANSFERS AND GOOD FAITH TRANSFEREES: THE CASE OF A DEBTOR-PARENT'S PAYMENT OF AN ADULT CHILD'S COLLEGE TUITION

*By Ralph Brubaker**

INTRODUCTION

This issue of *Bankruptcy Law Letter* will analyze the many cases that have been filed in recent years challenging a debtor-parent's payment of an adult child's college tuition as a constructively fraudulent transfer. The results in those cases have not been at all consistent. The difficulties that the courts are having with those cases is attributable to a largely overlooked statutory anomaly that gives insufficient protection to innocent transferees and obligees of avoidable fraudulent transfers and obligations.

The Reporter for the 2014 Uniform Voidable Transactions Act (UVTA), which proposed amendments to the 1984 Uniform Fraudulent Transfer Act (UFTA), Professor Kettering, has aptly noted that "[t]he interest of the debtor's transferee surprisingly often has been forgotten in discourse on fraudulent transfer law, but to ignore that interest is an error that invalidates the discourse."[1] That error is the source of the disarray we are witnessing in the decisions dealing with a debtor-parent's payment of an adult child's college tuition.

THE SUBSTANCE OF WHAT'S AT ISSUE

As a way of framing the gist of what's at stake in these tuition cases, consider two scenarios.

1. Scenario 1

Scenario 1 involves two sequential interrelated transactions among three parties.

*Andrew Kull and David Carlson provided me with very helpful comments, for which I am extremely grateful.

IN THIS ISSUE:

(1) **Parent** makes a gift to adult **Child** to enable Child to pay Child's college tuition at **University**.

(2) Upon receipt of those funds from Parent, Child pays them to University in satisfaction of Child's tuition obligation to University.

2. Scenario 2

Scenario 2 adds another, initial transaction to the series and, thus, involves three sequential interrelated transactions among four parties.

(1) **Parent** borrows money from **Lender** for the purpose of paying adult **Child**'s college tuition at **University**.

(2) Upon receipt of the loan proceeds, Parent makes a gift of the loan proceeds to Child to enable Child to pay Child's college tuition.

(3) Upon receipt of those funds from Parent, Child pays them to University in satisfaction of Child's tuition obligation to University.

And then, in each of the above two scenarios, within two years Parent files a Chapter 7 petition, and Parent's Chapter 7 trustee smells a fraudulent conveyance action under the constructive fraud provisions of Bankruptcy Code § 548(a)(1)(B) and/or the analogous constructive fraud provisions of applicable state law invoked via Code § 544(b)(1). In each of the above two scenarios, the series of interrelated transactions likely exposes Child to potential liability for a constructively fraudulent transfer, but not Lender nor University.

3. Child's Constructive Fraud Liability

In both Scenario 1 and Scenario 2, Child is at great risk of constructive fraud liability under Code § 548(a)(1)(B) because Child received a "transfer . . . of an interest of the debtor [Parent] in property" made "within 2 years before the date of the filing of [Parent's Chapter 7] petition," and Parent apparently "received less than a reasonably equivalent value in exchange for such transfer," within the meaning of Code § 548(a)(1)(B)(i). Indeed, Parent apparently received nothing in exchange for such transfer. Thus, if one of the financial-vulnerability tests in § 548(a)(1)(B)(ii) was met with respect to Parent's gift to Child, that gift was a *prima facie* constructively fraudulent transfer. Moreover, Child apparently has no § 548(c) fraudulent-transfer defense (for a transferee "that takes for value and in good faith"), because Child gave *no* "value" at all in exchange for such transfer. "Value" is defined for purposes of the Code's fraudulent transfer provisions (of § 548) in Code § 548(d)(2)(A) as "property, or satisfaction or securing of a present or antecedent debt of the debtor," and the recipient of a gift (essentially by definition) gives neither in exchange for the gift.

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Debtor-Parent's gift to Child (assuming Parent's insolvency or other qualifying financial vulnerability) is a paradigmatic constructively fraudulent transfer for which Child has no § 548(c) good-faith for-value defense. Indeed, modern constructive fraud law traces its origins to a line of 19th-century case law involving gifts (then commonly known as "voluntary conveyances") by insolvents.[2]

4. University's Protection as a Good Faith Transferee for Value

In both Scenario 1 and Scenario 2, if the gift to Child was a constructively fraudulent transfer, avoided under Code § 548(a)(1)(B), then the subsequent transfer of those gifted funds to University would make University potentially liable under § 550(a)(2), as an "immediate . . . transferee of [Child, the] initial transferee" of "the property transferred" via "a transfer . . . avoided under section . . . 548."

Such a *subsequent* transferee of property transferred via an avoided transfer, though, has an absolute good-faith for-value defense under § 550(b)(1), if that subsequent transferee "takes for value, including satisfaction or securing of a present or antecedent debt, in good faith, and without knowledge of the voidability of the transfer avoided." University gave value to Child in exchange for the transfer from Child, in the form of a college education, and "[a]ll of the courts that have considered this question have held or implied that value to the transferor [Child] is sufficient."[3] Thus, University would have no fraudulent transfer liability, as long as University took those funds "in good faith" and "without knowledge of the voidability of the [initial] transfer" to Child, which would typically be the case.

As Professor Kull has pointed out, "Section 550 is surely the most restitution-minded section of the Code" in that "it not only embodies the notion of following property" transferred via an avoidable transfer "through successive transfers," but also "the defense of purchase for value."[4] Both of these are "ideas … solidly grounded in common-law restitution."[5]

5. Lender's Protection as a Good Faith Obligee for Value

With respect to Lender's loan to Parent in Scenario 2, Bankruptcy Code § 548(a)(1)(B) also authorizes avoidance of "any obligation . . . incurred by the debtor . . . within 2 years before the date of the filing of the petition, if the debtor . . . received less than a reasonably equivalent value in exchange for such . . . obligation." But Lender, unlike Child, did provide debtor-Parent "value" in exchange for Parent incurring the loan obligation to Lender, in the form of the cash loan proceeds, which clearly constitute "property" within the definition of "value" in Code § 548(d)(2)(A). Moreover, assuming a reasonable interest rate on the loan, the value of the cash loan proceeds Parent received was undoubtedly "reasonably equivalent" to the amount of the obligation Parent thereby incurred, within the meaning of § 548(a)(1)(B)(i). What's more, Lender would also be protected by the § 548(c) good-faith for-value defense, which provides that an obligee "that takes for value and in good faith . . . may enforce any obligation incurred . . . to the extent that such . . . obligee gave value to the debtor in exchange for such . . . obligation."

6. Fraudulent Transfer Law's Protections Against Depletion of a Debtor's Estate

Those results align perfectly with the longstanding historical purposes of fraudulent conveyance law. "The purpose of the law of fraudulent transfers is to protect creditors from unfair transactions that hamper their efforts to collect from the debtor," and "constructive fraud is a form of strict liability designed to redress creditor injury"[6] via an "unjust diminution of the debtor's estate."[7] Thus, "it follows that any act of the debtor must be condemned if it brings about such a result."[8] And that is why modern fraudulent conveyance statutes not only provide for avoidance of a fraudulent "transfer" of a debtor's property; they also provide for avoidance of any "obligation" a debtor incurs that depletes the estate available to pay pre-existing creditors (which is the result if the debtor "received less than a reasonably equivalent value in exchange for such . . . obligation"[9]).

7. Fraudulent Transfer Law's Protection of Bona Fide Purchasers

At the same time, though, innocent transferees and obligees who take for value (i.e., the equivalent of bona fide purchasers at common law[10]) are shielded from fraudulent conveyance liability.

> The interests of the debtor's defrauded creditors in collecting their claim must be balanced against the legitimate expectations and interests of innocent transferees. A cardinal rule of fraudulent conveyance law from the earliest days of the Statute of Elizabeth has been that a *good faith purchaser for value is protected from recovery*.[11]

In Scenarios 1 and 2, the only aspect of the interrelated transactions that depleted debtor-Parent's estate to the injury of creditors was the gift to Child. Moreover, University and Lender are paradigmatic examples of bona fide purchasers and, thus, should not face any fraudulent conveyance liability.

A number of reported decisions in the past few years vividly demonstrate, though, that if one simply changes the transaction structure for each of the above-described scenarios, without any change whatsoever in the function and effect of the transactions, either as intended or as accomplished, the fraudulent transfer exposure of Child, University, and Lender can change dramatically. That is rather disconcerting, given that, by its very design, "[f]raudulent conveyance doctrine . . . is a flexible principle that *looks to substance, rather than form*" in "protect[ing] *creditors* from any transactions the debtor engages in that have the effect of impairing their rights, while [at the same time] assuring *third parties* that transactions done with the debtor at arm's length will *not* be second-guessed."[12] So let us analyze the alternative transaction structures with which the courts have been grappling, to see the extent to which substance has become subservient to form in the tuition gift cases.

DEBTOR-PARENT DIRECTLY PAYS ADULT CHILD'S COLLEGE TUITION

1. Revised Scenario 1

As a variation on Scenario 1, described above, now consider a case in which Parent, instead of gifting funds to Child that Child then pays to University (Scenario 1), Parent simply directly pays Child's tuition to University, which we shall call Revised Scenario 1. By so doing, then, what would otherwise be two separate transfer transactions (Parent-Child, Child-University) are collapsed into one direct Parent-University transfer that pays Child's tuition obligation to University.

Of course, the substantive purpose and effect of Revised Scenario 1, from the perspective of all three parties, is identical to that of Scenario 1; only the form and mechanics by which the transactions are accomplished has been altered. As Professor Glenn noted:

> A fraudulent conveyance [by gift] is usually made by direct conveyance to the intended donee, but the case is not different, in principle, when the debtor lays out money to the donee's use, as by paying his bills. The point is that value has left the debtor's estate, and so the donee who has benefitted by the payment must respond to the creditors of the [debtor] who made it.[13]

In accord with Professor Glenn's allusion to a concept of beneficiary (as opposed to transferee) liability,[14] modern constructive fraud statutes explicitly address the indirect gift being made by Parent to Child in Revised Scenario 1. Thus, Bankruptcy Code § 550(a)(1) provides as follows (emphasis added):

> **§ 550. Liability of transferee of avoided transfer**
>
> **(a)** . . . to the extent that a transfer is avoided under section . . . 548 . . . of this title, the trustee may recover, for the benefit of the estate, the property transferred, or, if the court so orders, the value of such property, from—
>
> **(1)** the initial transferee of such transfer *or the entity for whose benefit such transfer was made* . . . .[15]

In Revised Scenario 1, therefore, most courts would hold that University is "the initial transferee" of the Parent-University payment, and Child is "the entity for whose benefit such transfer was made."[16] Child's beneficiary liability under Code § 550(a)(1), though, is dependent upon avoidance of debtor-Parent's payment to University. Whether that Parent-University transfer is avoidable, though, has sharply divided the numerous bankruptcy courts that have considered Revised Scenario 1 cases.

Occasionally, a trustee alleges that Parent's payment to University was a fraudulent transfer of the "actual fraud" variety under Code § 548(a)(1)(A) and/or the analogous actual fraudulent transfer provision of applicable state law (i.e., made by Parent with "actual intent to hinder, delay, or defraud" Parent's creditors). With respect to familial gifts, though, that requisite intent to thereby injure creditors is typically absent. As Baird and Jackson put it, "[a] person who wishes to be generous to a relative or friend does not necessarily have a bad state of mind toward creditors."[17] Constructive fraud, therefore, is usually the basis on which the trustee challenges the Parent-University payment.

As regards constructive fraud, assuming the trustee can establish the existence of one of the financial-vulnerability measures of § 548(a)(1)(B)(ii), avoidability of the Parent-University payment turns on whether Parent "received less than a reasonably equivalent value in exchange for such transfer," within the meaning of § 548(a)(1)(B)(i). And the courts have come to sharply divergent conclusions on that question.

2. Does Debtor-Parent Receive "Value in Exchange for" Payment of Child's Tuition?

Some courts have held that debtor-Parent *does* receive "reasonably equivalent value" in paying Child's tuition, and thus, debtor-Parent's payment to University is not avoidable as constructively fraudulent.[18] In perhaps the leading case for that position, *In re Palladino*, the court reasoned as follows:

> I find that the [debtor-Parents] paid [University] because they believed that a financially self-sufficient [Child] offered them an economic benefit and that a college degree would directly contribute to financial self-sufficiency. I find that motivation to be concrete and quantifiable enough. The operative standard used in both the Bankruptcy Code and the UFTA is "reasonably equivalent value." The emphasis should be on "reasonably." Often a parent will not know at the time she pays a bill, whether for herself or for her child, if the medical procedure, the music lesson, or the college fee will turn out to have been "worth it." But future outcome cannot be the standard for determining whether one receives reasonably equivalent value at the time of a payment. A parent can reasonably assume that paying for a child to obtain an undergraduate degree will enhance the financial well-being of the child which in turn will confer an economic benefit on the parent. This, it seems to me, constitutes a *quid pro quo* that is reasonable and reasonable equivalence is all that is required.[19]

Most courts, though, have concluded that this is not "value" that counts for purposes of constructive fraud analysis.[20] Debtor-Parent does receive "reasonably equivalent value in exchange for" payment of the educational expenses of a *minor* child (including tuition for a private secondary school of Parent's choice), in the form of satisfaction of debtor-Parent's legal support obligations.[21] That is not the case, however, for *adult* Child for which debtor-Parent no longer has any legal obligation to support that child. "[D]ischarging a 'moral obligation' or meeting a 'societal expectation' is not 'value' within the meaning of the statute."[22]

> While such support is unquestionably admirable . . . , it is undisputed that the Debtor had no legal obligation pay for her adult [Child]'s college education. The Transfers did not, therefore, satisfy "a present or antecedent debt of the debtor" or otherwise confer "value" to the Debtor within the meaning of 11 U.S.C. § 548(d)(2)(A). "[T]ransfers made or obligations incurred solely for the benefit of third parties do not furnish reasonably equivalent value."[23]

The recent decision in *In re Sterman* is representative of this view:

> Whether insolvent parents receive reasonably equivalent value for college tuition payments made for the benefit of their adult children is a culturally and socially charged issue. With the greatest respect for the courts that have found reasonably equivalent value for such tuition payments, the Court is constrained by the language of the Bankruptcy Code and the [New York enactment of the 1918 Uniform Fraudulent Conveyance Act (UFCA)]—those statutes define the terms "value" and "fair consideration" to require either the transfer of property or the satisfaction of an antecedent debt in return for an insolvent debtor's payments.
>
> * * * *
>
> The Court does not question whether the Debtors' decision to send money to or for the benefit of their adult daughters for their college education was

> economically prudent. But, unfortunately, the economic "benefit" identified by the Defendants does not constitute "value" under the [New York UFCA] or the Bankruptcy Code.[24]

These courts also hold that whatever future economic benefits might accrue to debtor-Parent from payment of Child's college tuition are not received "in exchange for" that payment. The statutory "exchange" language suggests that only value received in a contractual, market, or other *quid pro quo* exchange can be included in the constructive fraud "reasonably equivalent" calculus. Indeed, in cases in which value equivalency is most dubious, it is often because of the lack of any indicia of an arms' length, *quid pro quo* exchange, and the tuition gift cases provide yet another example. As the court in *In re Knight* stated:

> It may be reasonable for parents to believe that investment in their child's college education will enhance the financial well-being of the child. It may also be reasonable for parents to assume that their child will someday reimburse them for the cost of tuition or otherwise confer an economic benefit in return. Piling one plausible inference upon another, however, is little more than wishful thinking. Moreover, such speculation about another's ability to repay in the future and their willingness to do so, however reasonable, does not amount to a *quid pro quo* and certainly does not provide economic value to current creditors.
>
> The absence of a *quid pro quo* is itself fatal [because] "[t]he statute requires that the debtor must have 'received' the value in question 'in exchange' for the transfer or obligation at stake." . . .
>
> . . . [I]t is, of course, true that future outcome cannot be the touchstone for whether a debtor received value, reasonably equivalent or otherwise at the time of payment. Indeed, . . . courts have concluded that a "mere expectation" of economic benefit "would suffice to confer 'value' so long as the expectation was '*legitimate and reasonable*.' " . . .
>
> In this case, Debtor could not have had a "legitimate and reasonable" expectation of economic benefit . . . from transfers that conveyed thousands of dollars for her son's college tuition, without even a vague promise that funds would be repaid in the future.[25]

Stated differently, if Child had made a bona fide contractual promise to debtor-Parent to repay the tuition in the future, such contract rights might constitute "property" that debtor-Parent received "in exchange for" paying Child's tuition[26] (although one would still need to value that contractual promise to determine whether its value was reasonably equivalent to the tuition payments). A hope and a prayer, however, are not "property" received "in exchange for" paying Child's tuition. Most courts, therefore, hold that debtor-Parent's payment of Child's tuition to University is an avoidable constructively fraudulent transfer.

3. Is University a Good Faith Transferee for Value?

Concluding that the Parent-University payment of Child's tuition is an avoidable transfer because it is constructively fraudulent subjects Child to beneficiary liability for that payment, under Code § 550(a)(1). But it *also* subjects *University* to liability under Code § 550(a)(1), as the "initial transferee" of that avoidable transfer. The only potential defense that the initial transferee of an avoidable fraudulent transfer can raise is the good-faith for-value defense of § 548(c). While that defense will shield University from any liability in Scenario 1, it does *not* protect University from liability in a Revised Scenario 1 case because it only applies (emphasis added) "to the extent that such transferee . . . gave value *to the debtor* in exchange for such transfer."[27]

In both Scenario 1 and Revised Scenario 1, University gave value in exchange for the tuition payment, of precisely the kind that would make University a protected bona fide purchaser of that money at common law. However, in Revised Scenario 1 (in contrast to Scenario 1), University gave that value to Child (rather than debtor-Parent), and thus, University has no statutory defense to constructive fraud liability in a Revised Scenario 1 case.

That anomaly in the statute is, I submit, why the courts have struggled with the tuition gift cases. There is no good reason why University's liability should differ as between Scenario 1 and Revised Scenario 1, which are substantively identical. Consistent with the traditional purposes of fraudulent conveyance law, subjecting University to liability in a Revised Scenario 1 case is manifestly at odds with courts' intuitive sense of justice and fairness. Even those courts that feel duty-bound by the explicit term of the statute to hold University liable, do so grudgingly. As the court in *In re Knight* acknowledged, "this Court credits concerns about . . . the wisdom of allowing trustees to claw back parents' tuition payments for their adult children."[28]

4. The Inexplicable Statutory Abandonment of a Third-Party-Value Defense for Good Faith Transferees and Obligees

Concern about the wisdom of subjecting University to constructive fraud liability in a Revised Scenario 1 case is well founded. Indeed, under the very first codifications of constructive fraud law—the 1918 UFCA, which remains in effect in Maryland and New York, and the 1938 Chandler Act amendments to the Bankruptcy Act of 1898—University would be shielded from any liability as a good-faith for-value transferee of debtor-Parent's tuition payments to University. For example, section 9(1) of the 1918 UFCA provided as follows (emphasis added):

> Where a conveyance or obligation is fraudulent as to a creditor, such creditor . . . may, as against any person *except a purchaser for fair consideration without knowledge of the fraud at the time of the purchase*, or one who has derived title immediately or mediately from such a purchaser,
>
> (a) Have the conveyance set aside or obligation annulled to the extent necessary to satisfy his claim, or
>
> (b) disregard the conveyance and attach or levy execution upon the property conveyed.[29]

Moreover, the UFCA's definition of "fair consideration" (in UFCA § 3), that would invoke the protection of the § 9(1) defense for an innocent transferee or obligee, did *not* limit the concept to consideration flowing to the debtor:

> Fair consideration is given for property, or obligation,
>
> (a) When in exchange for such property, or obligation, as a fair equivalent therefor, and in good faith, property is conveyed or an antecedent debt is satisfied, or
>
> (b) When such property, or obligation is received in good faith to secure a present advance or antecedent debt in amount not disproportionately small as compared with the value of the property, or obligation obtained.[30]

This aspect of the 1918 UFCA (and substantially similar provisions of § 67 of the Bankruptcy Act of 1898) was a codification of common-law bona fide purchase doctrine, which does *not* require that the consideration for a transfer or obligation be given *to* the transferor or obligor, in order for an innocent purchaser to take free and clear of claims to avoid or rescind the transfer or obligation.[31] A rule that "value counts" for purposes of an initial transferee's or obligee's defense to fraudulent conveyance liability "even if the debtor does not receive it rests on the idea of protecting good-faith purchasers for value,"[32] which (as we've seen) is one of the longstanding, fundamental precepts of fraudulent conveyance law. "In many other settings, the law shields such a purchaser from adverse claims to the purchased property even though the value given by the purchaser went to someone other than the adverse claimant."[33]

When the Bankruptcy Code was enacted in 1978, though, the § 548(c) defense (for good-faith for-value initial transferees and obligees) *eliminated* the defense for cases in which an innocent transferee or obligee gives value to a third party (as in Revised Scenario 1). Thus, § 548(c) provides as follows (emphasis added):

> [A] transferee or obligee of such a [voidable fraudulent] transfer or obligation that takes for value and in good faith . . . may retain any interest transferred or may enforce any obligation incurred, as the case may be, to the extent such transferee or obligee gave value *to the debtor* in exchange for such transfer or obligation.

As the tuition gift cases starkly demonstrate, that is a significant and puzzling change in the protection afforded an innocent transferee or obligee. As Professor Kettering has noted:

> [T]he drafters of the Bankruptcy Code deviated from the UFCA is some ways that are inexplicable. This is one of them. . . . Why the Bankruptcy Code's drafters chose to omit this additional protection for good-faith transferees is a mystery, at least to this author.[34]

Subsequently, the 1984 UFTA carried forward the UFCA's protection of innocent transferees and obligees who give value to a third party, but *only* for transfers made with actual fraudulent intent and *not* for constructively fraudulent transfers[35] (which is another perplexing mystery in the statutory abandonment of a third-party-value defense for innocent transferees and obligees[36]). And the 2014 UVTA continues the trend by amending the UFTA to (like the Bankruptcy Code) completely eliminate any protection for an initial transferee or obligee who gives value to a third party.[37]

As Professor Carlson has insightfully observed in a related context, subjecting University to fraudulent conveyance liability in a Revised Scenario 1 case undermines the negotiability of money.[38] For example, had Child stolen the funds at issue from Parent and then paid those funds to University, University would take good title to those funds (free and clear of any claim by Parent to get them back) under the time-honored "money rule" from Lord Mansfield's venerable *Race v. Miller* decision,[39] and the principle derived therefrom, that even a thief can convey good title of stolen funds to a bona fide purchaser.[40] University would enjoy the same bona fide purchaser protection if Child perpetrated an extreme fraud on Parent (constituting fraud in the execution, which is the functional equivalent of theft[41]) that induced Parent to directly (but unwittingly) transfer the funds to University. Yet, when Parent *voluntarily* pays University when insolvent (or at high risk thereof), University's innocent, good faith, bona fide purchase for value provides *no protection* at all? This is a serious and unjustified erosion of the negotiability of money.

