RECENT DEVELOPMENTS IN DELAWARE BANKRUPTCY LAW

Brendan L. Shannon and Christopher J. Sontchi*

I. Standard For Determining Whether A Creditor May Be Treated As A "Non-Statutory Insider" For Purposes Of Extending The Time For Recovering Preferential Transfers

In *Schubert v. Lucent Technologies Inc.* (*In re Winstar Communications Inc.*)*,* the U.S. court of Appeals for the Third Circuit clarified the standard for determining whether a creditor is a "non-statutory insider" for purposes of extending the time in which the trustee may recover preferential transfers under section 547 of the Code.[1]

The appeal arose out of a pre-petition "strategic partnership" between the debtor, Winstar Communications, Inc. ("Winstar"), and Lucent Technologies Inc. ("Lucent"), one of Winstar's primary creditors and suppliers. Both the bankruptcy court and district court below had concluded, *inter alia*, that Lucent's relationship with Winstar was such that Lucent was an "insider" of Winstar under the Code and, accordingly, the trustee could seek to recover for preferential transfers received from Winstar during the year before Winstar's bankruptcy, rather than those received in the 90-day period before bankruptcy applicable to non-insiders. More specifically, the bankruptcy court had held that Lucent was an insider of Winstar under both section 101(31)(B)(iii), which makes a "person in control" of a debtor an insider, and as a "non-statutory insider." The district court affirmed. Lucent appealed to the Third Circuit.

On appeal, Lucent argued that in order for a creditor to be an insider as either a "person in control" of the debtor or a non-statutory insider, that creditor must exercise "actual managerial control over the debtor's day-to-day operations."[2] The Third Circuit held otherwise.

Like the bankruptcy court before it, the Third Circuit held that "actual control (or its close equivalent) is necessary for a person or entity to constitute an insider under § 101(31)'s 'person in control' language."[3] The Third Circuit held that a finding of such control, however, is not necessary for an entity to be a so-called "non-statutory insider."[4] To hold otherwise "would render meaningless Congress's decision to provide a non-exhaustive list of insiders in 11 U.S.C. § 101(31) (B) because the 'person in control' category would function as a determinative test."[5] In light of this, the Third

* Brendan L. Shannon and Christopher J. Sontchi are judges on the United States Bankruptcy Court for the District of Delaware. The authors gratefully acknowledge the invaluable assistance of their law clerks, Nicholas Harper-Smith, Justin Rucki and Scott Koerner.

1. 554 F.3d 382 (3d Cir. 2009).

2. *Id.* at 395 (quoting Appellant's Br. at 32-33).

3. *Id.* at 396. The text of section 101(31) provides that "[t]he term 'insider' includes … (B) if the debtor is a corporation-(i) director of the debtor; (ii) officer of the debtor; (iii) person in control of the debtor; (iv) partnership in which the debtor is a general partner; (v) general partner of the debtor; or (vi) relative of a general partner, director, officer, or person in control of the debtor." 11 U.S.C. § 101(31)(B).

4. A "non-statutory insider" is an entity that falls within the definition of insider but is not included in the non-exclusive list (due to the use of the word "includes," of enumerated examples of insiders set forth in section 101(31) of the Code. *Schubert,* 554 F.3d at 395.

5. *Id.*

Circuit embraced the view taken recently by the Tenth Circuit "that it is not necessary that a non-statutory insider have actual control; rather, the question 'is whether there is a close relationship [between debtor and creditor] and … anything other than closeness to suggest that any transactions were not conducted at arm's length.'"[6]

On the record before it, the Third Circuit found Lucent to be an insider of Winstar under this test. The Circuit held that the bankruptcy court's "extensive findings regarding Lucent's ability to coerce Winstar into transactions not in Winstar's interest amply demonstrate Lucent's insider status."[7] These included findings that Lucent controlled many of Winstar's decisions relating to a specific project, forced the purchase of its goods well before the equipment was needed, and treated Winstar as a captive buyer for Lucent's goods.

II. District Court Reversal Of Bankruptcy Court Finding That Chapter 11 Cases Were Filed In Good Faith And Remand To Bankruptcy Court For Dismissal

In *Bepco L.P. v. 15375 Memorial Corporation*,[8] the district court reversed the bankruptcy court's ruling that the debtors' bankruptcy petitions were filed in good faith and remanded the case (as consolidated) to the bankruptcy court for dismissal.

Citing prior Third Circuit case law, the district court noted that chapter 11 bankruptcy petitions are subject to dismissal under section 1112(b) of the Code unless filed in good faith, and that "'[w]hether the good faith requirement has been satisfied is a 'fact intensive inquiry' in which the court must examine 'the totality of the circumstances' and determine 'where a petition falls along the spectrum ranging from the clearly acceptable to the patently abusive.'"[9] Third Circuit case law also counsels that two questions relevant to the good faith inquiry are (i) whether the petition served "a valid bankruptcy purpose, e.g., by preserving a going concern or maximizing the value of the debtor's estate," and (ii) whether the petition was "filed merely to obtain a tactical litigation advantage."[10]

Because the bankruptcy in question did not seek to preserve a going concern, the district court focused on whether the bankruptcy filing maximized the value of the debtors' estates in answering the first question. The district court found that the record did not support the conclusion that the debtors' petitions captured value for the estates that otherwise would have been lost. More specifically, the district court found that nothing in the record showed that each of the debtors' major assets — composed primarily of settlement funds, intercompany receivables, and indemnity rights and claims — "would not be just as valuable — and just as accessible — outside of bankruptcy."[11]

As to the second question, the district court held that the record supported the conclusion that the debtors' primary objective in filing the petitions — approximately two months before a major lawsuit against them was scheduled to go to trial — was to gain a tactical advantage in litigation. In reaching this conclusion, the district court held that the

---

6. *Id.* at 397 (quoting Anstine v. Carl Zeiss Meditec AG (*In re* U.S. Med., Inc.), 531 F.3d 1272, 1277 (10th Cir. 2008)).

7. *Id.*

8. 400 B.R. 420 (D. Del. 2009).

9. *Id.* at 427 (quoting *In re* Integrated Telecom Express, Inc., 384 F.3d 108, 118 (3d Cir. 2004)).

10. *Id.* (quoting *Integrated Telecom*, 384 F.3d at 119-20).

11. *Id.*

fact that the chapter 11 petitions were filed out of a desire to distribute efficiently the debtors' assets, without more, did not establish the debtors' good faith.

III. No Right To Triangular Setoff Under The Bankruptcy Code

In *In re SemCrude, L.P.,*[12] the bankruptcy court was faced with a motion from Chevron Products Company ("Chevron") seeking relief from the automatic stay to affect a "triangular setoff" of certain debts that were owed or owing between it and three separate debtors in a series of jointly administered cases. More specifically, Chevron owed a balance of approximately $1.4 million to one of the debtors, SemCrude. Chevron was owed $10.2 million by SemFuel, a second debtor, and an additional $3.3 million by SemStream, a third debtor.[13]

Chevron argued that its contracts with each of the three debtors permitted it to set off the debt it owed to SemCrude against the debts owed to it by SemFuel and SemStream. But the debtors, the official committee of unsecured creditors, and a host of the debtors' creditors filed objections to Chevron's motion. These objections took issue with Chevron's argument that parties can contract around the Code's requirement in section 553 that debts be "mutual" in order to be set off. The objectors contended that triangular setoff is impermissible in bankruptcy, even if contemplated by a valid, pre-petition contract. Alternatively, the objectors argued that even if there was such a contract exception to the mutuality requirement, the contracts in the instant case failed to effect such a result.

The court did not address the latter argument. Rather, it held that Chevron was not permitted to effect such a setoff against the debtors because, as a matter of law, section 553 of the Code prohibits a triangular setoff of debts against one or more debtors in bankruptcy.

