

**Hot Bankruptcy Topics in the Fifth Circuit:  
The Rise of Class Actions, the Fall of Gift Plans  
and That Equitable Mootness Doctrine**

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### I. INTRODUCTION

The Fifth Circuit has been active in bankruptcy appeals over the past year. Among its many recent decisions, the court of appeals recently held that a bankruptcy court has the jurisdiction and the authority to certify a class of debtors under the right circumstances. The court of appeals has also continued to explain the applicability (and non-applicability) of the equitable mootness doctrine. But perhaps the biggest recent news in circuit court decisions came from the Second Circuit in the *DBSD North America* decision.<sup>1</sup> In that appeal, the Second Circuit held that a “gift” from one senior class to another junior class through a chapter 11 plan violated the absolute priority rule under chapter 11’s “fair and equitable” cram down standards.

This paper will begin by discussing the *DBSD* decision, its analysis of the “gifting doctrine,” and the potential ramifications to chapter 11 plans in Fifth Circuit bankruptcy cases. Next, this paper will discuss the viability of class actions in bankruptcy courts, which is of particular relevance in light of the Fifth Circuit’s recent *Wilborn*<sup>2</sup> decision and other ongoing issues with the Mortgage Electronic Registration System (“MERS”). Finally, because the issue seems to appear in several recent Fifth Circuit decisions, this paper will discuss the Fifth Circuit’s recent applications and discussions of the equitable mootness doctrine.

### II. IS THE GIFTING DOCTRINE DEAD FOR CHAPTER 11 PLANS?

Perhaps one of the most useful and powerful tools for negotiating a chapter 11 plan is a “gift” arrangement.<sup>3</sup> In a typical “gifting” scenario, a senior class of creditors (usually an under-secured class) “gives” part of its recover to a junior class of claimants or interest holders as part of a plan. The primary argument for those supporting the concept is that “giving” creditors should be free to allocate its collateral to junior claim holders as part of a settlement under a plan, and that there is nothing unfair or inequitable about such allocations, though some creditors may be left out. Those opposing this concept, however, argue that “free allocation” is another way to skirt the absolute priority rule, because the classes skipped over have not been paid in full or consented to the proposed plan treatment.

What we now call the absolute priority rule is a codification of pre-Bankruptcy Code rules designed to counteract the dangers associated with the inherent bargaining power held by a debtor’s current management and ownership in negotiating a plan of reorganization.<sup>4</sup> Such restrictions were codified in section 1129(b)(2)(B) of the Bankruptcy Code and prohibit junior classes from receiving “any property” “under the plan” “on account of such junior claim” unless higher priority claims are paid in full or the intervening classes consent.

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<sup>1</sup> See *DISH Network Corp. v. DBSD N. Am., Inc. (In re DBSD N. Am., Inc.)*, --- F.3d ----, 2011 WL 350480, 2010 US App. LEXIS 27007 (2d Cir. Feb. 7, 2011) (pagination unavailable).

<sup>2</sup> See generally *In re Wilborn v. Wells Fargo Bank, N.A. (In re Wilborn)*, 609 F.3d 748 (5th Cir. 2010).

<sup>3</sup> See Leah M. Eisenberg, *Gifting and Asset Reallocation in Chapter 11 Proceedings: A Synthesized Approach*, 29 Am. Bankr. Inst. J. 50, 50 (Sept. 2010).

<sup>4</sup> See generally *Bank of Am. Nat’l Trust & Sav. Ass’n v. 203 N. LaSalle St. P’ship*, 526 U.S. 434, 444-45, 119 S. Ct. 1411, 1417-18; 143 L. Ed. 2d 607 (1999) (citations omitted) (“The reason for such a limitation was the danger inherent in any reorganization plan proposed by a debtor, then and now, that the plan will simply turn out to be too good a deal for the debtor’s owners.”).

## Hot Topics in Fifth Circuit Bankruptcy Cases

### A. Introduction to the *DBSD* Decision

In February 2011, the Second Circuit was faced with a plan where the undersecured junior lien holders attempted to “gift” some of the new equity they were entitled to receive to old equity.<sup>5</sup> The Second Circuit rejected the “gift” characterization and found, instead, that the plan gave the equity class property on account of its old equity interests, but did not pay unsecured claims in full. This, held the court, violated the absolute priority rule and required reversal.

To reach this conclusion, the analysis was straight-forward. The court considered the following elements: (i) did the equity holders receive property; (ii) was the property distributed under the plan; and (iii) was the property distributed “on account of” the existing equity or some new value? First, relying upon *Ahlers*, the court of appeals found that the shares and warrants given to old equity under the plan fell within the broad definition of “any property.”<sup>6</sup> Second, the court had no question that the shares and warrants were being distributed “under the plan.” Third, relying on *203 N. LaSalle*, the court of appeals found that the shares and warrants were distributed to old equity holders “because of” or “on account of” the existing equity interests in the debtor.<sup>7</sup>

The Second Circuit reasoned that *Ahlers* and *203 N. LaSalle* demonstrated the Supreme Court’s strict application of the absolute priority rule.<sup>8</sup> What made this case an easier call was that old equity offered nothing that could be considered “new value” in exchange for the property received under the plan. The only thing that old equity seemed to offer in exchange for the shares and warrants to be distributed under the plan—aside from its old equity—was its “continued support and assistance” of the reorganized debtor. But the Supreme Court expressly rejected sweat equity as “new value” in *203 N. LaSalle*. Without any potential “new value,” the Second Circuit had only to address whether the share and warrants could be considered a “gift” from a senior class of creditors, as the bankruptcy court did. Implicit in this argument was the belief that the “gifting” mechanism excused the distributions from the absolute priority rule, because the equity class would not be receiving the debtor’s property under the plan. To decide that issue, the court of appeals was required to decide whether *SPM*’s “gifting doctrine” had any application to chapter 11 cases.

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<sup>5</sup> *In re DBSD N. Am., Inc.*, *supra* note 1. The plan proposed to pay unsecured claims a dividend in the range of 4% to 46%, and allow existing equity to receive shares and warrants in the reorganized debtor in exchange for old equity’s support of the plan and “continued cooperation and assistance” in the reorganized debtor. Notably, the “gifting” mechanism was not explicit from the plan; the bankruptcy court characterized the extensions of shares and warrants as a “gift” from the junior lien holders and confirmed the plan. The district court affirmed.

<sup>6</sup> *See id.* at 25 (citing *Northwest Bank Worthington v. Ahlers*, 485 U.S. 197, 208, 108 S. Ct. 963, 969, 99 L. Ed. 2d 169 (1988)).

<sup>7</sup> *See id.* at 26 (citing *Bank of Am. Nat’l Trust & Sav. Ass’n v. 203 N. LaSalle St. P’ship*, 526 U.S. 434, 449, 119 S. Ct. 1411; 143 L. Ed. 2d 607 (1999)) (“Even under this general test, the existing shareholder here receives property ‘on account of’ its prior junior interest because it receives new shares and warrants at least partially ‘in exchange for’ its old ones.”).

<sup>8</sup> *See id.* at 29-30.

## Hot Topics in Fifth Circuit Bankruptcy Cases

### B. *SPM, MCorp and Genesis Health*

Before discussing the Second Circuit's answer, it is important to understand the doctrine. While not necessarily originating from the First Circuit, the concept of "gifting" was most famously endorsed by the First Circuit in *In re SPM Manufacturing Corp.*<sup>9</sup> In that case, during the course of the chapter 11 case, the senior secured lenders reached an agreement with the creditors' committee under which the lenders would share some of their rights to the debtor's proceeds in exchange for the committee's cooperation during the case. When the case converted to chapter 7 and the trustee began making distributions pursuant to the compromise approved by the court during the chapter 11, certain tax priority creditors objected, arguing that the distributions to unsecured creditors before payment of priority claims violated the scheme required under section 726 of the Bankruptcy Code. The First Circuit ultimately rejected the tax claimants' arguments:

The Code does not govern the rights of creditors to transfer or receive nonstate property. While the debtor and the trustee are not allowed to pay nonpriority creditors ahead of priority creditors, []creditors are generally free to do whatever they wish with the bankruptcy dividends they receive, including to share them with other creditors.<sup>10</sup>

Since the First Circuit issued the *SPM* decision in 1993, courts have divided on its application to chapter 11 cases. For example, even before the *DBSD* decision, the Second Circuit explained in 2007 *Iridium Operating* that "*SPM* stands for the proposition that in a Chapter 7 liquidation proceeding, an under-secured lender with a conclusively determined and uncontested 'perfected, first security interest' in all of a debtor's assets may, through a settlement, 'share' or 'gift' some of those proceeds to a junior, unsecured creditor, even though a priority creditor will go unpaid."<sup>11</sup>

On the other hand, following the issuance of the *SPM* decision, the U.S. District Court for the Southern District of Texas immediately applied the *SPM* "gifting doctrine" to a chapter 11 plan settlement in *MCorp*.<sup>12</sup> In that case, the Judge Lynn Hughes confirmed a liquidating chapter 11 plan over the objections of an intervening class of bond holders. The *MCorp* plan included a global settlement among the senior secured lenders and the FDIC. Judge Hughes held that the plan could be confirmed over the objections of several junior bond holders (with arguably superior claims). The junior bond holders argued that their claims had a higher priority than the FDIC's unsecured claims and that, because the secured bond claims were not being paid in full, the plan could not allow any distributions to bypass them and go the FDIC.<sup>13</sup> The court declined to address the relative priority between the bond claimants and the FDIC's general unsecured claims because, for purposes of the present dispute, the court found the only salient

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<sup>9</sup> 984 F.2d 1305 (1st Cir. 1993).

