



Procedural Due Process Requirements in Bankruptcy Cases

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Introduction

The Fifth Amendment¹ of the United States Constitution guarantees that an individual will not be deprived “of life, liberty, or property without due process of law.” In the context of bankruptcy, procedural due process requirements are especially important because although bankruptcy tries to ensure that rights that exist outside of bankruptcy are maintained in bankruptcy, title 11 of the United States Code (the “Bankruptcy Code”) or other federal laws may require a different result.² Given that the rights of an individual can be altered in bankruptcy proceedings, the adequacy of notice of the bankruptcy proceeding is of great importance. However, courts have had to grapple with determining the extent that procedural due process applies, including whether procedural due process requirements apply at all.

In *In re Motors Liquidation Company*,³ the Bankruptcy Court of the Southern District of New York evaluated competing claims about whether procedural due process requirements applied and, if so, whether a showing of prejudice was needed in order to show that procedural

1 U.S. Const. amend. V.

2 See *Butner v. United States*, 440 U.S. 48, 55 (“Property interests are created and defined by state law. Unless some federal interest requires a different result, there is no reason why such interests should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding.”).

3 *In re Motors Liquidation Co.*, 529 B.R. 510 (Bankr. S.D.N.Y. 2015).

due process rights had been violated. The court looked to the Supreme Court's landmark procedural due process case *Mullane v. Central Hanover Bank & Trust Corporation*⁴ which, although not a bankruptcy case, defined procedural due process requirements and enunciated principles of general application. However, the *Motors Liquidation* court acknowledged that although there are requirements to be met for procedural due process to be satisfied, the standard is still a flexible one dependent upon on the facts and circumstances of every case.⁵

Part I of this article details the *Mullane* court's understanding of procedural due process rights and requirements in a general sense. Part II discusses the application of *Mullane*'s principles in the bankruptcy context by the *Motors Liquidation* court as well as other federal courts. Part III explores the current state of the law regarding procedural due process requirements and its interaction with various provisions of the Bankruptcy Code. This article concludes that a court's determination of whether procedural due process requirements have been met depends largely on the exigency of the circumstances and the practicality of actual notice to interested parties.

II. *Mullane* and Constitutional Procedural Due Process Requirements.

In *Mullane*, the Supreme Court evaluated the adequacy of notice given to trust holders whose trusts were compiled into common trusts under New York law.⁶ These common trusts were set up under the theory that small or moderate size trusts would be undesirable for large corporate entities to administer, so the trusts were allowed by law to be compiled together to make one larger trust for investment administration.⁷ Income, capital gains and losses would all be shared proportionally among the common trust constituents.

⁴ 339 U.S. 306 (1950).

⁵ See *Motors Liquidation*, 529 B.R. at 546.

⁶ *Mullane*, 339 U.S. at 309.

⁷ *Id.*

Central Hanover Bank established a common trust by combining 113 trusts and naming itself as the common trustee.⁸ While the number of beneficiaries, or their residences, was not known, at the very least some of them were not New York residents.⁹ Notice of the bank's actions was given by publication in a local newspaper, the bare minimum required under New York law.¹⁰ Only later, after the first investment had been made, was actual notice provided to trust fund beneficiaries that the bank was aware of.¹¹ The appellant, a beneficiary, appeared and objected that the notice given was inadequate under the Fourteenth Amendment.¹² The objections to notice were overruled.¹³ A final decree was entered by the Supreme Court, New York County, which was affirmed by the Appellate Division, First Department, and the New York Court of Appeals.¹⁴

In reversing the judgment, the Supreme Court outlined the basics of procedural due process. An elementary and fundamental element of procedural due process was “notice reasonably calculated, under all the circumstances, to apprise interested parties of the pendency of the action and afford them an opportunity to present their objections.”¹⁵ Notice also had to convey required information and “afford a reasonable time for those interested to make their appearance.”¹⁶

Importantly, the mere gesture of giving notice is not enough if the form of notice given is not likely to actually inform an individual of the pendency of the proceedings.¹⁷ A person needs

⁸ *Id.*

⁹ *Id.*

¹⁰ *Id.* at 309-10.

¹¹ *Id.* at 310.

¹² *Id.* at 311.

¹³ *Id.*

¹⁴ *Id.*

¹⁵ *Id.* at 314.

¹⁶ *Id.*

¹⁷ *See id.* at 315.

sufficient information to choose to “appear or default, acquiesce, or contest.”¹⁸ Notice did not have to be perfect, but appropriate under the circumstances of the case.¹⁹ As long as an individual interest was represented in some capacity, that may be enough.²⁰

III. Application of Mullane in Bankruptcy Proceedings.

Mullane established the principle of a case-by-case analysis of the adequacy of notice. In applying *Mullane*, courts have had to determine whether or not the facts and circumstances of a given case have justified the use and specificity of the notice given or lack thereof.²¹ A clear pattern that has emerged, however, is that both procedural due process and statutory due process requirements must be met in order to enforce a sale order or confirmation plan.²²

A. In re Motors Liquidation Company.

In *In re Motors Liquidation Company*, several classes of plaintiffs sued General Motors (“GM”) for personal injuries and property damage sustained due to an ignition switch defect in their vehicles that GM knew about as far back as 2003.²³ On June 1, 2009, GM filed for chapter

¹⁸ *Id.* at 314.