The court noted that section 553 of the Code does not create a right of setoff under the Code, but merely preserves any setoff right that a creditor may have under applicable non-bankruptcy law. Nonetheless, section 553 of the Code imposes additional restrictions on a creditor seeking to enforce its non-bankruptcy right to a setoff debts against a debtor. These restrictions include the requirement that "to effect a set off in bankruptcy, courts construing the Code have long held that the debts to be offset must be mutual, prepetition debts."[14] The court also cited case law holding that, as a general rule at least, "triangular setoffs are impermissible in bankruptcy" because of the failure to meet the mutuality requirement.[15]

The court then discussed Chevron's contention that a valid, pre-petition contract — executed by a creditor, a debtor, and one or more third parties — either satisfies the mutuality requirement on its own or allows the parties to contract around the mutuality requirement found in section 553(a) if the contract provides that one or more parties to the agreement can elect to set off any debt it owes to one of the other parties against an amount owed to it by a different party to the agreement. The court observed that, "[a]t first blush, Chevron's position appears to enjoy a measure of support in the case law."[16] Almost a dozen cases decided in the last three decades under the Code, and a smaller number of cases decided under the Bankruptcy Act of 1898 have observed that an exception exists along the lines of that espoused by

---

12. 399 B.R. 388 (Bankr. D. Del. 2009).

13. These amounts are approximations.

14. *Id.* at 393.

15. *Id.*

16. *Id.*

Chevron in this case. Nonetheless, the court noted that, upon closer inspection, "not one of these cases has actually upheld or enforced an agreement that allows for a triangular setoff; each and every one of these decisions have simply recognized such an exception in the course of denying the requested setoff or finding mutuality independent of the agreement."[17] The court also observed that "these decisions cite only to other cases that recognize this purported exception in dicta, or, in some of the more recent cases, to a short reference in *Collier on Bankruptcy*, which also relies on this same handful of decisions for authority."[18] Each of these cases, in turn, directly or indirectly traces back to a single case decided under the Bankruptcy Act of 1898, *In re Berger Steel Co.*[19] The court in *Berger Steel* was faced with a request for triangular setoff. In analyzing the non-bankruptcy cases cited in favor of the setoff the court noted that all of the cases required the existence of a tripartite agreement, which was absent in the case before the court in *Berger*. Thus, the court held that, assuming the triangular setoff was permissible under the Act, it was nonetheless unavailable because the state law requirement of the existence of a tripartite agreement had not been met. The *Berger* court did not specifically hold that triangular setoff was permissible in bankruptcy.

Because of the history of these cases and the fact that no binding authority on the question exists, the court conducted its own analysis of two distinct questions. First, the court analyzed whether debts owing among different parties may be considered "mutual" when there are contractual netting provisions governing all parties' business relationship. Second, the court examined whether, if the answer is "no" to the first question, a "contractual exception" exists to section 553's mutuality requirement.

In answering the first question, the court noted that section 553 speaks only of setting off mutual debts. Therefore, the court concluded that, in determining whether a tripartite agreement that contemplates a triangular setoff can create mutuality for purposes of section 553, the court must scrutinize the meaning of the term "mutual debt" as it is used in that section. Because the term is not defined by the Code, the court looked to the definition of mutuality embraced by other courts tasked with interpreting section 553, and noted that "[i]t is also widely accepted that 'mutuality is strictly construed against the party seeking set off.'"[20]

Observing that "the overwhelming majority of courts to consider the issue have held that debts are mutual only if 'they are due to and from the same persons in the same capacity,'"[21] the court held that construing this definition narrowly means "that 'each party must own his claim in his own right severally, with the right to collect in his own name against the debtor in his own right and severally.'"[22] The court then concluded that mutuality cannot be supplied by a multi-party agreement contemplating only a triangular setoff. The court reasoned that, unlike a guaranty of debt where the guarantor is liable for making a payment on the debt it has guaranteed, an agreement to set off funds does not create an indebtedness from one party to another. The court further held that an agreement to set off funds, such as the one claimed by Chevron, does not give rise to a debt that is "due to" Chevron and "due from" SemCrude. Or, put another way, "[a] party such as SemCrude does not have to actually pay anything to a creditor such as Chevron under a tripartite setoff agreement; rather,

17. *Id.* at 394.

18. *Id.* (citing 5 Collier on Bankruptcy ¶ 553.03[3][b][ii], at 553-31 (15th ed. rev. 2008)).

19. 327 F.2d 401 (7th Cir. 1964).

20. *SemCrude*, 399 B.R. at 396 (citing *In re* Bennett Funding Group, Inc., 212 B.R. 206, 212 (2d Cir. BAP 1997)).

21. *Id.* (collecting cases).

22. *Id.* (collecting cases).

it only sees one of its receivables reduced in amount or eliminated. SemCrude does not owe anything to Chevron. Thus, there were no debts in the case before the court owed between the 'same persons in the same capacity.'"[23]

Moreover, the court held that Chevron did not have a "right to collect" against SemCrude under their agreement. At most, the agreement of the parties would have given Chevron a "right to offset" — a right to pay less than it would otherwise have to pay to the extent of the setoff. The agreement did not call for SemCrude to make a payment to Chevron, however. Consequently, the court observed, the agreement did not call for Chevron to "collect" anything from SemCrude. Chevron was, thus, without a "right to collect" from SemCrude.

The court found further support for its holding in the express language of section 553 of the Code, which speaks only of "the 'right of a creditor to offset a mutual debt owing by *such* creditor to the debtor that arose before the commencement [of the bankruptcy case] against a claim of *such* creditor against the debtor that arose before the commencement of the case.'"[24] Chevron and SemCrude did not fall within the terms of this language because the statute only allows for setoff of debts between a single creditor and a single debtor, and SemCrude does not owe Chevron anything. Moreover, the court noted, Chevron did not even have a claim against SemCrude because to have a claim it must have a "right to payment" from SemCrude, or "a 'right to an equitable remedy for breach of performance if such breach gives rise to a right to payment;'"[25] and SemCrude had neither.[26] Accordingly, the court held that non-mutual debts cannot be transformed into a "mutual debt" under section 553 simply because a multi-party agreement allows for setoff of non-mutual debts between the parties to the agreement.

The court then addressed whether there is a "contract exception" to the mutuality requirement found in section 553. The court found that nothing in the language of section 553 would permit it to recognize such an exception, and that policy considerations also counseled against allowing such an exception. Consequently, the court refused to recognize such an exception, and the court denied Chevron's motion for relief from the automatic stay.[27]

IV. Denial Of Confirmation Of Plan Of Reorganization Due To Discriminatory Settlement Contained Therein

The court in *In re Nutritional Sourcing Corp.*[28] was faced with a group of creditors who contended that their claims were unfairly discriminated against in a chapter 11 liquidation plan submitted to the court for confirmation. The

---

23. *Id.* at 397.

24. *Id.* (quoting 11 U.S.C. § 553(a)).

25. *Id.* at 398 n.8 (quoting 11 U.S.C. § 101(5)).

26. The court overlooked the fact that 11 U.S.C. § 102(2), the Code's construction section, provides that "a 'claim against the debtor' includes [a] claim against the property of the debtor." This oversight does not affect the Court's ultimate ruling, however, because Chevron did not have a claim against the property of SemCrude for the same reason that Chevron did not have a claim against SemCrude itself: because Chevron did not have a "right to payment" from the Chevron receivable, just as it did not have a right to payment from SemCrude. If Chevron's triangular setoff agreement were enforced as written, it would not have been entitled to receive any payment from SemCrude or its receivables — it would only have been entitled to pay less or, in this case, nothing, to SemCrude. A "right to pay less or nothing" is not the same as a "right to payment."

27. Chevron later sought reconsideration of the court's opinion, arguing for the first time that its contracts with the debtors were "forward contracts" and/or "swap agreements" that fall under the so-called "safe harbor provisions" of the Code, and that as a result the general rules for set-off should not apply. The court denied the motion for reconsideration and Chevron appealed.

28. 398 B.R. 816 (Bankr. D. Del. 2009).

court concurred, finding that the plan improperly classified the creditors' claims in violation of sections 1122 and 1123(a)(4) of the Code, which require equal treatment for substantially similar claims.

