Force Majeure Clauses – The Latest

Force majeure clauses are getting increased attention in bankruptcy courts these days. A recent opinion by Judge Cassling in In *re Hitz Restaurant Group* is instructive. Hitz operated a restaurant under a commercial lease with a landlord. After it filed its bankruptcy petition, the landlord filed a motion requesting the bankruptcy court to compel Hitz to continue paying post-petition rent obligations. Hitz argued that the force majeure clause in the lease excused it from paying rent obligations post-petition. The Court concluded that an Executive Order issued by Governor Pritzker prohibiting on-site consumption of food and beverage was a form of 'government action" covered by the force majeure clause. The Court allowed a 75 % rent abatement, based on the percentage of the restaurant's square footage rendered unusable by the Executive Order (according to the Court, 25% of the space used for pick-up, take-out, and delivery was not covered by the Executive Order).

Stay tuned.

If you have questions or would like additional information on the material covered, please contact the author below.

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Treatment of Small Business Chapter 11 Bankruptcy Cases Following the Small Business Reorganization Act and The Coronavirus Aid, Relief, and Economic Security Act

Two recent pieces of legislation may dramatically increase and affect the number of small business filings in the United States under chapter 11 of the Bankruptcy Code. In August 2019, Congress passed the Small Business Reorganization Act (the SBRA). It is now known as subchapter V of chapter 11 of the Bankruptcy Code. The SBRA addressed many of the issues that made it difficult for small business to take advantage of chapter 11, including expense and timing.

On March 27, 2020, Congress enacted The Coronavirus Aid, Relief, and Economic Security Act (the CARES Act). The CARES Act increased a key debt threshold set by the SBRA, which allows more small businesses to elect subchapter V of chapter 11 of the Bankruptcy Code.

The SBRA

The SBRA address three key issues for a small business debtor: (i) simplifying the plan process; (ii) making it easier for existing owners to retain equity; and (iii) reducing the cost and complexity of the chapter 11 process.

Under the SBRA, to be eligible for subchapter V, a debtor must be engaged in commercial activity and its total

secured and unsecured debts must be less than $2,725,625. At least half of those debts must come from business activity, and the debtor's principal activity cannot be a single-asset real estate operation. Debtors that wish to proceed under subchapter V must make the election at the time of filing. In the absence of a subchapter V election by the debtor, the regular chapter 11 rules apply, including those rules that apply to small businesses.

Under subchapter V, a debtor is not required to file or obtain approval of a disclosure statement. Instead, the plan must include a brief history of the business operations, a liquidation analysis, and projections demonstrating the ability of the debtor to make the proposed plan payments. The debtor also no longer needs to obtain affirmative votes of its creditors in support of the plan, but the debtor must demonstrate that the plan does not discriminate unfairly, is fair and equitable, and that creditors will receive as much under the plan as they would if the debtor were liquidated under chapter 7. Thus, debtors and creditors may still expect arguments over valuation as part of the confirmation process.

Existing owners of a debtor may now retain equity over the objection of a class of unsecured creditors if they commit all of the debtor's disposable income to pay creditors over a three to five year period. To confirm the plan, the court must find that the debtor will be able to make payments under the plan or that there is a reasonable likelihood that the debtor will be able to make payments under the plan and that the plan contains appropriate remedies to protect creditors if the debtor does not make the proposed payments. By making the retention of equity more predictable and attainable, Congress sought to eliminate a major disincentive to small business contemplating chapter 11.

Under subchapter V, there is also increased monitoring of the case by the court and a newly appointed trustee. The Court must hold a status conference within 60 days of the filing, after which the debtor must report in writing on its efforts to achieve a consensual plan. The United States Trustee will appoint a standing trustee in a subchapter V case that acts like an advisor and handler to facilitate the development of a consensual reorganization plan. The appointed trustee will also appear at hearings and ensure that the debtor makes timely payments under the plan.

In a further attempt to move quickly a case through bankruptcy, subchapter V shortens the time that a debtor has to propose a plan from 120 days to 90 days, and only the debtor may file a plan. The shortened time also helps reduce the debtor's administrative expense burden. The debtor's expenses may also be reduced because the United States Trustee does not appoint a committee of unsecured creditors, and the debtor is not required to pay U.S. Trustee fees.

Enhancements under the CARES Act

The CARES Act increases the debt ceiling that a company may have and still elect a case under subchapter V of chapter 11. Under the CARES Act, a business may now have debt up to $7,500,000. The debt limit increase is temporary and returns to the original $2,725,625 one year after the enactment of the CARES Act.

The raising of the debt ceiling is significant because many small businesses that were previously ineligible to file a case under subchapter V now have access to the new provisions that are designed to make bankruptcy faster and cheaper. Given the current uncertain economic outlook, we will not be surprised to see an uptick in small business chapter 11 filings under subchapter V of title 11. Creditors, and especially lenders, should expect contact with the debtor to occur early and often, as the debtor will proceed more quickly and less expensively through a case under subchapter V with the support of its creditors.

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A West Virginia District Court finds federal tax refunds to be property of a debtor's estate and beyond the reach of the federal government for purposes of setoff.

In re Wood, 611 B.R. 782 (S.D. W.Va. 2019), *appeal filed*, Larry Wood V. HUD, 20-1161 (4th Cir. Feb. 13, 2020).

