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HEALTH CARE PROVIDER BANKRUPTCY UPDATE: PATIENT CARE OMBUDSMAN NOT NECESSARY IN EVERY HEALTH CARE BUSINESS BANKRUPTCY CASE

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Recent headlines have starkly illuminated the headwinds facing health care providers struggling to recover from a host of financial pressures. Many providers have resorted to filing for bankruptcy protection as a way, among other things, to right-size their balance sheets or effect a sale of their assets or businesses.

Recognizing the special problems faced by health care providers (and their patients) in bankruptcy, Congress amended the Bankruptcy Code in 2005 to add many provisions that apply specifically to a debtor that is a "health care business." One of those provisions mandates the appointment of a "patient care ombudsman" to protect the rights of patients in any chapter 7, chapter 9, or chapter 11 case filed by a health care business, unless the bankruptcy court concludes that the appointment is unnecessary to protect patients under the circumstances. Two bankruptcy courts recently addressed this issue.

In *La Familia Primary Care, P.C.*, 2023 WL 5310817 (Bankr. D.N.M. Aug. 17, 2023), the U.S. Bankruptcy Court for the District of New Mexico ruled that a small rural medical practice providing primary-care services did not qualify as a "health care business" under the Bankruptcy Code, and that, even if it did meet the statutory definition, the appointment of a patient care ombudsman was not necessary to protect the practice's patients.

In *In re Parkchester Oral and Maxillofacial Surgery Associates PC*, 2023 WL 5761923 (Bankr. S.D.N.Y. Sept. 6, 2023), the U.S. Bankruptcy Court for the Southern District of New York similarly concluded that no patient care ombudsman need be appointed for a dentistry and dental surgery facility in the absence of any allegations or evidence of patient care problems.

FINANCIAL CHALLENGES FACED BY HEALTH CARE PROVIDERS

According to data from financial and legal analysis firm Reorg Research, Inc., the volume of U.S. health care provider bankruptcies in 2023 has been the greatest in the last five years, with 74 filings through the end of November. Of those bankruptcy cases, 27 were filed

IN THIS ISSUE

1 Health Care Provider Bankruptcy Update: Patient Care Ombudsman Not Necessary in Every Health Care Business Bankruptcy Case

2 Lawyer Spotlight: Alexander Ballmann

7 Florida Bankruptcy Court Substantively Consolidates Debtor and Non-Debtor Entities

11 Fifth Circuit: Bid Protections for Stalking Horse in Bankruptcy Asset Sale Satisfied Both Business Judgment and Administrative Expense Standards

15 New York Bankruptcy Court: Foreign Representative in Chapter 15 Case Need Not Be Appointed by Foreign Court

19 Cure and Reinstatement of Defaulted Loan Under Chapter 11 Plan Requires Payment of Default-Rate Interest

23 Eighth Circuit: Avoidance Causes of Action Are Property of the Bankruptcy Estate that Can Be Sold

26 U.S. Supreme Court Bankruptcy Roundup

27 Newsworthy

by providers with at least $100 million in liabilities, compared to seven in all of 2022, 10 in 2021, 16 in 2020, and 20 in 2019.

In addition to pandemic-driven issues that emerged beginning in 2020, the financial woes of health care providers can be attributed to a number of factors, including: increased competition; capital market constraints; labor disputes; the need for investment in additional personnel and technology; the erosion of profitability due to the evolution from a "fee for service" payment model to a "bundle of services" payment model; liquidity problems caused by government payment disputes; operational changes; and increased pharmaceutical and other supply cost pressures. These and other factors (e.g., the highest inflation rate in four decades at the end of 2022) have led an increasing number of financially distressed providers to consider bankruptcy as a vehicle for effectuating closures, consolidation, restructurings, and related transactions.

APPOINTMENT OF PATIENT CARE OMBUDSMEN IN HEALTH CARE BUSINESS BANKRUPTCY CASES

Certain provisions were added to the Bankruptcy Code in 2005 that deal specifically with a debtor that is a "heath care business."

Among them is section 101(27A) of the Bankruptcy Code, which provides that a "health care business":

> (A) means any public or private entity (without regard to whether that entity is organized for profit or not for profit) that is primarily engaged in offering to the general public facilities and services for—
> (i) the diagnosis or treatment of injury, deformity, or disease; and
> (ii) surgical, drug treatment, psychiatric, or obstetric care; and
>
> (B) includes—
> (i) any—
> (I) general or specialized hospital;
> (II) ancillary ambulatory, emergency, or surgical treatment facility;
> (III) hospice;
> (IV) home health agency; and
> (V) other health care institution that is similar to an entity referred to in subclause (I), (II), (III), or (IV); and
> (ii) any long-term care facility, including any—
> (I) skilled nursing facility;
> (II) intermediate care facility;
> (III) assisted living facility;
> (IV) home for the aged;
> (V) domiciliary care facility; and
> (VI) health care institution that is related to a facility referred to in subclause (I), (II), (III), (IV), or (V), if that institution is primarily engaged in offering room, board, laundry, or personal assistance with activities of daily living and incidentals to activities of daily living.

11 U.S.C. § 101(27A).

LAWYER SPOTLIGHT: ALEXANDER BALLMANN

Jones Day recently welcomed Alexander Ballmann as a partner in the Business Restructuring & Reorganization Practice in Munich. Alexander brings a broad range of experience advising clients worldwide on business restructuring and reorganizations. He advises distressed enterprises in restructuring situations, insolvency administrators, and debtors on the structuring of insolvency proceedings and distressed M&A transactions; lenders in debtor crises and insolvencies; and financial investors on distressed equity as well as debt investments and nonperforming loan transactions.

Prior to joining Jones Day in 2023, Alexander advised on one of the largest insolvencies in Germany affecting private investors, with more than 57,000 creditors and investments of more than €3.5 billion; and a €2.5 billion global financial restructuring and refinancing deal on behalf of an automotive technology company.

Among the leading bankruptcy and restructuring lawyers in Germany, Alexander has represented clients across the automotive, technology, health care, life sciences, and other sectors. He has been recognized by *Legal 500* in "Germany Restructuring" for his excellence in advising financial creditors and investors, as well as companies in crisis, with a focus on financial restructuring. At Jones Day, Alexander will collaborate with colleagues to resolve complex restructuring issues and problems in jurisdictions around the globe, including out-of-court workouts, chapter 11 cases, and other transactions with financially distressed entities.

"Jones Day's business restructuring practice has worked on some of the most important financial restructuring issues and problems in jurisdictions throughout the world, and I am delighted to join the team," he said. "I was especially attracted to the Firm's culture of collaboration among partners across practices and offices, with a laser focus on client service excellence. I look forward to working alongside my new colleagues in Munich."

Other than the statutory definition of "health care business" in section 101(27A), provisions added to the Bankruptcy Code in 2005 that apply specifically to "health care business" debtors include:

(1) section 351 (as supplemented by Rule 6011 of the Federal Rules of Bankruptcy Procedure (the "Bankruptcy Rules")), which creates procedures for the disposal of patient records by a health care business;
(2) sections 704(a)(12), 1106(a)(1), and 503(b)(8), which provide procedures and restrictions governing transfers of patients of a closing health care business and create an administrative expense priority for health care business closing expenses; and
(3) section 362(b)(28), which exempts from the automatic stay the "exclusion" of a debtor from participation in Medicare or any other federal health care program by the U.S. Secretary of Health and Human Services due to, among other things, criminal convictions, civil liability for fraud or obstruction of an investigation or audit, license revocation or suspension, failure to take corrective action, claims for excessive charges or unnecessary services, and the failure of certain organizations to furnish medically necessary services.

In addition, section 333 of the Bankruptcy Code provides that the bankruptcy court "shall" appoint a "patient care ombudsman" not later than 30 days after the commencement of any health care business's chapter 7, chapter 9, or chapter 11 case, "unless the court finds that the appointment of such ombudsman is not necessary for the protection of patients under the specific facts of the case." The ombudsman serves as a "patient advocate," as distinguished from a representative of creditors, entrusted with monitoring the quality of patient care, representing the interests of patients, and reporting to the bankruptcy court every 60 days on the status of patient care. *See* 11 U.S.C. § 333(a)(1), (b)(2).

In determining whether a patient care ombudsman is necessary under the specific facts of a case, many courts have examined the following nine nonexclusive factors:

(1) the cause of the bankruptcy;
(2) the presence and role of licensing or supervising entities;
(3) [the] debtor's past history of patient care;
(4) the ability of the patients to protect their rights;
(5) the level of dependency of the patients on the facility;
(6) the likelihood of tension between the interests of the patients and the debtor;
(7) the potential injury to the patients if the debtor drastically reduced its level of patient care;
(8) the presence and sufficiency of internal safeguards to ensure appropriate level of care; [and]
(9) the impact of the cost of an ombudsman on the likelihood of a successful reorganization.

In re Alternate Family Care, 377 B.R. 754, 758 (Bankr. S.D. Fla. 2007). According to the court in *In re Valley Health Sys.*, 381 B.R. 756, 761 (Bankr. C.D. Cal. 2008), other factors to be considered can include:

(1) the high quality of the debtor's existing patient care; (2) the debtor's financial ability to maintain high quality patient care; (3) the existence of an internal ombudsman program to protect the rights of patients, and/or (4) the level of monitoring and oversight by federal, state, local, or professional association programs which renders the services of an ombudsman redundant.

Id. at 761 (citing COLLIER ON BANKRUPTCY ¶ 333.02 (15th ed. 2007)); *accord In re Aknouk*, 648 B.R. 755 (Bankr. S.D.N.Y. 2023) (ruling that a chapter 11 dental provider established that a patient care ombudsman was unnecessary to protect its patients where, among other things, the cause of the bankruptcy (i.e., the debtor's alleged failure to remit employer contributions to a union), was unrelated to patient care; the debtor, which was regulated by the state, had been operating for 25 years in good standing and had no history of compromised patient care or malpractice claims; the debtor had sufficient internal mechanisms to monitor patient care; and the cost of an ombudsman could be the difference between positive and negative cash flow); *In re Mississippi Maternal-Fetal Medicine, P.A.*, 2021 WL 1941627, at **3–4 (Bankr. S.D. Miss. Feb. 18, 2021) (applying the *Alternate Family Care* factors and ruling that an ombudsman was unnecessary because, among other things, there was no evidence that the debtor's standard of care was deficient, the costs of appointment could adversely affect the debtor's ability to reorganize, and the bankruptcy filing was not precipitated by concerns relating to quality of patient care or to patient privacy matters).

"The weight given to the factors is at the discretion of the reviewing court." *In re Flagship Franchises of Minn. LLC*, 484 B.R. 759, 762 (Bankr. D. Minn. 2013) (citing *In re N. Shore Hematology-Oncology Assocs., P.C.*, 400 B.R. 7 (Bankr. E.D.N.Y. 2008)).

A simplified alternative (the "Huckaby test") to the nine-factor *Alternate Family Care* test was proposed by Nicholas A. Huckaby in his law review article titled *Toward A Workable Standard for Appointing A Patient Care Ombudsman: Proposed Changes for Applying § 333 of the Bankruptcy Code*, 48 U. TOL. L. REV. 367 (2017). In his article, Huckaby advocated a three-step test whereby the court would consider "whether patient care is a concern in the case," whether safeguards have been implemented to protect patients, and "the financial impact an ombudsman will have on the debtor." *Id.* at 369.

Bankruptcy Rule 2007.2 sets forth the procedure for appointing a patient care ombudsman. It provides that the court "shall" order the appointment of an ombudsman unless it determines that the appointment is unnecessary based on a motion filed by a party in interest "no later than 21 days after the commencement of the case or within another time fixed by the court." Fed. R. Bankr. P. 2007.2(a). Bankruptcy Rule 2007.2(d) provides that, upon the motion of a party in interest, the court may terminate the appointment of an ombudsman if it finds that the appointment is not necessary to protect patients.

If the court appoints an ombudsman, Bankruptcy Rule 2015.1 obligates the ombudsman to file certain reports with the court, as prescribed by section 333(b)(2) of the Bankruptcy Code. Further, section 330(a) of the Bankruptcy Code provides that patient care ombudsmen are entitled to apply for compensation from the estate.

Other provisions of the Bankruptcy Code apply more generally to nonprofit (eleemosynary) entities, which include many hospitals and other health care providers. For example: (i) section 303(a) prohibits the filing of an involuntary bankruptcy case against "a corporation that is not a moneyed business, or commercial corporation," which has been construed to include nonprofit entities; (ii) section 1112(c) of the Bankruptcy Code prohibits the conversion of a chapter 11 case to a chapter 7 liquidation if the debtor "is not a moneyed, business, or commercial corporation"; and (iii) section 363(d)(1) of the Bankruptcy Code provides that, "in the case of a debtor that is a corporation or trust that is not a moneyed business, commercial corporation, or trust," a trustee or chapter 11 debtor-in-possession may use, sell, or lease estate property "only in accordance with nonbankruptcy law applicable to the transfer" of the debtor's property. In addition, most courts have construed the "absolute priority rule" in section 1129(b), which precluded distribution of value under a chapter 11 plan to, among other entities, shareholders without full payment of creditors, to be inapplicable to nonprofit debtors because they generally do not have equity interests. *See, e.g., In re General Teamsters, Warehousemen and Helpers Union, Local 890*, 265 F.3d 869 (9th Cir. 2001); *In re Havre Aerie No. 166 Eagles*, 2013 WL 1164422 (Bankr. D. Mont. Mar. 20, 2013).

In addition, certain issues arising in bankruptcy cases have special significance for health care providers. These include: (i) disputes regarding the ability of a federal or state agency to terminate a health care debtor's Medicare or Medicaid provider agreement; (ii) special problems regarding recoupment and setoff in cases involving alleged Medicare and Medicaid overpayments to health care providers; and (iii) disputes regarding the assumption and assignment of provider agreements in connection with the sale or closure of a health care provider.

LA FAMILIA

La Familia Primary Care, P.C. (the "debtor") is a New Mexico corporation that provides primary medical care to patients in a small town with approximately 6,000 residents in northern New Mexico. As of 2023, the debtor's sole remaining doctor and owner was Dr. Misbah Zmily, a board-certified physician in internal medicine practicing since 1996. In addition to Dr. Zmily, the debtor employs a physician's assistant and a registered nurse practitioner. The debtor also provides medical care to two nearby nursing homes as well as a local high school. A large percentage of its patients are on Medicare or Medicaid. The debtor and Dr. Zmily had a good reputation in the community, and no malpractice, substandard patient care, improper record-keeping, or privacy violation claims had ever been asserted against either of them.

