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Fifth Circuit Protects Secured Creditor and Holds that Receipt of Notice is not "Participation" Required to Extinguish Lien through Plan Confirmation

It should be common knowledge that a secured creditor, having received proper notice in a Chapter 11 bankruptcy case, faces the risk that its lien will be extinguished if it fails to object to a reorganization plan that does not specifically preserve the lien. Apparently, however, not all secured lenders realize this risk, and some fall prey to a trap for the unwary in §1141(c) of the Bankruptcy Code by failing to protect their liens and place their collateral at risk. Thus, secured lenders should take reasonable precautions to protect their collateral by ensuring that any reorganization plan specifically provides for retention of their liens.

In a recently-reported Chapter 11 bankruptcy case, a properly-noticed secured lender placed its collateral at risk by failing to take reasonable precautions. *Acceptance Loan Co. v. S. White Transp., Inc. (In re: S. White Transp., Inc.)*, --- F.3d ----, 2013 WL 3983343 (5th Cir. Aug. 5, 2013). In fact, prior to plan confirmation, the secured lender ignored the notice it received and had no active involvement in the bankruptcy case at all. After the debtor filed and confirmed a plan of reorganization that failed to preserve the secured lender's lien, the secured lender woke up and argued that its lien survived despite not being specifically preserved by the plan. The United States Court of Appeals for the Fifth Circuit agreed, and held that confirmation of such a plan cannot extinguish a lien unless, among other things, the secured creditor has done "more" in the bankruptcy case than merely receive notice.

In the face of this decision, a secured lender that receives notice of a bankruptcy filing and reorganization plan may believe its lien will remain intact so long as it remains fairly inactive in the bankruptcy case, or it may be tempted to ignore the case altogether. However, such actions would not be prudent because it is not yet known how much, or what type of, involvement is sufficient for lien avoidance or whether the Fifth Circuit's "more-than-notice" rule will be widely adopted by other courts. Accordingly, secured lenders should monitor their borrowers' bankruptcy filings and object to the confirmation of a plan that fails to provide for retention of the lien. It is a simple objection and avoids the possibility, however slight, that the lien will be extinguished.

Background

In the Chapter 11 case of debtor S. White Transportation (the "Debtor") in the Southern District of Mississippi, secured creditor Acceptance Loan Company (the "Creditor") received notice of the bankruptcy but did not file a proof of claim or take other action in the case. The Debtor submitted its plan of reorganization to the Bankruptcy Court and served a copy on the Creditor. The plan stated that the Debtor disputed the validity of the Creditor's lien, the Creditor had not filed a proof of claim, and no payment would be made on the Creditor's claim. Further, the plan did not specifically preserve the Creditor's lien. The Creditor received notice of the plan confirmation hearing. Since no creditors voted against the plan or objected to confirmation, the plan was confirmed.

After confirmation, the Creditor asked the Bankruptcy Court to declare that its lien had survived the confirmation or, in the alternative, to amend the plan to preserve the lien. Citing 11 U.S.C. §1141(c), the

Court denied the Creditor's requests and held that the lien was extinguished through confirmation. Section §1141(c) provides that, "except as otherwise provided in the plan or in the order confirming the plan," property dealt with by a confirmed Chapter 11 reorganization plan is "free and clear of all claims and interests." The Fifth Circuit previously had held that §1141(c) voids liens only if, among other things, the secured creditor had "participated" in the reorganization and the lien was not specifically preserved in the plan. *Elixir Indus., Inc. v. City Bank & Trust Co. (In re Ahern Enters., Inc.)*, 507 F.3d 817, 822 (5th Cir. 2007). *Accord In re Penrod,* 50 F.3d 459, 463 (7th Cir. 1995). In *Ahern*, the Fifth Circuit explained that the purpose of the participation requirement was to ensure that the secured creditor "had notice of the plan and its potential effect on the creditor's lien." The Bankruptcy Court found that the Creditor had received notice throughout the case, including notice of the plan, and such notice was sufficient to satisfy the requirements of due process and to constitute "participation" within the meaning of the *Ahern* test.

The Creditor appealed the Bankruptcy Court's order to the District Court, which reversed on the basis that "[s]omething more" than notice is required to satisfy the participation requirement. The Debtor appealed the District Court's order to the Fifth Circuit.

The Fifth Circuit's Analysis

The Fifth Circuit affirmed the order of the District Court. According to the Fifth Circuit, "passive receipt of notice" does not constitute "participation" within the meaning of the *Ahern* test. The Court noted that the word participation "connotes activity, and not mere nonfeasance." The Court also stated that the Seventh and Eighth Circuits had "required more than notice" in similar scenarios, and that it had been unable to locate any decisions extinguishing the lien of a creditor who had no involvement with the bankruptcy case other than receiving notice.

Observations

- The Fifth Circuit held that something more "than mere passive receipt of effective notice" is required to meet the participation requirement. It is not clear how much, or what type of, participation would be sufficient. The Seventh Circuit has held that filing a proof of claim constitutes sufficient participation. Query whether filing a notice of appearance or attending a meeting of creditors would be adequate. Until there is additional guidance as to the level of participation that is necessary to invoke the risks in §1141(c), the most prudent course is to review any plan filed by a borrower, object to a plan that does not specifically preserve the lien and appeal any order confirming such a plan. This course of action prevents confusion regarding the existence of the lien and eliminates the need to litigate over the participation requirement after the fact.

- The Fifth Circuit and other circuit courts have grafted the participation requirement onto a statute that says nothing whatsoever about participation. However, the United States Supreme Court has repeatedly emphasized that the plain meaning of a statute should control its interpretation. *See, e.g., United States v. Ron Pair Enters*., 489 U.S. 235, 241 (1989). Under the plain meaning of §1141(c), the secured lender's active participation in the case is not required, and the Fifth Circuit acknowledged as much when it noted in *Ahern* that the participation requirement is a "judicial gloss" on §1141(c). Of course, a lienholder has rights under the Due Process Clause of the Fifth Amendment of the United States Constitution, and therefore is entitled to notice of the plan as well as an opportunity to object to its confirmation. Accordingly, there is a significant risk that, unlike the Fifth Circuit, another circuit court or the United States Supreme Court would conclude that constitutionally-sufficient notice is enough to extinguish the lien.

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