Case Snapshot

The United States Department of Housing and Urban Development (HUD), owed a deficiency incurred when the debtors, Larry and Jessica Wood (the Debtors) defaulted on a loan insured by HUD, was able to recover some of the amount owed by offsetting from the Debtors' 2018 federal tax refund. However, HUD was prevented from doing so with respect to the Debtors' 2019 federal tax refund because the Debtors had filed for bankruptcy protection and, pursuant to the holding of the bankruptcy court and district court, the refund was property of the estate and beyond the reach of the Debtors' creditors, even the federal government.

Factual Background

On September 9, 2008, the Debtors borrowed $39,739.44 (the Loan) to purchase a mobile home. The loan was insured by HUD. The Debtors defaulted on the Loan in 2014 and HUD paid the deficiency remaining after default in the amount of $23,066.66. On November 20, 2015, HUD notified the Debtors of the deficiency and made a demand for payment.

In December 2015, HUD issued the Debtors a notice informing them that the United States Department of the Treasury (the Treasury) could offset the Debtors' tax refund against the debt owed to HUD, which, on February 23, 2017, was effectuated when the Treasury Offset Program used $9,961.00 of the federal tax refund to offset the amount of debt owed to HUD, leaving a remaining balance owed to HUD of $15,486.47 plus interest.

On March 21, 2018, the Debtors filed a bankruptcy petition, and subsequently filed their federal and state income tax returns on March 26, 2018. The returns demonstrated a federal tax refund of $6,086 and a state tax refund of $316. On April 4, 2018, the Treasury used the federal tax refund to offset the remaining debt to HUD. No offset was made using the state tax overpayment.

The Debtors filed a complaint on May 17, 2018, seeking avoidance of HUD's lien and refund of the offset funds remitted to HUD. On April 15 2019 (of all days), the Bankruptcy Court entered a judgment in favor of the Debtors, ordering the United States to pay the Debtors $6,086. The United States appealed.

Court Analysis

On appeal, the District Court was faced with two issues: (1) whether a debtor's tax refund becomes property of the estate and hence protected by the automatic stay, and (2) whether, if part of the debtor's estate, the debtor may exempt[1] the overpayments under section 522 of the Bankruptcy Code and thereby defeat a governmental creditor's right to setoff under section 553 of the Bankruptcy Code and the Tax Offset Program codified at 26 U.S.C. section 6402.[2]

Acknowledging a circuit split on the first issue, the court joined the majority of courts in finding that the tax refund became property of the taxpayer at midnight on December 31 of the taxable year in which the payment occurred, absent the United States completing the statutorily authorized offset before that time or any time before a debtor's bankruptcy filing. In other words, if the taxpayer files for bankruptcy prior to the government employing the offset provisions, the debtor's interest in the property at that time vests in the bankruptcy estate. If, thereafter, the government wants to use the overpayment for a setoff, it must first get relief from the stay or act under an applicable exception.

Regarding the second issue, the court noted that there appears to be an apparent conflict between section 553, which unqualifiedly preserves the right of offset, and section 522(c), which provides that property claimed exempt is not liable for prepetition debts and that, in turn, courts have reached conflicting conclusions concerning both the interaction between section 522 and section 553 and the effect of a taxpayer's filing bankruptcy while the government is in the process of executing an offset. Recognizing the general principal that, in the Fourth Circuit, a properly claimed exemption trumps a creditor's right to offset mutual prepetition debts and liabilities, the court reviewed the bankruptcy court's holding to "disallow a setoff for abuse of discretion."

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1. The relevant exemption statute is W.Va. Code section 38-10-4, which provides:
   Any person who files a petition under the federal bankruptcy law may exempt from property of the estate in a bankruptcy proceeding the following property:
   (a) The debtor's interest, not to exceed twenty-five thousand dollars in value, in real property or personal

property that the debtor or a dependent of a debtor uses as a residence ...
(e) the debtor's interest, not to exceed in value eight hundred dollars plus any unused amount of the exemption provided under subsection (a) of this section in any property.

2. (1) In general. —Upon receiving notice from any Federal agency that a named person owes a past-due legally enforceable debt ... to such agency, the Secretary shall—
(a) reduce the amount of any overpayment payable to such person by the amount of such debt;
(b) pay the amount by which such overpayment is reduced under subparagraph (a) to such agency; and
(c) notify the person making such overpayment that such overpayment has been reduced by an amount necessary to satisfy such debt.

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Debtor Emerges as Victor in Confirmation Battle between Competing Chapter 11 Plans

In re Tara Retail Group, LLC, No. 17-bk-57, 2020 WL 424574 (Bankr. N.D. W. Va. Jan. 27, 2020).

Case Snapshot

Considering two competing proposed Chapter 11 plans, the U.S. Bankruptcy Court for the Northern District of West Virginia denied confirmation to the principal creditor seeking liquidation of the debtor's property. In confirming the debtor's proposed plan for reorganization, the court held that its discretion is better employed to promote reorganization when the Debtor has reasonable prospects for meeting its post-confirmation obligations.

Factual Background

Tara Retail Group, LLC (the Debtor) owns The Crossings Mall in Elkview, West Virginia, a multi-tenant commercial property. Public access to the mall is by way of a single bridge spanning a culvert over Little Sandy Creek. The Debtor financed the purchase of the mall with a loan obtained from UBS Real Estate Securities, Inc. which was assigned to Comm2013-CCRE12 Crossings Mall Road, LLC (Comm2013) in 2017.

The Debtor contributed monthly deposits to a Capital Expenditure account maintained by its loan servicer, Wells Fargo. This account held funds for replacements, building improvements, and major repairs, among other things. In January 2016, Debtor's management company requested funds from the Capital Expenditure account to repair the culvert at the mall's entrance, and warned Wells Fargo that the only entrance to the mall could collapse if the culvert repair was not resolved immediately. Later in January 2016, Wells Fargo responded to the request for funds by demanding an explanation of why collected rent rolls were below expected receipts. Although Wells Fargo did not deny the Debtor's request, it never released the funds for the culvert repair.