In January 2022, Medicare notified the debtor that it would not pay for osteoarthritis treatments using drugs provided to the debtor beginning in 2020 by pharmaceutical company BioLab Sciences because Medicare concluded that the results obtained for patients did not warrant the $4,000 charge per treatment. Medicare also claimed the right to "claw back" all the payments it had ever made to the debtor for such treatments—approximately $3.6 million—and to set off against this amount funds otherwise payable to the debtor as reimbursement for services to Medicare patients.

The setoff caused the debtor to lose most of its cash flow, and the debtor filed for chapter 11 protection in July 2023 in the District of New Mexico. The debtor filed a motion to dispense with the requirement in section 333 of the Bankruptcy Code that the court appoint a patient care ombudsman in the case. The Office of the United States Trustee (the "UST") opposed the motion, arguing that the debtor met the definition of "health care business" under section 101(27A)(A) and that the appointment of an ombudsman was necessary.

The bankruptcy court granted the debtor's motion, ruling that the debtor was not a "health care business" as defined by section 101(27A) or, alternatively, that the appointment of a patient care ombudsman was not necessary for the protection of the debtor's patients.

At the outset of his opinion, U.S. Bankruptcy Judge David T. Thuma noted that, because the debtor operated on a "very thin margin," any additional administrative expense (including the costs associated with an ombudsman) could cause it to shut

down, which would be a severe blow to the town's residents as well as the debtor's nursing home patients. *La Familia*, 2023 WL 5310817, at *2.

The bankruptcy court then examined whether the debtor was a "health care business" pursuant to section 101(27A). Initially, Judge Thuma stated that "[s]ection 101(27A) is not easy to parse" and, due to its ambiguity, courts have struggled with two questions in applying the definition:

[F]irst, must a debtor come within both subsections (A) *and* (B) to be a health care business. Or is it enough to come within either subsection; and second, if it is enough to come within either subsection (A) *or* (B) and a debtor seems to qualify under subsection (A), must the debtor's business be similar to the businesses listed in subsection (B)?

Id. at *3.

Based on lawmakers' sometimes inconsistent usage of "and" or "or" in the Bankruptcy Code and other court decisions addressing the issue, Judge Thuma was persuaded that "an entity is a health care business if it comes within either subsection (A) *or* (B)" of section 101(27A). *Id.* at *4 (citing *Aknouk*, 648 B.R. at 760; *In re Smiley Dental Arlington, PLLC*, 503 B.R. 680, 685 (Bankr. N.D. Tex. 2013)). He reasoned that "[i]f all the 'ands' in § 101(27A) are construed as conjunctions, very few entities would qualify as health care businesses." For example, Judge Thuma explained, homes for the aged, hospices, and home health agencies would not meet the definition because they do not "provide facilities and services for the treatment of injury, deformity, or disease," as provided in section 101(27A)(i). Likewise, he noted, "the strictly 'conjunctive' reading would require that hospitals also be long-term care facilities, and vice versa, as well as qualifying under subsection (A)," thereby effectively excluding nearly all health care businesses from the scope of the definition. *Id.*

According to Judge Thuma, the better reading of section 101(27A) is that:

> [T]he word "includes" at the beginning of subsection (B) applies to "health care business," rather than to subsection (A). Thus, the section should be read: "health care business" means [the definition in subsection (A)] and also includes [the examples of hospitals and long-term care facilities in subsection (B)]. That is the construction that makes the most sense. The drafters apparently wanted [§ 333] to apply to hospitals, long-term care facilities, and also to debtors coming within the subsection (A) definition.

Id.

Next, the bankruptcy court concluded that debtors satisfying section 101(27A)(A) need not be similar to hospitals, long-term care facilities, or the other health care providers listed in section 101(27A)(B). Judge Thuma reasoned that, if lawmakers had intended to limit the definition of a "health care business" to entities similar to the entities listed in "subsection (B) (whatever that might be), [Congress] could have omitted subsection (A) entirely; the 'catch-all' subclauses (B)(i)(V) and (B)(ii)(VI) would have been sufficient." *Id.* at *5.

The bankruptcy court agreed with the UST that the debtor did not qualify as a "health care business" under section 101(27A)(B). However, because the debtor did not offer facilities and services to the public for "surgical, drug treatment, psychiatric, or obstetric care," the court found that the debtor also did not qualify as a health care business under section 101(27A)(A). "[P]rescribing antidepressants, without more," Judge Thuma wrote, "is not tantamount to providing psychiatric care." *Id.* at *6.

Moreover, applying the *Alternate Family Care* and *Valley Health* factors, the bankruptcy court ruled that, even if the debtor were a "health care business," the appointment of a patient care ombudsman was not necessary to protect the debtor's patients. According to Judge Thuma, those factors "weigh[ed] heavily against" such an appointment. Among other things, he noted that: the debtor provided no inpatient treatment; its patients did "not face the prospect of being turned out on the street if Debtor fails to reorganize"; the debtor's patient care was good; the debtor would be "squeezed for cash" until Medicare began paying postpetition bills; and the debtor could "ill afford additional administrative expenses." *Id.* at *8.

Finally, the bankruptcy court emphasized that, while bankruptcy courts do not hesitate to appoint a patient care ombudsman in hospital and nursing home cases, "they are reluctant to do so in small business cases" such as the one before it. According to Judge Thuma, "[i]t is not an issue of statutory construction, but rather the conclusion that, with a typical small doctor's or dentist's office, the benefit of an ombudsman (if any), is substantially outweighed by the attendant expense and disruption." *Id.*

PARKCHESTER

Bronx, New York, dentistry and dental surgery provider Parkchester Oral and Maxillofacial Surgery Associates PC (the "debtor") filed for chapter 11 protection in the Southern District of New York on June 28, 2023. On July 12, 2023, the UST filed a motion for the appointment of a patient care ombudsman for the debtor. The debtor opposed the motion, arguing that the appointment was not necessary for the protection of its patients.

The UST argued that, in ruling on the motion, the court should consider the Huckaby test factors rather than the nine-factor *Alternate Family Care* test or the supplementary four-factor test considered by some courts. According to the UST, in each of the 15 reported decisions since 2007 in which those factors were applied, the court ruled that a patient care ombudsman was unnecessary, suggesting that the factors themselves must be improperly skewed. The *Parkchester* bankruptcy court rejected the UST's argument and held that the appointment of an ombudsman was unnecessary.

According to U.S. Bankruptcy Judge Michael E. Wiles, the UST's contention that courts in all of the post-2007 reported decisions applying the *Alternate Family Care* factors have ruled that an ombudsman was not necessary is misleading. In the vast majority of cases involving health care businesses, he explained, an ombudsman is appointed with no opposition or written decision. Moreover, Judge Wiles noted, the post-2007 cases cited by the UST involved dentists' practices and similar businesses that technically qualified as health care businesses, but had not experienced patient care concerns justifying the appointment of an ombudsman. Finally, Judge Wiles wrote, "I see little difference between the simplified formulation [in the Huckaby test] and the [*Alternate Family Care*] list of factors … [which] are in many ways … just sub-parts of the inquiry that help to guide a court in making the three-part decision that Mr. Huckaby has recommended." *Parkchester*, 2023 WL 5761923, at *3.

Although Judge Wiles found the *Alternate Family Care* factors to be informative, he determined that factor nine—"the impact of the cost of an ombudsman on the likelihood of a successful reorganization"—was inappropriate because no such consideration is expressly included in section 333 of the Bankruptcy Code. Section 333, he emphasized, "directs the court to determine whether an ombudsman is 'necessary for the protection of patients,'—not whether it is 'convenient,' or 'cost-effective,' or whether it might interfere with a debtor's financial reorganization." *Id.*

Applying the remaining factors, Judge Wiles concluded that no patient care ombudsman was necessary to protect the debtor's patients. Among other things, he found that: (i) the debtor's financial problems had nothing to do with patient care; (ii) the debtor's licenses were up to date and the debtor had no history of patient care issues or patient complaints; (iii) because the debtor provided dentistry and dental surgery (rather than, for example, nursing home services to particularly vulnerable patients), its patients were able to protect their rights; (iv) the debtor's patients did not depend on its services, which could readily be provided elsewhere if patients were dissatisfied with such services; and (v) the debtor had adequate resources to conduct its business and to maintain the high quality of its existing patient care.

The bankruptcy court accordingly denied the UST's motion for the appointment of a patient care ombudsman for the debtor.

OUTLOOK

Lawmakers understandably were motivated by the need to protect patients when they amended the Bankruptcy Code in 2005 to add the series of provisions that specifically apply to health care businesses filing for bankruptcy protection. However, Congress also understood that these safeguards need not necessarily apply in every case.

La Familia and *Parkchester* are perfect examples. In *La Familia*, the bankruptcy court carefully parsed the confusing language of section 101(27A) of the Bankruptcy Code to conclude that the appointment of a patient care ombudsman was not warranted, both because the small-town medical practice debtor did not qualify as a "health care business," and the circumstances—i.e., the existence of adequate patient protection measures—were such that the added expense involved was simply not justified under section 333. In *Parkchester*, the bankruptcy court similarly determined that an ombudsman was not necessary because the debtor had no patient care issues and its financial condition was not likely to create any, based upon the nature of the health care services that it provided.

FLORIDA BANKRUPTCY COURT SUBSTANTIVELY CONSOLIDATES DEBTOR AND NON-DEBTOR ENTITIES

T. Daniel Reynolds • Nick Buchta

The Bankruptcy Code does not explicitly authorize the equitable remedy of "substantive consolidation"—i.e., treating the assets and liabilities of two or more related entities as if they belonged to a single, consolidated bankruptcy estate. However, it is well recognized that a bankruptcy court has the authority to order such relief under appropriate circumstances in the exercise of its broad equitable powers when each of the original entities are already debtors subject to the court's jurisdiction. However, some courts have taken the remedy a step further and consolidated debtors in bankruptcy with their non-debtor affiliates. The exercise of this extraordinary power is a rare event that requires both the unique facts to justify the remedy and a court that is willing to do so.

These factors recently coalesced when the U.S. Bankruptcy Court for the Southern District of Florida granted a bankruptcy trustee's motion to substantively consolidate the estates of a debtor and several of its non-debtor affiliates in *In re No Rust Rebar, Inc.*, 2023 WL 4497328 (Bankr. S.D. Fla. July 12, 2023). The bankruptcy court held that substantive consolidation was appropriate because, among other things, all of the companies were controlled by an individual who operated the group as a single enterprise; the companies did not recognize corporate formalities; and their assets, liabilities, and affairs were hopelessly intertwined.

SUBSTANTIVE CONSOLIDATION

Substantive consolidation is an equitable remedy pursuant to which a bankruptcy court may order that the assets and liabilities (for ease of reference, the "estates") of separate entities be treated as if they belonged to a single, combined entity.

The Bankruptcy Code does not expressly authorize substantive consolidation, but it recognizes that a chapter 11 plan may provide for the "merger or consolidation of the debtor with one or more persons" as a means of implementation. *See* 11 U.S.C. § 1123(a)(5)(C). In addition, Rule 1015(b) of the Federal Rules of Bankruptcy Procedure (the "Bankruptcy Rules") provides that a bankruptcy court may direct that cases involving affiliated debtors be jointly administered, although the rule is silent regarding substantive consolidation. The Advisory Committee Note to Bankruptcy Rule 1015(b) states that "[c]onsolidation, as distinguished from joint administration, is neither authorized nor prohibited by this rule since the propriety of consolidation depends on substantive considerations and affects the substantive rights of the creditors of the different estates." 1983 Advisory Committee Note to Fed. R. Bankr. P. 1015 (reprinted in Collier on Bankruptcy App. 1015[1] (16th ed. 2023)).

A majority of courts have concluded that bankruptcy courts have the power to substantively consolidate *debtor* entities under section 105(a) of the Bankruptcy Code, which provides that a court "may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions" of the Bankruptcy Code. Forcing the creditors of one entity to share equally with those of another, however, is considered "a rough justice remedy that should be rare and, in any event, one of last resort after considering and rejecting other remedies." *In re Owens Corning*, 419 F.3d 195, 211 (3d Cir. 2005).

There is no unifying rule or approach to assess whether substantive consolidation is an appropriate remedy. The Second Circuit has established the closest to a standard-bearer test, developing a two-part disjunctive standard for gauging the propriety of substantive consolidation in *Union Savings Bank v. Augie/Restivo Baking Co., Ltd. (In re Augie/Restivo Baking Co., Ltd.)*, 860 F.2d 515 (2d Cir. 1988). There, the court concluded that the factual elements considered by the courts are "merely variants on two critical factors: (i) whether creditors dealt with the entities as a single economic unit and did not rely on their separate identity in extending credit, … or (ii) whether the affairs of the debtors are so entangled that consolidation will benefit all creditors." *Id.* at 518. According to *Augie/Restivo*, factors that may be relevant in satisfying these requirements include the following:

(1) Fraud or other complete domination of the corporation that harms a third party;
(2) The absence of corporate formalities;
(3) Inadequate capitalization of the corporation;
(4) Whether funds are put in and taken out of the corporation for personal rather than corporate purposes;
(5) Overlap in ownership and management of affiliated corporations;
(6) Whether affiliated corporations have dealt with one another at arm's length;
(7) The payment or guarantee of debts of the dominated corporation by other affiliated corporations;
(8) The commingling of affiliated corporations' funds; and
(9) The inability to separate affiliated corporations' assets and liabilities.

Id. at 518–19. The *Augie/Restivo* test was adopted by the Ninth Circuit in *Bonham v. Compton (In re Bonham)*, 229 F.3d 750 (9th Cir. 2000).

Many other circuit and lower courts have adopted tests similar to the *Augie/Restivo* standard. For example, in *Eastgroup Properties v. Southern Motel Assoc., Ltd.*, 935 F.2d 245 (11th Cir. 1991), the Eleventh Circuit initially applied the following seven-factor test set forth in *In re Vecco Const. Indus., Inc.*, 4 B.R. 407 (Bankr. E.D. Va. 1980):

(1) The presence or absence of consolidated financial statements.
(2) The unity of interests and ownership between various corporate entities.
(3) The existence of parent and intercorporate guarantees on loans.
(4) The degree of difficulty in segregating and ascertaining individual assets and liabilities.
(5) The existence of transfers of assets without formal observance of corporate formalities.
(6) The commingling of assets and business functions.
(7) The profitability of consolidation at a single physical location.

Eastgroup, 935 F.2d at 250. However, the Eleventh Circuit also considered five additional factors that could be relevant to the analysis, including:

> (1) the parent owning the majority of the subsidiary's stock; (2) the entities having common officers or directors; (3) the subsidiary being grossly undercapitalized; (4) the subsidiary transacting business solely with the parent; and (5) both entities disregarding the legal requirements of the subsidiary as a separate organization.

Id. at 251 (citations omitted).

