Recent Developments in Bankruptcy Law, October 2019

(Covering cases reported through 604 B.R. 100 and 932 F.3d 292)

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2.6.a **Reference in financing statement to collateral description in the security agreement adequately indicates the collateral.** The lender's financing statement described the collateral as "[a]ll Collateral described in First Amended and Restated Security Agreement dated March 9, 2015 between Debtor and Secured Party." To perfect a security interest by filing, the financing statement must "indicate the collateral covered by the financing statement." It may do so by, among other ways, "any other method, if the identity of the collateral is objectively determinable." "Indicate" means to serve as a signal, point out, or direct attention to. Because the financing statement is only an abbreviation of the security agreement, it adequately indicates the collateral by referencing the security agreement, even if the security agreement is not filed with the financing statement, because it gives third parties notice of the secured party's interest. *First Midwest Bank v. Reinbold (In re I80 Equip., LLC)*, ___ F.3d ___, 2019 U.S. App. LEXIS 30436 (7th Cir. Sept. 11, 2019).

2.7 Recovery

2.7.a **Avoiding mortgage and recovering mortgage proceeds from transferee is not a double recovery.** The debtor owned real property in tenancy by the entirety. After the order for relief, and with her husband's consent, she mortgaged the property for $250,000. She paid the $250,000 to three attorneys who were defending her in a criminal action. The trustee sued to avoid the mortgage and to avoid the transfers to one of the attorneys. The mortgagee settled with the trustee, agreeing to avoidance of the mortgage, which the trustee preserved for the benefit of the estate. The trustee then moved to sell the debtor's and her husband's real property under section 363(h), but the bankruptcy court denied the motion. After trial, the bankruptcy court ordered the avoidance and recovery of the payment to the attorney. Section 550(d) limits the trustee's recovery to a single satisfaction. Because the bankruptcy court denied the trustee's motion to sell the property, so that the trustee could not recover the value of the avoided mortgage, recovery of the mortgage proceeds from the attorney did not amount to more than a single satisfaction. *Jones v. The Brand Law Firm, P.A. (In re Belmonte)*, 931 F.3d 147 (2d Cir. 2019).

2.7.b **Trustee may recover proceeds of fraudulently transferred property from a subsequent transferee.** The debtor fraudulently transferred property to a related entity, which sold the property for cash. The transferee paid a portion of the cash to two law firms. The trustee avoided the transfer to the related entity then sought to recover from the law firms as subsequent transferees. Section 550(a) permits the trustee to recover fraudulently transferred property or its value from the initial transferee or from any immediate or mediate transferee of the initial transferee, except one who takes for value, in good faith, and without knowledge of the voidability of the transfer. The absence of the word "proceeds" in section 550(a) is not dispositive, as the trustee could have recovered the value—which might be in the form of proceeds—from an initial transferee who sold the property or from a subsequent transferee. The broader reading is consistent with the statute's purpose to restore the estate to the position it would have been in if the transfer had not been made. Therefore, section 550(a) permits recovery of cash proceeds in the hands of a subsequent transferee. *Rajala v. Husch Blackwell LLP (In re Generation Res. Holding Co, LLC),* 604 B.R. 896 (Bankr. D. Kan. 2019).

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5.5.a **Extra compensation for a back-stop agreement does not violate the equal treatment requirement.** Through a mediation with its major creditors, the debtor developed a plan that provided for a common stock rights offering and a preferred stock private placement at a 35% discount to plan equity value. In phase one, the creditors participating in the mediation were given the exclusive right to purchase 22.5% of the preferred stock but had to backstop the sale of the remaining 77.5%. In phase two, other creditors in the same class were given three days' notice to elect to purchase 5% of the preferred stock, at the same discount, but also had to backstop the sale of the remaining 72.5% of the preferred stock. In phase three, remaining creditors in the same class could elect to purchase preferred stock at the same discounted price. A small group of creditors did not participate and objected to confirmation. Section 1123(a)(4) requires a plan to provide equal treatment of all claims within a class. Extra compensation for legitimate rights or contributions other than satisfaction of the claims within the class does not violate the equal treatment requirement. Here, the opportunity to participate was consideration for the backstop agreement, not treatment for prepetition claims. Therefore, the court overrules the objection. *Ad Hoc Comm. of Non-Consenting Creditors v. Peabody Energy Corp. (In re Peabody Energy Corp.)*, 933 F.3d 918 (8th Cir. 2019).

