"Asleep at the Switch"? The Need to Hold Sophisticated Creditors to Higher Standards in Chapter 11

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“ASLEEP AT THE SWITCH”? THE NEED TO HOLD SOPHISTICATED CREDITORS TO HIGHER STANDARDS IN CHAPTER 11

INTRODUCTION

Imagine that a family of five has asked you to customize a car that would accommodate each of their individual tastes—something modern with a retro feel, with all of the latest features but without any of the clutter, a unique body design with their family crest, and more. You spend hours devising a plan, present your specifications for every aspect of the project, and hearing no objection from your clients, you begin construction of the car—poring over every detail until you most certainly have outdone yourself and created a masterpiece. Although the husband and children nod eagerly in approval, the wife now objects and reveals that she doesn’t care too much for the leather interior. “Sorry,” she says, “but we won’t be taking the car like this.”

Why hadn’t she protested earlier? Your clients were fully notified of your plans—down to every last detail. Nevertheless, you can certainly make the changes, but at what additional cost? As a seller, however, you are not without protection. The Uniform Commercial Code and common law have evolved to provide both sellers and buyers alike with procedural rights and remedies to protect their competing interests.1 In contrast, however, the Bankruptcy Code and common law still struggle to reconcile competing interests of debtors and creditors. Unlike our family of five, Chapter 11 bankruptcy reorganization proceedings involve potentially thousands of claimants.2 Yet, according to one critic, the nature of the provisions in the Bankruptcy Code and the Federal Rules of Bankruptcy Procedure (the Federal Rules), in conjunction with general disagreement over the “fundamental mechanics” of Chapter 11, have “render[ed] bankruptcy court orders, including orders of confirmation, and plans highly unstable.” 3

Instability threatens the purpose of reorganization, which requires finality to

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1. Under the Uniform Commercial Code (the UCC), a seller is not without protection. Particularly in sales of “specially manufactured goods” and nonconforming tenders, sellers have a statutory right to cure a defect upon receiving timely notice, and—in cases of breach of contract—recover the contract price. UCC § 2-201(3)(a) (2014); see also Thomas R. Malia, Sales: “Specially Manufactured Goods” Statute of Frauds Exception in UCC § 2-201(3)(a), 45 A.L.R. 4th 1126 § 3 (1986) (identifying contracts for specially manufactured goods and not suitable for sale to others as enforceable where sellers have taken substantial steps to manufacture goods). However, the UCC and common-law protections are not without fault. One commentator criticizes courts for overprotecting consumers. Harry G. Prince, Overprotecting the Consumer?: Section 2-607(3)(a) Notice of Breach in Nonprivity Context, 66 N.C. L. REV. 107 (1987).


ensure that creditors are protected and debtors are afforded a “fresh start.” A recent opinion by the Fifth Circuit, *In re S. White Transportation*, demonstrates the instability of Chapter 11 orders of confirmation and calls attention to the need for greater protection for commercial debtors seeking relief. Under the Fifth Circuit’s ruling, a creditor that receives effective notice repeatedly throughout Chapter 11 proceedings can thwart reorganization by asserting its claim even after the court has approved a final plan. The opinion challenges the authoritativeness of confirmed reorganization plans and diminishes the impact of receiving effective notice by adopting an unprecedented participation analysis.

This Note explores the implications, for debtors and creditors alike, of the Fifth Circuit’s opinion in *In re S. White Transportation*, which requires, but does not outline, a need for “something more” than passive receipt of notice of bankruptcy to constitute participation in Chapter 11 reorganization. Specifically, this Note considers the decision’s implications for commercial debtors. Part I of this Note explores the purpose of Chapter 11 bankruptcy reorganization and traces the evolution of the Bankruptcy Code and common law through key circuit court opinions. The remainder of this Note analyzes the Fifth Circuit opinion in *In re S. White Transportation*, some important questions it raises, and potential solutions for consideration. Part II challenges the need for “something more” by weighing the necessity of a “more than passive receipt” requirement and scrutinizing the sophistication of creditors involved. Part III evaluates the economic viability of the Fifth Circuit’s opinion in permitting creditors to take a “wait-and-see” posture. Finally, this Note recommends holding sophisticated creditors to a higher standard of review during Chapter 11 bankruptcy proceedings.

I. CHAPTER 11: EVOLUTION OF THE BANKRUPTCY CODE AND COMMON LAW

Congress developed Chapter 11 bankruptcy reorganization to provide troubled individual and business debtors with a “second chance”—an opportunity to salvage and rebuild under the protection of judicial process in the interest of economic efficiency.

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4. Acceptance Loan Co. v. S. White Transp., Inc. (*In re S. White Transp., Inc.*), 725 F.3d 494 (5th Cir. 2013).
6. *In re S. White Transp., Inc.*, 725 F.3d at 498 (holding that “meeting the participation requirement in *In re Ahern Enterprises* requires more than mere passive receipt of effective notice”).
8. *In re S. White Transp., Inc.*, 725 F.3d at 498.
The purpose of a business reorganization case, unlike a liquidation case, is to restructure a business’s finances so that it may continue to operate, provide its employees with jobs, pay its creditors, and produce a return for its stockholders. The premise of a business reorganization is that assets that are used for production in the industry for which they were designed are more valuable than those same assets sold for scrap. Often, the return on assets that a business can produce is inadequate to compensate those who have invested in the business. Cash flow problems may develop, and require creditors of the business, both trade creditors and long-term lenders, to wait for payment of their claims. If the business can extend or reduce its debts, it often can be returned to a viable state. It is more economically efficient to reorganize than to liquidate, because it preserves jobs and assets.9

For these policy reasons, the debtor in possession10 or appointed trustee11 is allowed to operate its business12 under the protection of Chapter 11 by wielding the shield of the automatic stay.13 Effective upon filing, the automatic stay preserves the debtor’s estates and keeps creditors from attempting to collect claims that arose prior to the petition for bankruptcy.14 During a lengthy reorganization process, which can take several months to over a year,15 it is in the interest of both the debtor and its creditors to proceed expeditiously in order to maximize creditor recovery and minimize further harm to the debtor.16 Successful bankruptcy reorganizations depend on the bankruptcy court’s power to bind parties to a single authoritative judgment17 and, in effect, discharge debtors of prepetition liability upon confirmation of a plan.18 Debtors depend on the discharge of prepetition debt in order to effectively reorganize.19

A. EFFECT OF CONFIRMATION: THE BANKRUPTCY CODE

Traditionally, courts have applied the principle that “liens pass through bankruptcy unaffected”—theoretically, even after Chapter 11

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11. Id. § 1104 (describing how trustees may be appointed in Chapter 11 cases).
12. Id. § 1108.
13. Id. § 362(a).
14. Id.
15. The Bankruptcy Code affords debtors with an exclusive right to file a plan of reorganization for the first 120 days of a case, and the period may be extended but cannot exceed eighteen months. Id. § 1121(b), (d).
17. Lawless, supra note 2, at 1216.
The principle dates back to the nineteenth century U.S. Supreme Court opinion in *Long v. Bullard*, nearly ninety-two years before the modern Bankruptcy Code was first enacted in 1978. In *Long v. Bullard*, the Court held that where “the creditor neither proved his debt in bankruptcy nor released his lien . . . , his security was preserved notwithstanding the bankruptcy of his debtor.” This principle, out of concern for unjust violation of creditors’ rights, was codified in the Bankruptcy Act of 1898 and began to morph with the enactment of the Bankruptcy Reform Act of 1978. Growing differences as to the extent of which debtors may be discharged of liability, however, challenge the applicability of the principle today. Particularly in the context of Chapter 11 reorganization, mechanisms that allow for claim abrogation or extinguishment make clear that “the principle that liens pass through bankruptcy unaffected cannot be taken literally.”

