ReedSmith

The business of relationships.℠

CR&B Alert

Commercial Restructuring & Bankruptcy News

JUNE 2012, ISSUE 2

In This Issue:

CONSTRUCTION LENDERS BEWARE

Peter S. Clark, II
Firmwide Practice Group Leader
Philadelphia

Under the Pennsylvania Mechanics' Lien Law, a mechanic's lien with respect to erection or construction of an improvement takes effect and has priority "as of the date of the visible commencement upon the ground of the work of erecting or constructing [an] improvement." Under the same law, a mechanic's lien is subordinate to an open-end mortgage "the proceeds of which are used to pay all or part of the cost of completing erection, construction, alteration, or repair of the mortgaged premises secured by the open-end mortgage." So, until last month, construction lenders and title companies proceeded under the assumption that a construction lender's mortgage, where the proceeds were used in part to pay the costs of construction, will take priority over a prior mechanic's lien. However, in *Commerce Bank v. Kessler,* 2012 WL 1610139 (Pa. Super. 2012), the Superior Court of Pennsylvania ruled that a construction lender's mortgage will have priority over a mechanic's lien only if *all* of the advances are used to pay all or part of the costs to complete erection, construction, alteration, or repairs of the property. If *any* of the advances under the open-end mortgage were made to pay soft costs, taxes, closing costs, interest reserve, satisfaction of an existing mortgage, or the like, the priority is lost as to *all* advances. As a result, as things now stand, if any mortgage advances are to be used for items other than the cost of completing erection, construction, alteration, or repair of the property, the lender will need to assure itself that no work on the property commenced prior to the recording of the mortgage. This case is already impacting how title companies are willing to insure construction mortgages in Pennsylvania and, as a result, construction lenders in Pennsylvania should reconsider their closing and loan administration requirements for construction loans in Pennsylvania where there is the possibility that work on the project has commenced or will commence prior to recordation of the mortgage.

SUPREME COURT UPHOLDS SECURED CREDITOR'S RIGHT TO CREDIT BID IN A BANKRUPTCY CASE

Robert P. Simons
Partner, Pittsburgh

The United States Supreme Court emphatically upheld a secured creditor's right to credit bid in bankruptcy cases. In *RadLAX Gateway Hotel, et al., v. Amalgamated Bank,* 566 U.S.___ (May 29, 2012), the Court found the case an "easy" one to resolve: when a secured creditor is denied the right to credit bid its debt in the sale of its collateral as a part of a bankruptcy plan, it will not receive the "indubitable equivalent" of its secured claim in the form of cash generated from the sale. The Court's unanimous decision should restore certainty in credit markets.

The Debtors purchased a hotel and real estate for development but ran out of funds. The Debtors commenced chapter 11 bankruptcy cases and proposed a bankruptcy plan to sell substantially all assets pursuant to a related motion to establish bidding procedures. The bidding procedures did not permit the lender to credit bid and forced the lender to bid cash. In addition, the bankruptcy plan provided that the secured claim would receive the cash generated from the sale and the plan would be "crammed down" over the secured creditors' objection. The bankruptcy court denied the sale procedures motion, certified the ruling for direct appeal to the Seventh Circuit (which affirmed), and the Supreme Court granted certiorari.

The Supreme Court heard the appeal to resolve a split among the Circuits. The Third Circuit, in *In re Philadelphia Newspapers, LLC,* 599 F.3d 298 (3d Cir. 2010), and the Fifth Circuit, in *In re Pacific Lumber Co.*, 584 F.3d 229 (5th. Cir. 2009), had ruled that debtors could hold auctions for properties without allowing secured creditors to credit bid and deem payment of the cash generated by the sale as fair and equitable treatment of the secured claim. This allowed plans to be "crammed down" over a secured creditor's objection.

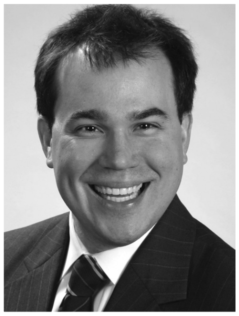
The Court applied a well-established canon of statutory interpretation to the cram-down provisions of the Bankruptcy Code: the specific governs the general. The Court stated:

> A Chapter 11 plan confirmed over the objection of a "class of secured claims" must meet one of the three requirements in order to be deemed "fair and equitable" with respect to the non-consenting creditor's claim. The plan must provide:
>
> > '(i)(I) that the holders of such claims retain the liens securing such claims, whether the property subject to such liens is retained by the debtor or transferred to another entity, to the extent of the allowed amount of such claims; and (II) that each holder of a claim of such class receive on account of such claim deferred cash payments totaling at least the allowed amount of such claim, of a value, as of the effective date of the plan, of at least the value of such holder's interest in the estate's interest in such property;
> >
> > (ii) for the sale, subject to section 363(k) of this title, of any property that is subject to the liens securing such claims, free and clear of such liens, with such liens to attach to the proceeds of such sale, and the treatment of such liens on proceeds under clause (i) or (iii) of this subparagraph; or
> >
> > (iii) for the realization by such holders of the indubitable equivalent of such claims." 11 U.S.C. §1129(b)(2)(A).'

Under clause (i), the secured creditor retains its lien on the property and receives deferred cash payments. Under clause (ii), the property is sold free and clear of the lien, "subject to section 363(k)," and the creditor receives a lien on the proceeds of the sale. Section 363(k), in turn, provides that "unless the court for cause orders otherwise the holder of such claim may bid at such sale, and, if the holder of such claim purchases such property, such holder may offset such claim against the purchase price of such property" – i.e., the creditor may credit-bid at the sale, up to the amount of its claim. Finally, under clause (iii), the plan provides the secured creditor with the "indubitable equivalent" of its claim.

CONTINUED ON PAGE 7

JOINTLY ADMINISTERED PLANS MUST OBTAIN IMPAIRED CLASS APPROVAL 'PER DEBTOR' RATHER THAN 'PER PLAN'



Jared S. Roach
Associate, Pittsburgh

In re Tribune Company, et al., 464 B.R. 126 (Bankr. D. Del. 2011)

CASE SNAPSHOT

The Tribune Company and certain of its subsidiaries filed chapter 11 petitions. The cases were jointly administered but not substantively consolidated. Two different constituencies filed competing plans of reorganization. The court held a confirmation hearing and applied the standards set forth in section 1129 regarding plan confirmation to the competing plans. Of specific note in the court's analysis, the court reviewed the provisions of section 1129(a)(10) pertaining to the acceptance of a plan by an impaired class. The court determined that approval of a plan must be obtained on a "per debtor" basis, so when multiple debtors file for bankruptcy protection, and the cases are jointly administered but not substantively consolidated, an impaired class of each debtor (not merely of the jointly administered case) must accept the plan. The court did not confirm either plan because, among other reasons, the plans were not properly accepted by impaired classes.

FACTUAL BACKGROUND

The Tribune Company and its subsidiaries were engaged in the media business, and owned publications including the *Chicago Tribune* and the *Los Angeles Times.* On December 8, 2008, the Tribune Company and 110 of its subsidiaries filed chapter 11 bankruptcy petitions. As background precipitating the bankruptcy filing, an investment trust, through a leveraged buyout, purchased The Tribune Company. The two-step LBO saddled The Tribune Company with approximately $12.7 billion in principal debt.

Two competing reorganization plans were proposed. One plan was proposed jointly by the Debtors, the Official Committee of Unsecured Creditors and certain senior lenders (the Debtor Plan). The other plan was proposed jointly by the holders of certain bonds that were issued prior to the LBO (the Holder Plan). The Debtor Plan and the Holder Plan were submitted to creditors for a vote. The difference of note between the two plans was the treatment of certain LBO-related causes of action. The Debtor Plan contemplated settling many of the leveraged buyout causes of action, while the Holder Plan would preserve said causes of action to prosecute post-petition.

The Debtor Plan proposed a settlement of certain causes of action with the senior lenders and bridge lenders arising from the LBO of the Tribune Company, in which the senior and bridge lenders had lent more than $10 billion to Tribune in connection with its LBO. The resolution of any causes of action associated with the LBO would be central to the Debtors' ability to formulate and implement a plan of reorganization. The court appointed an examiner to investigate and evaluate the potential claims, and the likelihood of success of these potential claims. The Debtor Plan and Holder Plan were circulated to creditors for a vote and after voting, the court held a hearing to review whether either plan could be confirmed pursuant to section 1129 of the Bankruptcy Code.

COURT ANALYSIS

Various objections to the Debtor Plan included: (i) whether the settlement of certain LBO-related causes of action were reasonable; (ii) whether the Debtor Plan granted improper third-party releases; (iii) whether the assignment of certain state law claims under the Debtor Plan was fair and equitable; and (iv) whether the Debtor Plan complied with section 1129(a)(10) by receiving acceptance by at least one impaired class.

The court disposed of most objections raised by the parties, either overruling them, imposing conditions that effectively overruled objections, or analyzing objections in such a way as to present solutions to the issue. Specifically, the court found that the settlement of certain LBO-related causes of action "(i) falls above the lowest point in the range of reasonable litigation possibilities, (ii) would certainly reduce cost and delay pursuing the LBO-Related Causes of Action, and, perhaps most importantly, (iii) has been approved by creditors across the Debtors' capital structure." Furthermore, the third-party releases were fair, although the language would need to be slightly revised. The court then turned its attention to section 1129(a)(10).

The focus of the court's analysis centered on section 1129(a)(10) of the Bankruptcy Code, which provides the following requirement for confirmation of a plan: "If a class of claims is impaired under the plan, at least one class of claims that is impaired under the plan has accepted the plan, determined without including any acceptance of the plan by any insider." Neither the Debtor Plan nor the Holder Plan received the affirmative vote of an impaired class for each debtor entity. The Holder Plan received the affirmative support of only *three* out of 256 impaired classes, yielding an accepting impaired class for *two* of the 111 Debtors. Two of these classes were controlled by the Holders themselves. The Debtor Plan fared better in voting among the impaired classes, but it still failed to garner acceptance from impaired classes of 39 out of 111 Debtors.

The Debtor Plan proponents argued that 1129(a)(10) requires at least one accepting impaired class per debtor, rather than per plan. Under this logic, the Debtor Plan proponents argued that the Holder Plan clearly failed. As for its own failure to attain at least one accepting impaired class per debtor, the Debtor Plan proponents stated that the "Debtor Plan received broad support and was *accepted by an impaired class at every Debtor for which votes were cast*" (emphasis in original). The Debtor Plan proponents argued that their plan was distinguishable from the Holder Plan because "there is a substantial difference between affirmative rejection of a plan and simple creditor inaction."

The court first noted that there was little authority on whether section 1129(a)(10) should be applied "per debtor" or "per plan" in a multi-debtor joint plan. Under a "per debtor" case analysis, at least one impaired creditor of each separate debtor would have to vote in favor of the plan. Alternatively, in a "per plan" case analysis, the Holder Plan proponents argued that when joint debtors file a plan, only one impaired class needs to accept the plan. Quite clearly, the plan proponent's burden related to acceptance on "per plan" basis is much lower than on a "per debtor" basis, particularly in cases involving a number of debtors.

In its analysis, the court considered the plain meaning of section 1129(a)(10), and to do that, the court looked to section 102(7) for rules of construction applicable

CONTINUED ON PAGE 5

COURT REJECTS 'WHOLE ENTERPRISE' ARGUMENT OF JOINTLY ADMINISTERED DEBTORS; HOLDS EACH DEBTOR IS A SARE

Joseph D. Filloy
Associate, Pittsburgh

In the Matter of Muruelo Maddux Properties, Inc., 667 F.3d 1072 (9th Cir. 2012)

CASE SNAPSHOT

A conglomerate of more than 50 single-purpose real estate entities and the parent company each filed voluntary chapter 11 petitions. Although the cases were jointly administered, they were not substantively consolidated. Some of the subsidiaries filed separate motions seeking determination that they were not subject to the "single asset real estate" provisions of the Bankruptcy Code. The secured lender of one of the moving debtors filed a cross motion seeking to apply the single asset real estate provisions to the debtor, and to lift the automatic stay as permitted by those provisions. The Circuit Court upheld the District Court's determination that the debtor was subject to the single asset real estate provisions, despite the debtor's argument that it was not subject to the provisions because its operations were interwoven with the entire enterprise.

FACTUAL BACKGROUND

Muruelo Maddux Properties, Inc. (MMPI) owned and developed real estate in the Los Angeles area, through a network of more than 50 subsidiaries. Each subsidiary owned one property. The business operated on a consolidated basis – revenues from the subsidiaries were swept into a general operating account from which expenses for the enterprise were paid; and the companies filed consolidated statements with the SEC and consolidated tax returns with the IRS. One of MMPI's subsidiaries, MMP Hill, executed a note and mortgage with a lender for $28 million. MMP Hill owned a single property, its sole source of revenue was the income generated by the property, and it engaged in no business other than owning and managing the property. In March 2009, MMPI and each of its subsidiaries filed chapter 11 petitions. The bankruptcy petitions were jointly administered, but not substantively consolidated.