In *Owens Corning*, however, the Third Circuit opted for an "open-ended, equitable inquiry" rather than a factor-based analysis. *Owens Corning*, 419 F.3d at 210.

SUBSTANTIVE CONSOLIDATION OF DEBTORS AND NON-DEBTORS

Although most courts have held that the substantive consolidation of debtor entities is permitted under appropriate circumstances, they disagree as to whether the substantive consolidation of debtors and non-debtors is permissible under the Bankruptcy Code. In *Sampsell v. Imperial Paper & Color Corp.*, 313 U.S. 215 (1941), the U.S. Supreme Court "tacitly approved" substantive consolidation of a non-debtor entity with a debtor event though it reversed a Ninth Circuit decision affirming an order consolidating the estates. *See Bonham*, 229 F.3d at 764 (noting that "the substantive consolidation of two estates was first tacitly approved by the Supreme Court [in *Sampsell*] in the context of a debtor who had abused corporate formalities and allegedly made fraudulent conveyances of the debtor shareholder's assets to the corporation").

Some courts have concluded that such substantive consolidation is appropriate on the basis of: (i) section 105's broad grant of authority; (ii) a bankruptcy court's ability to assert personal and subject matter jurisdiction over non-debtors; and/or (iii) a bankruptcy court's mandate to ensure the equitable treatment of all creditors. *See, e.g., id.* at 769–71; *In re Stewart*, 603 B.R. 138, 150 (Bankr. W.D. Okla. 2019); *In re Falls Event Ctr. LLC*, 600 B.R. 857, 868 (Bankr. D. Utah 2019); *In re AAA Bronze Statues & Antiques, Inc.*, 598 B.R. 27, 32 (Bankr. N.D. Fla. 2019); *Lassman v. Cameron Constr. LLC (In re Cameron Constr. & Roofing Co.)*, 565 B.R. 1, 10 (Bankr. D. Mass. 2016); *Simon v. ASIMCO Techs., Inc. (In re Am. Camshaft Specialties, Inc.)*, 410 B.R. 765, 786 (Bankr. E.D. Mich. 2009); *Walls v. Centurion Asset Mgmt., Inc. (In re Bolze)*, 2009 BL

157145, *4 (Bankr. E.D. Tenn. July 23, 2009); *Dominion Fin. Corp. v. Morfesis (In re Morfesis)*, 270 B.R. 28, 31 (Bankr. D.N.J. 2001); *see also Clark's Crystal Springs Ranch, LLC v. Gugino (In re Clark)*, 692 F. App'x 946 (9th Cir. 2017) (because the Bankruptcy Code does not expressly forbid the substantive consolidation of debtors and non-debtors, the U.S. Supreme Court's decision in *Law v. Siegel*, 571 U.S. 415 (2014), does not bar bankruptcy courts from ordering the remedy).

Other courts, however, have held that the substantive consolidation of debtors and non-debtors is inappropriate because, among other things, it circumvents the procedures concerning involuntary bankruptcies set forth in section 303 of the Bankruptcy Code. *See*, *e.g.*, *In re Archdiocese of Saint Paul & Minneapolis*, 888 F.3d 944, 951 (8th Cir. 2018) (involving nonprofit non-debtors, against which an involuntary petition may not be filed); *In re Concepts America, Inc*., 2018 WL 2085615, at *6 (Bankr. N.D. Ill. May 3, 2018); *In re Geneva ANHX IV LLC*, 496 B.R. 888, 901 (Bankr. C.D. Ill. 2013); *In re Pearlman*, 462 B.R. 849, 854 (Bankr. M.D. Fla. 2012); *Helena Chem. Co. v. Circle Land & Cattle Corp. (In re Circle Land & Cattle Corp.)*, 213 B.R. 870, 877 (Bankr. D. Kan. 1997); *In re Hamilton*, 186 B.R. 991, 993 (Bankr. D. Colo. 1995).

Even among those courts permitting substantive consolidation between debtors and non-debtors, some have observed that "substantive consolidation of a debtor with a non-debtor should be used sparingly and has a higher burden of proof than debtor-to-debtor consolidation." *In re Caribbean Auto Mart of St. Croix, Inc.*, 2021 WL 2419986, *11 (Bankr. D.V.I. June 11, 2021); *accord Simon v. ASIMCO Techs., Inc. (In re Am. Camshaft Specialties, Inc.)*, 410 B.R. 765, 786 (Bankr. E.D. Mich. 2009); *Morse Operations, Inc. v. Robins LE-COCQ, Inc. (In re Lease-A-Fleet, Inc.)*, 141 B.R. 869, 872-74 (Bankr. E.D. Pa. 1992).

NO RUST REBAR

No Rust Rebar presented a bankruptcy court with exactly the type of facts that could satisfy the high burden of proof necessary to consolidate a debtor with a non-debtor affiliate. Don Smith ("Smith") was the founder and owner of No Rust Rebar, Inc. (the "debtor"), a company engaged in the manufacture and sale of structural reinforcement products, particularly rebar, made from basalt fibers. He was also the founder of various related companies, including Raw Materials Corp. ("RMC"), Raw Energy Materials Corp. ("REM"), Global Energy Sciences, LLC ("GES"), and (purportedly) Raw, LLC ("Raw"), all of which were involved in some way in the production, sale, and development of basalt fiber products.

The debtor was created in 2015 with a $1.2 million investment from Robert Bryan ("Bryan"). In July 2015, the debtor contracted to purchase a Florida manufacturing facility. Because the debtor lacked the financing necessary to acquire the property, it assigned the right to purchase the facility to Green Tech Development, LLC ("Green Tech"), purportedly in exchange for an option to purchase the facility. No written option agreement was ever signed, and Green Tech later denied that it had granted the debtor a purchase option. Green Tech purchased the facility in January 2016, although the debtor continued in possession of the premises.

After Green Tech, as the property owner, refused to sign applications for the necessary permits to begin manufacturing at the facility, the debtor executed, but never recorded, a $400,000 mechanic's lien against the property in favor of its affiliate RMC, which also operated from the facility. Smith later testified that he did so to make the property "less enticing" to Green Tech.

In November 2016, the debtor sought to exercise its purported purchase option for the facility, but Green Tech refused to sell. The debtor then sued Green Tech in state court for specific performance (the "Property Dispute"). Green Tech countersued for damages in the amount of $1.95 million.

In December 2016, Smith founded Raw as a holding company, but Raw was actually a fictitious name for the debtor. In January 2017, Smith resurrected an older entity—GES—to hold his intellectual property, including trademark and brand licenses associated with his basalt rebar products. The following month, Smith caused various affiliated entities to grant PayMeOn, Inc. ("PayMeOn") an exclusive license to sell basalt rebar in Florida and the Caribbean. Although the debtor provided machinery, basalt fibers, and finished inventory as part of the deal, it received no consideration in exchange. Instead, RMC received $2.4 million from PayMeOn, and Raw received 10 million shares of PayMeOn's publicly traded stock.

In 2019, the ability of the debtor and its affiliates to do business in the facility was effectively eliminated after the electric power utility turned off service at the site due to nonpayment. In the four years that the debtor and its affiliates conducted business, Smith routinely transferred money among the companies with little or no documentation and otherwise failed to comply with corporate formalities for each of the entities. The companies also failed to keep books and records reflecting their separate assets and liabilities.

The debtor filed for protection under subchapter V of chapter 11 on March 5, 2021, in the U.S. Bankruptcy Court for the Southern District of Florida. The debtor's schedules were inaccurate and inconsistent in detailing the debtor's assets and liabilities, including intercompany claims. Shortly afterward, the debtor removed the Property Dispute to the bankruptcy court. The only creditor claims filed or listed in the chapter 11 case were: (i) Green Tech's $1.95 million claim arising from the Property Dispute; (ii) a secured claim for approximately $1 million arising from a mortgage on the manufacturing facility; and (iii) approximately $75,000 in claims asserted by various governmental entities for taxes, water service, and other items.

In April 2021, as part of a settlement agreement related to the PayMeOn licensing deal, Raw agreed to sell its 10 million PayMeOn shares for $1.2 million to an unaffiliated entity, which remitted the purchase price to Smith because Raw did not have

its own bank account. No bankruptcy court approval was sought for the sale and related settlement. Smith claimed that no such approval was necessary because the deal involved Raw rather than the debtor, even though Raw was a fictitious company.

In May 2022, the bankruptcy court granted Green Tech's motion to convert the debtor's chapter 11 case to a chapter 7 liquidation. Shortly afterward, the chapter 7 trustee filed a motion to substantively consolidate the debtor with non-debtors RMC, REM, GES, and Raw (collectively, the "Target Companies").

THE BANKRUPTCY COURT'S RULING

The bankruptcy court granted the trustee's motion.

U.S. Bankruptcy Judge Peter D. Russin explained that a bankruptcy court's general equitable powers under section 105(a) of the Bankruptcy Code include the power to substantively consolidate various estates, but only "sparingly and only when the proponent can show that it is necessary to achieve a fair and equitable distribution of the debtors' collective assets." *No Rust Rebar*, 2023 WL 4497328, at *5. That power extends to the consolidation of both debtors and non-debtors, as "implicitly recognized" by the Supreme Court in *Sampsell* and as "expressly approved by many other courts." *Id.*

In assessing the propriety of substantively consolidating the Target Companies, the court applied the *Eastgroup* standard and factors. Among other things, Judge Russin found that: (i) segregating and ascertaining the entities' individual assets was "sufficiently difficult," and their assets and business functions were "hopelessly commingled"; (ii) because the entities operated from the same location, commingled funds in bank accounts (if they even had any), and used the same corporate emblem, and because Smith was the principal, majority shareholder, president, and representative of each of the affiliated companies, the companies had a "unity of interest and ownership"; (iii) Smith utilized the companies "in concert to achieve their strategic financial goals"; and (iv) the companies failed to maintain corporate formalities, including with respect to the transfer of assets, and disregarded the legal requirements of corporate separateness. *Id.* at **6-10.

According to Judge Russin, although the Target Companies were given an opportunity to rebut the conclusion that consolidation was appropriate under the circumstances, none did so in any substantive way, but rather made merely procedural arguments.

The bankruptcy court rejected the Target Companies' argument that substantive consolidation must be sought in an adversary proceeding rather than by motion, concluding that, in accordance with relevant caselaw, a court "may substantively consolidate a non-debtor with a bankruptcy debtor by motion." *Id.* at *11 (citing cases). The court also found that notice of the motion to the Target Companies was adequate to satisfy due process concerns.

Finally, the bankruptcy court concluded that the Target Companies were collaterally estopped from contesting many of the factual findings and legal issues posed by the trustee's motion because, among other things, such findings and legal issues had already been litigated in the context of Green Tech's motion to convert the debtor's chapter 11 case to a chapter 7 liquidation.

OUTLOOK

Despite the unusual nature of the relief granted by the court, *No Rust Rebar* does not break any new ground regarding substantive consolidation in bankruptcy. Rather, the court's decision reinforces the unusual facts necessary to warrant such relief. In so doing, the decision reinforces several important principles.

First, although the bankruptcy court held that it had the power to substantively consolidate debtors with their non-debtor affiliates even though the Bankruptcy Code does not explicitly authorize the remedy, that interpretation has been rejected by some other bankruptcy courts.

Second, the ruling reaffirms the standard and factors that are customarily applied by courts in the Eleventh Circuit faced with motions to substantively consolidate debtor and non-debtor entities.

Third, *No Rust Rebar* indicates that a formal adversary proceeding is not necessary to seek substantive consolidation.

Finally, the bankruptcy court emphasized that where substantive consolidation is sought with respect to non-debtors, such non-debtors must be given notice of the motion and an opportunity to be heard as a matter of due process.

FIFTH CIRCUIT: BID PROTECTIONS FOR STALKING HORSE IN BANKRUPTCY ASSET SALE SATISFIED BOTH BUSINESS JUDGMENT AND ADMINISTRATIVE EXPENSE STANDARDS

Paul M. Green

Bankruptcy and appellate courts disagree over the standard that should apply to a request for payment of a break-up fee or expense reimbursement to the losing bidder in a sale of assets outside the ordinary course of the debtor's business. Some apply a "business judgment" standard, while others require that the proposed payments satisfy the more rigorous standard applied to administrative expense claims.

The U.S. Court of Appeals for the Fifth Circuit addressed this question in *Matter of Bouchard Transportation Co., Inc.*, 74 F.4th 743 (5th Cir. 2023). The Fifth Circuit court affirmed lower court orders approving a $3.3 million breakup fee and more than $885,000 in expense reimbursement to a disappointed "stalking-horse" bidder in an auction of the debtors' assets, finding that the payments satisfied both the business judgment test under section 363(b) of the Bankruptcy Code and the standard for approval of administrative expense claims under section 503(b).

STALKING HORSES AND BREAK-UP FEES

Section 363(b)(1) of the Bankruptcy Code authorizes a bankruptcy trustee or chapter 11 debtor in possession, "after notice and a hearing," to use, sell, or lease property of the estate outside the ordinary course of business. Most courts apply a "business judgment" standard to a proposed use, sale, or lease of property under section 363(b)(1), whereby "the bankruptcy court reviews the trustee's (or debtor in possession's) business judgment to determine independently whether the judgment is a reasonable one." COLLIER ON BANKRUPTCY ("Collier") ¶ 363.02[4] (16th ed. 2023) (citing and discussing cases).

A sale under section 363(b)(1) is most frequently undertaken by means of a public auction, in which assets are generally sold to the highest bidder. Generally speaking, the initial bidder in a public auction held under section 363—the "stalking-horse bidder"—sets the minimum price and other terms of the transaction. Because of the time and effort expended by the stalking-horse bidder in performing due diligence and engaging in the negotiations necessary to arrive at the initial bid, bankruptcy courts generally will allow reasonable bid protections for the bidder in the event the stalking-horse bidder does not prevail at the auction. Those bid protections, which are typically the subject of extensive negotiations, often include reimbursement of expenses incurred by the bidder in connection with the transaction, a "break-up" fee equal to a specified percentage of the bidder's purchase price, auction procedures, and certain other rights related to the stalking-horse bid.

Outside of bankruptcy, a seller's decision to give such protections is typically accorded deference under the "business judgment" rule if the protections are challenged in court. In the bankruptcy context, however, several different approaches have been applied by courts in assessing the propriety of bid protections. *See generally* Collier at ¶ 363.02[7]. Some courts apply a business judgment standard, which involves the highest degree of deference to the debtor's decision to commit to the bid protections under scrutiny. *See, e.g., In re Diocese of Buffalo, N.Y.*, 637 B.R. 701, 704 (Bankr. W.D.N.Y. 2022); *In re JW Res., Inc.*, 536 B.R. 193, 197 (Bankr. E.D. Ky. 2015); *In re Genco Shipping & Trading Ltd.*, 509 B.R. 455, 465 (Bankr. S.D.N.Y. 2014). Other courts apply stricter scrutiny, requiring evidence that proposed bid protections are in the "best interests of the estate." Collier at ¶ 363.02[7] (citing cases).

