FOR PUBLICATION

UNITED STATES BANKRUPTCY COURT
EASTERN DISTRICT OF CALIFORNIA

In re:	
Matheson Flight Extenders, Inc.,	Case No. 22-21148-C-11
Matheson Postal Services, Inc.,	Case No. 22-21149-C-11
Matheson Trucking, Inc.,	Case No. 22-21758-C-11
Substantively Consolidated Debtors.	DCN: NH-132

OPINION SUBORDINATING PUNITIVE DAMAGES

This Chapter 22 adventure includes a ride down the bankruptcy liquidation waterfall. The issue is: can a prior Chapter 11 plan cleanse debt of the taint of punitive damage status in a later case for purposes of distributions pursuant to Bankruptcy Code § 726(a)(4)? The answer is no.

The Plan Administrator under the liquidating Chapter 11 plan for the consolidated cases of Matheson Flight Extenders, Inc. ("MFE"), Matheson Postal Services, Inc. ("MPS"), and Matheson Trucking, Inc. ("MTI"), seeks an order determining that seven claims are mandatorily subordinated to other unsecured claims as having originated in a punitive damages award.

The claimants contend that their treatment in a prior chapter 11 case eliminated punitive damage status.

2015 Chapter 11 Case

Chapter 22 rears its head because MFE used a Chapter 11 case in 2015 to settle a $14 million punitive damages award before post-trial motions were decided. The award imperiled lifeblood contracts with the U.S. Postal Service, threatening collapse of the business.

The judgment was entered February 27, 2015, in U.S. District Court, District of Colorado, in Camara, et al. v. Matheson Flight Extenders, Inc. & Matheson Trucking, Inc., No. 12-CV-03040-CMA-CBS, on a jury verdict for unlawful discrimination practices.

The $14,968,100 Final Judgment in favor of the seven plaintiffs was for back pay and compensatory damages (total $968,000) and punitive damages ($14,000,000).

MFE filed an immediate Chapter 11 case in the District of Nevada to forestall post-trial motions and appeals in Colorado while negotiating a settlement. In re Matheson Flight Extenders, Inc., No. 15-50541-btb (Bankr. D. Nevada 2015) ("MFE Ch. 11").

The ensuing $8,000,000 settlement was baked into a Chapter 11 plan in a deal providing for withdrawal of post-trial motions, no appeal, and dismissal of the civil action with prejudice.

The dollar terms of the settlement were: (1) payment of $328,571 to each of the seven plaintiffs (total $3,000,000) before the effective date of plan; (2) payment by MFE of $714,286 to each plaintiff (total $5,000,000) in 32 equal quarterly installments commencing April 1, 2016; and (3) stipulated judgment against MTI for $2,700,000 for any payment default. The choice of law in the settlement agreement and in Article 7.4 of the Second Amended Plan is Nevada law.

The Second Amended Plan implementing the settlement was confirmed December 28, 2015, and went effective January 19, 2016.

The $3,000,000 paid before the effective date exceeded the cumulative $968,100 back pay and compensatory damage liabilities (with all taxes paid on the back pay), leaving only punitive damages to be paid in the 32 scheduled installments.

MFE timely made 25 of the 32 scheduled installments (78%), amounting to $558,036 of the $714,286 due each plaintiff (total $3,906,252). Each plaintiff was owed $156,250 as of the payment suspension triggered by the new Chapter 11 filings.

<u>2022 Chapter 11 Cases</u>

MFE and MPS filed Chapter 11 cases May 5, 2022. MTI added its case on July 14, 2022. The cases were administratively consolidated and eventually substantively consolidated.

When filed, prospects for enterprise reorganization seemed promising. But, the U.S. Postal Service's recalcitrance and then termination of the Matheson contracts in 2024 spelled doom.

The ensuing Debtors and Creditors' Committee Joint Plan of Liquidation confirmed with a Plan Administrator appointed to liquidate and assemble whatever value can be salvaged from the wreckage for distribution in accordance with the bankruptcy waterfall specified by 11 U.S.C. § 726(a).