MMP Hill filed a motion seeking determination that it was not subject to the "single asset real estate" (SARE) provisions of sections 101(51B) and 362(d)(3) of the Bankruptcy Code. MMP Hill's secured creditor filed a cross motion seeking to apply the SARE provisions. The Bankruptcy Court granted the debtor's motion. The District Court overturned the Bankruptcy Court decision, and the debtor appealed.

COURT ANALYSIS

Section 101(51B) defines single asset real estate. Essentially, a SARE entity owns only a single property, generates all or substantially all of its income from that property, and has no other business activities. Section 362(d)(3) mandates lifting the automatic stay upon motion of any creditor whose claim is secured by single asset real estate, unless, within the earlier of 90 days of the filing of the bankruptcy petition or 30 days of a court determination that a debtor is subject to the SARE provisions, the debtor files a plan of reorganization that has a reasonable possibility of being confirmed, or the debtor commences monthly adequate protection payments. The Bankruptcy Court had found that the debtor satisfied the section 101(51B) requirements, but nevertheless granted the debtor's motion because it concluded that Congress had not intended that the SARE provisions apply to consolidated, inter-related enterprises like MMPI and its subsidiaries.

The District Court agreed with the Bankruptcy Court that the debtor met the definitional requirements of SARE, but rejected the Bankruptcy Court's finding that Congress did not intend to apply the SARE provisions to consolidated enterprises, and therefore, held that the SARE provisions applied.

The Circuit Court of Appeals affirmed the District Court's holding. Recognizing that the plain language of the SARE provisions controlled, the Circuit Court stated, "the plain language of section 101(51B) gives no basis for a 'whole business enterprise' exception. Absent a substantive consolidation order, we must accept MMP Hill's chosen legal status as a separate and distinct entity from its parent corporation and sister subsidiaries ... " Moreover, in the absence of any evidence that the debtor received funds from MMPI or its sister subsidiaries that would constitute "income," the court rejected the debtor's argument that the consolidated management team and cash management system of MMPI allowed the debtor to claim income generated by other MMPI entities. The court concluded that it could not disregard the plain language of the statute, and that if Congress did not want the SARE provisions to apply to consolidated enterprises such as MMPI and its subsidiaries, then Congress could amend the Bankruptcy Code.

PRACTICAL CONSIDERATIONS

The SARE provisions give a debtor relatively little time to file a reasonably confirmable plan, or to begin adequate protection payments. This decision adds to the body of cases in which courts maintain the separate identities of separately organized yet inter-related entities, and affirmatively rejects the notion of a "whole business enterprise" exception to the SARE provisions. The holding strengthens the ability of secured creditors of single asset real estate entities to obtain relief from stay.

to the Bankruptcy Code. Section 102(7) provides that the "singular includes the plural," so that the reference to "plan" in 1129(a)(10) is not, by itself, a basis for concluding that, in a multi-debtor case, only one debtor – or any number fewer than all – must satisfy the standard.

The Debtors' cases had not been substantively consolidated, and neither the Debtor Plan nor the Holder Plan had any provisions that provided for substantive consolidation; each plan was found to comprise a separate and distinct plan for each debtor. The court held that the section 1129(a)(10) requirements had to be satisfied for each debtor.

As support for the holding, the court noted that entity separateness is fundamental in the Bankruptcy Code. Specifically, other subsections of section 1129 address issues on a class-by-class basis, including section 1129(a)(7) and (8), as well as section 1129(b), which address the "best interest of creditors." The court acknowledged that joint administration exists for the convenience of the court and parties, but pointed out that it is not a substantive remedy. Indeed, "[c]onvenience alone is not sufficient reason to disturb the rights of impaired classes of creditors of a debtor not meeting confirmation standards." The court found "nothing ambiguous" in the statute, so that, absent substantive consolidation or consent, section 1129(a)(10) must be satisfied by each debtor in a plan.

The court finished its analysis by concluding that "'deemed acceptance' by a non-voting impaired class, in the absence of objection" may constitute the necessary consent under a proposed "per plan" scheme. Alternatively, the court suggested that multiple debtor cases could, when faced with objections to a "per plan" scheme, drop from a proposed joint plan those debtors that do not or cannot satisfy section 1129(a)(10). The court held that neither the Debtor Plan nor the Holder Plan satisfied section 1129(a)(10) and the "per debtor" requirement.

While the court approved of many aspects of both the Debtor Plan and Holder Plan, the court did not confirm either plan because both contained multiple deficiencies. Common to both the Debtor Plan and Holder Plan was the failure of each to satisfy section 1129(a)(10).

PRACTICAL CONSIDERATIONS

This decision recognizes the importance of "entity separateness" and strengthens the rights of creditors in dealing with multiple debtor bankruptcies. Conversely, debtors that are jointly administering their cases, a common practice among large corporate bankruptcies, must be cognizant and plan for the "per debtor" rule. This rule could greatly impact a debtor's ability to set forth a confirmable plan and successfully exit chapter 11.

COURT ANALYZES OBJECTIVE FACTORS TO FIND CHAPTER 11 PETITION FILED IN BAD FAITH

Kathleen A. Murphy
Associate, Wilmington

In re JER/Jameson Mezz Borrower II LLC, No. 11-13338 (MFW) (Bankr. D. Del., Dec. 22, 2011)

CASE SNAPSHOT

A junior mezzanine borrower filed for chapter 11 bankruptcy on the eve of its lender's UCC foreclosure sale. The lender filed an emergency motion with the Bankruptcy Court to dismiss the bankruptcy case with prejudice on bad faith grounds or, alternatively, to lift the automatic stay to allow the UCC sale to go forward. The court applied the multi-factored test set forth in *Primestone Investment Partners* and concluded that the debtor sought chapter 11 protection in bad faith, and granted the lender's motion.

FACTUAL BACKGROUND

The debtor, JER/Jameson Mezz Borrower II, LLC, was formed as part of a capital structure to acquire a chain of budget motels for approximately $400 million. Two operating companies borrowed the initial $175 million and held title to the real estate and hotels. Four affiliate LLCs were formed to borrow an additional $160 million ($40 million each) toward the purchase price and were known as Mezz I, Mezz II, Mezz III and Mezz IV. The LLCs were stacked – Mezz I was the sole member (owner) of the operating companies; Mezz II was the sole member of Mezz I, and so on. Essentially, Mezz II was a single-purpose entity, whose sole asset was its ownership interest in Mezz I. Colony loaned $40 million each to Mezz I and Mezz II. The debt at Mezz III and Mezz IV was held by collateralized debt obligations serviced by an affiliate of Gramercy Loan Services LLC.

All of the debt was scheduled to mature in 2008; however, the maturity date was extended to August 9, 2011, pursuant to a provision in the loan documents that provided for 3, one-year extensions. Mezz II was unable to repay its obligations when due and the lenders began enforcement proceedings. Colony issued notice of its intention to auction Mezz II's sole asset (its membership interest in Mezz I) under Article 9 of the Uniform Commercial Code. The sale was scheduled for October 19, 2011, and Mezz II filed a chapter 11 bankruptcy petition October 18, 2011 at 11 p.m. Within two weeks, the other borrowers also filed chapter 11 petitions.

Colony filed an emergency motion to dismiss Mezz II's bankruptcy case for bad faith and for relief from the automatic stay, to which Mezz II objected.

COURT ANALYSIS

The debtor urged the court to utilize the good faith test enunciated by the Second Circuit, which emphasizes the debtor's subjective intent. The court refused because authority in the Third Circuit had already adopted a more objective test that evaluates whether the debtor has stepped "outside the equitable limitations of Chapter 11." Under this test articulated in *Primestone Investment Partners,* the court analyzed whether the debtor: was a single asset case; had few unsecured creditors; had no ongoing business or employees; had filed the petition on the eve of foreclosure; was involved in a two-party dispute that can be resolved in pending state court action; had no cash or income; had no pressure from non-moving creditors; had filed a previous bankruptcy petition; had no possibility of reorganization; had formed immediately pre-petition; and had filed solely to create automatic stay. The court also analyzed whether the pre-petition conduct was improper, and the subjective intent of the debtor.

The court found that nearly all of the *Primestone* factors were present in this case. Specifically, the court found that Mezz II was a single asset case; had no unsecured creditors; had no business or employees; filed petition on the eve of foreclosure; and had no possibility of reorganization (because Colony was the sole creditor and would object to a plan, there were no impaired creditors to approve the plan). Additionally, this boiled down to a two-party dispute capable of resolution in a pending state action. Finally, and perhaps fatally, the debtor's pre-petition appointment of a director to oppose the UCC foreclosure by filing for bankruptcy constituted strong evidence of bad faith.

The court reached its decision after agreeing with the debtor's argument to consider the totality of the financing and ownership structure, to view all of the debtors "holistically," rather than as stand-alone entities. Despite analyzing the debtor's enterprise as a whole, the court found that Mezz II (even if it proposed a plan of reorganization, which it had not) would be unable to obtain plan approval, given that Colony was the sole creditor, and Colony would not approve a plan. "Although the Debtors collectively have 103 inns and related assets and many creditors, Mezz II has only one creditor and one asset. Mezz II cannot confirm a plan over Colony's objection because it could get no accepting class. Therefore, in the absence of substantive consolidation, Mezz II does not have any chance of confirming a plan."

The court also found that the debtor's bad faith justified the dismissal of the bankruptcy case, with prejudice. The court thus left what it viewed as a two-party dispute to the state foreclosure action for resolution.

PRACTICAL CONSIDERATIONS

Single purpose entities like the Mezz I-IV companies are common components of structured finance arrangements. While this court acknowledged that such structures should be evaluated in entirety, it ultimately held that prospects for reorganization, absent substantive consolidation, must be determined single purpose entity by single purpose entity. By requiring each such entity to stand alone in terms of obtaining approval from an impaired class of a plan, the Delaware Bankruptcy Court implicitly put greater weight on the "possibility of reorganization" factor of the *Primestone* test.

In its unanimous opinion of only 12 pages, the Court made short shrift of the Debtors' argument that, while its plan cannot satisfy clause (ii) because it expressly prohibits the lender to credit bid under section 363(k), the plan can satisfy clause (iii) since clause (iii) does not expressly foreclose the possibility of a sale without credit bidding, and therefore, the lender can receive the "indubitable equivalent" of its secured claim in the form of cash generated from the auction. The Court stated: "[w]e find the debtors' reading of Section 1129 (b) (2) (A)–under which clause (iii) permits precisely what clause (ii) proscribes—to be hyperliteral and contrary to common sense." This is because clause (ii) is a detailed provision that spells out the requirements for selling collateral free and clear of liens, while clause (iii) is a broadly worded provision that says nothing about such a sale. Therefore, the general language of clause (iii) will not be held to apply to a matter specifically dealt with in clause (ii).

The Court noted that the ability to credit bid helps protect a creditor against the risk that its collateral will be sold at a depressed price, by enabling the creditor to purchase the collateral without committing additional cash to protect the loan. Interestingly, the Court also noted that the right to credit bid "is particularly important for the Federal Government, which is frequently a secured creditor in bankruptcy and which often lacks appropriations authority to throw good money after bad in a cash-only bankruptcy auction." This obviously reflects the Court's concern for the economic impact of a policy of not allowing secured creditors, including governmental creditors, to credit bid.

In summary, the Court's unanimous decision could not more clearly protect the rights of secured creditors to credit bid in a bankruptcy case. The right is important to protect against the risk of a sale of a lender's collateral to a third party at depressed values. As acknowledged by the Court, common sense dictates that a secured creditor should be allowed to offset what it is owed by credit bidding against the property that serves as its collateral. This offset is also beneficial to the debtor by the corresponding reduction of the secured claim. Further, the ruling restores certainty in the credit markets by providing lenders the benefit of their bargain.

RENTAL PAYMENTS AND ADMINISTRATION EXPENSES BACK IN THE SPOTLIGHT IN UK: LUMINAR DECISION CLARIFIES CIRCUMSTANCES IN WHICH RENTAL LIABILITIES QUALIFY AS ADMINISTRATION EXPENSES

Georgia M. Quenby
Partner, London

Edward Mathison
Associate, London

Summary

A recent London High Court judgment in a case arising from the administrations of various companies within the Luminar nightclubs group has provided much-needed clarity to the issue of how rental payments owing by a company in administration are to be treated.[1]

The High Court ruled that a rental payment in advance that falls *before* the date of the commencement of an administration is *not* payable as an expense of the administration, even if the administrator occupies, and uses, the leased property during the period to which such payment relates. Accordingly, where administrators are appointed following a rental payment date, the rent for that period will rank as an unsecured claim in the administration.

***Luminar* judgment**

Administrators were appointed to several companies within the Luminar nightclub group in October 2011. Following a six-week period in which the administrators continued trading, a sale of the business was achieved. The landlords of four of the group's nightclubs sought an order from the court that the rent falling due on the September 2011 quarter date (that is, shortly before the administrators were appointed) should be payable as expenses of the administrations of the relevant tenant companies, on the basis that the administrators had continued to use the properties by continuing to trade in advance of the sale.

The High Court ruled against the landlords, holding that it is the timing of when the liability to pay rent occurs that is key to the analysis, and not the fact that the administrators had continued to use the properties during the disputed rental period.