The case involved three separate debtors, Nutritional Sourcing Corporation ("NSC"), Pueblo International, LLC ("Pueblo"), and FLBN, LLC ("FLBN"), which together operated a chain of supermarkets. The dispute in question had its origins in an earlier bankruptcy of NSC, the corporate parent of Pueblo and FLBN. NSC filed for bankruptcy in 2002 and emerged in 2003. An integral part of NSC's 2003 reorganization was the issuance by NSC of senior secured notes dated June 5, 2003 that were issued in exchange for certain other senior secured notes that were due on August 1, 2003. The holders of the existing notes requested that the new notes be supported by secured guarantees by NSC's subsidiaries. NSC resisted this request and, instead, the Restated Subordinated Intercompany Real Estate Note dated June 5, 2003 was executed by Pueblo in favor of NSC (the "Mirror Loan Note"). Because NSC, as a holding company, did not have assets of its own to make payments on the new senior secured notes, the Mirror Loan Note provided for a transfer of funds from Pueblo to NSC and was secured by certain of Pueblo's real estate.

In order to assure Pueblo's trade creditors that they would be paid ahead of NSC's creditors, though, a subordination provision was added to the Mirror Loan Note. In particular, the Mirror Loan Note provided that payment would be "subordinate to *all* claims of any trade creditors of [Pueblo]."[29] The Mirror Loan Note did not include a definition of "trade creditor," however, nor did the senior note indenture executed in connection with the new senior secured notes and the Mirror Loan Note. This lack of definition in the Mirror Note and the subsequent definition in the plan of liquidation led to the dispute at issue.

The plan provided for dividing Pueblo's general unsecured creditors into two sub-classes — Class 4A: Pueblo Trade Claims ("Pueblo Trade Claims") and Class 4B: Pueblo General Unsecured Claims ("Pueblo General Unsecured Claims"). The plan defined "Pueblo Trade Claim" to include, essentially, only those creditors who had supplied Pueblo with groceries and other merchandise to be used as inventory in Pueblo's business.

The objecting parties' arguments hinged on the proposed plan's definition of Pueblo Trade Claims. The objectors argued that the definition sought to redefine the term "trade creditor" as included in the Mirror Loan Note. This distinction was important because, according to the disclosure statement filed with the proposed plan, Pueblo Trade Claims, totaling approximately $27 million were to be paid 100% on allowed claims, while Pueblo General Unsecured Claims, totaling approximately $79 million were only to receive an estimated recovery of 13.2% on allowed claims.

Although the plan proponents attempted to invoke the use of the term "trade creditor" within the supermarket industry to argue otherwise, the court found that the term trade creditor, as used in the Mirror Loan Note, encompassed the "commonplace, unambiguous meaning" of the term under applicable New York law, which was defined by the court as "someone who provides a good or service in the ordinary course of business and to whom debt is owed."[30] "Accordingly," the court held, "the definition of Pueblo Trade Claim in the Plan altered the definition of 'trade creditor' as intended by the parties to the Mirror Loan Note, likely to the surprise of many trade creditors."[31]

This led the court to conclude that the definition of "Pueblo Trade Claim," and, consequently, the definition of "trade creditor," was a "settlement" that the court had to evaluate under Federal Rule of Bankruptcy Procedure 9019, which sets the standards to be used in deciding whether to approve or reject a settlement. Of the four factors courts have laid out to determine whether a settlement is fair and reasonable, the court noted that three were relevant in the evaluation

29. *Id.* at 820 (quoting Doc. # 1676, ex. A, p. 2 (emphasis added)).

30. *Id.* at 827.

31. *Id.* at 832.

of the settlement constituted in the definition of Pueblo Trade Claim: (i) the probability of success in litigation; (ii) the complexity of the litigation involved and the expense, inconvenience, and delay necessarily attending it; and (iii) the paramount interest of creditors. The court found that the first two factors are closely intertwined and that both factors marginally weighed in favor of approval of the settlement and of the plan.

But the third factor led the court to reject the settlement. The court found that "[t]he compromise that is the definition of Pueblo Trade Claim severely adversely impacts 'non-goods' trade creditors who were not at the negotiating table and who were not adequately represented in their absence."[32] Furthermore, the court found that the parties negotiating settlement were the senior secured note holders and three "goods" trade creditors. While the official committee of unsecured creditors was a party to the negotiations and owed a fiduciary duty to the unrepresented non-goods trade creditors, the composition of the committee was such that it could not be said to adequately represent the non-goods trade creditors in the negotiations. Consequently, the court held that it "cannot hold that a settlement was fair and equitable under Rule 9019 when those parties whose rights were severely adversely impacted were not afforded meaningful participation in the negotiations."[33]

In doing so, the court also rejected the plan proponents' argument that the non-goods trade creditors voiced their opinion when they voted to accept the plan, contending that the court should take the vote as a demonstration of approval for the settlement. Nonetheless, the court held that the fact that eight non-goods trade creditors were currently objecting to the plan and only one of these creditors affirmatively voted against the plan did not indicate that such an inference was warranted. This conclusion was bolstered by statements from some of these creditors proclaiming that they did not understand that their claims had been reclassified until after voting on the plan. Thus, the court denied confirmation of the plan.[34]

V. Overruling Objection To Confirmation Of Plan Of Reorganization Based On The Argument That Plan Inappropriately Substantively Consolidates The Estates, Unfairly Discriminates Among Similarly Situated Creditors And Does Not Provide A Recovery To Creditors That Is Better Than They Would Receive In Chapter 7

In *In re New Century TRS Holdings, Inc.*,[35] the debtors' prepetition operations consisted of the origination, servicing and purchase of mortgage loans, as well as the sale of mortgage loans through whole loan sales and securitization. The debtors filed for chapter 11 and a confirmation hearing was held on the proposed chapter 11 plan.

The plan contained the following salient features:

- **Debtor Groups**: To facilitate distribution to unsecured creditors the plan separated the debtors into three distinct groups, based upon the function of each debtor entity (the "Debtor Groups"). Thus, the debtors were grouped into: (1) the Holding Company debtors; (2) the Operating Debtors; and (3) Access Lending.[36]

---

32. *Id.* at 835.

33. *Id.* at 836-37.

34. *Accord In re* New Century TRS Holdings, Inc., 390 B.R. 140 (Bankr. D. Del. 2008).

35. 390 B.R. 140 (Bankr. D. Del. 2008).

36. The Access Lending debtor group consisted solely of Access Lending, a subsidiary that provided warehouse financing to independent mortgage companies.

- **Classification of Claims**: The Plan classified claims based upon the three Debtor Groups. Thus, the Plan contained classes HC1 through HC13, which contained certain classes of claims against the Holding Company debtors, OP1 though OP12, which contained certain classes of claims against the Operating Debtors, and AL1 though AL3, which contained certain classes of claims against Access Lending. By way of illustration, Class HC3b, the sole dissenting class, consisted of "Other Unsecured Claims" against NCFC.
- **Treatment of Unsecured Claims**: The Plan provided for the distribution of the net cash available from the assets of the debtors in each Debtor Group to the holders of allowed unsecured claims against the debtors in that Debtor Group.
- **Claims Allowance**: The amount of allowed unsecured claims was determined by a set of formulas, resulting in a distribution amount. However, the distribution amount was also subject to certain protocols. These protocols were highly negotiated, and were designed to simplify the claims allowance process and to effect a settlement of certain potential litigation. The protocols included the following:

    - *The Multi-Debtor Claim Protocol*: This protocol adjusted the distribution amount for creditors holding allowed unsecured claims for which more than one debtor is jointly and/or severally liable. For example, a creditor holding allowed unsecured claims for which Holding Company debtors (i) NCFC and (ii) NC Credit are jointly and/or severally liable was assigned a distribution amount of 130% of the amount of its allowed unsecured claim against NCFC, and a distribution amount of 0% with respect to its claim against NC Credit.
    - *The Intercompany Claim Protocol*: This protocol addresses claims held by one debtor against another debtor. For example, all claims by one debtor in the Holding Company Debtor Group against another debtor in that same group were assigned a distribution amount of 0%. The same approach applies for debtors within the Operating Company Debtor Group. However, some intercompany claims were not completely wiped out. For instance, the claims by NCFC (in the Holding Company Debtor Group) against NCMC (in the Operating Company Debtor Group) received a distribution of 50%.

Out of the sixteen classes of claims eligible to vote, all but one voted in favor of the plan. The creditors that filed the sole unresolved objection to the plan were members of the rejecting class (the "Objecting Creditors"). The Objecting Creditors objected to confirmation of the Plan on three grounds: (1) the plan provided for substantive consolidation, which is precluded in the Third Circuit by *Owens Corning*;[37] (2) the plan did not provide for the same treatment of all claims within Class HC3b, the class containing the Objecting Creditors' claims; and (3) the Plan failed to comply with the "best interests of creditors test" as required by § 1129(a)(7).