5. Statutory Fixes

The inequity of the statutory abandonment of traditional bona fide purchaser protections, for an initial transferee or obligee who gives value to a third party, has not gone entirely unnoticed. Indeed, the tuition gift cases are sparking renewed attention to this problem. In 2017, the Connecticut state legislature enacted a non-uniform amendment to the UFTA to prevent avoidance of a transfer or obligation as constructively fraudulent as "against an institution of higher education . . . if the transfer was made or obligation incurred by a parent or guardian on behalf of a minor or adult child in furtherance of the child's undergraduate education."[42] And similar legislation to amend the Bankruptcy Code's fraudulent conveyance provision has been introduced in Congress.[43]

Of course, such a targeted, piecemeal fix does not address the larger statutory anomaly that leads to the inequity in the tuition gift cases. Precisely the same issue is presented by cases, for example, in which a principal of a corporate debtor directly pays personal expenses with corporate funds. A much better response, therefore, is that of the Washington state legislature, which (in enacting the UVTA amendments to the UFTA in 2017) enacted a non-uniform amendment that completely restores the UFCA's absolute protection of an initial transferee or obligee "that took in good faith and for a reasonably equivalent value *whether or not given to the debtor*."[44]

6. Judicial Fixes: "Reasonably Equivalent Value" Determinations, Mere Conduit Doctrine, and Equitable Transaction Recharacterization

In the absence of any explicit statutory protection for University in a Revised Scenario 1 case, the courts seem to be searching for ways to nonetheless shield University from liability within the framework of the existing statute and fraudulent transfer jurisprudence. The cases holding that debtor-Parent does receive reasonably equivalent value in exchange for payment of Child's tuition to University are one example of that phenomenon. Many, though, will judge that to be an imperfect response to the plight of University, because if debtor-Parent received reasonably equivalent value in exchange for the tuition payments to University, there is *no* avoidable transfer *at all* and, thus, *no liability for anyone*, not even for Child (the indirect recipient of an estate-depleting gift).

Another example of the judicial response to Revised Scenario 1 cases is provided by a pair of January 2019 decisions—*Pergament v. Brooklyn Law School*[45] and *In re Hamadi*[46]—holding that University is a "mere conduit" for Parent's tuition payments. Thus, Child is the *initial* transferee of Parent's tuition payments, and University is (*both* mere conduit *and*) a *subsequent* transferee, with the absolute protection of the good-faith for-value defense of § 550(b)(1) for the value University provided Child in exchange for debtor-Parent's tuition payments. Through this (rather convoluted) "mere conduit" move, therefore, these courts essentially recharacterize a Revised Scenario 1 case as being, in reality, a Scenario 1 case.

Mere-conduit doctrine is a bit of a mess,[47] and thus, we will not detain ourselves with the mere-conduit analysis of those courts.[48] I will note, however, that characterizing University as a mere conduit in a Revised Scenario 1 case is (in my opinion) a highly dubious invocation of the (itself, somewhat dubious) doctrine of the "mere conduit."[49] More importantly, though, it is evidently an incomplete solution to the difficulties a Revised Scenario 1 case poses for University. In both *Pergament* and *Hamadi*, the courts held that University was shielded from liability only for tuition payments made at a time when (and to the extent that) the tuition would be refundable should Child withdraw from University. For any tuition payments debtor-Parent made to University that were nonrefundable when made, those courts held that University was the *initial* transferee with constructive fraud liability and no § 548(c) good-faith for-value defense.

If a court is inclined to recharacterize a Revised Scenario 1 case to be, in substance and effect, the equivalent of a Scenario 1 case, a better approach would be to simply do so fully, openly, and forthrightly. And that sort of transactional recharacterization is nothing new to fraudulent conveyance law. As Professor Markell has noted, "[p]articulary in the leveraged buyout area, courts have not hesitated to collapse transactions in order to evaluate the substance of a transaction."[50]

Recharacterizing a Revised Scenario 1 case to be, in substance, a Scenario 1 case for purposes of fraudulent conveyance analysis is actually the converse of collapsing a transaction; it is unpacking a collapsed transaction structure (Revised Scenario 1) to identify the substantive effect of that collapsed transaction on the individual bilateral relationships between each of the parties (i.e., Scenario 1). Moreover, as Professor Kettering points out, collapsing the transaction structure of an LBO is used *offensively*, to impose fraudulent transfer liability where none would exist if formal transaction structure were respected.[51] By contrast, recharacterizing a Revised Scenario 1 case as, in substance, a Scenario 1 case would be a *defensive* use of recharacterization, to protect University from liability it faces if the formal transaction structure governs the analysis. Nonetheless, such a recharacterization is fully consistent with the legitimate equitable powers that bankruptcy courts exercise "in passing on a wide range of problems arising out of the administration of bankrupt estates . . . invoked to the end that fraud will not prevail, that substance will not give way to form, that technical considerations will not prevent substantial justice being done."[52]

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A straightforward equitable recharacterization of the transaction structure would also be a better means of addressing the alternative transaction structure courts have confronted, that is the substantive equivalent of Scenario 2.

1. Scenario 2

Recall Scenario 2, described above, is as follows:

(1) **Parent** borrows money from **Lender** for the purpose of paying adult **Child**'s college tuition at **University**.

(2) Upon receipt of the loan proceeds, Parent makes a gift of the loan proceeds to Child to enable Child to pay Child's college tuition.

(3) Upon receipt of those funds from Parent, Child pays them to University in satisfaction of Child's tuition obligation to University.

2. Revised Scenario 2

As a variation on Scenario 2, now consider the alternative transaction structure in which Lender simply directly pays the loan proceeds to University, which we shall call <u>Revised Scenario 2</u>. By so doing, then, what would otherwise be three separate transfer transactions (Lender-Parent, Parent-

Child, Child-University) are collapsed into one direct Lender-University transfer that pays Child's tuition obligation to University.

If one accepts that debtor-Parent does not receive "reasonably equivalent value" from University via payment of Child's tuition, then Revised Scenario 2 presents for University the same liability exposure for a constructively fraudulent transfer as does Revised Scenario 1. University is the *initial* transferee of the property transferred (the loan proceeds) and is not protected by the § 548(c) good-faith for-value defense, because University provided value to Child in exchange for that transfer rather than to debtor-Parent. By contrast, though, in Scenario 2 University is a *subsequent* transferee of that property that is fully protected by the good-faith for-value defense of § 550(b)(1).

3. Is University a Transferee of an "Interest of the Debtor in Property"?

As is equally true for Revised Scenario 1 cases (discussed above), there is no good reason to deny University the traditional protections afforded a bona fide purchaser in a Revised Scenario 2 case, and to do so is a serious and unjustified erosion of the negotiability of money. Consequently, courts have also devised a means of shielding University from fraudulent conveyance liability in Revised Scenario 2 cases.

The device courts have used is tied to the statutory language of Code § 548(a) (identical to that of the § 547(b) preference statute) that authorizes a trustee to avoid a "transfer of an interest of the debtor in property." Several courts in the last few years have held that the Lender-University transfer in a Revised Scenario 2 case is *not* a "transfer of an interest of the debtor [Parent] in property," and thus, is not an avoidable fraudulent transfer.[53]

The cases that have invoked this doctrinal dodge have all involved loans made by the U.S. Department of Education under the federal Direct Parent PLUS Loan program. Under the statute and regulations governing these Parent PLUS loans, the loan proceeds must and can only be disbursed directly to University and should Child withdraw from University or lose financial aid eligibility after disbursement of loan proceeds to University, University is "required to deliver any remaining Parent Plus loan proceeds to the Department [of Education], not to [debtor-Parent] or [Child]."[54] Debtor-Parent, therefore, supposedly does not exercise any "control" over disposition of the Parent PLUS Loan proceeds and, thus, has no property "interest" in them.

> [T]he Parent Plus proceeds were not and could not have been property in which [debtor-Parent] had an interest or over which he had control....
>
> Permitting the Trustee to proceed with this litigation ... would do nothing to further the fundamental premise underlying both the Bankruptcy Code and [the Pennsylvania UFTA] fraudulent transfer provisions which is ... to prevent the unjust diminution of the debtor's estate.[55]

This reasoning appears to borrow from the "control" concepts of both mere-conduit doctrine and the earmarking doctrine (originally developed in the context of alleged preferential transfers). Indeed, courts also reason that "the transfer of 'earmarked' funds does not involve property of the debtor because: 1) the debtor never exercised control over the third party funds; and 2) the debtor's property was not diminished by the transfer."[56]

We will leave for another day the larger question of the soundness of earmarking doctrine, in general, or its extension beyond alleged preferential transfers to alleged fraudulent transfers. Suffice it to say, though, that both prongs of that reasoning, as applied to a Revised Scenario 2 case, are manifestly false.

Debtor-Parent obviously has complete control over whether the Parent PLUS loan is ever made. If debtor-Parent consents to becoming the obligor on a Parent PLUS loan, the loan proceeds will be disbursed to University. If debtor-Parent does not consent to becoming the obligor on a Parent PLUS loan, then no loan proceeds are ever disbursed to University. That borrower control is a sufficient property "interest" in the loan proceeds to make Parent the obligor on the loan. Thus, when a debtor-borrower directs a lender to directly disburse (or, as is quite common for many loans, lender requires, as a condition of making the loan, direct disbursement of) loan proceeds to a designated third party, that is generally considered a "transfer of an interest of the debtor in property" for purposes of fraudulent conveyance law. (See, for example, the loan proceeds at issue in the Supreme Court's *Merit Management* case.[57])

Moreover, it is simply untrue that a Revised Scenario 2 case fails to implicate the kind of estate diminution that fraudulent conveyance law redresses. Revised Scenario 2 diminishes debtor's estate in the same manner as Scenario 2—via Parents' gift to Child, which is an indirect gift in the case of Revised Scenario 2. And recognizing that truism points up the perniciousness of the "no transfer of debtor property" dodge. If there is no transfer of debtor property at all in a Revised Scenario 2 case, then there is no means by which to hold Child liable for the indirect constructively fraudulent conveyance that Child clearly received. If there was no transfer of debtor property at all, Child cannot be held liable as an "entity for whose benefit such transfer was made," under Code § 550(a)(1). Debtor-Parent's indirect gift to Child, while insolvent, cannot be avoided as a constructively fraudulent transfer.

The reason that the trustee's suit against University in a Revised Scenario 2 case is inconsistent with the purposes of fraudulent conveyance law is *not* because there was no fraudulent "transfer" at all. It is because University was a bona fide purchaser who should be immune from fraudulent transfer liability.

A better response to a Revised Scenario 2 case would be to recognize that the Lender-University transfer obviously *is* a "transfer of an interest of the debtor in property," for which debtor-Parent does *not* receive a reasonably equivalent value. Thus, Child is an "entity for whose benefit such transfer was made," who has beneficiary liability under § 550(a)(1). Nonetheless, as against University, a court should equitably recharacterize the transaction (un-collapse the transaction structure, in effect) as substantively, in purpose and effect, the equivalent of a Scenario 2 case, in which University has a bona fide purchaser defense under § 550(b)(1).

4. Is Lender a Good-Faith For-Value Obligee?

In addition to immunizing Child from any constructive fraud liability, there is another glaring inadequacy in the "no transfer of debtor property" response to Revised Scenario 2 cases. That approach also exposes Lender's loan to avoidance as a constructively fraudulent obligation, because debtor-Parent "received less than a reasonably equivalent value in exchange for such … obligation," within the meaning of Code § 548(a)(1)(B)(i). Moreover, because the loan proceeds went to University rather than debtor-Parent, Lender has no § 548(c) good-faith for-value defense, which is only applicable (emphasis added) "to the extent such … obligee gave value *to the debtor* in exchange for such … obligation." A court could protect an innocent, good faith Lender in a Revised Scenario 2 case, however, by equitably recharacterizing the transaction (to un-collapse the transaction structure) as substantively, in purpose and effect, the equivalent of a Scenario 2 case in which Lender's loan is *not* a constructively fraudulent obligation.

Note, though, that the transaction structure employed in a Revised Scenario 2 case, and Lender's role therein, has eery similarities to a lender's role in an LBO transaction: financing, with eyes wide open, a transaction that Lender *knows* will be an estate-depleting transaction. Moreover, Lender (via its diligence in making the loan) may also be fully aware of the existence of one of the financial-vulnerability measures that makes estate-depleting transfers and obligations constructively fraudulent. If all of that is true, therefore, a court, in its equitable discretion and using reasoning very similar to that which goes into a decision to equitably collapse the transaction structure of an LBO as against an LBO lender,[58] might decide to *not* un-collapse the transaction structure of a Revised Scenario 2 case, as against (in effect) a *bad faith* Lender.[59]

CONCLUSION

"To ignore the transferee's interest is an error surprisingly common in discourse on avoidance law, but it is nonetheless an error."[60] That error is the source of the controversy and confusion surrounding the tuition gift cases. Moreover, the statutory anomaly that the tuition gift cases expose has implications that go well beyond familial gifts to, for example, the ubiquitous cases in which a debtor corporation directly pays a corporate principal's personal expenses. Renewed attention to the legitimate bona fide purchase interests of innocent initial transferees and obligees for value, as well as courts' legitimate equitable powers in recharacterizing transaction structure for purposes of fraudulent transfer analysis, could bring more coherence to courts' decisions in these cases.

ENDNOTES:

[1]Kenneth C. Kettering, Codifying a Choice of Law Rule for Fraudulent Transfer: A Memorandum to the Uniform Law Commission, 19 Am. Bankr. Inst. L. Rev. 319, 350 (2011).

[2]And to another line of 19th-century case law involving insolvent debtors' transfers for inadequate consideration (sometimes characterized as partial gifts or "partially voluntary" conveyances). See generally John C. McCoid, Constructively Fraudulent Conveyances: Transfers for Inadequate Consideration, 62 Tex. L. Rev. 639 (1983). Both lines of decision can be traced to early influential opinions by Chancellor Kent. See Reade v. Livingston, 3 Johns. Ch. 481 (N.Y. 1818) (gift transfer); Boyd & Suydam v. Dunlap, 1 Johns. Ch. 478 (N.Y. 1815) (transfer for inadequate consideration).

[3]Bonded Financial Services, Inc. v. European American Bank, 838 F.2d 890, 897, 17 Bankr. Ct. Dec. (CRR) 299, 18 Collier Bankr. Cas. 2d (MB) 155 (7th Cir. 1988).

[4]Andrew Kull, Common-Law Restitution and the Madoff Liquidation, 92 B.U. L. Rev. 939, 946 (2012). Professor Kull was the Reporter for the American Law Institute's 2011 Restatement (Third) of Restitution and Unjust Enrichment.

[5]Kull, 92 B.U. L. Rev. at 946-47.

[6]Charles J. Tabb & Ralph Brubaker, Bankruptcy Law: Principles, Policies, and Practice 483, 499 (4th ed. 2015).

[7]1 Garrard Glenn, Fraudulent Conveyances and Preferences § 195, at 348 (rev. ed. 1940).

[8]1 Glenn, Fraudulent Conveyances, § 211, at 364.

[9]11 U.S.C.A. § 548(a)(2)(B)(i).

[10]See generally Restatement (Third) of Restitution and Unjust Enrichment § 66 (2011) [hereinafter R3RUE] (bona fide purchaser defense); id. § 67 (bona fide creditor-payee defense); id. § 68 (value for purposes of those defenses); § 69 (notice for purposes of those defenses). "Statutes permitting the avoidance of fraudulent transfers incorporate defenses that are recognizably a version of the affirmative defense" of a bona fide purchaser and a bona fide creditor-payee. Id. § 67 cmt. i, at 575. The principal difference between a bona fide purchaser and a bona fide creditor-payee is that satisfaction of an antecedent debt qualifies as "value" that protects a bona fide creditor-payee from liability in connection with receipt of a monetary payment, whereas satisfaction of an antecedent debt is not "value" that will give a purchaser the protection of the bona fide purchase defense in connection with purchase of property other than money (at least under the original common-law understanding of bona fide purchase). See Andrew Kull, Defenses to Restitution: The Bona Fide Creditor, 81 B.U. L. Rev. 919, 934-46 (2001); Andrew Kull & Ward Farnsworth, Restitution and Unjust Enrichment 468-69, 470-71, 477-81 (2018).

Modern fraudulent conveyance law, as set forth in the 1918 Uniform Fraudulent Conveyance Act (UFCA), the 1984 UFTA, the 2014 UVTA, and the current Bankruptcy Code, have all incorporated *both* bona fide purchaser *and* bona fide creditor-payee principles, in that satisfaction or securing of an antecedent debt has uniformly qualified as "value" given by a transferee in exchange for a transfer of property (be it a transfer of money or other property). See 1918 UFCA §§ 3, 9; 1984 UFTA §§ 3(a), 8; 2014 UVTA §§ 3(a), 8; 11 U.S.C.A. § 548(c) & (d)(2)(A). The reason is that a transfer of property in reduction of debt is not a diversion of the debtor's assets away from the payment of creditors (i.e., that which fraudulent conveyance law condemns); rather, it is a use of the debtor's assets *to pay* creditors. As Justice Breyer put it (when sitting on the First Circuit), "[t]he basic object of fraudulent conveyance law is to see that the debtor uses his limited assets to satisfy *some* of his creditors; it normally does not try to choose among them." Boston Trading Group, Inc. v. Burnazos, 835 F.2d 1504, 1509 (1st Cir. 1987). "The focus [of fraudulent conveyance law] is not on the rights of creditors versus other creditors, but on the rights of creditors as a group versus the debtor." Tabb & Brubaker, Bankruptcy Law, at 483. The purpose of the law, therefore, "is *not* to provide equal distribution of the estates of debtors among their creditors." 1 Glenn, Fraudulent Conveyances, § 289, at 488 (emphasis added). Thus, the statutes have recognized and preserved "the difference between a fraudulent and a preferential conveyance." Van Iderstine v. National Discount Co., 227 U.S. 575, 582, 33 S. Ct. 343, 57 L. Ed. 652 (1913). "If there is in our law one point which is more ungrudgingly accepted than others, it is that the preferential transfer does not constitute a fraudulent conveyance." 1 Glenn, Fraudulent Conveyances, § 289, at 488.

Of course, that rationale for incorporating bona fide creditor-payee principles into fraudulent conveyance law will not suffice if the antecedent debt at issue (and satisfied or secured by a debtor's transfer or that of a subsequent transferee of fraudulently conveyed property) is a debt of someone other than the debtor. Cf. Bankruptcy Act of 1898 § 67d(6) (protecting a transferee of an avoidable fraudulent transfer only in cases of "a bona fide purchaser … for a *present* fair equivalent value" (emphasis added), reprinted in 4 Collier on Bankruptcy 7 (James Wm. Moore et al. eds., 14th ed. 1978). See 4 id. ¶ 67.41[4], at 588 ("In requiring present value that saving exception of § 67d(6) departs from the corresponding provision of the Uniform Fraudulent Conveyance Act, which preserves good faith transfers in satisfaction of antecedent debts." (footnote omitted)). In such cases, therefore, incorporation of bona fide creditor-payee principles into fraudulent conveyance law must be justified by the transactional finality objectives underlying the common-law bona fide creditor-payee defense.

The distinction between a bona fide purchaser and a bona fide creditor-payee is not implicated by the tuition gift cases, because the value given by both University and Lender (in Scenarios 1 and 2, above) in exchange for the transfer and obligation, respectively, that each receives, is the kind of new value (i.e., not simply satisfaction of an antecedent debt) that satisfies the traditional common-law definition of "value" for purposes of bona purchase doctrine.

[11]Charles Jordan Tabb, Law of Bankruptcy § 6.43, at 617 (4th ed. 2016). See also Kettering, 19 Am. Bankr. Inst. L. Rev. at 350 ("Fraudulent transfer law balances the interests of the debtor's creditors in avoiding a transfer against the interest of the debtor's transferee, against whom the action lies and who bears the burden of disgorging the transferred property or its value if the action is successful.").

[12]Boyer v. Crown Stock Distribution, Inc., 587 F.3d 787, 793, 52 Bankr. Ct. Dec. (CRR) 101, Bankr. L. Rep. (CCH) P 81628 (7th Cir. 2009) (Posner, C.J.) (emphasis added) (quoting Douglas G. Baird, Elements of Bankruptcy 153-54 (4th ed. 2006)).

[13]1 Glenn, Fraudulent Conveyances, § 210, at 358.

[14]Thus, Professor Glenn added that "[u]sually, in that type of case the only redress against the donee is a money judgment, because the donee had received no specific property as a result of the transaction." 1 Glenn, Fraudulent Conveyances, § 210, at 358. Neither the 1918 UFCA, in effect in most states as of the date of Professor Glenn's writing (in 1940), nor the fraudulent conveyance provisions of the 1938 Chandler Act amendments to the Bankruptcy Act of 1898, contained any explicit codification of such non-transferee beneficiary liability.

[15]Both the 1984 UFTA and the 2014 UVTA amendments to the 1984 UFTA (one or the other of which is now in effect in nearly all states) also codify a similar concept of non-transferee beneficiary liability. See 1984 UFTA § § 7(a)(1), 8(b)(1); 2014 UVTA § § 7(a)(1), 8(b)(1)(i).

[16]Professor Carlson nicely summarizes the courts' interpretation of the initial transferee and the transfer beneficiary in such a case as follows:

> D, wishing to enrich X, tenders the money to C, who accepts it in discharge of C's claim against X. Supposedly, C is the initial transferee of a fraudulent transfer. X is the benefitted person.

David Gray Carlson, Mere Conduit, 93 Am. Bankr. L.J. (forthcoming 2019) (manuscript, on file with author, at 51).

[17]Douglas G. Baird & Thomas H. Jackson, Fraudulent Conveyance Law and Its Proper Domain, 38 Vand. L. Rev. 829, 831 n.12 (1985).

[18]In re Lewis, 574 B.R. 536, 541, 348 Ed. Law Rep. 229 (Bankr. E.D. Pa. 2017); In re Palladino, 556 B.R. 10, 15-16, 62 Bankr. Ct. Dec. (CRR) 264, 76 Collier Bankr. Cas. 2d (MB) 89 (Bankr. D. Mass. 2016); In re Oberdick, 490 B.R. 687, 711-12 (Bankr. W.D. Pa. 2013); In re Cohen, 2012 WL 5360956, at *9-*10 (Bankr. W.D. Pa. 2012), aff'd in part, vacated in part, remanded, 487 B.R. 615 (W.D. Pa. 2013).

[19]Palladino, 556 B.R. at 16.

[20]Chorches v. Catholic University of America, 2018 WL 3421318, at *2-*6 (D. Conn. 2018); In re Sterman, 594 B.R. 229, 235-38, 361 Ed. Law Rep. 344 (Bankr. S.D. N.Y. 2018); In re Knight, 2017 WL 4410455, at *2-*7 (Bankr. D. Conn. 2017); Matter of Dunston, 566 B.R. 624, 635-37 (Bankr. S.D. Ga. 2017); In re Leonard, 454 B.R. 444, 454-59, 271 Ed. Law Rep. 339 (Bankr. E.D. Mich. 2011); In re Lindsay, 2010 WL 1780065, at *9-*10 (Bankr. S.D. N.Y. 2010).

[21]See Sterman, 594 B.R. at 238-39; In re Michel, 572 B.R. 463, 473-78 (Bankr. E.D. N.Y. 2017); In re Akanmu, 502 B.R. 124, 70 Collier Bankr. Cas. 2d (MB) 1361 (Bankr. E.D. N.Y. 2013).

[22]Chorches, 2018 WL 3421318, at *3.

[23]Knight, 2017 WL 4410455, at *5.

[24]Sterman, 594 B.R. at 236.

[25]Knight, 2017 WL 4410455, at *6-*7 (citations omitted).