In June 2016, the culvert bridge spanning Little Sandy Creek washed away after significant rainfall caused flooding. Thereafter, the mall tenants were unable to operate, tenant rents eventually ceased, and the Debtor could no longer service its debt to Comm2013. The Debtor sought bankruptcy protection after Comm2013 filed a civil action against it seeking the appointment of a receiver.

Court Analysis

Pending before the Bankruptcy Court were two proposed Chapter 11 plans. In cases of competing plans, a bankruptcy court must first determine whether each plan is confirmable under section 1129 (a) and (b), and if both plans are confirmable, the court may confirm only one plan. 11 U.S.C. section 1129(c).

The Bankruptcy Court found that both of the proposed plans were confirmable, and that it was appropriate for the court to exercise its discretion to confirm Debtor's plan. Although the court acknowledged that Comm2013's claim overshadowed the respective amounts of the other claims in the case, the overwhelming number of claimants supported the Debtor's proposed plan, including many individuals affected by the flood and lack of access to the mall. In contrast, Comm2013 was the only creditor with an allowed claim supporting its proposed plan. Citing *In re Valley View Shopping Center, L.P.*, the court noted that a reorganization plan is usually preferable to a liquidation plan. 260 B.R. 10, 40 (Bankr. D. Kan. 2001).

Debtor's Proposed Plan. The Debtor's plan proposed reorganizing Debtor's financial affairs and continuing operation of the mall into the future. Comm2013 opposed Debtor's plan contending, among other things, that the Debtor improperly classified its claim, that the proposed plan was not feasible; and that the Debtor's proposed treatment of Comm2013's claim was unfair and inequitable under section 1129(b) of the Bankruptcy Code.

The court rejected Comm2013's objections finding them to be "red herrings." Comm2013 argued that Debtor improperly classified its claim by not recognizing the secured and unsecured portions of its claim consistent with section 506(a). The court held that section 506(a) has no bearing on proposed plan treatment or the court's consideration under section 1129. Observing that section 1123(a) provides the only mandatory requirements for the contents of a plan, the court noted that there is no requirement in section 1123 or otherwise requiring that a plan proponent treat an under-secured creditor in the bifurcated fashion urged by Comm2013.

Next, the court held that the Debtor's plan met the confirmation requirements of section 1129(a), was otherwise fair and equitable as required by section 1129(b), and was feasible and consistent with the Supreme Court's guidance in *Till v. SCS Credit Corp.*, 541 U.S. 465 (2004).

Arguing for a higher interest rate, Comm2013 objected to the Debtor's proposed rate. The Debtor's proposed rate was based upon the Expected Loss Formula which the court deemed appropriate because it aligned with the Supreme Court's guidance in *Till* in that it provided an arithmetical process to calculate what is necessary to compensate a secured lender subject to cram-down under § 1129(b)(2)(A)(i)(II). The court rejected the higher rate proposed by Comm2013 because it overstated the debtor-specific risk of default.

In reaching its feasibility determination, the court found that Debtor's cash received from all sources exceeded the total of all payments required under the plan as well as the costs of operation including administrative expense claims, property taxes, insurance, common area maintenance, and capital repairs. The court also found that Debtor's post-confirmation prospects for increasing its tenant base and rental income were favorable noting that it need not find a likelihood of guaranteed success but only a reasonable prospect.

Comm2013's Proposed Plan. Comm2013's plan proposed liquidating The Crossings Mall, paying the bankruptcy estate's administrative claims, and compensating unsecured creditors with a cash infusion from the estate. The Debtor opposed the plan arguing, among other things, that the plan was not confirmable because Comm2013 was not authorized to file a competing plan under its Pooling and Servicing Agreement (PSA), and Comm2013 did not obtain acceptance of its plan from at least one impaired class pursuant to section 1129(a)(8) because, as an insider, its sole vote could not be counted. Unpersuaded by the Debtor's objections, the court held that Comm2013's plan also met the confirmation requirements of section 1129(a).

Reasoning that nothing in the Bankruptcy Code or at non-bankruptcy law precluded Comm2013 from filing a competing plan, the court found that the Debtor's section 1129(a)(3) arguments fell short of impeding confirmation because they were beyond the scope of the court's consideration of good faith, and because the bankruptcy court was an improper forum for considering claims that Comm2013 acted beyond its authority under its PSA. The court further held that Comm2013 was not an insider; therefore, its vote supporting its proposed plan qualified to give it an impaired class accepting its plan. Disagreeing with the Debtor's contention that Comm2013's exercised sufficient control over it to qualify as an insider, the court found that there was no evidence that Comm2013 took an active role in the management of Debtor. Rather, Comm2013's obstinance in approving Debtor's request for Capital Expenditure funds was based upon it affirmatively pursuing its rights and remedies as a secured creditor and not an effort to control the Debtor.

The Bankruptcy Court concluded by finding that both plans were confirmable, and that it was appropriate to confirm the Debtor's proposed plan. In reaching its conclusion, the court noted that Comm2013's liquidation plan would result in it receiving far less than under Debtor's plan, and would assuredly result in the end of Debtor.

Practical Considerations

Given a choice between a plan for reorganization and one for liquidation, a bankruptcy court is likely to exercise its discretion in favor of reorganization particularly when the overwhelming majority of claimants support a debtor's

proposed reorganization, and there exists a reasonable prospect of successful plan performance. Therefore, when submitting competing plans, creditors should be mindful of the impact of their plan on other claimants and a debtor's ability to perform post-confirmation.