Section 1141, outlining the effect of confirmation, provides:

(a) Except as provided in subsections (d)(2) and (d)(3) of this section, the provisions of a confirmed plan bind the debtor, any entity issuing securities under the plan, any entity acquiring property under the plan, and any creditor, equity security holder, or general partner in the debtor, whether or not the claim or interest of such creditor, equity security holder, or general partner is impaired under the plan and whether or not such creditor, equity security holder, or general partner has accepted the plan.

(c) Except as provided in subsections (d)(2) and (d)(3) of this section and except 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, equity security holders, and of general partners in the debtor.

21. Id. at 447–48.
22. 117 U.S. 617 (1886).
23. Id. at 620–21.
25. Id. at 448–49.
26. Id. at 448 (noting that courts have disagreed on “the extent the principle is applicable” and have “differing perceptions regarding the scope of the debtor’s discharge”).
27. In re Penrod, 50 F.3d 459, 462 (7th Cir. 1995).
Generally, a debtor under Chapter 11 is discharged of liability upon confirmation of the plan of reorganization, and any property dealt with under the plan of reorganization, such as a lien, is cleansed of claims and interests and may no longer be pursued by creditors. As a result, the process tends to be pro-debtor, or debtor-friendly, consistent with Congress’s intent. But the Bankruptcy Code also protects creditors and their interests and requires that reorganization plans detail how claims will be handled going forward. The plans may “contain only provisions that are consistent with the interests of creditors and equity security holders and with public policy.” To minimize harm to creditors and to provide creditors with a voice during this process, debtors are required to provide creditors with notice and court-approved disclosure statements containing sufficient information.

The requirement of effective notice, “the life blood” of bankruptcy law, codifies creditors’ interests to be heard on issues related to the
treatment of their claims. As the debtor in possession or trustee negotiates and structures a business reorganization, “[h]older[s] of a claim or interest” on notice are given the opportunity to reject or accept the proposed plan. Following a confirmation hearing and order, the plan of reorganization is binding on the debtor and all parties in interest, whether or not creditors have accepted the plan, on the theory that creditors of known claims have been given an opportunity for fair treatment and should not be permitted to unduly burden debtors who have attempted to resolve lingering issues.

Therefore, in the interests of fairness and rehabilitation, confirmation frees debtors from creditors’ interests and imports a res judicata effect on “property dealt with by the plan.” However, confirmation of a reorganization plan under common law has been criticized as “provid[ing] the parties with a bundle of rights which are subject to substantial change for a bewildering number of reasons.”

B. EFFECT OF CONFIRMATION: THE COMMON LAW

Prior to its opinion in In re S. White Transportation, under the guidance and “sound reasoning” of the Fourth, Seventh, Eighth, and Tenth Circuits, the Fifth Circuit adopted the “default rule that a confirmed Chapter 11 plan may avoid liens not specifically preserved” and delineated the criteria for extinguishing a lien under § 1141(c). The court set forth in In re Ahern Enterprises, Inc. that to extinguish a lien under § 1141(c), “[f]our conditions must therefore be met . . . : (1) the plan must be confirmed; (2) the property that is subject to the lien must be dealt with by the plan; (3) the lien holder must participate in the reorganization; and (4) the plan must not preserve the lien.”

40. 11 U.S.C. § 342 (requiring notice); id. § 1109(b) (giving creditors the right to be heard).
41. Id. § 1126. Claims that are “secured by a lien on property” are secured claims. Id. §§ 506, 1128.
42. Id. § 1141(a).
43. In re Penrod, 50 F.3d 459, 463 (7th Cir. 1995).
44. 11 U.S.C. § 1141(c); see also Buchanan Staudenmaier, supra note 20, at 456.
45. Avery, supra note 3, at 305.
46. Elixir Indus., Inc. v. City Bank & Trust Co. (In re Ahern Enters., Inc.), 507 F.3d 817, 822 (5th Cir. 2007).
47. Id.
48. Section 1141(c) of the Bankruptcy Code provides that, with exceptions, “after confirmation of a plan, the property dealt with by the plan is free and clear of all claims and interests of creditors, equity security holders, and of general partners in the debtor.” 11 U.S.C. § 1141(c).
49. Courts are divided on interpretations of the understanding of “dealt with.” Depending on what they emphasize—for example, failing to deal with or provide for liens in a plan of reorganization—courts may be more or less likely to extinguish liens upon confirmation.
50. In re Ahern Enters., Inc., 507 F.3d at 822.
1. Before *In re S. White Transportation: In re Penrod*

To extinguish a claim under § 1141(c), the Seventh Circuit first held in *In re Penrod* that a secured creditor’s lien is discharged upon confirmation, provided the creditor has participated by filing a proof of claim and the debtor’s reorganization plan includes a provision addressing the lien. At issue for the Seventh Circuit was a plan of reorganization that provided for payment of a claim but did not indicate whether the creditor still maintained its security interest. The debtors, John and Alyce Penrod, were hog farmers by trade. Secured creditor Mutual Guaranty Corporation (Mutual Guaranty) held a promissory note secured by the Penrods’ hogs. The debtors’ plan provided for monthly payments of Mutual Guaranty’s claim. However, when the hogs fell sick after the plan had taken effect, the Penrods sold the animals and retained the proceeds. In response, Mutual Guaranty filed suit against the Penrods to enforce its lien and recover the sale proceeds.

The Seventh Circuit affirmed the lower court holding that Mutual Guaranty’s lien had been extinguished and enjoined, rejecting the interpretation that a plan could expressly deal with a secured creditor’s property claim and not a creditor’s interest or lien in the claim as inconsistent with the reading of § 1141(c). The court was concerned that to hold otherwise, a reorganized entity “would continue to be burdened by secured creditors’ claims by virtue of their liens, even if the plan made provision for those claims.” Thus, even when a plan did not expressly provide for a lien attached to property addressed in the plan, the Seventh Circuit held that the lien was extinguished following confirmation—provided that the lienholder participated in the reorganization.

Following the *In re Penrod* opinion, the Fourth, Fifth, Eighth, and Tenth Circuit Courts of Appeals have also applied the Seventh Circuit’s interpretation of § 1141(c). The Eighth Circuit Court of Appeals, applying

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51. *In re Penrod*, 50 F.3d 459, 462 (7th Cir. 1995).
52. *Id.*
53. *Id.* at 461–62.
54. *Id.* at 461.
55. *Id.*
56. *Id.*
57. *Id.*
58. *Id.*
59. *Id.* at 461, 464.
60. *Id.* at 463.
61. *Id.*
principles from In re Penrod, recognized that confirmation of a reorganization plan only extinguished liens that were dealt with and held by participating creditors. Finding for the secured creditor in In re Be-Mac Transport, the Eighth Circuit determined that where a secured creditor was inappropriately denied an opportunity to participate in the reorganization, any lien held by that creditor survived the proceedings and was not extinguished by confirmation of the plan. The secured creditor, the Federal Deposit Insurance Corporation (the FDIC), had filed and amended its proof of claim in the Chapter 11 reorganization of Be-Mac Transport Company. The bankruptcy court, however, erroneously disallowed the FDIC’s amended claim and treated the claim as if it were never made. The Eighth Circuit recognized that such treatment denied the FDIC its right to participate in “the reorganization for purposes of voting and distribution,” effectively abrogating a creditor’s voice and interest in contravention to the Bankruptcy Code’s want for balanced interests.