<sup>10</sup> *Id.* at 1313 (citing *King v. United States*, 379 U.S. 329, 13 L. Ed. 2d 315, 85 S. Ct. 427 (1964)).

<sup>11</sup> *Motorola, Inc. v. Official Comm. of Unsecured Creditors (In re Iridium Operating LLC)*, 478 F.3d 452, 459 (2d Cir. 2007). The *Iridium Operating* decision is discussed *infra*.

<sup>12</sup> See generally *In re MCorp. Fin. Inc.*, 160 B.R. 941 (S.D. Tex. 1993).

<sup>13</sup> See *id.* at 690.

## Hot Topics in Fifth Circuit Bankruptcy Cases

point to be the relative priority between the settling senior lien holders (the “seniors”) and the objecting bond holders (the “juniors”):

The seniors [m]ay share their proceeds with creditors junior to the juniors, as long as the juniors continue to receive a[t] least as much as what they would without the sharing. For instance, a secured creditor could share its proceeds with unsecured creditors whose priority came behind that of the IRS. [citing *SPM*] That the creditor was secured is not relevant; it was the creditor's status as prior to the IRS that allowed it to share with those under the IRS, just as the seniors' priority over the juniors allows them to fund the FDIC settlement. . . . The seniors are senior because the juniors agreed to be junior. No manipulation of corporate shells, no gerrymandering of classes, created the position of the juniors as next to last in line for assets. The impaired class does not like the consequence of its having agreed to be the penultimate recipient of asset distributions, but the class is being treated by the plan in a fashion consistent with all other classes, with their contract, and with the law. The subordinated bonds will be paid the assets that exceed the claims prior to theirs, and they will be paid their claims before equity is paid. All equity is treated alike. The plans survive under the statutory test.<sup>14</sup>

Nearly a decade later, a district court in Delaware applied the *SPM* “gifting doctrine” in *Genesis Health Ventures*, by confirming a chapter 11 plan of reorganization over the objections of certain unsecured creditors.<sup>15</sup> In that case, the court held that senior secured lenders were “free to allocate” proceeds as it desired without violating the absolute priority rule.<sup>16</sup>

### C. *Armstrong World, OCA and Iridium Operating*

It would not be until 2005 that a circuit court would consider how the absolute priority rule affected the viability of plan gifting. In December 2005, the Third Circuit considered and rejected the “gifting doctrine” as applied to chapter 11 plans, concluding that the use of the doctrine ran afoul of the absolute priority rule.<sup>17</sup>

The plan in *Armstrong World* included 12 classes, though only three were relevant to the appeal.<sup>18</sup> Class 6 comprised the general unsecured non-priority claims. Class 7 comprised present and future unliquidated asbestos litigation-related claims. Class 12 comprised all holders

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<sup>14</sup> *Id.*

<sup>15</sup> See generally *In re Genesis Health Ventures, Inc.*, 266 B.R. 591, 601-02 (D. Del. 2001) (relying on *MCorp* and *SPM* in confirming a plan which allowed the senior lenders to decide which classes could share in the lenders' share of distributions).

<sup>16</sup> See *id.* at 617-18 (“The Senior Lenders are *free to allocate* such value without violating the ‘fair and equitable’ requirement.”) (emphasis added).

<sup>17</sup> See generally *In re Armstrong World Indus., Inc.*, 432 F.3d 507 (3d Cir 2005).

<sup>18</sup> See *id.* at 509.

## Hot Topics in Fifth Circuit Bankruptcy Cases

of equity interests in the debtor. The plan proposed to: (i) pay Class 6 claims 59.5% of their claims, (ii) fund \$1.8 billion into a trust for the benefit of Class 7 claimants, and (iii) issue warrants in the reorganized debtor to Class 12 equity holders. The plan also provided that, should Class 6 claimants reject the plan, the warrants would be issued to Class 7 claimants (who held claims of equal priority to Class 6 claimants), but then Class 7 claimants would “automatically” waive their rights to the warrants and allow the warrants to be issued to Class 12 equity holders.<sup>19</sup>

While the *Armstrong World* plan was negotiated among the holders of Class 6, 7 and 12 claims and interests, the plan was ultimately rejected by Class 6 claim holders. Under the terms of the plan, Class 6’s rejection caused the warrants to flow through Class 7—which voted to accept the plan—via “automatic waivers” to allow the warrants to be distributed to Class 12 equity holders. The net effect was the equity holders received the warrants in the reorganized debtor, but Class 6 unsecured creditors, which were not paid in full, were now a dissenting class. In its objection, the unsecured creditors committee argued that the plan’s automatic gifting mechanism violated the absolute priority rule. The bankruptcy court disagreed and recommended confirmation, but the district court sustained the committee’s objection and denied confirmation.<sup>20</sup> Appeal was taken to the Third Circuit.

Before the Third Circuit, the debtor first argued that there was no dissenting intervening class, because the new equity was flowing *through* Class 7, not *over* Class 6.<sup>21</sup> While noting that six does precede seven in a linear count, the court of appeals found that Class 6 and Class 7 claims were of the same priority. The court further concluded that there was nothing in the plain language of the statute or its legislative history that would require an “intervening” class for the absolute priority rule to be violated.<sup>22</sup> Because Class 6 and Class 7 were equal, and Class 6 was not consenting, the court agreed that the absolute priority rule had been implicated.

Second, the debtor argued that the court should follow the “*MCorp-Genesis*” rule and allow the Class 7 claimants to decide who may receive their property.<sup>23</sup> The Third Circuit, however, rejected the so-called *MCorp-Genesis* rule and concluded that *SPM*, *MCorp* and *Genesis Health* were each distinguishable and inapplicable.<sup>24</sup> Said the court, illustrating why the “gifting” mechanism proposed in the *Armstrong* plan violated the absolute priority rule:

[T]he structure of the Plan makes plain that the transfer between Class 7 and Class 12 was devised to ensure that Class 12 received the warrants, with or without Class 6’s consent. The distribution of

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<sup>19</sup> *Id.*

<sup>20</sup> *See id.* at 510-11 (citing *In re Armstrong World Indus., Inc.*, 320 B.R. 523 (D. Del. 2005)).

<sup>21</sup> *Id.* at 513.

<sup>22</sup> *Id.* (“Under this reading, the statute would be violated because the Plan would give property to Class 12, which has claims junior to Class 6.”)

<sup>23</sup> *See In re Armstrong World Indus., Inc.*, 432 F.3d at 513-14.

<sup>24</sup> *See id.* at 514 (“We adopt the District Court’s reading of these cases, and agree that they do not stand for the unconditional proposition that creditors are generally free to do whatever they wish with the bankruptcy proceeds they receive. Creditors must also be guided by the statutory prohibition of the absolute priority rule, as codified in 11 U.S.C. § 1129(b)(2)(B).”) (emphasis added).

## Hot Topics in Fifth Circuit Bankruptcy Cases

the warrants was only made to Class 7 if Class 6 rejected the Plan. In turn, Class 7 automatically waived the warrants in favor of Class 12, without any means for dissenting members of Class 7 to protest. Allowing this particular type of transfer would encourage parties to impermissibly sidestep the carefully crafted strictures of the Bankruptcy Code, and would undermine Congress's intention to give unsecured creditors bargaining power in this context.<sup>25</sup>

The Third Circuit made clear that the warrants were being paid to the Class 12 equity holders “on account of” their existing equity, and that because such distributions were barred by the absolute priority rule, the plan could not be confirmed.

### (1) The OCA Inc. Decision

To date, the only published opinion from a bankruptcy court in the Fifth Circuit to address the absolute priority rule as applied to gifting plans has agreed with *Armstrong World*.<sup>26</sup> In *OCA*, the secured lenders agreed to allow existing equity holders to participate in stock offerings and acquire equity in the reorganized debtor in exchange for their support of the plan. The court refused to confirm the plan, finding it violated the absolute priority rule.

In denying confirmation, the *OCA* court first distinguished *SPM*, noting that the distributions in *SPM* did not implicate the absolute priority rule, because that was a chapter 7 case.<sup>27</sup> Second, the court found the “settlement” approved in the *MCorp* case to be distinguishable because that settlement resolved *actual* litigation, whereas the ostensible settlement in *OCA* merely ensured existing equity’s support of the plan.<sup>28</sup> The court in *OCA* was persuaded by the Third Circuit’s decision in *Armstrong World*.<sup>29</sup> The *OCA* court further acknowledged that there were mechanisms and standards to address settlements through a plan, but concluded that the “settlement” proposed in this plan did not satisfy such standards.<sup>30</sup> Because the deal structure proposed in the *OCA* plan was a blatant violation of the absolute priority rule, the court denied confirmation.