The court first turned to the substantive consolidation argument. Substantive consolidation, the court noted, is a construct of federal common law that treats separate legal entities as if they were merged into a single survivor, resulting in the claims of creditors against separate debtors being consolidated against the survivor. This may be detrimental to creditors. For example, in extreme cases, claims against the assets of a solvent company may be merged with claims against an insolvent entity where those claimants share the solvent company's assets with creditors of the insolvent entity; thus, reducing the recovery for the solvent company's creditors.[38]

In *Owens Corning,* the Third Circuit eschewed a multi-factor test to determine whether substantive consolidation is permitted. Rather the court articulated the following guiding principles:

---

37. *In re* Owens Corning, 419 F.3d 195 (3d Cir. 2005).

38. Of course, this is advantageous for the insolvent company's creditors.

1. Limiting cross-creep of liability by respecting entity separateness is a 'fundamental ground rule.' … As a result, the general expectation of state law and of the Bankruptcy Code, and thus of commercial markets, is that courts respect entity separateness absent compelling circumstances calling equity (and even then only possibly substantive consolidation) into play.

2. The harms substantive consolidation addresses are nearly always those caused by debtors (and entities they control) who disregard separateness. Harms caused by creditors typically are remedied by provisions found in the Bankruptcy Code (e.g., fraudulent transfers, §§ 548 and 544(b)(1), and equitable subordination, § 510(c)).

3. Mere benefit to the administration of the case (for example, allowing a court to simplify a case by avoiding other issues or to make post petition accounting more convenient) is hardly a harm calling substantive consolidation into play.

4. Indeed, because substantive consolidation is extreme (it may affect profoundly creditors' rights and recoveries) and imprecise, this 'rough justice' remedy should be rare and, in any event, one of last resort after considering and rejecting other remedies (for example, the possibility of more precise remedies conferred by the Bankruptcy Code).

5. While substantive consolidation may be used defensively to remedy the identifiable harms cause by entangled affairs, it may not be used offensively (for example, having a primary purpose to disadvantage tactically a group of creditors in the plan process or to alter creditor rights).[39]

The court then found that:

> With these principles in mind, the *Owens Corning* Court held that, absent consent, what must be proven regarding the entities for whom substantive consolidation is sought is that (1) prepetition they disregarded separateness so significantly their creditors relied on the breakdown of entity borders and treated them as one legal entity, or (2) post petition their assets and liabilities are so scrambled that separating them is prohibitive and hurts all creditors.[40]

The bankruptcy court then turned to the facts at issue in *New Century*. The proponents of the plan argued that the plan did not affect a substantive consolidation, but rather "embodies a global settlement which benefits all creditors by resolving a myriad of issues without the costs, delay and uncertainty of litigation."[41] Thus, the court found its task was to determine whether the plan was either a proper framework for the fair and efficient resolution of complex disputes, or merely a way of circumventing the prohibitions of *Owens Corning*.

First, the court held that the plan did not propose substantive consolidation in form. Substantive consolidation typically merges separate entities into a single entity, with the survivor holding all the assets and liabilities of the now-defunct entities. In contrast, the proposed plan fashioned three Debtor Groups based upon the function of the entities comprising that group in an attempt to resolve intercompany claims and issues regarding asset ownership. The court found

---

39. *New Century*, 390 B.R. at 150-60 (citing *Owens Corning*, 419 F.3d at 211).

40. *Id.* at 160.

41. *Id.*

that the framework recognized the separate business functions and creditor bodies of the respective groupings. Moreover, the court-approved procedures required creditors to file claims against specific debtor entities, allowing creditors holding claims against multiple entities to file claim against each.

Second, the court held the plan did not propose to work an effective substantive consolidation, since the plan's use of claim protocols mitigated the typical harms found in substantive consolidation. The court noted that one of the primary concerns with substantive consolidation is that creditors who rely on the separateness of companies are harmed because they are no longer able to look for satisfaction from more than one entity. The Multi-Debtor Claim Protocol avoids that harm. "The Multi-Debtor Claim Protocol is applicable when a creditor has valid claims against more than one Debtor and, therefore, has claims in multiple classes. The Multi-Debtor Claim Protocol adjusts the [distribution amount] of the multiple claims to a single claim that is less than 100% of each claim against the Debtors, but more than 100% of a single claim against the combined Debtor Group."[42] The court then noted the second major concern with substantive consolidation is that it cancels inter-company claims. This harm was mitigated by the inclusion of the Intercompany Claim Protocol, which resolves many disputes over intercompany claims, but does not cancel those claims entirely.

The court then noted that, other than the single group of Objecting Creditors, the debtors "achieved a global agreement, settling all key intercreditor and inter-estate disputes through the use of numerous, tailored, interrelated protocols. This effect is far from the imprecise, 'rough justice' of substantive consolidation against which *Owens Corning* warns."[43] Instead, the court found, the plan "embodies thoughtful compromises that carefully preserve creditors' rights, rather than diminish or eliminate them."[44] Accordingly, the court held the plan did not provide for substantive consolidation.

Next, the court turned to the Objecting Creditors' argument that the plan does not comply with § 1123(a)(4), which requires that a plan shall "provide the same treatment for each claim or interest of a particular class, unless the holder of a particular claim or interest agrees to a less favorable treatment of such particular claim or interest."[45] The Objecting Creditors argued that the Plan, via the Multi-Debtor Claim Protocol, provided for better treatment for certain creditors in their class than they received. The proponents of the plan countered that the treatment characterized by the Objecting Creditors as better treatment for other creditors was, in fact, worse treatment. The court agreed, finding that for creditors in Class HC3b holding the same claim against other Holding Company entities, the Multi-Debtor Claim Protocol reduced their distribution:

> By way of illustration, instead of receiving a 100% [distribution amount] on account of its HC3b claim against NCFC and a 100% [distribution amount] on account of its HC10b claim against NC Credit (for a total Determined Distribution Amount of 200%), a creditor holding a claim for which both NCFC and NC Credit are liable has agreed to accept one claim against the Holding Company Debtors' assets with a 130% Determined Distribution Amount.[46]

Thus, rather than receiving more favorable treatment, Class HC3b provides worse treatment to certain creditors holding claim on which multiple debtors were jointly and/or severally liable, with their consent. Thus, the Multi-Debtor Claim Protocol did not violate section 1123(a)(4).

---

42. *Id.* at 161.

43. *Id.*

44. *Id.*

45. 11 U.S.C. § 1123(a)(4).

46. *New Century*, 390 B.R. at 163.

The court then analyzed whether the plan complied with section 1129(a)(7)'s "best interests of the creditors" test. The court found its task was to determine whether the Objecting Creditors, who voted against the Plan, "would receive more under the Plan as member of Class HC3b than they would if [the entity of which they were a creditor] were liquidated on its own in a chapter 7 case."[47] The court noted that under the liquidation analysis provided by the proponents of the plan, the Objecting Creditors would receive between 1.9% and 14.3% under the plan, and between 0% and 13.7% in a liquidation. As to the assumptions in the analysis, the court found sufficient evidence in the record to support the plan proponent's estimates. The court found that converting to Chapter 7 would result in substantial cost and delay. Moreover, the court found that the intricately negotiated settlements that were the bedrock of the plan would likely collapse if the case were converted. As such, the court held that the plan's treatment of the Objecting Creditors satisfied section 1129(a)(7).

