By Wendy Tien and Alicia Daniels-Hill

When Chapter 11 Meets Consumer Protection: Navigating the Limits of § 363(o)

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Twenty years ago, in the wake of the Enron and WorldCom financial scandals, Congress enacted comprehensive bankruptcy reforms aimed at "improving bankruptcy law and practice by both restoring personal responsibility and integrity in the bankruptcy system and ensuring that the system is fair to both debtors and creditors."[1] At its core, the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) sought to curtail fraudulent practices in both business and consumer bankruptcies. To address risks related to business bankruptcies, BAPCPA included "provisions designed to reduce system risk in the financial marketplace."[2]

One such reform was the creation of a pass-through provision under 11 U.S.C. § 363(o), which functions as an exception to the general rule in § 363(f) that allows debtors to sell estate property "free and clear of any interest in such property of an entity other than the estate."[3] As Sen. Chuck Schumer (D-N.Y.) explained, the amendment was "needed to ensure that the Bankruptcy Code is not used to exacerbate the effects of illegal predatory lending practices."[4] He identified a growing problem with predatory lenders:

> Obtained orders from bankruptcy courts, providing for the sale of their loans or the servicing rights associated with them under section 363.... Consumers who have attempted to challenge these loans or their servicing obligations based on violations of fair lending laws have been told by the purchasers of these loans that they are sold free and clear of any consumer claims and defenses.[5]

Recognizing the inherent injustice of using bankruptcy to release claims against debt-buyers purchasing loans originated through predatory practices, he stated, "The fact that innocent borrowers can be left in the lurch is flat-out wrong."[6]

1 H.R. Rep. No. 109-31 at 2 (2005).

2 *Id.* at 3.

3 11 U.S.C. § 363(f).

4 107 Cong. Rec. S2018-55, S2031 (March 8, 2001).

5 *Id.* at S2032.

6 *Id.*

Thus, § 363(o) was intended to ensure that bankruptcy could not be used to erase consumer rights that would otherwise survive in the nonbankruptcy context.

Interaction Between § 363(o) and Consumer Protection Laws

Section 363(o) occupies a critical intersection between bankruptcy law and consumer protection by safeguarding borrower rights during asset sales. The provision encompasses two categories of consumer credit arrangements: (1) "consumer credit transaction[s] that [are] subject to the Truth in Lending Act" (TILA); and (2) "consumer credit contract (as defined in section 433.1 of title 16 of the Code of Federal Regulations (January 1, 2004), as amended from time to time)."[7]

The plain text of § 363(o) preserves the same fair-lending claims and defenses that consumers might assert against debt-buyers that acquire loans outside of bankruptcy.[8] By incorporating transactions subject to TILA, § 363(o) protects consumers' rights to "meaningful disclosure of credit terms," enabling borrowers to compare credit options and avoid uninformed credit use.[9]

In addition, § 363(o) preserves consumer protections established under the Federal Trade Commission's (FTC) Holder Rule, which prevents assignees of consumer credit contracts from making "the consumer's duty to pay independent of the seller's duty to fulfill his obligations"[10] by "reallocating the costs of seller misconduct in the consumer market" to creditors.[11] After extensive hearings and public comment, the FTC found that "[a]s a practical matter, the creditor is always in a better position than the buyer to return seller misconduct costs to sellers."[12]

7 11 U.S.C. § 363(o).

8 *In re Ditech Holding Corp.*, 606 B.R. 544, 583 (S.D.N.Y. 2019) ("If section 363(o) is applicable to a sale of interests in consumer credit contracts or transactions, the buyer of those assets will be subject to claims and defenses related to the assets 'to the same extent' [that] the buyer would be so liable 'had such interest been purchased at a sale not under this section.'").

9 15 U.S.C. § 1601(a); *Anderson Bros. Ford v. Valencia*, 452 U.S. 205, 220 (1981) (internal citations omitted).

10 Guidelines on Trade Regulation Rule Concerning Preservation of Consumers' Claims & Defenses, 41 Fed. Reg. 20022-01, 20023 (May 14, 1976).

11 Promulgation of Trade Regulation Rule, Statement of Basis and Purpose, 40 Fed. Reg. 53523 (Nov. 18, 1975) ("Statement of Basis and Purpose").

12 *Id.*

Accordingly, the Holder Rule makes it an unfair act or practice for a seller to take or receive consumer credit contracts or accept full or partial payment for sales involving purchase-money loans without including a notice, stating that "any holder of this consumer credit contract is subject to all claims and defenses [that] the debtor could assert aganst the seller of goods and services."[13]

The FTC promulgated the Holder Rule in response to "widespread evidence of abuse and [consumer] injury"[14] stemming from courts' importation of the "holder in due course" doctrine — developed for commercial transactions — into the consumer credit context.[15] Under the doctrine, a holder of a negotiable instrument need not "look behind the instrument which on its face was negotiable,"[16] allowing creditors and assignees to enforce contracts regardless of the seller's misconduct. The Holder Rule rejects this framework because doing so "places the risk of a seller's misconduct on the party least able to bear the burden — the individual consumer,"[17] and ensures that finance companies and debt-buyers cannot compel consumers to pay for fraudulent or defective sales. Congress's decision to incorporate Holder Rule protections into § 363(o) confirms an intent to maintain these broad consumer rights — even when loans are sold as part of a bankruptcy estate.