Finally, some courts, and in particular the U.S. Court of Appeals for the Third Circuit, have generally allowed or disallowed bid protections, including break-up fees, according to the standards governing the allowance of administrative expenses under section 503(b). *See In re Reliant Energy Channelview LP*, 594 F.3d 200 (3d Cir. 2010); *Calpine Corp. v. O'Brien Envtl. Energy, Inc. (In re O'Brien Envtl. Energy, Inc.)*, 181 F.3d 527, 535 (3d Cir. 1999); *accord In re Acis Cap. Mgmt., L.P.*, 604 B.R. 484, 517 (N.D. Tex. 2019); *In re President Casinos, Inc.*, 314 B.R. 786, 788 (Bankr. E.D. Mo. 2004).

Section 503(b) of the Bankruptcy Code provides in pertinent part that, "[a]fter notice and a hearing, there shall be allowed, administrative expenses, ... including—(1)(A) the actual, necessary costs and expenses of preserving the estate." 11 U.S.C. § 503(b). According to the Third Circuit, for a claim to be entitled to administrative expense status under this provision, it must "arise from a [postpetition] transaction with the debtor-in-possession," and "be beneficial to the debtor-in-possession in the operation of the business." *O'Brien*, 181 F.3d at 532–33; *accord In re Philadelphia Newspapers, LLC*, 690 F.3d 161, 172–73 (3d Cir. 2012).

In *O'Brien*, the debtor sought court approval of a stalking-horse agreement prior to a planned auction of its assets. The

bankruptcy court refused to approve the break-up fee and expense reimbursement provisions, expressing concern that allowing such fees and expenses would chill or unnecessarily complicate the bidding process. After the auction, the losing stalking-horse bidder filed an application seeking allowance of more than $4 million in fees and expenses under section 503(b). The bankruptcy court denied the application, and the bidder appealed.

The Third Circuit ultimately affirmed. It concluded that there was no "compelling justification for treating an application for break-up fees under § 503(b) differently from other applications for administrative expenses under the same provision," meaning that the requesting party must "show that the fees were actually necessary to preserve the value of the estate." *O'Brien*, 181 F.3d at 535. The Third Circuit also determined that, although "the business judgment rule should not be applied as such in the bankruptcy context … , the considerations that underlie the debtor's judgment may be relevant to the Bankruptcy Court's determination on a request for break-up fees and expenses." *Id.*

In *Reliant*, Kelson Channelview LLC ("Kelson") submitted the winning bid in a private auction of the debtors' Texas power plant. Under the agreement with Kelson, the debtors were required to seek an order of the court either authorizing the sale without a public auction or approving bid protections for Kelson, including a $5 million minimum overbid threshold, a $15 million break-up fee, and reimbursement of up to $2 million in expenses.

Before the bankruptcy court could rule on the motion, a competing bidder—Fortistar, LLC ("Fortistar")—asserted that it was willing to enter a "higher and better" bid, but claimed that the $15 million break-up fee and the $2 million expense reimbursement would deter its competing bid. The court ruled that a public auction was necessary. It also refused to approve the $15 million break-up fee for Kelson, but approved both the $5 million overbid threshold and the expense reimbursement provision.

Fortistar's winning bid at the auction topped Kelson's previous bid by $32 million. The bankruptcy court approved the sale and authorized the debtors to pay Kelson approximately $1.2 million in expenses, but no break-up fee. After the district court affirmed on appeal, Kelson appealed to the Third Circuit.

The Third Circuit affirmed. Applying the *O'Brien* standard, the Third Circuit explained that there are two ways that a break-up fee can preserve the value of an estate: (i) by inducing the stalking-horse bidder to make an initial bid; and (ii) by inducing the bidder to adhere to its bid after the court orders an auction. According to the Third Circuit, the bankruptcy court correctly found that neither condition was satisfied in this case. The Third Circuit also concluded that any benefit to the estates was outweighed by the potential harm to the estates that a breakup fee would cause by deterring other bidders.

The U.S. Court of Appeals for the Fifth Circuit adopted a more nuanced approach to the issue in *In re ASARCO, L.L.C.*, 650 F.3d 593 (5th Cir. 2011). In *ASARCO*, the bankruptcy court granted the debtor's request to reimburse all qualified bidders for their expenses prior to an auction. The Fifth Circuit was not persuaded that *Reliant* and *O'Brien* should apply when a debtor requests the authority to reimburse expense fees "for second-round 'qualified bidders' in a multiple stage auction for a very unique and very valuable but possibly worthless asset." *Id.* at 602. Instead, because the bankruptcy court in *ASARCO* approved the expense reimbursement before any potential qualified bidders had incurred any due diligence and work fees, the Fifth Circuit "conclude[d] that the business judgment standard is the better fit for assessing ASARCO's reimbursement motion." *Id.*

Under the *ASARCO* approach, a request for approval of bid protections prior to an asset sale under section 363(b) should be examined under the business judgment standard, whereas a post-sale request for such protections not previously authorized by the bankruptcy court must be scrutinized under section 503(b).

BOUCHARD

In September 2020, ocean-going petroleum barge company Bouchard Transportation Company, Inc. and its affiliates (collectively, "BTC") filed for chapter 11 protection in the Southern District of Texas. BTC decided to sell substantially all of its assets (principally vessels) under section 363(b) of the Bankruptcy Code and sought court approval for a public auction and proposed bidding procedures. The bankruptcy court approved bidding procedures that allowed BTC to offer bid protections to an as-yet-unnamed stalking-horse bidder, including a break-up fee not to exceed 3% of the cash purchase price and expense reimbursement in an amount to be agreed upon by BTC and the stalking-horse bidder. The order approving the procedures established deadlines for designation and court approval of a stalking-horse bidder and for the filing of any objections to either the stalking-horse bidder, the bid protections, or the auction process.

Because BTC failed to generate significant interest in its fleet, either as a whole or in part, those deadlines were extended several times with the consent of the unsecured creditors' committee (the "committee"). Ultimately, BTC's board considered bids from only two prospective purchasers—Hartree Partners, LP ("Hartree") and Centerline Logistics Corp. ("Centerline"). Centerline submitted a bid to purchase 31 vessels pledged as collateral to postpetition lender JMB Capital Partners Lending ("JMB") and 19 additional vessels securing BTC's prepetition revolving-credit facility. Hartree bid only for the vessels securing the JMB loan.

The board decided not to proceed with the Centerline bid because it was unclear whether Centerline could obtain the necessary financing. Instead, on July 18, 2021, it agreed to sign a stalking-horse sale agreement with Hartree in anticipation of the auction. The agreement provided for a $3.3 million break-up fee equal to 3% of Hartree's $110 million bid and expense reimbursement up to $1.5 million. The agreement also included a $500,000 minimum overbid threshold. Thus, taking into account the

minimum overbid, the break-up fee, and reimbursable expenses, the agreement established a floor price of approximately $115 million for the covered vessels.

BTC filed a notice of the selection of Hartree as the stalking-horse bidder and the terms of the stalking-horse agreement on July 18, 2021. BTC never obtained court approval of the agreement, and the auction took place the following day. No party objected prior to the auction.

At the auction, the 19 vessels pledged to secure BTC's prepetition credit facility sold for $130 million. JMB outbid Hartree for the remaining 31 vessels by submitting a bid in the amount of $115.3 million. During the auction, the committee stated that it did not support the bid protections in the stalking-horse agreement. Two days later, the committee filed an objection to Hartree's designation as the stalking horse and to the bid protections. The committee argued that the bid protection request should be evaluated and denied under section 503(b).

The bankruptcy court approved the asset sale on August 5, 2021, but deferred any ruling on the bid protections. Acknowledging that it was unclear which standard should apply (i.e., section 363(b) or section 503(b)), the bankruptcy court later ruled that the stalking-horse agreement, including the bid protections, satisfied either standard because the agreement "certainly" conferred a benefit on the estate and BTC's decision to offer the bid protections to Hartree was "a knowing, intelligent, and thoughtful decision." The court allowed the break-up fee in full, but reduced the expense reimbursement cap to $1 million.

The committee appealed to the district court, which affirmed the ruling below and dismissed the appeal.

Like the bankruptcy court, the district court declined to decide whether section 363(b) or section 503(b) applied, but that the payments passed muster under either standard.

The district court distinguished the case before it from *O'Brien* and *Reliant*, where, after an auction, the losing stalking-horse bidders sought payment of fees and expenses that the bankruptcy court refused to approve prior to the auction. Instead, it noted, this case was more similar to *ASARCO*, the leading Fifth Circuit precedent on the issue.

The district court wrote that *ASARCO*, *O'Brien*, and *Reliant* were relevant, "but materially different from the facts of this case." *In re Bouchard Transp. Co., Inc.*, 639 B.R. 697, 710 (S.D. Tex. 2022), *aff'd*, 74 F.4th 743 (5th Cir. 2023). It explained that, because the bankruptcy court in this case never approved the final stalking-horse agreement before the auction, the court's rationale in *ASARCO* suggests that the section 503(b) standard should apply. However, the district court noted, the bankruptcy court did generally authorize BTC to provide bid protections within certain parameters prior to the auction, suggesting that the stalking-horse agreement should be reviewed under the business judgment test applied under section 363(b).

Given the "unusual facts of this case," the district court, like the bankruptcy court, ultimately declined to decide which standard should apply because it agreed with the bankruptcy court's determination that both standards were satisfied.

The district court explained that, although the bankruptcy court did not make detailed findings regarding the benefit the estate derived from the break-up fee and expense reimbursement, the record supported its conclusion that these bid protections satisfied the test for administrative expense status under section 503(b). Among other things, the stalking-horse agreement, although never approved by the bankruptcy court, "was a valid postpetition transaction," and Hartree "provided [BTC] with a service—acting as the stalking-horse bidder—and then sought payment for providing that service in the form of the bid protections offered in the stalking-horse agreement." *Id.* at 714-15.

In addition, the district court found that the bid protections were "actual and necessary expenses" given the difficulties encountered by BTC in finding prospective purchasers, the risks associated with a "naked auction," and evidence demonstrating that the bid protections were reasonable and necessary to induce Hartree to bid. *Id.* at 716–17. Finally, it noted, had there been no bidders at the auction, JMB would have foreclosed on its collateral, which would have led to "a host of other undesirable consequences," including the estate's administrative insolvency, conversion of the chapter 11 cases to chapter 7 liquidations, and "costly and uncertain litigation" among the parties. *Id.* at 718 n.3 (internal quotation marks omitted).

The district court also found no error in the bankruptcy court's conclusion that BTC's agreement to offer the bid protections satisfied the business judgment test under section 363(b). According to the district court, BTC's board reasonably concluded that an auction was in the best interests of the estate, attempted to market BTC's assets, and, once those marketing efforts generated little interest, made thoughtful and knowing decisions regarding the auction and the stalking-horse agreement, including the bid protections, after engaging in substantial negotiations. "The record is clear," the court wrote, "that the board acted in good faith, that it acted in the best interests of the estates, and that it reasonably believed that a stalking-horse bid was necessary for a successful auction, given the demonstrated low interest in bidding." *Id.* at 721.

The committee appealed the district court's ruling to the Fifth Circuit, which took the opportunity to revisit the standard for approving bid protections in connection with bankruptcy assets sales.

THE FIFTH CIRCUIT'S RULING

A three-judge panel of the Fifth Circuit affirmed.

Writing for the panel, U.S. Circuit Judge Jerry E. Smith acknowledged the disagreement among courts concerning the standard for approving bid protections. Like the district court, Judge Smith concluded that "*ASARCO*—our leading precedent on the issue—gives mixed signals about which provision applies to these facts" because the case "is somewhere between the two situations that *ASARCO* described." *Bouchard*, 74 F.4th at 751. For this reason, the Fifth Circuit, like the lower courts, declined to decide which standard should apply because "[u]nder either standard, the stalking horse payment was legal." *Id.*

Addressing section 503(b)—"the more stringent provision"—Judge Smith explained that the provision requires merely that the expenses were incurred "'as a result of actions taken by the debtor,' and that those actions occurred after bankruptcy," which was clearly the case here. *Id.* (quoting *Nabors Offshore Corp. v. Whistler Energy II, L.L.C. (In re Whistler Energy II)*, 931 F.3d 432, 441 (5th Cir. 2019)). The Fifth Circuit rejected the committee's argument that the Hartree asset purchase agreement was not a valid postpetition transaction because it was not enforceable until approved by the bankruptcy court. According to Judge Smith, by focusing on the agreement rather than its postpetition nature, "the Committee reads the 'post-petition agreement' requirement too strictly." He explained that "an agreement for services in bankruptcy is enforceable even if the 'post-petition business relationship [is] not … clearly defined.'" *Id.* (quoting *Whistler*, 931 F.2d at 442).

Judge Smith further noted that "although the associated fees [promised to Hartree] were dependent on court approval, that does not affect the postpetition nature of the transaction." "Indeed," he wrote, "§ 503(b) implicitly contemplates that debtors will incur postpetition administrative expenses before they seek court authorization." *Id.* at 752 (citing sections 503(a)–(b), which provide that "[a]n entity may timely *file a request* for payment of an administrative expense, … [and] [a]fter notice and a hearing, there shall be *allowed*, administrative expenses" (emphasis added)).

The Fifth Circuit found no error in the lower courts' findings that the break-up fee and expense reimbursement provided numerous benefits to the estate by, among other things: (i) securing Hartree's participation as a stalking horse and thereby avoiding a "naked auction"; and (ii) forcing JMB to pay more for BTC's vessels than it otherwise would have, which was essential to pay BTC's nearly $100 million in postpetition debts and to obtain confirmation of its chapter 11 plan. Judge Smith rejected the committee's argument that the bid protections did not benefit the entirety of the estate, but merely "JMB and certain senior creditors while providing no recovery to other creditors." *Id.* at 753. According to the Fifth Circuit, "a benefit is still a benefit even if it helps only secured creditors" and because "[u]nsecured creditors are in the back of the line, … sometimes that comes with downsides." *Id.*

In addition, the Fifth Circuit panel agreed with the lower courts that the bid protections were "necessary" to obtain those benefits because, among other things, Hartree would not have served as the stalking-horse bidder without them. Judge Smith wrote that:

> Considering the totality of the evidence, it is "plausible" both that Hartree's stalking horse bid created a benefit for the estate and that Hartree would not have served as the stalking horse bidder without the prospect of fees. It is also plausible that JMB only bid $115.3 million because it was forced to beat out Hartree. Therefore, the break-up fee and the expense reimbursement were "necessary" administrative expenses under § 503(b).

