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Improved T&C

May Avoid Lender-on-Lender Violence

By Jennifer Selendy, Max Siegel and Samuel Kwak

Serta, Boardriders, TriMark, and *TPC Group*. These are recent examples where a group of lenders struck a deal with a distressed borrower to benefit themselves to the detriment of other lenders in the same priority class. This so-called "lender-on-lender violence" transaction used to happen mostly in the context of an in-court restructuring process. This aggressive deal structure, however, has been increasingly utilized in the context of out-of-court restructurings.

Common structures of a "lender-on-lender violence" transaction include priming, uptiering, and financing through an unrestricted subsidiary. A "priming" transaction usually involves a borrower issuing a new debt that is secured by the same collateral as but is more senior to an existing debt. An "uptiering" transaction usually involves an incremental financing by the majority of lenders in the most senior class on a super-priority basis and an exchange of an existing debt held by

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Key Issues After *Siegel* Ruling

By Steven B. Smith and Rachel Ginzburg

In *Siegel v. Fitzgerald, 142 S.Ct. 1770 (2022)*, the U.S. Supreme Court decided an important case for bankruptcies, holding unanimously that a significant increase in United States Trustee quarterly fees was unconstitutional because it did not apply to debtors in non-UST districts, and thus violated the uniformity requirement of the Bankruptcy Clause in the Constitution. This article discusses the background of the UST Program, the legislative history leading up to Congress' enactment of the Bankruptcy Judgeship Act of 2017 (2017 Act), the parties' arguments for and against the constitutionality of the 2017 Act and the Court's reasoning for its decision, and the effect of the parties' proposed remedies following the Court's decision.

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UST & Bankruptcy Administrator Programs

The UST program began as a pilot in 1978 and, eight years later, Congress expanded the program nationwide except for the six judicial districts in North Carolina and Alabama. Those two states resisted joining the UST Program and were permitted to continue to use judicially appointed "bankruptcy administrators" — the BA Program — which they continue to use.

The UST Program and the BA Program handle the same administrative functions with one critical difference: the UST Program is funded by user fees paid by chapter 11 debtors, while the BA Program is funded by the judiciary's budget. Initially, Congress did not require debtors in the BA Program districts to pay user fees, but after the Ninth Circuit held that system unconstitutional in *St. Angelo v. Victoria Farms, Inc.*, 38 F.3d 1525 (1994), Congress amended the statute governing the Judicial Conference of the United States, the national policymaking body for the federal courts, to provide that it "*may*" require debtors in BA Program districts to pay fees equal to those paid by debtors in UST Program districts. After that amendment, debtors in the UST Program and the BA Program were charged uniform fees, but that changed with the enactment of the Bankruptcy Judgeship Act of 2017.

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In the mid-2010s, the balance in the UST Fund balance had fallen, requiring supplemental use of taxpayer funds. To eliminate that use of taxpayer funds Congress enacted the 2017 Act to temporarily increase the quarterly fee rates applicable to large chapter 11 cases filed between 2018 and 2022. The increase was significant — the maximum quarterly fee increased from $30,000 to $250,000. However, while the fees were mandatory in UST Program districts, they were not mandatory in the BA Program districts, leading to two differences between the programs: (1) The UST Program fee increase took effect as of January 1, 2018, whereas the BA Program fee increase took effect nine months later on October 1, 2018; and (2) the UST Program fee increase applied to all pending and newly filed cases, while the BA Program fee increase applied only to newly filed cases. In 2021, Congress once again amended the statute to address the inconsistency by replacing "may" — require BA Program debtors to pay the same fees as UST Program debtors — with "shall" require.

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Circuit City Bankruptcy Quarterly Fee Dispute

In 2008, Circuit City filed a chapter 11 petition in the Eastern District of Virginia, a UST Program district; the case was pending when the 2017 Act fee increases took effect in January 2018. In the first three quarters of 2018, the Circuit City trustee, Alfred H. Siegel, paid $632,542 in quarterly fees. Had Circuit City filed in a BA Program district, the trustee would have paid just $56,400. The Circuit City trustee objected to the quarterly fee increase as violating the Constitution's Bankruptcy Clause because they were nonuniform across UST Program districts and BA Program districts. Bankruptcy court Judge Kevin R. Huennekens ruled in favor of Circuit City, holding that that the statute was unconstitutional due to its lack of uniformity respecting cases

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pending prior to October of 2018.