Citing In re Be-Mac Transport, the Tenth Circuit Court of Appeals in In re Barton Industries reiterated that confirmation of a Chapter 11 bankruptcy plan may extinguish a lien but noted that confirmation was subject to appropriate notice under §§ 102(1) and 1128(a) of the Bankruptcy Code. Effective notice is required in the analysis and consideration of whether a creditor’s interest was extinguished upon confirmation. Creditors must receive notice of the treatment of their claims and have both an opportunity and sufficient information to make informed decisions about the reorganization plan. In the case of In re Barton Industries, creditors who received notice were not given sufficient information to adequately make a decision regarding their interest. Therefore, because the notice provided did not contain sufficient information, the creditors were not subject to the reorganization plan, and their interests were not extinguished.

The Fourth Circuit Court of Appeals, noting “every other circuit court of appeals to have addressed this issue has reached the same conclusion,”

64. Id.
65. Id. at 1023.
66. Id. at 1027.
67. Id.
69. Id. at 1245.
70. Id.
71. Id.
72. Id. at 1246.
also held the plain meaning of § 1141(c) implicated that liens are not preserved following confirmation of the plan of reorganization, and the Fourth Circuit would not excuse a creditor that failed to make a timely objection.\textsuperscript{74} In \textit{In re Regional Building Systems}, the Fourth Circuit found the creditor was notified of the Chapter 11 petition, actively participated in the proceedings, and had time to object to the plan of reorganization.\textsuperscript{75} And yet, the creditor “fell asleep at the switch” and made no objections prior to plan confirmation.\textsuperscript{76} “Having done so,” according to the Fourth Circuit, “it cannot escape the consequences of its inaction,” and the court affirmed the district court’s decision to extinguish the creditor’s lien.\textsuperscript{77}

Under the guidance and “sound reasoning” of the Fourth, Seventh, Eighth, and Tenth Circuits, the Fifth Circuit first examined the issue of § 1141(c)’s participation requirement in \textit{In re Ahern Enterprises}. The creditor of \textit{In re Ahern Enterprises}, Elixir Industries, Inc. (Elixir), submitted a proof of claim in the Chapter 11 reorganization of Ahern Enterprises, Inc. (Ahern).\textsuperscript{78} The bankruptcy court confirmed Ahern’s plan, which addressed property attached to Elixir’s lien and did not specifically preserve the lien.\textsuperscript{79} Under the Bankruptcy Code, Elixir’s claim was extinguished upon confirmation.\textsuperscript{80} Elixir, however, took issue with Ahern’s voluntary conversion from Chapter 11 reorganization to Chapter 7 liquidation.\textsuperscript{81} Elixir challenged the discharge of its lien because it contended the plan had not been substantially consummated and was not void upon confirmation of the Chapter 11 plan.\textsuperscript{82} Despite Elixir’s protests, the Fifth Circuit adopted and applied a four-part test—finding the reorganization plan had been confirmed, the property had been dealt with, the lien holder had participated, and the plan had not preserved the lien.\textsuperscript{83} Therefore, the Fifth Circuit held, as other circuit courts have, that confirmation extinguished the participating creditor’s lien.\textsuperscript{84}

The \textit{In re Ahern Enterprises} opinion highlighted a point of ambiguity in judicial interpretation that the Fifth Circuit would later revisit in \textit{In re S. White Transportation}. The Fifth Circuit noted that the requirement of secured creditors to participate in Chapter 11 reorganization is a “judicial gloss on section 1141(c).”\textsuperscript{85} In other words, the court acknowledges that

\begin{itemize}
  \item \textsuperscript{74} \textit{In re Reg’l Bldg. Sys., Inc.}, 254 F.3d at 533.
  \item \textsuperscript{75} \textit{Id}. at 532.
  \item \textsuperscript{76} \textit{Id}. at 533.
  \item \textsuperscript{77} \textit{Id}.
  \item \textsuperscript{78} \textit{Id}. at 819.
  \item \textsuperscript{79} \textit{Id}. at 819–20.
  \item \textsuperscript{80} 11 U.S.C. § 1141(c) (2012).
  \item \textsuperscript{81} \textit{In re Ahern Enters., Inc.}, 507 F.3d at 819.
  \item \textsuperscript{82} \textit{Id}. at 820.
  \item \textsuperscript{83} \textit{Id}. at 822–24.
  \item \textsuperscript{84} \textit{Id}.
  \item \textsuperscript{85} \textit{Id}. at 823 (emphasis added).
\end{itemize}
there is no statutory requirement of participation in the plain reading of § 1141(c). Participation, the court explained, “ensures that the secured creditor has notice of the plan and its potential effect on the creditor’s lien,” and in at least one instance of judicial interpretation, the only participation deemed necessary was a creditor’s receipt of notice and opportunity to object. Although it determined that Elixir’s proof of claim constituted a “sufficient level of participation,” the court refrained from adopting a standard or definition for understanding sufficiency of participation.

Through its opinion in In re S. White Transportation, the Fifth Circuit has implemented a vague standard of participation that deviates from common-law analysis and the balance of interests. Creditors are essentially permitted to fall “asleep at the switch” and preserve their liens, even after confirmation of a Chapter 11 reorganization plan, because notice alone under the Fifth Circuit is insufficient to meet the participation requirement of the In re Ahern Enterprises test.

2. In re S. White Transportation: A Decade-Old Relationship

Beginning in 2004, Acceptance Loan Co. (Acceptance) became involved in extensive litigation in state court surrounding the validity of its security interest in an office building in Saucier, Mississippi (the Mississippi Property), owned by S. White Transportation, Inc. (SWT). Acceptance and SWT disputed whether the individuals signing two deeds of trust in 2002 and 2004 had the authority to bind SWT, and if valid, whether the deeds would validate Acceptance’s lien on the Mississippi Property. If the lien were valid, Acceptance would have first priority over

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86. 11 U.S.C. § 1141(c) (2012).
87. In re Ahern Enters., Inc., 507 F.3d at 823.
89. Id. In a footnote, the court distinguished In re Be-Mac Transport Co., where the FDIC had filed a proof of claim and attempted to file an amendment to the claim, but the Be-Mac court ultimately held that plan confirmation did not void the FDIC’s lien. Id. at 823 n.4 (citing FDIC v. Be-Mac Transp. Co. (In re Be-Mac Transp. Co.), 83 F.3d 1020, 1027 (8th Cir. 1996)). The Be-Mac court found that disallowing the amended claim had the effect of a creditor not filing a proof of claim. In re Be-Mac Transp. Co., 83 F.3d at 1027.
91. Acceptance Loan Co. v. S. White Transp., Inc. (In re S. White Transp., Inc.), 725 F.3d 494, 496 (5th Cir. 2013) (“The parties agree that the first, second, and fourth conditions of the In re Ahern Enterprises test are met by the facts of this case; they only dispute whether Acceptance’s passive receipt of notice constitutes participation within the meaning of this test.”).
92. Id. at 495.
three other creditors that also had perfected security interests in the same property. 95

Nearly six years later, on May 17, 2010, SWT voluntarily filed a
Chapter 11 bankruptcy petition. 96 The question of Acceptance’s lien on the
property still had not yet been settled at the time of filing. 97 In the
documentation accompanying the bankruptcy petition, SWT identified
Acceptance on Schedule D to the petition as a secured claim creditor and
noted Acceptance’s disputed interest over the Mississippi Property. 98

Effective notice of SWT’s ongoing bankruptcy was served on Acceptance
on several occasions, but Acceptance never got involved with the
proceedings and never filed a proof of claim. 99