Id. at 755.

Finally, the Fifth Circuit did not fault the lower courts' determination that the bid protections passed muster under the business judgment standard applied under section 363(b). Given the facts of the case, Judge Smith wrote, "the stalking horse arrangement was the lesser of multiple evils" and, in signing the Hartree purchase agreement, BTC "acted well within the bounds of reasonable judgment," which is all that is required under section 363(b). *Id.* at 756.

OUTLOOK

Bouchard is an unusual case. It does not fit neatly into the framework established by the Fifth Circuit's binding precedent in *ASARCO* that pre-sale proposed bid protections be judged under the business judgement standard, whereas post-sale requests for such protections must be subjected to more exacting scrutiny under the estate-benefit analysis demanded by section 503(b). As a consequence, the bankruptcy and appellate courts examined the bid protections under both standards, and concluded that both were satisfied.

Given BTC's failure to seek court approval of the stalking-horse agreement prior to the auction (as it was obligated to do by court order) and the single day between the committee's receipt of notification that the agreement had been signed and the auction, the committee's objections were arguably understandable. As a result of approval of the auction results and the payment of a break-up fee and expenses to Hartree, unsecured creditors received little or nothing from BTC's estate. Even so, the committee was clearly aware that the court had already authorized bid protections for an as-yet-unnamed stalking horse.

In the end, the Fifth Circuit agreed with the lower courts' conclusion that BTC and its board of directors made the best of a bad situation in a way that passed muster under either section 503(b) or section 363(b).

NEW YORK BANKRUPTCY COURT: FOREIGN REPRESENTATIVE IN CHAPTER 15 CASE NEED NOT BE APPOINTED BY FOREIGN COURT

Corinne Ball • Dan T. Moss • Michael C. Schneidereit
David S. Torborg • Isel M. Perez • Ryan Sims

In most cases seeking recognition of a foreign bankruptcy proceeding in the United States under chapter 15 of the Bankruptcy Code, the foreign debtor's "foreign representative" has been appointed by the foreign court or administrative body overseeing the debtor's bankruptcy case. However, this is not always the case, especially if the foreign debtor retains operating control over its operations under court supervision as the functional equivalent of a chapter 11 debtor-in-possession ("DIP") with the power to appoint individuals or entities to represent it even without formal court approval.

The U.S. Bankruptcy Court for the Southern District of New York confronted this scenario in *In re Agro Santino, OOD*, 653 B.R. 79 (Bankr. S.D.N.Y. 2023). The court granted a petition for chapter 15 recognition of a Bulgarian bankruptcy proceeding even though the debtor's foreign representative was appointed by the foreign debtor's manager pursuant to a power of attorney ("PoA") rather than an order of the foreign court. According to the U.S. bankruptcy court, because the Bulgarian debtor was the functional equivalent of a DIP with the power to appoint foreign representatives, the individual appointed by the debtor in the PoA as its "foreign representative" qualified as such for purposes of chapter 15 eligibility and recognition.

RECOGNITION OF FOREIGN BANKRUPTCY CASES UNDER CHAPTER 15

Chapter 15 was enacted in 2005 to govern cross-border bankruptcy and insolvency proceedings. It is patterned on the 1997 UNCITRAL Model Law on Cross-Border Insolvency (the "Model Law"), which has been enacted in some form by more than 50 countries.

Under section 1515(a) of the Bankruptcy Code, the representative of a foreign debtor may file a petition in a U.S. bankruptcy court seeking "recognition" of a "foreign proceeding." Section 101(24) of the Bankruptcy Code defines "foreign representative" as "a person or body, including a person or body appointed on an interim basis, authorized in a foreign proceeding to administer the reorganization or the liquidation of the debtor's assets or affairs or to act as a representative of such foreign proceeding." The Bankruptcy Code defines "person" to include an "individual." *See* 11 U.S.C. § 101(41).

Section 1515(b) provides that:

> A petition for recognition shall be accompanied by—
> (1) a certified copy of the decision commencing such foreign proceeding and appointing the foreign representative;
> (2) a certificate from the foreign court affirming the existence of such foreign proceeding and of the appointment of the foreign representative; or
> (3) *in the absence of evidence referred to in paragraphs (1) and (2), any other evidence acceptable to the court of the existence of such foreign proceeding and of the appointment of the foreign representative.*

11 U.S.C. § 1515(b) (emphasis added).

Under section 1516(a), "[i]f the decision or certificate referred to in section 1515(b) indicates that the foreign proceeding is a foreign proceeding and that the person or body is a foreign representative, the [U.S. bankruptcy] court is entitled to so presume." However, in the absence of any such order or certificate, no such presumption is created, and the petition must be accompanied by "any other evidence acceptable to the court of the existence of such foreign proceeding and of the appointment of the foreign representative." *In re PT Bakrie Telecom Tbk*, 601 B.R. 707, 716 (Bankr. S.D.N.Y. 2019).

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

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

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

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

An "establishment" is defined by section 1502(2) as "any place of operations where the debtor carries out a nontransitory economic activity." Unlike with the determination of COMI, there is no statutory presumption regarding the determination of whether a foreign debtor has an establishment in any particular location. U.S. bankruptcy courts weigh a variety of considerations to determine whether nontransitory economic activity exists in the applicable jurisdiction, including where the debtor engages in local business activity and such business has an effect on the local market, the presence of an asset together with some degree of management of such asset, a minimum level of organization that is stable and apparent to third parties, and the activities of other entities within an integrated corporate group.

MUST A FOREIGN REPRESENTATIVE BE APPOINTED BY THE FOREIGN COURT?

In *PT Bakrie*, the unsecured noteholders of a subsidiary of an Indonesian telecommunications company that guaranteed $380 million of the notes argued that the U.S. bankruptcy court should refuse to recognize the parent company's "suspension of payments" proceeding in a Jakarta court. Among other things, the noteholders argued that the appointment of the debtor's foreign representative was invalid under Indonesian law because the foreign debtor's board of directors did not have the authority to appoint the representative unilaterally without the consent of the debtor's court-appointed administrators.

The bankruptcy court rejected this argument, initially explaining that the requirement that a foreign representative be authorized directly by a foreign court or administrative body in a foreign proceeding "is not an onerous one." *PT Bakrie*, 601 B.R. at 717. It further noted that, in *Ad Hoc Grp. Of Vitro Noteholders v. Vitro, S.A.B. de C.V. (In re Vitro, S.A.B. de C.V.)*, 470 B.R. 408 (N.D. Tex. 2012), *aff'd*, 701 F.3d 1031 (5th Cir. 2012), the courts rejected the same argument regarding a foreign representative appointed by the debtor's board of directors without the consent of a court-appointed administrator. According to the *PT Bakrie* bankruptcy court, the "ultimate issue" was whether the purported representative's appointment comported with sections 101(24), 1515, and 1517 of the Bankruptcy Code, rather than Indonesian law.

In *Vitro*, the debtor, a Mexican holding company, appointed two individuals to file a Mexican bankruptcy case on its behalf as well as a petition seeking chapter 15 recognition of its Mexican bankruptcy case. The U.S. bankruptcy court entered an order recognizing the debtor's Mexican bankruptcy case even though the debtor's foreign representatives were not appointed by the Mexican court. An ad hoc group of the debtor's noteholders appealed, arguing that the foreign representatives did not satisfy section 101(24) because neither representative was directly approved by the Mexican bankruptcy court.

The U.S. District Court for the Northern District of Texas affirmed. The district court interpreted the language of section 101(24) more broadly "to mean authorized *in the context* of a foreign bankruptcy proceeding." *Vitro*, 470 B.R. at 411. Foreign representatives appointed by a corporation engaged in a foreign bankruptcy case, the court reasoned, would therefore be considered "authorized in a foreign proceeding." The district court noted that case law suggests a debtor is permitted to appoint its own foreign representative and that under Mexican law, a debtor—like a DIP in the United States—is generally authorized to manage its business during a bankruptcy case.

According to the district court, although there are differences between the two nations' concepts of a DIP, the difference is not so great as to preclude the debtor from appointing its own foreign representative under section 101(24). The court also emphasized that the question of whether a foreign representative is

qualified is a matter of U.S. law. The district court concluded that the debtor's appointment of its foreign representatives satisfied the requirements of section 101(24).

The U.S. Court of Appeals for the Fifth Circuit affirmed on appeal, noting that the representatives were "not disqualified from serving as foreign representatives merely because they were not the subject of an official court appointment." *Vitro*, 701 F.3d at 1049. Examining the language of section 101(24), the Fifth Circuit noted that the provision is "wholly devoid of any statement that a foreign representative must be judicially appointed." *Id.* at 1047. Moreover, it reasoned, section 101(24)'s "requirement that a representative be 'authorized in a foreign proceeding' is certainly compatible with appointment by a foreign court, but it is hardly necessary" because it would also be compatible with a requirement that a representative be appointed *in the context* of a foreign proceeding or *during* a foreign proceeding. *Id.*

Looking for guidance to the Model Law, the Fifth Circuit explained that, in drafting the Model Law definition of "foreign representative" upon which section 101(24) is patterned, the UNCITRAL Working Group on Insolvency Law expressly rejected any requirement that a foreign representative be specifically authorized by statute or court order to act in connection with a foreign proceeding. *Id.* at 1048. In addition, the Fifth Circuit noted, the Working Group "clearly intended to include foreign representatives of proceedings in which a debtor in possession remains in control of its assets"—a conclusion shared by the National Bankruptcy Review Commission created by U.S. lawmakers in 1994 based upon its review of the (then draft) Model Law. *Id.*

The Fifth Circuit also rejected the noteholders' argument that foreign law determines whether an entity or individual qualifies as a "foreign representative" for purposes of chapter 15. Instead, the court explained, section 101(24) governs that determination, and it is satisfied if the proposed representative is authorized in a foreign proceeding to "act as a representative of such proceeding," or if the proposed representative is authorized "to administer the reorganization of the liquidation of the debtor's assets or affairs." *Id.* at 1049 (quoting section 101(24)).

The Fifth Circuit explained that the relevant inquiry under section 101(24) is whether the representatives had "administrative power over the reorganization of [the debtor's] business." *Id.* The Fifth Circuit agreed with the lower courts that this was the case because the debtor was acting as the functional equivalent of a DIP under U.S. law.

Other courts have similarly concluded that a foreign representative need not be appointed by a foreign bankruptcy court to qualify as a foreign representative under chapter 15. *See, e.g., In re Servicos de Petroleo Constellation S.A.*, 600 B.R. 237, 270 (Bankr. S.D.N.Y. 2019) (concluding that a representative appointed pursuant to Brazilian debtors' corporate resolutions was a proper "foreign representative" within the meaning of section 101(24) and thus met the section 1517(a)(2) eligibility requirements); *In re Cell C Proprietary Ltd.*, 571 B.R. 542, 553 (Bankr. S.D.N.Y. 2017) (recognizing that a South African debtor's board resolution appointing foreign representatives satisfied section 101(24)); *In re OAS S.A.*, 533 B.R. 83, 98 (Bankr. S.D.N.Y. 2015) (a foreign representative appointed by a debtor's board of directors satisfied section 101(24)).

AGRO SANTINO

Agro Santino OOD (the "debtor") is a limited liability company formed under the laws of the Republic of Bulgaria formerly engaged in the production and sale of agricultural products. It has 12 shareholders and is run by a single manager wielding exclusive executive and managerial authority.

In 2017, the debtor opened a commodities futures and option contract trading account with StoneX Markets LLC ("StoneX") to hedge its exposure to price declines in the crops that it grew and maintained in inventory. In August 2018, StoneX presented the debtor with a margin call in the amount of $2.2 million due to substantial losses suffered by the debtor on its open positions. The debtor made margin payments in the amount of $825,000, but disputed the remaining liabilities under its account. StoneX then liquidated the debtor's open positions and set off the proceeds from the liquidation against the outstanding margin call, leaving

a net settlement amount of approximately $1.3 million, which the debtor refused to pay.

Based on its right to payment under the account agreement with the debtor, StoneX obtained a preliminary injunction from a Bulgarian court freezing all of the debtor's Bulgarian bank accounts to the extent of the net settlement amount plus interest and costs. An appellate court later affirmed the preliminary injunction order.

Because the account agreement was governed by New York law and included a New York State or New York federal forum selection clause, StoneX sued the debtor in March 2020 in the U.S. District Court for the Southern District of New York to collect the net settlement amount. The debtor counterclaimed, seeking to recover the proceeds from its liquidated positions and the entirety of its net trading losses with StoneX (in excess of $1.5 million).

In July 2021, one of the debtor's creditors filed an insolvency proceeding against the debtor in a Bulgarian court. StoneX joined in the petition.

In March 2022, the Bulgarian court issued a judgment under the Bulgarian Commercial Act (the "BCA") initiating a Bulgarian bankruptcy proceeding (the "Bulgarian Proceeding"), finding that the debtor was unable to pay its debts as they matured. In accordance with the BCA, the debtor continued to operate its business under the supervision of a court-appointed trustee, but was required to obtain the prior consent of the trustee to "conclude new transactions."

On March 31, 2022, the debtor's manager executed a PoA appointing attorney Yordanka Ivanova Panchovska ("Panchovska") as the debtor's "attorney in fact and agent." The PoA granted Panchovska:

> the full extent of [the debtor's] authority [to] represent it in all matters related in any way whatsoever to the Bulgarian commercial bankruptcy case in which [the debtor] is a debtor … currently before the [Bulgarian court] … including for purposes of seeking any relief available to a "foreign representative" (as that term is defined in U.S. Code, Title 11, Section 101) under U.S. Code, Title 11, Chapter 15, and any other applicable United States legislation and/or relevant court rules) without limitation or exclusion to the maximum extent permitted by law.

The court-appointed trustee did not approve the debtor's retention of Panchovska, but the trustee never formally objected to the retention.

On June 15, 2022, Panchovska, as the debtor's putative "foreign representative," filed a petition in the U.S. Bankruptcy Court for the Southern District of New York seeking chapter 15 recognition of the Bulgarian Proceeding as a foreign main proceeding, as well as a determination that Panchovska is the debtor's "foreign representative" within the meaning of section 101(24).

StoneX objected to recognition, arguing that the debtor had not demonstrated that Panchovska qualified as its foreign representative because her appointment in that capacity violated the relevant provisions of the BCA, having never been approved by the trustee. StoneX also argued that the U.S. bankruptcy court must apply Bulgarian law to determine whether Panchovska could serve as the debtor's foreign representative in its chapter 15 case.

THE BANKRUPTCY COURT'S RULING

The U.S. bankruptcy court granted the petition for chapter 15 recognition of the Bulgarian Proceeding.