### (2) Iridium Operating

In 2007, the Second Circuit discussed the validity of gifting in *Iridium Operating, LLC*,<sup>31</sup> although outside the context of a plan. In that chapter 11 case, the creditors’ committee and senior secured lenders reached a settlement under which the committee agreed not to challenge the lenders’ liens in exchange for a cash distribution of the lenders’ cash collateral. This distribution was sufficient to fund litigation against Motorola, the debtors’ former parent. Motorola, who held administrative claims against the debtors, objected to the settlement and

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<sup>25</sup> *Id.* at 514-15.

<sup>26</sup> See generally *In re OCA, Inc.*, 357 B.R. 72 (Bankr. E.D. La. 2006) (ultimately concluding that gifting through a plan violates the absolute priority rule).

<sup>27</sup> See *id.* at 85.

<sup>28</sup> See *id.* Further, the *MCorp* court side-stepped the absolute priority rule by declining to decide whether the FDIC’s claim was superior to the junior bond holders’ claims.

<sup>29</sup> See *id.* at 87-88 (quoting *Armstrong World Industries*, 432 F.3d 507, 513 (3d Cir. 2005)).

<sup>30</sup> *In re OCA, Inc.*, 357 B.R. at 88-89.

<sup>31</sup> See generally *In re Iridium Operating, LLC*, 478 F.3d at 459-60.

## Hot Topics in Fifth Circuit Bankruptcy Cases

argued that the lenders' cash gifts were effectively distributions to unsecured creditors without first paying priority claims in full, in violation of the absolute priority rule. The Second Circuit noted the distinctions between this case and *SPM*, and went so far as to question *SPM*'s applicability in chapter 11 cases, but declined to go further.<sup>32</sup>

Instead, the court focused on whether the absolute priority rule applies to pre-plan settlements, noting that the Fifth Circuit had rigidly applied the rule in rejecting a pre-plan settlement in *AWECO*.<sup>33</sup> "The Fifth Circuit accurately captures the potential problem a pre-plan settlement can present for the rule of priority, but, in our view, employs too rigid a test."<sup>34</sup> Instead of employing a *per se* rule, as the Fifth Circuit apparently did in *AWECO*, the Second Circuit opted to make the consideration of the absolute priority rule just another factor in the 9019 analysis.<sup>35</sup> The case was remanded for the bankruptcy court to conduct its analysis with this additional factor in mind.

### (3) The Fifth Circuit's Application of the Absolute Priority Rule in *AWECO*

The Second Circuit's discussion of *AWECO* warrants further review. As noted above, the Second Circuit viewed the *AWECO* decision as a "rigid" application of the absolute priority rule to a pre-plan settlement.<sup>36</sup>

In *AWECO*, the chapter 11 debtor proposed to settle an unliquidated, unsecured non-priority claim asserted for \$27 million by paying the claimant \$5.3 million in cash and other property.<sup>37</sup> The IRS (a priority claimant), a judgment lien holder and other unsecured creditors objected to the settlement, arguing that the settlement depleted the estate of too much value, and left the estate with too little value to satisfy the secured and priority claims in full. The bankruptcy court held evidentiary hearings and, despite much conflicting evidence, found that the settlement was fair and equitable because it left sufficient assets to satisfy the objecting parties' claims.<sup>38</sup>

On appeal, the objecting claimants again urged that the settlement was not "fair and equitable" because it allowed assets to be distributed to a general unsecured creditor without a sufficient record to conclude that the debtor could still satisfy all claims with higher priorities.<sup>39</sup> The debtor responded that the Bankruptcy Code did not require a bankruptcy court to consider whether a pre-plan settlement satisfies the absolute priority rule, so long as the settlement is proposed outside of a plan. Thus, the Fifth Circuit was asked to address the question whether the absolute priority rule applies to settlements conducted outside of a chapter 11 plan.

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<sup>32</sup> See *id.* at 461 (distinguishing from *SPM* because no one disputed the lender's liens in that case, while the liens in this case were questionable due to the high-tech nature of the collateral, which included leases of low-orbiting satellites).

<sup>33</sup> See *id.* at 463-64 (quoting *United States v. AWECO, Inc. (In re AWECO, Inc.)*, 725 F.2d 293, 298 (5th Cir. 1984)).

<sup>34</sup> *Id.* at 464.

<sup>35</sup> See *id.* at 464 ("Rejection of a *per se* rule has an unfortunate side effect, however: a heightened risk that the parties to a settlement may engage in improper collusion. . . . The court must be certain that parties to a settlement have not employed a settlement as a means to avoid the priority strictures of the Bankruptcy Code.").

<sup>36</sup> See *id.*

<sup>37</sup> See *In re AWECO, Inc.*, 725 F.2d at 295.

<sup>38</sup> See *id.* at 296-97.

<sup>39</sup> *Id.* at 297.

## Hot Topics in Fifth Circuit Bankruptcy Cases

The debtor in *AWECO* argued that the absolute priority rule cannot apply to pre-plan settlements, because the relative priorities of creditors' claims cannot be determined before a plan has been negotiated and proposed.<sup>40</sup> The Fifth Circuit rejected this argument for two reasons.

First, the present appeal did not require the court to consider *how* rigidly the absolute priority rule must be applied to pre-plan settlements. Said the court: “The *limited question* that we face is whether the holder of an outstanding senior claim can validly object to a proposed settlement with a junior claimant on the basis that the settlement will keep the senior claimant from being paid in full. *The answer to this question has no necessary implications beyond the present, limited context.*”<sup>41</sup>

Second, the Fifth Circuit explained that the policy behind the Bankruptcy Code demands that there by *some* application of the absolute priority rule, even outside the context of a chapter 11 plan.

[W]e find the policy arguments convincing that *some* extension of the fair and equitable standard is proper. As soon as a debtor files a petition for relief, fair and equitable settlement of creditors' claims becomes a goal of the proceedings. The goal does not suddenly appear during the process of approving a plan of compromise. Moreover, if the standard had *no* application before confirmation of a reorganization plan, then bankruptcy courts would have the discretion to favor junior classes of creditors so long as the approval of the settlement came before the plan. Regardless of when the compromise is approved, looking only to the fairness of the settlement as between the debtor and the settling claimant contravenes a basic notion of fairness. An estate might be wholly depleted in settlement of junior claims -- depriving senior creditors of full payment -- and still be fair as between the debtor and the settling creditor. Our understanding of bankruptcy law's underlying policies leads us to make a *limited extension* of the fair and equitable standard: a bankruptcy court abuses its discretion in approving a settlement with a junior creditor unless the court concludes that priority of payment will be respected as to objecting senior creditors.<sup>42</sup>

In other words, the Fifth Circuit held that a bankruptcy court must consider the objecting creditors' relative priority to the settling creditor and whether the record supports a conclusion that the estate will have sufficient assets to satisfy senior claims, even after the settlement is effectuated. In that particular case, the court of appeals concluded that the record did not support the bankruptcy court's conclusion that the absolute priority rule could be satisfied upon the

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<sup>40</sup> *In re AWECO, Inc.*, 725 F.2d at 298.

<sup>41</sup> *Id.* (emphasis added).

<sup>42</sup> *Id.* (emphasis added).

## Hot Topics in Fifth Circuit Bankruptcy Cases

proposal of a plan, due to the conflicting testimony and evidence concerning the value and the proposed use of the debtor's remaining assets.

As it turns out, this conclusion was not so different from the Second Circuit's application of the rule in *Iridium Operating*.<sup>43</sup> Both courts seem to have concluded that *some* application of the absolute priority rule is required, even for pre-plan settlements, and that the bankruptcy court must consider whether the settlement will leave sufficient assets to satisfy the absolute priority rule when a plan is ultimately proposed. If the *Iridium Operating* decision could serve as an indicator for the Second Circuit's view of gifting plans, it is entirely possible that the *AWECO* decision could similarly serve as an indicator for what the Fifth Circuit would do with similar facts.

### (4) *Journal Register Company*

One more opinion warrants discussion before returning to the *DBSD* opinion. In 2009, the Hon. Allan Gropper, U.S. Bankruptcy Judge for the Southern District of New York, seemingly endorsed the gifting doctrine in confirming a chapter 11 plan.<sup>44</sup> While that endorsement would seem contrary to *Armstrong World* and *DBSD*, a review of the plan in that case highlights when a gifting plan does or does not violate the absolute priority rule. *Journal Register* seems to remain good law, even in the face of *DBSD* and *Armstrong World*.

In the *Journal Register* plan, the debtor proposed to satisfy the senior secured lenders' claims by giving the lenders 100% of the new equity in the reorganized debtor.<sup>45</sup> No one disputed that the lenders were under-secured or that the reorganized debtor's new equity (having an enterprise value of about \$300 million) was insufficient to satisfy the lenders' claims in full. The plan also proposed to pay unsecured creditors about 9% of their claims. But in addition to the unsecured creditors' plan treatment, the secured lenders proposed to establish a special "trade account" to pay additional trade claims, provided that the trade creditors supported the plan and released claims against the secured lenders.<sup>46</sup>

The plan won the overwhelming support of unsecured creditors, but one unsecured creditor in particular objected to the plan, arguing that the "gift" offered to trade creditors was unfair because it discriminated among unsecured creditors within the same class.<sup>47</sup> Judge Gropper overruled this argument and confirmed the plan, noting that there was legitimate business reason to support such discrimination. He further explained that the prohibition against unfair

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<sup>43</sup> Compare *In re Iridium Operating, LLC*, 478 F.3d at 464 ("The court *must be certain* that parties to a settlement have not employed a settlement *as a means to avoid the priority strictures of the Bankruptcy Code.*") (emphasis added) with *In re AWECO, Inc.*, 725 F.2d at 298 ("[A] bankruptcy court abuses its discretion in approving a settlement with a junior creditor *unless the court concludes that priority of payment will be respected as to objecting senior creditors.*") (emphasis added).