Finally, the court turned to the approval of the settlements in the Plan. The court noted that, under section 1123(b)(3)(A), a plan may provide for settlements or adjustments of any claim or interest. However, citing *Exide Technologies*,[48] the court noted it was under a duty to determine that the proposed compromise is fair and equitable. Furthermore, the Third Circuit has established four factors for consideration analyzing a proposed settlement: "(1) the probability of success in litigation, (2) the likely difficulties in collection, (3) the complexity of the litigation involved and the expense, inconvenience and delay necessarily attending it, and (4) the paramount interest of the creditors."[49]

Analyzing the plan, the court first noted that it constituted a global settlement of various claims and issues, which would likely fail if any one of the particular compromises were not approved. Citing *Exide Technologies*, the court found its duty in evaluating the merits of the litigation was to determine whether the settlement was reasonable in light of the potential litigation. As such, the settlement was clearly reasonable. Next, the court found that because the disputes being settled were largely intercompany disputes, the substantial expenses of such litigation would adversely impact the various entities' likelihood of collection. Third, the court found that the size and complexity of the potential claims would lead to lengthy, expensive trials. Finally, the court found that, as displayed in the overwhelming acceptance of the plan, the settlements were in the interest of the creditors. For those reasons, the court concluded the settlements contained in the plan were fair and equitable.[50]

Accordingly, the court overruled the Objection of the Objecting Creditors and confirmed the Plan.

VI. Claims Under WARN Act Arising From Pre-Petition Termination Of Employment Are Not Administrative Claims Under Section 503(b)(1)(A)(ii), Rather They Are Priority Unsecured Claims Under Section 507(a)(4)-(5) Up To The Statutory Cap After Which They Are General Unsecured Claims

In *Henderson v. Powermate Holding Corp.* (*In re Powermate Holding Corp.*),[51] the bankruptcy court was presented with a question "of first impression in this Circuit" — whether WARN Act claims are entitled to administrative priority in bankruptcy following the 2005 amendments to section 503 of the Code governing administrative claims.

---

47. *Id*. at 164.

48. *In re* Exide Techs., 303 B.R. 48 (Bankr. D. Del. 2003).

49. *New Century*, 390 B.R. at 167.

50. *Accord In re* Nutritional Sourcing Corp., 398 B.R. 816 (Bankr. D.Del. 2009).

51. 394 B.R. 765 (Bankr. D. Del. 2008).

Powermate Holding Corp., Powermate Corporation, and Powermate International, Inc., (collectively, "Debtor Defendants") filed chapter 11 on March 17, 2008. Prior to filing, the Debtor Defendants operated in three states. Their corporate headquarters and main operations center was in Illinois, with additional facilities in Nebraska and Minnesota. Seven days prior to filing bankruptcy, the Debtor Defendants sold all of their assets located in Minnesota, and terminated the employment of all workers at that location. On the same day that the Debtor Defendants filed bankruptcy (but immediately prior to doing so), they fired all of their remaining employees without prior notice. Approximately 260 employees lost their jobs.

A fired employee sued the Debtor Defendants on behalf of himself and other discharged employees alleging that the defendants violated his rights under the Worker Adjustment and Retraining Notification Act ("WARN Act")[52] in what he referred to as "part of a mass layoff and/or plant closing" at the Nebraska and Illinois locations.[53] Plaintiff further alleged that he and the other similarly situated former employees were entitled to recover their wages and other benefits for sixty days because he and his fellow employees were terminated without the sixty days' notice workers are entitled to under the WARN Act, and that these damages were entitled to administrative priority status pursuant to the 2005 amendments to section 503 of the Code. The Debtor Defendants answered the complaint and moved to dismiss. In the motion, the Debtor Defendants sought the court's determination that, if the court found that there were WARN Act violations, any damages be assigned fourth (or fifth) priority status under sections 507(a)(4) and (5) of the Code, and not administrative expense priority status.

After concluding that such a determination was ripe for adjudication, and noting that the question of whether any of the statutorily recognized exceptions to the WARN Act's sixty day notice requirement were not presently before it, the court addressed the issue of what priority status a WARN Act claim would receive. In doing so, the court examined the only other case that had interpreted section 503(b)(1)(A) of the Code since its 2005 amendment, *In re First Magnus Financial Corp.*,[54] as well as the plain language of section 503(b)(1)(A). As noted by the court, the pivotal language in section 503(b)(1)(A) reads, in relevant part, as follows: "(b)… there shall be allowed, administrative expenses … *including* … (1)(A) the actual, necessary costs and expenses of preserving the estate, *including* — (i) wages, salaries …; *and* (ii) wages and benefits awarded…."[55]

The court began its analysis by reviewing the interpretation of this language by the court in *First Magnus*. The court in *First Magnus* held that because the word "and" appears between subsections (i) and (ii) in section 503(b)(1)(A), the two provisions must be read together. Or, put another way, the *First Magnus* court held that the requirements of both sections must be satisfied for a claim to qualify as an administrative expense.

In this case, however, the court embraced a different interpretation of section 503(b)(1)(A). Relying on the placement of the word "including" before subsection (i), the court held that the word "and" makes subsections (i) and (ii) categories within a particular subset of allowable administrative expenses. The court also noted that this formulation, "including" followed by an "and," appears twice in section 503(b) alone, and that the final word prior to listing the various types of administrative expense claims is "including." Furthermore, the final word, set off by a semi-colon, between (b)(8)(B) and (b)(9) is "and." Thus, under the *First Magnus* statutory construction, "everything in subsection (b) would

---

52. 29 U.S.C. § 2101 *et seq*.

53. *Powermate*, 394 B.R. at 768.

54. 390 B.R. 667 (Bankr. D. Ariz 2008).

55. *Powermate*, 394 B.R. at 774 (emphasis in original).

have to be present in order for a claimant to have an administrative expense."[56] Although it did not say as much, the court clearly viewed such a reading as unreasonable.

With these principles in mind, the court noted that one's initial reaction to reading the amended section 503(b) is to conclude that the section is unclear. This is because the section describes two different time periods: (i) the period to which back pay is attributable and (ii) the time in which the unlawful conduct occurs and/or when the services were rendered. The court then observed that this confusion is further complicated by the fact that the priority of a given claim is dependent on how these two time periods correspond with the filing of the bankruptcy petition. But, the court's opinion stated, a closer reading "reveals that the only relevant consideration is the former time, the time to which the back pay is attributable which is when the rights or claims vest or accrue, and how that time relates to the petition date."[57] The effect is that if a claim vests pre-petition, then the back pay is attributable to the time occurring prior to the commencement of the case and, therefore, it is not an administrative expense claim. Conversely, if a claim vests post-petition, then the back pay is attributable to the time occurring after the commencement of the case and, therefore, is an administrative expense claim. Furthermore, the date the unlawful conduct occurred and/or services were rendered does not affect this determination, and the "payment due date" is not controlling because the accrual may occur before or after the payment date.

In order to determine when the WARN Act claim vested, the court observed that back pay under the WARN Act is meant as "compensation for lack of notice," or, more specifically, "pay at termination in lieu of notice" under existing case law.[58] The court further observed that, under existing Third Circuit case law, pay at termination in lieu of notice "vests at the time of the termination because it is based solely on lack of notice."[59] Therefore, the court concluded, "the entirety of [a WARN Act] claim becomes an administrative expense claim in a post petition discharge. Conversely, a claim for severance pay for a pre-petition termination does not receive administrative expense status."[60] Thus, the workers in *Powermate*, who were discharged from their jobs pre-petition, albeit on the day of filing, could only possess WARN Act claims that vested pre-petition and were not entitled to administrative expense status; instead, any damages they could prove would only be recoverable under section 507(a)(4)-(5) of the Code.

Because the court concluded the language of section 503(b) was unambiguous, it did not need to examine the legislative history accompanying the 2005 amendments to the section. Still, for "the sake of completeness," the court also examined the legislative intent behind the amended section.[61] In doing so, the court noted that its holding was consistent with pre-BAPCPA law requiring a claimant to render post-petition services in order to have an administrative expense claim. Changing this would be a "monumental shift in the administration of estates under bankruptcy law" on the part of Congress, and such a change presumably would have produced significant legislative history, the court reasoned.[62]

---

56. *Id.* at 774 n.52.

57. *Id.* at 774-75.

58. *Id.* at 775.

59. *Id.*

60. *Id.* at 775-76 (footnote omitted).

61. *Id.* at 777.

62. *Id.* at 777-78.

Because the legislative history concerning the amended section is "extremely sparse," however, the court inferred that Congress did not intend such a change.[63]

VII. Landlord's Entitlement To Administrative Expense ClaimFor "Stub Rent"

In *In re Goody's Family Clothing, Inc.*,[64] the court addressed two related issues: (i) whether sections 365(d)(3) and 365(b)(1)(A) are the sole bases for allowance of an administrative expense claim for post-petition rent; or (ii) whether a claim for unpaid post-petition rent on behalf of a commercial landlord may be entitled to administrative status under section 503(b)(1) of the Bankruptcy Code as an actual, necessary cost and expense of preserving the estate.

