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The Sale of Mortgage Loans Free and Clear in a Chapter 11 Plan

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Following an initial three-day confirmation trial and denial of the debtors' chapter 11 plan (the "second amended plan"), Hon. James L. Garrity Jr. confirmed the third amended joint chapter 11 plan of Ditech Holding Corp. and certain of its subsidiaries (collectively, "Ditech" or the "debtors").[1] His decision[2] denying confirmation of the second amended plan touched on several issues of importance for bankruptcy practitioners, including (1) the application of § 363(o) of the Bankruptcy Code (which preserves certain consumer creditor claims in sales of interests in consumer credit transactions pursuant to § 363) to the sale of consumer credit contracts; (2) whether a "free and clear" sale of assets consummated pursuant to a chapter 11 plan must comply with § 363; and (3) the interaction between §§ 363(o) and 1129's "best interests of creditors" test in the context of plan confirmation.

Background

Ditech, a servicer and originator of mortgage and reverse mortgage loans, filed for bankruptcy on Feb. 11, 2019. At the outset of the chapter 11 cases, the debtors and their secured lenders agreed to pursue a restructuring transaction, with a market-check sale toggle. The debtors then engaged in a marketing process for their assets and ultimately pursued two separate sale transactions to be consummated free and clear of claims, including consumer creditor claims, pursuant to their chapter 11 plan: one for the forward mortgage business, and one for the reverse mortgage business.

The members of the official unsecured creditors' committee (UCC) included two consumer creditors. While the UCC raised a number of objections to the debtors' initial plan, the UCC and the debtors ultimately reached a global settlement. Shortly thereafter, in early May 2019, an official committee of consumer creditors (CCC) was appointed in the chapter 11 cases. The CCC objected to confirmation of the proposed plan sales, raising two primary arguments: (1) § 363 is the sole source of authority for the sale of assets free and clear in bankruptcy; and (2) even if debtors can pursue a free-and-clear sale pursuant to a plan by relying solely on §§ 1123 and 1141(c), confirmation of such a plan must comply with § 363(o) to satisfy § 1129's best-interests-of-creditors test.

Prior to the issuance of the decision, the *ABI Journal* published an article in which the authors thereof argued that a plan sale should comply with § 363(o).[3] In his decision, Judge Garrity found that a plan need not do so.

Plain Language and Legislative History Make Clear that § 363(o) Is Not Applicable to Plan Sales

Section 363(f) of the Bankruptcy Code provides for the free-and-clear sale of assets in bankruptcy — that is, a purchaser may acquire assets without assuming most associated liabilities against the debtor-seller. The § 363 sale is a powerful tool in bankruptcy cases, helping debtors to maximize the value of their estates and recovery for creditors.

However, § 363 has its limitations. Section 363(o), a provision unique to the sale of consumer creditor contracts (like the mortgage and reverse mortgage loans that Ditech was selling), limits § 363(f)'s free-and-clear language by providing that certain consumer claims and defenses may not be discharged in a § 363 sale. Specifically, § 363(o) provides, in pertinent part,

> Notwithstanding subsection (f), if a person purchases any interest in [certain consumer credit obligations] *and if such interest is purchased through a sale under this section*, then such person shall remain subject to all [related] claims and defenses to the same extent as such person would be subject to such claims and defenses of the consumer had such interest been purchased at a sale not under this section.

The policy objective behind § 363(o) was articulated by Sen. Charles Schumer (D.-N.Y.) when, after a wave of bankruptcy filings by mortgage companies seeking to rid themselves of consumer claim liability, he proposed an amendment to § 363. He explained that this amendment "will prevent predatory lenders from being able to use bankruptcy as a means by which to shield themselves from liability and cut off consumer claims and defenses.... And we will protect consumers from those who seek to purchase predatory loans with the knowledge that the consumer's right has been undermined."[4]

1 *In re Ditech Holding Corp., et al.*, Case No. 19-10412-jlg (Bankr. S.D.N.Y. 2019).
2 *Memorandum Decision on Confirmation of the Second Amended Joint Chapter 11 Plan of Ditech Holding Corp. and Its Affiliated Debtors* [ECF No. 1240] (the "Decision").
3 Nathan T. Juster & Lindsey G. Anderson, "Closing the § 363(o) Loophole: Sales of Consumer Loans in Liquidating Plans," XXXVIII *ABI Journal* 8, 40-41, 56, August 2019, *available at* abi.org/abi-journal (concluding that "plan proponents should not be permitted to short-circuit § 363(o), and that a plan that does not comply with § 363(o) is not confirmable").
4 147 Cong. Rec. S. 420 (March 8, 2001) (statement of Sen. Chuck Schumer).