<sup>44</sup> See generally *In re Journal Register Co.*, 407 B.R. 520 (Bankr. S.D.N.Y. 2009).

<sup>45</sup> *Id.* at 526.

<sup>46</sup> *Id.* at 526-27. Notably, the plan provisions concerning the funding and distributions of the vendor account appeared in the "Means of Implementation" of the plan, instead of the "Treatment" section.

<sup>47</sup> *Id.* at 531-32.

## Hot Topics in Fifth Circuit Bankruptcy Cases

discrimination in section 1129(b) of the Bankruptcy Code “is concerned with plan treatment between classes--not within classes.”<sup>48</sup>

In dicta, Judge Gropper agreed with, but distinguished from, the Third Circuit’s *Armstrong World* decision. “Here, there is no forced distribution from one class to a junior class over the objection of an intervening dissenting or objecting class. The ‘gift’ by a small group of Secured Lenders is wholly consensual on their part, and there is no contention that they are making the ‘gift’ to another class over the dissent of an intervening class.”<sup>49</sup> In other words, the objecting creditor was not being skipped over; it just was not entitled to receive distributions from the “trade account” as were other unsecured creditors within its class. Judge Gropper held that the absolute priority rule was not implicated in this scenario, and that the “gift” to the trade vendors did not violate any provisions of the Bankruptcy Code. Judge Barbara J. Houser seemed to agree with this analysis and the use of a “gift” in confirming the chapter 11 plan in *IDEARC*.<sup>50</sup>

### D. The *DBSD* Court’s Conclusion Regarding “Gifting” and the Potential Fallout

With this background, we now turn to the Second Circuit’s answer in *DBSD* to the question whether property may be “gifted” around the absolute priority rule. Said the Court: “The Code extends the absolute priority rule to ‘any property,’ 11 U.S.C. § 1129(b)(2)(B)(ii), not ‘any property not covered by a senior creditor’s lien.’”<sup>51</sup> Further, the court noted that property subject to a creditor’s lien is still property of the bankruptcy estate.<sup>52</sup> Under that logic, a lien holder’s *consent* to share its collateral with junior creditors could not somehow exempt the “gift” from the strictures of the absolute priority rule.

Turning to the policy arguments in support of plan gifting, the court of appeals cited various articles highlighting the benefits of plan gifting. However, the court found no legislative support for the policy arguments, and even noted stylistic changes in the various iterations of section 1129(b)(2)(B) proposed before ultimately enacted in 1978. Said the court, “[N]one [of the iterations] altered the operation of the absolute priority rule in any way relevant here.”<sup>53</sup>

## III. CLASS ACTIONS IN BANKRUPTCY

Turning to what the Fifth Circuit *has* decided, in its recent *Wilborn* decision,<sup>54</sup> the court reiterated that class actions are viable in the bankruptcy forum. In that case, the Fifth Circuit vacated a class certified by the bankruptcy court, but not before making clear that there is a place

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<sup>48</sup> *Id.* at 532 (citing 7 Collier on Bankruptcy ¶ 1129.04[4] (15th ed. rev. 1998)) (emphasis added).

<sup>49</sup> *Id.* (emphasis added).

<sup>50</sup> See *In re Idearc, Inc.*, 423 B.R. 138, 172 (Bankr. N.D. Tex. 2009) (“Finally, because the \$ 3.0 million fund from which distributions will be made for Sub-Class 2 is being gifted from the Lenders’ collateral -- and will not be made from the Debtors’ assets -- any slight discrimination that could exist against claimants in Sub-Class 1 in favor of claimants in Sub-Class 2 does not violate the Bankruptcy Code.”) (emphasis added) (citing with approval *Journal Register, SPM, MCorp, Genesis Health Ventures* and others).

<sup>51</sup> *In re DBSD N. Am.*, slip op. at 30.

<sup>52</sup> See *id.* at 32 (citing *United States v. Whiting Pools, Inc.*, 462 U.S. 198, 203-04, 103 S. Ct. 2309, 76 L. Ed. 2d 515 (1983)).

<sup>53</sup> See *id.* at 37 n.8 (citations omitted).

<sup>54</sup> See generally *In re Wilborn v. Wells Fargo Bank, N.A. (In re Wilborn)*, 609 F.3d 748 (5th Cir. 2010).

## Hot Topics in Fifth Circuit Bankruptcy Cases

in the bankruptcy process for class actions litigation. “[I]f bankruptcy court jurisdiction is not permitted over a class action of debtors,” explained the court, “Rule 7023 is virtually read out of the rules.”<sup>55</sup>

Rule 7023 of the Federal Rules of Bankruptcy Procedure provides simply: “Rule 23 F.R.Civ.P. applies in adversary proceedings.” Because the Bankruptcy Rules incorporate this rule concerning class actions, it is clear that the Advisory Committee intended for class actions to be maintainable in bankruptcy cases. But how?

Since the enactment of the Bankruptcy Reform Act of 1978 and the subsequent promulgation of the Bankruptcy Rules, many courts have considered how class actions work within bankruptcy cases. In general, class actions work two ways: multiple claimants who assert class action claims against the debtor, and, as discussed in the *Wilborn* opinion, multiple debtors who assert class action claims against a common creditor or defendant (usually a lender).

In light of the widespread use of MERS<sup>56</sup> and mass securitization of residential mortgages, the potential for multi-debtor class action litigation in the bankruptcy forum is especially pertinent. Further, with catastrophes such as the British Petroleum oil spill and the tsunami in Japan that may threaten downstream supply and demand, multi-creditor class actions may soon become more prevalent in bankruptcy cases. The next section of this paper discusses the trends and rules affecting “bankruptcy class actions” in light of recent decisions from the Fifth Circuit and other courts.<sup>57</sup>

### A. Class Claims Against the Debtor

The first and, perhaps, more common type of class action seen in the bankruptcy forum is a class claim asserted against the debtor. The prime example is a personal injury or wrongful

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<sup>55</sup> *Id.* at 754.

<sup>56</sup> See generally *MERSCORP, Inc. v. Romaine*, 561 N.E. 81, 83 (N.Y. 2006) (“In 1993, the MERS system was created by several large participants in the real estate mortgage industry[] to track ownership interests in residential mortgages. Mortgage lenders and other entities, [] known as MERS members, subscribe to the MERS system and pay annual fees for the electronic processing and tracking of ownership and transfers of mortgages. Members contractually agree to appoint MERS to act as their common agent on all mortgages they register in the MERS system. . . . The initial MERS mortgage is recorded in the County Clerk's office with "Mortgage Electronic Registration Systems, Inc." named as the lender's nominee or mortgagee of record on the instrument. During the lifetime of the mortgage, the beneficial ownership interest or servicing rights may be transferred among MERS members (MERS assignments), but these assignments are not publicly recorded; instead they are tracked electronically in MERS's private system. [] In the MERS system, the mortgagor is notified of transfers of servicing rights pursuant to the Truth in Lending Act, but not necessarily of assignments of the beneficial interest in the mortgage.”) (footnotes omitted).

<sup>57</sup> Importantly, this paper will *not* discuss in great detail the standards for class certification under Federal Rule 23 other than stating generally that a class must satisfy the four prerequisites of Rule 23(a)—numerosity, commonality, typicality and adequacy of representation—while also proving that the class may be maintained under one of the types enumerated in Rule 23(b). For a discussion of those standards, see generally *Castano v. Am. Tobacco Co.*, 84 F.3d 734 (5th Cir. 1996); *Allison v. Citgo Petroleum*, 151 F.3d 402 (5th Cir. 1998); *Sandwich Chef of Texas, Inc. v. Reliance Nat. Indem. Ins. Co.*, 319 F.3d 205, 211 (5th Cir. 2003); *O’Sullivan v. Countrywide Home Loans, Inc.*, 319 F.3d 732, 738 (5th Cir. 2003) (citing *Amchem Prods. v. Windsor*, 521 U.S. 591, 624, 117 S.Ct. 2231, 138 L.Ed.2d 689 (1997)).

## Hot Topics in Fifth Circuit Bankruptcy Cases

death class claim against a chemical manufacturer. Once the bankruptcy case is commenced, existing class action litigation is stayed, and the class representative(s) must decide how to pursue its class claims against the debtor in the bankruptcy arena. This raises a dilemma for the class representative. Should she file a proof of claim against the debtor on behalf of the class? What if the class had not been certified before the bankruptcy case commenced? Can the named plaintiff seek certification of the class from the bankruptcy court? If so, when must the named plaintiff seek certification? Should the existing class litigation be removed to federal court? While the Fifth Circuit has not answered all of these questions directly, many other courts have.