[26]See 5 Collier on Bankruptcy ¶ 548.03[5], at 548–54 (16th ed. 2017). Whether an unperformed contractual promise *should* be considered "value" for purposes of fraudulent transfer law, however, is a legitimate question. Once upon a time, and consistent with the original common-law approach to bona fide purchase doctrine, an unperformed contractual promise did *not* count as "value" that

would protect a transferee from fraudulent conveyance liability. See 1 Glenn, Fraudulent Conveyances, § 235, at 406–07 & § 243, at 424–25; 4 Collier (14th ed.), ¶ 67.33, at 511–14.1. Cf. R3RUE § 68(b) & cmts. b, e.

[27]Likewise, Code § 548(d)(2)(A) defines "value" for purposes of § 548 to include (emphasis added) only "satisfaction or securing of a present or antecedent debt *of the debtor*."

[28]Knight, 2017 WL 4410455, at *4.

[29]The Bankruptcy Act's fraudulent conveyance provisions contained a similar protection for "a bona fide purchaser, lienor, or obligee for a present fair equivalent value." 1898 Act § 67d(6), reprinted in 4 Collier (14th ed.), at 7. "The saving exception in § 67d(6) is a carryover from former § 67," in effect before the 1938 Chandler Act amendments that conformed the Bankruptcy Act's fraudulent conveyance provisions to those of the 1918 UFCA. 4 Collier (14 ed.), ¶ 67.41[4], at 587.

[30]The Bankruptcy Act's definition of fair consideration was substantially identical. See 1898 Act § 67d(1)(e), reprinted in 4 Collier (14th ed.), at 5.

[31]See R3RUE § 67 cmt. d; Bonded Financial Services, Inc. v. European American Bank, 838 F.2d 890, 897, 17 Bankr. Ct. Dec. (CRR) 299, 18 Collier Bankr. Cas. 2d (MB) 155 (7th Cir. 1988) (protecting "[t]ransferees and other purchasers" who "give value" to "the transferors' designees" "emulates the pattern of other rules protecting good faith purchasers").

[32]Kenneth C. Kettering, The Uniform Voidable Transactions Act; or, the 2014 Amendments to the Uniform Fraudulent Transfer Act, 70 Bus. Law. 777, 819 (2015).

[33]Kettering, 70 Bus. Law. at 819.

[34]Kettering, 70 Bus. Law. at 817.

[35]See 1984 UFTA §§ 4(a), 5(a), 8(a).

[36]See Kettering, 70 Bus. Law. at 816, 820.

[37]See 2014 UVTA § 8(a) & (d). For an explanation of why the UVTA drafting committee adopted the Bankruptcy Code's approach to this issue, see Kettering, 70 Bus. Law. at 819-21.

[38]See Carlson, 93 Am. Bankr. L. J. (manuscript, on file with author, at 9-14). Professor Carlson makes this observation by way of lamenting the widespread application of fraudulent conveyance laws (improperly, in his opinion) to recover funds stolen from a debtor. As the tuition gift cases point up, though, the reason that is problematic is that the UFTA, the UVTA, and the Bankruptcy Code deny an initial transferee or obligee any good-faith for-value defense for value given to a third party, and that is a problem that goes well beyond stolen funds cases.

[39]Miller v. Race, 97 Eng. Rep. 398, 1 Burr. 452 (K.B. 1758).

[40]See Kull & Farnsworth, Restitution, at 487.

[41]See R3RUE § 13(2) & cmt. d.

[42]Conn. Gen. Stat. Ann. § 52-552i(f).

[43]See Jenna C. MacDonald, Note, Out of Reach: Protecting Parental Contributions to Higher Education From Clawback in Bankruptcy, 34 Emory Bankr. Dev. J. 234, 267-68 (2017).

[44]Wash. Rev. Code Ann. § 19.40.081(1) (emphasis added).

[45]Pergament v. Brooklyn Law School, 595 B.R. 6, 361 Ed. Law Rep. 1265 (E.D. N.Y. 2019), vacating In re Adamo, 582 B.R. 267, 353 Ed. Law Rep. 332 (Bankr. E.D. N.Y. 2018).

[46]In re Hamadi, 597 B.R. 67, 363 Ed. Law Rep. 712 (Bankr. D. Conn. 2019).

[47]The courts have "articulat[ed] different standards for determining whether a recipient of property was a transferee or a mere conduit." Christopher W. Frost, Initial Transferee of Mere Conduit: The Seventh Circuit Takes a Stab at a Slippery Concept, 31 Bankr. L. Letter No. 2, at 1, 4 (Feb. 2011). Moreover, "application and articulation of the [mere conduit concept] has been neither consistent nor predictable." Jessica D. Gabel & Paul R. Hage, Who Is a 'Transferee' Under Section 550(a) of the Bankruptcy Code?: The Divide Over Dominion, Control, and Good Faith in Applying the Mere Conduit Defense, 21 Norton J. Bankr. L. & Prac. No. 1, at 47, 49 (Feb. 2012). For an excellent analysis and critique of mere conduit doctrine, see Carlson, 93 Am. Bankr. L.J. (forthcoming 2019).

[48]For an excellent critique of those decisions, see David Gray Carlson, In Defense of Brooklyn Law School: Tuition as a Fraudulent Transfer (unpublished manuscript, on file with author).

[49]It appears to be an instance in which, in the words of Professor Carlson, "mere conduitry is, on this occasion, simply a stand-in for" an alternative characterization of the substance of the transaction. Carlson, 93 Am. Bankr. L.J. (manuscript, on file with author, at 58) (discussing In re Custom Contractors, LLC, 745 F.3d 1342, 59 Bankr. Ct. Dec. (CRR) 79, 71 Collier Bankr. Cas. 2d (MB) 399, Bankr. L. Rep. (CCH) P 82615, 113 A.F.T.R.2d 2014-1504 (11th Cir. 2014), a case that the *Pergament* court heavily relied upon in its "mere conduit" analysis).

[50]Bruce A. Markell, Substance Over Form in Fraudulent Transfer Law, 34 Bankr. L. Letter No. 2, at 2, 6 (Feb. 2014). See generally Ralph Brubaker, Understanding The Scope of the § 546(e) Securities Safe Harbor Through the Concept of the "Transfer" Sought to Be Avoided, 37 Bankr. L. Letter No. 7, at 1, 16-18 (July 2017).

[51]See Kettering, 70 Bus. Law. at 821-22.

[52]Pepper v. Litton, 308 U.S. 295, 304-05, 60 S.

Ct. 238, 84 L. Ed. 281 (1939).

[53]See In re Taylor, 2019 WL 1028508, at *3-*4 (Bankr. N.D. Ga. 2019); In re DeMauro, 586 B.R. 379, 384-88 (Bankr. D. Conn. 2018); In re Demitrus, 586 B.R. 88, 91-95, 356 Ed. Law Rep. 243 (Bankr. D. Conn. 2018); In re Lewis, 574 B.R. 536, 538-40, 348 Ed. Law Rep. 229 (Bankr. E.D. Pa. 2017).

[54]Lewis, 574 B.R. at 540.

[55]Lewis, 574 B.R. at 540.

[56]In re Dayton Title Agency, Inc., 262 B.R. 719, 729, 37 Bankr. Ct. Dec. (CRR) 265 (Bankr. S.D. Ohio 2001), aff'd in part, rev'd in part, 284 B.R. 238 (S.D. Ohio 2002).

[57]Merit Management Group, LP v. FTI Consulting, Inc., 138 S. Ct. 883, 200 L. Ed. 2d 183, 65 Bankr. Ct. Dec. (CRR) 92, Bankr. L. Rep. (CCH) P 83219 (2018). See Brubaker, 37 Bankr. L. Letter No. 7, at 3-5.

[58]See Brubaker, 37 Bankr. L. Letter No. 7, at 17.

[59]And conversely and by analogy to LBO transactions, if the collapsing criteria are met as to Lender in a Scenario 2 case, a court could collapse the transaction structure, as against Lender, to equitably recharacterize it as substantively, in purpose and effect, the equivalent of a Revised Scenario 2 case in which Lender's loan *is* avoidable as constructively fraudulent.

[60]Kettering, 70 Bus. Law. at 819.

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Stanford Receiver Urges $79M Ponzi Clawback Citing 5th Circ.

By **Vince Sullivan**

Law360 (March 5, 2021, 8:34 PM EST) -- The court-appointed receiver of Stanford International Bank asked a Texas federal judge late Thursday to enter a final judgment in his $79 million fraudulent transfer clawback claim against a group of the bank's investors after a Fifth Circuit panel mandated a return of the funds.

Ralph S. Janvey said in his motion seeking a clawback judgment against GMAG LLC and related entities referred to as the Magness parties that the Fifth Circuit ruling comes after a lengthy procedural history that included a federal jury verdict and appeals to the Fifth Circuit and the Texas Supreme Court.

With a the final decision of the Fifth Circuit in October, the question of whether the $79 million in transfers to the Magness parties must be returned to the receiver has been answered.

"The October 2020 opinion and judgment have become final, and the judgment was issued as the mandate," Janvey said in his motion. "The receiver now moves for entry of final judgment, which can be followed by resolution of the question of attorney's fees and then, at long last, this case can come to a close."

The claims stem from the Magness parties' receipt of $88 million from the Stanford International Bank as part of a $7 billion Ponzi scheme that saw founder R. Allen Stanford misappropriate investment funds into the bank to fund his personal business and investment activities. He was found guilty and sentenced to 110 years in prison in June 2012 for his role in the 20-year scheme.

The receiver began the clawback action against the Magness parties and others in 2009. Four years later he was granted a partial summary judgment ruling that allowed him to recover $8 million in "net winnings" paid to the parties through the investment scheme that were in excess of its payments into the fraud, according to his motion.

The Texas federal court then cleaved off remaining claims against the Magness parties, through which Janvey pursued a return of $79 million. In December 2016, the court granted another summary judgment motion that characterized the $79 million in payments to the parties as fraudulent transfers as matter of law. A jury trial followed, with a 2017 verdict that found the Magness parties had been informed the Stanford International Bank was being run as a Ponzi scheme, but that an investigation into it by the parties would have been futile. The ruling meant the Magness parties did not have to return the $79 million in transfers because they accepted them in good faith, according to court documents.

The receiver appealed the decision to the Fifth Circuit, which found in favor of the receiver in January 2019, saying the Texas Uniform Fraudulent Transfer Act contained no good faith safe harbor for receiving such transfers after being on notice of a fraud, the receiver's motion said. Upon request of the Magness parties, the appellate panel certified a question about the scope of TUFTA's good faith defense to the Texas Supreme Court.

The state's high court found there is no good faith exception to the fraudulent transfer law that can be invoked when a recipient of such transfers is on notice of an actual fraud, according to Janvey's motion. Instead, the court there found that a receiving party must show they conducted a diligent investigation of the fraud claims before using the good faith defense.

Following briefing to the Fifth Circuit about the impact of the Texas Supreme Court ruling, the appellate panel issued a final opinion in October that reversed the district court's order and found in favor of the receiver.

The motion comes with not only a request for clawback of the $79 million but interest totaling more than $43 million plus attorneys' fees.

"The receiver is pleased that the victims of the Stanford fraud are one major step closer to recovery of the massive fraudulent transfers that billionaire Gary Magness received from the Stanford Ponzi scheme over 12 years ago," receiver attorney Kevin Sadler of Baker Botts LLP told Law360 on Friday. "Those fraudulent transfers, nearly $90 million in total, were only made possible by the large number of Stanford victims who unwittingly invested their money in the Ponzi scheme in the fall of 2008, just as Magness was successfully cashing out. It is well past time that the money be returned to the victims of the fraud."

He said the final award being sought will likely exceed $130 million when interest and fees are included, which could make it one of the largest recoveries ever under TUFTA, and the largest single litigation recovery to the receivership since it began in 2009.

Representatives for the Magness parties did not immediately respond late Friday to a request for comment.

The receiver is represented by Evan A. Young, Scott D. Powers, Stephanie F. Cagniart, Grayson E. McDaniel, Kevin M. Sadler and Delaney J. McMullan of Baker Botts LLP.

The Magness parties are represented by Andrew J. Petrie and Burt M. Rublin of Ballard Spahr LLP and M. David Bryant Jr. of Dykema Gossett PLLC.

The case is Janvey et al. v. GMAG LLC et al., case number 15-401, in the U.S. District Court for the Northern District of Texas.

--Additional reporting by Dean Seal and Rick Archer. Editing by Andrew Cohen.

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The Importance of Good Faith in Fraudulent Transfer Analysis

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Often, when asserting a §548(c) or 550(b) exception to avoidability, practitioners evaluating the exception focus on the value or lack of value paid or realized by the debtor in the transfer at issue. However, this focus on value risks minimizing—or even overlooking—the important aspect of good faith explicitly set forth in both §§548(c) and 550(b). Failure to consider the good-faith prongs of these exceptions could be a mistake, for while a given transaction might satisfy the requirement of value, it might still be avoided for lack of good faith. Conversely, a transaction that was determined to lack sufficient value might still be successfully defended if the good-faith requirement is met.

In light of the possible impact the good faith requirement might have on the §548(c) or 550(b) exception analysis, independent of a transfer valuation analysis, litigants, both trustees and transferees, would be well advised to consider the presence or absence of good faith as a crucial element of their examination of any fraudulent transfer.

General Statutory Framework

In a fraudulent transfer action brought under §548 of the Bankruptcy Code, the debtor-in-possession (DIP) or trustee has two goals. The first goal is to avoid a transfer, the effect of which is either to place putative property of the estate beyond the reach of the general body of creditors, or to burden the estate with an obligation, such as a mortgage or security agreement that stands in the way of a meaningful distribution to unsecured creditors. The second goal is to utilize §550 of the Code to recover the value of property for creditors or rid the estate of the obligation incurred, thereby enhancing the value of the estate's existing property.

Section 548 provides, in relevant part:

(a) (1) The trustee may avoid any transfer of an interest of the debtor in property, or any obligation incurred by the debtor, that was made or incurred on or within one year before the date of the filing of the petition, if the debtor voluntarily or involuntarily—
(A) made such transfer or incurred such obligation with actual intent to hinder, delay or defraud any entity to which the debtor was or became, on or after the date that such transfer was made or such obligation was incurred, indebted or
(B)(i) received less than a reasonably equivalent value in exchange for such transfer or obligation; and
(ii)(I) was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation;
(II) was engaged in business or a transaction, or was about to engage in business or a transaction, for which any property remaining with the debtor was an unreasonably small capital; or
(III) intended to incur, or believed that the debtor would incur, debts that would be beyond the debtor's ability to pay as such debts matured…
Section 550 says, in relevant part:

(a) Except as otherwise provided in this section, to the extent that a transfer is avoided under §544, 545, 547, 548, 549, 553(b) or 724(a) of this title, the trustee may recover, for the benefit of the estate, the property transferred, or, if the court so orders, the value of such property, from—
(1) the initial transferee of such transfer or the entity for whose benefit such transfer was made; or
(2) any immediate or mediate transferee of such initial transferee.
Like many sections in the Code, §548(c) also provides an exception to the trustee's avoidance power that shapes the analytical framework of fraudulent transfer actions in bankruptcy:

Except to the extent that a transfer or obligation voidable under this section is voidable under §544, 545 or 547 of this title, a transferee or obligee of such a transfer or obligation that takes *for value **and** in good faith* has a lien on or may retain any interest transferred or may enforce any obligation incurred, as the case may be, to the extent that such transferee or obligee gave value to the debtor in exchange for such transfer or obligation. (emphasis added)

Likewise, §550(b) provides safe harbor for a good-faith immediate or mediate transferee of the initial transferee, as follows:

(b) The trustee may not recover under §(a)(2) of this section from—

(1) a transferee that takes for value, including satisfaction or securing of a present or antecedent debt, in good faith, and without knowledge of the voidability of the transfer avoided; or

(2) any immediate or mediate good faith transferee of such transferee.

Section 550(b) was specifically tailored to prevent an initial transferee from whom a trustee could recover under §550(a)(1) from "washing" the transaction through to a subsequent transferee who might be acting in concert. This technique is forestalled by requiring that the subsequent transferee also act in good faith. *See, e.g.,* ***In re Commercial Acceptance Corp.,*** **1993 U.S. App. LEXIS 23158 (9th Cir. 1993)**.

Two Types of Fraud—Actual and Constructive

The starting point for analyzing any transfer under §548 necessarily begins with the fraudulent nature of the challenged transfer. There are two types of fraud that are avoidable under the Code: actual fraud and constructive fraud.

While proof of actual fraud, or fraud in fact, is often difficult, the criteria for establishing actual fraud are expressly set forth in §548: "a transfer made or an obligation incurred *with actual intent to hinder, defraud or delay* any entity to which the debtor was or became on or after the date such transfer was made or such obligation was incurred, indebted[.]" **11 U.S.C. §548(a)(1)(A)** (emphasis added). Here, the Bankruptcy Code is concerned with the debtor's actual, subjective intent to hinder, defraud or delay its present or future creditors.[1]

A determination of such intent treats the three elements of intent—hindrance, delay or fraud—as "distinct elements, any one of which is sufficient to render the transaction fraudulent."[2]

Recognizing that proof of subjective fraudulent intent is a difficult evidentiary hurdle to overcome, courts typically look at the totality of circumstances, relying on the so-called "badges of fraud" to draw an inference of fraudulent intent.[3] The badges of fraud include, but are by no means limited to, finding that (1) the transfer or obligation was to an insider; (2) the debtor retained possession or control of the property transferred after the transfer; (3) the transfer or obligation was concealed; (4) before the transfer was made or obligation was incurred, the debtor had been sued or threatened with suit; (5) the transfer was of substantially all the debtor's assets; (6) the debtor absconded; (7) the debtor removed or concealed assets; (8) the value of the consideration received by the debtor was not reasonably equivalent to the value of the asset transferred or the amount of the obligation incurred; (9) the debtor was insolvent or became insolvent shortly after the transfer was made or the obligation was incurred; (10) the transfer occurred shortly before or shortly after a substantial debt was incurred; and (11) the debtor transferred the essential assets of the business to a lienor who transferred the assets to an insider of the debtor."[4] It is noteworthy that proof of a debtor's insolvency at the time of the transfer or immediately thereafter, while a possible indicia of fraudulent intent, is not by itself determinative when a trustee is seeking to demonstrate actual fraud.[5]

In short, proof of actual fraud focuses more on the debtor's intent than on the transferee's payment of value or the debtor's insolvency either at the time of the transaction or immediately thereafter.[6]

Constructive fraud, however, requires proof that the debtor was insolvent at the time of the transaction, or that, as a result of the transaction, the debtor received less than reasonably equivalent value.[7] While an examination of the definitions of "insolvency" and "value" is beyond the scope of this article, it is important to note that transfers that may have been made for a reasonably equivalent value, and therefore, in satisfaction of the standards examined in a constructive fraud analysis, may nonetheless have been made in the absence of good faith, thereby exposing the transaction to avoidance by a trustee. In other words, even though a transferee paid value under §548(c) or 550(b), his lack of good faith may nevertheless doom the transaction. To examine the transaction from another, and perhaps more important, perspective, payments made to a debtor in furtherance of that debtor's fraudulent scheme, or in a transaction where the value paid is less than a reasonable equivalent, may not be avoidable if a transferee acted in good faith so long as some value is given. Note, however, that proof of the existence of good faith under either §548(c) or 550(b) rests squarely with the transferee, and establishing good faith in the absence of reasonably equivalent value may be very difficult indeed.[8] Nevertheless, given that good faith is expressly set forth as a distinct criteria for examining any fraudulent transfer under §§548 and 550, and despite any problems associated with proof and the potential to blur the analytical distinctions between good faith and value, the presence or absence of good faith in any fraudulent conveyance action is a crucial element to the transferee's defense.

What Is Good Faith?

The good-faith analysis under §548(c) or 550(b) is not made any easier because, as with many important terms used in the Code, "good faith" is not defined. Therefore, one must look beyond the Code for guidance. Revised Article 9 contains a somewhat opaque definition that, one might hope, comes as close to capturing the spirit of this elusive term:

"Good faith" means honesty in fact and the observance of reasonable commercial standards of fair dealing. Rev. Art. 9, §9-102(43).
It does not seem, however, that the standard set forth in the Uniform Commercial Code fits the exigencies of a fraudulent transfer inquiry. In fact, it has been said that "[t]he unpredictable circumstances in which courts may find its presence or absence render any definition of 'good faith' inadequate, if not unwise." *Collier,* ¶548.07[2][a] at 548-60. Instead, the relevant inquiries made by courts deciding good-faith issues seem to be not merely what did the transferee know and when did he know it, but how hard did he try to find out what objectively he should have known? In other words, courts confronted with challenges to transfers under §§548 and 550 have set up an objective standard in which they "examine whether circumstances would place a reasonable person on inquiry of a debtor's fraudulent purpose."[9]

Note that this standard works both in the case of actual fraud and constructive fraud. If the transferee knew, or should have known, of the debtor's fraudulent purpose, then even though the transferee gave value, the transaction is not one carried out in good faith. Furthermore, if circumstances were such that they would have placed a reasonable person on notice, and "diligent inquiry would have discovered the debtor's fraudulent purpose, then the transfer is fraudulent."[10] Indeed, it is not enough that a diligent transferee make inquiry of the debtor's fraudulent purpose. Even if that element is lacking, the transferee must not ignore facts that would lead a reasonable person to conclude that the debtor is insolvent at the time of the transfer.[11] Finally, a transferee will find no shelter under §548(c) in remaining willfully ignorant of the foregoing signs of fraud or insolvency.[12]

Some Lessons in the Case Law

The *Cuthill* case provides some valuable guides on the presence or absence of a successful good faith defense to a fraudulent conveyance complaint. *See* ***Cuthill, supra* at 641**. In that case, a chapter 7 trustee sued a number of defendant brokers whom the trustee accused of being participants in a Ponzi scheme by virtue of the brokers' sales of the debtor's promissory notes, obligations that the trustee alleged the debtor never intended to honor. The trustee further alleged that the commissions paid to the defendants were fraudulent conveyances and should be avoided and paid into the chapter 7 estate.

The brokers raised a number of defenses, including that they were independent contractors servicing the debtor for commissions that were in accord with industry standards that automatically made them fair and reasonable. In addition, the brokers stated that, because they were independent third parties and not insiders of the debtor, they had no reason to know of the debtor's insolvency.

The *Cuthill* court disagreed with the defendants' assertions and found for the trustee. In deeming all of the commissions paid by the debtor to be avoidable fraudulent transfers, the court said:

The defendants did not perform the minimal due-diligence steps needed to demonstrate that they acted in good faith… If the defendants had completed any true investigation, the defendants quickly would have learned of the debtor's insolvency, the debtor's lack of a legitimate business…[and] the fraudulent nature of the notes. ***Id.* at 660**.
In a similar set of circumstances, the *Max Sugarman Funeral Home* case is instructive as to what constitutes good faith under §550(b)(1). In that case, the First Circuit found that an immediate transfer of the debtor's transferee (the defendant), whom the court found had full knowledge of the debtors' prior fraudulent transfers, was not acting in good faith and therefore could not claim the protection of §550(b)(1). The court first found that the subject transfers were shams.[13]

Having found that the transfers were fraudulent, the court then upheld the "well-supported findings of the bankruptcy court" that the principal officer/shareholder of the defendant had "knowledge of the voidability" of the transfers. Of course, this is the crucial element in this case. If the court had found that the defendant had acted without knowledge, even after diligent inquiry, then it would have found that the good faith element of the statute had been fulfilled. It was the defendant's misfortune that it knew of the voidability of the transfers, but it would have been equally as culpable had it, by and through its corporate principal, been required to make an "inquiry of the debtor's fraudulent purpose." ***Cuthill, supra* at 659**.