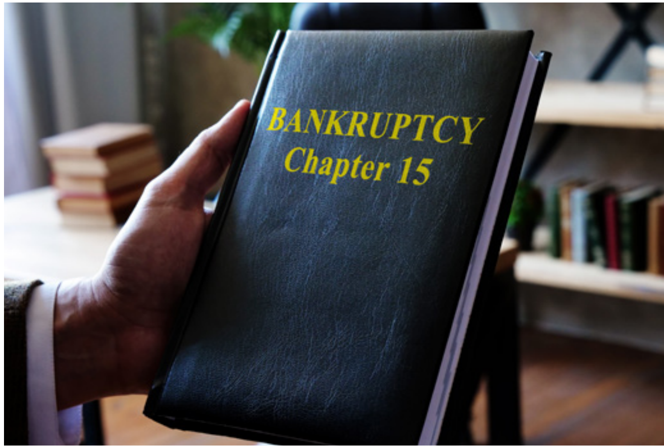
Initially, U.S. Bankruptcy Judge James L. Garrity, Jr. concluded that, other than the requirement in section 1515(a) that the debtor's chapter 15 petition be filed by its "foreign representative," the Bulgarian Proceeding clearly satisfied all of the requirements for recognition under chapter 15.

Next, Judge Garrity agreed with *Vitro* that the relevant issue in assessing whether Panchovska qualified as a "foreign representative" for purposes of chapter 15 recognition is whether section 101(24) was satisfied, "i.e., whether the foreign debtor [is] the functional equivalent of a debtor in possession" with the power to appoint foreign representatives. *Agro Santino*, 653 B.R. at 94.

According to Judge Garrity, the unrefuted evidence, including the PoA, correspondence between the trustee and the debtor's manager, and correspondence between the manager and the Bulgarian court notifying it of the filing of the chapter 15 case, demonstrated that the debtor was acting as the functional equivalent of a DIP, "as contemplated by section 101(24)"—a point that was not contested by StoneX. *Id.* at 95. The U.S. bankruptcy court accordingly found that "[the debtor] retains the ability to operate as a debtor in possession during the Bulgarian insolvency, and … has sufficient authority to authorize Ms. Panchovska to act as the foreign representative in this insolvency." *Id.*

Although reluctant to opine on questions of Bulgarian law in keeping with principles of comity, Judge Garrity explained, but did not decide, that Panchovska's appointment as the debtor's foreign representative was likely valid under the BCA despite StoneX's contention that the appointment was "a new transaction" requiring the trustee's approval. Among other things, Judge Garrity was skeptical that the debtor was required by the BCA to seek the trustee's approval before retaining an attorney to coordinate the insolvency process. Moreover, he wrote, "[t]ellingly, this Court has not been apprised of any actions taken by the Trustee to challenge Ms. Panchovska's appointment," nor were there any actions taken by the Bulgarian court to prevent Panchovska's participation in the debtor's chapter 15 case. *Id.* at 97 and n.17.

The U.S. bankruptcy court accordingly recognized the Bulgarian Proceeding as a foreign main proceeding under chapter 15.



OUTLOOK

Agro Santino does not represent a sea change regarding the requirements for the appointment of a foreign representative in a chapter 15 case. Even so, the ruling is significant for a number of reasons.

First, the decision clarifies that a foreign representative need not be appointed by the foreign court overseeing a foreign debtor's bankruptcy or insolvency proceeding, as evidenced by a certified court order or certificate described in sections 1515(b)(1) and 1515(b)(2) of the Bankruptcy Code. Instead, as contemplated by section 1515(b)(3), in the absence of such an order or certificate, a U.S. bankruptcy court, in assessing whether recognition of a foreign bankruptcy case is warranted under chapter 15, may rely on "any other evidence acceptable to the court of the existence of such foreign proceeding and of the appointment of the foreign representative." According to *Agro Santino* (and other similar rulings), such evidence can include evidence demonstrating that the foreign debtor is the "functional equivalent" of a DIP, and therefore has the authority to direct its affairs, including the power to appoint a foreign representative—via power of attorney or otherwise—to seek recognition of the foreign debtor's bankruptcy case in the United States and other Model Law jurisdictions.

Second, the ruling clarifies that U.S. law (namely, section 101(24) of the Bankruptcy Code), rather than the law governing a foreign debtor's bankruptcy or insolvency case, determines whether the debtor's representative qualifies as a "foreign representative" for purposes of chapter 15 eligibility and recognition.

Third, *Agro Santino* and other similar rulings effectively reduce barriers to chapter 15 access, particularly in cases involving foreign jurisdictions that have adopted restructuring frameworks that do not contemplate courts or other administrative bodies formally appointing foreign representatives (e.g., the German Corporate Stabilization and Restructuring Act and the Dutch Act on Confirmation of Extrajudicial Plans (*Wet Homologatie Onderhands Akkoord*).

CURE AND REINSTATEMENT OF DEFAULTED LOAN UNDER CHAPTER 11 PLAN REQUIRES PAYMENT OF DEFAULT-RATE INTEREST

Oliver S. Zeltner

Section 1124(2) of the Bankruptcy Code gives chapter 11 debtors a valuable tool for use in situations where long-term prepetition debt carries a significantly lower interest rate than the rates available at the time of emergence from bankruptcy. Under this section, in a chapter 11 plan, the debtor can "cure" any defaults under the relevant agreement and "reinstate" the maturity date and other terms of the original agreement, thus enabling the debtor to "lock in" a favorable interest rate in a prepetition loan agreement upon bankruptcy emergence.

For decades, however, courts have struggled to determine exactly what a debtor must do to cure defaults, for purposes of cure and reinstatement in a chapter 11 plan, where payment terms under the loan agreement have been accelerated and the agreement requires the payment of a higher default rate of interest. Certain Bankruptcy Code provisions added by Congress in 1994 left uncertain whether a debtor must pay the default rate of interest to cure and reinstate a lender's claim under such an agreement.

On the one hand, section 1123(d) of the Bankruptcy Code provides that, if a chapter 11 plan proposes to cure a default under a contract, the cure amount must be determined in accordance with the underlying agreement and applicable nonbankruptcy law. This provision facially suggests that a debtor must pay a contractual default rate of interest to cure and reinstate a lender's prepetition claim, to the extent the payment of default interest is in accordance with non-bankruptcy (usually state) law.

On the other hand, section 365(b)(2)(D) of the Bankruptcy Code—which Congress incorporated into section 1124(2)—provides that curing defaults for purposes of the debtor's assumption of an executory contract or unexpired lease does not require the debtor to satisfy "any penalty rate or penalty provision relating to a default arising from any failure by the debtor to perform nonmonetary obligations under the executory contract or unexpired lease." 11 U.S.C. § 365(b)(2)(D). Debtors frequently point to section 365(b)(2)(D) in arguing that cure and reinstatement under section 1124(2) of the Bankruptcy Code should not require payment of a contractual default interest rate.

A substantial majority of courts, including the U.S. Courts of Appeals for the Ninth and Eleventh Circuits, have held that such a cure amount must include any default-rate interest required under either the contract or applicable nonbankruptcy law. However, the arguable dissonance between section 1123(d) and section 365(b)(2)(D) of the Bankruptcy Code has long been a source of consternation in the bankruptcy courts.

The U.S. Bankruptcy Court for the Southern District of New York addressed this conundrum in *In re Golden Seahorse LLC*, 652 B.R. 593 (S.D.N.Y. 2023). The court ruled that, based upon a close examination of sections 365(b)(2)(D), 1123(d), and 1124(2) of the Bankruptcy Code, a debtor was obligated to pay default-rate interest to cure a monetary default under a loan that would be reinstated in a chapter 11 plan.

CURE AND REINSTATEMENT UNDER A CHAPTER 11 PLAN

Upon the occurrence of an event of payment default under a loan agreement, the lender generally has the right to accelerate the loan and exercise its legal and contractual collection remedies. However, if the borrower files for chapter 11 protection, the lender must refrain from exercising such remedies unless it obtains relief from the automatic stay to do so. As long as the stay remains in place, the borrower as a chapter 11 debtor-in-possession can propose a plan that decelerates a defaulted loan, "cures" any defaults (with certain exceptions), and reinstates the original terms of the debt—in effect, "roll[ing] back the clock to the time before the default existed." *MW Post Portfolio Fund Ltd. v. Norwest Bank Minn., N.A. (In re Onco Inv. Co.)*, 316 B.R. 163, 167 (Bankr. D. Del. 2004); *see also* 11 U.S.C. § 1123(a)(5)(G) (providing that a plan shall provide adequate means for its implementation, such as "curing or waiving of any default").

To the extent that its claim is not "impaired" under the terms of the proposed plan, the lender will be deemed to have accepted the plan and will not be entitled to vote on it. *See* 11 U.S.C. § 1126(f). Even though the lender is precluded from enforcing its contractual right of acceleration, the lender's claim will be deemed unimpaired if the plan: (i) cures any defaults, "other than a default of a kind specified in section 365(b)(2) … or of a kind that section 365(b)(2) expressly does not require to be cured"; (ii) reinstates the pre-default maturity of the debt; (iii) compensates the lender for any damages sustained due to reasonable reliance on its contractual or legal ability to accelerate the debt; (iv) compensates the lender for any actual pecuniary loss arising from the debtor's failure to perform a nonmonetary obligation; and (v) does not "otherwise alter the legal, equitable, or contractual rights" of the lender. *See* 11 U.S.C. § 1124(2).

Under section 365(b) of the Bankruptcy Code, if there has been a default in an executory contract or unexpired lease, the trustee or chapter 11 debtor-in-possession may not assume the contract or lease without, among other things, curing the default (or providing adequate assurance of prompt cure):

> other than a default that is a breach of a provision relating to the satisfaction of any provision (other than a penalty rate or penalty provision) relating to a default arising from any failure to perform nonmonetary obligations under an unexpired lease of real property, if it is impossible for the trustee to cure such default by performing nonmonetary acts at and after the time of assumption… .

11 U.S.C. § 365(b)(1)(A). In addition, Congress added section 365(b)(2)(D) to the Bankruptcy Code in 1994. As noted above, that section provides that section 365(b)(1)'s cure obligation does not apply to any default that is a breach of a provision pertaining to "the satisfaction of any penalty rate or penalty provision relating to a default arising from any failure by the debtor to perform nonmonetary obligations under the executory contract or unexpired lease." 11 U.S.C. § 365(b)(2)(D).

THE MEANING OF "CURE"

Prior to 1994, the Bankruptcy Code did not provide guidance as to the meaning of the term "cure," and courts were split as to whether payment of default-rate interest was required in order to cure a default under an executory contract, an unexpired lease, or a loan agreement.

In 1994, however, lawmakers added section 1123(d) to the Bankruptcy Code, which provides that, notwithstanding the entitlement of oversecured creditors to collect postpetition interest under section 506(b), the "best interests" requirement of section 1129(a)(7), and the cramdown requirements of section 1129(b), "if it is proposed in a plan to cure a default[,] the amount necessary to cure the default shall be determined in accordance with the underlying agreement and applicable nonbankruptcy law." 11 U.S.C. § 1123(d).

Section 1123(d) was enacted to abrogate the U.S. Supreme Court's decision in *Rake v. Wade*, 508 U.S. 464 (1993). In *Rake*, the Court held that, in order to cure a mortgage default under a chapter 13 plan, the mortgagee must be paid interest on the defaulted payments, including "interest on interest," regardless of whether such interest was provided for in the agreement or under state law. Congress overruled the decision by enacting section 1123(d) because the ruling "had the effect of providing a windfall to secured creditors at the expense of unsecured creditors by forcing debtors to pay the bulk of their income to satisfy the secured creditors' claims," which would include interest on interest, late charges, and other fees, "even where applicable law prohibits such interest and even when it was … not contemplated by either party in the original transaction." H.R. Rep. No. 103-835, at 55 (1994).

Most courts have interpreted section 1123(d) of the Bankruptcy Code to require the payment of default-rate interest as a condition of cure to the extent that it is required by the underlying agreement or applicable nonbankruptcy law. *See, e.g., In re Lewisberry Partners, LLC*, 2022 WL 2398694, at **15-16 (Bankr. E.D. Pa. July 1, 2022); *In re Moshe*, 567 B.R. 438, 444-45 (Bankr. E.D.N.Y. 2017); *In re 1 Ashbury Court Partners, LLC*, 2011 WL 4172010, at **4-5 (Bankr. D. Kan. Oct. 5, 2011); *In re General Growth Props., Inc.*, 451 B.R. 323, 328 (Bankr. S.D.N.Y. 2011); *In re Schatz*, 426 B.R. 24, 27 (Bankr. D.N.H. 2009); *In re Moody Nat'l SHS Houston H, LLC*, 426 B.R. 667, 672 (Bankr. S.D. Tex. 2010); *see generally* Collier on Bankruptcy ¶ 1123.04 (16th ed. 2023) (noting that "[a] majority of courts have held that to cure and reinstate a claim under a plan, the debtor must pay postdefault interest to the extent provided under the debtor's agreement with the creditor").

However, in light of its legislative history, some courts have determined that section 1123(d) should not be interpreted to require payment of default-rate interest, even where the contract provides for it. According to these courts, support for this interpretation can be found in: (i) section 365(b)(2), which, as noted previously, was also added to the Bankruptcy Code in 1994 and provides that a "penalty rate" related to the debtor's failure to perform nonmonetary obligations need not be satisfied to cure a default under an executory contract or an unexpired lease; and (ii) section 1124(2), which does not require the holder of a claim to be paid default-rate interest for the claim to be rendered unimpaired by expressly incorporating section 365(b)(2)(D)'s cure carve-out. *See In re Phoenix Bus. Park Ltd. P'ship*, 257 B.R. 517, 522 (Bankr. D. Ariz. 2001); *accord Brody v. Geared Equity, LLC*, 2014 WL 4090549,*3 (D. Ariz. Aug. 6, 2014).

Until 2016, courts in the Ninth Circuit were outliers in this debate, adhering to an approach articulated more than three decades ago—well before the enactment of section 1123(d)—by the Ninth Circuit in *Great Western Bank & Trust v. Entz-White Lumber and Supply, Inc. (Entz-White Lumber and Supply, Inc.)*, 850 F.2d 1338 (9th Cir. 1988). In *Entz-White*, the Ninth Circuit held that the payment of default-rate interest is not required to cure and reinstate a defaulted secured debt under a chapter 11 plan because cure effectively nullifies all aspects of the default and rolls back the status quo to a time prior to its occurrence. In so ruling, the Ninth Circuit relied on the Second Circuit's pre-1994 amendment ruling in *DiPierro v. Taddeo (In re Taddeo)*, 685 F.2d 24, 27, 29 (2d Cir. 1982), where the court held in a chapter 13 case that curing a default under a home mortgage "return[s the parties] to pre-default conditions" and "nullifies" the consequences of default. The Second Circuit also noted that "'curing a default' in Chapter 11 means the same thing as it does in Chapter 7 or 13; the event of default is remedied and the consequences are nullified." *Id.* at 29.

