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Alert

Second Circuit Affirms Voiding of Secured Creditor's Lien

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A Chapter 11 reorganization plan may extinguish a secured creditor's lien if: (1) the plan "does not preserve the lien"; (2) the court confirms the plan; (3) the plan "dealt with" the lender's collateral; and (4) the lender "participated in the bankruptcy" case, held the U.S. Court of Appeals for the Second Circuit on Aug. 4, 2015. *In re Northern New England Tel. Operations, LLC*, 2015 WL 4619576 (2d Cir. Aug. 4, 2015). Affirming the bankruptcy and district courts, the Second Circuit explained that the debtor's confirmed plan had extinguished a city's ("City's") property tax lien, enabling the bankruptcy court to deny the City's motion for allowance of its tax claim.

Relevance
Bankruptcy Code ("Code") Section 1141(c) "preserves, … with a caveat," the general rule that "liens pass through bankruptcy unaffected." *Id.* at *1, citing *Dewsnup v. Timm*, 502 U.S. 410, 417 (1992), and Code § 506(d) (lien not voided for failure to file claim against estate). The "caveat" is contained in Code Section 1141(c): "[L]iens are extinguished if the underlying property was 'dealt with' by a confirmed plan, unless the plan or the order of confirmation provides otherwise." *Id.*

The Second Circuit had "not previously considered the circumstances under which a reorganization plan extinguishes a lien." *Id.* Other circuits have, however, wrestled with the issue over the past 30 years, as discussed in this *Alert*.

Facts
The debtor filed its Chapter 11 petition in October 2009, and the bankruptcy court confirmed its reorganization plan in January 2011. As of the commencement of the reorganization case, the debtor owned real property in the City, which would issue quarterly real property tax bills. The City had already issued bills for the first and second quarters of the 2009 tax year and filed claims against the debtor's estate for that period. It billed the debtor, but never filed claims, for the third and fourth quarters, and payment on those bills was due during the pendency of the case. The bankruptcy court eventually allowed the City's claims for the first two quarters but disallowed the claims for the third and fourth quarters on the ground that confirmation of the debtor's reorganization plan had extinguished the secured tax claims. Specifically, the confirmed plan extinguished creditors' interests in "all property" of the debtor. The district court affirmed.

Analysis
Code Section 1141(c) provides in relevant part: "… [E]xcept as otherwise provided in the plan or in the order confirming the plan, after confirmation of a plan, the property dealt with by the plan is free and clear of all claims and interests of creditors … ." According to the Second Circuit, "The phrase [ ]

'interests of creditors' … includes liens." *Id.* at *3. Moreover, "courts have uniformly held that confirmation of a reorganization [plan] can … extinguish liens." *Id.*, quoting *In re Chrysler LLC*, 576 F.3d 108, 126 (2d Cir.), *vacated as moot sub nom. Ind. State Police Pension Tr. v. Chrysler LLC*, 558 U.S. 1087 (2009).

Required Secured Creditor Participation

"[A] requirement of lienholder participation is located squarely within § 1141(c)," stressed the Second Circuit. Because the statutory language requires that the lender's collateral be "dealt with," that "condition cannot be fairly satisfied in the absence of the interested parties, including the securityholder." *Id.* at *4. And because bankruptcy courts "are courts of equity," "lienholder participation is a stand-alone requirement for extinguishment of a lien." *Id.* at n.2. Moreover, reasoned the court, "the participation requirement implements the background rule (that liens pass through bankruptcy unaffected) by allowing each lienholder to decide whether to 'bypass his debtor's bankruptcy [case] and enforce his lien in the usual way' or (alternatively) to 'collect his debt in the bankruptcy [case].'" *Id.*, quoting *In re Penrod*, 50 F.3d 459, 461 (7th Cir. 1995).

Lien Preservation for Non-Participating Lenders

Code Section 506(d)(2) preserves a lien when the underlying claim is allowed despite "the failure of [the secured lender] to file a proof of claim … ." In other words, the section "preserves liens of *non-participating lienholders* whose liens would otherwise be extinguished *solely as a result of their non-participation*." *Id.* at *4 (emphasis in original).

Code Section 1141(c), therefore, applies "only to liens located outside of § 506(d)(2)'s safe harbor." *Id.* Accordingly, a secured lender must have participated in the case if its lien is to be extinguished.

Applying Law to Facts

The parties agreed in *Northern New England* that the reorganization plan contained "no language preserving the City's lien" and that "the bankruptcy court [had] confirmed the plan." *Id.* at *5. Nevertheless, the court rejected the City's argument that the plan had not sufficiently "dealt with" the City's collateral and that the City had not "sufficiently" participated in the reorganization case.

Plan Dealt with Collateral

First, the confirmed reorganization plan provided that all of the debtor's property "shall be free and clear of all Claims, Liens and interests, except as specifically provided in the Plan, the Confirmation Order, or the New Credit Agreement." *Id.* at *9. The debtor's property mentioned in the plan "includes the six parcels of real property subject to the City's putative lien," confirming that it was "dealt with." Despite the City's argument that the language of the plan was "insufficiently specific," a reorganization plan may "deal in broad strokes with property subject to liens," said the court, and a reorganization plan need not "list each specific property in order to have 'dealt with' it." *Id.* According to the court, creditors not only have an obligation to "take an active role in protecting their claims" but should be aware of "the risk that interests left unprotected may be swept away." *Id.*, quoting *In re Barton Indus. Inc.*, 104 F.3d 1241, 1246 (10th Cir. 1997).