On September 14, 2010, SWT submitted its reorganization plan (the
Plan) to the bankruptcy court and again noted that Acceptance’s lien was
contested and Acceptance had never filed a proof of claim. 100 The Plan
described Acceptance’s lien “as a disputed claim upon which no payment
would be made unless the Court ordered otherwise.” 101 A copy of the Plan
was provided to Acceptance, including a notice of the confirmation hearing,
at which Acceptance would have had an opportunity to make objections. 102

Despite receiving repeated notice of SWT’s bankruptcy and open challenge
of Acceptance’s claim, Acceptance remained silent and absent in the SWT
bankruptcy proceedings, “in stark contrast to its aforementioned litigation
activity against SWT in preceding years.” 103 The Plan was confirmed on
December 21, 2010. 104

Two weeks after the Plan was confirmed, Acceptance filed an adversary
proceeding in the U.S. Bankruptcy Court for the Southern District of
Mississippi on January 4, 2011. 105 Acceptance moved the bankruptcy court
for a declaratory judgment stating that Acceptance’s lien survived
confirmation or, alternatively, that the confirmation order be amended and
provide for Acceptance’s lien on the Mississippi Property. 106

Acceptance argued that under In re Ahern Enterprises, 107 “lienholder
participation in the reorganization [is] a condition for avoiding a lien

95. In re S. White Transp., Inc., 725 F.3d at 495.
96. Id.
97. Id.
99. In re S. White Transp., Inc., 725 F.3d at 495.
100. Id.
102. Id.
103. Id. Acceptance did not file a single document with the bankruptcy court, nor did it attend
the meeting of creditors for this matter. Id.
104. In re S. White Transp., Inc., 725 F.3d at 496.
106. In re S. White Transp., Inc., 725 F.3d at 496.
107. Elixir Indus., Inc. v. City Bank & Trust Co. (In re Ahern Enters., Inc.), 507 F.3d 817 (5th
Cir. 2007).
through the Chapter 11 Plan Confirmation process.”

As Acceptance had not filed a claim or participated in the proceedings, Acceptance contended that it had not participated and, therefore, its lien should remain intact. The bankruptcy court denied the motion on both accounts, finding that effective notice sufficiently constituted participation and warranted lien extinguishment. The court determined that the Plan’s confirmation voided Acceptance’s liens on the basis of 11 U.S.C. § 1141(c), and Acceptance did not qualify for modification. The decision was appealed to the district court, which reversed and remanded, holding that “[s]omething more [than notice] was required” to satisfy the participation requirement.

SWT appealed the district court holding to the Fifth Circuit. Reviewing the case de novo, the Fifth Circuit affirmed the district court’s decision, holding that Acceptance’s lien on the Mississippi Property survived confirmation of the Plan, and “passive receipt of effective notice” did not constitute participation.

II. BREAKING DOWN THE FIFTH CIRCUIT’S ANALYSIS

A. THE COURT’S READING OF “PARTICIPATION” IN REORGANIZATION DEVIATES FROM PRECEDENT

In preserving the creditor’s lien after confirmation, the Fifth Circuit’s opinion in In re S. White Transportation has added a new layer to the analysis by requiring “more than mere passive receipt of effective notice” to satisfy the participation requirement of In re Ahern Enterprises. Liens, as held in In re Ahern Enterprises and applied in In re S. White Transportation, are void if four conditions are met: (1) the plan is confirmed; (2) the property subject to the lien has been accounted for in the reorganization plan; (3) the lien holder has participated in the reorganization; and (4) the plan does not preserve the lien. The In re S.

109. Id. at 514.
110. Id. at 519.
111. Id. at 520.
112. Id. at 523.
114. Acceptance Loan Co. v. S. White Transp., Inc. (In re S. White Transp., Inc.), 725 F.3d 494, 496 (5th Cir. 2013).
115. Id. at 496, 498.
116. Id. at 498.
117. Id.
118. Id. at 496 (citing Elixir Indus., Inc. v. City Bank & Trust Co. (In re Ahern Enters., Inc.), 507 F.3d 817, 822 (5th Cir. 2007)).
White Transportation opinion hinges on the court’s understanding of “participated,” in the context of a Chapter 11 bankruptcy proceeding. Participation, as a “condition for avoiding a lien through the Chapter 11 Plan Confirmation process,”119 is critical to the viability of a claim, and yet the standards and understanding of “participation” were and still remain ambiguous and vague.

The Fifth Circuit’s analysis characterizes the word “participation” as “connote[ing] activity, and not mere nonfeasance.” 120 To support its interpretation, the Fifth Circuit referred to Black’s Law Dictionary, which defines “participation” as “[t]he act of taking part in something, such as a partnership, a crime, or a trial.” 121 And yet, one could take part in a partnership as a silent partner and satisfy the reading of “participation” without actively managing the firm.122 Silent partners—even undisclosed partners that provide capital but do not interfere with management of the partnership—are held liable for and bound to contracts that acting partners have entered into for purposes of their business.123 In a partnership, claims against silent partners are not estopped by virtue of their inactivity.124

The Fifth Circuit also referred to the Supreme Court’s opinion in National Federation of Independent Business v. Sebelius125 for the distinction between “‘activity’ and a ‘decision not to do something’ or a ‘failure to do it,’” 126 but underlying the Court’s interpretation of participation in the health care industry are fears and concerns not present in the bankruptcy context, and bankruptcy notions of good faith and equity at risk are not captured by the Court’s analysis. In National Federation of Independent Business v. Sebelius, the Supreme Court held that the individual mandate of the Patient Protection and Affordable Care Act failed under the Commerce Clause because congressional power to regulate activity did not extend to inaction, or a person’s decision not to purchase health care.127 The Court was concerned about potential abuse if Congress were authorized to use its commerce power to compel action—to compel those who have chosen not to have health care to make such purchases—as

120. In re S. White Transp., Inc., 725 F.3d at 497.
121. Id. (citing BLACK’S LAW DICTIONARY 1229 (9th ed. 2009)).
122. BLACK’S LAW DICTIONARY, supra note 121, at 1230 (A “silent partner” is one “who shares in the profits but who has no active voice in management of the firm and whose existence is often not publicly disclosed.”).
123. 68 C.J.S. Partnership § 231 (2013).
124. Id.
127. Sebelius, 132 S. Ct. at 2587.
part of its regulation of activity. Therefore, the Supreme Court held that only individuals who purchased health care were under the purview of the Commerce Clause and said to have participated in the health care industry.

In the context of Chapter 11 reorganization, these concerns of abuse of power by authority or inappropriate compulsion of action—that shape the Supreme Court’s interpretation of participation—are simply not present. Chapter 11 reorganization seeks to balance two underlying concerns (or competing interests) that serve as the bedrock principles of bankruptcy: the debtor’s right to a “fresh start” and the creditors’ right to recovery and protection of their claims. Creditors under the Bankruptcy Code have always been required to act diligently; “creditors who acted with the most speed and diligence would be paid, and the other creditors would be left out.” Those that do not act diligently to perfect their security interests by the time bankruptcy commences are subject to avoidance by the trustee’s strong-arm powers, even if it gives a debtor’s other creditors a “windfall” cash infusion and appears inequitable. This is the nature of bankruptcy.

The Bankruptcy Code’s pressure on creditors to act diligently is tempered by the recognition that modification of liens under Chapter 11 reorganization invokes the need for “constitutional due process protection.” Liens concern property rights protected under the Fifth Amendment. As set forth by Mullane v. Central Hanover Bank & Trust Co. and its progeny, the protection of due process takes the form of adequate notices and opportunities to be heard: “An elementary and fundamental requirement of due process in any proceeding which is to be accorded finality is notice reasonably calculated, under all the circumstances, to apprise interested parties of the pendency of the action and afford them an opportunity to present their objections.”

128. Id. at 2588. The Supreme Court observed by analogy that with such a power, “Congress could address the diet problem by ordering everyone to buy vegetables.” Id. at 2591.