Rental payments in advance

Accordingly, in relation to rental payments that are payable in advance, the following rules apply to both administrations and liquidations:

- Where the rental payment occurs before the commencement of an administration or liquidation, then that payment is not payable as an expense but ranks as an unsecured claim.
- Confirming the widely reported decision in *Goldacre v. Nortel,* where rent falls due during the period of administration or liquidation, and the property is being used for the purposes of the administration or liquidation, such rent is payable in full as an expense.[2]

Rental payments in arrears

The dispute in the *Luminar* case concerned rental payments payable in advance. However, the judge also confirmed the rule relating to rental payments in arrears. Following the 19th century case *Re Silkstone & Dodsworth Coal*,[3] a liquidator and, by analogy, an administrator, will be liable to pay as an expense at the least that amount of the rent that has accrued from the date of commencement of the administration or liquidation.

The judge in *Luminar* expressed some doubt as to whether *Silkstone* would be decided in exactly the same way today. In *Silkstone*, it was held that a liquidator in possession of a property for which rent was payable in arrears was liable to pay as an expense not just the rent accrued since the commencement of the liquidation, but also the rent in relation to the gap between the previous rental payment date and the commencement of the liquidation. The *Luminar* judgment expressed some doubt as to whether a court addressing the same question today would extend the insolvency practitioner's liability to pay rent as an expense in this way. Accordingly, it remains a possibility that a future case could decide that a practitioner's liability to pay rent payable in arrears as an expense is restricted to only that amount of rent which has been accrued from the commencement of the appointment onwards.

Consequences of *Luminar* decision

The decision in Luminar gives insolvency practitioners and indeed landlords a definitive rule to apply to the question of rental payments. From the perspective of struggling tenants and administrators, the case has given formal approval to the practice of making appointments immediately or shortly after rental payment dates. This strategy will surely continue, given the effective rent-free period this gives administrators in which to continue trading or to secure a sale.

For landlords, the decision is likely to be unwelcome as the appointment of administrators after a rental payment date will often deprive them of much or all of the rent owed to them for that rental period, given the often marginal recoveries made by unsecured creditors. However on the plus side, the decision may encourage landlords to agree to or even propose switching to monthly rental payments when a tenant is experiencing financial difficulties in order to reduce their exposure in the event of a tenant's administration to the loss of one month, as opposed to one entire quarter's, rent.

An increasingly flexible approach by landlords to monthly rental payments may well be welcome by tenants alike, for whom moving to monthly rental payments can assist with cash flow during periods of trading difficulties.

Overall, the judgment in *Luminar*, while no doubt an irritant to landlords, should prove to be a great help to administrators and tenants in financial difficulties. By freeing administrators from the often significant burden of paying rent as an expense for the period following appointment (at least until the next rental payment date), it buys administrators more time to continue to trade and more time to secure a sale of a business, thus improving the chances of a rescue of a business and improving recoveries for creditors as a whole.

CONTINUED ON PAGE 12

CREDITOR'S PROPOSED PLAN VIOLATED ABSOLUTE PRIORITY RULE – COURT DISMISSED BANKRUPTCY CASE

Brian M. Schenker
Associate, Philadelphia

In re Brewery Park Associates, L.P., 2011 WL 1980289 (Bankr. E.D. Pa. Apr. 29, 2011)

CASE SNAPSHOT

After a chapter 11 debtor failed to propose a plan of reorganization during the exclusivity period, a secured creditor proposed its own plan. The debtor objected to the plan and moved to dismiss its bankruptcy case. At the confirmation hearing, the secured creditor sought either to have its plan confirmed under the "cram down" provisions of the Bankruptcy Code, or to convert the case to chapter 7. The court held that the secured creditor's plan would likely result in the creditor obtaining a recovery greater than the allowed amount of its secured claim and, therefore, violated the absolute priority rule and could not be confirmed. Concluding that the debtor was unable to propose a confirmable reorganization plan and that there would be no assets for a trustee to administer and distribute in a chapter 7 case, the court refused to convert the chapter 11 case and instead dismissed the case.

FACTUAL BACKGROUND

The debtor, Brewery Park Associates, L.P., was formed to purchase and develop a large piece of real property in Philadelphia. Unable to develop the property, Brewery Park eventually defaulted under its secured loan with TRF. TRF then confessed judgment in state court against Brewery Park in the amount of $4.3 million. Brewery Park filed a petition to strike and/or open the judgment but failed to move to stay execution. TRF, therefore, scheduled a sheriff's sale of the property. Brewery Park filed its chapter 11 bankruptcy petition the day before the scheduled sheriff's sale, thereby staying the sale. Unaware of the chapter 11 filing, the state court held for Brewery Park on its petition, striking the confessed judgment. The Bankruptcy Court, however, voided the state court's order as a violation of the automatic stay.

TRF asserted a secured claim in the bankruptcy case in excess of $5 million, including post-petition interest, fees, and costs, therefore suggesting that its claim was over-secured by the property. The City of Philadelphia also asserted a claim secured by the property, seeking $105,000 for unpaid real property taxes. At the hearing, TRF's expert opined that the property had a value of about $6 million – $7 million, but a sale of the property on a six- to 12-month timeline would only realize $5 million – $6 million in proceeds. The non-contingent, liquidated, and undisputed unsecured claims against Brewery Park totaled about $677,650. Thus, there was the possibility of a recovery for equity holders upon the sale of the property.

Brewery Park, however, was unwilling to voluntarily sell its property. Rather, Brewery Park's intent was to obtain $20 million in new financing to develop the property. However, given the state of the financial markets, Brewery Park was unable to implement its development plan and, therefore, was unable to and did not file any plan of reorganization giving effect to that plan.

TRF, therefore, proposed a plan to market the property for sale with a commercial broker for a six-month period. Qualified purchase offers could not contain any contingency other than clear title, not even a financing contingency, and would only be acceptable if in excess of $5.8 million, an amount sufficient to pay TRF, the City of Philadelphia, and all administrative claims in full; to pay all closing costs; and to provide a 30 percent recovery to unsecured creditors. The plan provided that TRF would be permitted to credit bid in the initial amount of $2 million with leave to increase its credit bid to the entire allowed amount of its claim. In the event TRF was the successful bidder, TRF would be required to pay the City of Philadelphia's claim and all administrative claims in full, pay all closing costs, and provide a 30 percent recovery for unsecured creditors.

Brewery Park objected to TRF's plan and moved to dismiss the bankruptcy case, contending that the dismissal of its case would allow for reentry of the state court order striking the confessed judgment, which would enable it to obtain the financing it needed to develop the property.

COURT ANALYSIS

The court focused on Brewery Park's implicit argument that, because TRF's plan could provide TRF with a recovery greater than the allowed amount of its claim, it violated the absolute priority rule under section 1129(b) of the Bankruptcy Code and, therefore, TRF had not proposed its plan in good faith as required by section 1129(a)(3) of the Bankruptcy Code.

In order to confirm a plan under the "cram down" provisions of section 1129(b), the plan must provide that no junior class will receive a distribution from the estate unless more senior classes are compensated in full. This is known as the "absolute priority rule." A judicial corollary to this rule is that the plan must provide that no senior class will receive more than full compensation of its claims, otherwise the junior classes will be denied a recovery that they should rightly receive. In other words, if senior creditors are overcompensated, then junior creditors and equity holders receive less than they otherwise would, and are entitled to, receive.

The court found that, given the timeline and intended advertising for the sale, limited due diligence period, and nature of qualified purchase offers under TRF's plan, TRF would likely acquire the property for essentially its credit bid of $2 million. Given that the most conservative estimates of TRF's experts still valued the property at more than $5 million, the court found that TRF could recover more than the allowed amount of its claim under the plan. Furthermore, the court found that, under different sale terms, a recovery for the equity holders of Brewery Park was possible. Thus, the court concluded that TRF's plan was not fair and equitable and could not be confirmed over Brewery Park's objection.

The court then turned to the Brewery Park's motion to dismiss the bankruptcy case. Section 112(b)(1) authorizes the Bankruptcy Court to dismiss a case upon a showing of "cause" by the movant. The term "cause" is not defined in the Bankruptcy Code, so courts have discretion to determine whether cause has been shown in any particular case. Courts will typically consider the totality of the circumstances.

Here, Brewery Park argued that it was unable to obtain financing to propose a viable plan, but that dismissal of the case would enable it to obtain financing, develop the property, and that dismissal would, therefore, inure to the benefit of its creditors. The City of Philadelphia was not opposed to dismissal. The United States Trustee was in favor of dismissal because no viable plan would likely

CONTINUED ON PAGE 12

DIVIDEND PAID IN LBO/RECAPITALIZATION NOT PROTECTED BY 546(E) SAFE HARBOR

Brian M. Schenker
Associate, Philadelphia

Michaelson v. Farmer (In re Appleseed's Intermediate Holdings, LLC), Adv. Case No. 11-807 (JEI/KMW), Bankr. Case No. 11-10160 (KG), 2012 WL 748652 (D. Del. March 7, 2012)

CASE SNAPSHOT

The trustee of a litigation trust formed pursuant to a chapter 11 reorganization of a debtor brought a fraudulent conveyance adversary action against numerous direct and indirect owners of the debtor, as well as the investment manager. The trustee sought to avoid and recover transfers related to a dividend recapitalization that occurred as part of a merger and leveraged buyout, alleging that the defendants caused the debtor to become insolvent by engaging in the complex merger, secured loan, and dividend payment scheme to the sole benefit of the defendants. The defendants moved to dismiss the fraudulent transfer claim. The court denied the defendants' motions to dismiss.

FACTUAL BACKGROUND

Appleseed's Intermediate Holdings, LLC, the debtor, was wholly owned by Orchard Brands, which was wholly owned by Orchard Brands Topco, which was partially owned by Catalog Holdings, an investment fund managed by Golden Gate. All of these direct and indirect owners of the debtor, as well as the investment manager, were grouped together by the court and known as the PE Parties.

Golden Gate formed BLR Acquisition Corporation for the purpose of acquiring Blair Corporation through a merger worth $158 million facilitated by a leveraged buyout transaction. In other words, the PE Parties borrowed funds secured by Blair's assets to finance the merger. The PE Parties, however, did not merely borrow enough money to finance the merger. Rather, the PE Parties also borrowed money secured by all of the debtor's and its affiliated debtors' assets to simultaneously fund a dividend recapitalization, borrowing in total $710 million. The trustee alleged that the PE Parties obtained this financing by use of unreasonably optimistic financial projections, which financial projections were belied by the PE Parties' more conservative internal projections.

After obtaining the financing, the PE Parties commenced the merger and then selected and caused Haband Company, LLC (also a debtor in this case), a wholly owned subsidiary of the debtor, to declare a dividend of $310 million payable to the PE Parties (the remaining loan proceeds were used to pay existing debt). This dividend was paid directly from the lender to the beneficiaries, thereby bypassing the administrative hassle of transferring the loan proceeds through the corporate ladder. The day prior to the board meeting to consider this dividend, the PE Parties temporarily replaced two Haband directors with the managing director of Golden Gate and a director of Orchard Brands. The newly constituted Haband board approved the dividend payment, and then the two temporary directors were replaced with the original Haband directors. The inference drawn was that, absent these machinations, the Haband board would not have approved the dividend.

The trustee alleged that the merger, leveraged buyout, and dividend recapitalization transactions left the debtor teetering on the brink of insolvency and unable to weather the recession. In fact, the debtor's own audited balance sheet showed equity of $95 million before the transactions were completed and a deficit of $279 million afterwards. Furthermore, shortly after the transactions, the debtor was unable to make the loan payments, forcing the debtor to utilize the "payment in kind" provision of the loan agreement, which added missed payments to the principal due. But for this feature, the trustee alleged, the debtor would have filed for bankruptcy sooner than it did, which was four years after the transactions.

COURT ANALYSIS

The court focused on two key arguments advanced by the defendants when addressing their motion to dismiss the trustee's fraudulent transfer claim with respect to the dividend payment.

First, the defendants argued that an essential element of the trustee's fraudulent transfer claim was that the debtor must have had an interest in the property transferred. The defendants contended that the debtor never had any interest in the loan proceeds as none were disbursed directly to the debtor; rather, the loan proceeds went directly to the beneficiaries of the merger, dividend, and existing corporate debt. Specifically, the defendants argued that the debtor never had control over the loan proceeds used to pay the dividend because the debtor was legally required to pay the dividend under the loan agreement. The court quickly clarified that an interest of the debtor in property encompasses "that property that would have been part of the estate had it not been transferred before the commencement of bankruptcy proceeding." The debtor, therefore, did have an interest in all of the loan proceeds. The court noted that the defendants' argument that the debtor had no choice under the loan agreement but to issue the dividend was belied by the machinations required to obtain the Haband board's consent to the dividend; clearly the original board members believed they had a choice. The court emphasized that "it would be paradoxical to allow the PE Parties to offer Debtors' property as collateral, abscond with the proceeds of the loan in the form of a dividend, and yet declare that the Debtors had no interest in the property."