In *Ditech*, § 363(o) complicated the debtors' efforts to find potential purchasers for their assets. The debtors therefore decided to pursue plan sales to be consummated pursuant to §§ 1123(b)(4) and 1141(c) of the Bankruptcy Code.

The CCC argued that the debtors could not rely on §§ 1123(b)(4) and 1141(c) to effectuate a free-and-clear sale because § 363(f) "is the only provision in the Bankruptcy Code that grants statutory authority to sell property free and clear (subject to Section 363(o))."[5] In taking this position, the CCC relied on two arguments rooted in a textual interpretation of the relevant Code provisions. The CCC explained that (1) § 1123(b)(4) merely allows a plan to provide "for the sale of all or substantially all of the property of the estate," but not a free-and-clear sale; and (2) § 1141 is not a source of authority providing debtors the power to consummate a free and clear sale, because it simply articulates the effect of a confirmed plan.[6] The CCC also stressed that § 1129(a) provides that all "applicable provisions of this title" must be complied with in order for a plan to confirmed. Because § 363 is, the CCC argued, the only source to effectuate a free-and-clear sale, § 363 (and specifically, § 363(o)) is an "applicable provision" that must be complied with.

Judge Garrity rejected these arguments. The text of § 363(o) unambiguously provides that where consumer credit contracts are being sold in bankruptcy "under this section" (that is, pursuant to § 363), the purchaser remains subject to all consumer borrower claims and defenses to the same extent a purchaser would be in a nonbankruptcy sale. However, § 1123 contains no such limitation. Instead, § 1123(a)(5)(D) and (b)(4) state that a plan may provide for an asset sale, and, upon confirmation, § 1141(c) provides that assets sold pursuant to a plan are free and clear of pre-petition claims and interests. No Code provision implicates § 363(o) in the context of a plan sale, and there are no § 363(o)-style exceptions to plan sales effectuated pursuant to §§ 1123 and 1141.

Legislative history supports the conclusion that § 363(o) only applies to § 363 sales. A version of § 363(o) was initially proposed in 2001. At the time, the proposed amendment to § 363 provided as follows:

> Notwithstanding subsection (f), the sale by a trustee or transfer *under a plan of reorganization* of any interest in a consumer credit transaction ... is subject to all claims and defenses [that] the consumer could assert against the debtor.[7]

Significantly, the original draft language of § 363(o) clearly provided that it applied to both § 363 sales and sales pursuant to a plan. The proposed language was amended, however, to read as follows:

> Notwithstanding subsection (f), if a person purchases any interest in [certain consumer credit obligations], and that interest *is purchased through a sale under this section*....[8]

This revised language significantly altered the earlier draft by deleting the reference to plan sales, thus explicitly providing that the protections of § 363(o) would only apply to § 363 sales. The legislative history confirms that Congress made a conscious decision to narrow the application of § 363(o) protections to § 363 sales. This decision makes sense, given the heightened standards required to obtain confirmation of a chapter 11 plan. For a § 363 sale to be approved, the debtor only needs to show that the proposed sale satisfies the business-judgment rule by selecting the highest or best bid for the assets.

In contrast, for a plan to be approved, the debtor must embark on a process that includes satisfying broad noticing requirements, drafting a disclosure statement that must be approved by the bankruptcy court, obtaining sufficient votes to accept the plan, and satisfying § 1129's confirmation standards. Because approval of a sale pursuant to a plan will necessarily be subject to heightened approval standards, providing additional safeguards and protections for parties-in-interest, it is logical for Congress to have intended to apply different rules for plan sales that enable debtors and purchasers to obtain relief not otherwise available in a § 363 sale. As demonstrated by the CCC in *Ditech*, consumer borrowers can (with the assistance of able counsel to an official committee representing their interests) defend their interests in the context of plan confirmation.

The Interaction Between § 363(o) and the Best-Interests-of-Creditors Test

In *Ditech*, the CCC presented the alternative argument that even if the debtors could rely on §§ 1123 and 1141 to effectuate a free-and-clear sale of their assets, § 363(o) must be considered when determining whether the plan satisfies § 1129(a)(7)(A)(ii) (also known as the best-interests-of-creditors test). Judge Garrity agreed.

Section 1129(a)(7)(A)(ii) provides that for a plan to be confirmed, it must be shown that each holder of a claim or interest has accepted the plan or will receive "not less than the amount such holder would receive or retain if the debtor were liquidated under chapter 7." In *Ditech*, the second amended plan provided that holders of allowed consumer borrower claims and defenses would receive their *pro rata* share of a $5 million fund, which the debtors maintained satisfied the best-interests-of-creditors test.