The problem for defendants in this position is that it puts them almost in the unenviable posture of having to prove a negative; that is, a defendant must show not only did it not know of the debtor's fraudulent purpose, it must also show that there was no way, after reasonable inquiry, that it could have known. In the murky circumstances of a fraudulent transfer action, it might be easier to prove the sun rises in the west.

Conclusion

As the *Cuthill* opinion makes clear, a transferee—particularly a transferee of a transferor whose financial condition is suspect—cannot simply rely on the existence of an exchange for reasonable value to erect an impermeable shield to later challenges to such transfers under §§548(c) and 550. As the brokers in *Cuthill* found to their dismay, equivalent value alone may be insufficient to assure survival of a fraudulent transfer action. The transferee appears to be charged with an affirmative duty to make reasonable inquiry not only into the transferor's financial condition and the nature of the transfers, but into the circumstances underlying such transfers to ferret out any fraudulent intent implicated by such transactions. In the absence of this level of due diligence, good faith may be found lacking, and payment of value will fail as a complete defense.

Footnotes

[1] *See, e.g.,* ***Max Sugarman Funeral Home Inc. v. A.D.B. Investors,* 926 F.2d 1248, 1254 (1st Cir. 1991)**. **Return to article**

[2] *See* 5 *Collier on Bankruptcy,* ¶548.04[1] at 548-23; ***Cuthill v. Greenmark LLC, et al. (In re World Vision Entertainment Inc.),* 275 B. R. 641, 656 (Bankr. M.D. Fla. 2002)** (finding that actual fraud looks at totality of circumstances and elements of fraud surrounding the circumstances)

fraud looks at totality of circumstances and elements of fraud surrounding the circumstances). *See, e.g.*, *Shapiro v. Wilgus*, 287 U.S. 348 (1932) (debtor's transfer of all assets to newly formed corporation after creditor threatened to sue, in effort to obtain additional time to repay all creditors, was part of scheme to hinder or delay creditors); *Flushing Sav. Bank. v. Parr*, 81 A.2d 655, 656 (2d dept. 1981), *appeal dismissed*, 54 N.Y. 2d 770 (1981) ("hinder" and "delay" are in the disjunctive and "exist independently of an intent to defraud"). **Return to article**

[3] *See, e.g.*, *Brown v. Third Nat'l. Bank (In re Sherman)*, 67 F.3d 1348, 1354 (8th Cir, 1995); *Cuthill, supra*, at 656, *citing* *In re Goldberg*, 299 B.R. 877, 885 (Bankr. S.D. Fla. 1998). **Return to article**

[4] *See, e.g.*, *In re Brantz*, 106 B.R. 62, 67 (Bankr. E.D. Pa. 1989) (setting forth a number of the badges of fraud from which a fraudulent intent may be inferred). **Return to article**

[5] *See* *Id.* **Return to article**

[6] *See* *Id.* **Return to article**

[7] 11 U.S.C. §548(a)(1)(B); *Cuthill, supra* at 657. **Return to article**

[8] *United States v. Tabor Court Realty Corp.*, 803 F.2d 1288,1296 (3d. Cir. 1986), *cert. denied, sub. nom.* *McClellan Realty Co. v. United States*, 483 U.S. 1005 (1987); *In re M & L Business Machine Co. Inc.*, 84 F.3d 1330, 1338 (10th Cir. 1996); *Noland v. Hunter (In re National Liquidators Inc.)*, 232 B. R. 99, 102 (Bankr. S.D. Ohio 1999). *See, also*, 5 *Collier on Bankruptcy*, ¶548-04[1] at 548-24. **Return to article**

[9] *Cuthill, supra* at 659; *but, see* *In re Independent Clearing House Co.*, 77 B. R. at 862 (reasoning that good faith is a subjective question). **Return to article**

[10] *See, e.g.*, *Jobin v. McKay (In re M&L Business Co.)*, 84 F.3d 1330 (9th Cir. 1996); *Max Sugarman Funeral Home Inc., supra* at 1257; *In re Agricultural Research & Technology Group Inc.*, 916 F. 2d 528, 535-36 (9th Cir. 1990) (citations omitted). **Return to article**

[11] *See* *In re Sherman*, 67 F.3d 1348, 1355 (8th Cir. 1995). **Return to article**

[12] *In re Model Imperial Inc.*, 250 B. R. 776, 798 (Bankr. S.D. Fla. 2000) (citation omitted). **Return to article**

[13] "The Bankruptcy Code §550(b) places only 'good-faith' transferees beyond the reach of the recovery powers conferred upon the trustee in bankruptcy by Bankruptcy Code §550(a)(2). On the record developed before the bankruptcy court, there can be no doubt that the...transfers effected sham ('wash') transactions for the benefit of [the defendant]." 926 F.2d at 1256. Return to article

Bankruptcy Rule: 2003

By Arthur J. Steinberg and Michael R. Handler

The Good-Faith Defense to Fraudulent-Transfer Claims

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Now that the longest bull market in history has likely ended, a new batch of "dubious" transactions might soon come to light, and with them, contentious fraudulent-transfer litigation. The recent decision from the U.S. Bankruptcy Court for the Southern District of New York in *Picard v. Citibank NA, et al. (In re Madoff)*[1] addresses an important element in fraudulent-transfer actions: In what circumstance should a transferee's "good faith" be measured by a subjective standard (as compared to an objective standard)? The "good faith" question comes up in establishing the transferee's affirmative defense under § 548(c) of the Bankruptcy Code and the potential liability of a mediate/subsequent transferee of a fraudulent transfer under § 550(b)(2) of the Bankruptcy Code.

Although the Code does not define "good faith" for purposes of either §§ 548(c) or 550(b), most courts have applied an objective person or "inquiry notice" standard — *i.e.*, lack of good faith is present when a reasonable person in the transferee's position, based on the information the transferee knew or should have known (*i.e.*, "red flags"), would have investigated further and uncovered the fraudulent scheme or improper purpose relating to the transfer.[2] In applying this standard, the inquiry frequently turns on what the transferee "should have known" versus what the transferee "actually knew."

In *Picard v. Katz*, a 2011 decision arising from the *Madoff* debacle, however, the U.S. District Court for the Southern District of New York ruled that the *subjective* standard for good faith — not the *objective* standard — should be utilized in *Madoff*-related litigation because the fraudulent-transfer litigation arose in the context of a proceeding under the Securities Investor Protection Act (SIPA), and violations of securities law generally implicate the subjective intent of the defendant.[3] The bankruptcy court's recent decision in *Picard v. Citibank* followed this precedent and applied the subjective good-faith standard in another *Madoff*-related fraudulent-transfer litigation.

In certain situations, the application of the subjective good-faith standard (as compared to the objective standard) in a fraudulent-transfer litigation may be outcome-determinative. Thus, this article considers how the subjective good-faith standard applied in *Picard v. Citibank* differs from the objective standard that is generally applied in non-SIPA proceedings, and why it arguably made a difference in the result in that case.

Statutory and Case Law Background

Under § 548(a)(1), the trustee (or other bankruptcy estate representative) is empowered to, among other things, "avoid any transfer ... of an interest of the debtor in property ... that was made ... on or within [two] years before the date of the filing of the petition," under two different circumstances. The first, known as an "actual intent" fraudulent transfer, occurs if the debtor "made such transfer ... with actual intent to hinder, delay, or defraud any entity to which the debtor was or became ... indebted."[4] The second circumstance, known as a "constructive" fraudulent transfer, occurs if the debtor "received less than a reasonably equivalent value in exchange for such transfer or obligation" and was insolvent or undercapitalized (or rendered so) as of (or resulting from) such transfer.[5] Section 548(c) provides that "a transferee ... of such a transfer ... that takes for value and *in good faith* has a lien on or may retain any interest transferred ... to the extent that such transferee ... gave value to the debtor in exchange for such transfer."[6]

Section 550(a)(1) allows a trustee (or another debtor estate representative) to recover an avoidable transfer from the "initial transferee of such transfer or the entity for whose benefit such transfer was made." Under § 550(a)(2), the trustee may also recover from "any immediate or mediate transferee of" the initial transferee. In an attempt to recover from the immediate/mediate transferee, the trustee must plead that the initial transfer is avoidable, and that the defendant is a subsequent transferee of the initial transferee (*i.e.*, that the funds at issue originated with the debtor). Section 550(b) provides an affirmative defense from avoidance to a subsequent transferee who "[took] for value ... *in good faith*, and without knowledge of the voidability of the initial transfer."

Whether the transferee can establish "good faith" is a key issue in many fraudulent-transfer

1 Adv. Proc. No. 10-05345 (SMB) D.E. 170 (Bankr. S.D.N.Y. Oct. 18, 2019) (hereinafter, "*Picard v. Citibank*").
2 *See infra* fn.3.
3 *See infra* fn.5.

4 *See* § 548(a)(1)(A).
5 *See* § 548(a)(1)(B).
6 *See* § 548(c) (emphasis added).

litigations. A transferee that can successfully assert a good-faith defense under § 548(c) would only be liable to return transfers received to the extent such transfers exceeded the transfers made to the debtor. If the transferee could not establish the good-faith defense, it would be liable for all transfers received without regard to what it transferred to the debtor.

Prior to *Picard v. Katz, et al.*,[7] courts within the Second Circuit and elsewhere generally applied an objective good-faith standard (*i.e.*, whether alleged "red flag" information would have put a reasonably prudent person on inquiry notice of a fraudulent scheme).[8] However, in *Picard v. Katz*, the district court ruled that the "objective person" good-faith standard has "much less applicability ... in a context of a SIPA trusteeship, where bankruptcy law is informed by federal securities law. Just as fraud, in the context of federal securities law, demands proof of *scienter*, so too 'good faith' in this context implies a lack of fraudulent intent."[9] For the court in *Picard v. Katz*, "willful blindness" must be a conscious and purposeful intention; being "clueless" as a result of anything short of "willful blindness" would preserve a "good faith" defense.[10]

In *Securities Investor Protection Corp. v. Bernie L. Madoff Investment Securities LLC (In re Madoff Securities)*,[11] the district court followed its holding from *Picard v. Katz* and ruled that a subjective standard for purposes of evaluating "good faith" under §§ 548(c) and 550(b)(2) was appropriate for fraudulent-transfer actions brought in SIPA proceedings. The district court explained that the SIPA trustee's proposed objective-person inquiry notice standard "would impose a burden of investigation on investors totally at odds with the investor confidence and securities market stability that SIPA is designed to enhance."[12] Notably, the Second Circuit has not directly ruled on whether the district court's application of a subjective "good faith" standard is appropriate for fraudulent-transfer litigation arising in SIPA proceedings.[13]

Picard v. Citibank

In *Picard v. Citibank NA*, the SIPA trustee sued Citibank as the subsequent transferee from payments made by a Madoff entity to Tremont Partners. Citibank had made loans to Tremont to fund its investments in *Madoff*.

Prior to the complaint against Citibank, the *Madoff* trustee filed a complaint against Tremont to recover the transfers made to Tremont from the Madoff entity. The trustee alleged that Tremont knew that Madoff was not trading securities and was operating a Ponzi scheme, and therefore, Tremont did not have the requisite good faith and thus was not entitled to offset the transfers it made to Madoff. Ultimately, Tremont settled with the *Madoff* trustee.

Citibank responded to the SIPA trustee's lawsuit by filing a motion to dismiss on various grounds, including asserting a defense under § 550(b) that Citibank provided value to Tremont, and that the trustee's complaint "[did] not allege that the Defendants willfully blinded themselves to Madoff's Ponzi scheme." After establishing that Citibank provided value to Tremont by making a loan to Tremont, the bankruptcy court turned to whether the *Madoff* trustee adequately pled that Citibank took the subsequent transfers from Tremont without good faith and with knowledge of the avoidability of the initial transfer (*i.e.*, the transfer from Madoff to Tremont). The trustee argued that "without knowledge" picks up the subjective standard, so "good faith" must mean something different (*i.e.*, the "objective standard"). The bankruptcy court explained that the concepts of "good faith" and "without knowledge" represent separate elements, and while they were related, it did not mean that they were the same. Therefore, it concluded that the subjective standard could still be applied to the good-faith element.

The bankruptcy court, citing the district court's decision in the aforementioned *Securities Investor Protection Corp. v. Bernard L. Madoff Investment Securities LLC (In re Madoff Securities)*,[14] stated that "good faith should be determined under a subjective standard" and that to satisfy this standard, the SIPA trustee must plead that the defendant "willfully blinded" itself to the facts suggesting that Madoff was not actually trading securities.[15] More specifically, "willful blindness" consists of two elements: "(1) the defendant must subjectively believe that there is a high probability that a fact exists and (2) the defendant must take deliberate actions to avoid learning of that fact."[16] The bankruptcy court further explained that "[i]f a person who is not under an independent duty to investigate nonetheless intentionally chooses to blind himself to the 'red flags' that suggest a high probability of fraud, his 'willful blindness' to the truth is tantamount to a lack of good faith."[17]

Although **Irving H. Picard** (BakerHostetler; New York), the *Madoff* trustee, made various allegations concerning Citibank NA's willingness to continue to do business with Tremont (and, indirectly, Madoff), notwithstanding its suspicions regarding Citibank NA's inability to confirm Madoff's option trades, the risk of fraud and its improbably consistent investment returns, the bankruptcy court concluded

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7 462 B.R. 447 (S.D.N.Y. 2011), *abrogated by Sec. Investor Prot. Corp. v. Madoff Invest. Securities LLC*, 513 B.R. 437 (S.D.N.Y. 2014) (hereinafter "*Picard v. Katz*").

8 *See In re Bayou Grp. LLC*, 439 B.R. 284, 313 (S.D.N.Y. 2010) (holding that "[a]n objective, reasonable investor standard applies to both the inquiry notice and the diligent investigation components of the good-faith test"); *Hayes v. Palm Seedlings Partners-A (In re Agric. Research & Tech. Grp. Inc.)*, 916 F.2d 528, 535 (9th Cir. 1990) (applying objective "good faith" standard); *Jobin v. McKay (In re M & L Bus. Mach. Co.)*, 84 F.3d 1330, 1338 (10th Cir. 1996) (same); *Brown v. Third Nat'l Bank (In re Sherman)*, 67 F.3d 1348, 1355 (8th Cir. 1995) (same); *but see Goldman v. City Capital Mortg. Corp. (In re Nieves)*, 648 F.3d 232 (4th Cir. 2011) (applying subjective "good-faith standard" to § 550(b)(1) defense analysis).

9 *See Picard v. Katz* at 455.

10 *Id.* ("If an investor, nonetheless, intentionally chooses to blind himself to the 'red flags' that suggest a high probability of fraud, his 'willful blindness' to the truth is tantamount to a lack of good faith. But if, simply confronted with suspicious circumstances, he fails to launch an investigation of his broker's internal practices — and how could he do so anyway? — his lack of due diligence cannot be equated with a lack of good faith, at least so far as section 548(c) is concerned as applied in the context of a SIPA trusteeship.").

11 516 B.R. 18 (S.D.N.Y. 2014).

12 *Id.* at 22.

13 In another *Madoff*-related case, in commenting on the fraudulent-transfer claims that the SIPA trustee brought against certain investors, the Second Circuit stated in a footnote that "[t]he presence of 'good faith' depends upon, *inter alia*, 'whether the transferee had information that put it on inquiry notice that the transferor was insolvent or that the transfer might be made with a fraudulent purpose.'" *In re Bernard Madoff Inv. Sec. LLC v. Picard*, 740 F.3d 81, 90 n.11 (2d Cir. 2014). That is the objective standard for good faith. The Second Circuit's comment was based on the holding in *In re Bayou Grp. LLC v. Bayou No Leverage Fund LLC*, 439 B.R. 284, 310 (S.D.N.Y. 2010), which, like the *Madoff* scheme, was a Ponzi case, but *Bayou* did not arise in a SIPA proceeding. *Bayou* applied the objective good-faith standard. 439 B.R. 284, 312. Notably, the district court in *Sec. Investor Prot. Corp. v. Madoff Invest. Securities LLC* cast aside the Second Circuit's comment in support of an objective "good faith" standard as *dictum*. 516 B.R. 18, 22, n.2 (S.D.N.Y. 2014).

14 516 B.R. 18 (S.D.N.Y. 2014).

15 *Picard v. Citibank* at 24.

16 *Id.* at 26 (quoting *Global-Tech Appliances Inc. v. SEB SA*, 563 U.S. 754, 769 (2011)). The court further noted that "[u]nder *Global-Tech*, recklessness and 'should have known' do not satisfy the first prong of willful blindness." *See id.* at 28, n.22.

17 *Id.* (quoting *Picard v. Katz* at 455).

that the *Madoff* trustee did not plead facts establishing that Citibank NA had a "subjective belief" in the high probability that BLMIS was not trading securities when it made loans to Tremont.[18] The bankruptcy court concluded that the *Madoff* trustee failed to allege anything more than that Citibank "assumed the 'remote' risk that BLMIS [the Madoff trading entity] was not trading securities and might be a fraud and, at most, were reckless and deliberately indifferent to that risk."[19] Finally, the bankruptcy court found that it would have been implausible for Citibank to lend Tremont partners so much money "at a time when they entertained a subjective belief in the high probability that BLMIS was an illegal, criminal enterprise."[20]

Analysis

The bankruptcy court's analysis in *Picard v. Citibank NA* underscores how the applied "good faith" standard could affect the outcome of the underlying fraudulent-transfer claim. Arguably, the facts pled by the SIPA trustee in that case might have satisfied the "objective" good-faith standard for purposes of surviving a motion to dismiss by establishing that an objective person, armed with the facts that Citibank NA possessed, was put on notice that Madoff was a fraud. In contrast, the subjective analysis — and, specifically, the requirement that Citibank NA actively willfully blinded itself to the alleged fraud — was materially more difficult for the SIPA trustee to plead.

By way of illustration, under the objective good-faith standard, the transferee's good-faith defense is vulnerable to the argument that the transferee "should have known better" (that the transferee should have observed the red flags, then become aware of the fraud). Under the willful-blindness criteria set forth in the subjective good-faith standard, the transferee has to actually believe that it was highly probable that there was fraud taking place. Moreover, the transferee had to have taken a volitional act to avoid learning of the fraud; mere inaction did not seem to be sufficient.

Although the bankruptcy court applied a subjective good-faith analysis in *Picard v. Katz*, it considered a quasi-objective person standard: the implausibility of Citibank NA transferring funds to Tremont to invest in Madoff while believing that Madoff was a Ponzi scheme. The implausibility was based on the bankruptcy court's analysis of how Citibank NA would or would not behaved if it were a rational actor, which arguably is much more closely aligned with the objective good-faith standard than the subjective good-faith standard.

It is unclear how the Second Circuit might ultimately rule on the issue. The crux of the district court's rationale for applying the "subjective" standard is based on the fact that federal securities law informs bankruptcy law in the context of a SIPA proceeding. However, this underlying premise is based on a broad reading of the SIPA statute, which provides that "[t]o the extent consistent with the provisions of this chapter, a liquidation proceeding shall be conducted in accordance with, and as though it were being conducted under, chapters 1, 3, and 5 and subchapters I and II of chapter 7 of title 11."[21] The district court found a tension between federal securities law and the Bankruptcy Code and, in reconciling the policy objectives of the two federal statutes, leaned toward the principles of the securities laws to impose a subjective good-faith standard that otherwise is not generally recognized in Bankruptcy Code fraudulent-transfer cases.

Notably, in other circumstances, where the Code's policy objectives conflict with the policy objectives of a federal statute such as in labor law[22] or environmental laws,[23] courts have attempted to reconcile the policy objectives of the two federal statutes. The *Madoff* trustee has appealed the decision in *Picard v. Citibank NA*. If the Second Circuit ultimately gets a chance to weigh in on this issue, we might get greater clarity as to which policy objective will prevail for the application of the good-faith defense. abi

18 *Id.* at 34.
19 *Id.*
20 *Id.* at 35.

21 15 U.S.C. § 78fff(b).
22 *See NLRB v. Bildisco and Bildisco*, 465 U.S. 513, 526-27 (1984) (holding that in context of determining whether to permit rejection of collective-bargaining agreement subject to National Labor Relations Act pursuant to § 365(a) of Bankruptcy Code, debtor must show that agreement burdens estate and equities balance in favor of rejection, as opposed to business-judgment standard generally applicable to debtor's decision to reject executory contracts).
23 *See Midlantic Nat'l Bank v. NJDEP*, 474 U.S. 494 (1986) (holding that trustee in bankruptcy may not abandon property in contravention of state statute or regulation that is reasonably designed to protect public health or safety from identified hazards notwithstanding § 554(a) of Bankruptcy Code, which permits trustee in bankruptcy to abandon any property of estate that is burdensome to estate or that is of inconsequential value).

I Didn't Know, I Swear! Section 548(c)'s Good-Faith Defense to Fraudulent Transfer Actions

Mar 18, 2014

Contributed by Christopher Hopkins

Section 548(c) of the Bankruptcy Code provides transferees subject to fraudulent conveyance actions with an affirmative defense if they received the transfer for value and in good faith. As with any affirmative defense, the transferee bears the burden of proof. In cases where the trustee attempts to avoid a debtor's repayment of a monetary obligation—such as a repayment of a loan or a return of an investor's cash investment—the "for value" component is rarely at issue because the property transferred—cash—has a readily ascertainable value. But the question of what constitutes "good faith" under section 548(c) is not so easily determined. Complicating matters, the Fourth Circuit's recent decision in *In re Taneja*, adds to the uncertainty by departing, at least in part, from the good-faith standard applied in other circuits.

"Good Faith" Pre-*Taneja*

Neither the Bankruptcy Code nor its legislative history provides the parameters for determining the "good faith" required of transferee's raising an affirmative defense under section 548(c). Instead, courts have constructed the applicable framework for assessing whether a transferee received the transfer in good faith. As a general matter, courts will ask whether the transferee knew or reasonably should have known that the transfer was made either (i) when the transferor was insolvent or (ii) with a fraudulent purpose. If the transferee can prove that it did not know and that it should not have reasonably known of the transfer's fraudulent purpose, then its burden of proof is met.

In cases where the trustee alleges that the transferee "should have known" of a transferor's fraudulent purpose, the analysis consists of two components. Initially, courts will consider whether the transferee knew or reasonably should have known of certain facts—often referred to as "red flags"—that would have alerted a reasonably prudent transferee to the fraud. If the court determines that there were sufficient red flags surrounding the transfer to provide such "inquiry notice" of potential fraud, the transferee can still avail itself of section 548(c)'s affirmative defense by showing that a reasonably diligent inquiry would not have discovered the fraud. Both the inquiry notice and diligent inquiry components are objective tests. Accordingly, the court considers what a similarly situated, reasonably prudent transferee either should have known, or, if there are sufficient red flags such that a transferee would have inquiry notice of the potential fraud, should have discovered after a reasonably diligent inquiry.

The Good Faith Standard in *In re Taneja*

The Fourth Circuit's split decision in *Taneja* introduces a measure of subjectivity into the standard of "good faith" required by section 548(c). In *Taneja*, the court held that the appropriate standard of good faith in the section 548(c) context is whether the "transferee actually was aware or should have been aware, at the time of the transfers and in accordance with routine business practices, that the transferor-debtor intended to hinder, delay, or defraud any entity to which the debtor was or became . . . indebted." At first glance, this good-faith standard seems to comport with the generally accepted standard discussed above. It is in the application of this standard, however, that the Fourth Circuit appears to break new ground.