The City's Participation

The City filed "several proofs of claim" covering the first and second quarters of 2009 but filed no claims for the third and fourth quarter tax bills putatively secured by its lien. Although the lien secured the tax claims for the third and fourth quarters, the City argued that it had not participated with respect to

those claims or "*with respect to* the lien that arguably secured their payment." *Id.* at *6 (emphasis in original). Nevertheless, reasoned the court, the City had participated directly by submitting several claims in the reorganization case relating to "the same six real properties … at issue here." *Id.* As the Second Circuit noted, the City had "participated as to the property subject to the lien … ." *Id.* at *7 "[P]ayment of the [first and second quarter] tax bills was secured by the same lien at issue on this appeal." *Id.* (Under New Hampshire law, a single, automatic statutory lien arises on the first day of each tax year to secure payment of the entire tax burden for the tax year. *Id.*) In sum, reasoned the court, the bankruptcy court properly refused "to allow the City to file unnecessary proofs of claim more than two years after confirmation of the plan" that had extinguished the City's lien. *Id.*

Comments

Other appellate courts have wrestled with the question of whether a secured lender has participated in the case. Just two years earlier, the Fifth Circuit held that a secured lender's disputed "lien on [the debtor's] principal asset survived … confirmation of [the debtor's] Chapter 11 … reorganization plan" because the lender had not participated in the bankruptcy case. *S. White Transp., Inc. v. Acceptance Loan Co.*, 725 F.3d 494 (5th Cir. 2013). Had the lender participated in the case, the court reasoned, its lien might have been avoided. *Id.*, citing *In re Ahearn Enterprises, Inc.*, 507 F.3d 817, 822 (5th Cir. 2007) (*held*, Code Section 1141(c) only voids liens held by a "lien holder [who] participate[s] in the reorganization").

Still, the Second Circuit's reasoning in *Northern New England* is inconsistent with other Fifth Circuit precedent. For example, a "secured creditor 'with a loan secured by a lien on the assets of a debtor who becomes bankrupt before the loan is repaid may ignore the bankruptcy [case] and look to the lien for satisfaction of the debt.'" *In re Howard*, 972 F.2d 639, 641 (5th Cir. 1992) (a "secured creditor is therefore not bound by a plan which purports to reduce the claim when no objection has been filed … . Strict adherence to the requirement that an objection be filed to challenge a secured claim is necessary … . [T]he secured creditor [has an interest] in being confident that its lien is secure unless a party … objects to it."), quoting *In re Simmons*, 765 F.2d 547, 552, 556 (5th Cir. 1985) (*held*, plan may not substitute for an objection to a secured creditor's claim; once creditor files claim, "Code … Rules clearly impose the burden of placing the claim in dispute on any party in interest desiring to do so by means of filing an objection.").

The Fifth Circuit rejected the bankruptcy court's finding in *S. White Transportation* that the lender had "participated" in the reorganization merely "by having received notice of the bankruptcy." 725 F.3d at 496. In short, reasoned the court, the lender's "passive receipt of notice" did not constitute participation in the case. *Id.* The Seventh Circuit has a clear rule consistent with *S. White Transportation*: "[A] secured creditor seeking to retain the value of a security interest has two options: he can 'bypass his debtor's bankruptcy [case] and enforce his lien in the usual way' outside of bankruptcy, or he can 'decide to collect his debt in the bankruptcy [case], and to this end may file a proof of claim in that [case].'" *In re Penrod*, 50 F.3d at 461-62.

Conclusion

The facts in *Northern New England* do not fit squarely within the holdings of these other cases. The City unquestionably participated in the reorganization case by filing claims and litigating over those claims. Because it failed to file claims for the unpaid taxes during the latter half of 2009 and, more important, failed to object to the plan's proposed extinguishment of its lien, it was bound by the terms of the debtor's plan. Under the reasoning of the Fifth and Seventh Circuit cases, it might have fared better had

it done nothing. At the very least, however, the lesson for secured lenders is to monitor reorganization cases closely and to object to the terms of a reorganization plan if it purports to impair a lender's lien in any way.

What all of these cases do not say, however, is what the Chapter 11 debtor, trustee or plan proponent must prove in order to knock out an otherwise valid lien. Had the City objected in *Northern New England* prior to confirmation of the plan, the bankruptcy court would have had a hard time invalidating a lien securing a valid tax claim. *See generally* R. Brubaker, 34 Bankr. L. Letter, at 7 (Jan. 2014) ("… most courts hold that a plan … (through the confirmation proceedings thereon) is an improper procedural vehicle for resolving" the validity of a lien; "Code § 506(d) … provides that a lien cannot be voided simply because no proof of claim has been filed." If a secured lender "timely objected to confirmation of [a] plan on [that] basis … , then the bankruptcy court might well have been constrained to deny confirmation of the plan.").

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If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or the author.

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