### (1) Whether the Bankruptcy Code Permits Class Proofs of Claim

In the early stages of the Bankruptcy Code, courts were unsure how to pursue or defend class actions under the Bankruptcy Code. One of the first circuit courts to address this issue concluded that the Bankruptcy Code did not authorize class actions to be asserted through a proof of claim.<sup>58</sup> In *Standard Metals*, the Tenth Circuit held that “class proofs of claim violate the statutory scheme of the Act and the Rules,” because “each individual claimant must file a proof of claim or expressly authorize an agent to act on his or her behalf,” and “a class representative cannot be considered the authorized agent of all of the creditors in a putative class.”<sup>59</sup>

Other courts have not followed the Tenth Circuit’s logic.<sup>60</sup> Months after the *Standard Metals* decision, the Seventh Circuit came to a different conclusion.<sup>61</sup> Noting that the Bankruptcy Code neither permitted nor prohibited class proofs of claim, Judge Easterbrook found section 501 of the Bankruptcy Code to provide a non-exclusive list of persons authorized to file proofs of claim.<sup>62</sup> Further, Judge Easterbrook noted that the use of “representational litigation” in bankruptcy was a concept dating back to the “creditors’ bills” used in cases predating the Bankruptcy Act of 1898. Judge Easterbrook relied on the Supreme Court’s “Yamasaki presumption”<sup>63</sup> that class actions are generally authorized unless Congress expressly

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<sup>58</sup> See *Sheftelman v. Standard Metals Corp. (In re Standard Metals Corp.)*, 817 F.2d 625, 630 (10th Cir. 1987), vacated on other grounds at 839 F.2d 1383; see also *In the Matter of GAC Corp.*, 681 F.2d 1295 (11th Cir. 1982) (finding no authority for allowing class claims in pre-Bankruptcy Code Chapter X cases).

<sup>59</sup> *In re Standard Metals Corp.*, 817 F.2d at 630-32; see also Fed. R. Bankr. P. 2019. Courts have only departed from this logic in the last decade. As recently as 2000, Judge Abramson adopted this approach, finding that a class claimant could not establish its authority to pursue claims on behalf of putative class members as required by Rule 2019(a). See *Kahler v. FirstPlus Fin., Inc. (In re FirstPlus Fin., Inc.)*, 248 B.R. 60 (Bankr. N.D. Tex. 2000); see also *In re Great W. Cities, Inc. of New Mexico*, 88 B.R. 109 (Bankr. N.D. Tex. 1988), *rev'd on other grounds*, 107 B.R. 116 (N.D. Tex. 1989). Judge Lynn addressed these opinions in *In re Craft*, discussed *infra*, and concluded that class claimants are not required to comply with Rule 2019. See *In re Craft*, 321 B.R. 189, 197 (Bankr. N.D. Tex. 2005).

<sup>60</sup> In fact, the *Standard Metals* court’s discussion of class proofs of claims has been labeled dicta and called into serious question. See, e.g., *In re Charter Co.*, 876 F.2d 866, 869 n.4 (11th Cir. 1989) (“Therefore, despite the scope of the order vacating the original panel opinion, the discussion of the class proofs of claim in the original *Standard Metals* opinion may be dicta.”).

<sup>61</sup> See *In the Matter of Am. Reserve Corp.*, 840 F.2d 487, 490-92 (7th Cir. 1988) (Easterbrook, J.).

<sup>62</sup> *Id.* at 492.

<sup>63</sup> See *Califano v. Yamasaki*, 442 U.S. 682, 700, 99 S. Ct. 2545, 2557, 61 L. Ed. 2d 176 (1979) (“[I]n the absence of a direct expression from Congress of its intent to depart from the usual course of trying all suits of a civil nature under the Rules established for that purpose, class relief is appropriate in civil actions brought in federal court.”).

## Hot Topics in Fifth Circuit Bankruptcy Cases

states otherwise.<sup>64</sup> After recognizing the pros and cons of “representational litigation” through class proofs of claim, the court concluded that class proofs of claim are valid under the Bankruptcy Code.<sup>65</sup>

But that conclusion did not end the analysis. For a class proof of claim to be authorized, the claimant must first obtain certification of her class. If certification was not obtained pre-petition, the only way to do so post-petition is through the invocation of Rule 23, made applicable to *adversary proceedings* by Bankruptcy Rule 7023. Claim objections generally give rise to *contested matters*, not adversary proceedings, and contested matters are governed by Bankruptcy Rule 9014, which does not *expressly* invoke Rule 7023. In *American Reserve Corp.*, Judge Easterbrook explained that, because Bankruptcy Rule 7023 is not enumerated in Bankruptcy Rule 9014, the bankruptcy judge has broad discretion in whether to invoke it.<sup>66</sup>

Thus, a two-pronged approach was born. In deciding whether a representative may assert a proof of claim on behalf of a putative class, courts consider, first, whether to invoke Rule 7023, and, second, whether the claimant satisfies the certification requirements of Rule 23. Of course, courts are divided on the standards applied to these prongs.

### (2) When to Invoke Rule 7023

The year following the Seventh Circuit’s *American Reserve* decision, the Eleventh Circuit picked up where the Seventh Circuit left off.<sup>67</sup> After adopting Judge Easterbrook’s rationale for concluding that the Bankruptcy Code authorizes class proofs of claim,<sup>68</sup> the court discussed the procedural requirements for invoking Rule 7023. The court explained:

[T]he first opportunity a claimant has to move under Bankruptcy Rule 9014, to request application of Bankruptcy Rule 7023, occurs when an objection is made to a proof of claim. Prior to that time, invocation of Rule 23 procedures would not be ripe, because there is neither an adversary proceeding nor a contested matter.<sup>69</sup>

In *Charter*, the claimant filed a timely proof of claim on behalf of a class of shareholders alleging securities violations.<sup>70</sup> Two years later, the debtors objected to the claim, and the claimant responded (within weeks of the claim objection) with a motion to invoke Rule 7023 and

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<sup>64</sup> See *In re Am. Reserve Corp.*, 840 F.2d at 492.

<sup>65</sup> See *id.* at 493.

<sup>66</sup> See *id.* at 493 (“Finally, the bankruptcy judge did not recognize that he has discretion under *Rule 9014* not to apply *Rule 7023* -- and therefore not to apply *Rule 23* -- in this ‘contested matter.’ We trust that the bankruptcy judge will exercise discretion prudently on remand.”).

<sup>67</sup> See *Certified Class in the Charters Securities Litigation v. Charter Co. (In re Charter Co.)*, 876 F.2d 866 (11th Cir. 1989).

<sup>68</sup> see generally *id.* at 868-873.

<sup>69</sup> *Id.* at 874.

<sup>70</sup> *Id.* The claimant had filed a class action complaint against the debtors two weeks before the petition date. The claimant severed the debtors from his complaint and pursued the non-debtor defendants. The class was eventually certified in that action.

## Hot Topics in Fifth Circuit Bankruptcy Cases

certify the class. The court of appeals held that, despite the two years from the time of the filing of the proof of claim, there was no undue delay in seeking certification.<sup>71</sup>

### (3) Application of the Two-Prong Approach

Since the *American Reserve* and *Charter* decisions, several bankruptcy and district courts have expanded on the standards and procedures for invoking Rule 23 for the purposes of pursuing class proofs of claim, though not necessarily following the *Charter* court's ruling.

In *In re Craft*,<sup>72</sup> Judge Lynn addressed class proofs of claim filed in two different bankruptcy cases<sup>73</sup> with two distinctive sets of circumstances. In the *Craft* bankruptcy case, the claimant had obtained certification of his class pre-petition. For that claim, Judge Lynn relied on the state court's certification order, and found no extraordinary circumstances to preclude him from holding that the pre-petition class certification was sufficient to authorize the named plaintiff to file a proof of claim on behalf of the certified class.<sup>74</sup>

In the *Mirant* bankruptcy case, the claimants had not obtained certification of their classes before the bankruptcy petition date. Rather than objecting to the claims, the debtors merely moved to strike the proofs of claim as being filed on behalf of uncertified classes. In exercising his discretion to invoke Bankruptcy Rule 7023, Judge Lynn considered circumstances "peculiar to bankruptcy law," including "[1] prejudice to the debtor or its other creditors, [2] prejudice to putative class members, [3] efficient estate administration, [4] the conduct in the bankruptcy case of the putative class representatives, and [5] the status of proceedings in other courts."<sup>75</sup> He concluded that Bankruptcy Rule 7023 should not be invoked for a host of reasons, including detriment to the estate and its creditors because of the delay certification litigation would cause to the claims administration process and distributions. Judge Lynn also found that the putative class members would not be harmed by his refusal to invoke Bankruptcy Rule 7023, as they had received constructive or actual notice of the bankruptcy cases and the claims bar dates. Finally, in addressing the timing, Judge Lynn explained that "it is the view of this court that it is the burden of the class representatives to raise the issue of class certification."<sup>76</sup> In other words, Judge Lynn disagreed with the *Charter* court, where the Eleventh Circuit held two years was not too long to wait before seeking certification. Instead, it was Judge Lynn's view that a claimant should seek certification as early as possible.