If you have questions or would like additional information on the material covered, please contact the author below.

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'Til Debt Do Us Part: Debtor's Ex-Wife Breached Fiduciary Duties as Committee Member, Leading to Equitably Subordination of Domestic Support Claim

Naylor v. Farrell (In re Richard Clark Farrell) Ch. 7 Case No. 14-11729-MW, Adv. No. 16-01123 (Bankr. C.D. Ca. Nov. 15, 2019),

Case Snapshot

The United States Bankruptcy Court for the Central District of California (the Bankruptcy Court) found that a debtor's ex-wife breached her fiduciary duties as a member of the official unsecured creditors committee (the Committee) when she failed to disclose—following the appointment of a chapter 11 trustee (the Trustee)—that the allowance of her domestic support award as a first priority unsecured claim would exhaust estate funds, thereby precluding recovery by any other creditor. Specifically, the Bankruptcy Court held that the ex-wife actively concealed her intentions with respect to her claim by refusing to answer the Trustee's repeated inquiries as to the nature and the scope of the claim, thereby effectively luring the estate's professionals into performing work and administering the estate for what might end up being her sole benefit. As a result of her conduct, the ex-wife's entire claim was equitably subordinated to all professional fees for work performed by the Trustee's professionals and the Committee's professionals from and after 15 days after Trustee's appointment.

Factual Background

Richard Clark Farrell (the Debtor) originally filed a petition for relief under chapter 11 of the Bankruptcy Code in 2014, and the United States Trustee's Office appointed a three-member Committee in connection with the case. Among those appointed to the Committee were Betty Farrell—the Debtor's ex-wife—who asserted a first-priority unsecured domestic support obligation claim (estimated at approximately $6 million) related to the division of community property and retroactive or permanent spousal support claims. Although the Farrells divorced in 2000, the California family law court (the Family Court) had not, as of the petition date, determined how to divide the community property of the marriage or whether to award Ms. Farrell spousal support. Ms. Farrell was an active participant on the Committee for nearly two years, during which time she provided information regarding the Debtor's real and personal property—which in turn greatly increased the funds available to creditors.

In December 2014, the Bankruptcy Court appointed a Chapter 11 Trustee. The Trustee immediately expressed her concerns regarding the magnitude of Ms. Farrell's claims and their potential first-priority status and emphasized that she would not administer a case where only one priority creditor would be paid. The Trustee was unable to get a straight answer from Ms. Farrell or her attorneys regarding the extent of her claims or how Ms. Farrell intended to pursue them. In the interim, the Trustee incurred a sizable amount of professional fees in connection with locating buyers of estate assets, bringing sale motions, and performing other tasks to reduce estate property to cash for distribution to unsecured creditors. Following months of actively demanding that the Trustee and the Committee take aggressive action to obtain and liquidate estate assets, Ms. Farrell objected to

the interim fee applications filed by the Trustee's attorneys, the Committee's attorneys and other professionals, stating that:

> 'It is entirely possible it will ultimately be adjudicated that Debtor has little to any remaining interest in community property and that [Ms. Farrell's] pre-petition support claim which has the highest priority for payment will consume the property that remains in this estate. As such,on this record, it is impossible for this Court to authorize payment for any allowed fees at this time. [Ms. Farrell] is cognizant that Applicants have a right to be paid for their services; however, they do not have a right to be paid from her property or from funds that should be payable to her on account of domestic support.'

After objecting to the interim fee applications, Ms. Farrell resigned from the Committee.

In May 2016, the Committee filed an adversary complaint (the Complaint) against Ms. Farrell. The bankruptcy case was converted to chapter 7 shortly thereafter and the (now chapter 7) Trustee was substituted as plaintiff. The Complaint states causes of action for (i) equitable subordination of Ms. Farrell's claim and (ii) breach of fiduciary duty by Ms. Farrell. The complaint also seeks two declaratory judgments relating to the community sub-estate within the chapter 7 estate. Specifically, the complaint seeks declarations that (1) a 'Binding Mediation Term Sheet' between the Debtor and Ms. Farrell bound the parties in the Bankruptcy Court with respect to the liability and equal division of the community property sub-estate, and (2) the "interest of justice" within the meaning of 11 U.S.C. section 726(c)(1) requires that all administrative expense claims against the chapter 7 Estate be paid from the community property sub-estate. Trial commenced in October 2019. However, the Family Court had not determined whether Ms. Farrell will be awarded permanent and/or retroactive domestic support—meaning that any section 507(a)(1) first priority claim based upon a domestic support order remained unliquidated. The Family Court had entered a judgment (the July 2019 Judgment) with respect to the marital property, holding that a number of assets did not constitute community property to which Ms. Farrell was entitled.

Court Analysis

The Bankruptcy Court began with the caveat that the waterfall of distributions by the Trustee from Estate property pursuant to 11 U.S.C. section 726 remains unknowable due to (i) the uncertainty concerning the amount of permanent and/or retroactive support that the Family Court may award to Ms. Farrell and (ii) the uncertainty as to whether community claims will exceed the value of community property held by the Estate for the payment of such claims pursuant to 11 U.S.C. sections 541 and 726.