129. Id. at 2591.


133. Richards, supra note 16, at 45–46 (“[T]he Supreme Court has repeatedly held that the laws passed pursuant to the Bankruptcy Clause are subject to the requirements of due process.”); see also Avery, supra note 3, at 264 (highlighting the debate over the necessity for constitutional due process protection).


136. Id.
standard has been applied in the bankruptcy context and is incorporated in the Federal Rules. Sufficient notice is flexible and its form depends on context, but at minimum it must be intelligible for an unsophisticated creditor and “more than mere ‘boilerplate,’” containing at least some explicit and conspicuous information to alert the creditor. At a minimum, the notice of hearing should direct the creditor to the pertinent part of the proposed plan which prescribes the treatment of the creditor’s lien.

The fundamental principles of due process require that the notice be sufficiently detailed to alert even an unsophisticated creditor that its lien rights are in jeopardy if it fails to object to the proposed plan of reorganization.

Under these standards, the Federal Rules ensure that all creditors—particularly unsophisticated creditors—are put on notice that their interests are affected and require action before liens are modified or extinguished through reorganization. To ensure that creditors have actually received notice, courts look for evidence of participation. It is undisputed that SWT gave Acceptance effective and repeated notice of the ongoing bankruptcy proceedings. The bankruptcy court determined SWT’s notice satisfied due process requirements—enough to inform even an unsophisticated creditor—and was all that was required under In re Ahern’s “participation analysis.” The bankruptcy court’s reading is consistent with the Fifth Circuit’s opinion in In re Ahern Enterprises. There, the Fifth Circuit noted, without comment, that “[a]t least one bankruptcy court [in the

137. City of New York v. N.Y., New Haven & Hartford R.R. Co., 344 U.S. 293 (1953); see also Avery, supra note 3, at 269 (“The Chapter 11 case law is becoming more uniform along the lines set down by the Mullane-City of New York precedent . . . .”).
139. Lawless, supra note 2, at 1231 & n.69 (citing Morrissey v. Brewer, 408 U.S. 471, 481 (1972) (“It has been said so often by this Court and others as not to require citation of authority that due process is flexible.”)); Richards, supra note 16, at 104–05 (outlining notice requirements).
140. Richards, supra note 16, at 105 (citing Cen-Pen Corp. v. Hanson, 58 F.3d 89, 93 (4th Cir. 1995) (“We do not think, however, that the Hansons’ inclusion of this boilerplate language in the plan avoided the liens . . . .”); 4 WILLIAM L. NORTON, JR., NORTON BANKRUPTCY LAW AND PRACTICE § 95:5, at 137 (2d ed. Supp. 1997) (“To allow the discharge of a creditor’s property interest through ‘boilerplate’ language in a plan without serving notice of the debtor’s intention is contrary to the due process protections under the Fifth Amendment.”)).
141. Richards, supra note 16, at 105 (emphasis added).
142. See Elixir Indus., Inc. v. City Bank & Trust Co. (In re Ahern Enters., Inc.), 507 F.3d 817, 823 (5th Cir. 2007) (stating that the requirement of creditor participation is meant to ensure that creditors have been given notice of the plan and the possibility of it affecting their property).
144. Id. (internal quotation marks omitted).
Fourth Circuit] ha[d] stated that the only participation necessary is that the creditor receive notice of the plan and an opportunity to object.”

Nearly six years later, the Fifth Circuit now qualifies its silent acquiescence to the idea that notice was sufficient to constitute participation. In support, the Fifth Circuit cites two circuit court opinions—*In re Penrod* and *In re Be-Mac Transport*—“addressing similar issues [that] have required more than notice.” To be precise, the Seventh Circuit in *In re Penrod* hardly required more than notice. It merely stated that a creditor who filed a claim was subject to lien extinction, providing no further analysis on what constituted participation. The Fifth Circuit noted that the secured creditor in *In re Be-Mac Transport*—the FDIC—was permitted to maintain its claim after confirmation because not only had the creditor received effective notice, but it was also actively involved. The Fifth Circuit’s emphasis on the FDIC’s active participation is misleading. The Eighth Circuit opinion’s recitation of the facts makes no mention of effective notice. The question for the Eighth Circuit court was whether the FDIC’s claim was erroneously denied by the bankruptcy court and subsequently impeded the FDIC’s participation in the reorganization. After all, the purpose of giving notice is to ensure that creditors are given an unimpeded, unobstructed opportunity to protect their interests; otherwise, notice would be nothing more than an empty promise. When rights to participate were abrogated, the Eighth Circuit appropriately ruled that judicial error should not bar the creditor’s claim. Still, neither the Seventh nor Eighth Circuit can be said to have required more than effective notice.

In addition, the court remarked that it was “unable to find any case voiding a lien in the face of no involvement by a secured creditor other than

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146. Acceptance Loan Co. v. S. White Transp., Inc. (*In re S. White Transp., Inc.*), 725 F.3d 494, 497 (5th Cir. 2013) The Fifth Circuit acknowledged that notice was sufficient to constitute participation under the Fourth Circuit but stated that the facts leading up to the circuit court’s ruling indicated that more than notice was necessary. *Id.* (citing *In re Reg’l Bldg. Sys., Inc.*, 251 B.R. at 286–87).

147. *In re S. White Transp., Inc.*, 725 F.3d at 497.

148. *In re Penrod*, 50 F.3d 459, 462 (7th Cir. 1995) (“We have concluded that the default rule for secured creditors who file claims for which provision is made in the plan of reorganization is extinction and is found in the [Bankruptcy] Code itself.”).


151. *Id.* at 1027 (holding “[a]ny lien held by the FDIC should have survived the bankruptcy proceedings . . . because the bankruptcy court did not determine the lien’s validity before disallowing the claim and it improperly confirmed a plan extinguishing the FDIC’s lien without permitting the FDIC to participate in the reorganization as a secured creditor”).

152. *Id.*
the passive receipt of notice” 153 and dismissed debtor SWT’s argument that the Supreme Court’s decision in United Student Aid Funds, Inc. v. Espinosa weighed in its favor. 154 In Espinosa, the Court held that where a student loan creditor “received actual notice of the filing and contents of [a debtor’s] Chapter 13 plan,” there was no violation of the creditor’s due process rights by the bankruptcy court in confirming the debtor’s plan. 155

The Espinosa Court further posited that the creditor having “been afforded a full and fair opportunity to litigate,” “could have timely objected” to seek relief. 156 In fact, creditors did not have a “license . . . to sleep on their rights.” 157 As a threshold matter, the creditor filed a proof of claim during the pendency of the proceedings but made no objections until after the plan’s confirmation, and therefore under the Fifth Circuit’s standard, the creditor participated and was subject to the plan. 158 Although the Fifth Circuit dismisses Espinosa as “wholly inapposite” and limited to due process under Rule 60(b)(4), 159 the Espinosa Court’s emphasis on fair treatment of litigants and the importance of finality is far from irrelevant:

Rule 60(b)(4) [which provides relief from judgment] strikes a balance between the need for finality of judgments and the importance of ensuring that litigants have a full and fair opportunity to litigate a dispute. Where . . . a party is notified of a plan’s contents and fails to object to confirmation of the plan before the time for appeal expires, that party has been afforded a full and fair opportunity to litigate, and the party’s failure to avail itself of that opportunity will not justify . . . relief. 160

Yet, on the basis of its interpretation of these cases, the Fifth Circuit indicates that creditors are entitled to more than due process and leaves open the question of precisely what is sufficient protection. The Fifth Circuit distinguished between “active” and “mere passive receipt of effective notice,” 161 creating a spectrum between doing nothing and filing a claim, where due process has always been met by providing mere notice and an opportunity to be heard. Requiring greater protection than what is constitutionally necessary for parallel non-bankruptcy contexts demonstrates misplaced fear. Creditors such as Acceptance are protected when they are notified of the potential risk to their claims, how and when their claims will be modified, and when and where they have an opportunity

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153. In re S. White Transp., Inc., 725 F.3d at 497.
154. In a footnote, the court dismissed the case as inapposite because the instant case did not “implicate due process under Rule 60(b).” Id. at 497 n.1.
156. Id. at 272, 275.
157. Id. at 275.
158. Id. at 276.
159. In re S. White Transp., Inc., 725 F.3d at 497 n.1.
160. Espinosa, 559 U.S. at 276.
161. In re S. White Transp., Inc., 725 F.3d. at 498.
to be heard on their claims. Particularly in reorganization proceedings that span several months, such as *In re S. White Transportation*, the fear is utterly misplaced for the sophisticated creditor.