Prior to the bankruptcy filing, the debtors operated approximately 350 stores throughout the United States and held unexpired leases of nonresidential real property (the "Leases") with certain landlords. The debtors did not pay the rent under the Leases due on June 1, 2008. On June 9, 2008 (the "Petition Date"), the debtors filed Chapter 11 petitions. Thereafter, the debtors continued to occupy the premises under each of the Leases and failed to pay rent for the post-petition period from the Petition Date through June 30, 2008 (the "stub rent"). Three landlords filed a motion for allowance and immediate payment of the applicable stub rent, and the debtors objected to each motion.

The debtors argued that the landlords could not seek administrative expense status or timely payment of stub rent under section 365(d)(3) because the obligation to pay the stub rent arose prepetition. The court agreed, noting that the section requires the trustee to timely perform all the obligations of the debtor *arising from and after* the order for relief under unexpired leases of nonresidential real property, until such leases are assumed or rejected, *notwithstanding* section 503(b)(1).[65] The Leases required the rent to be paid in advance on the first of each month, and the June rent was due on June 1st, nine days before the Petition Date. As such, the obligation to pay arose *before* the order for relief and could not receive administrative expense status under section 365(d)(3).

In addition, the debtors argued that section 365(d)(3)'s "notwithstanding" language preempted section 503(b)(1). Furthermore, they asserted that section 503(b)(1) conflicted with sections 365(b)(1)(A) and 365(g)(1), as the determination of whether the landlords' claims for stub rent could be allowed and paid as administrative claims depended entirely on whether the debtors assumed or rejected the applicable lease. The landlords countered that sections 365(d)(3) and 503(b)(1) were mutually exclusive.

The court agreed with the landlords. Based on the dictionary definition of "notwithstanding."[66] it found that the proviso "notwithstanding section 503(b)(1)" at the end of section 365(d)(3) meant that the trustee must "timely perform all the obligations of the debtor … arising from and after the order for relief under any unexpired lease of nonresidential real property, until such lease is assumed or rejected, *in spite of the terms of section 503(b)(1)*." The debtors' interpretation of "notwithstanding" would have it mean "in lieu of" or "in place of." Instead, the plain meaning of section 365(d)(3) expanded a landlord's remedies for payment of post-petition rent rather than limiting them.

Furthermore, the court held that the effect of the debtors' ultimate assumption or rejection of the Leases on the priority of the landlords' claims did not alter the court's conclusion that it could allow an administrative claim for stub

63. *Id.* at 778 n.73.

64. 392 B.R. 604 (Bankr. D. Del. 2008).

65. 11 U.S.C. § 365(d)(3) (emphasis added).

66. *See* II Shorter Oxford English Dictionary 1952 (6th ed. 2007) (notwithstanding means "[i]n spite of, without regard to or prevention by").

rent under section 503(b)(1). The debtors assumed that, if they rejected one or more of the Leases, all of the landlords' claims under the rejected leases would be unsecured because of section 365(g)(1), including the claims for unpaid stub rent. However, the court observed that the courts routinely allow administrative claims for post-petition occupancy and use of real property by a debtor as an actual, necessary cost of preserving the estate, even if the debtor had already rejected the applicable lease or if the lease expired prepetition.

The court noted that the Third Circuit had stated that "[t]here is no question, of course, that the payment of rent for the use and occupancy of real estate ordinarily counts as an 'actual, necessary' cost to which a landlord, as a creditor, is entitled."[67] Indeed, the Third Circuit noted that there is no authority to support the contrary position, i.e., "possession free of charge."[68] The fact that, under section 365(g)(1), the rejection of the lease constituted a breach of the lease immediately before the date of the filing of the petition was of no moment as to whether the debtors might be liable for an administrative expense claim for post-petition use and occupancy of the premises. Moreover, allowing a landlord whose premises were occupied by the debtors post-petition under an unexpired lease that is ultimately rejected to be in a worse position than a landlord whose lease expired pre-petition would grant the debtors a windfall neither contemplated nor justified by the Code.

The court held that the amount of an administrative claim for use and occupancy is the market rate of rent, which is presumptively the contract rate. As no evidence was offered to rebut that presumption, the court awarded each of the moving landlords an administrative claim based on the contract rate. However, the court did not require immediate payment of the claims. The landlords argued that the debtors should not be allowed to pick and choose when certain administrative claims would be paid, as that could result in different treatment for claims of the same priority in derogation of key principles of the Code, and unfairly place the risk of administrative insolvency solely on unpaid administrative claimants. The debtors argued that, for the same reason, i.e., risk of disparate treatment, that the court should allow the debtors to wait to pay the landlords until confirmation of the debtor's reorganization plan. The debtors also contended that requiring payment would be inequitable to other administrative claimants, and that such a requirement would open the floodgates of litigation by encouraging other landlords to request immediate payment of stub rent.

The court noted that it had discretion to decide when the administrative expenses would be paid, and that one of the chief factors that courts consider in exercising this discretion is bankruptcy's goal of an orderly and equal distribution among creditors and the need to prevent a race to the debtor's assets.[69] It then found the landlords' argument regarding inequitable treatment of claims to be fundamentally flawed because equal distribution among creditors does not require simultaneous distribution. While the landlords are losing the time value of their unpaid stub rent, that is simply a normal and unremarkable result of the fact that bankruptcy proceedings take time. Furthermore, the court found little risk of administrative insolvency and that any risk of administrative insolvency would be further reduced since the debtors had a pending plan of reorganization that was scheduled for confirmation about a month away from the date of the court's decision. In addition, there was no evidence before the court of any potential harm to the landlords arising from the ongoing delay in payment of the stub rent.

Alternatively, the court found the debtor's decision as to the timing of the payment of post-petition rent to be within the ordinary course of the debtors' business and, thus, within the scope of the debtors authority under the Code. As

---

67. Zagata Fabricators, Inc. v. Superior Air Prods., 893 F.2d 624, 627 (3d Cir. 1990).

68. *Id.* at 628.

69. *In re* HQ Global Holdings, Inc., 282 B.R. 169, 173 (Bankr. D. Del. 2002).

such, the decision was entitled to deference under the business judgment rule. The court, therefore, allowed the landlord's claims for stub rent as administrative expenses but denied the request for immediate payment.

VIII. Secured Creditor Has Standing To Assert Claims Of Equitable Subordination Against Other Secured Creditors Based Upon Assertion Of Individualized Harm

The court in *Elway Co., LLP v. Miller* (*In re Elrod Holdings Corp.*)[70] was presented with the question of whether a secured creditor has standing to seek the equitable subordination of another secured creditor's claim.

The adversary proceeding in which the *Elrod* opinion was issued was commenced by a secured creditor, Elway Company, LLP ("Elway"), that was seeking (i) a determination of the scope, validity, and priority of its liens on the debtors' property, and (ii) the allowance of its claims against the debtors. The adversary complaint filed by Elway named the chapter 7 trustee in the case and the debtors' other secured creditors, including Webster Growth Capital Corp. ("Webster"), as defendants.

After filing a response, Webster sought leave to amend its response to include several cross-claims and counterclaims that were essentially the same as claims the chapter 7 trustee had already asserted on behalf of the debtors' estates. Elway and the trustee objected to Webster being granted leave to amend, however, on the ground that the only party with standing to assert the claims was the trustee. Webster responded by conceding to the objection as to all counts except its claim for equitable subordination against Elway.