The transfers at issue in *Taneja* involved certain payments Financial Mortgage, Inc., a mortgage originator, made to First Tennessee National Bank, N.A., one of FMI's mortgage warehouse lenders. Leading up the financial crisis of 2007–08, FMI was engaged in a fraudulent scheme that had started as early as 1999. As the financial crisis deepened, FMI's operations crumbled. By the time the dust settled, First Tennessee had suffered nearly $5.6 million in losses. FMI filed for bankruptcy protection in June 2008, and a trustee was appointed to oversee the estate. Shortly thereafter, the trustee sought to avoid certain payments First Tennessee received from FMI as fraudulent transfers under section 548(a) of the Bankruptcy Code. In response, First Tennessee raised an affirmative defense under section 548(c).

During a three-day trial before the United States Bankruptcy Court for the Eastern District of Virginia, First Tennessee relied on the testimony of two of its employees to establish that it had received the transfers in good faith. Neither witness provided expert testimony. Based on the witnesses' testimony, the bankruptcy court concluded that First Tennessee had proved that it acted with the requisite good faith when it accepted the transfers from FMI. Accordingly, because the trustee conceded that the transfers were received for value, the court held that the transfers could not be avoided under section 548(a). The United States District Court for the Eastern District of Virginia affirmed the bankruptcy court's decision, and the trustee appealed.

On appeal, the trustee argued that (i) the bankruptcy court had misapplied the objective good-faith standard required by section 548(c), and (ii) First Tennessee failed to present sufficient evidence to prove it accepted the payments in good faith. The Fourth Circuit rejected these arguments and affirmed the district court's decision. The court held that First Tennessee's two lay witnesses had adequately demonstrated that the bank had received the transfers in good faith and without knowledge that should have alerted First Tennessee that the transfers were fraudulent. Notably, First Tennessee's evidence did not seem to address whether a reasonably prudent warehouse lender would have been alerted to the fraud. The dissent noted that if the Fourth Circuit was truly applying an objective good-faith test, the proper inquiry should have been whether the facts would have alerted a reasonably prudent warehouse lender to the fraud. Although First Tennessee's witnesses may have been able to explain why FMI's conduct did not raise suspicions of fraud at First Tennessee, the dissent stated that a truly objective inquiry would have required First Tennessee to present evidence showing that its conduct followed routine industry practices and that its response to the various "red flags" at FMI would not have alerted a reasonably prudent mortgage warehouse lender to the fraud.

Conclusion

Taneja introduces a measure of subjectivity into the court's analysis of a transferee's good faith under section 548(c) of the Bankruptcy Code. By focusing on whether First Tennessee acted reasonably, instead of whether a reasonably prudent warehouse lender would have been alerted to the fraud, the Fourth Circuit departed from the objective analysis typically applied in the section 548(c) context. Further, it alleviated First Tennessee's burden of presenting expert evidence concerning the warehouse lending industry. Whether other circuits will introduce a subjective analysis when assessing good faith in the section 548(c) context remains to be seen.

Bankruptcy Law Letter

OCTOBER 2019 | VOLUME 39 | ISSUE 10

THE SMALL BUSINESS REORGANIZATION ACT OF 2019

By Ralph Brubaker

On August 23, 2019, President Trump signed into law the Small Business Reorganization Act of 2019,[1] which will take effect in February of 2020. This legislation adds a new Subchapter V to Chapter 11 of the Bankruptcy Code, entitled "Small Business Debtor Reorganization." There are many aspects of the new Small Business Debtor Reorganization provisions of Chapter 11 that should help more small businesses successfully reorganize through Chapter 11, particularly the abrogation of Chapter 11's absolute priority rule as applied to unsecured creditors, which is replaced with a best-efforts test modeled on those of Chapters 12 and 13.

This issue of *Bankruptcy Law Letter* will summarize and analyze the new Subchapter V provisions of Chapter 11. Before doing so, though, this article will provide some background on predecessor small business reorganization provisions.

A BRIEF HISTORY OF SMALL BUSINESS REORGANIZATIONS UNDER THE BANKRUPTCY CODE

1. CHAPTERS X AND XI OF THE BANKRUPTCY ACT OF 1898

The Bankruptcy Act of 1898 contained different reorganization procedures for large and small businesses. While not perfectly implemented by the eligibility criteria, Chapter X was designed for large, publicly held corporations, and Chapter XI was for use by smaller businesses. The leading practice treatise summarized that object as follows:

> It apparently was the legislative intent that Chapter X should be used by "large" corporations, while Chapter XI offered a means of "flexible . . . settlement" by way of an arrangement through the composition or extension of unsecured debts which

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Chapters 12 and 13, though, only the Subchapter V debtor can propose post-confirmation modifications.

PREFERENCE AMENDMENTS

In addition to enactment of the Subchapter V small business debtor reorganization provisions, the 2019 Act also contains two defense-friendly preference amendments, both of which appear to be inspired by recommendations of the ABI Commission.

1. REASONABLE INQUIRY INTO AFFIRMATIVE DEFENSES

The 2019 Act amends Code § 547(b) to provide (additions in italics) that "the trustee may, *based on reasonable due diligence in the circumstances of the case and taking into account a party's known or reasonably knowable affirmative defenses under subsection (c)*, avoid any [preferential] transfer."[148] The ABI Commission recommended "codifying a standard" virtually indentical to that 2019 amendment.[149] The purpose of this amendment, though, is not immediately apparent.

Will this statutory due diligence requirement provide an independent basis for dismissal of an otherwise meritorious preference suit simply because the trustee or DIP did not perform the required "reasonable due diligence" before filing suit? Surely not. Then what is the purpose of codifying the due diligence requirement?

The bite in the new statutory due diligence requirement is in the directive that the trustee or DIP must "tak[e] into account a party's known or reasonably knowable affirmative defenses under subsection (c)." This is an expansion of the reasonable inquiry requirement already imposed upon a trustee or DIP via Bankruptcy Rule 9011 (the bankruptcy version of F.R.C.P. 11).[150]

Under Bankruptcy Rule 9011(b)(2), presentation of a preference complaint to the court constitutes a certification, "formed after an inquiry reasonable under the circumstances," that "the claims, defenses, and other legal contentions *therein* are warranted."[151] Moreover, a plaintiff's complaint need not anticipate (and plead the inapplicability of) a defendant's affirmative defenses. In fact, it "is improper pleading" for "a plaintiff's complaint [to] contain allegations that seek to avoid or defeat a potential affirmative defense that he or she anticipates will be included in the responsive pleading" because "these allegations are not an integral part of the plaintiff's claim for relief and lie outside his or her burden of pleading."[152] Under conventional pleading practice, therefore, a preference plaintiff's complaint need only address the existence of the plaintiff's prima facie case under Code § 547(b).

The 2019 amendment to Code § 547(b), therefore, appears to be an attempt to alter these conventional pleading obligations for preference suits, by placing an affirmation obligation on a trustee or DIP to conduct "reasonable due diligence" into each preference defendant's "known or reasonably knowable affirmative defenses under" § 547(c).[153] Preference plaintiffs, therefore, may now be put to pleading in the complaint (with a correlative Rule 9011 certification) that, to the best of plaintiff's knowledge and belief formed after reasonable due diligence, the defendant does *not* have any valid defenses under § 547(c). That is obviously a rather dramatic change in pleading practice.

It is difficult to anticipate exactly what this new obligation to conduct "reasonable due diligence" into the defendant's affirmative defenses will ultimately be determined to require of a plaintiff. The general object, though, appears to be changing the economic dynamics of preference litigation by increasing the plaintiff-side costs and risks of preference suits. The magnitude of that increase will depend upon how the courts interpret, apply, and enforce this new obligation.

2. SMALL-SUIT VENUE

With limited exceptions, the so-called home-court district (in which a debtor's bankruptcy case is pending) is always a proper venue for any individual bankruptcy proceeding brought in administering that case. One of the exceptions to home-court venue is the small-suit venue provision of Judicial Code § 1409(b). That statute provides that the *only* proper venue for a trustee's or DIP's suit is in the district in which the defendant resides, if the trustee or DIP seeks to recover a money judgment or property worth less than a specified amount. Before the 2019 Act, the indexed amounts, that triggered the exclusive small-suit venue, were:

- less than $1,375 for an insider-defendant
- less than $13,650 for a non-insider defendant
- less than $20,450 for a consumer debt

The 2019 Act raises the applicable small-suit amount for suits against a non-insider defendant to $25,000,[154] thereby enlarging the category of suits in which the trustee or DIP must sue in a venue relatively more convenient to (and less expensive for) the defendant and relatively less convenient to (and more expensive for) the trustee or DIP.

The non-insider category of small suits was added by the 2005 BAPCPA amendments, and it is widely recognized that the objective of that small-suit category was to "raise[] the litigation cost of bringing small *preference* claims" in order to counter "perceived abuses of the *preference* power."[155] By its terms, though, the small-suit venue provision only applies to trustee or DIP suits "arising in or related to" the bankruptcy case—an apparent reference to the corresponding grant of bankruptcy jurisdiction over proceedings "arising in or related to" a bankruptcy case in Judicial Code § 1334(b). The § 1334(b) jurisdictional basis for a preference suit (under Bankruptcy Code § 547), however, is as a proceeding "arising under" the Bankruptcy Code and *not* as a proceeding "arising in or related to" a bankruptcy case.

As codified, therefore, the small-suit venue provision may have no application whatsoever to preference suits, and some courts have so held. Other courts, by contrast, have chosen to effectuate the perceived purpose of Congress by holding that the small-suit venue provision *does* apply to preference suits.[156] With the 2019 Act amendments to the small-suit venue provision, Congress could have explicitly resolved that problem. Indeed, the ABI Commission recommended that the small-suit venue provision "should be amended to . . . clarify that the section applies to preference actions under section 547."[157] The 2019 Act, however, contains no such clarification. In fact, Congress has now amended the small-suit venue provision twice (in 2005 and 2019) *without* settling the lingering and important question of whether that venue provision applies to preference suits.

ENDNOTES:

[1]Small Business Reorganization Act of 2019, Pub. L. No. 116-54.

[2]6 Collier on Bankruptcy ¶ 0.12, at 121 (James Wm. Moore et al. eds, 14th ed. 1978) (quoting H.R. Rep. No. 75-1409, at 51 (1937)).

[3]Report of the Commission on the Bankruptcy Laws of the United States, pt. I, at 23 (1973).

[4]H.R. Rep. No. 95-595, at 5 (1977). See generally Hon. Leif M. Clark, Chapter 11—Does One Size Fit All?, 4 Am. Bankr. Inst. L. Rev. 167, 170-75 (1996).

[5]National Bankruptcy Conference, A Proposal for Amending Chapter 12 to Accommodate Small Business Enterprises Seeking to Reorganize, at 1 (Jan. 3, 2010) [hereinafter

(enacting 11 U.S.C.A. § 1193(d)).

[144]Pub. L. No. 116-54, § 2(a) (2019) (enacting 11 U.S.C.A. § 1193(c)).

[145]See 11 U.S.C.A. § 1127(b).

[146]See 11 U.S.C.A. § 1229.

[147]See 11 U.S.C.A. 1329.

[148]H.R. Rep. No. 116-171, at 51 (2019) (reprinting 11 U.S.C.A. § 547(b), marked to show H.R. 3311 revisions).

[149]ABI Commission Report at 151. See id. at 148 ("The trustee should be precluded from . . . filing a complaint against, any party for an alleged claim under section 547 unless, based on reasonable due diligence, the trustee believes in good faith that a plausible claim for relief exists against such party under section 547, taking into account the party's known or reasonably knowable affirmative defenses under section 547(c).").

[150]Althouh there is some authority for the proposition that, under F.R.C.P. 11 and Bankruptcy Rule 9011, "plaintiffs and their attorneys 'may have a responsibility to examine whether any *obvious* affirmative defenses bar the case.' " Fish v. GreatBanc Trust Co., 749 F.3d 671, 687 (7th Cir. 2014) (quoting In re Excello Press, Inc., 967 F.2d 1109, 1113 (7th Cir. 1992) (quoting White v. Gen. Motors Corp., 98 F.2d 675, 682 (10th Cir. 1990) (emphasis added)).

[151]Fed. R. Bankr. P. 9011(b)(2) (emphasis added).

[152]5 Charles Alan Wright & Arthur R. Miller, Federal Practice and Procedure § 1276, at 623 (3d ed. 2004). And "if the plaintiff purports to negative an affirmative defense by way of anticipation but does not admit the effectiveness of the defense in his pleading, the district court should treat the plaintiff's references to the defense as surplusage." Id. at 623-24 (footnotes omitted).

[153]"The Commission considered supplementing the elements of section 547(a) with an affirmative statement concerning diligence performed to evaluate the merits of the preference claim in light of any section 547(c) defenses available to the creditor." ABI Commission Report at 150. "[T]he Commission determined that the potential abuses under section 547 are addressed most effectively through the changes in . . . pleading requirements . . . described in these principles . . . ." Id. at 148.

[154]The ABI Commission had recommended a much larger increase, to $50,000. See ABI Commission Report at 148, 151.

[155]NBRC Report at 799-800 (emphasis added). See generally Tabb, Bankruptcy, § 4.10, at 378-79.

[156]See Tabb, Bankruptcy, § 4.10, at 379.

[157]ABI Commission Report at 148.

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Fixing Ch. 11 For Small Biz: SBRA's Puzzling Preference Edit

By **Joel Cohen, Robert Michaelson and Howard Magaliff** (February 26, 2021, 5:16 PM EST)

On Feb. 19, 2020, Congress enacted the Small Business Reorganization Act to improve the Chapter 11 reorganization process for small business debtors. In this ***Expert Analysis series****, bankruptcy experts reflect on ways the law has worked — and ways it hasn't — during the past year, a time of crisis for many small businesses.*

On Feb. 19, 2020, Subchapter V of Chapter 11 of the Bankruptcy Code — the Small Business Reorganization Act — became effective. The SBRA is widely recognized as a move to help make Chapter 11 less costly for small businesses.


Joel Cohen

Slipped into the law, with no legislative history, apparent discussion or evident reason, is an amendment to Section 547(b) of the Bankruptcy Code: "[T]he trustee may, based on reasonable due diligence in the circumstances of the case and taking into account a party's known or reasonably knowable defenses under subsection (c), avoid any transfer of an interest of the debtor in property" that is a preference.

On its face, the amendment seems innocuous.


Robert Michaelson

Rather than engaging in the routine exercise of reviewing the debtor's accounts payable reports to compile a list of litigation targets based upon payments the debtor made within the 90-day preference period, the trustee is now required to consider a potential defendant's known or reasonably knowable defenses based upon reasonable due diligence.

This should cause the trustee to seek to recover only net preferences.

In theory this is straightforward, but what the amendment actually means, what is reasonable due diligence and how it implicates other sections of the Bankruptcy Code are issues that judicial interpretation will sort out in the months and years ahead. One year after the SBRA came into effect, this article explores some of those issues.


Howard Magaliff

What Is a Plausible Claim?

A preference claim is theoretically simple to establish.

First, the debtor's books and records are reviewed to determine if any payments were made on account of antecedent debts owed to noninsider creditors in the 90 days immediately preceding the filing of the debtor's bankruptcy petition. For payments to insiders, the period is extended to one year.

An antecedent debt is a debt that is created prior to payment. Thus, prepayments and cash on delivery are not made on account of antecedent debts and, therefore, not preferential transfers.

Second, the payment is evaluated to determine whether it is protected by any of the affirmative defenses available to the creditor who received payment.

If the trustee concludes that a payment is not plainly protected by an available defense, it may fairly be concluded that a plausible preference claim exists. It is then up to the creditor who received the payment to present facts showing that it has a recognized defense.

Reasonable Due Diligence of Known and Reasonably Knowable Defenses

The starting point for the trustee's analysis is the statutory defenses to a preference claim, which are:

- The creditor provided value to the debtor at the time of the transaction — the contemporaneous exchange of new value defense under Section 547(c)(1);
- The payment by the debtor was made in the ordinary course of business with the creditor or according to industry standards — the ordinary course of business defense under Section 547(c)(2);[1]
- The creditor made additional transfers of property to the debtor after the payments in question were made — the subsequent new value defense under Section 547(c)(4).

Under Section 547(b), the trustee is required to consider these defenses. How is the trustee supposed to conduct diligence and what is reasonable? There are several things the trustee can and should do.

First, the trustee must carefully examine the debtor's books and records to determine a payment history and course of business for the creditor. This entails more than just looking at the accounts payable ledger.

The trustee should examine the full course of dealing with the creditor, including the frequency of invoicing, the time between delivery of goods or services and invoicing, the average time between invoice and payment, and the method of payment. The trustee should also look at deliveries by the creditor after payment.

This analysis is relevant to the subsequent new value and subjective ordinary course of business defenses.

Second, if appropriate in the circumstances, the trustee should thoroughly familiarize herself with the debtor's industry to educate herself about how business is conducted generally in that industry. This analysis is relevant to the objective ordinary course of business defense.

Third, the trustee should make ample use of Bankruptcy Rule 2004, which allows the trustee to examine any entity relating to "the acts, conduct, or property or to the liabilities and financial condition of the debtor, or to any matter which may affect the administration of the debtor's estate" and to compel the production of documents by subpoena.

The scope of inquiry under Rule 2004 is exceedingly broad, and it is without doubt the single most important tool in the trustee's arsenal to conduct prelitigation discovery. It seems obvious that a trustee should be using her subpoena powers to gather the information necessary to help assess reasonably known and knowable defenses available to a potential defendant.

Evaluating the Defenses

Subsequent New Value

Subject only to differing interpretations of the methodology by which it is calculated,[2] the subsequent new value defense should be the easiest for a trustee to evaluate, because it is generally subject only to a simple mathematical calculation. Section 547(c)(4) provides that:

> The trustee may not avoid under this section a transfer ... to or for the benefit of a creditor to the extent that, after such transfer, such creditor gave new value to or for the benefit of the debtor ... on account of which new value the debtor did not make an otherwise unavoidable transfer to or for the benefit of such creditor.

In practical terms, subsequent new value means the extension of credit by a creditor in the form of goods or services after a debtor's receipt of a voidable transfer. The reason the calculation of new value is usually simple is because it merely requires an examination of invoices that are matched against prior invoices and payments.

Unless a debtor's books and records are incomplete, there is no reason why this should be a problem. And if the records are incomplete, the trustee can often fill in the gaps through Rule 2004 subpoenas.

Ordinary Course of Business

The ordinary course of business defense protects from avoidance any transfer that was made in the ordinary course of business between the parties or according to terms that are consistent with the standards for payment in the industry in which the debtor and the creditor conduct business.

While not as straightforward as the new value defense, the information available to a trustee or obtainable through Rule 2004 discovery should enable the trustee to form a reasonable opinion of whether a payment made to a creditor during the preference period is consistent with the creditor's course of business transaction history with the debtor, or reflects a standard course of dealing in the particular industry.

Contemporaneous Exchange for Value

Arguably, this is the hardest defense for a trustee to assess, because it requires the defendant to establish that both the creditor and the debtor intended for the exchange of value to be contemporaneous. Assessing the availability of this defense would almost certainly entail the trustee deposing the creditor, unless intent is clear from the face of available documents.

It is not unreasonable to assume that a trustee asserting a preference claim will not have undertaken this level of prelitigation discovery and analysis with every defendant, particularly in large cases where there can be hundreds of preference cases.

Hence, the trustee could be justified in relying on the qualification of due diligence in the circumstances of the case to bring preference claims without having evaluated a contemporaneous exchange defense.

Pleading, Burdens and Other Issues

The impact on preference litigation of the Section 547(b) amendment remains to be seen, but certain issues are immediately clear.

The first is pleading the claim. A plain reading of the language of Section 547(b) suggests that the trustee should plead net preferences after giving credit for known and reasonably knowable defenses as a result of her due diligence.

However, this runs smack into Section 546(g), which provides that "the creditor or party in interest against whom recovery or avoidance is sought has the burden of proving the nonavoidability of a transfer under subsection (c) of this section." If the trustee asserts the avoidability of a net preference giving account to the creditor's defenses, what is the effect of Section 547(g)?

We do not envision anyone seriously arguing that in enacting the amendment to Section 547(b) Congress implicitly repealed or amended the creditor's burden of proof in Section 547(g). But then, how does the creditor defend the claim? Even if the trustee pleads net preferences, a fair reading of the statute does not imply that she has to say which defenses she took into account.

A flip question is whether there is a benefit to the creditor if the trustee in fact pleads net preferences. When analyzing transactions with the debtor, lawyers who represent preference defendants often choose to apply ordinary course of business defenses to the transfers first, because transfers that are not ordinary can still be immune from avoidance under the subsequent new value defense.

The reverse is not necessarily true; once you knock out transfers that are protected by new value, remaining transfers may no longer be within the ordinary course of business.

The rationale for defending preference claims in this manner is because what is ordinary usually involves a temporal limitation between the creation of the antecedent debt and its payment, whereas the only temporal issue with subsequent new value is that it be given after the avoidable transfer.

Finally, how does a defendant assess the trustee's level of diligence? Suppose that before filing a complaint the trustee sends the creditor a demand letter in which she gives credit for new value and demands payment only of the net transfers.

Suppose further that in her complaint the trustee pleads that she undertook "reasonable due diligence in the circumstances of the case and taking into account a party's known or reasonably knowable affirmative defenses under Subsection (c)," but nevertheless pleads gross transfers because the burden of establishing defenses is the defendant's under Section 547(g).

Even if the prior letter acknowledging the net transfers is protected under Federal Rule of Evidence 408, we would argue that the trustee cannot plead gross transfers in good faith and consistent with her Rule 11 duties.

But proving that may be difficult; if the defendant seeks in discovery to learn about the trustee's due diligence concerning known and reasonably knowable defenses, the trustee would likely assert a privilege or work product objection.

Judicial Consideration of Section 547(b)

In the year since the SBRA went into effect, we have found four opinions that discuss whether a trustee is required under Section 547(b) to affirmatively allege that she conducted reasonable due diligence prior to filing the complaint.

The U.S. Bankruptcy Court for the Eastern District of California held on Nov. 24, 2020, in In re: ECS Refining Inc. that the reasonable due diligence requirement is a condition precedent and "an element of the trustee's prima facie case."[3] The other courts declined to take a position on the matter.[4]

In Sommers v. Anixter Inc. decided on Dec. 21, 2020, because the complaint alleged that the trustee had reviewed the debtor's bank and wire records, invoices, correspondence and the parties' contract, and had mapped out the alleged structure of their relationship, the U.S. Bankruptcy Court for the Southern District of Texas found that "given the circumstances of this case, and taking into account Anixter's known or reasonably knowable affirmative defenses, Trustee's Complaint contains sufficient information regarding the reasonable due diligence prong of § 547(b) to survive dismissal."[5]

Conclusion

As we noted in the beginning of this article, the seemingly straightforward attempt to streamline preference litigation is anything but: It raises a host of questions and issues that the legislation doesn't address. Moreover, we could find no legislative history to explain why Section 547(b) was amended.

Until more courts weigh in to offer interpretation and guidance about the meaning of Section 547(b) and its relation to Sections 547(c) and 547(g), trustees should tread cautiously when assessing and pleading preference claims.

One possibility to consider is that a preference complaint reflect subsequent new value that is apparent from the debtor's books and records, a view that is supported by a sensible plain reading of the statute.

The circumstances of each case will dictate how much more prelitigation analysis the trustee should undertake.

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The opinions expressed are those of the author(s) and do not necessarily reflect the views of the firm, its clients or Portfolio Media Inc., or any of its or their respective affiliates. This article is for general information purposes and is not intended to be and should not be taken as legal advice.