### B. The Court’s Holding Overlooks That Acceptance is a Sophisticated Creditor

In reading the Fifth Circuit’s opinion, it is important to bear in mind two troubling facts that undercut Acceptance’s position and demonstrate that the reorganization process has been needlessly undermined. First, Acceptance and SWT developed a relationship as early as 2002 and engaged in communication and litigation over Acceptance’s security interest for several years leading up to SWT’s bankruptcy petition. Second, Acceptance had repeatedly received effective notice challenging the very interest being litigated, and according to its counsel, “in fact they were ignored” due to “inadvertence and oversight.” Acceptance is far from the ordinary creditor. It had competent counsel. It was considerably more sophisticated than the average flesh-and-blood investor. Rather than protecting its interest reasonably upon notice, Acceptance, by sheer “inadvertence and oversight,” sat idly for months as SWT proceeded through Chapter 11 reorganization. Acceptance failed to act diligently, and it then contended, only after confirmation of the Plan, that its lien should have survived the Plan or the confirmed Plan should have been amended to provide for its lien. It “fell asleep at the switch.”

The purpose of reorganizing a company is “not a lawsuit in the ordinary sense . . . , but a complex exercise of legal method, corporate finance and business management,” and the process of negotiating a plan of reorganization can take several months and potentially continue for

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164. *In re S. White Transp., Inc.*, 455 B.R. at 513.
165. *Id.* at 523.
166. *Id.* at 512.
167. *Id.* at 523.
168. Acceptance Loan Co. v. S. White Transp., Inc. *(In re S. White Transp., Inc.)*, 725 F.3d 494, 495–96 (5th Cir. 2013).
170. 7 *COLLIER ON BANKRUPTCY* ¶ 1100.01 (16th ed. 2013).
171. Section 1121 provides that a debtor has the exclusive right to file a plan of reorganization for 120 days, a period the court may extend, but not to exceed eighteen months. 11 U.S.C. § 1121(b), (d) (2012). If a debtor fails to file a plan of reorganization during the exclusivity period, any party in interest, with the exception of the U.S. trustee, may file a plan of reorganization. *Chapter 11: Reorganization Under the Bankruptcy Code*, supra note 35 (citing 11 U.S.C. § 307).
years. It is essential, then, to devise a timely remedy. Debtors are encouraged to file Chapter 11 petitions when “they can still realistically be organized,” can continue to operate, and can be “returned to a viable state.” Timely remedies mutually benefit and balance the interests of the debtor and its creditors. The Bankruptcy Code provides tools to safeguard the interests of debtors and creditors alike, but with the Fifth Circuit’s opinion, we have effectively allowed creditors to circumvent protections afforded to debtors seeking reorganization—seeking a “fresh” start.

Creditors “have a responsibility to take an active role in protecting their claims,” and as previously discussed, secured creditors that fail to act diligently are not cosseted and stand to lose priority to unsecured creditors. Chapter 11 debtors may have many—even thousands of—claimants, which puts creditors in the best position to prove and maintain their security interests and to decide whether they wish to pursue those interests. Provided that debtors have delivered adequate information for consideration, creditors must diligently assess notices to protect their claims. Yet under In re S. White Transportation, creditors—with claims that the debtor is fully aware of and ready to address—are encouraged to take a “wait-and-see” posture. Under the new Fifth Circuit analysis, creditors that receive effective notice have not yet met the participation requirement under In re Ahern Enterprises that would extinguish their liens; therefore, they need not act timely or diligently.

172. Chapter 11: Reorganization Under the Bankruptcy Code, supra note 35.
173. See infra Part II.C.
174. 7 COLLIER ON BANKRUPTCY ¶ 1100.01 (16th ed. 2013).
175. Id.
179. See, e.g., 11 U.S.C. § 544 (2012) (trustees stand in the shoes of the perfect judgment lien creditor and may avoid secured claims that are not perfected at the time of filing).
180. In re Barton Indus., Inc., 104 F.3d at 1246 (citing Turney v. FDIC, 18 F.3d 865 (10th Cir. 1994)). The In re Barton Industries court determined that notice received by the creditors was defective for failure to include adequate information on the treatment of their claims. Therefore, it did not constitute adequate notice of the plan, and the claims were not affected. Id. In re S. White Transportation, however, involves a creditor that received notice with adequate information but did not act diligently to protect its interests. In re S. White Transp., Inc., 725 F.3d at 496.
181. See In re S. White Transp., Inc., 725 F.3d at 496–97 (holding that nonfeasance does not meet the In re Ahern Enterprises participation requirement for lien extinguishment); see also Dan B. Prieto & Mark G. Douglas, Secured Creditor May Choose to Take No Action During Chapter 11 Case Without Hazarding Lien Stripping, 9 PRATT’S J. BANKR. L. 749, 754–55 (2013) (discussing the In re S. White Transportation opinion as leaving open the possibility for debtors to “wait in the wings during the case and proceed to exercise its remedies in a more favorable forum after confirmation of a plan”).
182. See In re S. White Transp., Inc., 725 F.3d at 496–97; see also Prieto & Douglas, supra note 181, at 754–55.
sitting idly would affect a creditor’s right to recovery. Such a result unfairly
tips the balance of interests and prioritizes creditors’ interests over that of
debtors.

Yet, should we hold sophisticated and unsophisticated creditors alike to
the same standard? A similar question has been drawn for institutional
investors who have fallen victim to Ponzi schemes. Writing for the court in
SEC v. Nadel, Judge Richard Lazzara stated that the “investors [bore] the
burden of showing that ‘red flags’ were not ignored when they invested
their money in what is later realized as a Ponzi Scheme.” The district
court denied the investors’ claim largely on the basis of their sophisticated
status and lack of good faith. The opinion suggests, as the receiver
Burton Wiand highlighted, “that sophisticated investors shouldn’t expect to
be treated like any other victim when they ‘make these investments without
the level of diligence that ought to be necessary.’”