Challenges in Applying § 363(o) to Chapter 11 Plan Sales

As the legislative history of § 363(o) makes clear, Congress intended — at least at the time of BAPCPA — to strengthen consumer protections related to the TILA or Holder Rule claims, and to prevent wrongdoers from using bankruptcy as a shield to the detriment of consumer creditors. To the extent that a debtor sells or transfers its interests in consumer credit transactions, § 363(o) should, on its face, provide assurance that bankruptcy proceedings will not extinguish the remedies available to consumers or to the states against bona fide purchasers for value.

In practice, however, applying § 363(o) in chapter 11s has proven more complicated, particularly where the debtor exits chapter 11 through a plan. *In Ditech*,[18] the first published decision addressing the application of § 363(o), the debtor (a mortgage-originator and servicer) sought confirmation of a chapter 11 plan structured around going-concern sale transactions of two business components. The plan proposed asset sales under § 1123 and provided that these plan sales were not subject to the limitations of § 363(o). The debtor argued that § 363(o) applies only to sales under § 363(f), not plan sales, and that its plan sales accordingly were free and clear of consumer claims and defenses.[19]

A consortium of creditors and parties-in-interest (including the creditors' committee, the U.S. Trustee and state attorneys general) objected to plan confirmation, arguing that the plan sales could not be made "free and clear" of consumer claims and defenses without also complying with § 363(f), which by extension was subject to the limitations of § 363(o).[20] The bankruptcy court disagreed, concluding that both §§ 363(f) and (o) apply only to sales "under section 363" and not those taking place under a chapter 11 plan.[21] The few other courts considering § 363(o) have maintained the same distinction between § 363 sales and plan sales.[22]

This distinction between asset sales made under § 363(b) and (c) on the one hand, and those made as part of a chapter 11 plan under § 1123(a)(5)(D) and (b)(4) on the other, has become pivotal because the landscape of chapter 11 practice has changed considerably over the past three decades. The *sine qua non* of chapter 11 is no longer the confirmation of a "classic" reorganization plan — solicited months after the petition date in accordance with a disclosure statement under § 1125 and confirmed later still in conformity with the requirements of § 1129. Prepackaged or pre-negotiated plans and expedited § 363 sales of substantially all assets now serve as the most common mechanisms for existing chapter 11.[23]

These vehicles have supplanted the reorganization plan in popularity because they can be negotiated largely in advance of the petition and consummated quickly (often within 60 to 90 days of filing). Further complicating matters, debtors increasingly employ "sale toggles," filing plans that simultaneously contemplate both a § 363 sale and a traditional reorganization, with the option to select between them based on evolving circumstances.[24]

While these tools offer speed and flexibility to debtors and secured lenders, they each pose significant challenges for states seeking to protect the interests of consumer creditors under the TILA or Holder Rule. Most importantly, states must be mindful that the chapter 11 process frequently involves extensive pre-petition negotiations among debtors, secured lenders, institutional equityholders and prospective purchasers — negotiations that typically exclude states or consumer credit claimants. As a result, states must closely scrutinize the plan and sale documents, and have little time to do so. Moreover, the debtor's exit strategy might shift rapidly during the chapter 11 case, altering the legal consequences for consumer protections. Several components of typical chapter 11s warrant close scrutiny.

First- and Second-Day Motions

Because § 363 "is clear that any sale under § 363(f) involv-

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13 *See* 16 C.F.R. § 433.2.

14 *Id.*

15 *Id.*

16 *See id.* at 5307 (citing Miller v. Race, 97 Eng. Rep. 398 (K.B. 1758)).

17 Statement of Basis and Purpose, 40 Fed. Reg. at 53509.

18 606 B.R. 544.

19 *Id.* at 552.

20 *Id.* at 552-53, 579-96.

21 *Id.* at 593-94.

22 *See, e.g., In re Lett*, No. 10-61451-BEM, 2021 WL 955910, at *7 (Bankr. N.D. Ga. March 12, 2021), *report and recommendation adopted*, No. 1:21-CV-02471-WMR, 2021 WL 7708553 (N.D. Ga. Nov. 8, 2021) (liquidating plans are not subject to § 363 (o) under *Ditech*); *see also Rambert v. Reverse Mortg. Sols. Inc.*, No. 18CV3541PKCLB, 2020 WL 2769133, at *3 (E.D.N.Y. May 27, 2020) (terms of confirmed plan barred plaintiff from prosecuting "Consumer Creditor Claim" against defendant) (citing *Ditech*).

