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Second Circuit Articulates the Standard for the Extinguishment of Liens under a Chapter 11 Bankruptcy Plan

By Marc Abrams, Joseph G. Minias, and Weston T. Eguchi*

This article discusses a recent United States Court of Appeals for the Second Circuit opinion articulating the circumstances under which a plan of reorganization extinguishes the lien of a secured creditor.

The U.S. Court of Appeals for the Second Circuit has issued an opinion (the "Opinion") articulating the circumstances under which a plan of reorganization extinguishes the lien of a secured creditor. In *City of Concord, N.H. v. Northern New England Telephone Operations LLC (In re Northern New England Telephone Operations LLC)*,[1] the Second Circuit held, as a matter of first impression, that a lien is extinguished by a plan under Section 1141(c) of the Bankruptcy Code if "(1) the text of the plan does not preserve the lien; (2) the plan is confirmed; (3) the property subject to the lien is 'dealt with' by the terms of the plan; and (4) the lienholder participated in the bankruptcy proceedings."

BACKGROUND

On October 26, 2009, the telecommunications company FairPoint Communications, Inc. and certain of its subsidiaries, including the appellee Northern New England Telephone Operations LLC ("NNETO"), commenced Chapter 11 proceedings[2] in the U.S. Bankruptcy Court for the Southern District of New York. The appellant, the City of Concord, New Hampshire (the "City"), timely filed proofs of claim against NNETO relating to property taxes for the prepetition portion of the 2009–2010 tax year. The City also mailed property tax bills—but did not file proofs of claim—for the postpetition period of the 2009–2010 tax year (the "Disputed Tax Claim").[3]

On January 13, 2011, the bankruptcy court confirmed a plan of reorgani-

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1 795 F.3d 343 (2d Cir. 2015).

2 No. 09-16335 (CGM).

3 We do not address whether any of the City's claims would have been entitled to treatment as administrative expenses.

zation for the debtors (the "Chapter 11 Plan"), which contained the following provision (the "Free and Clear Provision"):

> As of the Effective Date, all property of FairPoint and Reorganized FairPoint 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.

The bankruptcy court ultimately allowed the City's prepetition property tax claims.

Following confirmation of the Chapter 11 Plan, the City moved for an order to formally allow its postpetition Disputed Tax Claim and direct the payment thereof, contending that the Disputed Tax Claim continued to be secured by a statutory lien on the property. The bankruptcy court denied the City's motion, concluding that its lien had been extinguished upon plan confirmation pursuant to the Free and Clear Provision. On appeal, the district court affirmed.

ANALYSIS

While acknowledging the "longstanding background rule . . . that 'liens pass through bankruptcy unaffected,'"[4] the Second Circuit noted that Section 1141(c) of the Bankruptcy Code carves out a "caveat" to the general rule in the context of Chapter 11 proceedings. Specifically, Section 1141(c) provides:

> 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,[5] equity security holders, and of general partners in the debtor.

Based on Section 1141(c), the Second Circuit articulated four conditions that must be satisfied in order for a Chapter 11 plan to extinguish a lien:

(1) the text of the plan does not preserve the lien;

(2) the plan is confirmed;

(3) the property subject to the lien is "dealt with" under the terms of the plan; and

(4) the lienholder participated in the bankruptcy proceedings.

Although Section 1141(c) does not expressly refer to a lienholder's participation

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[4] 795 F.3d at 346 (quoting *Dewsnup v. Timm*, 502 U.S. 410, 417 (1992)).

[5] The phrase "interests of creditors" includes liens. 795 F.3d at 346 (citing to the definition of "lien" under Section 101(37) of the Bankruptcy Code and prior Second Circuit case law).

(i.e., the fourth prong), the Second Circuit concluded that such participation was nevertheless required as a "procedural safeguard" since the underlying collateral could not be fairly "dealt with" if the lienholder were absent. This conclusion comports with case law from the Fourth, Fifth, Seventh, Eighth, and Tenth Circuit Courts (as well as certain lower courts). The Second Circuit also noted that the lienholder participation requirement is consistent with Section 506(d)(2) of the Bankruptcy Code (which preserves a lien for the lienholder's benefit as long as the claim was disallowed only because the lienholder had failed to file a proof of claim).

Applying the test to the City's liens, the Second Circuit determined that the Chapter 11 Plan had "dealt with" the subject property through the Free and Clear Provision. The court rejected the City's argument that a broad catch-all provision, such as the Free and Clear Provision's reference to "all property" of the debtors, was not sufficiently specific to deal with the particular parcels that were subject to the City's liens. In addition to administrative considerations that weighed against requiring a debtor to list each specific property, the Second Circuit concluded that the categorical phrasing of the plan put all participants on notice that their rights might be affected, which was in keeping with the general principle that "creditors have a responsibility to take an active role in protecting their claims."[6]

The Second Circuit also concluded that the City's participation in NNETO's bankruptcy proceedings, while limited, nevertheless satisfied the participation requirement. Although the City had not filed a proof of claim for the Disputed Tax Claim, it had submitted other proofs of claim relating to the same properties and the same tax year. Under New Hampshire law, a single, statutory lien arises at the beginning of each tax year (on April 1) to secure the entire tax burden for the entire tax year; thus, the same statutory lien that secured the prepetition property tax claims asserted in the City's proofs of claim also secured the postpetition Disputed Tax Claim. As a result, the Second Circuit concluded that even if the City had not participated in the case with respect to the *claims* at issue, it had nevertheless participated in the case with respect to the *same lien* and *same underlying property*, and that this was sufficient to satisfy the fourth prong of its test.