Sophisticated investors are those individuals or entities that have the
expertise or access to resources and information that allow them to evaluate
their position and make educated decisions with respect to their
investments. Congress has recognized that sophistication may merit a
different standard of consideration and has implemented regulations
reflecting such a notion in non-bankruptcy law contexts. Congress and
the U.S. Securities and Exchange Commission have also adopted an
objective investor sophistication standard, which considers “financial
sophistication, net worth, knowledge, and experience in financial matters,
or amount of assets under management.” Consideration of the level of
sophistication is not new for the judiciary either. Courts have considered
party sophistication in various areas of law including tort, contract,

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185. Id. at 11.
186. Id. at 12–13.
187. Albergotti, supra note 183.
188. Felicia Smith, Madoff Ponzi Scheme Exposes “The Myth of the Sophisticated Investor,” 40 U. BALTIMO. L. REV. 215, 243 (2010) (Sophisticated investors are considered to have “the wherewithal to ‘fend for themselves.’”).
189. Id. at 243 (Congress has permitted a private offering disclosure exemption under the premise that sophisticated investors involved in private offerings were of a class that would least likely benefit from statutorily required disclosure.).
190. Id. at 250 (citing 15 U.S.C. § 77b(a)(15)(ii)).
191. William Jordan, Design Professionals May Be Liable to Third-Party Purchasers of Residential Condominiums, PROF. LIABILITY REP., Jan. 2013 (describing “sophisticated investors or creditors who can control their risks through their contracts and insurance coverage”).
and bankruptcy law. Bankruptcy courts—and notably, even the Fifth Circuit—have examined creditor sophistication to determine whether creditors were at fault for delays in bringing claims. In reviewing the Chapter 7 bankruptcy case In re Royale Airlines, the Fifth Circuit advanced consideration of creditor sophistication as a reason to preclude a creditor’s claim. The court determined that the “legally sophisticated creditor,” who was under advisement of counsel and extensively involved throughout the bankruptcy proceedings, impermissibly waited to file a complaint after the bankruptcy proceedings closed. The court pointed out that the creditor was aware of the bankruptcy issues yet neither expressed concern nor sought removal of the trustee during the proceedings. The In re Royale Airlines opinion is in line with the Fifth Circuit’s current participation requirement—extensive involvement and control precluded the creditor’s claim.

Regardless of whether the creditor was extensively involved, the In re Royale Airlines court also raised an issue that should not be overlooked:

It is well recognized that where a party is found to have by their conduct, either expressly or impliedly, consented to another party’s action, they are precluded from asserting a claim against that party for damages they may have suffered. “[A] secured creditor cannot remain silent with knowledge of the Trustee’s actions and not act upon it and then be heard that the Trustee made the wrong decision.”

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of contract—even to make a bad bargain, or to relinquish fundamental rights.”); Oppenheimer & Co. v. Oppenheim, Appel, Dixon & Co., 660 N.E.2d 415, 421 (N.Y. 1995)) (“If [sophisticated parties] are dissatisfied with the consequences of their agreement, ‘the time to say so [was] at the bargaining table.’”); 3 CORBIN ON CONTRACTS § 28.38 (2013) (“The more sophisticated the party, the greater the burden to read.”)).

193. See 9B AM. JUR. 2D Bankruptcy § 1960 (2013) (citing cases where bankruptcy courts have highlighted a creditor’s sophistication or advisement under counsel in finding the creditor liable for violations of the automatic stay); see also 2B BANKR. SERV. L. ED. § 19:1364 (2013) (citing cases that use a factor test in determining punitive damages for violations of the automatic stay, including consideration of creditor sophistication by the Seventh and Eleventh Circuit).

194. Clark v. Am.’s Favorite Chicken Co., 190 B.R. 260, 268 n.20 (E.D. La. 1995) (internal citations omitted) (“Sophistication in bankruptcy was considered by the Sixth Circuit in determining whether the notice to creditors sent in that case was sufficient and whether an attorney’s neglect could be visited on his clients. Other courts . . . have also considered the sophistication of creditors in determining the ‘fault’ of a creditor as to the reason for delay in not filing a proof of claim, whether the delay was in the creditor’s control and whether the creditor acted in bad faith, and thus, the Court questions whether [plaintiffs] have ‘unclean hands’ as to knowledge of bankruptcy procedure.”).


196. Id.

197. Id.

198. Id.

199. Id. (emphasis added) (quoting In re Peckinpaugh, 50 B.R. 865, 869 (Bankr. N.D. Ohio 1985)).
The court found that the creditor, having full knowledge of the proceedings and failing to take certain corrective actions, “implicitly consented to the actions or inactions” of the trustee.\textsuperscript{200} The \textit{In re Royale Airlines} court recognized that a sophisticated creditor’s silence can function as implicit consent, and the sophisticated creditor is no longer permitted to object after the conclusion of the case.\textsuperscript{201} Regardless of consent, the court implicitly recognized that the creditor must have known during the pendency of the proceedings if it had any objections and should have addressed the issues prior to confirmation. Arguably, the reading of implicit consent could be limited to situations in which a creditor has been involved in all respects of the bankruptcy proceeding but failed to contest a specific issue—now said to have been implicitly consented to. However, the court does not appear to take such a restrictive view and addresses secured creditors with knowledge generally.\textsuperscript{202} Accordingly, a sophisticated creditor that has received effective notice yet remained silent and failed to act despite knowledge of debtors’ actions cannot now be heard to say “that the Trustee made the wrong decision.”\textsuperscript{203}

C. THE COURT’S AMBIGUOUS STANDARD IS NOT ECONOMICALLY Viable

“It is more economically efficient to reorganize than to liquidate, because it preserves jobs and assets.”\textsuperscript{204} Economic efficiency is at the heart of Chapter 11 bankruptcy reorganization, but the costs of bankruptcy proceedings in conjunction with the present opinion chip away at the core purpose of providing debtors with a socially and economically beneficial fresh start.\textsuperscript{205} When debtors voluntarily file for bankruptcy, creditors are unwillingly drawn into proceedings and stand to lose that for which they bargained. The Bankruptcy Code is aware of the risk and, together with the Federal Rules, provides mechanisms for protecting creditor rights and balancing their interests fairly. However, the Fifth Circuit has effectively permitted creditors to draw out proceedings and forced debtors to take every precautionary measure, including those that are not particularly necessary. “The adverse impact on the creditor’s property rights must be weighed against the administrative costs associated with additional judicial procedures.”\textsuperscript{206}

The \textit{In re S. White Transportation} opinion imposes additional costs and burdens on an already time-consuming and costly proceeding. Bankruptcy

\textsuperscript{200} Id.
\textsuperscript{201} Id.
\textsuperscript{202} Id.
\textsuperscript{203} Id. (quoting \textit{In re Peckinpaugh}, 50 B.R. at 869).
\textsuperscript{205} Buchanan Staudenmaier, \textit{supra} note 20, at 461–62.
\textsuperscript{206} Richards, \textit{supra} note 16, at 106.
involves direct costs from participating in formal proceedings and indirect costs that stem from formal bankruptcy proceedings. Direct costs are transactional costs such as “the legal administrative and advisory fees that the firm bears as a direct result of entertaining the formal bankruptcy process.” Fees are required to commence and to continue with proceedings. Specifically, debtors in possession must pay quarterly fees to trustees handling the case ranging from $325 to $30,000 per quarter. Generally, indirect costs are presumed to be “substantially larger” than direct costs and are the consequences of: “inter- or intra-group conflicts of interest, asymmetric information, free-rider problems, lost sales and competitive position, higher operating costs, and ineffective use of management’s time.”

As a consequence of these costs, the question is raised as to the effectiveness of Chapter 11 when “high costs drain troubled firms of resources.” In evaluating the efficiency of reorganization, one critic, recognizing the diminishing value of a failing business over time, suggests selling companies if a plan were not adopted “by the end of the initial exclusivity period, which is 180 days if managers propose a plan or 120 days if they do not.” Although two critics find that the correlation between costs and time in bankruptcy is weak, their research has shown that for every year a Chapter 11 proceeding endures, “the total costs of the proceedings consume another 2.1% to 2.2% of the total distributions in the case”—approximately half the costs of the median Chapter 11. Costs deemed administrative expenses take priority and reduce creditors’ recovery.