[1] The "subjective test" provides that a payment is not a preference if the creditor received the payment in the ordinary course of the debtor's business based on the history and pattern of payments between the creditor and the debtor. The "objective test" provides that a payment is not a preference if the creditor received the payment in accordance with "ordinary business terms" based on standard payment practices in the industry in which the creditor and debtor do business. A creditor can defeat a preference claim under either the subjective or the objective test.

[2] Courts are split on as to whether the "new value" defense includes paid as well as unpaid "new value."

[3] Husted v. Taggart (In re ECS Ref., Inc.), 2020 Bankr. LEXIS 3524 at *45 (Bankr. E.D. Cal. Dec. 15, 2020).

[4] See Harker v. Cummings (In re GYPC, Inc.), 2020 Bankr. LEXIS 2384 at *25 (Bankr. S.D. Ohio Aug. 4, 2020) ("the court cannot determine from the pleadings [whether due diligence must be pled by the trustee] as a matter of law"); Englander v. Blunt (In re Essex Constr., LLC), 2020 Bankr. LEXIS 2616 at *48 fn. 17 (Bankr. D. Md. Sept. 30, 2020) ("Whether or not the amended language of the statute applies in this case, the court has taken it into consideration . . . ."); Sommers v. Anixter, Inc. (In re Trailhead Engineering LLC), 2020 Bankr. LEXIS 3547 at *20 (Bankr. S.D. Tex. Dec. 21, 2020) ("While the Court need not determine today whether 'reasonable due diligence' is an element of any preference claim, a plain reading of the statute references due diligence 'in the circumstances of the case' meaning that a level of discretion is involved.").

[5] Id. at p. 15.

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BANKRUPTCY'S UNEVEN RESPONSE TO NUISANCE CLAIMS

Kara J. Bruce

In fall 2020, an estimated 500 dairy farmers and milk shippers received letters demanding the return of payments made to them by bankrupt milk processor Dean Foods within the 90 days preceding Dean's bankruptcy petition date. The letters admonished farmers to reach settlements quickly to avoid litigation.[1] The farmers and shippers who had received these payments reacted incredulously, a common response of those unfamiliar with the cruelties of bankruptcy equity:

> "They want money back they paid us after we sold them our milk to their plant, and paid to ship it there . . . . They then paid me for it, and they processed it and sold it elsewhere. They now want the money back they paid me for my milk, which is a product that's long gone. This was a year and a half ago."[2]

The Bankruptcy Code, of course, deems such prebankruptcy payments to be "preferential transfers." Absent a defense, these "preferences" can be recovered for the benefit of the estate. Here the farmers and shippers argued they had an ironclad (and more importantly obvious) defense to preference liability.[3] The milk industry is heavily regulated in the United States, and Federal Milk Marketing Orders ("FMMOs") determine the grading, classifying, and minimum payments for milk products. These FMMOs feature detailed schedules that determine the timing and amount of payment due to suppliers and shippers, like the preference defendants here.[4] Payments that complied with FMMO schedules, the farmers and shippers argued, are without question made within the ordinary course of business between the debtor and preference defendant, and are therefore insulated from clawback for the benefit of the Dean Foods' estate.[5]

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That the *Dean Foods* case generated so many preference demands, notwithstanding this industry norm and apparent applicability of a complete defense, taps into a long-standing complaint about abuses in preference litigation. The complaint is that preference plaintiffs—often third-party assignees of claims—make demands of any and all recipients of transfers within preference law's 90-day lookback period. These demands, whether letters or formal complaints, are said to be made without considering whether these transfers meet the definition of a preference or whether a defense to preference liability exists. Some preference defendants might not understand that they have valid defenses and, particularly when lawsuits to recover preferences are filed in a district far from the defendant's base of operations, might not be in a position to bear the expense to assert them. As such, preference defendants could be pressured into settling claims notwithstanding the likelihood that they would prevail at trial.[6]

Congress has repeatedly amended the Code to curb the filing of these nuisance-style preference cases. Most recently, the Small Business Reform Act of 2019 ("SBRA") rebalances traditional pleading burdens in preference actions by requiring preference plaintiffs, before bringing suit, to conduct due diligence regarding "known or reasonably knowable affirmative defenses."[7] The SBRA also attempts to adjust the venue rules to require small-dollar preference suits to be filed in the defendant's home district, rather than the debtor's.[8]

In this *Law Letter*, I evaluate these reforms. I begin with a narrow lens, evaluating how effectively the amendments achieve their intended aims. On this point, while the reforms will likely curb some nuisance-style litigation, they likely will fall short of the goals apparently motivating the reforms. Stepping back a bit farther, I then question whether the goals underlying the SBRA amendments align with core bankruptcy policy. Here, I suggest that the recent SBRA amendments fall into a pattern that continually reduces the scope of preference recoveries, moving preference law farther away from the equality-of-distribution rationale that undergirds preference law. I also point out inconsistencies in the level of attention that such litigation abuses receive from

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Congress. I suggest that the problem of stale debt claims, which I have written about in several past BLLs, might also be deserving of this type of burden-shifting legislative reform.

A VERY BRIEF BACKGROUND ON PREFERENCES

Preferences are a venerable feature of bankruptcy law, dating back to decisions of the Kings Bench.[9] Preferences embody the idea that individual creditors should not extract more than their fair share of the debtor's limited assets as the debtor approaches bankruptcy. And so, Code section 547 allows the estate to avoid and recover transfers made to or for the benefit of creditors, on account of debts that preceded the transfers, made typically within the 90 days before commencement of the bankruptcy case,[10] while the debtor was insolvent,[11] which result in the creditor receiving more than it would have received in a chapter 7 liquidation.[12] The legislative history justifies preference avoidance on dual grounds: enhancing equality between creditors, on the one hand, and deterring the piecemeal evisceration of the debtor during its descent into bankruptcy, on the other.[13] But as discussed below, these policy rationales often work at cross purposes, and this dissonance has confused the development of the law.

Since the Bankruptcy Reform Act of 1978, preference law has functioned as a form of strict liability.[14] Creditors need not have acted with dubious intent when receiving preferential payments. It is enough to have received a payment that fits the statutory definition.[15] A large number of preference defenses, however, mitigate this expansive sweep of liability. The most commonly applied defense shields from avoidance transfers made in the "ordinary course of business"—that is, transfers made to repay debt incurred in the ordinary course of business of the debtor and transferee, if the payments were also made either in the ordinary course of business of the debtor and transferee or according to ordinary business terms.[16] A variety of additional preference defenses serve various discrete legislative aims, such as encouraging creditors to provide new value to the debtor,[17] excluding from liability transfers that do not have preferential effect,[18] shielding low-dollar transfers and domestic support payments from liability,[19] avoiding the hassle of tracking frequent changes relating to floating liens,[20] protecting financial markets,[21] and harmonizing the preference provisions with other sections of the Code.[22] Taken together, these defenses give persons who find themselves on the receiving end of a preference demand a variety of potential avenues to reduce or (avoid entirely) liability for preferential payments.

But even with the expansive defenses available, preferences remain a very bitter pill to swallow.[23] A major conceptual issue is that preferences impose bankruptcy's equality-of-distribution policy on non-bankruptcy collections, where a "race to the assets" is not only permitted, but encouraged.[24] Preferences thereby penalize creditors for activities that would have been permissible had they occurred more than 90 days prior to the bankruptcy case.[25] On top of this confusion, it is nearly impossible to harmonize the push and pull between preferences' equality and deterrence policies.[26] With one hand, preferences enhance equality of distribution by sweeping 90-day payments into the estate, no matter the intent of the parties. But with the other hand, preference defenses cherry-pick certain preferential payments that are somehow worthy of exclusion. The standards for determining which preferences are "worthy" under the applicable exceptions are vaguely defined, which increases the expense of litigating the issues.[27] This litigation over exceptions, in turn, "encourages the view that preference law is arbitrary and capricious, despite its stated pursuit of equality."[28] Many scholars who have tried to resolve this dissonance have observed that deterrence is a weak rationale for preference law[29] and have concluded that the equality of distribution policy should predominate.[30] The Code's legislative history also suggests that deterrence is of secondary importance.[31]

It is not inconceivable that, similar to the Creditor's Bargain theory, preference defendants might collectively agree to the concept of preferences on the theory that recovering preferences for the estate produces a tide that lifts all unsecured creditors' boats.[32] But it is difficult to see that broader picture when one's own ox is being gored. Moreover, preference's rose-colored rationales are cold comfort in cases in which preference recoveries do not trickle down to general unsecured creditors. Indeed, preference recoveries can be used to plug gaps in administrative expense obligations or inure to the benefit of the debtor's DIP lenders.[33]

To put it simply, preferences are strange and unpopular beasts. And preference defendants, among many others, have loudly and consistently decried their perceived injustices.[34] The following section describes a subject of particularly strident criticism: the problem of nuisance preferences.

COMPLAINTS OF NUISANCE PREFERENCES AND CONGRESS'S MULTIPLE ATTEMPTS TO ADDRESS THEM

It has long been said that preference plaintiffs file large numbers of claims without first taking into account applicable defenses. Commenters have argued that it is a business practice of preference plaintiffs—sometimes the trustee or debtor in possession, but often a liquidating trust or assignee—to pursue these types of preference cases as a manner of extorting small settlements from trade creditors.[35] Particularly when such cases are filed in the debtor's home court, rather than the defendant's district, the cost of traveling or hiring distance counsel to fully defend the suit might quickly eclipse the amounts claimed. As such, it can make economic sense for defendants to settle even claims for which a strong defense exists, rather than bear the outsized cost of litigation.[36] The concern becomes that settlement at these low-dollar prices does little to enhance the value of the estate, but instead serves primarily to enrich estate professionals.[37]

Congress has been rather solicitous to these concerns, repeatedly amending section 547 to rebalance the playing field in favor of preference defendants. For example, in 1984, Congress first added what is now the section 547(c)(8) safe harbor, which provides a complete defense to actions to recover preferences less than $600 in consumer cases.[38] In the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA), Congress created a new $5,000 safe harbor applicable to cases "filed by a debtor whose debts are not primarily consumer debts."[39] BAPCPA also expanded the venue protections for defendants in 28 U.S.C.A. § 1409(b) by providing that suits to recover non-consumer debts against non-insiders for less than $10,000 be brought in the *defendant's* home district, rather than the *debtor's*.[40] Finally, BAPCPA raised a similar cap in section 1409(b), applicable to consumer transactions, from $5,000 to $15,000.[41]

But the complaints about coercive preference demands continued, and were again considered in the 2014 final report of the American Bankruptcy Institute Commission to Study Chapter 11 Reform.[42] The Commission considered a range of potential solutions to the problem of nuisance preferences, including codifying a presumption that preferential transfers were ordinary-course transactions and abolishing preference law entirely.[43] Ultimately, the Commission settled on the following recommendations as a "compromise" position:

(1) "codifying a standard that required the trustee to perform reasonable due diligence and to make good faith efforts to evaluate the merits of the preference claim" before filing suit or issuing a demand letter to recover a preference;

(2) "requir[ing] the trustee to plead with particularity in the complaint the facts supporting each element of the preference claim under section 547(b)"; and

(3) "increasing the monetary caps in section 547(c)(9) of the Bankruptcy Code and section 1409(b) of title 28 of the U.S. Code (the small claims venue provision) to $25,000 and $50,000, respectively."[44]

In the SBRA, Congress adopted several of the ABI Commission's suggestions, at least in part. First, the SBRA imposes expanded diligence duties on trustees, debtors in possession, or liquidation trusts bringing preference suits. Section 547 now reads that "the trustee may, based on reasonable due diligence in the circumstances of the case and taking into account a party's known or reasonably knowable affirmative defenses under subsection (c), avoid any transfer" that meets the elements of a preference.[45] The SBRA also raised a financial cap in bankruptcy's small-suit venue exception, 28 U.S.C.A. § 1409(b). That provision now provides that certain suits to recover a money judgment or property worth less than $25,000 in non-consumer cases must be brought in the defendant's home district.[46]

The SBRA reforms take a more nuanced approach to curbing litigation abuses in the preference context than prior reform efforts took. Rather than prohibiting small-value suits outright, a tactic that commentators have called both over- and under-inclusive,[47] these reforms instead adjust the cost-benefit analysis behind preference plaintiffs' attempts to sue. The goal appears to be to weeding out negative-value cases without damaging to the broader policies underlying preference litigation.[48] Whether they accomplish that goal remains to be seen. The following sections consider outstanding questions and potential limitations of the SBRA provisions, with reference to the case law that has come down since the SBRA became effective.

SBRA'S PROCEDURAL LIMITATIONS

The SBRA's diligence inquiry amounts to a "dramatic change in pleading practice."[49] Bankruptcy Rule 9011(b) typically requires plaintiffs to certify, after an "inquiry reasonable under the circumstances," that "the claims, defenses, and other legal contentions" relating to their *prima facie case* are warranted.[50] Here, though, the plaintiffs' inquiry must also "take[ ] into account" affirmative defenses.[51] A variety of procedural dimensions relating to this new standard will take time to sort out.

A dominant concern among practitioners is the level of inquiry necessary to achieve "reasonable due diligence." Clearly, spamming every recipient of a transfer within the 90 days preceding the bankruptcy case with a lawsuit will violate this standard. But does the trustee satisfy the diligence inquiry by reviewing the debtor's books and records for obvious defenses? "Does the trustee have to undertake a Rule 2004 examination of each potential defendant, or is questioning a representative of the debtor enough?"[52] It is clear from the statute that the diligence inquiry is intended to apply somewhat flexibly, but it is unclear what factors will merit more or less scrutiny on behalf of the trustee or other plaintiff. "Does the effort required to satisfy the trustee's need to exercise reasonable due diligence vary depending, for example, upon the amount of money in the estate, the condition of the debtor's books and records when the trustee examines them, or the availability of the debtor's accounting personnel?"[53] Relatedly, must the trustee plead its diligence as an element of its prima facie case? Put another way, "[w]ill this statutory due diligence requirement provide an independent basis for dismissal of an otherwise meritorious preference suit simply because the trustee or DIP did not perform the required 'reasonable due diligence' before filing suit?"[54]

The most thorough treatment of these questions appears in *Husted v. Taggart (In re ECS Refining, Inc.)*.[55] There, the court considered a motion to dismiss a complaint containing conclusory allegations that transfers made from the debtor to an insider-lessor were avoidable under section 547.[56] The court dismissed the complaint, holding that the new trustee duties under section 547(b) amounted to a condition precedent to litigation and "an element of the trustee's prima facie case."[57] To reach this holding, the court analogized section 547(b)'s new diligence inquiry to the exhaustion requirements in the Prison Litigation Reform Act of 1995 (PLRA).[58] The PLRA requires that prisoners exhaust their prison grievance procedures before filing suit under section 1983.[59] Before the Supreme Court's 2007 decision in *Jones v. Bock*, courts were split on whether this exhaustion-of-remedies element fell to the plaintiff or defendant to plead.[60] In *Jones*, the Court held that exhaustion of remedies was an affirmative defense, and therefore did not need to be pleaded as part of the plaintiff's prima facie case.[61]

ECS Refining found section 547(b) distinguishable from the PLRA on a number of grounds that indicated the diligence requirement is an element of the trustee's prima facie case. First, the court noted that section 547(b) provides the "source of the trustee's substantive rights," unlike the PLRA, which "provides a procedural overlay" to a prisoner's claims.[62] Second, the court read section 547 to "expressly require[ ] that the trustee affirmatively prove due diligence."[63] It so held based on the placement of the diligence inquiry in subsection (b), which contains the elements of a preference, and 547(g), which "expressly allocate[s] the burden of proof" of 547(b) matters to the trustee."[64] "[I]f the plaintiff bears the burden of proof of the fact at trial, in most instances it is an element," and as such must be pleaded.[65] The court held that this interpretation aligns with the plain reading of the statute and is consistent with Congressional intent to curb "improper use of preference actions in some instances."[66]

Having established the due diligence requirement as an element of the case that should be individually pleaded, the court then turned to the complaint, which it found lacking. The court noted that the complaint did not "expressly recite the efforts [trustee] undertook to evaluate the merits of a prima facie case or reasonably knowable affirmative defenses."[67] These generalized allegations "suggest[ed] a lack of pre-filing due diligence."[68] In particular, the court found that "reasonable inferences do not suggest the trustee . . . considered whether the debt was antecedent[,] whether those transfers improved the debtor's position[,]" or "the inapplicability of all affirmative defenses."[69] Note that these deficiencies relate both to the plaintiff's prima facie case and the existence of affirmative defenses.

The Bankruptcy Court for the Southern District of Texas took a far softer approach to the diligence inquiry in *Sommers v. Anixter, Inc. (In re Trailhead Engineering)*.[70] There the court considered a motion to dismiss on the basis that the complaint failed to allege that the trustee conducted the requisite pre-filing due diligence.[71] The court avoided the question of whether "due diligence" is an element of a preference claim by concluding that the complaint, liberally construed, demonstrates that the trustee had done diligence in that case.[72]

Notably, the complaint made no specific allegations about the diligence conducted, and it did not expressly reference to the possible applicability of any affirmative defenses. But the complaint was far more detailed in its allegations than the complaint considered in *ECS Refining*. In particular, the complaint "demonstrate[d] that Trustee reviewed [the debtor's] bank and wire records, invoices relating to the [allegedly preferential] Transfer, correspondence, and the contract . . . . Additionally, Trustee mapped out the alleged structure of the parties' relationships in the Complaint."[73] These general allegations, which seem primarily focused on the elements of the prima facie case, satisfied the court that "the Complaint contains sufficient information regarding the reasonable due diligence prong of § 547(b) to survive dismissal."[74]

Little additional case law exists to shed light on how courts will interpret the trustee's new diligence requirement.[75] It is clear that preference plaintiffs should plead facts relating to their pre-suit diligence and consideration of potential affirmative defenses. But these two cases suggest that, at least in the near term, the overall quality of the complaint might play some role in determining how closely courts pay attention to the diligence standard.

VENUE APPLICABILITY CONCERNS REMAIN UNRESOLVED

As noted in a recent *Law Letter*,[76] the SBRA also failed to resolve an apparent drafting error in the venue provisions discussed above. In BAPCPA, Congress amended 28 U.S.C.A. § 1409(b) to require actions to recover non-consumer debts of less than $10,000 against non-insider defendants to be filed in the defendant's home district, and the SBRA increases this monetary floor to $25,000.[77] But by its terms, section 1409(b) applies to proceedings "arising in" and "related to" a bankruptcy case.[78] Preference claims "arise under" the Bankruptcy Code, and thus on a plain-text reading would fall out of the section 1409(b) exception.[79] The residual venue rule, section 1409(a), is grounded in general principles of centralization and provides that "arising-under" proceedings can be asserted in the district in which the *debtor's* bankruptcy case is pending.[80] Thus, despite the apparent intent of these amendments to reduce the cost of defending a preference action in a distant forum, the venue provisions appear to direct preference litigation to the debtor's home court.

Before the SBRA amendments, a majority of courts held that preference actions were not governed by the 1409(b) exception.[81] A minority of courts, however, stretched section 1409(b) to cover "arising under" cases, on the theory that the legislative history demonstrates that the omission of "arising under" from section 1409(b) was a drafting mistake.[82] Whatever merit this argument commanded before the SBRA, the argument is much harder to support after the recent amendments, because Congress ostensibly was aware of the mistake, but nevertheless declined to address it.[83]

Some pre-SBRA courts shoehorned preference claims into section 1409(b) by arguing that even though they are "arising under" claims, they also "arise in" a bankruptcy case and therefore fit within section 1409(b).[84] But the terms "arising under" and "arising in" represent distinct grants of bankruptcy jurisdiction with independent meaning and scope.[85] "To treat these terms as synonymous would defeat the Congressional intent behind § 1334 in which Congress conferred broad but distinct jurisdictional powers upon bankruptcy courts."[86]

The published cases interpreting section 1409(b) after SBRA have so far hewed to the plain meaning of the statute. As such, they have held that the defendant-friendly home-court rule in section 1409(b) does not apply to small-dollar preference actions.[87] Perhaps a technical corrections amendment will resolve this issue, but in the meantime, these SBRA reforms appear to fall short of their apparent goals.

SBRA'S DECISION NOT TO IMPOSE A DILIGENCE INQUIRY ONTO DEMAND LETTERS

Finally, the new diligence inquiry does not extend to sending preference *demand letters* as well as preference *lawsuits*, as recommended by the ABI Commission to Study Chapter 11 Reform.[88] As such, preference plaintiffs are free to spam 90-day payees with demand letters in an effort to extract settlements. Since much preference litigation is settled without ever filing suit, the exclusion of demand letters from the diligence inquiry is a significant limitation of the SBRA reforms. Few of us, when receiving a strongly worded letter with threats of litigation, would feel sanguine about simply ignoring it. Likewise, few of us (esteemed readers of this publication aside) could gauge the merits of a preference claim or defense without assistance of counsel. As such, the SBRA reforms do not necessarily neutralize concerns about coercion in preference actions. Defendants might still incur legal costs in determining how to respond to these letters, and less sophisticated preference defendants in particular might continue settling claims rather than shouldering the burden and expense of contesting them.[89] Indeed, SBRA's new diligence inquiry might simply shift coercive preference activities off court dockets and into defendants' mailboxes.

But consider as a counterpoint to these concerns how the *Dean Foods* preference litigation was resolved. After the preference defendants received their demand letters, the American Farm Bureau Federation stepped in on behalf of the dairy farmers, accusing Dean Foods' attorneys of a "predatory shakedown" and threatening litigation if the letters were not withdrawn.[90] The Dairy Farmers of America also issued a statement condemning the action:

> "We find it extremely disappointing that hardworking dairy farm families are now put in the position of having to incur costs, either in paying the amounts demanded, or obtaining legal counsel to defend themselves against these farfetched claims."[91]

Meanwhile, the Pennsylvania Milk Marketing Board worked with the law firm that sent the demand letters to create a simple, fill-in-the-blank response sheet to help farmers and shippers quickly resolve these claims.[92] This is not the only example of trade groups assisting their members with preference defense. In the VeraSun ethanol bankruptcy case, for example, hundreds of corn farmers received letters demanding the return of preferences. There, the National Corn Growers Association and similar groups ultimately prevailed upon the preference attorneys to withdraw the claims.[93]

We cannot tell from public records what number of defendants succumbed to the Dean Foods' preference demands by paying settlements, much less what they might have paid back to the estate. But this experience tells us that trade groups can provide information and support to preference defendants. Of course, not all preference defendants will have the protection of groups like the Farm Bureau at their side. But in those cases, internet posts or message boards might provide a venue for informal collaboration and information sharing, as they have in other bankruptcy contexts.[94] This reality might mitigate, at least in part, the vulnerability of preference defendants to coercive demand letters.

EVALUATING THE GOALS OF SBRA'S PREFERENCE AMENDMENTS

The previous sections evaluate how well the SBRA's preference amendments meet their apparent aims. The sections that follow evaluate the merits of SBRA's aims themselves. First, let us identify several distinct dimensions underlying the concerns of coercive preference litigation. This is predominantly a concern of economics: in actions to recover small preferences, the trustee's cost of bringing the action, at least before the recent reforms, is thought to be far lower than the cost of defense. Added to this, with respect to small-dollar preference actions brought in a distant forum, the cost of litigating meritorious defenses might exceed the costs of settlement. A distinct but related economic concern is that the benefits in these small cases might enrich parties other than the residual beneficiaries of the estate. Lurking below these economic issues are broader fairness concerns relating to high-volume nuisance litigation in general,[95] as well as concerns that less sophisticated preference defendants are particularly vulnerable to litigation abuses.