¹⁹ *See id.* at 314-15.

²⁰ *See id.* at 319. The *Mullane* court stated:

The individual interest does not stand alone but is identical with that of a class. The rights of each in the integrity of the fund and the fidelity of the trustee are shared by many other beneficiaries. Therefore notice reasonably certain to reach most of those interested in objecting is likely to safeguard the interests of all, since any objection sustained would inure to the benefit of all. We think that under such circumstances reasonable risks that notice might not actually reach every beneficiary are justifiable.

²¹ *See, e.g., In re Drexel Burnham Lambert Grp.*, 995 F.2d 1138 (2d Cir. 1993) (“Notice may satisfy due process without setting forth verbatim the full text of a proposed settlement; it may describe the settlement in general terms.”); *In re Polycel Liquidation, Inc.*, No. 00-62780 (RTL), 2006 Bankr. LEXIS 4545, at *23-26 (Bankr. D.N.J. Apr. 18, 2006) (“And while it is undisputed that Pool Builders learned of the bankruptcy proceedings from another supplier prior to the execution of the sale, this is not sufficient knowledge to satisfy the due process requirements.”); *Fogel v. Zell*, 221 F.3d 955, 962 (7th Cir. 2000) (“Denver was not served with that notice, and there is no indication that it knew about it, which means that Denver would not have known how to compute the bar date--and so was entitled to notice of that date.”).

²² *See, e.g., Miller v. Cappuccilli (In re Cappuccilli)*, 193 B.R. 483 (Bankr. N.D. Ill. 1996) (vacating a default judgment against a debtor on procedural due process grounds due to ineffective service of process).

²³ 529 B.R. at 521-22, 528.

11 bankruptcy due to a steep decline in revenues, operating losses, and decreased liquidity.²⁴ When GM filed for bankruptcy protection, at least 24 then GM employees knew about the ignition switch defect.²⁵

Given the fact that the Treasury Department gave GM only 60 days to come up with a viable plan to ensure GM's survival, GM sought to sell its assets in a section 363 sale to an entity that would later become the new GM.²⁶ After hearing objections to the section 363 sale and its free and clear provision,²⁷ GM's bankruptcy was resolved on July 10, 2009, creating the new GM.²⁸ Plaintiffs only received notice of the hearings by publication.²⁹ It was not until the spring of 2014 that GM finally acknowledged the ignition switch issue and recalled vehicles with the ignition switch defect.³⁰

After publicly announcing the ignition switch defect in March 2014,³¹ several class action lawsuits asserting successor liability claims were brought against GM.³² In response to the class action lawsuits, GM sought to enforce the free and clear³³ provision of the 363 sale order.³⁴ Plaintiffs countered by alleging that their procedural due process rights were violated.³⁵ GM responded by asserting that procedural due process requirements did not apply because there was no deprivation of property.³⁶ The bankruptcy court disagreed with GM and

²⁴ *Id.* at 529-30.

²⁵ *Id.* at 525.

²⁶ *Id.* at 530-31.

²⁷ *Id.* at 531-32.

²⁸ *Id.* at 534.

²⁹ *Id.* at 535.

³⁰ *Id.* at 538.

³¹ *Id.* at 521.

³² *Id.* at 539.

³³ *See* 11 U.S.C. 363(f)

³⁴ *Motors Liquidation*, 529 B.R at 538-39.

³⁵ *Id.* at 539.

³⁶ *Id.* at 550.

held that procedural due process requirements do apply, and examined whether those requirements were met.³⁷

In regards to the accident victims whom GM was unaware of, the court found that notice by publication was proper because actual notice to either the 27 million people with some defect requiring a recall then or in the future, or the 70 million owners of all GM vehicles, would have been impractical given the dire financial situation GM found itself in.³⁸ However, notice by publication for the plaintiffs in the *Motors Liquidation* case was held to be insufficient, because GM was aware of the ignition switch defect and knew that those vehicle owners would qualify as known claim holders.³⁹

However, the mere fact that actual notice was due to the plaintiffs was not enough to establish a violation of the plaintiffs' procedural due process rights, as the plaintiffs also had to show that they suffered prejudice as a result of the lack of actual notice.⁴⁰ The bankruptcy court found that most classes of plaintiffs suffered no prejudice, because the arguments plaintiffs were making had previously been considered and rejected during GM's bankruptcy, provided no basis to reconsider any prior rulings, and called for speculation as to political factors.⁴¹ In fact, the bankruptcy court found that *Mullane* expressly stated that the presentation of an argument by one among many with a shared interest, as had happened in *Motors Liquidation*,⁴² could protect the

³⁷ See *id.* at 555.