The Disclosure Statement in support of the Joint Plan estimated that non-priority unsecured claim holders would receive about 26 percent of the allowed claims under the Bankruptcy Code's distribution scheme.

The Joint Plan was confirmed with a finding under the "best interest" test that each holder of an unsecured claim would receive not less than the value, as of the plan effective date, that such holder would receive if the debtor were liquidated under chapter 7 on such date. 11 U.S.C. § 1129(a)(7)(A)(ii).

Chapter 22

Consecutive Chapter 11 cases for the same debtor invite scrutiny for the bona fides of the second case.

While there is no per se prohibition of serial Chapter 11 filings, there must be a good reason for another case. Elmwood Dev. Co. v. Gen'l Electr. Pension Trust (In re Elmwood Dev. Co.), 964 F.2d 508, 511-12 (5th Cir.1992); Fruehauf Corp. v. Jartran Inc. (In re Jartran, Inc.), 886 F.2d 859, 867 (7th Cir. 1989).

Filings made to circumvent the binding effect of § 1141(a) in the prior case or to renege on earlier agreements are vulnerable to dismissal, either for bad faith or as a collateral attack on the first order of confirmation. The analysis of any given situation includes how the two cases are related in time and substance. E.g., Lincoln Nat'l Life Ins. Co. v. Bouy, Hall & Howard & Assocs., 208 B.R. 737, 744 (Bankr. S.D. Ga. 1995).

The Ninth Circuit BAP applies a two-part inquiry to assess whether a chapter 22 case passes scrutiny: (1) the case must not have been filed in bad faith; and (2) there must be unforeseeable and extraordinary changed circumstances that substantially impair performance under the confirmed plan. Caviata Attached Homes, LLC v. U.S. Bank, N.A. (In re Caviata Attached Homes, LLC), 481 B.R. 34, 48-50 n.12 (9th Cir. BAP 2012).

Here, the two MFE cases are fundamentally different in scale, purpose, and circumstance. The first MFE case in 2015 was for the limited purpose of resolving a single judgment against MFE and MTI. The second MFE case in 2022 is part of an enterprise group reorganization effort dictated by changed economic and operating conditions that were not foreseeable in 2015.

In the second case, the debtors did not question the allowability of claims based on the settlement in the first case. There was no intent to circumvent the effect of § 1141. Nor was it foreseen that the new case would collapse into liquidation.

When the second MFE case imploded following the U.S. Postal Service's termination of Matheson contracts, the status of the remaining 2015 debt for purposes of liquidation became relevant for the first time.

The matrix for analysis is the "bankruptcy waterfall" necessitating making precise distinctions among various debts.

Bankruptcy Waterfall

Congress prescribed the "bankruptcy waterfall" (or "ladder") as the order of distribution in Bankruptcy Code § 726(a).

There are six tiers of distribution for property of the estate:

> (1) § 507 priority claims and expenses (with sub-tiers);
> (2) timely filed allowed unsecured claims + tardily filed claims by creditors without notice or actual knowledge of the case whose proofs of claim arrive in time to permit payment;
> (3) allowed unsecured claims tardily filed;
> (4) allowed claims, whether secured or unsecured for any fine, penalty, or forfeiture, or for multiple, exemplary, or punitive damages, arising before the earlier of the order for relief or the appointment of a trustee, to the extent that such fine, penalty, forfeiture, or damages are not compensation for actual pecuniary loss suffered by the holder of such claim;
> (5) payment of interest at the legal rate from the date of the filing of the petition on any claim paid under tiers (1) through (4); and
> (6) to the debtor.

11 U.S.C. § 726(a).

Distribution must be made in the order Congress prescribed. Payment is pro rata within each tier. 11 U.S.C. § 726(b).

If funds are not adequate to pay in full all claims within a particular tier, then all claims in that tier are paid pro rata.