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<sup>71</sup> *Id.* at 874-75.

<sup>72</sup> 321 B.R. 189 (Bankr. N.D. Tex. 2005).

<sup>73</sup> The issues arising from the *Craft* and *Mirant* bankruptcy cases were consolidated into a single opinion under this *Craft* citation.

<sup>74</sup> *See id.* at 197-98; *see also In re Entergy New Orleans, Inc.*, 353 B.R. 474 (Bankr. E.D. La. 2006) (declining to invoke Bankruptcy Rule 7023 because, under state law, no civil court had jurisdiction to consider the class certification issue until the public utilities commission determined certain regulatory issues on which the class claims were predicated).

<sup>75</sup> *See In re Craft*, 321 B.R. at 198-99.

<sup>76</sup> *Id.* at 199.

## Hot Topics in Fifth Circuit Bankruptcy Cases

That same year, District Judge Rakoff of the Southern District of New York issued the decision in *In re Ephedra Products Liability Litigation*,<sup>77</sup> reaching virtually the same conclusion as Judge Lynn.

If a party in interest asks the bankruptcy court to certify a class, the class claim becomes a “contested matter” *at least* as of the time that the request is opposed, and even before if opposition is known or reasonably foreseeable -- in the words of the Advisory Committee, “whenever there is an actual dispute.” [footnote omitted] Objection to the class proofs of claim was not a necessary prerequisite to a motion for class certification.<sup>78</sup>

In so ruling, the *Ephedra* court expressly parted from the Eleventh Circuit’s ruling in *Charter*, and ruled that a claimant cannot wait for a claim objection to seek certification.

In the *Ephedra* case, the debtors’ liquidating plan had been approved for solicitation when the claimant first moved for class certification. By the time the certification motion came on for hearing, the plan had been confirmed, most other personal injury claims had been settled, and the estates creditors were ready for distribution. For these reasons, the court held that it was “simply too late in the administration of this Chapter 11 case to ask the Court to apply Rule 23 to class proofs of claim.”<sup>79</sup>

But there was a second reason highlighted by Judge Rakoff for denying the certification motion, which other courts since have cited with agreement.<sup>80</sup> For a class seeking monetary damages to be certified, the putative class representative must demonstrate that “a class action is superior to other available methods for the fair and efficient adjudication of the controversy.” Fed. R. Civ. P. 23(b)(3). The *Ephedra* court recognized that the bankruptcy process vitiates the superiority of class litigation.

[S]uperiority of the class action vanishes when the “other available method” is bankruptcy, which consolidates all claims in one forum and allows claimants to file proofs of claim *without counsel* and *at virtually no cost*. In efficiency, bankruptcy is superior to a class action because in practice small claims are often “deemed allowed” under § 502(a) for want of objection, in which case discovery and fact-finding are avoided altogether.<sup>81</sup>

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<sup>77</sup> 329 B.R. 1 (S.D.N.Y. 2005).

<sup>78</sup> *Id.* at 7.

<sup>79</sup> *Id.* at 5.

<sup>80</sup> See, e.g., *In re Bally Total Fitness of Greater New York, Inc.*, 402 B.R. 616, 621-22 (Bankr. S.D.N.Y. 2009); *Rodriguez v. Tarragon Corp. (In re Terragon Corp.)*, 2010 Bankr. Lexis 3410 at \*7-8 (Bankr. D.N.J. Sept. 24, 2010); *In re Blockbuster Inc.*, 441 B.R. 239 (Bankr. S.D.N.Y. Jan. 20, 2011); *In re Motors Liquidation, Inc.*, 2010 Bankr. LEXIS 240 \*33-34 (Bankr. S.D.N.Y. Jan. 28, 2011).

<sup>81</sup> *Id.* at 9 (emphasis added).

## Hot Topics in Fifth Circuit Bankruptcy Cases

In other words, if the bankruptcy court is convinced that the debtors have given fair notice to potential class members (whether directly or through publication), and absent extraordinary circumstances, class proofs of claim for classes not certified pre-petition will almost never be allowed in bankruptcy cases, because courts view the general bankruptcy claims administrative process to be a superior mechanism for adjudicating claims on an individual basis.<sup>82</sup>

To date, few published opinions exist where a bankruptcy court has certified a class post-petition for purposes of asserting class proofs of claim. In fact, the only one found by the authors was *In re United Artists Theatre*,<sup>83</sup> and the facts of that case differ from the facts in the cases discussed above. In *United Artists*, there were really two classes. First, a class representative obtained relief from the bankruptcy court to continue its pre-petition class action in U.S. District Court for the District of Arizona. That relief was granted, and the litigation resulted in certification of the class and a judgment of \$28.8 million.

The second class was the one addressed in this opinion, and differed from the first class. The named plaintiff in the second class action did not seek to assert a proof of claim, but merely sought a determination that the putative class members (the same as the first class) were entitled to receive distributions from the estate on account of the \$28.8 million judgment. The court explained that this issue, while it may have an economic impact on the estate, really just boiled down to whether the claimants were barred by notices given in the bankruptcy case. This issue, concluded the court, could readily be made on a class-wide basis and fell under Rule 23(b)(2).<sup>84</sup> Accordingly, the court certified the second class, and the litigation is now awaiting approval of a settlement.

### B. Multi-debtor Class Actions

The case law developed for the multi-claimant proofs of claim—the first type of bankruptcy class action—highlights the tug between due process concerns and the need for efficient administration of bankruptcy estates. However, the multi-claimant class litigation differs drastically from multi-debtor class actions—the second type of bankruptcy class action. In multi-*debtor* class actions, the issue is no longer whether to invoke Rule 7023. Instead, courts

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<sup>82</sup> See generally *In re Bally Total Fitness of Greater New York, Inc.*, 402 B.R. 616, 621-22 (Bankr. S.D.N.Y. 2009) (denying certification of class for claims filing purposes, finding that the debtors had given direct notice to the putative class members, and no claims had been filed before the bar date); *In re Terragon Corp.*, 2010 Bankr. Lexis 3410 at \*12 (Bankr. D.N.J. Sept. 24, 2010) (“The plaintiffs, named or unnamed, received actual notice of the claim bar date by [the claims agent]. Though they may not have known of the Claimant’s class proofs of claim, they had an opportunity to investigate and pursue potential individual claims and did not do so.”); *In re Blockbuster Inc.*, 441 B.R. 239 (Bankr. S.D.N.Y. Jan. 20, 2011) (finding that a competent court had already denied certification, and that claims for improperly charged late fees were best resolved on an individual basis).

<sup>83</sup> *Hacienda Heating & Cooling, Inc. v. United Artists Theatre Co. (In re United Artists Theatre Co.)*, 410 B.R. 385 (Bankr. D. Del. 2009).

<sup>84</sup> For an authoritative decision on whether a class may be maintained under Rule 23(b)(2) (for injunctive or declaratory relief) versus Rule 23(b)(3) (for monetary relief), see generally *Bolin v. Sears, Roebuck & Co.*, 231 F.3d 970 (5th Cir. 2000) (vacating certification under Rule 23(b)(2), finding that the only “meaningful relief” to be obtained by the multi-debtor class was for monetary damages, and requiring the district court to consider whether the class could be maintained, if at all, under Rule 23(b)(3)).

## Hot Topics in Fifth Circuit Bankruptcy Cases

addressing multi-debtor class claims focus on jurisdiction. How far does bankruptcy jurisdiction extend where a debtor seeks to define a class of similarly situated debtors?

### (1) Jurisdictional Scope

Last year, the Fifth Circuit addressed this issue directly.<sup>85</sup> In *Wilborn*, the Fifth Circuit concluded that “a bankruptcy judge *may* certify a class action comprised of debtors under appropriate circumstances but that the proposed class in *this* case does not satisfy the requirements of [Rule 23].”<sup>86</sup> In that case, the proposed class was defined as follows:

All individuals who filed for bankruptcy under Chapter 13 in the Southern District of Texas between November 16, 2002 through November 16, 2007 who owed Wells Fargo, as servicer or holder, on a mortgage debt secured by real property, and upon whom Wells Fargo either charged, or both charged and collected, professional fees and costs during the pendency of each of their respective bankruptcy cases which were never disclosed to this Court, the debtors, or other parties-in-interest nor approved by this Court by written order entered on the docket in their respective bankruptcy cases.<sup>87</sup>

The “Court” defined above was defined as the U.S. Bankruptcy Court for the Southern District of Texas, regardless of the particular bankruptcy judge to which the case was assigned. Wells Fargo argued that the judge presiding over the *Wilborn* class action proceeding lacked jurisdiction over the claims arising in bankruptcy cases administered by other bankruptcy judges (though in the same jurisdictional district).<sup>88</sup>

Said the Fifth Circuit in rejecting Wells Fargo’s theory, “We have read the jurisdictional statutes of § 1334(b) and § 157(a) as restricting the *placement* of jurisdiction in the bankruptcy courts, rather than as restricting the *scope* of bankruptcy court jurisdiction.”<sup>89</sup> Under Wells Fargo’s view, a bankruptcy court could never certify a class of debtors unless those debtors’ cases had been assigned to that particular judge. But such logic, reasoned the Fifth Circuit, “would restrict a bankruptcy court’s class certification authority to a proposed class of creditors rather than debtors.”<sup>90</sup> The court found no express limitation in the rules to so limit bankruptcy class actions.