Despite the enactment of section 1123(d) and the weight of judicial authority in other circuits rejecting the *Entz-White* approach, Ninth Circuit courts, including the court of appeals, remained faithful to the *Entz-White* rule for 28 years, albeit sometimes reluctantly.

However, the primacy of *Entz-White* in the Ninth Circuit finally ended in 2016. In *In re New Invs., Inc. (Pacifica L 51 LLC v. New Invs., Inc)*, 840 F.3d 1137 (9th Cir. 2016), a divided three-judge panel of the Ninth Circuit held that "*Entz-White*'s rule of allowing a curing debtor to avoid a contractual post-default interest rate in a loan agreement is no longer valid in light of § 1123(d)."

In so ruling, the Ninth Circuit aligned itself with the Eleventh Circuit, which in 2015 rejected the *Entz-White* approach in *JPMCC 2006-LDP7 Miami Beach Lodging, LLC v. Sagamore Partners, Ltd. (In re Sagamore Partners, Ltd.)*, 620 F. App'x 864 (11th Cir. 2015). In *Sagamore*, the court ruled that "the clear mandate of § 1123 … allows a creditor to demand default-rate interest as a condition for reinstating [a defaulted] loan," to the extent that the loan agreement provided for the payment of interest at the default rate.

GOLDEN SEAHORSE

Golden Seahorse LLC (the "debtor") owned a 50-story hotel in Manhattan encumbered by a $137 million non-amortizing 10-year mortgage with an annual interest rate of 5.259% and a default interest rate of 10.259%. In May 2020, the debtor committed a payment default, and the lenders accelerated the loan. A state court later granted the lenders' motion to appoint a receiver for the property. However, in November 2022, before the receiver could take possession of the hotel, the debtor filed for chapter 11 protection in the Southern District of New York.

In its chapter 11 plan, the debtor proposed to reinstate the loan under its original terms, including the non-default interest rate (which was then significantly below market), and to treat the lenders' claim as unimpaired under section 1124(2). Alternatively, if the bankruptcy court were to conclude that the payment of default-rate interest were required (nearly $18 million), the debtor proposed to "cram down" the lenders' claim by leaving the mortgage in place and giving the lenders a restructured note bearing interest at the market rate.

The debtor and the lenders asked the bankruptcy court to rule on this issue in anticipation of the confirmation hearing.

THE BANKRUPTCY COURT'S RULING

In a painstakingly detailed opinion addressing the interaction among sections 365(b)(2)(D), 1123(d), and 1124(2) of the Bankruptcy Code, the bankruptcy court held that "to cure and reinstate its loan under a plan of reorganization, the Debtor must pay default interest and fees to the extent required by its loan agreement and New York law." *Golden Seahorse*, 652 B.R. at 616.

In his opinion, U.S. Bankruptcy Judge Philip Bentley identified the three questions before the court as follows:

(i) do §§ 1124(2) and 365(b)(2)(D) create an exception to § 1123(d)'s otherwise absolute mandate?;
(ii) does § 365(b)(2)(D)'s cure carve-out, as incorporated by § 1124(2)(A), apply to loan agreements?; and
(iii) does § 365(b)(2)(D)'s cure carve-out extend to all penalty rates, or only to those triggered by non-monetary defaults?

Id. at 605.

Surveying relevant caselaw, Judge Bentley noted that only a handful of courts—and none in the Second Circuit—have addressed the interrelationship among the three provisions in question, "and those courts have reached varying conclusions." *Id.* at 604–05. Judge Bentley rejected both the Second Circuit's ruling in *Taddeo* as well as the Ninth Circuit's (now overruled) decision in *Entz-White* as authority for the proposition that cure of defaults under a reinstated obligation as part of a chapter 11 plan does not require the payment of default-rate interest. Both cases, he emphasized, pre-dated the 1994 amendments and have been legislatively overruled. *Id.* at 604. Judge Bentley further noted that the handful of post-1994 decisions from lower courts in the Second Circuit holding that, under section 1123 and 1124, reinstatement of a debt requires the payment of default-rate interest, "curiously" make no mention of section 1124(2)'s express incorporation of the section 365(b)(2) carve-out. *Id.* (citing *In re Depietto*, 2021 WL 3287416, at **6-8 (S.D.N.Y. Aug. 2, 2021); *Moshe*, 567 B.R. at 443-47; *In re 139-141 Owners Corp.*, 306 B.R. 763 (Bankr. S.D.N.Y. 2004), *aff'd in part and vacated in part*, 313 B.R. 364, 368 (S.D.N.Y. 2004)).

Judge Bentley explained that sections 1123(d), 1124(2)(A), and 365(b)(2)(D) were not part of the Bankruptcy Code when it was enacted in 1978. Instead, he noted, those provisions were either added or amended in 1994 or 2005, "and the congressional purposes underlying these amendments are not always discernable." *Id.* at *2. Judge Bentley further explained that the "cure requirements for reinstatement and assumption w[ere] straightforward until 1994, when the passage of the Bankruptcy Reform Act threw a wrench into the works." Since that time, he stated, the amendments to sections 365(b) and 1123 "have confounded courts." *Id.* at 599.

Ultimately, Judge Bentley determined that "the carve-out created by § 1124(2)'s incorporation of § 365(b)(2)(D) must be treated as an exception to § 1123(d)'s otherwise absolute mandate." *Id.* at 605. He also adopted "the more natural reading of § 1124(2)(A): that it excuses defaults arising under loan agreements, so long as the defaults are 'of a kind' addressed by § 365(b)(2)—that is, *ipso facto* defaults, and failures to satisfy penalty rates and penalty provisions relating to non-monetary defaults." *Id.* at 608.

However, addressing the scope of section 365(b)(2)(D), which, as noted, exempts from the cure requirement "the satisfaction of any penalty rate or penalty provision relating to a default arising from any failure by the debtor to perform nonmonetary obligations under the executory contract or unexpired lease," Judge Bentley applied principles of statutory construction and "conventions of ordinary speech" to conclude that the provision "excuse[s] cure only of penalty provisions, and not also of the underlying defaults." *Id.* at 610, 615. Thus, because the debtor's default in the case before him involved a penalty rate triggered by a monetary default, rather a penalty rate resulting from failure to perform a nonmonetary obligation, the section 365(b)(2)(D) carve-out did not apply.

The bankruptcy court accordingly held that, to cure and reinstate the lender's loan under the debtor's chapter 11 plan, the debtor was obligated to pay default-rate interest and fees to the extent required by its loan agreement and applicable state law.

OUTLOOK

Golden Seahorse arguably stands alone in its exacting examination of the relevant Bankruptcy Code provisions that govern cure and reinstatement of a defaulted loan under a chapter 11 plan. Unfortunately, although it provides useful guidance, the decision is unlikely to end the debate regarding provisions that are (perhaps needlessly) complex and confusing.

The ruling is no doubt a welcome development for lenders—and an unwelcome one for borrowers faced with the more costly prospect of paying default-rate interest as a condition to reinstating debt in connection with confirmation of a chapter 11 plan. This is particularly the case under current market conditions, where reinstatement of low-interest-rate prepetition debt could be highly beneficial to a debtor emerging from bankruptcy.

EIGHTH CIRCUIT: AVOIDANCE CAUSES OF ACTION ARE PROPERTY OF THE BANKRUPTCY ESTATE THAT CAN BE SOLD

Julian E.L. Gale

A debtor's non-exempt assets (and even the debtor's entire business) are commonly sold during the course of a bankruptcy case by the trustee or a chapter 11 debtor-in-possession ("DIP") as a means of augmenting the bankruptcy estate for the benefit of stakeholders or to fund distributions under, or implement, a chapter 9, 11, 12, or 13 plan. However, it is less well understood that causes of action that become part of th e bankruptcy estate in connection with a bankruptcy case (e.g., fraudulent transfer, preference, or other litigation claims) may also be sold or assigned by a trustee or DIP during bankruptcy to generate value.

The U.S. Court of Appeals for the Eighth Circuit examined the circumstances under which estate avoidance claims can be sold in *Pitman Farms v. ARKK Food Co. LLC (In re Simply Essentials LLC)*, 78 F.4th 1006 (8th Cir. 2023). In affirming an Iowa bankruptcy court's ruling that avoidance causes of action can be sold as property of the estate, the Eighth Circuit rejected the argument that such causes of action cannot constitute estate property because avoidance claims "belong" only to the trustee or the DIP. In so ruling, the Eighth Circuit adopted the broad majority view that estate property includes a debtor's "inchoate or contingent" interests.

BROAD SCOPE OF PROPERTY OF THE ESTATE

When a debtor files a bankruptcy petition, the filing creates an "estate" that consists of, among other things, "all legal or equitable interests of the debtor in property as of the commencement of the case" (with certain exceptions) as well as all property that the estate acquires "after the commencement of the case." 11 U.S.C. § 541(a)(1) and (a)(7). Also included in "property of the estate" is "[a]ny interest in property that the trustee [or DIP] recovers" under various provisions of the Bankruptcy Code (*see* 11 U.S.C. § 541(a)(3)), including section 550, which authorizes the trustee or DIP to recover any property (or its value) that has been fraudulently or preferentially transferred by the debtor during a specified period prior to its bankruptcy filing. The estate also includes any property interest that a bankruptcy court orders to be transferred to the estate or preserved for the estate's benefit because it is either a lien securing an equitably subordinated claim (*see* 11 U.S.C. § 510(c)) or an avoided transfer (*see* 11 U.S.C. § 551). In addition, under section 541(a)(6) of the Bankruptcy Code, estate property includes any "[p]roceeds, product, offspring, rents, or profits of or from property of the estate," with certain exceptions.

Section 541 "is intended to include in the estate any property made available to the estate by other provisions of the Bankruptcy Code." *City of Chicago, Illinois v. Fulton*, 141 S. Ct. 585, 589 (2021). Carefully defining the scope of estate property in a given case may be critical to the outcome of the bankruptcy. Property of the estate is protected (with certain exceptions) by the automatic stay under section 362; it may generally be sold, used, or leased under section 363; and, if unencumbered or non-exempt, it is available to stakeholders for distribution under a chapter 9, 11, 12, or 13 plan. Given the importance of estate property, courts have found that a wide variety of interests of the debtor qualify as property of the estate. *See United States v. Whiting Pools, Inc.*, 462 U.S. 198, 204 (1983) ("Both the congressional goal of encouraging reorganizations and Congress' choice of methods to protect secured creditors suggest that Congress intended a broad range of property to be included in the estate."); *see, e.g., ACandS, Inc. v. Travelers Cas. & Sur. Co.*, 435 F.3d 252 (3d Cir. 2006) (insurance policies were estate property); *Whetzal v. Alderson*, 32 F.3d 1302 (8th Cir. 1994) (causes of action); *Windstream Holdings, Inc. v. Charter Commc'ns Inc. (In re Windstream Holdings, Inc.)*, 2022 WL 5245633 (S.D.N.Y. Oct. 6, 2022) (customer contracts).

AVOIDANCE ACTIONS

An indispensable tool available to a bankruptcy trustee or DIP is the power to augment the estate by avoiding and recovering certain transfers or obligations incurred by the debtor prior to filing for bankruptcy that either are fraudulent or unfairly prefer certain creditors. With respect to the former of these categories, section 548 of the Bankruptcy Code provides in part that the trustee (or DIP, by operation of section 1107(a)) "may avoid any transfer … of an interest of the debtor in property, or any obligation … incurred by the debtor, that was made or incurred within 2 years before the date of the filing of the petition." 11 U.S.C. § 548(a)(1).

Fraudulent transfers that can be avoided include both: (i) actual fraudulent transfers, which are transfers made with "actual intent to hinder, delay, or defraud" creditors (*see* 11 U.S.C. § 548(a)(1)(A)); and (ii) constructive fraudulent transfers, which are "transactions

that may be free of actual fraud, but which are deemed to diminish unfairly a debtor's assets in derogation of creditors." Collier on Bankruptcy ("Collier") ¶ 548.05 (16th ed. 2023); 11 U.S.C. § 548(a)(1)(B). Due to the difficulty in proving actual fraud based on an avoidance defendant's subjective state of mind, some courts consider "badges of fraud" in assessing whether a transfer or obligation was made or incurred with intent to defraud, including, among other things, the adequacy of the consideration involved, the relationships between the parties, whether the transferor continued to use the property even after the transfer, and the transferor's financial condition at the time of and after the transfer. *See, e.g., In re TransCare Corp.*, 81 F.4th 37 (2d Cir. 2023); *see generally* Collier at ¶ 548.04[1][b][i] (citing cases); *see also* Section 4(b) of the Uniform Fraudulent Transfer Act (the "UFTA") and its successor, the Uniform Voidable Transfer Act (the "UVTA") (listing 11 separate badges of fraud to be applied in determining whether an actual fraudulent transfer should be avoided under state law) (discussed below).

A transfer is constructively fraudulent if the debtor received "less than a reasonably equivalent value in exchange for such transfer or obligation" and was, among other things, insolvent, undercapitalized, or unable to pay its debts as such debts matured. *See* Collier at ¶ 548.05; 11 U.S.C. § 548(a)(1)(B).

Fraudulent transfers may also be avoided by a trustee or DIP under section 544(b) of the Bankruptcy Code, which provides that, with certain exceptions, "the trustee may avoid any transfer of an interest of the debtor in property or any obligation incurred by the debtor that is voidable under applicable law by a creditor holding an unsecured claim that is allowable under section 502 of [the Bankruptcy Code] or that is not allowable only under section 502(e) of [the Bankruptcy Code]." 11 U.S.C. § 544(b)(1). This provision permits a trustee to step into the shoes of a "triggering" unsecured creditor that could have sought avoidance of a transfer under applicable non-bankruptcy law (*e.g.*, the UFTA or its successor, the UVTA, which has been enacted in many states). *See generally* Collier at ¶ 544.06. Section 544(b) is an important tool, principally because the reach-back period for avoidance of fraudulent transfers under state fraudulent transfer laws (or even non-bankruptcy federal laws, such as the Internal Revenue Code) is typically longer than the two-year period for avoidance under section 548. *Id.*

Section 547(b) of the Bankruptcy Code provides that, with certain exceptions, a trustee or DIP, "based on reasonable due diligence in the circumstances of the case and taking into account a party's known or reasonably knowable affirmative defenses under subsection (c)," may avoid "any transfer" made by an insolvent debtor within 90 days of a bankruptcy petition filing (or up to one year, if the transferee is an insider) to a creditor for or on account of an antecedent debt, if the creditor, by reason of the transfer, receives more than it would have received in a chapter 7 liquidation and the transfer had not been made. 11 U.S.C. § 547(b).