A corollary of the § 726(b) pro rata rule is that where the pro rata share of a particular tier is less than 100%, then all inferior tiers receive zero.

A so-called "surplus" case means that after full payment of § 726(a) tiers (1) through (5), funds remain for a § 726(a)(6) distribution to the debtor.

The waterfall is a mandatory subordination scheme fixing the order of distributions.

In other words, in § 726(a)(4) Congress subordinated to timely and tardily filed allowed unsecured claims under §§ 726(a)(2) and (3) all allowed secured and unsecured punitive damage claims that are not compensation for actual pecuniary loss suffered by the holder.

The Congressional enactment materials for the 1978 Bankruptcy Code were explicit that both §§ 726(a)(3) and 726(a)(4) are "subordination provisions." H.R. Rep. No. 595, 95th Cong., 1st Sess. 412-413 ("subordination provisions")(1977); 7 R. Levin & H. Sommers, eds., COLLIER ON BANKRUPTCY ¶ 1129.02[7][c] (16th ed. 2009) ("7 COLLIER").

Three other forms of subordination are recognized at § 510 and are affixed to the § 726(a) distribution scheme by the preambular language of § 726(a): "Except as provided in section 510 of this title..." 11 U.S.C. § 726(a).

Subordination under § 510 is on a claim-by-claim basis. It may be contractual subordination. 11 U.S.C. § 510(a). It may be mandatory subordination. 11 U.S.C. § 510(b). Or, it may be equitable subordination. 11 U.S.C. § 510(c).

Subordination of a claim should be distinguished from disallowance of a claim. Subordination entails adjusting an allowed claim's position in the waterfall queue. Disallowance formally entails rejecting a claim on the merits, but colloquially is sometimes used to include lack of funds to pay.

Bankruptcy Waterfall in Chapter 11

The bankruptcy waterfall pertains to chapter 11 cases primarily by way of the "best interest" test for plan confirmation.

A fundamental economic justification for reorganization in chapter 11 is that a plan provides for greater return to creditors than what would result from a chapter 7 liquidation.

The best interest test is an essential element for confirmation of a chapter 11 plan with respect to holders of impaired claims that have not accepted the plan. Such holders must receive under the plan value at least, or greater than, what they would receive in a hypothetical chapter 7 liquidation. 11 U.S.C. § 1129(a)(7)(A)(ii).

The hypothetical chapter 7 liquidation analysis for chapter 11 confirmation that is required when not all holders of impaired claims have accepted the plan necessarily focuses on the hierarchy of the bankruptcy waterfall.

The House Committee Report on the 1978 Bankruptcy Code explained the § 1129(a)(7)(A)(ii) confirmation requirement regarding the hypothetical chapter 7 liquidation:

> In order to determine the hypothetical distribution in a liquidation, the court will have to consider the various

> subordination provisions of proposed 11 U.S.C. 510, 726(a)(3), 726(a)(4), and the postponement provisions of proposed 11 U.S.C. 724.

H.R. Rep. No. 595, at 412-413; 7 COLLIER ¶ 1129.02[7][c]. The Senate ultimately acquiesced in the House version.[1]

The net effect of § 726(a)(4) is that punitive damages claims that are not compensation for actual pecuniary loss are mandatorily subordinated and cannot be paid as § 726(a)(2) unsecured claims.

If a chapter 11 plan provides for liquidation, then the subordinations inherent in the chapter 7 bankruptcy waterfall become mandatory.

Although it is possible to sidestep § 726 when all holders of impaired claims have accepted a chapter 11 plan, a plan of liquidation ordinarily plunges everybody down the waterfall.

In short, there not having been universal acceptance by all impaired claimants, honoring the § 726(a)(4) subordination of punitive damages under the "best interest" test was an essential element for this Court's confirmation of the Joint Plan.