(i) Breach of Fiduciary Duty

With respect to the breach of fiduciary duty claim, the Bankruptcy Court first recited the well-established principle that a member of a creditors' committee has a fiduciary duty to all the creditors they represent. Specifically, the Bankruptcy Court held that member of a creditors' committee owes their constituencies a duty of care and duty of loyalty, as well as a corresponding duty of disclosure, which can be breached by failing to disclose of material facts. The Bankruptcy Court made a more nuanced point regarding unsecured creditors' committee members, stating that they are hybrids who serve more than one master (*i.e.* themselves and the other creditors who are not committee members). A committee member does not breach his or her fiduciary duties by asserting its own rights under applicable bankruptcy law, even though allowance of their claim will dilute distributions to other creditors.

The Bankruptcy Court found that Ms. Farrell seriously breached her fiduciary duties of disclosure and loyalty by actively concealing her intentions with respect to her domestic support claim and dodging the Trustee's repeated inquiries. Ms. Farrell was required, at the outset of the case, to disclose her position that the Estate's professionals (and, by implication, general unsecured creditors) do not have a right to be paid from her property or from funds that should be payable to her on account of domestic support. The Bankruptcy Court found that because of Ms. Farrell's non-disclosure, Estate's professionals were effectively lured into possibly working for free and administering the Estate for what might end up being her sole benefit.

(ii) Equitable Subordination

Turning to the equitable subordination claim, the Bankruptcy Court first noted that under prevailing Ninth Circuit law, the proponent of such claim bears the burden of proving three elements: (1) the claimant engaged in some type of inequitable conduct; (2) the misconduct injured creditors or conferred an unfair advantage on the holder of the claim sought to be subordinated and (3) subordination would not be inconsistent with the Bankruptcy Code. Regarding the first prong of the test, the Bankruptcy Court found that Ms. Farrell's actions clearly rose to the level of inequitable conduct.

With respect to the third prong, Ms. Farrell argued that subordination of her claim would be inconsistent with the Bankruptcy Code because it would deprive her of the priority position to which she is entitled under 11 U.S.C. section 507(a)(1). The Bankruptcy Court found this position untenable because it would mean that no priority claim could be subordinated under section 510(c) of the Bankruptcy Code, thereby rendering that such

superfluous.

In addressing the second prong, the Bankruptcy Court was unable to determine the extent to which the unsecured creditor body was harmed by Ms. Farrell's inequitable conduct due, in part, to the absence of a ruling from the Family Court regarding Ms. Farrell's entitlement to retroactive and/or future domestic support. However, recognizing that damages for wrongful conduct may be determined by analyzing what likely would have happened if such wrongful conduct had not occurred, the Bankruptcy Court equitably subordinated Ms. Farrell's claim in its entirety to all professional fees incurred by the Trustee and the Committee from and after fifteen days after the Trustee's appointment as chapter 11 trustee. The Bankruptcy Court reasoned that had the Trustee known soon after her appointment of Ms. Farrell's true intentions with respect to her claim, she likely would have declined to administer the estate and would not have incurred professional fees. According to the Bankruptcy Court, non-administrative priority creditors (other than Ms. Farrell) and general unsecured creditors may have been able to collect from Debtor after his bankruptcy case was dismissed, or may have benefited from a carve-out agreement negotiated by the Trustee. Alternatively, the issue of any payment to non-administrative priority creditors and general unsecured creditors would be moot if no Estate assets remained after payment of the professional administrative claims. Accordingly, the Bankruptcy Court made no conclusion on this issue and required further briefing from the parties.

(iii) Declaratory Judgments

In terms of the declaratory judgments requested in the Complaint, the Bankruptcy Court first found that the Binding Mediation Term Sheet was binding and enforceable in the Bankruptcy Court upon the liability and equal division of the community property sub-estate. With respect to the request that all administrative expense claims be paid from the community property sub-estate pursuant to the "interest of justice" rule of 11 U.S.C. section 726(c)(1), the Bankruptcy Court granted the request, subject to modification if the July 2019 Judgment regarding marital property were reversed on appeal.

The Bankruptcy Court opined that it envisioned the Debtor and Ms. Farrell would return to Family Court to obtain a ruling on Ms. Farrell's entitlement to domestic support, as well as a determination as to whether certain property is separate or community property—and if the latter, such property would be available to pay professional fees incurred by the Trustee and the Committee. The Trustee would then distribute to non-administrative priority creditors an amount equal to the subordination of Ms. Farrell's claims to the claims of such creditors after the Bankruptcy Court determines such amount. Any remaining funds would be distributed to general unsecured creditors while also creating a reserve for the payment of the Trustee's own fees. If at that point there is still remaining property to distribute, the Bankruptcy Court would determine a waterfall of distributions consistent with the provisions of bankruptcy law.

Practical Considerations

The moral of this story is that members of official committees of unsecured creditors (and their counsel) should be aware that they owe fiduciary duties to all of the creditor constituents they represent, and that failure to satisfy their duties of care, loyalty, and disclosure could lead to the equitable subordination of a breaching member's claims against the estate.

If you have questions or would like additional information on the material covered, please contact the author below.

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Bankruptcy Court for the Northern District of New York Addresses Whether it Should Convert a Chapter 11 Case to Chapter 7 under Section 1112(b) of the Bankruptcy

Code

In re: Herb Philipson's Army and Navy Stores, Inc., No. 18-6137 (DD) (Bankr. N.D.N.Y Dec. 19, 2019)

Case Snapshot

The United States Trustee (the Trustee) and Gary L. Philipson (Philipson), a creditor, sought conversion of the Debtor's chapter 11 case to a case under chapter 7, pursuant to 11 U.S.C. section 1112(b) asserting that: (1) chapter 11 had done nothing to protect or advance the Debtor's interests; (2) the Debtor is unable to rehabilitate its business; and (3) the expenses of confirming a chapter 11 plan and the continuation of accumulating costs to remain in chapter 11 would be significantly higher than the cost of a chapter 7 case. The Bankruptcy Court for the Northern District of New York (the Court) agreed with the Trustee and Philipson, holding that the Court's discretion on whether to convert or dismiss under section 1112(b) of the Bankruptcy Code is restricted, and because "cause" clearly exists here, the Court converted the case to chapter 7.

