ALERTS

Fifth Circuit Protects Secured Lender Who Bypasses Chapter 11 Reorganization Plan

August 12, 2013

The U.S. Court of Appeals for the Fifth Circuit held on August 5 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 Transportation, Inc. v. Acceptance Loan Co.*, 2013 WL 3983343, *1,*3 (5th Cir. Aug. 5, 2013). Had the lender participated in the case, the court reasoned, its lien might have been avoided. *Id.*, at *1, citing *In re Ahern Enterprises, Inc.*, 507 F.3d 817, 822 (5th Cir. 2007) (*held*, Code §1141(c) only voids liens held by a "lien holder [who] participate[s] in the reorganization."). This decision, based on established precedent, has practical significance to both lenders and troubled companies.

Facts

The debtor had contested the lender's lien on its office building prior to bankruptcy, resulting in years of unresolved litigation in the Mississippi state courts. *Id.* Three other lenders later perfected junior liens on the building, which constituted the debtor's "principal asset." *Id.*

The debtor filed its Chapter 11 petition in May 2010, scheduling the lender's lien as "disputed." The lender received notice of the pending reorganization case, but never filed a claim and never "involve[d] itself in any way with the ongoing bankruptcy." *Id.* In its later filed reorganization plan, the debtor noted that the lender had never filed a claim, "contested the validity of" the lender's lien, and provided no recovery for the lender in

the plan. *Id.* The bankruptcy court confirmed the debtor's plan on Dec. 1, 2010. The lender later moved on Jan. 4, 2011 for "a declaratory judgment that its lien had survived the Plan's confirmation or, alternatively, for the bankruptcy court to amend its confirmation order to provide for [the lender's disputed] lien." *Id.*

The Lower Courts

The bankruptcy court denied the lender's motion, relying on the plain language of Bankruptcy Code ("Code") §1141(c), which provides that property dealt with by a reorganization plan is "free and clear of all claims and interests." The court reasoned that the lender "had 'participated' [in the Chapter 11 case] . . . by having received notice of the bankruptcy." *Id.* The district court reversed, "holding that mere notice does not constitute participation. . . ." *Id.*

The Fifth Circuit Analysis

Substantial Fifth Circuit precedent governed this case. A "secured creditor 'with a loan secured by a lien on the assets of the 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 its claim where 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.") citing *In re Simmons*, 765 F.2d 547, 552, 556 (5th Cir. 1985) (*held*, a plan may not substitute for an objection to a secured creditor's claim; once creditor files claim, "Code and . . . 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 court of appeals rejected the bankruptcy court's finding that the lender had "participated" in the reorganization merely "by having received notice of the bankruptcy." *Id.* at*1. It first discussed the meaning of Code §1141(c), explaining that the plan will bind the secured lender only if the lender participates in the reorganization case. *Id.*, at *2. The key issue, therefore, was whether the lender's "passive receipt of notice constitutes participation" in the case. *Id.*

Conceding that the requirement of participation by the secured lender "is a judicial gloss on section 1141(c)," the court agreed with two other courts of appeals who "required more than notice" for a secured lender to be bound by the terms of a plan. *Id.* In the Seventh Circuit, for example, "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].'" *Id.*, quoting *In re Penrod*, 50 F.3d 459, 461-62 (7th Cir. 1995). Relying on *Black's Law Dictionary* 1229 (9th ed. 2009), the Fifth Circuit added "that the word 'participation' connotes activity, and not mere nonfeasance." 2013 WL 3983343, *2.

The court was "unable to find any case voiding a lien in the face of *no involvement* by a secured creditor other than the passive receipt of notice." *Id.*, at * 3. It thus held that "the participation requirement in *In re Ahern Enterprises Inc.* [507 F.3d 817, 822 (5th Cir. 2007)] requires more than mere passive receipt of effective notice." *Id.* Because the lender here had only received notice of the bankruptcy and had not otherwise participated in the case, its lien would be unaffected by the debtor's reorganization plan. As a result, post-bankruptcy litigation over the validity of the debtor's lien will continue in the Mississippi courts.

Comments

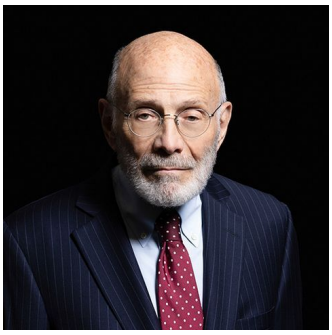
1. Secured lenders will like the result in *White*. Unless the debtor actively litigates against the lender or the lender seeks to enforce its lien in the bankruptcy court, the lender can simply wait and attack the debtor later in a more favorable forum. [Nevertheless,] "once a debtor has objected to a claim, the creditor is on notice that full participation in the [plan] confirmation proceedings is required or its lien will be at risk." *In re Howard*, 972 F.2d at 642.

2. The *White* case is not only consistent with Fifth Circuit precedent and the Seventh Circuit's *Penrod* decision, but also with an Eighth Circuit case. *In re Be-Mac Transp. Co.*, 83 F.3d 1020, 1023 (8th Cir. 1996) (*held*, despite creditor's receiving notice and litigating merits of its late filed secured claim, it "was not permitted to participate as a secured creditor[;] its lien was never brought into the bankruptcy [case] and could therefore not be extinguished by confirmation of the plan.").

Authored by Michael L. Cook .

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

Related People



Michael Cook

Of Counsel

New York

Practices

Attachments

Download Alert