Second, the defendants argued that the dividend transaction was protected under section 546(e) of the Bankruptcy Code because it involved a settlement payment made by or to a financial institution; a settlement payment being any payment commonly used in the securities trade. Though noting that section 546(e) can often be used to protect payments for securities in a leveraged buyout transaction, the court disagreed that it protected the dividend transfer here. The court reasoned that the protections of 546(e) were intended for transactions where exchanges of securities occurred, presumably for value. Here, the court found that the dividend transaction was a one-way payment not involving the exchange of any security. In fact, the court found that the debtors had received nothing in exchange for the dividend. The court emphasized that "while the Blair leveraged buyout may fall within the meaning of a settlement payment, the Blair acquisition cannot be conflated with the payment of the dividend. In other words, even if section 546(e) were to apply to the Blair acquisition in this multifaceted transaction, the dividend would not automatically be exempt as well."

CONTINUED ON PAGE 11

ASSET PURCHASERS MAY BE SUBJECT TO SELLER'S LIABILITIES, DE FACTO MERGER DOCTRINE EXPANDED IN PENNSYLVANIA

Joseph D. Filloy
Associate, Pittsburgh

Fizzano Brothers Concrete Products Inc. v. XLN Inc., PICS 12-0636 (Pa. S.Ct. 2012)

CASE SNAPSHOT

The Pennsylvania Supreme Court broadened the de facto merger exception for successor liability in a case involving asset purchaser liability for breach of contract. This holding creates some uncertainty as to whether purchasers of assets may also become de facto purchasers of liabilities.

FACTUAL BACKGROUND

Fizzano Brothers Concrete purchased a license to use software from SDG for approximately $67,000. The system was never implemented. XLN purchased the stock, assets and liabilities of SDG for $5.4 million, pursuant to a stock purchase agreement. Under this agreement, XLN executed promissory notes totaling $5.1 million payable to SDG shareholders, and as collateral for these loans, ownership of the software source codes was transferred to SDG shareholders. The source codes were placed in escrow, and would transfer to XLN upon payment in full of the promissory notes. Two of the SDG shareholders, Hamlin and Fritsch, were the primary owners of the software, and were given employment contracts with XLN. Both worked daily at XLN, but neither Hamlin, nor Fritsch, nor any other SDG shareholder, was a shareholder in XLN.

XLN began to struggle financially, and entered into an asset purchase agreement with XLNT (an unrelated company). Under this agreement, XLNT purchased virtually all of the assets of XLN, and assumed liability for payment of the promissory notes. XLN did retain some equipment and two customers, but was required to change its name. Hamlin and Fritsch entered into employment contracts with XLNT, and ownership of the software codes remained with the SDG shareholders; and as in the SDG-XLN sale, the codes would transfer to XLNT upon payment in full of the promissory notes.

Fizzano had filed suit against XLN for breach of contract and breach of warranty for the failure of the software's implementation. After the sale to XLNT, Fizzano amended its complaint to include XLNT as a party. Fizzano was granted summary judgment against XLN, and judgment for $114,000 was entered against XLN. The case against XLNT proceeded to a bench trial. XLNT argued that, as a mere purchaser of assets, it had no liability arising from the suit against XLN, since XLNT had not expressly assumed this liability. The trial court found, however, that the XLNT-XLN transaction fell within two exceptions to the rule that a purchaser of assets does not assume the seller's liabilities – the de facto merger exception, and the "mere continuation of enterprise" exception, and therefore, XLNT was liable for the $114,000 judgment in favor of Fizzano. On appeal, the Superior Court reversed the trial court, and Fizzano appealed to the state Supreme Court.

COURT ANALYSIS

The court set forth the four factors that are generally examined to determine whether a de facto merger occurred. They are:

- There is a continuation of the enterprise of the seller corporation, so that there is continuity of management, personnel, physical location, assets, and general business operations
- There is a continuity of shareholders that results from the purchasing corporation paying for the acquired assets with shares of its own stock, this stock ultimately coming to be held by the shareholders of the seller corporation so that they become a constituent part of the purchasing corporation
- The seller corporation ceases its ordinary business operations, liquidates, and dissolves as soon as legally and practically possible
- The purchasing corporation assumes those obligations of the seller ordinarily necessary for the uninterrupted continuation of normal business operations of the seller corporation

The trial court found that all but the second element were present, and expressly rejected XLNT's contention that all four factors must be present in order to find a de facto merger. The trial court also found that the transaction fell within the "mere continuation of enterprise" exception, noting essentially the same factors it relied on to find a de facto merger, emphasizing that XLNT held itself out as the "successor" to XLN, thereby satisfying the "mere continuation" exception. The Superior Court not only rejected the trial court's finding that three of the four factors were satisfied, but it also held that all four factors *must* be present in order to show that a de facto merger occurred. The Superior Court also found that the "mere continuation" exception could not possibly apply here because of the lack of commonality of ownership between XLNT and XLN.

CONTINUED ON PAGE 12

Dividend Paid in LBO/Recapitalization Not Protected by 546(e) Safe Harbor—continued from page 10

PRACTICAL CONSIDERATIONS

Secured lending for purposes of leveraged buyouts has long been an area where lenders must tread cautiously. This case is a reminder of that fact. This case is also one of many recent cases where courts are shaping the boundaries of the safe harbor provided for leveraged buyouts by section 546(e) of the Bankruptcy Code, an area of law that continues to develop. In many instances, lenders will benefit from the advice of counsel before financing a leveraged buyout or any transaction related to a leveraged buyout. During any such transaction, as this case demonstrates, one must take a step back and evaluate how the transaction will appear under later scrutiny.

Creditor's Proposed Plan Violated Absolute Priority Rule – Court Dismissed Bankruptcy Case—continued from page 9

ever be proposed and dismissal would enable the creditors to pursue their rights against Brewery Park in state court. TRF opposed dismissal, arguing that the case ought to be converted to chapter 7.

In considering TRF's position, the court noted that conversion should only be granted where there are assets that a chapter 7 trustee could administer. Here, Brewery Park had no cash, no liquid source for cash, and, therefore, no means to fund a chapter 7 bankruptcy (the chapter 11 case was being funded by equity contributions). The lack of available financing in the market made it unlikely that a chapter 7 trustee would be able to sell the property and achieve any dividends for the unsecured creditors, which in turn, made it likely that the trustee would abandon the property. The court concluded that this case had essentially come down to a two-party dispute between Brewery Park and TRF, whose issues could better be handled in state court, that it would not be in the best interests of creditors and Brewery Park to convert the case and, therefore, dismissed the case.

PRACTICAL CONSIDERATIONS

Pursuing a "competing plan" in a chapter 11 bankruptcy case can often be a successful strategy for a secured creditor for a number of reasons. Here, the strategy proved less than fruitful. This case, however, can serve as a sort of roadmap for secured creditors going forward as to how to avoid certain pitfalls. Generally speaking, the court admonished the secured creditor here for not proposing a commercially reasonable sale of the property.

Rental Payments and Administration Expenses Back in the Spotlight: Luminar Decision Clarifies Circumstances in Which Rental Liabilities Qualify as Administration Expenses—continued from page 8

1. *Leisure (Norwich) II Limited v. Luminar Lava Ignite Limited (in administration) and others* [2012] EWHC 951

2. *Goldacre (Offices) Limited v. Nortel Networks UK Limited* [2009] EWHC 3389

3. *Re Silkstone & Dodsworth Coal & Iron Co* [1881] 17 Ch D 158

Asset Purchasers May Be Subject to Seller's Liabilities, De Facto Merger Doctrine Expanded in Pennsylvania—continued from page 11

The Supreme Court focused on the Superior Court's holding that all four factors, particularly the "commonality of ownership" factor, must be present. The Supreme Court observed that a split among other jurisdictions, and even some splits within jurisdictions, exists on this question. The Supreme Court performed an exhaustive review of past Supreme Court jurisprudence, as well as salient cases from other jurisdictions. The court noted that other courts tend to relax the common ownership factor somewhat in criminal and/or tort cases and in instances involving serious public policy concerns, e.g., products liability actions. However, this relaxed approach would be atypical in a contract or commercial case. The court stated that it could adopt what it called a "broad" holding, requiring common ownership to be shown in commercial and contract cases in order to show a de facto merger. Instead, the court chose to focus on the narrower facts before it, using the case analyses it had set forth as guidance.

The court reviewed the factual record before it:

Factor 1 - The court found that there was a continuation of the enterprise from SDG to XLN to XLNT, given that the companies all were located in the same premises, the general business operations were the same, and Hamlin and Fritsch – the primary owners of the software – moved from entity to entity to entity.

Factor 3 - The court found that, although XLN retained some equipment and intended to continue operations, XLN did, for all intents and purposes, cease to operate.

Factor 4 - The court also found that, because of the employment of Hamlin and Fritsch, as well as the assumption of the obligation to pay the promissory notes, XLNT did assume the obligations of XLN necessary to continue those operations.

The court also emphasized that the only asset of value throughout the string of entities was the software program itself. Without the program and its source codes, none of the companies had any value or viability.

This brought the court back to the second factor – commonality of ownership.

The court looked to the Pennsylvania Business Corporation Law provisions on the elements of a statutory merger as further guidance. The court noted that the statute provides that merger or consolidation contemplates the conversion of shares of the predecessor corporation for shares "or *obligations*" of the surviving corporation, which obligations might include repayment of corporate notes. The court concluded that, since an exchange of shares is not always required to effect a statutory merger, it "would be incongruous to adopt a blanket rule that a de facto merger would *always require* a rigid showing that the shareholders of a predecessor corporation have exchanged their ownership interests for shares of the successor corporation." (Emphasis in opinion.) The court concluded that in contract cases, the de facto merger exception requires "some sort of proof of continuity of ownership or stockholder interest," but that such proof was not restricted to the strict exchange of shares.

Applying its legal conclusion to the facts of this case, the court found that the record showed a continuity of the business formed by the shareholders and originating in SDG because the only valuable asset – the program source codes – had been sold by SDG to XLN, and by XLN to XLNT. The court also held that the Superior Court erred by taking a narrow and mechanical view of the continuity of ownership prong; instead the Supreme Court noted that the realities of the entire transaction, rather than one narrow piece, should be taken into consideration.

CONTINUED ON PAGE 22

ENDING FORBEARANCE IS NOT EQUIVALENT TO ECONOMIC DURESS

Brian M. Schenker
Associate, Philadelphia

Interpharm, Inc. v. Wells Fargo Bank, N.A., 655 F.3d 136 (2d Cir. 2011)

CASE SNAPSHOT

A borrower under a revolving line of credit sued its lender alleging various breach of contract and tort claims. The lender defended by relying on numerous releases in its favor provided by the borrower in connection with several forbearance agreements entered into between the parties. The borrower, however, contended that the lender obtained these releases through use of economic duress and, therefore, the releases were void and unenforceable. Specifically, the borrower claimed that the lender compelled the borrower's entry into these releases by wrongfully threatening the borrower with, and then taking actions exceeding, the lender's rights under their agreements. The court dismissed the borrower's claims, finding that the lender's actions did not exceed its rights under their agreements and, therefore, did not constitute a "wrongful threat."

FACTUAL BACKGROUND

Interpharm, a pharmaceutical manufacturer, entered into a credit agreement with the lender, whereby the lender extended a revolving line of credit to Interpharm secured by its inventory, equipment, and accounts receivable. The line of credit allowed Interpharm to borrow up to $22.5 million, depending on the value of its inventory and account receivables. Specifically, the credit agreement provided that the borrowing base would be calculated as the sum of 50 percent of the value of eligible inventory and 85 percent of the value of eligible receivables. The credit agreement, however, allowed the lender to exercise reasonable discretion to alter those percentages or to deem assets ineligible for calculation of the borrowing base. The credit agreement also provided the lender with a range of rights and remedies upon the occurrence of an event of default thereunder, including imposition of the default rate of interest, termination of the line of credit, acceleration of the loan obligations, and liquidation of the collateral.

A decline in Interpharm's revenues led to events of default under the credit agreement. Rather than exercising any of its rights and remedies, the lender agreed to enter into a Forbearance Agreement with Interpharm. The first Forbearance Agreement increased Interpharm's credit limit by $2 million and imposed additional fees, a higher interest rate, and new income and cash flow requirements on Interpharm. Interpharm alleged that it conveyed its doubt about meeting the new financial requirements to the lender and alleged that the lender "vaguely propos[ed] to negotiate new financial covenants for the first half of 2008 that would provide Interpharm with the relief it needed to succeed." Thinking it had "little choice" but to agree to these terms, Interpharm signed the first Forbearance Agreement, thereby releasing all claims it might have against the lender arising prior to its execution.

Interpharm's failure to meet the new financial requirements resulted in additional events of default under the credit agreement. Upon the occurrence of these events of default, the lender imposed the default rate of interest and other penalties. The lender also excluded the receivables of four of Interpharm's major wholesale customers from the calculation of Interpharm's borrowing base because of these customers' practice of charging-back to Interpharm certain price differences. Interpharm countered that such charge-backs were standard industry practice and the lender's exclusion of these accounts was a pretext for constricting its available credit. Thereafter Interpharm's financial condition deteriorated so badly that it could no longer pay its suppliers or meet its payroll, and Interpharm informed the lender that it would be forced to liquidate absent additional advances of credit for working capital.

Rather than pursue liquidation, the lender agreed to enter into a second Forbearance Agreement with Interpharm. The second Forbearance Agreement made additional advances of credit available to Interpharm but also specifically excluded receivables from wholesalers from Interpharm's borrowing base, and required Interpharm to hire a chief restructuring officer. Interpharm signed the second Forbearance Agreement, thereby releasing all claims it might have against the lender arising prior to its execution.