³⁸ See *id.* at 556.

³⁹ See *id.* at 560.

⁴⁰ See *id.* at 560-565.

⁴¹ See *id.* at 526, 573.

⁴² *Id.* at 566.

interests of all.⁴³ Ultimately, only one class of plaintiffs, the “Economic Loss” class, was prejudiced in a way that allowed the court to provide some relief.⁴⁴

B. *Western Auto Supply Company v. Savage Arms (In re Savage Industries)*.

In *Western Auto Supply Company v. Savage Arms (In re Savage Industries)*,⁴⁵ a firearms manufacturer had declared bankruptcy, and attempted to sell its assets to a newly incorporated corporation.⁴⁶ In approving the asset transfer, the bankruptcy court “prescribed safeguards for interests held by objecting creditors,” but did not “require[] court approval of the asset-transfer terms” negotiated or “[make] provision[s] for the interests of holders of contingent product liability claims” against the firearm manufacturer.⁴⁷ The asset transfer went through, and the new corporation continued manufacturing the same firearms.⁴⁸ A consumer that was injured by a firearm prior to the bankruptcy sued the retailer that sold it, who in turn brought a third-party action against the new corporation under a theory of successor liability.⁴⁹ The new corporation sought to enjoin the third-party action based on the disposition of the bankruptcy case.⁵⁰ The bankruptcy court enjoined the action, but was reversed by the district court.⁵¹

In affirming the district court, the First Circuit held that lack of adequate notice to claimants of the chapter 11 proceedings was a violation of their procedural due process rights.⁵² The First Circuit stated that notice was “the cornerstone underpinning Bankruptcy Code procedure” and that it was the responsibility of the debtor-in-possession to ensure that all “parties

⁴³ *See id.* at 543.

⁴⁴ *See id.* at 575. (“The Plaintiffs could have made overbreadth arguments if given appropriate notice before the 363 Sale hearing, and to that extent they were prejudiced. And for that the Plaintiffs should be entitled to remedial relief to the extent the law otherwise permits.”).

⁴⁵ 43 F.3d 714 (1st Cir. 1994).

⁴⁶ *Id.* at 717.

⁴⁷ *Id.*

⁴⁸ *Id.*

⁴⁹ *Id.*

⁵⁰ *Id.* at 718.

⁵¹ *Id.* at 719

⁵² *Id.* at 720.

in interest” had adequate notice and an opportunity to be heard with respect to a proceeding that would be adverse to their interests.⁵³ As no attempt was made in the case to give adequate notice to those whose pecuniary interests were at stake, the claims in the action could not be enjoined.

C. In re Ex-Cel Concrete Company, Inc.

In *In re Ex-Cel Concrete Company, Inc.*,⁵⁴ a couple and the business they owned both filed for chapter 11 bankruptcy.⁵⁵ The business held a secondary lien on the couple’s home.⁵⁶ The primary lien was a mortgage held by Citicorp.⁵⁷ The bankruptcy cases were eventually converted to chapter 7 liquidations, and the trustee of the couple’s estate attempted to sell the couple’s home free and clear of the liens that existed in the business bankruptcy case.⁵⁸ Notice was given to an individual attorney that represented Citicorp in prior bankruptcy cases, but did not represent Citicorp in either the personal or business bankruptcy cases.⁵⁹ Additionally, this attorney was not even in the country at the time notice was given.⁶⁰

Citicorp did not become aware of the hearings or the sale until two weeks after the sale order had been entered.⁶¹ Citicorp filed a motion to set aside the sale, and the court held subsequent hearings on whether the motion should be granted.⁶² The court ultimately denied

⁵³ *Id.* See also 11 U.S.C. 363(b)(1) (“The Trustee, after notice and a hearing, may use, sell, or lease, other than in the ordinary course of business, property of the estate . . .”).

⁵⁴ 178 B.R. 198 (9th Cir. B.A.P. 1995)

⁵⁵ *Id.* at 199-200.

⁵⁶ *Id.*

⁵⁷ *Id.* at 200.

⁵⁸ *Id.*

⁵⁹ *Id.*

⁶⁰ *Id.*

⁶¹ *Id.* at 201.