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

Unauthorized postpetition transfers of estate property may be avoided under section 549, and other provisions of the Bankruptcy Code authorize the trustee or DIP to avoid certain other kinds of transfers. *See* 11 U.S.C. § 545 (certain statutory liens); 11 U.S.C. § 553(b) (certain setoffs); 11 U.S.C. § 724(a) (avoidance of liens securing certain claims for damages, fines, penalties, and forfeitures).

If a transfer is avoided under any of these provisions, section 550 of the Bankruptcy Code authorizes the trustee or DIP to recover the property transferred or its value from the initial or subsequent transferees, with certain exceptions.

SIMPLY ESSENTIALS

Simply Essentials, LLC (the "debtor") operated a chicken processing facility in Iowa. In March 2020, disgruntled creditors filed an involuntary chapter 7 petition against the debtor in the Northern District of Iowa. The bankruptcy court entered an order for relief and appointed a chapter 7 trustee. Creditors Pitman Farms ("Pitman") and ARKK Food Co. LLC ("ARKK") filed claims against the estate.

The trustee concluded that the estate had colorable claims to avoid transfers made by the debtor pre-bankruptcy to Pitman. However, after determining that the estate lacked sufficient funds to litigate the avoidance claims, the trustee sought court approval of a settlement of ARKK's claims as well as a sale of the avoidance claims against Pitman free and clear of all interests, pursuant to section 363 of the Bankruptcy Code. Both ARKK and Pitman bid for the avoidance claims, but the trustee chose ARKK's bid as the highest and best offer.

Pitman objected to both the proposed sale and settlement. It contended that the avoidance claims could not be sold because avoidance actions generally are not part of the bankruptcy estate under section 541(a). The bankruptcy court disagreed. It held that avoidance causes of action are property of the debtor's estate that can be sold under appropriate circumstances. The bankruptcy court later certified a direct appeal by Pitman of its ruling to the Eighth Circuit. The court denied a motion for a stay pending the appeal, but directed that, even absent a stay, the appeal would not be mooted by section 363(m) of the Bankruptcy Code.

THE EIGHTH CIRCUIT'S DECISION

A three-judge panel of the Eighth Circuit affirmed the bankruptcy court's decision, ruling that avoidance actions are property of the estate under either section 541(a)(1) or section 541(a)(7) of the Bankruptcy Code.

Writing for the Eighth Circuit panel, Circuit Judge Michael J. Melloy reasoned that the Supreme Court's "broad" interpretation of 541(a)(1) in *Whiting Pools* clearly encompasses avoidance causes of action. This interpretation, he explained, is bolstered by the Eight Circuit's earlier decision in *Whetzal*, where the court wrote that the scope of section 541(a) "is very broad and includes property of all descriptions, tangible and intangible, as well as causes of action." *Simply Essentials*, 78 F.4th at 1008 (quoting *Whetzal*, 32 F.3d at 1303).

According to Judge Melloy, a plain reading of section 541(a)(7) dictates that an avoidance cause of action qualifies as an "interest in property that the estate acquires after the commencement of the case."

To a point, the Eighth Circuit panel was receptive to Pitman's argument (but only to a point) that a reading of either section 541(a)(1) or 541(a)(7) to include avoidance causes of action would cause "surplusage." According to Pitman, because section 541(a)(6) of the Bankruptcy Code can fairly be read to include the "proceeds" from an avoidance action as property of the estate, and sections 541(a)(3) and 541(a)(4) each specify property recovered from particular kinds of avoidance actions, defining "property of the estate" to include an avoidance cause action itself would be duplicative. The Eight Circuit agreed that its holding appeared to create surplusage. However, it explained that the "canon against surplusage is not an absolute rule." "[G]iven the drafting history and the complex nature of the Bankruptcy Code," Judge Melloy wrote, "the possibility of our interpretation creating surplusage does not alter our conclusion that avoidance actions are part of the estate." *Id.* at 1010.

The Eighth Circuit panel noted the apparent absence of any decisions in which a court denied a motion to sell an avoidance cause of action because the claim was not estate property. According to Judge Melloy, the case "most contrary to this conclusion" is the Third Circuit's ruling in *In re Cybergenics Corp.*, 226 F.3d 237 (3d Cir. 2000). However, he emphasized, in *Cybergenics*, the Third Circuit held that avoidance actions are not "assets" of the debtor, but it did not decide whether such actions were "property of the estate." *Simply Essentials*, 78 F.4th at 1010 (citing *Cybergenics*, 226 F.3d at 246). Judge Melloy explained that, "evidenced in part by the numerous provisions in the Bankruptcy Code that distinguish between property of the estate and property of the debtor, or refer to one but not the other," the terms "assets" and "property of the estate" have different meanings. Moreover, he noted, *Cybergenics*'s value on this point is undercut by a subsequent Third Circuit ruling in which the court stressed that "*Cybergenics* does not hold that trustees cannot transfer causes of action." *Id.* at 1010–11 (quoting *In re Wilton Armetale, Inc.*, 968 F.3d 273, 285 (3d Cir. 2020)).

The Eighth Circuit panel concluded that, "[e]ven if there were any ambiguity in the statutory language we are persuaded by the consensus of courts across the country: avoidance actions are property of the estate." *Id.* at 1010. Given the potential value of the litigation claims and the absence of sufficient value in the estate to fund the litigation, the Eighth Circuit found no error in the bankruptcy court's decision to approve the sale of the estate's avoidance claims to ARKK.

OUTLOOK

There are a few key takeaways from the Eighth Circuit's decision in *Simply Essentials*. First, when lawmakers enacted the Bankruptcy Code in 1978, they intended that the scope of "property of the estate" would be quite broad to ensure that all of a debtor's assets could be administered in a bankruptcy case. Second, the expansive definition of estate property in section 541 of the Bankruptcy Code encompasses pre-bankruptcy causes of action belonging to the debtor as well as causes of action or claims that spring into existence on the petition date (e.g., avoidance causes of action under the Bankruptcy Code, including claims that a trustee or DIP can assert on behalf of creditors). Third, under appropriate circumstances, such as cases like *Simply Essentials*, where the estate lacks sufficient resources to prosecute colorable claims or causes of action, the trustee or DIP can sell such claims or causes of action to generate value for the estate.

The Eighth Circuit's decision in *Simply Essentials* is therefore a positive development for bankruptcy trustees, DIPs, or other parties seeking to maximize estate value.

U.S. SUPREME COURT BANKRUPTCY ROUNDUP

Charles M. Oellermann

The U.S. Supreme Court agreed to hear three cases involving issues of bankruptcy law in the most recent Term beginning in October 2023.

THIRD-PARTY RELEASES IN CHAPTER 11 PLANS

On August 10, 2023, the Supreme Court granted a stay of the mandate as well as an informal petition for a writ of *certiorari* with respect to the ruling of the U.S. Court of Appeals for the Second Circuit affirming the bankruptcy court order that confirmed the chapter 11 plan of Purdue Pharma. *See Harrington v. Purdue Pharma L.P.*, No. 23-124 (U.S. Aug. 10, 2023). In its decision, the Second Circuit reversed a district court decision finding that the bankruptcy court lacked the power to approve a plan provision releasing the founding Sackler family from liabilities arising from Purdue's sale of opioids. *See In re Purdue Pharma L.P.*, 69 F.4th 45 (2d Cir. 2023), *mandate stayed and cert. granted sub nom. Harrington v. Purdue Pharma L.P.*, No. 23-124 (U.S. Aug. 10, 2023). In the Supreme Court's order, Justice Sotomayor stated as follows:

> Applicant suggested this Court treat the application as a petition for a writ of certiorari; doing so, the petition is granted. The parties are directed to brief and argue the following question: Whether the Bankruptcy Code authorizes a court to approve, as part of a plan of reorganization under Chapter 11 of the Bankruptcy Code, a release that extinguishes claims held by nondebtors against nondebtor third parties, without the claimants' consent.

The Court heard argument in the case on December 4, 2023.

Jones Day filed three amicus briefs in support of the respondents (those defending Purdue's chapter 11 plan).

REMEDY FOR OVERPAYMENT OF U.S. TRUSTEE FEES IN CHAPTER 11 CASES

On September 29, 2023, the Supreme Court granted the U.S. Solicitor General's petition for a writ of *certiorari* in *Office of the U.S. Trustee v. John Q. Hammons Fall 2006 LLC*, 22-1238 (U.S. Sept. 29, 2023), where it will have an opportunity to decide whether chapter 11 debtors are entitled to refunds for overpayment of fees to the U.S. Trustee System. In *Siegel v. Fitzgerald*, 142 S. Ct. 1770 (Sup. Ct. June 6, 2022), the Court unanimously held that the 2018 increase in fees paid by chapter 11 debtors to the U.S. Trustee System was unconstitutional because it was not immediately applicable in the two states with Bankruptcy Administrators rather than U.S. Trustees. The Court in *Siegel* explicitly left open the question of remedy.

Since *Siegel* was handed down, all four federal circuit courts of appeals that have reached the issue have, without any dissents, decided that refunds are owed to the debtors in U.S. Trustee districts who paid those excess fees. *See USA Sales, Inc. v. Off. of United States Tr.*, 76 F.4th 1248 (9th Cir. 2023); *U.S. Trustee Region 21 v. Bast Amron LLP (In re Mosaic Management Inc.)*, 71 F.4th 1341 (11th Cir. 2023) (petition for cert. filed Sept. 22, 2023); *In re Clinton Nurseries, Inc.*, 53 F.4th 15 (2d Cir. 2022) (petition for cert. filed July 17, 2023); *In re John Q. Hammons Fall 2006, LLC*, 2022 WL 3354682 (10th Cir. Aug. 15, 2022), *cert. granted sub nom. United States Tr. v. Fall*, No. 22-1238 (U.S. Sept. 29, 2023).

STANDING IN BANKRUPTCY CASES

On October 13, 2023, the Supreme Court granted a petition for a writ of *certiorari* in *Truck Insurance Exchange v. Kaiser Gypsum Co. Inc.*, No. 22-1079 (U.S. Oct. 13, 2023), where it agreed to review a ruling by the U.S. Court of Appeals for the Fourth Circuit that a chapter 11 debtor's insurer lacked standing under section 1109(b) of the Bankruptcy Code and Article III of the U.S. Constitution to object to the debtor's chapter 11 plan, which created a trust for the payment of the uninsured claims of asbestos injury plaintiffs, because the insurer had no financial stake underpinning its objection. *See Truck Insurance Exchange v. Kaiser Gypsum Co. (In re Kaiser Gypsum Co.)*, 60 F.4th 73 (4th Cir. Feb. 14, 2023), *cert. granted*, No. 22-1079 (Oct. 13, 2023). According to the Fourth Circuit, the insurer had no standing to object as a "party in interest" under section 1109(b) because the chapter 11 plan was "insurance neutral," and the insurer lacked constitutional standing as a creditor to object to other aspects of the plan.

The Court agreed to review the ruling to resolve a claimed split among the federal circuit courts of appeals concerning the interplay of section 1109(b) and Article III in bankruptcy cases. *See In re Global Industrial Technologies, Inc.*, 645 F.3d 201, 211 (3d Cir. 2011) (concluding that section 1109(b), by its plain text, simply codifies the right of any party with Article III standing to appear and be heard in a chapter 11 case); *In re Tower Park Properties, LLC,* 803 F.3d 450, 457 n.6 (9th Cir. 2015) (determining that Article III and section 1109(b) are not "coextensive"); *In re Thorpe Insulation Co.*, 677 F.3d 869, 885 (9th Cir. 2012) (looking to "the real-world impacts of the [chapter 11] plan to see if it increases insurance exposure and likely liabilities of [the insurers]," and ruling that an insurer would have standing to object to the plan provided there were "a substantial economic impact" on the insurer); *In re James Wilson Associates*, 965 F.2d 160, 169 (7th Cir. 1992) (holding that section 1109(b) silently preserves certain "other" pre-Bankruptcy Code "limitations on standing, such as that the claimant be within the class of intended beneficiaries of the statute that he is relying on for his claim").

Justice Alito took no part in considering the petition for *certiorari*, suggesting that he will not participate in the ruling on the merits.

Jones Day represents Kaiser Gypsum Company, Inc. in connection with the litigation.

NEWSWORTHY

Dan T. Moss ***(Washington and New York)*** has been nominated for the International Insolvency Institute, a selective nonprofit organization of leading practitioners, academics, judges, and regulators in the international insolvency field, with 400 members from more than 45 countries. Since its inception, the Institute has made significant contributions to the development and improvement of fair and effective insolvency laws and practices around the world. The Institute works collaboratively with many other organizations, sharing ideas and developing best practices and thought leadership.

Ben Larkin ***(London)*** earned a "Hall of Fame" ranking in the 2024 edition of *Legal 500 United Kingdom* in the area of Finance-Corporate Restructuring and Insolvency.

Hannah Plumb ***(London)*** was ranked in the 2024 edition of *Legal 500 United Kingdom* as a "Rising Star" in the area of Finance-Corporate Restructuring and Insolvency.

Ben Larkin ***(London)*** was recognized in the 2024 edition of *Chambers UK: A Client's Guide to the UK Legal Profession* in the field of Restructuring and Insolvency

An article written by ***Corinne Ball*** ***(New York)*** titled "The Calculus of Default, Cure and Reinstatement of a Loan in Chapter 11 Gains Clarity in New York" was published in the October 25, 2023, edition of the *New York Law Journal*.

An article written by ***Oliver S. Zeltner*** ***(Cleveland)*** and ***Mark G. Douglas (New York)*** titled "Texas Bankruptcy Court Blesses Serta Chapter 11 Plan Over Objections of Lenders Excluded from Position Enhancement Transaction" was published on September 16, 2023, in *Lexis Practical Guidance*.

An article written by ***Dan B. Prieto*** ***(Dallas)*** and ***Mark G. Douglas (New York)*** tilted "Circuit Split Widens on Extent of Abrogation of Sovereign Immunity for Governmental Units in Bankruptcy Avoidance Litigation" was published on September 16, 2023, in *Lexis Practical Guidance*.

An article written by ***Daniel J. Merrett*** ***(Atlanta)*** and ***Mark G. Douglas (New York)*** titled "Court's Broad Interpretation of Definition of Securities Contracts Promotes Expansive Scope of Bankruptcy Code 'Safe Harbor'" was published on September 16, 2023, in *Lexis Practical Guidance*.

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