Soon thereafter, the parties entered into a third Forbearance Agreement whereby the lender imposed additional fees, required Interpharm to provide additional collateral, and required Interpharm to pursue a refinance or liquidation, and Interpharm agreed to release all claims it might have against the lender arising prior to the execution of the third Forbearance Agreement.

Soon thereafter, the lender reduced the percentage of eligible inventory for Interpharm's borrowing base from 50 percent to 39.6 percent, based on an inventory valuation obtained from a third party retained by the lender. In response to Interpharm's protests that it needed more available credit to continue operating, the lender agreed to a fourth Forbearance Agreement in which the lender agreed to temporarily increase the percentage of eligible inventory for Interpharm's borrowing base from 39.6 percent to 49 percent, while retaining sole discretion to reduce the percentage as it deemed appropriate. Interpharm signed the fourth Forbearance Agreement, thereby releasing all claims it might have against the lender arising prior to its execution.

Unable to secure new financing, a circumstance that Interpharm alleged arose because of the lender's actions, Interpharm agreed to sell its assets to a third party, but informed the lender that its operations could not survive through closing without additional advances of credit. The lender agreed to enter into a fifth and final Forbearance Agreement, whereby the lender made additional advances of credit available to Interpharm and Interpharm agreed to release all claims it might have against the lender arising prior to the execution of the fifth and final Forbearance Agreement.

After completing the sale of substantially all of its assets, Interpharm paid its obligations to the lender. Sometime thereafter, Interpharm advised the lender that it was repudiating all of the Forbearance Agreements, which necessarily included the release provisions. Interpharm then filed suit against the lender, alleging breach of contract, breach of the implied duty of good faith and fair dealing, tortious interference with business expectations, unjust enrichment, and breach of fiduciary duty. The lender sought dismissal of the suit, citing the release provision in the final Forbearance Agreement. Interpharm opposed the motion, arguing that the release was obtained wrongfully as a result of economic duress.

CONTINUED ON PAGE 22

STATUTE OF FRAUDS BARS CLAIMS, EXCEPT FOR INTERFERENCE WITH PROSPECTIVE CONTRACTUAL RELATIONS

400 Walnut Associates, L.P. v. 4th Walnut Associates, L.P., et al., (In re 400 Walnut Associates, L.P.), 454 B.R. 60 (E.D. Pa., 2011)

Joseph D. Filloy
Associate, Pittsburgh

CASE SNAPSHOT

The chapter 11 debtor brought an adversary action against the successor-in-interest to the debtor's mortgage lender, asserting claims for breach of contract, breach of oral contract, breach of duty of good faith and fair dealing, negligence, declaratory judgment, intentional interference with existing contractual relations, and intentional interference with prospective contractual relations. The suit was based on an alleged oral agreement between the debtor and its lender, pursuant to which the debtor asserted the lender agreed to forbear from foreclosing on the property securing the loan. The defendant-lender moved to dismiss the action, and the court found that the Statute of Frauds precluded all but one of the debtor's claims. The court granted the motion with respect to six counts, but denied the motion to dismiss the count alleging intentional interference with prospective contractual relations.

FACTUAL BACKGROUND

400 Walnut Associates, L.P. executed a note and mortgage in favor of Sovereign Bank, and subsequently defaulted on its obligations. Sovereign initiated foreclosure proceedings, and the borrower attempted to negotiate a forbearance agreement with Sovereign. During the course of these negotiations, Sovereign suspended the foreclosure proceedings. Before the oral agreement was memorialized in writing, Sovereign reinstated the foreclosure proceedings, and 4th Walnut Associates, L.P. purchased the note and mortgage from Sovereign. The borrower filed a bankruptcy petition, then brought this adversary action against 4th Walnut, alleging seven causes of action revolving around the supposed forbearance agreement and 4th Walnut's role in the failure to put the oral forbearance agreement in writing.

The defendant filed a motion to dismiss all counts, raising the Statute of Frauds as its defense. The debtor argued that two letters from Sovereign, as well as Sovereign's suspension of the foreclosure action, together constituted sufficient written proof to overcome the Statute of Frauds. The court disagreed, and dismissed six of the counts of the debtor's complaint.

COURT ANALYSIS

Five of the seven counts in the complaint relied on the legal existence of the alleged forbearance agreement between Sovereign and the debtor. Since there was no written document embodying the forbearance agreement, and the forbearance involved real property, 4th Walnut raised the Statute of Frauds as a defense. The Statute of Frauds requires a memorandum in writing signed by the parties to be charged that sufficiently indicates the terms of the contract and the property to be conveyed. Under Pennsylvania law, the Statute of Frauds' aim is to prevent the enforcement of a contract that was never made. The Statute of Frauds defense cannot be used, however, to prevent the performance or enforcement of an oral contract that has, in fact, been made. The Statute can be satisfied by an amalgam of documents that, when taken together, make out the requisite elements and terms of the alleged contract, without resorting to parol evidence.

The debtor relied on two sets of documents in support of its contention that the Statute of Frauds was satisfied – certain letters to the debtor's subtenants, and a state court docket reflecting the suspension of a mortgage foreclosure action. Additionally, the debtor asserted that Sovereign's intention and agreement to forbear was further confirmed by three other letters pursuant to which the debtor accounted for rents collected, expenses paid, and net rents remitted to Sovereign – which, according to the debtor, was in keeping with the parties' agreement. The court found that the documents did not constitute a forbearance agreement, primarily because there was no mention in any document that Sovereign was forbearing or taking any action in accordance with any decision or agreement to forbear. Moreover (addressing an alternative argument of 4th Walnut's), there was no evidence that the debtor had provided consideration for this alleged agreement – a vital element of any contract. The court therefore found sufficient grounds to grant 4th Walnut's motion to dismiss the five counts of the complaint that relied on the existence of a contract.

The complaint also set forth a count seeking a declaratory judgment that, based on the defendant's breach of contract and related wrongdoing, the debtor alleged that it was entitled to be absolved of any liability. The court disagreed, noting that declaratory judgment is intended to address uncertainty as to legal rights between parties, with the aim of expediting a conclusion of a pending dispute or avoiding one altogether. The court concluded declaratory judgment was inappropriate because the parties were already engaged in litigation. The court noted, "The parties are past the point where a declaratory judgment action can serve a prophylactic purpose." Finally, the court analyzed the debtor's claim of interference with *prospective* contractual relations and found that the debtor's allegations were sufficient to survive the motion to dismiss stage. The gist of this claim was that the debtor and Sovereign would have reached an accord, i.e., a prospective contractual relationship, but for the actions of 4th Walnut. To survive a motion to dismiss, the debtor had the burden to demonstrate "something more than a mere hope" that the parties would come to terms; it had to show a reasonable likelihood, or probability, that a contract would come to exist. The debtor satisfied its burden by showing that during negotiations with Sovereign it had requested draft forbearance agreements, which Sovereign assured were forthcoming on more than one occasion. The court found that this indicated "that the parties would memorialize the deal which they had reached in principle. That is not to say that such event was a certainty, but Debtor's expectation is fairly characterized as reasonably likely or even probable."

In addition to sustaining its burden with respect to the prospective contract, the debtor was required to allege sufficient facts to support its allegations that 4th Walnut intentionally interfered with this relationship. Specifically, the debtor alleged that 4th Walnut intentionally interfered with this relationship by directing Sovereign to: instruct the debtor that it was in default; instruct the debtor that it had never agreed to forbear; and, reinstate the foreclosure proceeding. The court concluded that "directing Sovereign to disavow the existence of any agreement to forbear, when Sovereign's alleged conduct suggests that it was forbearing for the three months following the debtor's meeting with Sovereign arguably constitutes

CONTINUED ON PAGE 23

ILLINOIS MORTGAGEES BEWARE – MORTGAGES LACKING INTEREST RATE AND MATURITY DATE AVOIDABLE BY BANKRUPTCY TRUSTEE

Stephen Bobo
Partner, Chicago

Mortgages on Illinois real estate that fail to recite the interest rate and maturity date of the underlying loans are avoidable by a bankruptcy trustee, according to a recent Bankruptcy Court decision, in *Richardson v. The Gifford State Bank (In re Crane),* Case Number 11-9067 (Bankr. C.D. Ill., February 29, 2012). The case involved two mortgages granted several years before the individual debtors filed their chapter 7 cases. Both mortgages failed to state the applicable interest rate and the maturity date of the debts they secured.

The chapter 7 trustee filed an adversary proceeding seeking to avoid the mortgages on the basis that they did not comply with section 765 ILCS 5/11 of the Illinois mortgage statute. This section lists the elements of a real estate mortgage, including the interest rate and the maturity date. The trustee alleged that the mortgages in question did not give constructive notice to third parties and were not properly perfected.

The Bankruptcy Court granted summary judgment for the trustee. Based on decisions by two other Illinois bankruptcy judges, the court determined that the bank's failure to include all of the elements listed in 765 ILCS 5/11 in the mortgages took them out of the safe harbor from avoidance by a bankruptcy trustee provided by the statute. By omitting the interest rate and maturity date information, the mortgages did not give sufficient constructive notice to third parties, including the bankruptcy trustee, even though the mortgages were effective as between mortgagor and mortgagee.

The language of the statute in question, 765 ILCS 5/11, on its face does not appear to mandate requirements for mortgages to be enforceable against third parties. Instead, it states "Mortgages of lands may be substantially in the following form. . . ." However, the earlier Illinois Bankruptcy Court decisions construed this statute as mandating what was required for a mortgage to provide constructive notice to a good faith purchaser or a trustee in bankruptcy. See, *In re Berg,* 387 B.R. 524 (Bankr. N.D. Ill. 2008) and *In re Share Manning Properties,* 2010 Bankr. Lexis 3688 (Bankr. C.D. Ill. 2010). The *Richardson* court followed those holdings.

The issue will be subject to further review since the lender filed a notice of appeal from this decision. However, lenders obtaining mortgages on Illinois real estate should take care to include all the elements listed in 765 ILCS 5/11 in their mortgages. Holders of existing mortgages may want to consider amending their mortgages where possible to cure any deficiencies.

SPLIT CONTINUES – INDIVIDUAL CHAPTER 11 DEBTORS NOT SUBJECT TO ABSOLUTE PRIORITY RULE

Christopher Rivas
Associate, Los Angeles

Friedman v. P+P, LLC (In re Friedman), 466 B.R. 471 (9th Cir. BAP 2012)

CASE SNAPSHOT

Individual chapter 11 debtors sought confirmation of a reorganization plan that allowed the debtors to retain their assets, including their equity interests in their businesses, while paying less than a full amount of unsecured creditors' claims. An unsecured creditor voted against the plan, and filed an objection to confirmation, on the grounds that the plan violated the "absolute priority rule" because it permitted the debtors/equity holders to retain valuable property interests before unsecured creditors were paid in full. The Bankruptcy Court held that the absolute priority rule applied to individual debtors and denied confirmation of the plan. The debtors appealed, and, recognizing a split in authority on the question, the Bankruptcy Appellate Panel held, in a 2-to-1 decision, that the absolute priority rule did not apply to individual chapter 11 debtors, and reversed and remanded the case.

FACTUAL BACKGROUND

Gregory and Judith Friedman owned and operated several Internet technology companies, some of which had earlier filed bankruptcy petitions. With an imminent foreclosure pending against their property, the Friedmans filed for chapter 11 bankruptcy. The property lost so much value that junior lienholder P+P, LLC became fully unsecured and was classified as such in the Friedmans' bankruptcy plan.

The plan proposed that all assets, including the business equity interests, would revest in the debtors, and that monthly payments of $634 would be made to the general unsecured creditors.

P+P voted against this plan and objected to confirmation, on the grounds, among other things, that it violated section 1129(b)(2)(B)(ii) (the "absolute priority rule"). In connection with its objection, P+P offered expert evidence that the business ownership interests of the debtors were worth far more than the zero value assigned by the debtors. The Bankruptcy Court denied plan confirmation on the basis that the plan violated the absolute priority rule and ordered that a third amended plan be filed. After the debtors disregarded that order and appealed instead, the Bankruptcy Court converted the case to chapter 7. The debtors moved for a stay, pending appeal, which was granted.

COURT ANALYSIS

The Bankruptcy Appellate Panel stated the issue simply: Does the absolute priority rule apply to chapter 11 debtors who are individuals? The issue is one that has created a split in authority among bankruptcy courts all over the country.

The court saw its task as one of statutory construction, to determine how an individual chapter 11 debtor may cram-down a plan. The absolute priority rule, as it is frequently called, is set forth in section 1129(b)(2)(B)(ii). However, in the case of individual chapter 11 cases, 1129(b)(2)(B)(ii) expressly states that an individual debtor "may retain property included in the estate under section 1115."