A major problem with the economic arguments is that the costs and benefits underlying preference litigation are difficult to generalize across cases. After all, the value to the estate of a small preference recovery will vary dramatically in relation to the size of the estate, and litigation costs can differ depending on the legal market. For this reason, prior reforms that impose exceptions on preference recoveries based on a static dollar amount have been criticized as overbroad, in that they likely foreclose suits that would bring some value to the estate.[96] Moreover, if remote litigation in the wake of the COVID-19 public health emergency continues, it could disrupt these foundational concerns about the cost of defending claims in a distant forum.[97]

This most recent set of reforms takes a more nuanced approach to addressing litigation asymmetries in preference cases. Rather than carving out claims from liability entirely, the SBRA amendments adjust the relative costs of litigation between plaintiff and defendant. In that way, and putting aside the limitations discussed above, the reforms are not particularly objectionable. But they nevertheless continue a Congressional trend that favors expanding the exceptions and exclusions from preference liability at the expense of preference's key aims. Taking the big-picture view, even a small-dollar action that feels "coercive" to an individual creditor nevertheless generates a return that, at least in theory, inures to the benefit of unsecured creditors as a whole. As such, unsecured creditors as a group might be better off in a preference system that maximizes preference recoveries, at least "unless one's ox got gored more than average."[98] Viewed from this vantage point, Congress's attempts to increase the costs of bringing preference actions (together with other amendments that expand the exceptions and carveouts from preference liability) not only distance preference law from its equality-of-distribution aims but also arguably disadvantage their intended beneficiaries.

True, those who decry the injustices of preference litigation note that the recoveries of small-value preferences tend to benefit parties other than unsecured claimants. But if that were the dominant concern underlying preference reform, there are narrower means of solving that problem.[99] Rather than limiting recovery of small-dollar preference claims, courts could instead put a stop to the practice of allowing secured creditors to take liens on avoidance actions in general, or preference actions in particular. Or, courts could exercise greater oversight over professional fee awards in preference litigation to ensure that the estate's residual claimants enjoy some of the fruits of the litigation recoveries.[100]

Finally, the fairness concerns underlying these preference amendments are no doubt salient, but raise empirical questions. The first involves the scope of the problem: Scholars have suggested that complaints of abuses in preference litigation are overblown, or at least in need of further empirical study.[101] And it is worth observing that the complaints about preference litigation abuses do not appear to have lessened through the multiple rounds of amendments preceding SBRA.[102] Second, the resolution of the Dean Foods case, described above, raises questions about the vulnerability of some types of preference defendants to coercion. These questions should be explored in more detail if Congress again takes up the problem of nuisance-value preference actions.

CONGRESS'S UNEVEN RESPONSE TO NUISANCE LITIGATION

Before closing, we should also consider why this particular example of nuisance litigation has received so much attention from Congress, while similar issues in other areas of bankruptcy practice have gone unaddressed. If addressing abusive litigation practices in bankruptcy indeed merits the attention it has received from Congress, then the problem of time-barred debt claims also might benefit from a similar burden-shifting diligence inquiry.[103]

As I have detailed in past *Law Letters*, debt buyers, who buy portfolios of old debts for pennies on the dollar, have filed massive numbers of proofs of claim in consumer bankruptcy cases without regard to whether the claims are barred by applicable statutes of limitations.[104] This practice relies on asymmetries similar to those present in the preference context. Just as preference defendants may have difficulty defending against negative-value suits filed in a distant forum, the bankruptcy system has difficulty detecting and objecting to the very large numbers of stale debt claims filed across the country.[105]

I have explored elsewhere the practical impediments that case trustee and other parties face in case-by-case review and objection to stale-debt claims.[106] It is enough here to say that this is a situation that cries out for a comprehensive, rather than a case-by-case response.[107] And, for the past several years, the bankruptcy community has failed to find a legal theory that targets this behavior on an aggregate basis. Debtors' attorneys, case trustees, and the U.S. Trustee Program have sought relief under the court's inherent contempt authority, Rule 9011, and the vexation litigation statute (28 U.S.C.A. § 1927), among others.[108] But these attempts have tended to fall flat, largely because statutes of limitations are affirmative defenses that are the estate's burden to plead.[109] As such, even a creditor who *knowingly* files a time-barred debt claim does not run afoul of the Code or procedural rules. Fair Debt Collection Practices Act (FDCPA) claims arguing this behavior is false, deceptive, misleading, unfair, or unconscionable became all the rage for a short time.[110] For similar reasons, the Supreme Court held that the practice of filing a stale debt claim was not a violation of the FDCPA.[111]

In light of bankruptcy's remedial gaps in this area, "many have concluded that amendments to the Code or Rules are the next logical step."[112] There have been multiple calls for section 501 to be amended to require that claimants have a good faith belief that their claim is allowable, a change similar to the diligence inquiry described above.[113] Others have recommended similar changes to the bankruptcy rules or official forms, or changes to federal consumer protection law that would achieve similar results.[114]

Imposing a diligence requirement on claims filers might not have much of an effect in an individual case, but it would give teeth to the court's remedial powers under section 105(a), 28 U.S.C.A. § 1927, and Bankruptcy Rule 9011, allowing courts to fashion relief to address egregious examples of misuse of the claims-allowance process. And note that—unlike efforts to address litigation abuses in the preference context—targeting payments made on stale debt claims would actually *further* bankruptcy's equality-of-distribution paradigm. Moreover, because the claims allowance process is an administrative process rather than a lawsuit, it would not present as many procedural hurdles relating to pleading, venue, and dismissal that have arisen in the preference context.

To be sure, problem of coercion in preference claims can be distinguished from the problem of time-barred debt claims on any number of grounds. To name just a few, the preference issue has been around for longer than the time-barred debt issue. The dollars at stake in an individual preference case are likely larger than the value of a stale-debt claim. Moreover, the procedural difficulty of objecting to a stale-debt claim pales in comparison to the effort it takes to respond to a preference suit. And, perhaps most important, the Bankruptcy Code has various "structural features," including the presence of a case trustee, to guard against the problem of stale-debt claims.[115] On any of these bases, one could reasonably argue that the time-barred debt situation is less in need of Congressional action than abusive preference litigation. But Congress's uneven response to these two examples of nuisance litigation could instead be the product of a vocal and organized response among trade creditors, which debtors in bankruptcy could never replicate.[116]

CONCLUSION

Bankruptcy is a forum with many losers and few winners, and apportioning losses among competing parties in bankruptcy requires difficult value judgments. Preference defendants are attractive parties for Congressional attention because the act of recovering a preference—sometimes months or years after the underlying transaction—seems inherently unjust.[117] But the continual attention this issue has received might be poorly calibrated to the nature of the problem. Meanwhile, a legislative solution is yet to come for the problem of time-barred debt claims. While juxtaposing these two examples of nuisance litigation no doubt qualifies as "whataboutism,"[118] it also reminds us to be mindful of methods and the circumstances in which the Code is enacted. In all areas of law, squeaky wheels get more grease, and preference defendants are likely more well organized and effective than dispersed debtors or case trustees in bankruptcy. A bankruptcy reform process that keeps its eyes on these asymmetries, and views reforms through the lens of bankruptcy's broader normative goals, is key.

ENDNOTES:

[1]Leah Douglas, Dean Foods Seeks to Get Back Money Paid to Diary Farmers Before Bankruptcy, Successful Farming, Dec. 10, 2020, https://www.agriculture.com/news/business/dean-foods-seeks-to-get-back-money-paid-to-dairy-farmers-before-bankruptcy.

[2]Colleen Kottke, Farm Groups Stand up for Farmers in Predatory Shakedown by Dean Foods Estate, Wisconsin State Farmer, Dec. 7, 2002, https://www.wisfarmer.com/story/news/2020/12/07/dean-foods-estate-threatens-farmers-legal-action-past-payments/3855267001/. This is a common response. See Brook E. Gotberg, Relational Preferences in Chapter 11 Proceedings, 71 Oklahoma Law Review 1013, 1047 (2019) ("[I]ndividuals and companies who find themselves on the wrong end of preference liability are, more often than not, shocked and outraged at the prospect of owing money back to the debtor's estate on account of otherwise legal collection activity.").

[3]See 11 U.S.C.A. § 547(c)(2) ("The trustee may not avoid under this section a transfer . . . to the extent that such transfer was in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee, and such transfer was . . . (A) made in the ordinary course of business or financial affairs of the debtor and the transferee; or (B) made according to ordinary business terms.").

[4]See 7 C.F.R. §§ 10XX.70-10XX.74 (setting forth a detailed framework for grading and calculating payment for milk, and setting a schedule for payments for milk purchases); Lois Bonsal Osler, An Overview of Federal Milk Marketing Orders, 5 San Joaquin Agric. L. Rev. 67, 69 (1995).

[5]See Kottke, supra note 2 (quoting the American Farm Bureau Federation as stating that the preference demands are "disturbing because the debtor, as a participant in the dairy industry, fully understands the application and import of FMMOs, the fact that they govern the form and manner of payment to producers and that they supplied the business terms under which the transactions and payments at issue in the letters occurred").

[6]See infra notes 33-37 and accompanying text.

[7]See 11 U.S.C.A. § 547(b) (2020).

[8]Pub. L. No. 116-54 § 3(a), effective February 19, 2020. For a more thorough background on the SBRA and early interpretive issues, see Ralph Brubaker, The Small Business Reorganization Act of 2019, 39 No. 10 Bankr. L. Ltr. NL 1 (2019), and Bruce A. Markell, Big Changes for Small Business, 40 No. 6 Bankr. L. Ltr. NL 1 (2020).

[9]See, e.g., The Case of Bankrupts, 7 Eng. Rep. 441 (K.B. 1584); Alderson v. Temple, 96 Eng. Rep. 384 (K.B. 1768).

[10]Section 547(b)(4)(B) provides a one-year reach back for transfers to insiders. 11 U.S.C.A. § 547(b)(4)(B).

[11]Insolvency is presumed during the 90-day preference window. See 11 U.S.C.A. § 547(f).

[12]11 U.S.C.A. § 547(b).

[13]See, e.g., H. REP. NO. 95-595, at 177-78 (1977) ("The purpose of the preference section is two-fold. First, by permitting the trustee to avoid prebankruptcy transfers that occur within a short period before bankruptcy, creditors are discouraged from racing to the courthouse to dismember the debtor during his slide into bankruptcy. . . . Second, and more important, the preference provisions facilitate the prime bankruptcy policy of equality of distribution among creditors of the debtor.").

[14]Vern Countryman, The Concept of a Voidable Preference in Bankruptcy, 38 Vand. L. Rev. 713, 748, 778 (1985) ("The function of the preference concept is to avoid prebankruptcy transfers that distort the bankruptcy policy of distribution. Transfers that do distort this policy do so without regard to the state of mind of either the debtor or the preferred creditor.").

[15]See 11 U.S.C.A. § 547(b). This strict-liability standard was established as part of the Bankruptcy Reform Act of 1978. Before the Bankruptcy Code was enacted in 1978, preference recovery required a preference defendant to receive a transfer with "reasonable cause to believe that the debtor is insolvent." See Bankruptcy Act of 1898, § 60(b). For a short description of the various state-of-mind requirements in preference law over the years, see Lawrence Ponoroff, Bankruptcy Preferences: Recalcitrant Passengers Aboard the Flight from Creditor Equality, 90 Am. Bankr. L.J. 329, 339 & n.45 (2016) (tracing this history). For a longer discussion of the history of preferences, see Charles Jordan Tabb, Rethinking Preferences, 43 S.C. L. Rev. 981 (1992).

[16]11 U.S.C.A. § 547(c)(2).

[17]See 11 U.S.C.A. § 547(c)(4) (limiting a defendant's preference liability to the extent it gave new value to benefit the debtor).

[18]See, e.g., 11 U.S.C.A. § 547(c)(1) (excluding transfers that are substantially contemporaneous exchanges for new value); 11 U.S.C.A. § 547(c)(3) (providing a 30-day grace period for enabling loans to be perfected).

[19]11 U.S.C.A. § 547(c)(8) (transfers aggregating less than $600 in cases filed by debtors whose debts are primarily consumer debts are exempted from preference liability); (c)(9) (transfers aggregating less than $6,825 in cases involving nonconsumer debts are exempted from preference liability); (c)(7) (excluding domestic support obligations from preference liability).

[20]11 U.S.C.A. § 546(c)(5) (imposing an improvement-of-position formula to measure the aggregate preferential effect of changes to floating liens).

[21]11 U.S.C.A. § 546(e) (insulating from preference and most fraudulent transfer liability "a margin payment . . . or settlement payment . . . made by or to (or for the benefit of) a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency, or that is a transfer made by or to (or for the benefit of) a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency, in connection with a securities contract, . . . commodity contract, . . . or forward contract, that is made before the commencement of the case").

[22]See, e.g., 11 U.S.C.A. § 547(c)(6) (protecting statutory liens from preference recovery if they are not avoidable under Code section 545); 11 U.S.C.A. § 547(h)

(exempting transfers made as on a payment schedule "created by an approved nonprofit budget and credit counseling agency").

[23]While preferences are no doubt least popular with preference defendants, frustration with this area of law is widespread among the bankruptcy community. The Chair of the American Bankruptcy institute's preference study in 1997 summarized complaints as such:

> While many supported the concept of recovering certain transfers made shortly before a bankruptcy filing, increasingly, complaints were voiced that the preference law was unfair and should be modified drastically or eliminated completely. Even the most ardent supporters of the preference law expressed the view that some change was mandated. The concerns ranged from claims that the law was not providing for a meaningful redistribution of property, to abuses in the manner in which preference claims were pursued, to claims that the law, through uncertain concepts like "ordinary course of business," fostered unnecessary and expensive litigation. These concerns, in varying degrees, were expressed by trade creditors, lenders, and bankruptcy practitioners alike.

American Bankruptcy Institute Task Force on Preferences, PREFERENCE SURVEY REPORT (ABI Bankruptcy Reform Study Project) (May 1997), Introduction by Joseph S.U. Bodoff, Chair.

[24]Tabb, Rethinking Preferences, supra note 15, at 989 ("Many of the problems in casting preference law stem from the difficulty of making the transition from the nonbankruptcy race paradigm to the bankruptcy equality model.").

[25]Tabb, Rethinking Preferences, supra note 15, at 988 ("Outside of a collective proceeding . . . a preference is not considered inherently evil.").

[26]See, e.g., Brook E. Gotberg, Conflicting Preferences in Business Bankruptcy: The Need for Different Rules in Different Chapters, 100 Iowa L. Rev. 51, 57 (2014) [hereinafter "Conflicting Preferences"] (noting preference policy is "internally inconsistent"); John C. McCoid, II, Bankruptcy, Preferences, and Efficiency: An Expression of Doubt, 67 Va. L. Rev. 249, 252-53 (1981) ("The distinction between a deliberate preference that may be recaptured and other transfers with preferential effect that are invulnerable does not mesh neatly with the announced purpose of bankruptcy law to provide equal distribution among creditors.")

[27]See Gotberg, Conflicting Preferences, supra note 26, at 67 (noting that preferences are "by far the most litigated of the avoidance powers" and that much preference litigation "deals with exceptions to the rule").

[28]Gotberg, Conflicting Preferences, supra note 26, at 57.

[29]Tabb, Rethinking Preferences, supra note 15, at 991 (explaining how the realities of preference payments and subsequent litigation provide few meaningful disincentives to receiving a preference); but c.f. 5 Collier on Bankruptcy P 547.01 (16th 2020) (agreeing generally, but noting "[a]n exception to this general observation may exist when the debtor and its creditors are engaged in an out-of-court workout and it may be in everyone's interest to avoid a bankruptcy filing that would probably occur if one of the creditors obtained a preference").

[30]See, e.g., Gottberg, Conflicting Preferences, supra note 26, at 64 ("The purpose of deterrence in preference law is generally understood to be subordinate to the primary purpose of ensuring equal distribution"); Ponoroff, supra note 15, at 343-44 (collecting commentary that is "critical of the deterrence justification for the preference law"); Tabb, Rethinking Preferences, supra note 15 at 987 (arguing that the equality rationale "should be given ascendancy," and by extension, the ordinary course of business defense should be repealed); but see A. Ari Afilalo, The Impact of Union Bank v. Wolas on the Ordinary Course of Business Defense to a Trustee's Avoiding Powers, 72 B.U. L. Rev. 625, 635, 635 (1992) ("The ultimate objective of preferences law is not absolute equality.").

[31]See H.R. Rep. No. 95-595, at 17778 ("The purpose of the preference section is two-fold. First, by permitting the trustee to avoid prebankruptcy transfers that occur within a short period before bankruptcy, creditors are discouraged from racing to the courthouse to dismember the debtor during

his slide into bankruptcy. . .. *Second, and more important*, the preference provisions facilitate the prime bankruptcy policy of equality of distribution among creditors of the debtor.") (emphasis added).

[32]Creditors who return a preference have a claim against the estate for their unpaid debts. And, with every preference recovered, the pool of assets available to unsecured creditors may improve. As such, and particularly across multiple cases, repeat players should theoretically support the broader recovery of preferences, as preferences maximize collective returns to the group. But preference defendants generally prefer solutions that prevent them from having to return preferences. Charles J. Tabb, The Brave New World of Bankruptcy Preferences, 13 Am. Bankr. Inst. L. Rev. 425, 439 (2005) [hereinafter Brave New World] (noting that these arguments are "utterly unpersuasive to trade creditors").

[33]See Final Report and Recommendations, American Bankruptcy Institute Commission to Study the Reform of Chapter 11 at 149 (2012-14), available at http://commission.abi.org/full-report [hereinafter ABI Commission Report] ("[A]necdotal evidence shows that, in many cases, the value of preference recoveries no longer is reallocated among general unsecured creditors. Rather, secured creditors are granted liens in preference claims and recoveries as part of adequate protection, cash collateral, or debtor in possession financing orders in the case. Alternatively, the estate may not have sufficient resources to pay administrative and priority claims in the case, and the trustee applies preference recoveries to these claims."); Thomas D. Goldberg, Curbing Abusive Preference Actions Rethinking Claims on Behalf of Administratively Insolvent Estates, Am. Bankr. Inst. J., May 2004, at 14 (collecting examples).

[34]Ponoroff, supra note 15, at 347, 388 n.279-280 (collecting examples).

[35]Collier on Bankruptcy suggests that liquidation trusts often hire third-party "preference mills" to handle preference litigation. These mills are said to file suit against every creditor identified in the debtor's statement of financial affairs as having received payment within the preference window, whether or not these payments meet the definition of a preference, qualify as contemporaneous-exchange transactions, are offset by new value, or are subject to any other defenses. 5 Collier on Bankruptcy P 547.02A (16th 2020). See also ABI Commission Report, supra note 33, at 150 (collecting testimony that suggests "some trustees appear to file preference actions not necessarily to recover the alleged preference, but to extract a settlement payment"); American Bankruptcy Institute Task Force on Preferences, Preference Survey Report, May 1997, at 25 (noting that a "significant and pervasive problem identified is that creditors often feel pressured into making nuisance settlements, even if the action is of dubious validity . . . . When suits are brought for very small amounts, the pressure on the preference defendant to settle is enormous.").

[36]Deborah L. Thorne & John T. Gregg, A Partial Solution to "Preference Litigation Run Amok," Am. Bankr. Inst. J., November 2007, at 22 ("The filing of avoidance actions without prior reasonable due diligence is often considered tantamount to extortion because litigation costs in some adversary proceedings may exceed the amount of the alleged liability unless a settlement can be achieved at the outset of the adversary proceeding."); see also ABI Commission Report, supra note 33, at 150 n.559 (quoting testimony that "[t]his practice imposes costs on creditors vastly disproportionate to the gain to estates, and is particularly difficult for factors who do not have direct access to the original vendors' records").

[37]Daniel J. Bussel, The Problem with Preferences, 100 Iowa L. Rev. Bull. 11, 11 (2014) ("The problem with preference law is that in too many cases it operates, often arbitrarily, to force settlements from diligent creditors based on the costs of litigation and potential liability for basically innocent conduct; settlements that, in the aggregate, do little to meaningfully help creditors generally, but simply enrich estate professionals.").

[38]See Bankruptcy Reform Act of 1984, Pub. L. No. 98-353, § 310(3), 98 Stat. 352, 355 (codified as amended at 11 U.S.C. § 547(c)(8)); Tabb, Brave New World, supra

note 32, at 432 (discussing this history). The 1984 amendments also eliminated a 45-day time period related to payments in the ordinary course of business, greatly expanding the scope of that exception. See Ponoroff, supra note 15, at 355.

[39]See BAPCPA, Pub. L. No. 109-8, § 409, 119 Stat. 23, 106; Tabb, Brave New World, supra note 32, at 432. BAPCPA also further broadened the ordinary-course-of-business defenses by changing an "and" relating to the ordinariness of payments to an "or." See Ponoroff, supra note 15, at 345-46.

[40]BAPCPA, Pub. L. No. 109-8, § 410, 119 Stat. 23, 106. Tabb, Brave New World, supra note 32, at 428.

[41]Id.

[42]See ABI Commission Report, supra note 33, at 150-51. To be sure, the Commission expressed some skepticism about the scope of these problems. See id. at 151 (noting the opinion of some commissioners that these problems represented "the exception rather than the rule").

[43]ABI Commission Report, supra note 33, at 150-51.

[44]The Commission also recommended that Congress amend 28 U.S.C.A. § 1409 to clarify that it applies to preference actions. Id. at 150.

[45]Small Business Reorganization Act of 2019, PL 116-54, August 23, 2019, 133 Stat 1079, § 3 (codified in 11 U.S.C.A. § 547(b)).

[46]Small Business Reorganization Act of 2019, PL 116-54, August 23, 2019, 133 Stat 1079, § 3.

[47]See Ponoroff, supra note 15 at 372-77; Tabb, Brave New World, supra note 32, at 433-35 (questioning rather BAPCPA's caps were too high).

[48]Nat'l Bankr. Rev. Comm'n, Bankruptcy: The Next twenty years, Final Report (1997) at 796 ("The tension, therefore, is to develop efficient procedures to restrain abusive litigation techniques by the trustee without interfering with the policy goals of the preference power itself.").

[49]Brubaker, supra note 8, at 19.

[50]Fed. R. Bankr. P. 9011(b).

[51]11 U.S.C.A. § 547(b); Brubaker, supra note 8, at 19 (noting that in ordinary civil litigation, allegations that seek to avoid an anticipated affirmative defense are improperly pleaded).

[52]5 Collier on Bankruptcy P 547.02A (16th 2020).

[53]5 Collier on Bankruptcy P 547.02A (16th 2020).

[54]Brubaker, supra note 8, at 19.

[55]In re ECS Refining, Inc., 69 Bankr. Ct. Dec. (CRR) 184, 2020 WL 7383655 (Bankr. E.D. Cal. 2020).

[56]In re ECS Refining, Inc., 69 Bankr. Ct. Dec. (CRR) 184, 2020 WL 7383655, at *18 (Bankr. E.D. Cal. 2020).

[57]In re ECS Refining, Inc., 69 Bankr. Ct. Dec. (CRR) 184, 2020 WL 7383655, at *18 (Bankr. E.D. Cal. 2020).

[58]In re ECS Refining, Inc., 69 Bankr. Ct. Dec. (CRR) 184, 2020 WL 7383655, at *19 (Bankr. E.D. Cal. 2020).