The court began its analysis by noting that, under section 541(a) of the Code, an estate is created upon the commencement of a bankruptcy case, which "is made up of, *inter alia*, 'all legal or equitable interests of the debtor in property as of the commencement of the case.'"[71] This estate "includes 'causes of action existing at the time the bankruptcy action commences.'"[72] The court also noted that section 323(a) of the Code provides that the trustee is the sole representative of this estate, and that section 323(b) provides that the trustee "has the capacity to sue and be sued."[73] Taken together, the court reasoned, these two provisions "grant the trustee the exclusive standing to assert causes of action that have become property of the estate by operation of § 541."[74] For this reason, the court observed, "the Third Circuit has stated that, 'once a company or individual files for bankruptcy, creditors lack standing to assert claims that are "property of the estate."'"[75]

But, the court also noted that the Third Circuit has held that a cause of action is only property of the estate if it is a general claim with no "particularized injury" to any creditor resulting from it.[76] Accordingly, the court reasoned, it must determine whether a secured creditor's claim for equitable subordination pursuant to section 510(c) of the Code is such a general claim.

---

70. 392 B.R. 110 (Bankr. D. Del. 2008).

71. *Id.* at 114 (quoting 11 U.S.C. § 541(a)).

72. *Id.* (collecting cases).

73. *Id.* (quoting 11 U.S.C. § 323(b)).

74. *Id.* (citing Cain v. Hyatt, 101 B.R. 440, 442 (E.D. Pa. 1989)).

75. *Id.* (quoting Bd. of Trs. of Teamsters Local 863 Pension Fund v. Foodtown, Inc., 296 F.3d 164, 169 (3d Cir. 2002)).

76. *Id.* (quoting *Bd. of Trs. of Teamsters*, 296 F.3d at 170).

The court cited a number of cases indicating that equity may sometimes "require a court to subordinate a senior secured claim to a junior secured claim," or, in "other instances of more egregious misbehavior, equity may require a court to strip a secured claimant of its secured status altogether."[77] In the former instance, the court noted, "only the junior secured creditor benefits from a court's employment of § 510(c) as it alone surpasses the senior secured creditor in priority."[78] In the latter circumstance, however, each creditor benefits from the subordination of the senior secured claim. Consequently, the court noted that "a secured creditor is capable of having suffered a particularized injury and that a court may fashion a remedy in response to that injury that benefits only the affected secured creditor and not all general creditors ultimately seeking to recover from a debtor's estate."[79]

The court also reasoned that a secured creditor with such a particularized injury should be "permitted to pursue its separate interest apart from the trustee."[80] The court based this conclusion, in part, on the fact that circumstances could exist where "a trustee has little interest in an equitable subordination dispute between two secured creditors," and also partly on the fact that a number of other courts have taken similar positions.[81] Accordingly, the court held that "a secured creditor has standing to seek the equitable subordination of another secured creditor's claim to the extent that it seeks relief for a particularized injury, which differs from the injury incurred by all creditors."[82]

The court held that Webster failed to state such a particularized claim, however, because his proposed equitable subordination claim simply mirrored the trustee's claim that was brought to remedy the injury suffered by all creditors. Thus, the court denied Webster's motion.

IX. Based Upon Third Circuit Decision In *In re Price*, Post-Discharge Repossession Of Motor Vehicle By Secured Creditor Is A Violation of Discharge Injunction Where Debtor Entered Into A Reaffirmation Agreement But Agreement Was Not Approved By Court — Distinguishes/Disagrees With *In re Anderson*, 348 B.R. 652 (Bankr. D. Del. 2006) (MFW)

In *In re Baker*,[83] the debtors filed a chapter 7 case and subsequently agreed to and filed a Reaffirmation Agreement to reaffirm the debtors' car loan with its lender, which had a security interest in the car. The Reaffirmation Agreement provided debtors would make 48 monthly payments of $348.90. The debtors' monthly income less expenses, as reflected in the Reaffirmation Agreement as well as the debtors' schedules, was $200. The Reaffirmation Agreement was presumed to be an undue hardship, since the debtors' income less expenses was insufficient to make the monthly payments under

77. *Id.* at 115 (collecting cases).

78. *Id.*

79. *Id.*

80. *Id.*

81. *Id.* In so holding, the Court stated that, "It would make little sense to preclude an injured party from pursuing unique relief in the hope that a disinterested party would zealously pursue it for them." *Id.*

82. *Id.*

83. 390 B.R. 524 (Bankr. D. Del.), *aff'd*, 400 B.R. 136 (D. Del. 2008).

the Reaffirmation Agreement. No evidence to rebut the presumption was presented to the court at the hearing to consider the Reaffirmation Agreement and, thus, the court entered an order declining to approve it.

The debtors were granted a discharge and the case was closed. Six days later, the lender repossessed the debtors' vehicle. At an evidentiary hearing relating to the vehicle repossession, the lender acknowledged that the sole basis for repossessing the vehicle was the court's failure to approve the Reaffirmation Agreement.

The debtors argued that under the Third Circuit's decision in *Price*,[84] the car loan passed through the bankruptcy case unaffected. In *Price*, the Third Circuit held that the enumeration of three options for treatment of secured property under former section 521(2), i.e., surrender, redemption or reaffirmation, did not preclude the debtor from exercising a so-called "fourth option," i.e., retaining the property while remaining current on payments."[85] The bankruptcy court analyzed the holding of *Price* after the enactment of BAPCPA, finding that, subject to certain limitations, none of BAP-CPA's changes preclude a debtor from retaining the collateral while remaining current on payments.

First, the court noted the importance of section 521(a)(2)(A) in the Third Circuit's analysis in Price and that BAPCPA made no changes to that section.[86]

Second, the court analyzed the addition of section 521(a)(6),[87] finding that, although the section terminates the automatic stay and removes the property from the estate in certain circumstances, the debtor was in compliance with the section's requirements because the debtors and creditor timely entered into a reaffirmation agreement.

Third, the court analyzed the interplay between section 521(a)(2)(C) and 362(h). Although section 521(a)(2)(A) (upon which the Third Circuit relied in *In re Price*) was not altered by BAPCPA, section 521(a)(2)(C) was modified to provide that "nothing in subparagraphs (A) and (B) of this paragraph shall alter the debtor's or the trustee's rights with regard to such property under this title, *except as provided in section 362(h)*."[88] In turn, "section 362(h) provides that the stay will be terminated and the collateral will no longer be property of the estate if the debtor fails to file and perform a statement of intention to surrender, redeem, reaffirm or, in the case of leased property, assume the unexpired lease."[89] The

84. Price v. Delaware State Police Fed. Credit Union (*In re* Price), 390 B.R. 524 (3d Cir. 2004).

85. *Baker*, 390 B.R. at 527.

86. "[T]he debtor shall file with the clerk a statement of his intention with respect to the retention or surrender of such property and, if applicable, specifying … that such property is claimed as exempt, that the debtor intends to redeem such property, or that the debtor intends to reaffirm debts secured by such property." 11 U.S.C. § 521(a)(2)(A).

87. [I]n a case under chapter 7 of this title in which the debtor is an individual, [the debtor shall] not retain possession of personal property as to which a creditor has an allowed claim for the purchase price secured in whole or in part by an interest in such personal property unless the debtor, not later than 45 days after the first meeting of creditors under section 341(a), either-

> (A) enters into [a reaffirmation] agreement with the creditor pursuant to section 524(c) with respect to the claim secured by such property; or
>
> (B) redeems such property from the security interest pursuant to section 722.
>
> If the debtor fails to so act within the 45-day period referred to in paragraph (6), the stay under section 362(a) is terminated with respect to the personal property of the estate or of the debtor which is affected, such property shall no longer be property of the estate, and the creditor may take whatever action as to such property as is permitted by applicable nonbankruptcy law … .

11 U.S.C. § 521(a)(6).

88. 11 U.S.C. § 521(a)(2)(C) (emphasis added).

89. *Baker*, 390 B.R. at 529.

court noted that "[c]ourts have held that the proviso at the end of section 521 (a)(2)(c) referencing section 362(h) trumps the 'if applicable' language in section 521(a)(2)(A)." Indeed, Judge Walrath had so ruled in *In re Anderson*.[90] Nonetheless, the court in *Baker* held otherwise, respectfully disagreeing with the holding in Anderson and finding that the language in section 521(a)(2) and the "context" of the Code upon which the Third Circuit had relied in *Price* remained unchanged.

In addition, the court distinguished *Anderson* and the other cases with similar holdings on the facts. Although the debtors in *Baker* filed a statement of intention which did not indicate one of the three options, instead stating the debtors' intention to retain the collateral and continue making payments, the debtors cured the defect by complying with section 362(h)(B), i.e., timely entering into a reaffirmation agreement.