The bankruptcy court decision was appealed directly to the Fourth Circuit, which, in a 2-1 split decision, reversed and remanded, ruling in favor of the UST. The Fourth Circuit interpreted the Bankruptcy Clause as forbidding only "arbitrary" geographic differences and ruled that the 2017 Act was enacted to address a program-specific distinction that only directly had a geographic impact. In other words, the Fourth Circuit held that although the 2017 Act may render it more expensive for some debtors in Virginia — as opposed to North Carolina or Alabama — to go through Chapter 11, the 2017 Act did not draw an arbitrary distinction based on the residence of the debtors or creditors; instead, the distinction was simply a byproduct of Virginia's use of the BA Program. Judge Quattlebaum authored a spirited dissent in which he concluded that the 2017 Act was not uniform and Congress' decision to allow BA Program districts to operate in the first place was arbitrary.

Supreme Court Decision

The Fourth Circuit was not the only circuit to consider this issue. The Fifth Circuit and the Eleventh Circuit (in *Hobbs v. Buffets, L.L.C.* (*In re Buffets, L.L.C.*), 979 F.3d 366 (5th Cir. 2020) and *United States Tr. Region 21 v. Bast Amron LLP* (*In re Mosaic Mgmt. Grp.*), 22 F.4th 1291 (11th Cir. 2022), respectively) found that the 2017 Act was constitutional. But the Second Circuit and the Tenth Circuit (in *In re Clinton Nurseries, Inc.*, 998 F.3d 56 (2d Cir. 2021) and *John Q. Hammons Fall 2006, LLC v. Office of the U.S. Tr. (In re John Q. Hammons Fall 2006, LLC)*, 15 F.4th 1011 (10th Cir. 2021), respectively) found that the 2017 Act was unconstitutional. The Supreme Court granted *certiorari* to resolve the split and considered three issues: (i) whether the 2017 Act was subject to the Bankruptcy Clause's uniformity requirement; (ii) whether the 2017 Act was a permissible exercise of the Bankruptcy Clause; and (iii) whether Congress permissibly imposed nonuniform fees because it was responding to a funding deficit limited to the UST Program districts.

2017 Act was subject to the Bankruptcy Clauses' uniformity requirement

The Bankruptcy Clause empowers Congress to establish ***uniform*** laws on the subject of bankruptcies throughout the United States. The UST argued that the Bankruptcy Clause only extends to laws that "alter the substance of debtor-creditor relations," and thus it did not apply to the 2017 Act, which was a law meant to help administer substantive bankruptcy law. But the Supreme Court disagreed, finding no language in the Bankruptcy Clause to support any distinction between substantive and administrative laws; it noted that the language in the Bankruptcy Clause is broad, granting plenary power to Congress over the whole subject of bankruptcies. The Court further reasoned that the 2017 Act amended a statute titled "Bankruptcy fees", observing that the provision's effect is to set fees that must be paid by a debtor's estate in a bankruptcy proceeding, leading it to conclude that the 2017 Act does affect the "substance of debtor-creditor relations" because increasing mandatory fees paid from a debtor's estate decreases the funds available for distribution to creditors. The Supreme Court distinguished the 2017 Act from laws that allow for "local variation" by allowing districts to establish their own procedures for certain bankruptcy matters, including fees, based on local needs and conditions. Unlike laws allowing for local determination of governing rules, in the 2017 Act, "Congress exempted debtors in only 2 states from a fee increase that applied to debtors in 48 states, without identifying any material difference between debtors across those states." Accordingly, the Supreme Court found that the 2017 Act fell within the ambit of the Bankruptcy Clause's uniformity requirement.

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2017 Act was not a permissible exercise of the Bankruptcy Clause

The Supreme Court had addressed the uniformity requirement three times before Siegel, but it had been more than 40 years since the last decision. In *Hanover National Bank v. Moyses*, 186 U.S. 181, 22 S.Ct. 857, 46 L.Ed. 1113 (1902), the Court held that the Bankruptcy Clause's uniformity principle does not require Congress to eliminate existing state exemptions in bankruptcy laws, explaining that the "general operation of the law is uniform although it may result in certain particulars differently in different States." In *Blanchette v. Connecticut General Insurance Corporations*, 419 U.S. 102, 95 S.Ct. 335, 42 L.Ed.2d 320 (1974), the Court found that the Regional Rail Reorganization Act, which applied only to rail carriers operating within a specific region of the country, "operated uniformly upon all bankrupt railroads then operating in the United States," and was thus consistent with the uniformity principle. The Court noted that the Bankruptcy Clause "does not deny Congress power to take into account differences that exist between different parts of the country, and to fashion legislation to resolve geographically isolated problems." Finally, in *Railway Labor Executives' Assn v. Gibbons*, 455 U.S. 457, 102 S.Ct. 1169, 71 L.Ed.2d 335 (1982), the Supreme Court struck down the Rock Island Railroad Transition and Employee Assistance Act (RITA), which altered the order of priority of claimants in a single railroad's bankruptcy proceedings, finding that it "singled out one railroad and did not apply to other similarly situated railroads that were engaged in bankruptcy proceedings." The Court found that RITA was "not a response either to the particular problems of major railroad bankruptcies or to any geographically isolated problem: it [was] a response to the problems caused by the bankruptcy of one railroad." The Court further found that, under the Bankruptcy Clause, a law must "at least apply uniformly to a defined class of debtors." Based on the foregoing, the Supreme Court concluded that its precedent "provides that the Bankruptcy Clause offers Congress flexibility, but does not permit the arbitrary, disparate treatment of similarly situated debtors based on geography."