Factual Background

On or about October 18, 2018, Herb Philipson's Army and Navy Stores, Inc. (the Debtor) filed a petition for relief under chapter 11 and began operating as a debtor-in-possession under section 1107 and 1008 of the Bankruptcy Code. The Official Committee of Unsecured Creditors (the Committee) was appointed on October 19, 2018. Both of the Debtor's principal and Debtor's counsel represented that the Debtor intended to restructure and reorganize its business while in chapter 11.

In efforts to restructure, the Debtor filed a motion seeking Court approval to obtain secured, superpriority debtor-in-possession financing from Crossroads Financial, LLC (Crossroads) (the DIP Financing Motion), which was granted, and on April 8, 2019, Debtor filed a proposed Chapter 11 Plan and Disclosure Statement, wherein the Debtor set forth an exit financing strategy and a proposed 100% repayment plan over a 5-year term.

On July 2, 2019, however, the Debtor filed an emergency motion seeking Court approval to conduct a section 363 sale of substantially all assets (the Sale Motion), which the Court granted in part. Later, on July 24, 2019, though, the Debtor withdrew the Sale Motion after the proposed buyer and sole bidder backed out. Following the collapse of the Debtor's sale efforts, the Trustee immediately sought conversion of the case.

At this time, the Debtor had also defaulted on its obligations to Crossroads under the DIP Financing Motion and it did not have the ability to cure the default. Crossroads therefore had the right to exercise its rights and remedies under the DIP Financing Order. The United States Trustee, with the express approval of the Committee, Philipson, and the Debtor's commercial landlords, agreed to table the issue of conversion and to allow the Debtor to begin a wind-down and liquidation of its business. The store closing sales were completed on November 11, 2019, and all of the Debtor's retail inventory, as well as certain furniture, fixtures, and equipment, were sold. During this process, the Debtor continued to adjourn its motion for an order approving the Disclosure Statement.

Meanwhile, on September 20, 2019, Philipson commenced an adversary proceeding against the Debtor to determine the nature and extent of their liens. On November 14, 2019, the Debtor filed an answer, including affirmative defenses of unclean hands and setoff, and counterclaims for the avoidance and recovery of preferential transfers made individually to Philipson, avoidance of the Philipson lien, avoidance and recovery of fraudulent transfers made individually to Philipson, equitable subordination of the Philipson claim, and disallowance of the Philipson claim, under Chapter 5 of the Bankruptcy Code.

Both the Trustee and Philipson filed motions seeking to convert the chapter 11 case to a chapter 7 case, arguing that (i) chapter 11 had done nothing to protect or advance Debtor's interests; (ii) because Debtor is unable to rehabilitate its business, as is required by section 1112(b)(1), the plain language of section 1112(b) requires the Court to convert the case to a case under chapter 7; and (iii) even if the Debtor could pursue post-confirmation litigation and obtain funding to prosecute the chapter 5 avoidance litigation through a litigation trust, the expenses of confirming a chapter 11 plan and the continuation of accumulating costs to remain in chapter 11 would be significantly higher than the cost of a chapter 7 case.

The Debtor filed an objection, to which the Committee joined, asking the Court to follow a line of cases wherein bankruptcy courts assessed which chapter would better serve the interests of the creditors and the estate and, upon finding that chapter 11 would do so, permitted debtors-in-possession to remain in control of their businesses while liquidating under chapter 11. The Debtor and the Committee countered the Trustee's and Philipson's arguments by asserting that, even if the Court finds cause for conversion or dismissal exists under

section 1112(b), the Court should, in its exercise of discretion, deny the relief requested because a chapter 11 liquidating plan that would preserve avoidance actions for a post-confirmation fiduciary would best serve the interests of creditors and the estate.

Court Analysis

The Court granted the motions of the Trustee and Philipson, and converted the chapter 11 case to chapter 7.

Subject to certain exceptions, 11 U.S.C. section 1121(b)(1) provides that a court shall dismiss a case under chapter 11 or convert the case to one under chapter 7, whichever is in the best interests of the creditors and the estate, if the movant establishes "cause." The moving party bears the burden of demonstrating cause by a preponderance of the evidence. *In re BH S&B Holdings, LLC*, 439 B.R. 342, 346 (Bankr. S.D.N.Y. 2010).

"The bankruptcy court has wide discretion to determine if cause exists and how to ultimately adjudicate the case." *In re 1031 Tax Group, LLC*, 374 B.R. 78, 93 (Bankr. S.D.N.Y. 2007). Although the Bankruptcy Code does not define "cause" as that term is used in section 1112(b)(1), section 1112(b)(4) provides a nonexclusive list of what constitutes cause for dismissal or conversion. This includes "substantial or continuing loss to or diminution of the estate and the absence of a reasonable likelihood of rehabilitation." 11 U.S.C. section 1112(b)(4)(A).

The Court noted that once cause has been demonstrated under section 1112(b)(4)(A), however, a court must either dismiss or convert a chapter 11 case. *In re TCR of Denver, LLC*, 338 B.R. 494, 498 (Bankr. D. Colo. 2006) ("[I]t appears that Congress has purposefully limited the role of this Court in deciding issues of conversion and dismissal, such that this Court has no choice, and no discretion, in that it **shall** dismiss or convert a case under Chapter 11 if the elements for "cause" are shown under 11 U.S.C. section 1112(b)(4).") (emphasis in original).