Thus, after analyzing the relevant BAPCPA amendments, the court found that the "fourth option" under *Price* remained viable and a debtor may retain collateral while remaining current on the payments. In order for the automatic stay to remain in effect and for the property to remain in the debtor's estate, however, the debtor must *enter* into a reaffirmation agreement within 45 days after the section 341 meeting. But, the court's refusal *to approve* the reaffirmation agreement is of no consequence to debtor's ability to retain the collateral.

The court also addressed the lender's right to repossess the vehicle under Delaware law. Since the debtors were current on their payments, the only default under the debtors' loan agreement was the filing of a bankruptcy petition. Noting that *ipso facto* clauses are generally unenforceable, the court found there are limited exceptions. In particular, section 521(d)[91] provides for the limited enforceability of *ipso facto* clauses if a debtor does not comply with sections 521(a)(6) or 362(h)(1) and (2). However, the court noted that state law must also allow for enforceability of the *ipso facto* clause. In this case, the court found that it need not reach the question of the enforceability of *ipso facto* clauses under Delaware law, since the debtors complied with sections 521(a)(6) and 362(h). Thus, the Code prevented the creditor from exercising its right, if any, under state law to repossess the vehicle based on the ipso facto clause.

Accordingly, as the debtors properly exercise the "fourth option" under *Price* to retain their car while remaining current on their payments and the lender had no right to repossess the car, the court found the lender violated the discharge injunction, awarded compensatory damages and ordered the immediate return of the debtors' vehicle.

X. Presumption Of Abuse Under The "Means Test" In An Individual's Chapter 7 Case

In *In re Smale*,[92] the court addressed whether an individual chapter 7 debtor in performing the "means test" calculation was entitled to deduct monthly payments on motor vehicles that the debtor intended to surrender. In the case before the court, the debtor's personal property included four vehicles on which other parties held secured claims. The

---

90. *In re* Anderson, 348 B.R. 652, 658 (Bankr. D. Del. 2006).

91. Section 521(d) states:

> If the debtor fails timely to take the action specified in subsection (a)(6) of this section, or in paragraphs (1) and (2) of section 362(h), with respect to property … as to which a creditor holds a security interest … nothing in this title shall prevent or limit the operation of a provision in the underlying … agreement that has the effect of placing the debtor in default under such … agreement by reason of the occurrence, pendency, or existence of a proceeding under this title or the insolvency of the debtor. Nothing in this subsection shall be deemed to justify limiting such a provision in any other circumstance.

11 U.S.C. § 524(d).

92. 390 B.R. 111 (Bankr. D. Del. 2008).

debtor intended to surrender three of the vehicles and claim one remaining vehicle as exempt property. Nonetheless, the included as deductions in completing his "means test" calculation the loans for all four vehicles.

The debtor's calculations indicated he had no disposable income. However, if the debtor was unable to claim the deductions for the vehicles to be surrendered, his disposable income would trigger the presumption of abuse under section 707(b)(2) of the Code and his case would have to be dismissed or voluntarily converted to a chapter 13 case. The United States Trustee filed a motion to dismiss the case, arguing that section 707(b)(2)'s presumption of abuse arose because giving effect to the debtor's intention to surrender his vehicles by excluding them from the calculation of his monthly disposable income would result in that income being higher than allowed under section 707(b)(2)'s "means test."

The "means test" applies a formula to calculate disposable income by deducting a list of permitted expenses from a figure calculated by averaging the debtor's income for the six months prior to the petition date. The section permits a deduction based on a debtor's actual payments on secured debts, calculated as the sum of "the total of all amounts *scheduled as contractually due* to secured creditors in each of the 60 months following the date of the petition … divided by 60."[93] The debtor argued that this provision enabled him to deduct his debt payments, notwithstanding that he intended to surrender three of his four vehicles. The United States Trustee argued that the debtor could not deduct payments on debts secured by property he intended to surrender.

The court found the phrase "scheduled as contractually due" to be ambiguous. It also noted a split of authority on the question of whether payments on property that has been or will be surrendered may be included in calculating a debtor's average monthly payments on account of secured debts under section 707(b)(2)(A)(iii)(I).

The majority of courts have determined that a debtor could claim a deduction for payments on debts secured by property that the debtor intends to surrender by determining the amount of payments owed under the contract for each secured debt at the time of filing. These courts cite to the dictionary definition of "schedule" to mean "to plan for a certain date," and the common meaning of "as contractually due" to be "that the debtor is legally obligated under the contract … to make a payment in a certain amount, with a certain amount of interest, for a set number of months into the future." The courts in the minority assert that the term "scheduled" in section 707(b)(2)(A)(iii) has a bankruptcy-specific meaning that refers to how the debt is listed on the debtor's schedules and statements.

The court found both lines of argument problematic. The majority courts construed the plain meaning of the statute as providing for the calculation of the total of all amounts contractually due. This argument is flawed because one could come to the same conclusion about the meaning of the statute if the words "scheduled as" were not present. The arguments of the minority courts fare no better because the same courts go on to hold that "the [d]ebtor's schedules *and statements*" form the basis from which courts should determine whether a debt is "scheduled as contractually due," even though section 707(b)(2)(A)(iii)(I) fails to mention the debtor's statements. The court also noted the argument that Congress intended to use the phrase "scheduled as" to refer to whether a debt is identified on a debtor's bankruptcy schedules had been proven inaccurate.

Since the statutory language failed to clarify the purpose of the statute, the court next examined the legislative history to the 2005 amendments to the Bankruptcy Code. However, the court found it difficult to apply any overarching legislative purpose. Other courts attempting to do so had arrived at disparate conclusions. Moreover, the legislative history specifically applicable to section 707 was irrelevant to the issue before the court.

The court therefore turned to the principle of *noscia a sociis*. Under this theory, of the various possible meanings a word should be given, the particular meaning to be given to an unclear word or phrase must be determined in a manner

---

93. 11 U.S.C. § 707(b)(2)(A)(iii) (emphasis added).

that makes the word 'fit' with the words with which it is closely associated.[94] Applying the principle, the court held that the most reasonable interpretation of sections 707(b)(2) and (3), taken as a whole, was to allow the debtor to include in its calculations the average monthly payments on property that has been or would be surrendered under section 707(b)(2)(A)(iii).

The court observed that Judge Shannon had recently analyzed the interplay between sections 702(b)(2) and (b)(3) in *In re Haman*.[95] Specifically, Judge Shannon analyzed cases discussing whether a debtor can deduct payments on debts secured by property he intends to surrender. The court agreed with Judge Shannon that allowing a movant to include the outcome of future events as part of the means test would eliminate the distinction between the presumption of abuse test and the totality of the circumstances test. An analysis that includes future circumstances would be more properly conducted under section 707(b)(3), rather than section 707(b)(2).

Finally, the court noted that its analysis was consistent with Judge Walrath's opinion in *In re Pennington*.[96] The issue in *Pennington* was whether, in considering the "totality of the circumstances of the debtor's financial situation" under section 702(b)(3), the court was limited to considering the debtor's financial situation as of the date of the filing of the petition, and whether the court may or must consider the debtor's financial situation at the time the motion to dismiss was heard. The court held it had to consider the debtor's financial condition at the time of the hearing on the motion to dismiss when deciding whether granting chapter 7 relief would be an abuse under section 707(b)(3). In so ruling, Judge Walrath noted that the contrary decision in *In re Walker*[97] was inapplicable because there the court addressed the issue of whether payments due at the time of filing were used for purposes of the means test under section 707(b)(2), but not for purposes of the totality of the circumstances test under section 707(b)(3).

Thus, the court held that a presumption of abuse had not arisen under section 707(b)(2) and denied the U.S. Trustee's motion to dismiss.

---

94. James v. United States, 550 U.S. 192 (2007) (Scalia, J., dissenting) (citing Jarecki v. G.D. Searle & Co., 367 U.S. 303 (1961)).

95. *In re* Haman, 366 B.R. 307, 316-17 (Bankr. D. Del. 2007).

96. 348 B.R. 647 (Bankr. D. Del. 2006).

97. *In re* Walker, 2006 WL 3804682, 2006 Bankr. LEXIS 845 (Bankr. N.D. Ga. 2006).