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[1]The Senate Subcommittee Chair explained:

> Section 1129(a)(7) adopts the position taken in the House Bill in order to insure that the dissenting members of an accepting class will receive at least what they would otherwise receive under the best interest of creditors test; it also requires that even the members of class that has rejected the plan be protected by the best interest of creditors test for those rare cramdown cases where a class of creditors would receive more on liquidation than under reorganization of the debtor.

Statement by Hon. Dennis DeConcini, Subcommittee Chairman Upon Introduction of Senate Amendment to House Amendment to H.R. 8200. 124 Cong. Rec. S 17406 (Daily Ed. October 6, 1978).

Plan Administrator's Arguments

The Plan Administrator objects that the bankruptcy waterfall requires that the claims based on the 2015 judgment against MFE and MTI, together with the $2,700,000 payment default provision, be treated under § 726(a)(4) as being on account of punitive damages that were not compensation for actual pecuniary loss by the holders of the claims.

In addition, the objection questions allowability on the merits of the $2,700,000 payment default provision as being an unenforceable penalty under governing Nevada law.

Claimants' Arguments

Claimants argue that the 2015 plan implementing the settlement of the 2015 judgment transformed the debt from status as punitive damages to status as garden-variety contract debt. The theory is, first, that the settlement was a contract that extinguished the judgment by way of dismissing the Complaint and, second, that the $2,700,000 payment default provision was part of the bargained-for consideration in 2015.

Claimants further urge that the order confirming the plan in the 2015 Chapter 11 case is binding as to the status of the debt.

Analysis

Straightforward analysis leads to the conclusion that the Plan Administrator's objections prevail.

Punitive Damages Mandatorily Subordinated: § 726(a)(4)

It is beyond dispute that § 726(a)(4) requires mandatory subordination wherever it applies.

The claimants' argument that the confirmation of the 2015 plan transformed the punitive damages into a garden-variety contract runs counter to Supreme Court precedent.

The Supreme Court decisions in Archer v. Warner, 538 U.S. 314, 318-22 (2003), and in Brown v. Felsen, 442 U.S. 127, 131-38 (1979), settle the proposition that neither a consent decree, nor the settlement of a fraud debt by way of contract, prevents a Bankruptcy Court from looking behind a decree or settlement contract to ascertain proper treatment of a debt in bankruptcy.

Those precedents permit this Court to look behind the 2015 plan confirmation order and the attendant settlement agreement to determine the position of the debt in the § 726(a) waterfall.

The origin of the debt thereby compromised was the 2015 judgment for punitive damages.

As the § 726(a)(4) exception to categorical subordination of punitive damages is limited to the extent to which such "damages are not compensation for actual pecuniary loss suffered by the holder of such claim," an allocation among § 726 tiers sometimes is needed.

The exception being a creature of federal statute without nonbankruptcy counterpart, the burden is on the claimant to demonstrate the extent, if any, of compensation for actual pecuniary loss that may be embedded in a punitive damages award. Here, the claimants have proffered no evidence to suggest that an allocation is needed in this case.

The awards of "back pay" and "other compensatory damages" totaling $968,000 were extinguished by the payment of $3,000,000 before the effective date of the plan on January 19, 2016, leaving only punitive damages to be paid by way of the remaining 32 plan payments.

From the payments of all awarded "back pay" (including taxes thereon) and "other compensatory damages" before the January 19, 2016, plan effective date, it follows that no "compensation for actual pecuniary loss suffered by the holder of such claim" is allocable to the punitive damages remaining for each of the seven claimants for purposes of § 726(a)(4).

To the extent nonbankruptcy law may affect an allocation of the original judgment debt, the conclusion that the remaining debt solely consists of punitive damages is consistent with Nevada law, which provides that when there is partial payment on a judgment as to which neither the judgment creditor nor judgment debtor designates allocations, the court determines the allocation guided by basic principles of "justice and equity" so a fair result can be achieved. 9352 Cranesbill Trust v. Wells Fargo Bank, N.A., 136 Nev. 76, 80-81 (2020); Able Elec., Inc. v. Kaufman, 104 Nev. 29, 32 (1988).