⁶² *Id.*

Citicorp's motion, holding that notice was sufficient and that the balance of equities favored the purchasers of the home.⁶³

On appeal, the Bankruptcy Appellate Panel found that notice was both constitutionally and statutorily deficient. First, several provisions of the Bankruptcy Code provided that a sale order could only be approved after notice and hearing.⁶⁴ Because the Bankruptcy Code was designed to provide assurances to lien holders that they would receive timely notice prior to any sale, "the trustee failed to pass even the threshold of [the Bankruptcy Code's] requirements."⁶⁵ Second, service of process on an attorney that has represented a party before but was no longer doing so was insufficient to satisfy constitutional procedural due process requirements, even if that lawyer had forwarded the notice to the client.⁶⁶ Accordingly, the Bankruptcy Appellate Panel voided the sale order and remanded the case back to the bankruptcy court for further proceedings.⁶⁷

III. Current State of the Law.

While procedural due process notice requirements are flexible, certain principles are nearly universal and readily applicable. Contrary to GM's assertions in *Motors Liquidation*, procedural due process requirements do apply in bankruptcy cases.⁶⁸ There are pecuniary interests at stake in bankruptcy litigation, and the Fifth Amendment gives stakeholders the right to have an opportunity to be heard and have their interests addressed. Not only does the due

⁶³ *Id.* at 201-02.

⁶⁴ *See* Fed. R. Bankr. P. 6004(a) ("Notice of a proposed use, sale, or lease of property, other than cash collateral, not in the ordinary course of business shall be given pursuant to Rule 2002(a)(2), (c)(1), (i), and (k) and, if applicable, in accordance with § 363(b)(2) of the Code.") *See also* Fed. R. Bankr. P. 6004(c); Fed. R. Bankr. P. 9014 (reasonable notice and opportunity for hearing shall be afforded the party against whom relief is sought. No response is required under this rule unless the court directs otherwise.)

⁶⁵ *Ex-Cel Concrete*, 178 B.R. at 202-03.

⁶⁶ *See id.* at 203-04.

⁶⁷ *Id.* at 205.

⁶⁸ *Motors Liquidation*, 529 B.R. at 550.

process clause mandate this result, but several provisions of the Bankruptcy Code provide that action can only be taken upon notice and hearing.⁶⁹

This notice must be delivered in a manner most likely to reach the potential stakeholder.⁷⁰ It may very well be that actual notice by mail would be impractical under the circumstances.⁷¹ The stakeholders may be so numerous or hold claims of so little value that notice by mail may not be economically feasible.⁷² In those instances, notice by publication may be the most appropriate way to reach those with an interest in the outcome of the litigation.⁷³

Notice must also give the stakeholder adequate information about the proceedings at hand so that the stakeholder can decide to “appear or default, acquiesce, or contest.”⁷⁴ Again, with interests in property at stake, notice that inadequately describes the impending proceedings does not sufficiently inform an individual of what the consequences to their interests can be.

However, the complication comes with *Mullane*’s holding that individuals in a class can make arguments on behalf of the whole class, even if not every member of the class received appropriate notice.⁷⁵ In order to succeed in showing prejudice, the members receiving inadequate notice will have to prove that the bankruptcy court “got it wrong” in some sense, either by other objectors failing to bring case law to the court’s attention, pointing to statutory authority that would have mandated a different result, or suggesting any other way the result would have otherwise been different had they received notice at an appropriate time.⁷⁶ Mere

⁶⁹ *Ex-Cel Concrete*, 178 B.R. at 202-03; *See also* 11 U.S.C. 363(b)(1) (“The trustee, after notice and a hearing, may use, sell, or lease, other than in the ordinary course of business, property of the estate . . .”).

⁷⁰ *Motors Liquidation*, 529 B.R. at 566.

⁷¹ *Fogel*, 221 F. 3d at 962.

⁷² *Id.* at 963.

⁷³ *Id.*

⁷⁴ *Mullane*, 339 U.S. at 314.

⁷⁵ *Id.* at 319.

⁷⁶ *Motors Liquidation*, 529 B.R. at 567.

speculation as to other factors that might have changed things is not enough.⁷⁷ This is a particularly steep hurdle to climb.

Conclusion

Meeting procedural due process requirements can be complicated. Even a bankruptcy as large and complex as GM's could involve circumstances where mass mailings to stakeholders are needed to adequately ensure that those interests can be protected if they so choose. It is also the case that notice given to even one individual, who then appears at a hearing and presents an argument that all others would have made, may be enough to safeguard all from the harms of ineffective or improper notice. That being said, selectively mailing notices also increases the risk that those who are due actual notice by mail may be able to attack orders entered by the courts on the grounds that they received inadequate notice and the results would have been different had they had the opportunity to appear and argue their case. The *Motors Liquidation* case is a clear example of that risk, with certain classes of plaintiffs able to succeed in claiming a violation of their procedural due process rights.⁷⁸ Wisdom would caution the debtor-in-possession to cast the widest net possible in serving notice on potentially interested parties for the sake of protecting any final order entered into by the bankruptcy court.

⁷⁷ *Id.* at 568.

⁷⁸ *Id.* at 570.