[59]42 U.S.C.A. § 1997e(a).

[60]In re ECS Refining, Inc., 69 Bankr. Ct. Dec. (CRR) 184, 2020 WL 7383655, at *19 (Bankr. E.D. Cal. 2020).

[61]Jones v. Bock, 549 U.S. 199, 212-217, 127 S. Ct. 910, 166 L. Ed. 2d 798, 68 Fed. R. Serv. 3d 643, 51 A.L.R. Fed. 2d 633 (2007).

[62]In re ECS Refining, Inc., 69 Bankr. Ct. Dec. (CRR) 184, 2020 WL 7383655, at *20 (Bankr. E.D. Cal. 2020).

[63]In re ECS Refining, Inc., 69 Bankr. Ct. Dec. (CRR) 184, 2020 WL 7383655, at *20 (Bankr. E.D. Cal. 2020).

[64]In re ECS Refining, Inc., 69 Bankr. Ct. Dec. (CRR) 184, 2020 WL 7383655, at *21 (Bankr. E.D. Cal. 2020).

[65]In re ECS Refining, Inc., 69 Bankr. Ct. Dec. (CRR) 184, 2020 WL 7383655, at *20 (Bankr. E.D. Cal. 2020). See Fed. R. Civ. P. 9(c), Fed. R. Bankr.P. 7009(c).

[66]In re ECS Refining, Inc., 69 Bankr. Ct. Dec. (CRR) 184, 2020 WL 7383655, at *21 (Bankr. E.D. Cal. 2020).

[67]In re ECS Refining, Inc., 69 Bankr. Ct. Dec. (CRR) 184, 2020 WL 7383655, at *22 (Bankr. E.D. Cal. 2020).

[68]In re ECS Refining, Inc., 69 Bankr. Ct.

Dec. (CRR) 184, 2020 WL 7383655, at *22 (Bankr. E.D. Cal. 2020).

[69]In re ECS Refining, Inc., 69 Bankr. Ct. Dec. (CRR) 184, 2020 WL 7383655, at *22 (Bankr. E.D. Cal. 2020).

[70]In re Trailhead Engineering LLC, 2020 WL 7501938, at *7 (Bankr. S.D. Tex. 2020).

[71]In re Trailhead Engineering LLC, 2020 WL 7501938, at *7 (Bankr. S.D. Tex. 2020) (seeking dismissal of preference complaint because, *inter alia*, it "contains no factual allegations to the effect that the Trustee conducted any due diligence of the factual circumstances" surrounding the claims and defenses in the suit).

[72]In re Trailhead Engineering LLC, 2020 WL 7501938, at *7 (Bankr. S.D. Tex. 2020).

[73]In re Trailhead Engineering LLC, 2020 WL 7501938, at *7 (Bankr. S.D. Tex. 2020).

[74]In re Trailhead Engineering LLC, 2020 WL 7501938, at *7 (Bankr. S.D. Tex. 2020).

[75]Indeed, courts seem eager to avoid the issue. See, e.g., Harker v. Cummings (In re GYPC, Inc.), 2020 Bankr. LEXIS 2384, *25 (determining the adequacy of the trustee's diligence, "along with determinations of the applicability of any affirmative defenses such as ordinary course of business and subsequent new value, require factual determinations based upon an evidentiary record which does not exist at this pleading stage of the proceeding").

[76]See Brubaker, supra note 8.

[77]In re Cirino Construction Co., Inc., 2020 WL 2989750, at *1 (Bankr. M.D. N.C. 2020).

[78]28 U.S.C.A. § 1409(b) ("Except as provided in subsection (d) of this section, a trustee in a case under title 11 may commence a proceeding arising in or related to such case to recover a money judgment of or property worth less than $1,000 or a consumer debt of less than $15,000, or a debt (excluding a consumer debt) against a noninsider of less than $25,000, only in the district court for the district in which the defendant resides.").

[79]Arising under jurisdiction refers to actions based on substantive rights created by the Bankruptcy Code. See, e.g., Matter of Wood, 825 F.2d 90, 96, 17 Collier Bankr. Cas. 2d (MB) 743, Bankr. L. Rep. (CCH) P 71955 (5th Cir. 1987) ("Congress used the phrase 'arising under title 11' to describe those proceedings that involve a cause of action created or determined by a statutory provision of title 11").

[80]11 U.S.C.A. § 1409(a).

[81]See In re Cirino Construction Co., Inc., 2020 WL 2989750 *2 & n.2 (Bankr. M.D. N.C. 2020) (collecting authority).

[82]See, e.g., Dynamerica Mfg. LLC v. Johnson Oil Co., LLC, 53 Bankr. Ct. Dec. (CRR) 39, 63 Collier Bankr. Cas. 2d (MB) 1272, 2010 WL 1930269 (Bankr. D. Del. 2010) ("[C]onsistent with legislative intent expressed in the legislative history, the Court finds that the venue provisions of Section 1409(b) apply to avoidance actions. The absence of the 'arising under' language in Section 1409(b) was unintentional.").

[83]Brubaker, *supra* note 8 (noting that "Congress has now amended the small-suit venue provision twice (in 2005 and 2019) *without* settling the lingering and important question of whether that venue provision applies to preference suits"); see also Lamie v. U.S. Trustee, 540 U.S. 526, 542, 124 S. Ct. 1023, 1034, 157 L. Ed. 2d 1024, 42 Bankr. Ct. Dec. (CRR) 122, 50 Collier Bankr. Cas. 2d (MB) 1299, Bankr. L. Rep. (CCH) P 80038 (2004) ("If Congress enacted into law something different from what it intended, then it should amend the statute to conform it to its intent. It is beyond our province to rescue Congress from its drafting errors, and to provide for what we might think . . . is the preferred result.") (internal quotation omitted).

[84]See, e.g., In re Little Lake Industries, Inc., 158 B.R. 478, 24 Bankr. Ct. Dec. (CRR) 1132, Bankr. L. Rep. (CCH) P 75464 (B.A.P. 9th Cir. 1993).

[85]Mendelsohn v. Central Garden & Pet Co. (In re Petland Discounts, Inc.), No 19-72292, Adv. Pro. No. 20-08088, slip op. at 8 (Bankr. E.D.N.Y. Jan. 26, 2021).

[86]Mendelsohn, slip op. at 8.

[87]See Mendlesohn, slip op. at 8; Novak, Trustee for Estate of OnlineAutoParts.com, LLC v. Parts Authority, LLC, 2020 WL

4034897, at *1 (E.D. N.Y. 2020) (" '[P]reference actions "arise under" title 11' and the venue provision of Section 1409(b) is inapplicable.").

[88]See ABI Commission Report, supra note 33, at 150.

[89]Brook Gotberg, Preference Law Perpetuates Preferences in Chapter 11, Am. Bankr. Inst. J., September 2019, at 56 (noting that less sophisticated creditors often "declin[e] to hire an attorney to assist them in their preference defenses, citing expense. As a consequence, they would frequently pay all or nearly all of the preference claim, despite wide reporting of heavily discounted settlements among other creditors who had representation.").

[90]Kottke, supra note 2.

[91]Dennis Rudat, Dean Foods' attempts to recover money from dairy producers are 'Frivolous,' says DFA, Michigan Farm News, Dec. 4, 2020, available at https://www.michiganfarmnews.com/dean-foods-attempts-to-recover-money-from-dairy-producers-are-frivolous-says-dfa.

[92]Douglas, supra note 1.

[93]VeraSun retracts demands for farmer payments, High Plains Journal, Oct. 11, 2010, available at https://www.hpj.com/archives/verasun-retracts-demands-for-farmer-payments/article_428cf5d6-0ca0-5430-818c-f4a1d4880527.html.

[94]For examples of such informal aggregation among other bankruptcy participants, see Diane Lourdes Dick, Grassroots Shareholder Activism in Large Commercial Bankruptcies, 40 J. Corp. L. 1, 5 (2014) (discussing how individual shareholders use internet message boards to organize collective action in large corporate bankruptcy cases). C.f. Matthew Adam Bruckner, Crowdsourcing (Bankruptcy) Fee Control, 46 Seton Hall L. Rev. 361, 365 (2016) (arguing that such "crowdsourcing" mechanisms could help with the policing of bankruptcy fees).

[95]See Thorne & Gregg, supra note 36, at 57 (attributing the problem of preference litigation to mega bankruptcy cases, where preference plaintiffs file large numbers of preference complaints in a short period of time).

[96]Tabb, Rethinking Preferences, supra note 15, at 433-34; Ponoroff, supra note 15, at 374 ("[A] a dollar-denominated floor for bringing a preference action is a simultaneously overinclusive and underinclusive strategy for responding to the behavior sought to be controlled.").

[97]Ponoroff, supra note 15, at 377 (noting, in a pre-COVID world, that technological advances in litigation has made "tinkering with the venue rules of much more limited utility in policing truly bad faith preference actions than may have been true in the past").

[98]See Tabb, Brave New World, supra note 32, at 439 ("A trade creditor who might have been disadvantaged by a 'coercive' preference suit in one case may have been advantaged in other cases, when other unfortunate trade creditors were the coercive targets . . . . [O]ne could argue that the 2005 changes would run counter to the best interests of unsecured creditors as a whole.").

[99]See Goldberg, supra note 33, at 54; but see Ponoroff, supra note 15, at 375 (distributions to unsecured creditors is not "necessarily the only purposive goal of the preference law").

[100]See Goldberg, supra note 33, at 54.

[101]See Ponoroff, supra note 15, at 367 (calling for empirical study of the complaints regarding the ineffectiveness of preference laws); ABI Commission Report, supra note 33, at 151 (noting some commissioners' views that coercive preference actions are "the exception rather than the rule.").

[102]See Tabb, Brave New World, supra note 32 at 439 (noting that some of BAPCPA's changes to address litigation abuses were "change[s] no one was asking for").

[103]See Kara J. Bruce, The Supreme Court's 2017 FDCPA Rundown, 37 No. 9 Bankr. L. Ltr. 1 (2017); Kara J. Bruce, Debt Buyers Beware: Filing Proofs of Claim for Time-Barred Debts in the Eleventh Circuit and Beyond, 36 No. 6 Bankr. L. Ltr. 1 (2016).

[104]See Kara J. Bruce, The Supreme Court's 2017 FDCPA Rundown, 37 No. 9 Bankr. L. Ltr. 1 (2017); Kara J. Bruce, Debt Buyers Beware: Filing Proofs of Claim for

Time-Barred Debts in the Eleventh Circuit and Beyond, 36 No. 6 Bankr. L. Ltr. 1 (2016).

[105]Proofs of claim have prima facie validity. These claims will be allowed unless a party in interest, such as the case trustee, debtor, or competing creditor, objects. 11 U.S.C.A. § 502(a). In cases in which a party does object, the debt buyer will withdraw the stale debt claim or the claim will be disallowed. But it is inevitable that, due to the sheer volume of filed claims, the economics of bankruptcy case administration (under which the cost of objecting might exceed the value of the claim), or related factors, a portion of these time-barred debt claims will slip through the cracks. Even though not all unsecured claims receive distributions in consumers' bankruptcy cases, the small distributions that are made, when multiplied across thousands of cases nationwide, can add up to real money paid to claimants with claims that should have been disallowed. For a broader discussion of these issues, see Kara J. Bruce and Alexandra P.E. Sickler, Private Remedies and Access to Justice in a Post-Midland World, 34 Emory Bankr. Dev. J. 365 (2018).

[106]See Bruce & Sickler, supra note 106. In brief, consumer debtors are typically little help in this process, considering that the allowance or disallowance of stale claims typically does not affect their personal outcomes. Similarly, competing creditors may have too little on the line in any individual suit to justify the monitoring it would require to identify and object to stale debt claims. Chapter 7 and 13 trustees, who are charged with the duty to "examine proofs of claims and object to the allowance of any claim that is improper," therefore bear the laboring oar on this task. The sheer number of claims filed, combined with information limitations and the costs of review, may make claim-by-claim review in some cases impracticable. Id. at 376. Meanwhile, stale debt claimants have virtually no incentive not to file a claim in hopes that it will escape detection.

[107]Bruce & Sickler, supra note 106.

[108]See, e.g., In re Freeman-Clay, 578 B.R. 423, 443-44 (Bankr. W.D. Mo. 2017) (United States Trustee Program filed a complaint seeking a nationwide injunction, appointment of a monitor, monetary damages, and the imposition of sanctions against several debt purchasers for their "systematic abuse of the bankruptcy process."); In re Edwards, 539 B.R. 360, 367 (Bankr. N.D. Ill. 2015) (arguing, inter alia, that creditor's practice of filing time-barred debt claims is a fraud on the court punishable under Code section 105(a) and Bankruptcy Rule 9011); In re Freeman, 540 B.R. 129, 144 (Bankr. E.D. Pa. 2015) (motion for sanctions under Bankruptcy Rule 9011); In re Andrews, 394 B.R. 384, 388 (Bankr. E.D. N.C. 2008) (same); In re Keeler, 440 B.R. 354, 366-67 (Bankr. E.D. Pa. 2009) (alleging that this practice violates sections 105(a), 502, and 524, various federal and state consumer protection laws, and 28 U.S.C.A. § 1927).

[109]See, e.g., In re Keeler, 440 B.R. 354, 366-67 (Bankr. E.D. Pa. 2009) ("Given that section 501(a) authorizes every creditor holding a claim to file a proof of claim, even if that claim is later disallowed under section 502(b), section 105(a) does not state a cause of action to sanction such a filing."); see also Edwards, 539 B.R. at 367 ("[G]iven the split of authority in this circuit and elsewhere . . . there is no basis for sanctioning the defendants for filing their proofs of claim in this case in any event."); In re Freeman, 540 B.R. at 144 ("[G]iven the split in the case law, it is difficult to see how sanctions under Rule 9011(b)(2) can be imposed on claimants filing stale proofs of claim."); In re Andrews, 394 B.R. 384, 388 (Bankr. E.D. N.C. 2008) (acknowledging "a substantial body of existing case law upon which [creditors] reasonably relied" and finding sanctions were not justified); Freeman Clay, 578 B.R. at 454 (concluding the court lacked the authority to award the aggregate relief that the U.S. Trustee sought); But see the Matter of Sekema, 523 B.R. 651, 653 (Bankr. N.D. Ind. 2015) (sanctioning creditor for filing proof of claim for time-barred debt)

[110]See Bruce, supra note 104 (describing these cases).

[111]Midland Funding, LLC v. Johnson, 137 S. Ct. 1407, 1414, 197 L. Ed. 2d 790, 64 Bankr. Ct. Dec. (CRR) 31, 77 Collier Bankr. Cas. 2d (MB) 1308, Bankr. L. Rep. (CCH) P 83101 (2017).

[112]Bruce & Sickler, supra note 106, at 381.

[113]See, e.g., In re Keeler, 440 B.R. at 368; see also In re Chaussee, 399 B.R. 225, 240 (B.A.P. 9th Cir. 2008) ("In deeming uncontested proofs of claim which otherwise comply with the Code and Rules prima facie valid and allowed, Congress and rulemakers arguably elevated the need for efficiency in bankruptcy cases too far. But while we understand a debtor's procedural predicament, any solution must come via an amendment to the Code and Rules . . ..").

[114]Andrews, 394 B.R. at 389 ("The court will ask the Advisory Committee on Bankruptcy Rules to consider whether changes should be made to the Federal Rules of Bankruptcy Procedure and to the Official Bankruptcy Forms to alleviate the significant burden on individual debtors and on the bankruptcy system caused by the large number of undocumented, stale claims being filed by the bulk purchasers of charged-off debts."); but see Bruce & Sickler, supra note 106, at 381 (noting that changes to the rules without changing the Code is constrained by the Rules Enabling Act). Recently proposed bankruptcy legislation would make filing a proof of claim to collect time-barred debt a violation of the FDCPA. See Consumer Bankruptcy Reform Act, S. 4991, 116th Cong. (2019-2020).

[115]This final point was made explicitly in *Midland Funding v. Johnson* to support the holding that the FDCPA should not be extended to address the problem of stale-debt claims. 137 S. Ct. at 1414.

[116]For a similar analysis underlying the Bankruptcy Abuse Prevention and Consumer Protection Act, see Kara J. Bruce, Rehabilitating Bankruptcy Reform, 13 NEV. L. J. 174 (2012).

[117]Congress has a long history of providing misguided assistance to "helpless" groups in bankruptcy cases. See Troy McKenzie, "Helpless" Groups, 81 Fordham L. Rev. 1324 (2018).

[118]Whataboutism is a term of recent origin that describes the rhetorical method of criticizing a person's point by highlighting a parallel issue that is of equal or greater importance.

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Bankruptcy Update

New Court Ruling on Whether Avoidance Powers Require Benefit to Creditors

Categories: Case Summaries

by Jonah Wacholder and Daniel A. Lowenthal on July 21, 2021

The Bankruptcy Code grants the power to avoid certain transactions to a bankruptcy trustee or debtor-in-possession. *See, e.g.,* 11 U.S.C. §§ 544, 547–48. Is there a general requirement that these avoidance powers only be used when doing so would benefit creditors? In a recent decision, the United States Bankruptcy Court for the District of New Mexico addressed this question, concluding, in the face of a split of authority, that there was such a requirement. *In re U.S. Glove, Inc.*, No. 21-10172-T11, 2021 WL 2405399 (Bankr. D.N.M. June 11, 2021).

U.S. Glove, Inc. ("Plaintiff") is a manufacturer of gymnastic grips and wrist supports. Michael J. Jacobs ("Defendant") was once the sole owner of Plaintiff but, in October 2018, had 57% of his stock redeemed for a $2,140,000 promissory note and a $1,250,000 promissory note. The larger note is secured by Plaintiff's property, but for unknown reasons, the security interest was not perfected until June 2020, 20 months after the buyout closed. Plaintiff filed for bankruptcy in February 2021. Plaintiff's two principal creditors are Defendant, with claims totaling $3,545,000, and the Small Business Administration ("SBA"), with a claim of $149,143. By mutual agreement, Defendant's lien is subordinate to the SBA's. Plaintiff filed an adversary proceeding in March 2021, seeking, among other things, to avoid Defendant's security interest as a preference. Plaintiff moved for summary judgment on this issue in April 2021.

The Court first concluded that Plaintiff had met the requirements for a preference claim under section 547. The security interest was a transfer to Defendant; the transfer was on account of antecedent debt, the promissory note associated with the buyout; Plaintiff was insolvent at the time of the transfer; the transfer occurred within eight-and-a-half months of the bankruptcy filing, which is within the one-year preference period for insiders like Defendant; and the security interest would enable Defendant to recover more than he would recover in chapter 7 liquidation absent the security interest.

Defendant did not contest these contentions. Instead, Defendant argued that Plaintiff lacked standing to bring the avoidance action because avoiding Defendant's security interest would not benefit creditors, only Plaintiff.

The Court noted that in cases decided under the Bankruptcy Act, the predecessor to the Bankruptcy Code, courts uniformly held that the purpose of the avoidance powers was to benefit creditors and that avoidance powers could not be used to benefit the debtor exclusively. The Court further noted that Bankruptcy Code section 550, which governs the liability of transferees for property transferred in avoided transfers, requires that recovery be "for the benefit of the estate," which courts have read as a requirement that it be for the benefit of creditors. Here, however, where Plaintiff simply sought to avoid a lien, section 550 was not pleaded, and the avoidance provisions themselves do not contain the "for the benefit of the estate" language. The Court noted a split in authority under this question, with some cases requiring a benefit to the estate even absent section 550, and some cases not imposing such a requirement.

The Court sided with the cases imposing a requirement that the use of the avoidance powers benefit the estate. The Court emphasized the principle in Supreme Court case law that a clear indication is required before concluding that Congress intended to depart from past bankruptcy practice, such as the uniform approach requiring benefit to creditors under the Bankruptcy Act. The Court further emphasized that it would be arbitrary to distinguish between lien avoidance cases and cases seeking recovery of property, and held that, in any event, section 550 should apply since a security interest is a grant of property and avoiding it is a recovery of property. Finally, the Court noted that Congress's purpose in enacting the avoidance powers in the Bankruptcy Code was to help creditors collect fairly and equitably and not to generate windfalls for debtors.

The Court held that the question of whether avoiding Defendant's lien would benefit the estate depended on a case-by-case, fact-specific analysis, and therefore denied Plaintiff's summary judgment motion.

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Venue Provisions Fail to Provide Relief in Smaller Dollar Preference Cases

By Dylan Trache

Almost two years ago, the Small Business Reorganization Act of 2019 (SBRA) was enacted. While the provisions regarding the new Subchapter V reorganization received the most press (streamlined chapter 11 for businesses with debts of no more than $7,500,000), the SBRA also included other important changes to the Bankruptcy Code. Among these additional changes was an increase in the venue threshold under 28 U.S.C. § 1409(b) to $25,000.00 as follows:

> (b) Except as provided in subsection (d) of this section, a trustee in a case under title 11 may commence a proceeding **arising in or related to** such case to recover a money judgment of … against a noninsider of less than $25,000, **only in the district court for the district in which the defendant resides.**

28 U.S.C. § 1409(b) (emphasis added).

The intent of this amendment seems to be to limit the amount of small dollar preference cases brought by trustees and debtors in possession in jurisdictions far from where a vendor operates so as to reduce the burden on these smaller preference targets. It has become common practice for trustees and post-confirmation trusts to utilize the preference powers under 11 U.S.C. § 547 to demand repayment of amounts paid to the debtor within 90 days of the petition date. The Bankruptcy Code provides numerous defenses to such demands, such as the ordinary course of business defense and the subsequent new value defense. However, in small cases, vendors face the difficult task of defending these demands without incurring legal cost in excess of the demand itself. Accordingly, reports have indicated that Congress intended to raise the prior limit of $13,650.00 to $25,000.00 and have this limit apply to preference cases.

However, the technical language used in the venue provision created ambiguity. Bankruptcy Courts exercise subject matter jurisdiction in three ways — "arising in, arising under and related to" a bankruptcy proceeding. Yet the limitation in § 1409(b) applies only in cases arising in or related to a bankruptcy proceeding. Preference lawsuits commenced under § 547 are generally considered proper under a court's "arising under" jurisdiction because they seek to enforce rights created by the actual filing of a bankruptcy case. Accordingly, the majority of courts to consider the matter have held that a trustee may bring a preference case in the jurisdiction where the bankruptcy has been filed even if the demand is less than $25,000.00.

For example, in *In re Tadich Grill of Washington DC LLC*, 598 B.R. 65 (Bankr. D.D.C. 2019), the District of the District of Columbia considered the statutory language and found unpersuasive arguments that Congress unintentionally omitted "arising under" jurisdiction — and therefore preference cases — from the ambit of the venue limitations. It similarly rejected arguments that the phrase "arising in" could also include "arising under" noting among other things Congress expressly used referenced "arising under" jurisdiction earlier in the statute and that such a conclusion would produce odd results such as possibly precluding trustees from proceedings to avoid security interests on property. Thus, the Court rejected all arguments to the contrary and ruled that preference actions of less than $25,000.00 may be brought in the trustee's home court.

While a minority of courts have found that trustees are precluded from bringing these smaller dollar cases, vendors facing smaller dollar preference claims face the difficult decision as to whether to mount a defense or settle quickly even if their defenses are strong. Even attempting to invoke the venue threshold can result in significant cost to the preference defendant — although often these preference targets hire the same firm to mount such a venue attack in order to spread the costs.

Nelson Mullins attorneys are experienced in handling preference matters of all sizes and are well equipped to advise recipients of preference demands on both the legal and practical aspects of responding to demand.

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