

NINTH CIRCUIT CREATES HIDDEN DANGER FOR CHAPTER 11 PLAN PROPONENTS.

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SYNOPSIS: The United States Court of Appeals for the Ninth Circuit in the case of *Arden v. Motel Partners*, No. 97-55968, ___ F.3d ___ (9th Cir., June 1, 1999), affirmed a decision of the Bankruptcy Appellate Panel for the Ninth Circuit holding that a bankruptcy court abused its discretion in confirming a chapter 11 plan that compromised the plan proponent's claim against the bankruptcy estate, when the Court's decision to approve the compromise was predicated on an error of law. The decision emphasizes the need for diligence in the plan confirmation process to ensure a trial court order confirming a chapter 11 plan is final and free from attack on appeal.

FACTS: Valley Budget Operational, L.P. ("Valley Budget") was the lessee under a motel lease with Motel Partners. One of its general partners, Perry Arden, guaranteed payment of its obligations under the lease. In 1993, Valley Budget breached the lease and surrendered possession of the real property. Motel Partners then sued Valley Budget and Perry Arden for damages resulting from the breach. It received a prejudgment writ of attachment for \$2,743,004.

In February 1995, Perry Arden filed a chapter 11 bankruptcy petition. Motel Partners filed a proof of claim for \$2,743,004 -- the only unsecured claim filed in the case. Perry Arden objected to the amount of the claim and on the grounds that the claim was capped by operation of 11 U.S.C. § 502 (b)(6). The bankruptcy court ruled that the §502 cap, which operates to limit claims of real property lessors, was inapplicable to a lessor's claim against a lease guarantor. Perry Arden filed a motion for reconsideration.

Motel Partners then filed a creditor's plan of reorganization containing a provision compromising its claim for \$1,700,000. At the hearing on plan confirmation, the bankruptcy court heard evidence on the amount of the claim, determined that the proposed compromise was fair and reasonable, denied Perry Arden's motion for reconsideration of its decision regarding application of the §502 cap, and confirmed the plan.

The Court of Appeals for the Ninth Circuit noted that the question of whether the §502 cap applies to a lease guarantor was one of first impression in the Ninth Circuit. The Ninth Circuit addressed the issue in its decision, holding that the §502 cap does apply to a claim against a lease guarantor under the plain meaning of the statute. Because the bankruptcy judge had failed, as a result of his incorrect legal conclusion, to consider the effect of the cap when evaluating the proposal to compromise Motel Partner's claim, the Ninth Circuit held that the bankruptcy judge abused his discretion when he confirmed the plan. The Ninth Circuit affirmed a decision of the BAP reversing and remanding the order of confirmation.

ANALYSIS: Section 1123 (b)(3)(A) of the Bankruptcy Code allows a bankruptcy court to approve a claim compromise as part of a chapter 11 plan. The standard for compromising a claim as part of a chapter 11 plan was set forth by the United States Supreme Court in *Protective Committee for Independent Stockholders of TMT Trailer Ferry, Inc. v. Anderson*, 390 U.S. 414, 88 S. Ct. 1157, 20

L. Ed. 2d 1 (1968). The proposed compromise must be fair and equitable. In determining whether the compromise is fair and equitable, the judge must apprise himself of all facts necessary for an intelligent and objective opinion of the probabilities of ultimate success if the claim is actually litigated. The judge should consider the complexity, expense and expected duration of the litigation; the risk of collection; and any other relevant factors.

The standard for review of an order confirming a chapter 11 plan containing a claim compromise is whether the bankruptcy judge abused his discretion in confirming the plan. In the Ninth Circuit, an exercise of discretion based on an erroneous interpretation of the law can be freely overturned. *La Grand Steel Products Co. v. Goldberg*, 796 F. 2d 318 at 321 (9th Cir. 1986).

The bankruptcy court judge approved the compromise based on his holding that the §502 cap did not apply to the claim. This legal conclusion was incorrect. The cap did apply to the compromised claim and therefore the bankruptcy judge abused his discretion in approving the compromise and confirming the plan.

COMMENT: The analysis in the *Arden* decision is straightforward. It is based on the well-understood principal that an exercise of discretion based on an incorrect ruling of law is an abuse of discretion. However, the result of the decision is somewhat disturbing. The purpose behind compromising a claim is to create certainty out of uncertainty. This is especially important in the context of a plan confirmation, where finality is greatly desired. While a judge should consider the possible results if the matter in controversy were litigated and finally determined, the judge is not expected to actually determine the issues, legal or factual. Requiring that all legal issues relevant to the dispute be determined correctly before the court can confirm a plan including a compromise eviscerates the purpose behind compromising claims: providing finality while reducing costs.

When an estate representative makes a decision to settle a claim, the bankruptcy judge's expected decision on the legal issues plays an important part in the settlement decision. Where the judge has already ruled on the issue, the settlement decision should be based on the likelihood that the judge will rule the same way again (usually very high), the chance of obtaining a different result on appeal, and the cost, both in time and money, of obtaining a different result on appeal. Assessing these issues requires an application of judgment and assessment of unknown factors. The compromise, and the decision to approve the compromise, if made after appropriate consideration of these factors, should be final.

In the *Arden* case, the creditor was effectively compromising its own claim. Stricter scrutiny by the court is required. However, as far as can be told from the Court of Appeal's decision the prior decision of the bankruptcy judge that the §502 cap did not apply had not been appealed and was final. Given a final decision that the §502 cap did not apply, the compromise was appropriate and it difficult to see what other options were available to the plan proponent. The 9th Circuit's decision in *Arden* is disturbing because it seems to require that all relevant legal issues be determined **by an appellate court** before plan confirmation. Otherwise, the decision to confirm a plan containing a compromise remains open to collateral attack on appeal.