Citing *Andover Covered Bridge, LLC v. Harrington (In re Andover Covered Bridge, LLC)*, 553 B.R. 162, 174 (B.A.P. 1st Cir. 2016), the Court explained the following two-prong test to determine "cause" under section 1112(b)(4):

> (1) whether after the commencement of the case, the debtor has suffered or continued to experience a negative cash flow, or alternatively, declining asset value; and (2) whether there is any reasonable likelihood that the debtor, or some other party, will be able to stem the debtor's losses and place the debtor's business enterprise back on a solid financial footing within a reasonable amount of time.

Applying the two-prong test above, the Court held that there had been substantial and continuing losses to and diminution of the estate here, as evidenced by Debtor's financial statements, monthly operating reports, inability to pay administrative expenses associated with the wind-down of its affairs, completed liquidation, and store closings, satisfying the first prong.

Regarding the second prong, the Court questioned whether "rehabilitation" in the context of section 1112(b)(4)(A) includes a liquidating plan. The Court stated that the case law is clear that rehabilitation refers to a debtor's ability to restore the viability of a business. Therefore, because "rehabilitation" does not include a liquidating plan, the Court held that the second prong of the test is satisfied as well.

Finding that both prongs of the test in *Andover* had been satisfied, the Court found that cause had been established within the meaning of section 1112(b)(4)(A), and contrary to the Debtor and Committee's position, the Court **must** convert the case to chapter 7. The Court declined to reach the question of whether allowing the Debtor to remain in chapter 11 would better serve the interests of creditors.

Practical Considerations

Under 11 U.S.C. 1112(b)(4), if cause exists under the two-prong test, established by *Andover Covered Bridge, LLC v. Harrington (In re Andover Covered Bridge, LLC)*, 553 B.R. 162, 174 (B.A.P. 1st Cir. 2016), a court must either dismiss or convert the case. A court's discretion is restricted in this context.

Additionally, for the purposes of section 1112(b)(4), it is important to note that "rehabilitation" does not include a liquidating plan.

If you have questions or would like additional information on the material covered, please contact the author below.

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The Government is not Exempt from the Priority Scheme of the Bankruptcy Code

Alex M. Azar II, et al. v. True Health Diagnostics, LLC (In re THG Holdings LLC), Civ. No. 19-2215-RGA, 2019 U.S. Dist. LEXIS 209627 (D. Del. Dec. 5, 2019):

Case Snapshot

Debtor True Health Diagnostics, LLC (THD) filed a complaint against the Government to enforce the automatic stay and enjoin the Government from withholding Medicare payments owed to THD in bankruptcy. The bankruptcy court agreed, finding that the Government violated the automatic stay by withholding property belonging to the estate. The bankruptcy court entered an order (**Payment Order**) that 100% of withheld funds be delivered to THD (**Ordered Payments**). The Government appealed the Payment Order and filed an emergency motion for stay relief, which was ultimately denied by the bankruptcy court.

Subsequently thereafter, the bankruptcy court entered its order confirming the Debtors' proposed Chapter 11 Plan of Liquidation (hereinafter, the **Confirmation Order**). The Government then appealed the Confirmation Order, and filed an *Emergency Motion for Stay Relief* with the District Court. The Government argued, in part, that the Confirmation Order should not have been entered without: (1) providing an avenue for recovery if the Government succeeds in its appeal of the Payment Order was a "deliberate attempt to take money from the United States and pay it to other creditors. . . ."; sand (2) "the absence of sufficient funding to repay the United States in the likely event that it succeeds on appeal renders the Plan infeasible." *Alex M. Azar II, et al. v. True Health Diagnostics, LLC (In re THG Holdings LLC)*, Civ. No. 19-2215-RGA, 2019 U.S. Dist. LEXIS 209627, at *9 (D. Del. Dec. 5, 2019). According to the Government, the Ordered Payments would have to qualify as an administrative expense of the Debtors' estates in order to be returned in full. *Id.* at *17.

Ultimately, the District Court found that the Government "failed to establish that it will suffer irreparable harm in the absence of a stay," and denied the requested stay relief. *Id*. at *22.

Factual Background

On July 30, 2019 (the Petition Date), the Debtors filed voluntary petitions for relief under chapter 11 of the Bankruptcy Code. On the Petition Date, THD filed a complaint against the Government to enforce the automatic stay and enjoin the Government from withholding Medicare payments owed to THD in bankruptcy. The bankruptcy court agreed, and entered the Payment Order.

The Government appealed the Payment Order — and simultaneously filed an *Emergency Motion for Stay Pending Appeal* (First Emergency Stay Motion), seeking a stay pending appeal. The Motion was denied by the bankruptcy court. *Id*. at *1-2.

The bankruptcy court then proceeded with the confirmation hearing on November 26, 2019. Prior to the confirmation hearing, the Debtors and the Government entered into a stipulation governing the evidence to be admitted at the Confirmation Hearing (the Stipulation). *Id*. at *5-6. Pursuant to the Stipulation, the Government agreed that it would not introduce any evidence challenging the Debtors' evidence that they provided valuable and necessary services in exchange for the Ordered Payments. *Id*. The Government also stipulated that it would not offer any evidence of misconduct by the Debtors or evidence supporting an administrative expense claim. *Id*. As noted by the Bankruptcy Court, "The Government, in its closing argument, agreed that it was limiting its objections to feasibility, good faith, and the scope of the releases being provided under the terms of the Plan." *Id*. The bankruptcy court subsequently entered its Confirmation Order.