Class actions promote efficiency and economy in litigation and permit multiple parties to litigate claims that otherwise might be

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<sup>85</sup> As noted in footnote 84 *supra*, the Fifth Circuit did address multi-debtor class actions in *Bolin*, vacating that class certification order because the relief sought by the named plaintiffs should have been certified, if at all, under Rule 23(b)(3). While jurisdiction was discussed in the *Bolin* decision, that section focused on appellate jurisdiction, not bankruptcy jurisdiction.

<sup>86</sup> *In re Wilborn*, 609 F.3d at 750 (emphasis added).

<sup>87</sup> *Id.* at 751.

<sup>88</sup> *See id.* at 753.

<sup>89</sup> *Id.* (citing *In re Majestic Energy Corp.*, 835 F.2d 87, 90 (5th Cir. 1988)) (emphasis in the original).

<sup>90</sup> *Id.* at 754 (citation omitted).

## Hot Topics in Fifth Circuit Bankruptcy Cases

uneconomical to pursue individually. These principles are no less compelling in the bankruptcy context. We hold therefore that the bankruptcy court has authority to certify a class action of debtors whose petitions are filed within its judicial district provided that the prerequisites for a class under Rule 23 are satisfied.

*Id.* (citing *Am. Pipe & Constr. Co. v. Utah*, 414 U.S. 538, 553, 94 S. Ct. 756, 766, 38 L. Ed. 2d 713 (1974)).

Thus, the Fifth Circuit explained that the scope of bankruptcy jurisdiction is not restricted by which judge presided over the putative class members' bankruptcy cases. While the class in *Wilborn* only defined the class to cases filed in the Southern District of Texas, the rationale employed by the court of appeals would seem to support a much broader reach of bankruptcy jurisdiction.

### (2) The Requirements Rule 23

Jurisdictional victories aside, the class claimant still must satisfy the prerequisites for certification under Rule 23.<sup>91</sup> As explained by the court in *Wilborn*, for a class to be maintained under Rule 23(b)(3), the monetary damages sought must be readily calculated on a class-wide basis. The class in *Wilborn*, however, could not be maintained under Rule 23(b)(3), because the damage model was too fact-specific.<sup>92</sup>

Just over one month after the Fifth Circuit issued the *Wilborn* decision, Judge Isgur issued an order certifying a class under Rule 23(b)(2) against Countrywide Home Loans, Inc.<sup>93</sup> There, Judge Isgur narrowed the class definition to cover only those individuals who were charged fees subject to Bankruptcy Rule 2016(a) disclosures that were not specifically authorized by a court order (ignoring individualized issues of notice and agreements). He further held that the certification was conditionally granted to consider whether to grant injunctive relief at trial. The proposed injunction would bar Countrywide from collecting further amounts from class members until the class members received credits for the fees charged in violation of the Bankruptcy Code and Bankruptcy Rule 2016(a).<sup>94</sup> As of the time of this paper, Countrywide's appeals of that opinion and a subsequent opinion denying Countrywide's motion to reconsider were pending before the Fifth Circuit.

## IV. THAT PESKY EQUITABLE MOOTNESS DOCTRINE

While the doctrine of equitable mootness is neither new nor complicated, one cannot ignore the Fifth Circuit's consistent discussions of the doctrine. In the last 18 months, the Fifth Circuit

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<sup>91</sup> See *supra* note 57.

<sup>92</sup> See *In re Wilborn*, 609 F.3d at 756 ("The differing circumstances of the debtors render the reasonableness of the individual charges a fact-specific inquiry rather than a class-oriented decision.").

<sup>93</sup> See *Rodriguez v. Countrywide Home Loans, Inc. (In re Rodriguez)*, 432 B.R. 671 (Bankr. S.D. Tex. 2010).

<sup>94</sup> See Statement of Issued Presented on Appeal, Doc. No. 392, Adversary Proc. No. 08-01004 (Bankr. S.D. Tex. Feb. 2, 2011), available on CM/ECF. The issues raised by Countrywide on appeal were whether: (1) the *Wilborn* decision applied to Rule 23(b)(2) classes; (2) a consent judgment entered in FTC litigation pending in California rendered the class complaint and proposed injunction moot; and (3) the proposed injunction was properly included in the class certification order.

## Hot Topics in Fifth Circuit Bankruptcy Cases

has explained and applied the doctrine in over half a dozen bankruptcy appeals. This section briefly discusses the messages to be carried away from these various opinions.

### A. The Equitable Mootness Doctrine in General

Equitable mootness—not to be confused with “statutory mootness” under section 363(m) of the Bankruptcy Code<sup>95</sup>—is a judicially created doctrine which generally applies to appeals of orders confirming chapter 11 plans.<sup>96</sup>

Equitable mootness is a kind of appellate abstention that favors the finality of reorganizations and protects the interrelated multi-party expectations on which they rest. . . . The doctrine is firmly rooted in Fifth Circuit jurisprudence, as this court attempts to “strik[e] the proper balance between the equitable considerations of finality and good faith reliance on a judgment and competing interests that underlie the right of a party to seek review of a bankruptcy order adversely affecting him.”<sup>97</sup>

In deciding whether an issue is equitably moot for purposes of appeal, courts generally consider (i) whether a stay has been sought or granted; (ii) whether a plan has been substantially consummated; and (iii) whether the appellate court may grant effective relief without upsetting the expectations of third-parties who are not parties to the appeal.<sup>98</sup> Of the recent Fifth Circuit decisions, the following opinions demonstrate issued found to be moot.

In *Green Aggregates*,<sup>99</sup> the principal of two debtors appealed an order substantively consolidating the bankruptcy estates of his two companies. The bankruptcy court granted the principal’s petition to take a direct appeal to the Fifth Circuit, but while the appeal was pending, the chapter 11 trustee obtained confirmation of a plan and substantially consummated that plan. The principal never sought or obtained a stay of the confirmation order, and the only relief he was seeking was the reversal of the substantive consolidation order. In light of the confirmed and consummated plan, the Fifth Circuit concluded that it could not grant the relief requested on appeal—i.e., reversal of the consolidation order—because the plan extinguished old equity and issued new equity to a third party not before the court.

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<sup>95</sup> See 11 U.S.C. § 363(m) (“The reversal or modification on appeal of an authorization under subsection (b) or (c) of this section of a sale or lease of property does not affect the validity of the sale under such authorization to an entity that purchased or leased such property in good faith, whether or not such entity knew of the pendency of the appeal, unless such authorization and such sale or lease were stayed pending appeal.”).

<sup>96</sup> See *In re Hilal*, 534 F.3d 498, 500 (5th Cir. 2008) (“The doctrine of equitable mootness should be and often is applied to forestall bankruptcy appeals from confirmed bankruptcy plans, because the appellate courts recognize that there is a point beyond which they cannot order fundamental changes in reorganization cases.”).

<sup>97</sup> *Bank of New York Trust Co., N.A. v. Official Creditors’ Committee (In re Pacific Lumber Co.)*, 584 F.3d 229, 240 (5th Cir. 2009) (quoting *In re Manges*, 29 F.3d 1034, 1039 (5th Cir. 1994)).

<sup>98</sup> See generally *In re Hilal*, 534 F.3d at 500; *In re Manges*, 29 F.3d at 1039.

<sup>99</sup> *In re Green Aggregates, Inc.*, 345 Fed. Appx. 890 (5th Cir. Apr. 28, 2009) (per curiam).

## Hot Topics in Fifth Circuit Bankruptcy Cases

Similarly, in *Premier Entertainment*,<sup>100</sup> the Fifth Circuit dismissed the appeal as equitably moot based on the specific relief sought by the appellants. In that case, the plan established an escrow fund for the appellants and other creditors to litigate over their asserted rights to the funds. Following confirmation, the debtor deposited the funds as the plan required. Nevertheless, the appellants appealed the confirmation order and continued to urge that they held superior rights to the funds. In their notice of appeal and statement of issues on appeal, the appellants framed the issues so that the only relief requested was an unfettered right to collect the escrowed funds. But in framing the issues as such, the Fifth Circuit found that the appellants effectively rendered their own issues as moot, because the same relief could be granted without the appeal.<sup>101</sup> Because the other parties to the litigation over the escrowed funds were not present in the appeal, and because the same relief could be granted without considering the merits of the appeal, the Fifth Circuit concluded that the issue was moot and dismissed the appeal.

### B. Application to Chapter 7 Appeals?

At least two of the recent opinions addressing equitable mootness have highlighted that the purpose of the doctrine is best suited to appeals of chapter 11 plans, or orders that have an effect on confirmed chapter 11 plans. The next two decisions discuss attempts to dismiss chapter 7 appeals under theories of equitable mootness. The Fifth Circuit rejected both attempts.