Congress' attempt to impose nonuniform fees was not permitted

The 2017 Act's fee increase was indisputably not geographically uniform because debtors in Alabama and North Carolina paid no fee increases for the first three quarters of 2018, and because the fee increase only applied to newly filed cases, and not pending cases, in those two states. Because of that "geographical disparity," the Circuit City trustee paid more than $500,000 in fees which was substantially more than an identical debtor in North Carolina or Alabama would have paid. The UST argued that the disparities were permissible and justified because the 2017 Act was meant to solve a particular geographic problem: the shortfall in the UST Fund. But the Court pointed out that the shortfall only existed because Congress had "arbitrarily separated the districts into two different systems with different cost funding mechanisms, requiring [the UST] Program districts to fund the Program through user fees while enabling [BA] Program districts to draw on taxpayer funds by way of the Judiciary's general budget." For that reason, the 2017 Act was in stark contrast to the Regional Rail Reorganization Act of 1973, which was a response to a crisis that arose when eight major railroads located in the Northeast and the Midwest entered reorganization proceedings. The Supreme Court held that the Bankruptcy Clause's uniformity requirement prohibits Congress from arbitrarily burdening only one set of debtors with a more onerous funding mechanism than that which applies to debtors in other States but, at the same time, made clear that the decision should not be understood to impair Congress' authority to structure relief differently for different classes of debtors or to respond to geographically isolated problems.

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After *Siegel*

Two key issues arise in the wake of the Siegel opinion: (i) will the dual UST/BA scheme survive, and (ii) what is the appropriate remedy for debtors who paid quarterly fees now found to be unconstitutional? The Circuit City trustee argued that, although unnecessary to the disposition, the constitutional defects in the 2017 Act could be addressed by striking down the UST/BA system itself. The Supreme Court declined to do so but the opinion may cast doubt on the validity of having separate BA and UST districts in different parts of the county which could also prompt litigation.

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The Supreme Court did not opine on the appropriate remedy, noting that the parties raised a "host of legal and administrative concerns" with the potential remedies proposed, including "the practicality, feasibility, and equities of each proposal; their costs; and potential waivers by nonobjecting debtors." The Court stated that the court below had not yet had an opportunity to address these issues and remanded to the Fourth Circuit to consider these questions in the first instance. In the interim, we are left to speculate considering the three remedy proposals discussed during oral argument: (i) the refund alternative, (ii) the retroactive payments alternative, and (iii) the "do-nothing" approach. Each has its own set of issues.

First, refunding the higher fees paid by UST district debtors is the path the Second and Tenth Circuits took in their 2021 rulings, which *Siegel* leaves undisturbed and which opens the door to further refund actions nationwide. Issuing refunds, however, would require a significant administrative undertaking to figure out how much each debtor is owed, and it is unclear whether debtors or the UST's office would bear the cost of that undertaking. And query how the UST would respond to requests to disgorge hundreds of millions of dollars in fees when the 2017 Act was meant to address the UST Fund deficit. Would Congress be forced to enact an even larger fee increase across all districts? Second, the UST's suggestion to have BA district debtors retroactively pay the higher fees would potentially require reopening years-old cases and charging debtors money that may have already been distributed to creditors or otherwise spent. And some of those BA district debtors may no longer even exist. Third, a "do-nothing" approach contains a constitutional flaw in that debtors would be left with claims for damages with no recourse to resolve those claims. With no guidance from the Supreme Court, all eyes now turn to the bankruptcy court, who received the case from the Fourth Circuit, as we await its determination of the appropriate remedy. The existence of a circuit level split respecting remedies, however, could mean *Siegel* finds its way back to the hallowed halls of the Supreme Court. ¤

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