CONTINUED ON PAGE 23

COURT RELIES ON ITS OWN LOGIC TO VALUE MORTGAGE SERVICING RIGHTS

Kathleen A. Murphy
Associate, Wilmington

In re TMST, Inc., et al., Case No. 09-00574 (Bankr. D. Md., Feb. 22, 2012)

CASE SNAPSHOT

The debtors owned, securitized and serviced mortgages. Prior to filing for bankruptcy, the debtors entered into security agreements with Credit Suisse, under which Credit Suisse was granted a security interest in certain mortgage servicing rights. After the commencement of the bankruptcy case, Credit Suisse initiated this adversary proceeding to determine the extent of its rights in the mortgage servicing rights, arguing that its lien encompassed both rights as the owner of the mortgages, and the rights as the servicer of the mortgages. The debtors argued that the lien only encompassed the owner rights. The court agreed with the debtors, but found that the owner rights were far more valuable because of the contractual right of the owner to terminate the servicer without cause.

FACTUAL BACKGROUND

TMST, Inc. and several subsidiaries were in the business of owning, securitizing and servicing high-quality-rated luxury mortgages. Credit Suisse Securities and TMST entered into a series of security transaction agreements, in which Credit Suisse was granted a security interest in all of TMST's rights "in, under and to the Mortgage Servicing Agreements, Sub-Servicing Agreements and all Servicing Records, *solely as the owner of the mortgage servicing rights or rights* to receive any payments related to such mortgage servicing rights under such Mortgage Servicing Agreements." (Emphasis added.) Following TMST's bankruptcy filing, Credit Suisse and TMST were unable to reach agreement as to the extent of Credit Suisse's lien in and value of the mortgage servicing rights (MSRs), and thereafter, Credit Suisse initiated an adversary proceeding, seeking a declaratory judgment to determine such. Both parties filed cross-motions for partial summary judgment and conceded that the documents at issue were unambiguous.

COURT ANALYSIS

The "ultimate question" was whether the grant of rights in the security agreement provided Credit Suisse with a security interest in all of the interests held by the Trustee in the MSRs, or "just those rights held 'solely as owner' (the word 'solely' having appeared in several sections of the Security Agreement and its meaning existing as a strong point of contention between the parties)."

Credit Suisse argued that it held as collateral the entire right to designate the servicer both as "Seller" and as "Servicer," and therefore, all proceeds held by the Trustee for the sale of the MSRs ($79 million) were subject to its security interest. The debtors argued that the word "solely" must be read to have meaning that therefore excluded from the liens any of the estates' interests in the MSRs that were not held "solely as owner." Further, the debtors believed that the Security Agreement contained distinct bundles of rights of which the right to act as Servicer held substantial value. The debtors argued that under the contract, the term "Seller" meant "solely as owner" and therefore the references to "Servicer" were separate rights that had not been granted in the collateral to Credit Suisse. The debtors also argued that if one conceded that the security interest was held as owner of the MSR rights, that right would still require a process of replacing a current Servicer, a process that was of value, and not part of the security grant.

The court determined that the Security Agreement unambiguously set forth two sets of rights – "Owner" and "Servicer," and that the Credit Suisse lien encompassed only the rights of "Owner." The court's task now was to determine the value of the lien, given that MSRs were split into two sets of rights.

The debtors' expert provided probative evidence as to how the marketplace would view the purchase of such rights generally. Based upon Credit Suisse's assertion that the agreements provide to the Owner an absolute right to terminate the Servicer, the expert observed, "we're really going to be talking about the economic benefit of veto power." The debtors' expert further testified that "this boils down to the fact that as a buyer, I would not touch this portfolio without the consent of every party involved, the Seller in particular." Based on this, the court concluded that "the market for buying and selling these types of mortgage servicing rights does not separately sell or value Seller's Rights and Servicer's Rights. The combined rights are what buyers are willing to purchase. Thus there are no historical sales figures of similar rights, nor other market records that can be brought to bear on the allocation question now before the court."

The court had not permitted any expert to opine as to the separate values of the rights, and because there were no historical sales, the court relied on logic and business sense. Given that the right of the Owner/Seller to terminate the Servicer was unilateral, explicit and paramount, the court concluded that Credit Suisse's MSR was worth significantly more than the debtors' right as Servicer. Because the debtors' expert testified that he would "not touch" a sale of the MSRs without the consent of all of the counterparties, the Servicer rights must have some value. The court assigned 95 percent of the value of the MSRs to the Owner, Credit Suisse, and 5 percent to the debtors.

PRACTICAL CONSIDERATIONS

The court agreed with the debtors that the subject agreements created two bundles of rights, and that Credit Suisse's lien went only to the "Owner" rights. While the "Servicer" would typically be considered to be more valuable by virtue of the ability to actually generate revenue, the unilateral power of the Owner to terminate the Agreement and replace the Servicer greatly reduced the value of the revenue-generation. This fact-intensive case teaches that very precise drafting is vital.

SARE CREDITOR'S RIGHT TO PRE-PETITION INTEREST GOVERNED BY STATE LAW

Ann Pille
Associate, Chicago

In re 785 Partners LLC, 2012 WL 1154282 (Bankr. S.D.N.Y., April 9, 2012)

CASE SNAPSHOT

The chapter 11 debtor, a single asset real estate entity, sought to confirm a plan over the objection of its senior secured lender. The parties disputed the amount of the secured claim, and whether the claim should include pre- and post-petition default interest, as well as late charges. The debtor contended that the secured creditor was entitled to a claim equal to the sum of principal, pre-petition interest at the non-default rate and the administrative fee. The secured creditor asserted that it was entitled to principal, pre-petition and post-petition interest at the default rate, the administrative fee, as well as a late payment premium. After reviewing the stipulated facts submitted by the parties, the court held that the creditor was entitled to pre- and post-petition interest at the contractual default rate, but further held that the creditor could not recover both default interest and a late payment premium.

FACTUAL BACKGROUND

In 2007, 785 Partners LLC borrowed $85 million to finance the acquisition of a building in New York City. The loan was secured by mortgages on the building. Under the loan documents, the non-default rate of interest was 5 percent. Upon the occurrence of an event of default, a default rate of interest equal to an additional 5 percent above the non-default rate was triggered. In addition, the loan documents provided for payment of a late payment premium equal to 5 percent of any missed payment, which was intended to cover administrative and related expenses incurred in handling delinquent payments.

In 2009, 785 Partners failed to make the required payments at maturity and instead filed a chapter 11 petition. The secured lender filed a secured claim in the amount of $105 million. The debtor, disputing the lender's right to both default interest (pre- and post-petition) and the late payment premium, calculated the creditor's claim to be $92 million.

COURT ANALYSIS

The court began its analysis of the interest rate discussion by noting that a creditor's right to pre-petition interest is governed by state law. Evaluating New York law, the court concluded that the secured creditor was entitled to pre-petition interest at the default rate, and that the default rate was not a penalty or inequitable, and was within the range found to be reasonable in prior case law.

The court then turned to a discussion of post-petition interest. It found that, pursuant to section 502(b)(2), interest generally ceases to accrue as of the petition date. An exception to this rule, however, is codified in section 506(b) of the Bankruptcy Code, which entitles an oversecured creditor to certain post-petition interest, fees, costs and charges, up to the value of its collateral. The "interest" allowed under section 506(b), however, is not necessarily the contract rate of interest negotiated between the parties. Instead, there is a rebuttable presumption that the oversecured creditor is entitled to interest at the contract rate subject to adjustment based on equitable considerations. Generally, misconduct by the creditor, or a showing that the default rate is a penalty or impairs the debtor's fresh start, is required to rebut the presumption. It is the debtor's burden to rebut the presumption, and this particular debtor failed to present sufficient evidence to rebut the presumption. As a result, the court found that the secured creditor was oversecured, and that the creditor was entitled to post-petition interest at the contractual default rate.

The court next addressed the creditor's entitlement to the late payment premium. As set forth in the loan documents, this premium was intended to cover additional costs incurred by the creditor in processing late payments. Here, the debtor's proposed plan provided for the creation of an amended and restated note and mortgage upon confirmation. As such, the court reasoned that this debtor would never make a late payment under the original note or mortgage, and that the additional costs that the late payment premium was intended to address would never be incurred.

The court further noted that, even had the debtor's proposed plan not provided for the extinguishment of the original note and mortgage, "[t]he decisional law is uniform that oversecured creditors may receive payment of either default interest or late charges, but not both." For these reasons, the court held that – so long as the creditor was charging default interest under the loan documents – the late payment premium could not be included in the value of the secured creditor's claim as an additional measure of damages.

The court concluded that the creditor was entitled to principal, pre-petition and post-petition interest at the contractual default rate, and the administrative fees.

PRACTICAL CONSIDERATIONS

This case reaffirms that: (i) a Bankruptcy Court may not modify pre-petition interest unless such interest can be modified under the applicable state law; (ii) post-petition default interest on oversecured claims need not necessarily accrue at the contractual default rate, and can be modified by the court under principles of equity; and (iii) an oversecured creditor may be entitled to default interest or late charges, but not both.

CMBS CERTIFICATEHOLDER IS NOT A 'PARTY IN INTEREST' IN CHAPTER 11 CASE

Amy Tonti
Partner, Pittsburgh

Query: Do certificateholders in commercial mortgage-backed securities ("CMBS") have standing to be heard in chapter 11 cases under section 1109(b) of the Bankruptcy Code as "parties in interest?"

Short Answer: Possibly, depending on the provisions of the Servicing Agreement.

In *Innkeepers*, a holder of certificated interests in the two REMICs that owned the largest of the debtors' pre-petition loans sought to object to a pending motion to approve the debtors' proposed stalking horse agreement for the sale of the debtors' assets. To enable the holder to be heard on such objection, it had to convince the court that the holder was a "party in interest" under section 1109(b) of the Bankruptcy Code. Denying the holder's request for "standing," the court relied on controlling law and the ***express terms of the applicable servicing agreement.*** Under the servicing agreement, the special servicer is the party responsible for representing the certificateholders upon an event of default under a mortgage loan held by the REMIC—to consider the collective interests of all certificateholders. The *Innkeepers* court stated in its opinion on the matter, that allowing a certificateholder standing "would dramatically alter the CMBS landscape and render the delegation to a special servicer meaningless." *In re Innkeepers USA Trust,* No. 10-13800, 448 B.R. 131, 144 (Bankr. S.D.N.Y. 2011).

COURT ALLOWS PRO SE CLAIMANT TO WITHDRAW CLAIM TO PRESERVE RIGHT TO JURY TRIAL

Ann Pille
Associate, Chicago

Field v. Albright et al. (In re Maui Industrial Loan & Finance Company), 2012 WL 405056 (Bankr. D. Hawaii, Feb. 8, 2012)

CASE SNAPSHOT

Individual victim of a Ponzi scheme operator/debtor filed a proof of claim in the chapter 7 proceeding – without the benefit of legal counsel. The chapter 7 trustee sued the claimant, seeking avoidance and recovery of transfers the debtor made. In his answer to the suit, the claimant demanded a jury trial. While filing a proof of claim in a bankruptcy proceeding does waive the right to a jury trial, the fundamental right is not extinguished completely. The Bankruptcy Court allowed the claimant to withdraw his bankruptcy claim with prejudice, so that he could proceed with a jury trial before the District Court on the claims stated in the adversary action.

FACTUAL BACKGROUND

The defendant in this case invested $97,152 with Maui Industrial Loan & Finance Company and its principal, unaware that Maui was a Ponzi scheme. Profits were paid to the defendant. In January 2010, Maui filed a chapter 7 petition, and a trustee was appointed. The defendant filed a proof of claim in the case. There was no evidence that the defendant used the services of an attorney to help file the proof of claim, and it did not appear that the defendant had any reason to believe that the trustee might sue him.

The trustee did sue, however, seeking to avoid and recover the transfers from the debtor to the defendant. In his answer to the trustee's complaint, the defendant denied the allegations and demanded a jury trial. The trustee, at the court's direction, filed a motion to determine the defendant's demand.

COURT ANALYSIS

The court began its discussion by citing the Seventh Amendment to the Constitution – "[i]n Suits at common law, where the value in controversy shall exceed twenty dollars, the right of a trial by jury shall be preserved …." The court, citing decisions of the U.S. Supreme Court, then noted that the filing of a proof of claim in a bankruptcy proceeding serves to waive the creditor's right to a jury trial, not only with respect to its claim, but also with respect to claims brought against the creditor for the avoidance of fraudulent or preferential transfers.

In order to preserve his right to jury trial, the defendant sought leave to withdraw his bankruptcy claim. The Supreme Court cases did not address whether withdrawal of a claim served to reinstate the right to a jury trial.

Federal Rule of Bankruptcy Procedure 3006 states that a proof of claim may be withdrawn only upon court order after a hearing. Thus, the rule vests discretion in the court to approve, deny or condition a request to withdraw a proof of claim, and withdrawals are generally permitted so long as the opposing party does not suffer prejudice. Observing that the suit could be pursued in the district court, and that the loss of a preferred forum is not "legal prejudice," the court concluded that the no prejudice to the trustee existed. The court also considered, and rejected, the trustee's argument that the defendant waived his right to a jury trial by filing the proof of claim. Instead, it found that the defendant did not have legal counsel when he filed his proof of claim, so it "would be a stretch" to say that he knowingly waived his right to jury trial.

After considering the facts before it, the court held that the defendant could withdraw his claim to preserve his right to a jury trial, but further held that the claim must be withdrawn with prejudice.

