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Third Circuit Holds a Plan Administrator in Debtor's Second Bankruptcy was Not in Privy of Debtor in the First Bankruptcy for Res Judicata Purposes and 11 U.S.C. § 1111(b) Permits Non-Recourse Claims to Become Recourse for Distribution Purposes Only

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In *In re Montgomery Ward, LLC*, 634 F.3d 732 (3d. Cir. 2011), the Court of Appeals for the Third Circuit clarified the principles of *res judicata* in the context of a bankruptcy proceeding and further defined the scope of 11 U.S.C. § 1111(b). The decision is significant because it is the first appellate decision to determine what constitutes privity for *res judicata* purposes in the context of a bankruptcy proceeding and also because it held that section 1111(b) transforms non-recourse claims into recourse claims only for distribution purposes.

Facts and Procedural History

Montgomery Ward, LLC (“Montgomery Ward”) contracted with Jolward Associates Limited Partnership (“Jolward”) to construct a department store, on land Montgomery Ward owned in Illinois that was the planned site to develop a mall. The parties entered into a ground lease and Montgomery Ward transferred a leasehold interest in the land upon which the department store was to be constructed to Jolward.

The parties also entered into a lease and sublease agreement (the “Lease and Sublease Agreement”) whereby Jolward subleased the land underlying the

department store back to Montgomery Ward, and also leased the department store back to Montgomery Ward, for a period of thirty years. Jolward obtained construction financing by executing a mortgage (the "Mortgage") in favor of State Farm Life Insurance Co. ("State Farm"). Montgomery Ward joined in the execution of the Mortgage, but assumed no personal liability. Thus, the Mortgage was without recourse to Montgomery Ward.

Some twenty years later, in 1997 and again in 2000, Montgomery Ward filed chapter 11 bankruptcy petitions. In the first bankruptcy proceeding ("Ward I"), State Farm filed a proof of claim for the outstanding balance of the Mortgage. The confirmed plan ("Ward I Plan") provided for no distribution to State Farm on account of the Mortgage. However, State Farm retained its security interest. In addition, Montgomery Ward assumed the Lease and Sublease Agreement.

In the second bankruptcy proceeding ("Ward II"), a liquidating chapter 11, Dika-Ward, LLC ("Dika-Ward"), as assignee of the State Farm and Jolward bankruptcy claims, filed a proofs of claim for the full amount of the Mortgage and lease rejection damages based on the Lease and Sublease Agreement. Dika-Ward asserted that the Mortgage, although initially nonrecourse, had become recourse in Ward I under section 1111(b) of the Bankruptcy Code.

The Plan Administrator objected to both claims. Specifically, the Plan Administrator argued that the Lease and Sublease Agreement was merely a structured financing agreement and not a true lease. Dika-Ward argued that the confirmed Ward I Plan precluded the Plan Administrator from challenging the Lease and Sublease Agreement on principles of *res judicata*. The Delaware Bankruptcy Court granted summary judgment for Dika-Ward on the *res judicata* issue and summary judgment for the Plan Administrator on the Dika-Ward Mortgage claim. Both Dika-Ward and the Plan Administrator appealed.

The Appellate Ruling

The Third Circuit vacated the summary judgment for Dika-Ward regarding *res judicata* and remanded the issue to the Bankruptcy Court for a determination as to whether the Lease and Sublease agreement was a true lease or a structured financing. The Third Circuit observed that *res judicata* bars relitigation of a claim if there has been a final judgment on the merits in a prior suit involving the same claim and the same parties or their privies. Here, the Court focused on "whether the Ward II Plan Administrator, as successor in interest to the Ward II Estate, was the same party as, or privy of, the Ward I Debtor." The Court found that the Plan Administrator in Ward II was not in privity with the debtor in Ward I and, therefore, was not barred by the doctrine of *res judicata* from contending that the arrangement was a structured financing agreement and not a true lease. The Court reasoned that the Ward I debtor was a party to the Ward I confirmation proceeding, and that upon confirmation, the Ward I debtor ceased to exist, and

the reorganized Montgomery Ward succeeded to the Ward I estate. When the Ward II bankruptcy was filed, the Ward II debtor became the trustee of the new bankruptcy estate.

Moreover, the Court found that as trustee, the Ward II debtor was not the same party as the debtor in the first instance because it did not have the same incentives as the Ward I debtor had in the first proceeding. In Ward I, the debtor had an incentive not to bring the cause of action because it wanted Montgomery Ward to continue operating the store; however, in Ward II, the Plan Administrator had an incentive to challenge the lease because Montgomery Ward was liquidating, and a successful challenge would increase returns to the general unsecured creditors. Accordingly, the Court held that because the Plan Administrator was not in privity with the Ward I debtor, *res judicata* did not preclude the Plan Administrator from challenging the Lease and Sublease Agreement.

The Third Circuit next addressed Dika-Ward's argument that the Mortgage had become recourse under section 1111(b) as a result of the first bankruptcy proceeding. Section 1111(b) provides that if a debtor elects to continue using encumbered property in its reorganization, the bankruptcy court will grant the nonrecourse creditor, whose claim is secured by an interest in that property, an allowed claim under section 502 as if its security interest had recourse. The Court found that "[s]ection 1111(b)'s language and purpose indicate that the recourse transformation is for distribution purposes only." In affirming the Bankruptcy Court, the Third Circuit held that Dika-Ward possessed no claim against the Ward II debtor on account of the Mortgage because the security interest remained nonrecourse as to Montgomery Ward.

Conclusion

This case represents one of the first appellate decisions determining who constitutes a "party in privity" for *res judicata* purposes in a bankruptcy proceeding and establishes that in the Third Circuit for *res judicata* to bar relitigation of a claim in a bankruptcy proceeding the parties at issue must have aligned incentives.

In light of the *Montgomery Ward* decision, a trustee appointed in bankruptcy would not be barred by *res judicata* from challenging the actions taken by a debtor-in-possession prior to the trustee's appointment as long as the trustee can prove different incentives.

This case also represents one of the first appellate decisions finding that section 1111(b) transforms non-recourse claims into recourse claims only for distribution purposes. Affirming the Bankruptcy Court, the Third Circuit emphasized that while section 1111(b) provides recourse status to non-recourse claimants in

bankruptcy, it does not alter the creditor's legal and contractual rights outside of bankruptcy

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