6. CLAIMS AND PRIORITIES

6.1 Claims

6.2 Priorities

6.2.a **Fifth Circuit defines requirements for treatment as an administrative expense claim.** The debtor operated offshore oil and gas platforms. It contracted with a drilling contractor to drill another well from one of the debtor's platforms. After a fatal accident during the drilling operation, drilling ceased. Shortly thereafter, creditors filed an involuntary petition. The debtor consented to an order for relief. The debtor in possession then rejected the drilling contract. As a result, the contractor had to plan and execute a demobilization plan to remove its equipment from the debtor's platform. That process took several months: regulatory approvals and the contractor's preparation of a demobilization plan were both delayed. The contractor asserted an administrative expense claim for its entire pre-demobilization and demobilization expenses. An administrative expense is an actual and necessary postpetition cost that benefitted the estate (regardless of cost to the creditor) and arose as a result of the trustee's actions, either by direct request or other inducement or by voluntary acceptance of desired goods or services. A supplier's mere availability to provide goods or services suffices, if it meets these requirements for an administrative expense. Therefore, the contractor is entitled to an administrative expense claim for its pre-demobilization services, including waiting (availability) time, except to the extent of any delay the contractor caused. However, because the removal of the contractor's equipment from the platform benefitted the contractor, not the estate, the contractor is not entitled to an administrative expense claim for its demobilization costs. *Nabors Offshore Corp. v. Whistler Energy II, L.L.C. (In re Whistler Energy II, L.L.C.)*, 931 F.3d 432 (5th Cir. 2019).

6.2.b **Damages arising from purchase of an equity-like interest is subject to section 510(b) subordination.** Through a long series of transactions over 80 years, including most recently a merger, a party did not own any equity security interests in the debtor but had a right to receive a certain percentage of dividends the debtor declared. The debtor stopped paying the party, who sued for breach of contract, advanced tort claims, and breach of fiduciary duty. Once the debtor filed bankruptcy, the party filed a proof of claim. Section 510(b) subordinates a claim for damages arising from the purchase or sale of a security of the debtor or an affiliate. The section effectuates a principal bankruptcy policy that creditors are entitled to be paid before equity interest holders. It applies when three conditions are met: (1) damages (2) arising from a purchase or sale (3) of an equity security. The party acknowledged it was seeking damages. The party acquired the interest through a merger that converted a prior existing interest in dividends to the current one. "Arising from" is broadly construed, so the party's damages claim arises from the purchase of the interest. The interest tracked the debtor's value and entitled the party to the upside, just as an equity interest would, and subjected the holder to the same risks as a shareholder. Although this form of instrument does not fall within any of the enumerated kinds of securities in section 101(49), it comes within the catch-all of "other claim or interest commonly known as a security." The court notes the interest, though unusual, is more like equity than debt. Therefore, the court subordinates the claim. *French v. Linn Energy, L.L.C. (In re Linn Energy, L.L.C.)*, 936 F.3d 334 (5th Cir. 2019).

6.2.c **Nursing home state quality assurance fee is entitled to priority as an excise tax.** The state department of health services imposes a quality assurance fee on skilled nursing facilities. The fee is "assessed per resident per day, based on the aggregate net revenue" of the facility. The state filed a proof of claim for prepetition fees, asserting priority as an excise tax. Section 507(a)(8)(E) grants priority to an excise tax on "a transaction occurring [prepetition] for which a return, if required, is last due … after three years before the date of the filing of the petition." Because the fee is measured on a per resident per day basis, the fee is an excise tax that is assessed on a transaction, which is the "sale" of the services of a bed to a resident each day, and is therefore entitled to priority under section 507(a)(8)(E). *Calif. Dept. of Heath Care Servs. v. Ehrenberg (In re Ridgecrest Healthcare, Inc.*, 601 B.R. 826 (C.D. Cal. 2019).

7. CRIMES

8. DISCHARGE

8.1 General

8.2 Third-Party Releases

8.2.a **Court disapproves nonconsensual third-party releases of claims the debtor would assume under the plan.** The debtors' plan incorporated a settlement agreement with nondebtor affiliates under which the affiliates would pay a substantial amount to the debtors in settlement of various claims the debtors asserted against them and for the debtors' assumption of all the affiliates' liabilities arising from their operation as part of the debtors' business, including environmental obligations. Several creditors, including governmental units whose potential future environmental claims remained contingent, objected to the approval of the disclosure statement on the ground that the releases rendered the plan unconfirmable on its face. In the Sixth Circuit, a bankruptcy court may approve a nonconsensual third-party release if, among other things, there is an identity of interest between the debtor and the third party and the release is essential to the reorganization. Those conditions are met where the debtor is primarily liable to the third parties and the releases protect entities that are secondarily liable and would have indemnification claims against the debtor that must be released to return the debtor to viability. Here, the affiliates were primarily liable for the released claims, and the debtor was assuming the liability, not being protected from it. Accordingly, the releases do not meet the Sixth Circuit's standards of an identity of interest and necessity to the reorganization, so the court denies approval of the disclosure statement. *In re FirstEnergy Solutions Corp.*, ___ B.R. ___, 2019 Bankr. LEXIS 2742 (Bankr. N.D. Ohio Aug. 29, 2019).