Holding sophisticated creditors to a different standard has important policy considerations. When creditors have knowledge and the resources to navigate proceedings, the In re Royale Airlines court compels these
sophisticated creditors to act sooner rather than later. Such a standard intends to discourage inaction and deny incentives to those acting in bad faith. All creditors are subjected to human biases that affect decision-making, but sophisticated creditors have the distinct advantages of expertise and superior resources that allow them to facilitate efficiency and prevent bankruptcy proceedings from becoming needlessly burdensome. The burden on debtors to challenge and discern the extent of their liability for each claim through adversary proceedings, for instance, is unduly taxing and costly. Drawing problems to light as sophisticated creditors become aware saves parties from the time and costs spent negotiating and renegotiating terms in what is already a time-consuming process. Efforts and expenses are better redirected towards effective reorganization to the benefit of diligent creditors and the public good.

III. RECOMMENDATIONS

Under the Fifth Circuit’s opinion, can it still be said that it is more efficient to reorganize than to liquidate? Confirmation after In re S. White Transportation becomes almost meaningless if negligent creditors are allowed to spring awake and strip debtors of finality. Courts certainly have good reason to protect creditors—especially those who are not adequately equipped to protect themselves. But by extending similar latitude to sophisticated creditors, the Fifth Circuit allows secured creditors to remain silent and bring their claims whenever they are unsatisfied. Yet, how can a plan ever comport with a creditor’s expectation if the debtor never receives a response? A solution is needed.

Perhaps the only foolproof option a debtor presently has to avoid future harassment is to bring adversary proceedings to preclude future attempts to enforce claims. However, such proceedings are costly and burdensome for both the debtor and the court. Additionally, if the creditor is not interested in pursuing its claim, debtors’ proceedings are extraneous and not

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216. Howard v. Fidelity & Deposit Co. of Md. (In re Royale Airlines, Inc.), 98 F.3d 852, 857 (5th Cir. 1996).
217. Smith, supra note 188, at 262–67 (discussing factors affecting decision-making that may explain why sophisticated investors fell for Madoff’s Ponzi scheme).
219. Id. at 105 (indicating that due process requires notice that at minimum can be understood by an unsophisticated creditor because claim modifications affect property rights.); see also Buchanan Staudenmaier, supra note 20, at 465 (remarking on courts’ concerns over inadequate protection of creditors’ rights where interests may not be fairly balanced).
220. Feder, supra note 39 (“A requirement that the mere provision of notice to such creditors can no longer suffice to address such liens would place a huge and costly burden on chapter 11 debtors to effectuate the ‘participation’ of passive creditors in their cases, such as by utilizing Section 501(c) of the Bankruptcy Code to file proofs of claim on such creditors’ behalf.”); see also Prieto & Douglas, supra note 181, at 754–55 (discussing the In re S. White Transportation opinion as leaving open the possibility for debtors to “wait in the wings during the case and proceed to exercise its remedies in a more favorable forum after confirmation of a plan”).
cost-effective. Still, it remains a necessary, prophylactic measure for the debtor under the Fifth Circuit’s opinion. One scholar has advanced the idea of a Restatement of Notice so as to better delineate expectations and guide judicial interpretation, but such a restatement of the law would not adequately address concerns of equitable treatment for creditors’ rights that underlie the Fifth Circuit’s want for “something more.”

In light of the room for abuse by creditors and risk to debtors, the Fifth Circuit’s standard for something more than notice must be tempered with a heightened standard of scrutiny for sophisticated creditors. Already, the Bankruptcy Code makes a distinction between individual and business debtors in definition and treatment, and it would not be far off for Congress to implement a statutory creditor distinction or for courts to hold sophisticated creditors to greater scrutiny. In cases where a statutory or common-law sophisticated creditor has received effective notice, the creditor should be presumed to have participated in the reorganization proceedings, or alternatively, debtors should be permitted to raise a sophisticated creditor defense.

Ultimately, the lack of response from sophisticated creditors who actually receive notice will amount to those who choose not to pursue their interests and those creditors, like Acceptance, who choose not to act until an opportune time. By holding sophisticated creditors to a higher standard of review, creditors like Acceptance are prevented from taking advantage of the reorganization process, and costs of litigation are saved. Admittedly, holding sophisticated creditors to a different standard operates on a presumption that sophistication allows for exercise of good judgment. Recent events rebut the presumption; in fact, the great losses stemming from Bernard Madoff’s Ponzi scheme were largely on account of sophisticated investors’ failure to conduct due diligence. However, sophisticated creditors dragged into bankruptcy do not face the temptation of indolence induced by the glamor of a “marquee name” like Madoff. Creditors do not stand to profit from bankruptcy and are subject to priority rules. They can only expect to have claims fulfilled as to what they bargained for or run the risk of losing their interests altogether.

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221. Lawless, supra note 2, at 1250.
222. Although the Bankruptcy Code defines the term “debtor” to include individuals and business entities, the Code specifies who may be considered a debtor under each chapter. 11 U.S.C. §§ 101, 109 (2012). Additionally, even within the provisions governing Chapter 11, distinctions are made between individuals and business entities. See, e.g., id. § 1141(d)(5) (specifically referring to individuals).
223. See Smith, supra note 188, at 253–60.
224. Id. at 264.
225. 11. U.S.C. § 507 (outlining the priorities of expenses and claims in bankruptcy proceedings and indicating that secured creditors do not receive a payment from the estate until other claims and expenses have first been accounted for).
226. In line with statutory priorities delineated in § 507, plans under Chapter 11 must be “fair and equitable” in the treatment of claims in order to be confirmed. Id. § 1129. Treatment is fair...
Undoubtedly, sophisticated investors and creditors alike are still prone to error on account of human biases and, as in the case of In re S. White Transportation, poor counsel. In recognition of these lapses, court-approved notice of all relevant proceedings must be given, but following notice to sophisticated creditors, there should be no further obligation by the debtor to induce action or do more. The onus is on these creditors to act diligently. Creditors that fail to act diligently under the advice of counsel should bring a separate cause of action, where counsel should bear the weight of liability and penalties for acting in bad faith, as provided for in other aspects of the Federal Rules.

CONCLUSION

Both debtors and creditors are entitled to equitable treatment and protection throughout the reorganization process. The Fifth Circuit’s opinion in In re S. White Transportation overprotects creditors to the disadvantage of debtors by requiring, but not articulating, the need for more than mere receipt of notice to meet the In re Ahern Enterprises participation requirement. When debtors provide effective notice, they confer their readiness to account for their debt and the security interests of their creditors. To allow sophisticated creditors that “fell asleep at the switch” to suddenly wake up and take action thwarts progress and incentivizes abuse of procedure. Sophisticated creditors must be held to a higher standard of scrutiny through a statutory or common-law definition that affords debtors a defense. Without such a safeguard, proceedings are unnecessarily prolonged and result in social and economic costs that run counter to the purpose of Chapter 11 reorganization. Where effective disclosure is made to a sophisticated creditor intimately involved with the debtor, as was the case for the creditor Acceptance, mere receipt of notice is simply enough.

Liana-Marie Lien*

and equitable if payments to secured creditors amount to “at least the allowed amount of such claim [or] at least the value of such holder’s interest in the estate’s interest in such property.” Id. § 1129(2)(A)(i)(II). Unsecured creditors are entitled to the same right but subject to the interests of those with greater priority. Id. § 1129(2)(B)(ii).

227. The Supreme Court determined that sophisticated creditors are still entitled to personal service or notice, even if they are capable of discovering that their interests have or will be affected. Mennonite Bd. of Missions v. Adams, 462 U.S. 791, 799 (1983).

228. See, e.g., FED. R. BANKR. P. 9011 (describing how attorneys may be sanctioned for violations in representations to the court).

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