In *San Patricio County*,<sup>102</sup> the appellants were a group of lenders entered into a sale and lease-back agreement that was ultimately unenforceable due to misrepresentations made by debtor's principal.<sup>103</sup> The lender sued the debtor and its principal in state court and sought to recover from proceeds of the debtor's D&O policy. The debtor filed a chapter 7 case, the trustee intervened in the lawsuits and removed them to the bankruptcy court. Once in the bankruptcy court, the trustee obtained a ruling that the insurance proceeds were property of the debtor's bankruptcy estate. The bankruptcy court then approved a settlement with the insurance carriers, and the trustee began distributing proceeds.<sup>104</sup> The lenders sought to stay the approval orders, but were denied. They appealed to the district court, but after three-quarters of the settlement proceeds were distributed, the trustee moved to dismiss the appeal as equitably moot. The district court granted the motion.<sup>105</sup>

In *San Patricio County*, the Fifth Circuit held that the appeal was not equitably moot, because the lenders sought a determination that the lawsuit against the debtor's principal should not have been removed to federal court. The Fifth Circuit noted that, if successful, the proceeds

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<sup>100</sup> *In re Premier Entm't Biloxi LLC v. Pac. Inv. Mgmt. Co. (In re Premier Entm't Biloxi LLC)*, 2009 U.S. App. LEXIS 12672 (5th Cir. June 9, 2009).

<sup>101</sup> *Id.* at \*11 (finding that considering the appeal “would necessarily involve overturning the provisions of the confirmed plan that establish the escrow funds and the adversary proceeding”)

<sup>102</sup> *Tech. Lending Ptrs., LLC v. San Patricio County Cmty. Action Agency (In re San Patricio County Cmty. Action Agency)*, 575 F.3d 553 (5th Cir. 2009).

<sup>103</sup> *Id.* at 555-56.

<sup>104</sup> *Id.* at 556-57.

<sup>105</sup> *See id.* at 557.

## Hot Topics in Fifth Circuit Bankruptcy Cases

would not have been property of the debtor's bankruptcy estate, and would be available to satisfy the lender's claims.<sup>106</sup> Said the court in finding such relief to be available:

This case involves the payment of money to parties who were before the bankruptcy court, with three-quarters of the settlement being paid to the either [the trustee] or the state of Texas. We realize that the money paid to the state was then to be given to a comparable charity or charities. Still, we do not find the fact to create a hardship in this case sufficient to outweigh the general right of dissatisfied litigants to have a review of their appellate issues.<sup>107</sup>

While noting that it was unclear whether equitable mootness had *any* application to chapter 7 appeals, the Fifth Circuit concluded that it had no application to the present appeal.<sup>108</sup>

Then, in *Bodenheimer*,<sup>109</sup> the Fifth Circuit again considered whether equitable mootness applied to an appeal of a chapter 7 order. The court once again declined to apply the doctrine broadly, but also held that the particular appeal was not moot. In that appeal, a partner of the chapter 7 debtor argued that the bankruptcy court improperly awarded fees to the debtor's state appointed liquidator. The liquidator argued that the appeal was equitably moot because the chapter 7 trustee had made all distributions and closed the case. The court again considered what effective relief could be granted on appeal, noting that "the only relevant party in interest not before the court is the liquidated estate, which is not truly a 'third-party' in the bankruptcy but a central litigant whose assets remain at issue."<sup>110</sup> As it did in *San Patricio County*, the Fifth Circuit concluded that the *Bodenheimer* appeal was not equitably moot. The court held that reopening the bankruptcy case to consider whether to redistribute assets "would not upset the liquidation plan or disturb the settled interests of parties not before the court."<sup>111</sup>

The reasoning from these two chapter 7 appeals highlights a perceived difference in the Fifth Circuit between appeals of orders affecting chapter 11 plans and orders affecting chapter 7 liquidations. In the latter, third-party creditors are not harmed by an appeal that could lead to further distributions. On the other hand, as discussed below, issues may become equitably moot in chapter 11 appeals, if it means that some of the third-party creditors would have to give their distributions back to the debtor.

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<sup>106</sup> *See id.* at 558-59.

<sup>107</sup> *Id.* at 559.

<sup>108</sup> *See id.* at 558 ("It is certainly arguable that equitable mootness has no application to an appeal in a Chapter 7 liquidation. Yet, there is no reason to make such a comprehensive statement here. Instead, we find that under traditional equitable mootness analysis, this case is not moot.")

<sup>109</sup> *Szwak v. Earwood (In re Bodenheimer, Jones, Szwak, & Winchell, LLP)*, 592 F.3d 664 (5th Cir. 2009).

<sup>110</sup> *Id.* at 669.

<sup>111</sup> *Id.* at 670.

### C. Focus on the Remedies Available

In recent decisions, the Fifth Circuit has reminded us that rote incantations of equitable mootness are insufficient to preclude appellate review. In other words, it is not enough that a plan has been substantially consummated and no stay was obtained (the first two factors of the mootness inquiry). Instead, the Fifth Circuit puts most weight on the final factor—whether effective relief may be granted without upsetting expectations of third parties not before the court.

Take *Pacific Lumber* for example. The appellants raised six issues on appeal. Out of these six issues, the Fifth Circuit found only two to be equitably moot.<sup>112</sup> For those issues, the court noted that certain unsecured creditors had already received payment under the plan, and they were not parties to the appeal.<sup>113</sup>

On the other hand, the court *did* consider the merits of the remaining four issues, including: (i) whether the plan satisfied requirements for cramdown (specifically, whether the noteholders received the “indubitable equivalent” of their secured claim); (ii) whether the plan amounted to a *de facto* consolidation of the debtors’ estates; (iii) whether the bankruptcy court properly calculated the appellants’ administrative priority claim; and (iv) whether the plan’s third party releases and exculpation clauses were valid. While one could legitimately argue that overturning any one of these issues would seriously threaten the success of the plan, the Fifth Circuit disagreed. Said the court on the potential impact of its review on the plan:

That there might be adverse consequences to [the appellees] is not only a natural result of any ordinary appeal—one side goes away disappointed—but adverse appellate consequences were foreseeable to them as sophisticated investors who opted to press the limits of bankruptcy confirmation and valuation rules.<sup>114</sup>

Then, last year, the Fifth Circuit again considered issues arising from the *Pacific Lumber* case.<sup>115</sup> This time, the court considered the amount of the section 507(b) superpriority administrative claim awarded to the note holders. The debtors and plan proponents again argued that consideration of the issue would seriously undermine the success of the confirmed plan.<sup>116</sup> The court of appeals however rejected the mootness argument, noting that “so long as there is the

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<sup>112</sup> Those issues were: (1) whether the plan artificially impaired one class and gerrymandered classes to obtain a consenting, impaired class; and (2) whether the plan unfairly discriminated against the appellants’ deficiency claims.

<sup>113</sup> *In re Pac.Lumber Co.*, 584 F.3d at 251 (“Third-party expectations cannot reasonably be undone, and no remedy for the Noteholders’ contentions is practicable other than unwinding the plan.”).

<sup>114</sup> *Id.* at 244.

<sup>115</sup> *Bank of New York Trust Co., NA v. Pac. Lumber Co. (In re SCOPAC)*, 624 F.3d 274, 282 (5th Cir. 2010).

<sup>116</sup> *Id.* at 281.

## Hot Topics in Fifth Circuit Bankruptcy Cases

possibility of ‘fractional recovery,’ the Noteholders need not suffer the mootness of their claims.”<sup>117</sup>

Notwithstanding the Fifth Circuit’s conclusions on equitable mootness in the *Pacific Lumber* and *SCOPAC* appeals, there are some issues that are easier cases for equitable mootness. For example, in *Asarco*, there were two competing plans which both satisfied confirmation requirements, but the district court chose one over the other and confirmed it. The unsuccessful plan proponents appealed without obtaining a stay of the confirmation order, and that confirmed plan was substantially consummated. On appeal, the unsuccessful plan proponents asked the Fifth Circuit not to unwind the consummated plan, but merely to substitute the appellants as the primary equity-holders of the reorganized debtors, as proposed under their unsuccessful plan. “There is ample reason to think that substituting Sterlite as the primary equity-holder would have a far-reaching impact. It would be difficult to maintain anything resembling the status quo if the primary equity holder were replaced by Sterlite.”<sup>118</sup> Finding that a change in equity holders would affect “numerous complex financial transaction,” the Fifth Circuit dismissed the appeal on mootness grounds.

In these recent decisions, the Fifth Circuit has highlighted at least a few important factors to consider when raising or responding to an appeal. First, the statement of issues must be crafted in a manner that, if successful, provides at least a “fractional recovery” that may be granted by the appellate court. Second, the appellant should give thought to who should be a party to the appeal, as having the affected parties present on appeal may carry significant weight what the appellate court is able to consider in light of equitable mootness concerns. Third, in moving for dismissal on equitable mootness grounds, the appellee should consider whether the relief requested may be granted, at least fractionally.

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<sup>117</sup> *Id.* at 282; see also *Alberta Energy Ptrs. v. Blast Energy Servs., Inc. (In re Blast Energy Servs., Inc.)*, 593 F.3d 418 (5th Cir. 2010) (reversing district court’s order, finding that appeal was not equitably moot because relief *could* be granted where the parties stipulated that the issue could be reviewed on appeal without affecting the plan).

<sup>118</sup> *In re Asarco, LLC*, slip op. at 4, Case No. 09-41259 (5th Cir. Nov. 12, 2010).