8.3 Environmental and Mass Tort Liabilities

9. EXECUTORY CONTRACTS

9.1

9.1.a **An *ipso facto* clause in tail coverage on a prepetition D&O policy is unenforceable.** The debtor had a directors' and officers' liability insurance policy that permitted it to purchase "tail" or run-off coverage. The policy expired shortly after the petition date, but the carrier renewed the policy for another year. Within a month, the debtor in possession purchased three-year tail coverage as an endorsement to the policy. The endorsement excluded certain claims related to bankruptcy or insolvency. A liquidating trust sued directors for claims based on events that led to the bankruptcy. The carrier denied coverage, based on the exclusion. Section 365(e) prohibits termination or modification of any rights under an executory contract based on the insolvency or financial condition of the debtor—an *ipso facto* clause. As of the petition date, the policy was an executory contract, and the renewal was merely an extension of the contract, not a new contract. The tail coverage arose from an endorsement and therefore was also a part of the original policy, not a separate contract. As such, the *ipso facto* clause prohibition applied to the policy. Because the exclusion was based on the insolvency or financial condition of the debtor, it was unenforceable, and coverage applied. *CMH Liquidating Trust v. Nat'l Union Fire Ins. Co. (In re Community Mem. Hosp.)*, ___ B.R. ___ (E.D. Mich. July 23, 2019) (unrept'd).

10. INDIVIDUAL DEBTORS

10.1 Chapter 13

10.2 Dischargeability

10.2.a **Environmental penalties resulting from false reports may be dischargeable.** The debtor operated its factory in violation of environmental protection laws and filed false reports with the environmental regulator about the violations. The regulator claimed that it would have shut the factory earlier if the debtor had filed accurate reports. The regulator imposed daily fines for the violations and filed a proof of claim in the debtor's chapter 11 case for the amount of the fines. The debtor confirmed a chapter 11 plan and emerged as a going concern. Section 1141(d) generally provides for a comprehensive discharge upon plan confirmation, but section 1141(d)(6) excepts from a corporate debtor's discharge a debt "of a kind specified in paragraph (2)(A) or (2)(B) of section 523(a) that is owed to a domestic governmental unit." Sections 523(2)(A) and (B) except from discharge "any debt … for money, property, [or] services … to the extent obtained by (A) false pretenses, a false representation, or actual fraud" or a false financial statement. It extends to any debt arising from the fraud, including penalties, but the creditor much show a loss or damages as a proximate result of the misrepresentation or fraud. In this case, the fines do not represent any loss or damage incurred by the regulator resulting from the false reports. And the regulator's claim that it would have shut down the facility earlier but for the false reports is too attenuated to show damages or loss resulting from the misrepresentations or fraud. Therefore, the debt is dischargeable. *In re Exide Techs*., 601 B.R. 271 (Bankr. D. Del. 2019).

10.3 Exemptions

10.4 Reaffirmations and Redemption

11. JURISDICTION AND POWERS OF THE COURT

11.1 Jurisdiction

11.1.a **Jurisdiction attaches at the time of filing.** The debtor in possession sued a creditor, who did not have a presence in the state where the action was pending, in the district court, fixing related-to jurisdiction under 28 U.S.C. § 1334(b) and serving process under Bankruptcy Rule 7002, which permits nationwide service of process. The debtor in possession then sold the claim; as a result, the claim was no longer related to the bankruptcy case. Federal subject matter jurisdiction is determined at the time the action is filed. Because the district court had related-to jurisdiction at filing, the later transfer of the claim did not divest it of jurisdiction. Similarly, service of process is governed by the rule applicable when the plaintiff effects service. Although Civil Rule 4 permits service only on a defendant that could be served in the state under state law, service under Rule 7004 was proper and binding, despite the claim transfer. *Double Eagle Energy Servs., L.L.C. v. MarkWest Utica EMB, L.L.C.*, 936 F.3d 260 (5th Cir. 2019).