The CCC argued that in a hypothetical chapter 7 liquidation, the debtors would sell their assets, potentially piecemeal, pursuant to § 363 (because they could not rely on §§ 1123 or 1141 in a chapter 7 liquidation). Such a sale would be subject to § 363(o), meaning that in a hypothetical chapter 7 liquidation, consumer borrowers would retain certain claims and defenses against the purchaser of the assets. According to the CCC, for the debtors to satisfy the best-interests-of-creditors test, they would have had to have shown that the claims and defenses retained by the consumer borrowers against a hypothetical purchaser of assets in a chapter 7 liquidation would not yield a higher recovery than the $5 million distribution contemplated by the second amended plan.

In their initial liquidation analysis, the debtors assumed a sale of the debtors' assets in a chapter 7 liquidation. At

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5 *Objection of the Official Committee of Consumer Creditors to the Debtors' Amended Joint Chapter 11 Plan and Sale of the Debtors' Forward and Reverse Businesses* [ECF No. 943, ¶ 6].

6 11 U.S.C. § 1141(c) ("[A]fter confirmation of a plan, the property dealt with by the plan is free and clear of all claims and interests of creditors.").

7 147 Cong. Rec. S. 420 (March 8, 2001) (emphasis added; statement of presiding officer).

8 Before this language was enacted, it was revised again to further clarify that it only applied to § 363 sales by adding the following language to the end of the provision: "had such interest been purchased at a sale *not under this section*." (emphasis added). This language is from § 363(o) as it was enacted.

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oral argument, however, the debtors clarified that a sale of assets in a chapter 7 case is "highly speculative and uncertain,"[9] because no purchaser would be willing to purchase the debtors' assets without a comprehensive free-and-clear sale order.[10] Judge Garrity held the debtors to their liquidation analysis, however, notwithstanding argument to the contrary.

Because the debtors believed that no chapter 7 sale would occur, they did not ascribe any value to consumer borrower claims and defenses retained against hypothetical asset-purchasers. Therefore, the debtors were unable to establish at the confirmation trial that consumer creditors fared better under the second amended plan than in a chapter 7 liquidation.[11] While the $5 million fund made available to holders of consumer borrower claims and defenses might have been sufficient to satisfy the best-interests-of-creditors test, Judge Garrity could not make such a finding upon the evidence presented by the debtors.[12]

9 Decision at 106.

10 Government-sponsored enterprises also maintained that the proposed sales could not be consummated in a chapter 7 liquidation. *See, e.g., Transcript Regarding Confirmation Hearing Held on 8/8/2019* [ECF No. 1155]167: 2-14 (counsel to Fannie Mae arguing that "if this case converts to chapter 7, Fannie Mae will exercise every one of its rights to terminate its contracts. It will not sit around in chapter 7 and allow — or have a trustee service its loans").

11 Decision at 105 ("In a liquidation under chapter 7 the holders, Consumer Creditors would retain their claims and defenses pursuant to section 363(o). The Liquidation Analysis did not account for these Consumer Claims, but should have.... As such, the Debtors have failed to satisfy the 'best interests' test of section 1129(a)(7).").

12 *Id.* at 114 ("[The debtors' expert] did not evaluate the merits of any Consumer Creditor Claims and ... his report does not purport to be a valuation of Consumer Claims.").

The debtors also argued that even if a sale were consummated in a chapter 7 case, a consumer borrower's claim against a hypothetical chapter 7 purchaser is not a claim against the debtor that should be taken into account for purposes of the best-interests-of-creditors test. Indeed, § 1129(a)(7)(A)(ii) specifically provides that "each holder of a *claim* … will receive … on account of such *claim* … not less than the amount such holder would receive or retain if the debtor were liquidated under chapter 7."

A claim in bankruptcy is one that can be asserted against the debtor, not against nondebtor third parties (like a hypothetical chapter 7 asset-purchaser). Nonetheless, Judge Garrity viewed pre-petition consumer claims against a chapter 7 purchaser as derivative of claims against the debtor, and therefore "claims" for purposes of § 1129.

Judge Garrity's decision confirmed the availability of a significant tool in bankruptcy: Plan proponents *may* pursue a free-and-clear plan sale pursuant to §§ 1123 and 1141 without having to rely on § 363 (and its limitations). As Judge Garrity made clear, however, debtors pursuing a plan sale should carefully consider the effect of § 363's provisions in a hypothetical chapter 7 case to ensure that their proposed plan complies with the best-interests-of-creditors test. abi