PRACTICAL CONSIDERATIONS

This opinion emphasizes the fundamental right to a jury trial, and the efforts a court will make to preserve that right – especially in the case of a pro se defendant. Here, the court used its discretion to allow the defendant to pursue a jury trial, while ensuring that the bankruptcy trustee was not prejudiced by the withdrawal of the proof of claim.

INDENTURE NO-ACTION CLAUSE BARS SUIT AGAINST ISSUER, DIRECTORS AND OFFICERS

Joseph D. Filloy
Associate, Pittsburgh

Akanthos Capital Management, LLC, et al. v. CompuCredit Holdings Corp., et al., 2012 WL 1414247 (11th Cir., Apr. 25, 2012)

CASE SNAPSHOT

Holders of a majority of the issuer's unsecured notes brought suit against the issuer and the directors and officers of the issuer under the state fraudulent transfer act. The defendants argued that the "no-action" clause of the indentures barred the suit, and that the plaintiffs had not satisfied the indentures' exceptions to the bar. The District Court denied the defendants' motion to dismiss. On appeal, the Circuit Court reversed and remanded, holding that the plaintiffs' suit was barred because: (i) plaintiffs had not satisfied the exceptions to the "no action" clause provided in the indentures; (ii) state law provided that, in the absence of evidence of trustee misconduct or conflict of interest, the no-action clause barred plaintiffs' fraudulent transfer claims; and (iii) the "prevention doctrine," which applies when the time period for performance of a condition precedent is so short that it excuses performance, was inapplicable here because, under the indenture, the plaintiffs had assumed the risk that the fulfillment of the condition precedent would be prevented.

FACTUAL BACKGROUND

CompuCredit Holdings Corporation issued a series of notes. Each series was issued pursuant to a trust indenture, and each indenture contained an identical "no-action" clause, which provided that noteholders "may not pursue any remedy with respect to this Indenture or the Securities." The no-action clause provided two standard exceptions. The first exception (not at issue in this case) was a "right to payment" exception, which applies when the holder files suit seeking payment of principal and/or interest, e.g., a breach of contract claim for failure to pay the notes upon maturity. The second exception, referred to as the "trustee demand exception," permitted a noteholder to bring suit if: (i) a noteholder gave the Trustee written notice that a default has occurred and is continuing; (ii) holders of at least 25 percent of the notes make a written demand to the Trustee to pursue a remedy; (iii) a noteholder agrees to indemnify or offer security to the Trustee for any costs incurred; (iv) the Trustee does not respond to the request of the noteholders within 60 days of receipt of the notice and the offer of security or indemnity; (v) the majority of the noteholders, during the 60-day window, do not give the Trustee an instruction inconsistent with the request for a remedy.

A majority of noteholders brought suit against CompuCard, its directors and officers, under the state fraudulent transfer act law, alleging that the company was in financial distress, and the company planned to issue dividends to shareholders (a number of whom were insiders), and that the company planned to spin off a profitable portion of its business, further benefiting the insider/shareholders. The plaintiffs alleged that these actions endangered the ability of the company to pay the notes as due. The defendants filed a motion to dismiss, which the District Court denied, on the basis that the no-action clause did not apply to the plaintiffs' suit because: (i) the plaintiffs constituted a majority of the noteholders, therefore satisfying the purpose of the clause – to prevent suits not in the majority's best interest; (ii) the plaintiffs were prevented from satisfying the 60-day waiting period requirement of the trustee demand exception because of CompuCredit's intent to pay a dividend fewer than 60 days in advance; and (iii) the plaintiffs' claims were extra-contractual and the terms of the clause contemplated a contractually defined default predicating a suit. The defendants appealed.

COURT ANALYSIS

The plaintiffs first argued that the directors and officers could not rely on the no-action clause because they were not parties to the indentures. The court, applying New York law (the choice-of-law required in the indentures) held that non-parties had the right to assert the no-action clause. Case law dictates that the scope of the no-action clause "depend[s] on the nature of the claims brought, not the identity of the defendant." This court agreed with those decisions, and rejected the plaintiffs' contention. Finding that the plaintiffs agreed to the terms of the no-action clause at the inception of the indenture, the court held the no-action clause (which is standard in indentures) prohibited "the pursuit of any remedy with respect to this Indenture or the Securities."

Next the court reviewed the District Court's decision, which it ultimately found erroneous as a matter of law. First, the court examined whether, under New York law, extra-contractual fraudulent transfer claims are exempt from the no-action clause. The plaintiffs argued, and the lower court agreed, that because the trustee demand exception contemplated an event of default, the no-action clause barred suits only predicated on a default. The Circuit Court found this argument meritless. The Circuit Court held the no-action clause barred the fraudulent conveyance action because it was an action "with respect to" the indentures. The court noted that "no-action clauses in the indentures constitute waivers by plaintiffs of their rights to bring claims relating to the securities and instead vest those rights in the trustee." This ensures that that all holders share in any recovery provided on such a claim on a *pari passu* basis.

The court then discussed the judicial exceptions to strict application of the "trustee demand exception" – where the trustee, by reason of conflict of interest or unjustifiable unwillingness, cannot or will not properly pursue a remedy for trust beneficiaries. In such a case, courts allow suits otherwise prohibited by no-action clauses to proceed. Here, there were no allegations of trustee conflict or misconduct.

The second basis of the District Court's decision was the fact that the plaintiffs constituted a majority of noteholders. The District Court had reasoned that one purpose of a no-action clause is to protect the majority from the potentially selfish or ill-advised actions of one or a few noteholders and here, that purpose had been served. The Circuit Court disagreed, finding "two problems" with this reasoning. First, the plain language of the no-action clause required several prongs to be satisfied, only one of which had been satisfied in the instant case. Because the contract language was plain and unambiguous, it must be enforced in accordance with all of its terms and those terms were not satisfied. Secondly, the court found the no-action clause served multiple purposes. In addition to the reason discussed above, the court found the no-action clause also serves to "prevent rash, precipitate, or harassing suits by bondholders who disrupt corporate affairs," and to protect the issuer from a multiplicity of suits. Accordingly, the court found the plaintiffs' arguments unpersuasive. The court

CONTINUED ON PAGE 24

IPSO FACTO CLAUSE RESULTS IN MASTER LEASE TERMINATION, NULLIFIES SUBLESSEE'S RIGHT TO POSSESSION

Ann Pille
Associate, Chicago

Cahaba Forests, LLC v. Hay, 2012 WL 380126 (M.D. Ala., Feb. 6, 2012)

CASE SNAPSHOT

The court determined whether the debtor/lessee/sublessor's deemed rejection of a master lease and sublease terminated the sublessee's right to possession of the real property. Examining the issue under applicable state and federal law, the court held that, upon termination of the master lease, the non-debtor sublessee had no further right to possession of the property.

FACTUAL BACKGROUND

This case involved a declaratory judgment suit brought by a sublessee against the owners of real property. The defendants owned 24,000 acres of undeveloped land, which they leased to a predecessor-in-interest to the chapter 7 debtor, Bowater Alabama, LLC, under a master lease. The master lease contained no restrictions on subleasing. Prior to commencement of the debtor's chapter 7 case, virtually all of the property was subleased to Cahaba Forests, LLC. This sublease required Cahaba to comply with all terms of the master lease, make rent payments directly to defendants, and pay ad valorem taxes. The defendants were not a party to the sublease.

On April 16, 2009, the debtor filed for bankruptcy. At that time, all rent and tax payments were current. Despite a provision in the master lease stating that the lease would not be rejected in bankruptcy, the debtor's trustee allowed the deadline for accepting/rejecting executory leases to lapse without taking any action, and both the master lease and the sublease were deemed rejected under section 365(d)(4) of the Bankruptcy Code. There was no evidence that the master lease or sublease were listed as assets or liabilities of the debtor, and neither the defendants nor Cahaba were listed as creditors or had any notice of the rejection.

In May 2011, Cahaba attempted to obtain the defendants' agreement that the debtor's deemed rejection of the master lease and sublease had no effect on the validity of the sublease or Cahaba's possessory or leasehold rights in the property. Cahaba further sought the defendants' agreement that the sublease had been converted into a direct lease between the defendants and Cahaba. The defendants refused, and Cahaba filed an action for declaratory judgment, seeking a determination that its rights continued under the sublease. The defendants contended that they possessed all rights in the property because of the rejected status of the master lease and the sublease.

COURT ANALYSIS

There was no dispute that these leases were deemed rejected in the debtor's bankruptcy case. The dispute was the effect of that rejection on the sublease.

The court began by noting that there is a split of authority over whether a deemed rejection serves to breach, or to terminate, the rejected lease. The court did not rule on this issue, however, because Cahaba and the defendants agreed that the leases were breached, but not terminated, because of the debtor's rejection of the same.

Having resolved that preliminary issue, the court considered the status of the master lease and the sublease in the debtor's bankruptcy case. Upon rejection, the leases ceased to be assets of the debtor's bankruptcy estate. As such, the court determined that the dispute between the defendants and Cahaba was governed by state law.

Specifically, under Alabama law – which governed the leases – the court considered the impact of the breach of the master lease on the continued viability of the sublease. Under Alabama law, a sublessee's right to possession is subject to the terms of the master lease, and a sublessee can not have greater rights than the sublessor. Here, the master lease contained an *ipso facto* clause, which gave the defendants the option to terminate the lease upon a bankruptcy filing by the debtor. Cahaba argued that this *ipso facto* provision was unenforceable under section 365(e) of the Bankruptcy Code. The court, however, rejected this argument, finding instead that section 365(e) is designed to protect debtors and that it is applicable only in bankruptcy proceedings. Since these leases were no longer part of the bankruptcy estate, and because there was no indication that the section was intended to inure to the benefit of non-debtors, the court rejected any protection that Cahaba might have obtained pursuant to section 365(e).

Finally, the court interpreted the terms of the master lease and sublease, and found that the sublease provided that it would terminate upon termination of the master lease. The master lease, in turn, gave the defendants the option to terminate the lease upon a bankruptcy filing by the debtor. Cahaba had not negotiated for, nor received, any exception to these termination provisions when it executed the sublease. As such, the court held that the defendants had the right to terminate the master lease, that the defendants had exercised this right after the master lease was rejected, that these actions had transferred any possessory rights in the property to the defendants, and that any right Cahaba might have had under the sublease had been terminated.

PRACTICAL CONSIDERATIONS

At the end of the opinion, the court mentioned that the sublease contained a provision that the sublease would terminate in the event the master lease terminated. Had Cahaba been more aware of these termination provisions when it entered into the sublease, it might have negotiated different terms and, in doing so, might have preserved its rights under the sublease.

SECOND CREDITOR OUT OF LUCK IN DEBTOR'S FRAUDULENT TRANSFER SCHEME

Christopher Rivas
Associate, Los Angeles

Merrill Lynch Business Financial Services, Inc. v. Kupperman, et al., 2011 WL 3328492 (3d Cir., Aug. 3, 2011)

CASE SNAPSHOT

A debtor granted security interests in its collateral to obtain a loan from one bank, which properly perfected its security interests in the collateral, and the debtor then fraudulently transferred the collateral to a new entity to obtain additional borrowing from a second bank, which also properly perfected its security interests in the collateral (without knowledge of the fraudulent scheme). On summary judgment, the court found that the first bank's security interest was superior to the second bank's because the debtor's security agreement with the first bank provided that it was binding on the debtor's successors and assigns.

FACTUAL BACKGROUND

In 2002, PITTRA G.B. International, Inc. granted Merrill Lynch a security interest in all of its current and future assets to secure a series of loans. The security agreement provided that Merrill's security interest was binding upon PITTRA's successors and assigns. Merrill recorded a financing statement and perfected its security interest. A year later, Arnold Kupperman, PITTRA's secretary and treasurer, fraudulently transferred PITTRA's assets (Merrill's collateral) to PGB International, LLC. PGB continued PITTRA's operations, using the same office, principals and employees. Kupperman's actions violated the terms of the loan agreement with Merrill, and were not disclosed to Merrill. Kupperman continued to draw on the PITTRA line of credit from Merrill, though, providing falsified financial documents to Merrill to do so.

PGB, meanwhile, entered into a loan transaction with JPMorgan Chase Bank, under which PGB granted a security interest in all of its assets (the same assets securing Merrill's loan) to Chase. Like Merrill, Chase filed a financing statement and perfected its security interest. Chase was not aware of the PITTRA fraudulent transfer or Merrill's prior liens.

Two years later, PITTRA filed for chapter 7 bankruptcy. The bankruptcy trustee filed an adversary proceeding against Merrill seeking to avoid payments received and filed an action to recover assets as a result of the fraudulent PITTRA-PGB scheme. Both actions were eventually settled. Merrill specifically reserved its claims against Kupperman and PGB. Merrill then filed suit against PGB and others asserting claims arising from the secured loans made by Merrill to PITTRA. Merrill asserted priority over all other creditors of PGB, naming Chase as a defendant. In response, Chase asserted a first priority security interest in PGB's assets and brought a cross-claim stating that it was entitled to foreclose its security interest against PGB's assets. The District Court granted Merrill's motion, and Chase appealed.

COURT ANALYSIS

Chase first argued that Merrill lacked standing to bring a fraudulent transfer claim because the claim belonged to the PITTRA trustee. The court rejected this argument, because the trustee, in the settlement agreement, had stipulated to dismissal of a fraudulent conveyance claims against PGB, and Merrill had reserved its claims against PGB.