Thereafter, the Government appealed the Confirmation Order, and simultaneously filed another *Emergency Motion for Stay Pending Appeal* (the Second Emergency Motion for Stay), which the District Court ultimately denied.

Court Analysis

Here, the Government argues that, "once the Chapter 11 Plan becomes effective, it is likely to be irreparably harmed absent a stay because there will be no meaningful opportunity to adjudicate the Payment Order Appeal." *Id*. at *17. More specifically, the Government argued that: (1) the Debtors' failure to include an avenue for recovery if the Government succeeds in its appeal of the Payment Order was a "deliberate attempt to take money from the United States and pay it to other creditors. . . ."; and (2) "the absence of sufficient funding to repay the United States in the likely event that it succeeds on appeal renders the Plan infeasible." *Id*. at *9. To be returned in full, the payments at issue would have to qualify as an administrative expense of the Debtors' estates. *Id*. at *17.

Unfortunately, the Government "stipulated not to offer an administrative expense claim in connection with its objection to the entry of the Confirmation Order." *Id*. at *18. Therefore, "[h]aving failed to assert a basis for administrative priority treatment in the first place, the Government cannot assert the Plan's failure to accord such treatment as irreparable harm." *Id*.

Additionally, both the Bankruptcy Court and District Court recognized that the Government was attempting to circumvent the Bankruptcy Code's priority scheme and secure a finding that it would be automatically entitled to a return of the Ordered Payments if it were successful in the Payment Order appeal:

The Government continues that it should be able to recover payments without showing, under Section 503(b) of the Code, that the payments are an administrative claim. Notably, the Government cites no authority that it should be exempt from that provision of the Code, and the Court is not aware of any such exemption for the Government.

Id. at 14 (citing bankruptcy court transcripts). The District Court further agreed with the Bankruptcy Court's rationale that "the Ordered Payments were earned by the Debtors during the bankruptcy cases, which clearly undermines the Government's theory that it would be entitled to the return of the Ordered Payments." *Id*.

Therefore, the District Court found that the Government "failed to establish that it will suffer irreparable harm in the absence of a stay," and denied the Second Emergency Motion for Stay.

Practical Considerations

All parties, including a government entity, must provide evidence that their claims are entitled to administrative expense priority. Here, the Government presented no evidence that the Ordered Payments were entitled to be treated as an administrative claim under Section 503(b). Absent a statutory mechanism to do so, such as proving an entitlement to a secured claim or an administrative expense, the Government has no automatic right to payment if it succeeds in its appeal.

If you have questions or would like additional information on the material covered, please contact the author below.

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Supreme Court Holds Order Unreservedly Denying Stay Relief Is A Final, Appealable Order

Summary of Ritzen Group, Inc. v. Jackson Masonry, LLC, No. 18-938, 589 U.S. (Jan. 14, 2020)

In this unanimous decision, the Supreme Court held that an order that unreservedly denies a motion for relief from the automatic stay is a final order subject to immediate appeal. In order to timely appeal, the appeal needed to be filed within 14 days of entry of the order.

The facts in this case are not unique. Prebankruptcy, two parties were involved in ongoing state court litigation. Immediately prior to the trial date, the defendant/debtor filed a bankruptcy case staying the state court litigation. The plaintiff/creditor filed a motion for relief from the automatic stay arguing that the claim should be determined in state court. The bankruptcy court denied the motion. The plaintiff/creditor did not appeal at that time. The plaintiff/creditor then filed a proof of claim, asserting the same grounds as in the state court action. The bankruptcy court held proceedings and ultimately disallowed the claim. Thereafter, the debtor filed and confirmed a plan. After confirmation, the plaintiff/creditor filed two notices of appeal. The first notice of appeal challenged whether the bankruptcy court properly denied its motion for relief. The second notice of appeal related to the claims adjudication process and the plan.

On the substantive, the lower appellate courts concluded that the bankruptcy court's rulings were appropriate under the appropriate appellate standard. With respect to the motion for relief appeal, each of the appellate courts concluded that the appeal was "out of time" because it was not filed within 14 days of the order originally entered.

The Supreme Court relied heavily on its "finality" jurisprudence in bankruptcy dating back to *Bullard v. Blue Hills Bank*, 575 U.S. 496 (2015). The Court reiterated that orders in bankruptcy cases are immediately appealable if they finally dispose of a discrete dispute within the larger bankruptcy case. More pointedly, when there is an alteration of the relative rights and obligations of the parties, the pragmatic "finality" standard is often met. The ruling on the stay relief motion addressed a specific "procedural unit" which is different and distinct from the ultimate claims allowance process. Therefore, by resolving the discrete dispute, the resolution was immediately appealable.

The creditor argued that the stay relief denial was simply a determination of the "forum" for ultimate adjudication. The Court refuted the creditor's argument by holding that "finality" is determined by whether the ruling terminated a procedural unit separate and distinct from the overall case. Here, because the stay relief decision fully resolved the procedural unit that constituted finality. Since the notice of appeal was not filed within 14 days of the order, the appeal was not timely.

The Court did include a footnote that its decision may be altered if the bankruptcy court's decision was "without prejudice"; however, as a general practice, the Court is highlighting the importance of tracking and timely filing notice of appeal from any orders which complete a procedural unit within the larger bankruptcy case

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If you have questions or would like additional information on the material covered, please contact the author below.

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guarantee a similar outcome in the future.