11.1.b **Court refuses to enforce arbitration clause in an action to avoid transfers and object to a claim.** The creditor filed a proof of claim for amounts owing under an agreement that contained an enforceable arbitration clause. The reorganized debtor filed a 35-count adversary proceeding objecting to the proof of claim and asserting avoiding power and other claims for affirmative recovery and as offsets to the proof of claim. Under the Federal Arbitration Act, an arbitration clause is enforceable in a bankruptcy case except to the extent the underlying nature of the proceeding derives from the Code and enforcement would conflict with the Code's purposes, such as the equitable and expeditious administration of the case, centralized resolution of pure bankruptcy issues, protection against piecemeal litigation, and a bankruptcy court's power to enforce its own orders. Because the adversary proceeding primarily seeks avoidance of voidable transfers and disallowance of a proof of claim, enforcing the arbitration clause would conflict with the Code's purpose of equitable and expeditious distribution of assets. Therefore, the court declines to enforce the arbitration clause. *Phelan v. Highland Cap. Mgmt., L.P. (In re Acis Cap. Mgmt., L.P.)*, 600 B.R. 541 (Bankr. N.D. Tex. 2019).

11.2 Sanctions

11.3 Appeals

11.4 Sovereign Immunity

12. PROPERTY OF THE ESTATE

12.1 Property of the Estate

12.1.a **Substantive consolidation motion requires notice to nondebtors' creditors.** The trustee moved to consolidate the debtor's estate with nondebtors who were related to the debtor and were possible fraudulent transfer recipients. The trustee did not give notice of the motion to the nondebtors' creditors. Nondebtors' creditors should be afforded just as much, if not more, notice than the debtor's creditors, because consolidation would directly affect their rights. Consolidation is an equitable order to achieve fairness to all creditors, so the bankruptcy court can hear from them to ensure fairness. Therefore, notice to creditors of the target entities is required. *Leslie v. Mihranian (In re Mihranian)*, 937 F.3d 1214 (9th Cir. 2019).

12.2 Turnover

12.3 Sales

12.3.a **Eighth Circuit affirms finality of sale order despite alleged undisclosed side deals.** The debtor in possession proposed a sale to a stalking horse bidder and bid and auction procedures, which the court approved. At the auction, a group of second lien creditors submitted a bid that the DIP's advisers valued higher, even though it had a lower face amount than the stalking horse bid. The court approved the second lien creditors' bid, finding the bid to be the highest and otherwise best, and the sale closed. After the case was converted to chapter 7, the trustee brought an action against the buyer, the advisers, and the creditors committee claiming there was an undisclosed agreement between the largest holder on the committee and the second lien creditors that promised the committee member a lucrative contract if the second lien creditors purchased the assets and that the advisers were aware of the agreement and manipulated the valuations to favor the second lien creditors' bid, resulting in a substantial loss of value to the estate. An order under section 363 approving a sale is an *in rem* order that is good against the world, not just against the parties to the transaction. It prohibits any attack on the sale, even an indirect one against the participants in the sale process, if it challenges any of the sale order's finding. The trustee's action effectively challenged the bankruptcy court's finding that the bid was the highest and otherwise best bid and therefore must be dismissed. *Fulmer v. Fifth Third Equip. Fin. Co. (In re Veg Liquidation, Inc.)*, 931 F.3d 730 (8th Cir. 2019).

13. TRUSTEES, COMMITTEES, AND PROFESSIONALS

13.1 Trustees

13.2 Attorneys

13.3 Committees

13.3.a **U.S. Trustee may not appoint a committee in a chapter 9 case.** The U.S. Trustee appointed a committee of creditors holding unsecured claims in a chapter 9 case. The debtor moved to disband the committee. Section 901(a) makes section 1102 applicable in a chapter 9 case. Section 1102(a)(1) requires the U.S. Trustee to appoint such a committee "as soon as practicable after the order for relief under chapter 11." Nothing in chapter 9 provides for a different interpretation in a chapter 9 case of the phrase "order for relief under chapter 11." Because there is no order for relief under chapter 11 in a chapter 9 case, the U.S. Trustee does not have authority to appoint a committee of creditors in a chapter 9 case. *In re Coalinga Regional Med. Center*, ___ B.R. ___, 2019 Bankr. LEXIS 5552 (Bankr. E.D. Cal. Oct. 2, 2019).

13.4 Other Professionals

13.5 United States Trustee

14. TAXES

15. CHAPTER 15—CROSS-BORDER INSOLVENCIES