Justice and equity favor allocation of punitive damages to the inferior position.

The procedural facts underlying the confirmation of the 2015 plan do not suggest a contrary conclusion. The 2015 chapter 11 plan could not have been confirmed without a "best interest" finding under § 1129(a)(7)(A)(ii) applying the bankruptcy waterfall. The evidence probative of the "best interest" facet of plan confirmation included the unchallenged opinion of a valuation expert that in a hypothetical chapter 7 liquidation, "there would be no cash available to the unsecured creditors." Expert Opinion, MFE Ch. 11, Dkt. #341 p.5 & Dkt. #482 p.127.

In other words, the 2015 bankruptcy court ruled there would be no distribution to general unsecured creditors under § 726(a)(2) or to any creditor downstream from that tier.

It follows that the "best interest" test for the 2015 plan confirmation required mandatory subordination of the punitive damages claims pursuant to § 726(a)(4). The status of the debt as punitive damages was not relevant to any question being decided in the course of confirming the 2015 chapter 11 plan.

It warrants repetition that mandatory subordination does not necessarily lead to disallowance. An allowed punitive damages claim retains its status as an "allowed" claim and will be paid to the extent funds remain available at the § 726(a)(4) tier.

Accordingly, the 2015 plan provided for paying the remaining allowed punitive damage claims still remaining after the effective date of the plan.

The claimants' issue preclusion argument that plan confirmation in the prior chapter 11 case established a new status under the bankruptcy waterfall in the later chapter 11 case fails because the claim status of punitive damages in the bankruptcy waterfall was not actually and necessarily litigated.

The conclusion that mandatory subordination under § 726(a)(4), which is a form of categorical subordination, applies to the challenged punitive damage claims makes it unnecessary to rule on the Plan Administrator's argument that § 510(c) equitable subordination is also applicable here.

The Supreme Court has disapproved categorical § 510(c) equitable subordination, approved fact-based equitable subordination, and left open the question whether creditor misbehavior is essential to equitable subordination. United States v. Noland, 517 U.S. 535, 542-43 (1996). The question remains for another day.

Stipulated Judgment for Payment Default

The objection to the claim for $3,793,751 subdivides into two components. First, there is no objection to the $1,093,750 remaining unpaid under the settlement agreement. Second, there is the claim for $2,700,000 based on the stipulated judgment for payment default. It is objected that this sum is an unenforceable penalty under governing Nevada law. This is a merits-based disallowance issue, rather than a subordination issue.

Nevada law refuses to enforce contractual damage clauses as contrary to state public policy where the clause is not designed to compensate the injured party for breach, but instead requires payment of a sum grossly disproportionate to actual damages. E.g., Mason v. Fakhimi, 109 Nev. 1153, 1157 (1993).

Under the terms of the settlement contract, the $2,700,000 would be payable even if the only payment default was not making the 32nd of the 32 required payments. In other words, it is a fixed charge of $2,700,000 regardless of the actual amount of the payment default. That is “grossly disproportionate” to actual damages and hence, a “penalty” under Nevada law.

The fact that a penalty unenforceable under the chosen state law was embodied in the 2015 confirmed chapter 11 plan and settlement agreement does not now insulate it from attack. This

Court has the power to determine in a claim objection the enforceability of the penalty under applicable nonbankruptcy law.

To be sure, it may seem odd that the parties agreed to an unenforceable penalty in the 2015 settlement agreement and chapter 11 plan, but the choice of law provisions in the settlement and plan to apply Nevada law are not ambiguous.

Accordingly, the objection to $2,700,000 of the $3,793,751 claim will be sustained and that portion of the claim disallowed as unenforceable under governing state law.

An appropriate separate order will issue.

Dated: July 28, 2025

United States Bankruptcy Judge