OBSERVATIONS

While its precise impact on future bankruptcy cases and the treatment of secured creditors remains to be seen, the Opinion is nevertheless significant

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[6] 795 F.3d at 349 (internal quotation and citation omitted).

because it articulates, for the first time, the standard for extinguishing a secured creditor's liens under Chapter 11 plans for bankruptcy cases pending in the Second Circuit, including the Southern District of New York. At a minimum, the Second Circuit's admonitions stress the need for secured creditors to remain vigilant regarding the treatment of their liens and collateral under a Chapter 11 plan.

The Second Circuit did not decide what type of lienholder participation would be "too limited or too unrelated" to subject the lienholder to a Chapter 11 plan, and we would expect further litigation to clarify the nature and extent of a lienholder's participation for purposes of the test. Interestingly, however, the Second Circuit noted that, at a minimum, the participation requirement "requires more than [the lienholder's] mere passive receipt of effective notice" that a plan might deal with its lien.[7] As such, the Second Circuit stated, 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 proceeding and enforce his lien in the usual way or (alternatively) to collect his debt in the bankruptcy proceeding."[8]

While the Opinion suggests that a secured creditor that has received notice of a bankruptcy case may, as a threshold matter, assess whether to participate in the bankruptcy case at all, and that a secured creditor that chooses not to participate should not be subject to provisions of a Chapter 11 plan that purport to deal with its collateral, careful consideration should be exercised before a secured creditor chooses to ignore the bankruptcy case altogether. Although the secured creditor's participation decision will depend on the particular facts and circumstances, in most cases the risks of not appearing and protecting its collateral in the bankruptcy case, not to mention the delay caused by postponing the exercise of its remedies until resolution of the bankruptcy case, will be too substantial to justify nonparticipation.

For example, it remains to be seen how the Opinion can be reconciled with the longstanding principle, articulated as far back as the Supreme Court's

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[7] 795 F.3d at 348 n.2. Similarly, while in the context of a sale rather than a plan, a bankruptcy court in the Second Circuit recently held that a debtor's assets could not be sold free and clear of certain secured creditors' liens because the secured creditors' failure to object to the sale after receiving notice thereof did not constitute consent for the purposes of Section 363(f)(2) of the Bankruptcy Code. *See In re Arch Hospitality, Inc.*, 530 B.R. 588, 591 (Bankr. W.D.N.Y. 2015). Parties should be wary of the possibility of a creeping line of cases recognizing a secured party's right to ignore bankruptcy notices.

[8] *Id.* (internal quotation and citation omitted).

decision in *Stoll v. Gottlieb*,[9] that an order confirming a plan of reorganization has *res judicata* effect even against creditors that have notice of, but do not appear in, the bankruptcy proceeding. Thus, even in a situation where a secured creditor's lien "passes through" the bankruptcy case, there is a risk that plan injunctions, releases, stays or other provisions may hamper or foreclose the creditor's remedies in a manner that may be difficult to predict from the outset of the case.

Lastly, although not addressed in the Opinion, the concern that led the Second Circuit to adopt the participation requirement as a "procedural safeguard" may be mitigated, to some degree, by the cramdown requirements of the Bankruptcy Code. Under Section 1129(b), if a class of creditors rejects or is deemed to reject a plan,[10] the plan may be confirmed only if it does not discriminate unfairly and is "fair and equitable" with respect to each impaired non-accepting class (which, with respect to a secured creditor class, requires, at a minimum, compliance with the requirements set forth under Section 1129(b)(2)(A)).[11]

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[9] 305 U.S. 165, 59 S. Ct. 134, 83 L. Ed. 104 (1938); *cf. United Student Aid Funds, Inc. v. Espinosa*, 559 U.S. 260, 130 S. Ct. 1367, 176 L. Ed. 2d 158 (2010) (student loan creditor violated discharge injunction under Chapter 13 plan even though bankruptcy court had failed to find "undue hardship" to justify discharge where creditor received actual notice of filing and contents of debtor's plan but failed to object).

[10] Whether a class is deemed to have accepted a plan may, in turn, depend on whether the non-participating secured creditors are separately classified and their failure to vote on a plan can be deemed an acceptance. *See, e.g., Heins v. Ruti-Sweetwater, Inc. (In re Ruti-Sweetwater, Inc.)*, 836 F.2d 1263, 1266 (10th Cir. 1988) (separately classified judgment lien creditor that neither voted on nor objected to plan was deemed to accept plan such that plan confirmation did not require meeting cramdown requirements); *In re Adelphia Commc'ns Corp.*, 368 B.R. 140, 260–261 (Bankr. S.D.N.Y. 2007) (accepting presumption set forth in plan that classes for which no votes have been submitted will be deemed accepting); *but see In re Friese*, 103 B.R. 90 (Bankr. S.D.N.Y. 1989) (rejecting *Ruti-Sweetwater*). The Second Circuit has not decided the issue. *See DISH Network Corp. v. DBSD N. Am., Inc. (In re DBSD N. Am., Inc.)*, 634 F.3d 79, 106 n.14 (2d Cir. 2011) (declining to address issue of whether a non-voting class may be deemed to accept a plan).

[11] Generally, under Section 1129(b)(2)(A), in order for a plan to meet the "fair and equitable" requirement for cramdown with respect to a class of secured claims, the plan must: (i) provide that such secured creditors retain their liens to the extent of the allowed amount of their claims and will receive sufficient deferred cash payments; (ii) provide, in the case of a sale of the collateral, for the liens to attach to the sale proceeds; or (iii) provide secured creditors with the "indubitable equivalent" of their claims.