23 *In re Gen. Motors Corp.*, 407 B.R. 463, 486-87 (Bankr. S.D.N.Y. 2009) ("[N]either section 363 nor section 1123(b)(4) provides that resort[ing] to § 1123(b)(4) is the only way by which all or substantially all of the assets can be sold in a chapter 11 case."), *enforcement denied, In re Motors Liquidation Co.*, 529 B.R. 510 (Bankr. S.D.N.Y. 2015), *aff'd in part and rev'd in part on other grounds, In re Motors Liquidation Co.*, 829 F.3d 135, 152 (2d Cir. 2016) ("The [Bankruptcy] Code permits a debtor to sell substantially all of its assets to a successor corporation through a section 363 sale, outside of the normal reorganization process.").

24 Any more than a cursory mention of some of the popular exit strategies available in chapter 11 is beyond the scope of this article.

ing interests in consumer credit transactions or contracts implicates § 363(o),"[25] states must be prepared to promptly review motions for § 363 sales that are free and clear of liens, claims and encumbrances. If the debtor intends to pursue a prepackaged plan or § 363 sale, its intentions will typically be reflected in the first- or second-day filings.

Chapter 11 Plan Considerations

As previously described, § 363 sales preserve a consumer's ability to assert their claims and defenses against purchasers by virtue of § 363(o),[26] whereas sales under chapter 11 plans do not (at least in the jurisdictions that have considered the question). However, chapter 11 plans contain numerous other provisions of interest to states involved in consumer credit litigation or ongoing investigations. Above all, to be confirmed, the plan must satisfy all the applicable provisions of title 11.[27]

For example, in a hypothetical loan-servicing case, a chapter 11 plan might authorize the reorganized debtor to continue servicing loans while providing for the sale of its loan-servicing subsidiaries. Such a plan might provide for discharges and releases with respect to nondebtors for the underlying loans that the reorganized debtors, as well as certain third parties, will continue to service. It might also seek to use voting and affirmative opt-out procedures to impose nonconsensual releases on creditors or governmental units. Such broad discharge and release provisions might capture ongoing governmental investigation and litigation that vindicate crucial state interests in consumer protection.

Such provisions as to nondebtor third parties might contravene the limitations of the Bankruptcy Code.[28] Bankruptcy injunctions "similarly act to shield persons and entities from liability and therefore may not be entered to protect non-debtors not legally entitled to release."[29]

The plan might contain language improperly cutting off rights to defenses or rights of recoupment against third parties under applicable nonbankruptcy law.[30] It also might fail to satisfy the best interests of consumer creditors (including states) based on a hypothetical chapter 7 liquidation, even if the plan proposes to establish a litigation fund or other settlement fund to resolve their disputes.[31] In short, whether in consumer creditor cases or otherwise, the prerequisites for plan confirmation apply with equal force.

Conclusion

Although BAPCPA sought broadly to prevent wrongdoers from using bankruptcy as a shield to the detriment of consumer creditors, the procedural limitations on § 363(o)'s applicability require states to navigate bankruptcy with precision to preserve claims against third-party purchasers. While § 363(o) serves an essential purpose, its protections depend heavily on the debtor's chosen exit strategy, and its narrow scope imposes substantial challenges for consumers. However, regardless of this strategy, states must rigorously evaluate each component of the chapter 11 process to ensure that the rights of consumers are not curtailed. abi

25 *Ditech*, 606 B.R. at 608.

26 As with the Bankruptcy Code generally, § 363(o) does not create new substantive rights.

27 11 U.S.C. § 1129(a)(1).

28 11 U.S.C. § 524(e) (discharge of debt of debtor does not affect liability of any other entity on, or property of any other entity for, such debt, except for certain community claims inapplicable here).

29 The use of opt-out mechanisms to effectuate nondebtor releases might be inappropriate in some circuits. *See Matter of Highland Cap. Mgmt. LP*, 132 F.4th 353, 358 (5th Cir. 2025); 11 U.S.C. § 524(e) (discharge given to debtor does not affect liability of third party liable for that same debt). "The fresh start § 524(e) provides to debtors is not intended to serve th[e additional] purpose" of releasing nondebtors. *In re Pac. Lumber Co.*, 584 F.3d 229, 252-53 (5th Cir. 2009) (expressly rejecting release and discharge provisions for plan proponents and current owners of reorganized debtors on § 524(e) grounds).

30 *Ditech*, 606 B.R. at 597-98 (noting that "the Consumer Creditors' defenses to enforcement — including rights of recoupment — cannot be extinguished through the Plan Sale Transactions," and declining to distinguish between affirmative and defensive use of recoupment).

31 11 U.S.C. § 1129(a)(7). *See Ditech*, 606 B.R. at 617-18 (determining that impaired class of consumer creditors would receive less than under liquidation analysis, applying § 363(o) in the chapter 7 context; stating that TILA and Real Estate Settlement Procedures Act claims were not categorically foreclosed, but that "whether such claims ride through is entirely dependent on the specific factual and legal details related to each claim").