Chase then argued that the District Court had erred in finding that the PITTRA asset transfers were fraudulent. The court rejected Chase's assertion on the basis of the many badges of fraud in Kupperman's transaction, including his secret transfer to PGB and his fraudulent financial statements to Merrill.

Lastly, the court likewise rejected Chase's arguments that Merrill's interest did not include PGB's accounts receivable and that Merrill's interest was subordinate to Chase's. Merrill's security specifically included a pledge of future-acquired assets, and bound PITTRA's successors and assigns (i.e., PGB). Thus, PGB acquired the collateral subject to Merrill's prior security interest.

The court affirmed the District Court's grant of Merrill's summary judgment motion.

PRACTICAL CONSIDERATIONS

This case is a lesson that even properly perfecting one's security interest may not be enough if a borrower is committed to a fraudulent scheme. Although Chase may have avoided this result with additional investigation into PGB's predecessors before loaning PGB funds, there is no guarantee that even this would have uncovered PGB's scheme.

The Supreme Court reversed the Superior Court's decision, and remanded the case for "proceedings consistent with this opinion."

PRACTICAL CONSIDERATIONS

Rather than make a ruling on whether a de factor merger had occurred, the Supreme Court simply overturned the Superior Court's ruling that continuity of ownership is an absolute prerequisite to proving a de facto merger. This case demonstrates that a court may look outside of the four corners of the contract and transaction at issue to determine whether successor liability is appropriate. The Supreme Court's holding broadens the scope of when an asset or stock purchaser may be deemed a successor. This decision definitely gives asset purchasers in Pennsylvania some unsettling food for thought, and it remains to be seen what the Superior Court will do on remand.

Ending Forbearance is Not Equivalent to Economic Duress—continued from page 13

COURT ANALYSIS

The court began its analysis by emphasizing that the doctrine of economic duress is based on the principle that courts will not allow one party to unjustly take advantage of the economic necessities of another and thereby threaten to do unlawful injury. In other words, "a mere demonstration of financial pressure or unequal bargaining power will not, by itself, establish economic duress." Rather, conduct must be wrongful, i.e., "outside a party's legal rights." Therefore, a threat to withhold contractually required performance in order to compel submission to new demands can constitute a wrongful threat, but a threat to exercise legal rights in pursuit of those same demands is not wrongful. In other words, a party cannot be guilty of economic duress by merely exercising its contractual rights or failing to forbear from exercising those rights when it has no legal duty to do so.

The court then found that, once Interpharm defaulted under the credit agreement, the lender could have exercised its rights and remedies under the agreement, including terminating the line of credit, accelerating the loan obligations, and liquidating the collateral. In other words, after the default, the lender was under no legal obligation to continue to extend credit to Interpharm or forbear from exercising its rights and remedies. Rather, the lender's only legal obligation was to act within the confines of those rights and remedies. The court concluded that the lender had acted within its contractual rights and remedies and, while the lender may have driven a hard bargain for each Forbearance Agreement, it had not acted wrongfully. In the words of the court: "If Interpharm had little choice but to agree to the covenants of the October Forbearance Agreement, it was not because [the lender] was threatening to withhold performance under its contract with Interpharm, but because [the lender] was otherwise unwilling to forbear from its contract right to terminate the line of credit. The former circumstance might evidence a wrongful threat; the latter illustrates only permissible hard bargaining."

The court specifically addressed three alleged "wrongful acts" of the lender: (1) the imposition of the default rate of interest; (2) the exclusion of the receivables of four of Interpharm's major wholesale customers from the calculation of Interpharm's borrowing base because of these customers' practice of charging-back to Interpharm certain price differences; and (3) the reduction of the percentage of eligible inventory for Interpharm's borrowing base from 50 percent to 39.6 percent, based on the inventory valuation obtained from the third party retained by the lender. The court found that each of these acts was either expressly permitted by the credit agreement or within the reasonable discretion afforded to the lender under the credit agreement to take certain actions. In particular, the court found that "even assuming that charge-backs are a customary pharmaceutical industry practice, it would hardly be unreasonable for a lender to view receivables subject to such reductions as a less reliable indicator of anticipated borrower income than receivables not subject to such reductions." Furthermore, the court compared each act taken by the lender with the rights and remedies available to the lender under the credit agreement, each time emphasizing that, from Interpharm's perspective, the lender consistently chose the lesser of two evils.

PRACTICAL CONSIDERATIONS

This case presents a familiar fact pattern where a borrower is in default of its financial covenants. The lender, therefore, seeks to increase its level of security in a Forbearance Agreement as the borrower is now less creditworthy; and, with each subsequent default and successive Forbearance Agreement, the lender makes higher and higher demands on the borrower. Then when the borrower faces liquidation, it turns around and blames the lender's hard bargaining along the way as the reason the borrower reached that point, rather than the borrower's financial decline that caused it to breach its financial covenants in the first place. The borrower then sues the lender claiming, in essence, that the lender is liable for the worsening of the borrower's financial condition. This court makes clear that a lender is entitled to drive hard bargains when agreeing to forbearance agreements so long as the lender acts within the scope of its contractual rights and reasonable discretion, and such hard bargaining does not cross the line into the realm of wrongful conduct and economic duress.

Statute of Frauds Bars Claims, Except for Interference with Prospective Contractual Relations—continued from page 14

purposeful meddling. The same can be said for allegedly inducing Sovereign to reactivate the foreclosure proceeding."

Finally, the court addressed whether 4th Walnut had a right or privilege to act in the manner alleged. Recognizing that there was nothing wrong with 4th Walnut purchasing the bad loan, the court went on to note, "What is actionable is meddling with an alleged existing understanding between the borrower and the original lender in order to obtain the loan without strings attached. Such conduct, if proven, unquestionably would have adversely impacted the Debtor by cutting off its rights in the property when it believed a final deal was to be put down on paper." Accordingly, the court held that the complaint sufficiently pled facts to support the debtor's intentional interference claim and therefore denied the motion to dismiss this count.

PRACTICAL CONSIDERATIONS

The court found that the writings upon which the debtor relied failed to satisfy the Statute of Frauds, but found that these same writings (and the conduct of the parties) did suffice to state a claim for interference with prospective contractual relations. This case presents important considerations for commercial parties that seek to buy distressed loans. Although the decision does not affect or constrain a party from exercising its rights after purchasing notes, the decision emphasizes the need for parties to be cautious and mindful of the actions and requests that they make during negotiations with current noteholders.

Split Continues – Individual Chapter 11 Debtors Not Subject to Absolute Priority Rule—continued from page 15

Section 1115 provides that property of the estate (in the case of an individual) "**includes, in addition to the property specified in section 541**… all property of the kind specified in section 541 that the debtor acquires after the commencement of the case . . ." (emphasis added). In turn, section 541 provides that all pre-petition property, with a few exceptions not relevant here, is property of the estate. The question causing the split in authority, then, is what section 1115 means when it says "includes" and "in addition to."

Some courts have found that section 1115 "absorbs" or "supersedes" section 541. In this line of cases, section 1115 includes pre-petition and post-petition property, and the absolute priority rule would no longer apply because an individual debtor's entire estate (pre- and post-petition) could be retained by the debtor, subject to certain other provisions. These courts include the Bankruptcy Courts of Kansas, Nebraska, Connecticut, Nevada, the Northern District of Indiana, and the Ninth Circuit BAP (in this decision).

Other courts have found that section 1115 supplements section 541 by adding post-petition property to an individual debtor's estate. In this line of cases, section 1115 property includes post-petition property only. The absolute priority rule would still apply to the individual debtor's non-section 1115 property. These courts include the District Courts of the Eastern and Western Districts of Virginia, the Middle District of Florida, the Northern, Southern and Central Districts of California, the District of Massachusetts, and the Southern District of Texas.

To decide whether the absolute priority rule applied to individuals, the Ninth Circuit BAP considered the statutory language in contextual statutory scheme, and with the logic of plan confirmation requirements in mind. The court stated that "including the section 541 property within the universe of property contained in section 1115, as we believe a plain-meaning interpretation requires, does no violence to the logical impact of the reorganization process or scheme established in chapter 11. Indeed, especially combined with the new additional requirement of five years of debtor's disposable income, it is illogical to thereafter remove the debtor's means of production of debtor's disposable income by maintaining the absolute priority rule in an individual's case."

The court also analyzed the issue in the context of the 2005 amendments to the Bankruptcy Code, the Bankruptcy Abuse Prevention and Consumer Protection Act (the BAPCPA). The court stated that, through BAPCPA, Congress had purposefully adopted some chapter 13 provisions for individual chapter 11 debtors. For example, as in chapter 13, the chapter 11 disposable income requirement requires that the individual debtor dedicate all of his or her disposable income over a designated time period (three or five years in chapter 13, at least five years in chapter 11) to plan payments directed to unsecured creditors. The court reasoned that, by this amendment, Congress prioritized the ability of an individual chapter 11 debtor to pay creditors over the application of the absolute priority "rule" to such a debtor.

The court recognized that a split of authority existed, but found contrary decisions to be based on "flawed" reasoning. The court held that the absolute priority rule does not apply to chapter 11 debtors who are individuals, and reversed the orders denying the second amended plan and converting the case to chapter 7, and remanded for further action consistent with its opinion.

In a dissenting opinion, Judge Jury, of the Bankruptcy Court for the Central District of California, agreed with the line of cases holding that the absolute priority rule did apply in chapter 11 cases. In other words, Judge Jury opined that section 1115 did not "absorb" section 541. Among substantive criticisms of the majority's statutory consideration, Judge Jury also found that the majority had lost sight of two important policies. The first was the "long-standing purpose" of striking a balance between the debtor's interest in reorganizing and the creditor's interest in maximizing the value of the estate. The majority approach "loses sight of this balance, allowing the reorganized individual debtor to retain all his or her assets while disenfranchising the vote of unsecured creditors who seek more value." Secondly, the dissent believed that the policy behind the enactment of BAPCPA was to enhance the return to creditors, and the majority decision undermined this policy.

PRACTICAL CONSIDERATIONS

The applicability of the absolute priority rule in individual chapter 11 cases is far from settled (even within the Ninth Circuit, where the BAP's decision is persuasive, but not binding, authority). Decisions on both sides of the issue are well-reasoned and persuasive, and, until there is a circuit level or Supreme Court decision, or until Congress clarifies its intent, debtors and creditors must be prepared to argue the issue on a case-by-case basis.

SECURED PARTY MUST TURN OVER REPOSSESSED COLLATERAL IF THE DEBTOR'S RIGHTS TO THE COLLATERAL WERE NOT TERMINATED PRE-PETITION

Amy Tonti
Partner, Pittsburgh

In re Jason R. Herbst (Case No. 3-12-11044) (Bankr. W.D. Wis. 2012) (Opinion dated April 11, 2012)

Prior to the filing of the chapter 13 petition, and after a default, a secured party obtained a default judgment for replevin of the equipment subject to the secured party's valid, perfected first lien. Under the Writ of Replevin, the secured party repossessed the equipment. Thereafter, the debtor filed a chapter 13 petition. At the time of the filing of the chapter 13 petition, the repossessed equipment had not been sold. The debtor demanded the equipment be returned to the debtor and the secured party refused. The debtor then filed an action, alleging the secured party to be in contempt of the automatic stay and sought actual and punitive damages.

Under Wisconsin law, debtors retain the right of redemption so long as a sale or contract for sale has not occurred. Under the Uniform Commercial Code, "the debtor or another secured party may redeem collateral as long as the secured party has not collected (Section 9-607), disposed of or contracted for the disposition of (Section 9-610), or accepted (Section 9-620) the collateral." "Even if the debtor's right to redeem the collateral expired when the bank repossessed it, ownership of the collateral remains with the debtor until it's sold."

The court concluded that the secured party had to return the equipment to the debtor. The court also found that the secured party willfully violated the automatic stay (as "intent" is not relevant), but denied the debtor's request for actual damages for a willful violation of the automatic stay, finding that the debtor did not incur actual damages.

Had the judgment in replevin extinguished the debtor's rights to or interest in the equipment, the result should have been in favor of the secured party.

Indenture No-Action Clause Bars Suit Against Issuer, Directors and Officers—continued from page 19

concluded that the unambiguous language of the contract did not allow that majority action, by itself, could allow a suit to proceed.

The court then turned to the third basis for the lower court decision, the "prevention doctrine." The prevention doctrine excuses performance of a condition precedent by one party where the other party's wrongful conduct prevents such performance. Here, to satisfy the trustee demand exception, the noteholders were required to wait 60 days for the Trustee to act on the remedy request. CompuCredit's issuance of the dividend, however, was scheduled to occur within 20 days of declaration. The plaintiffs argued that it was therefore impossible to comply with the 60-day waiting period. The court rejected this argument. The indenture itself required CompuCredit to give only 20 days' notice of a dividend. Because this 20-day period was authorized in the contract it was not wrongful; therefore, the prevention doctrine was inapplicable.

The court reversed and remanded for dismissal of the plaintiffs' claims.

PRACTICAL CONSIDERATIONS

Issuers, indenture trustees and bond/noteholders alike should take heed of this case. The decision highlights the applicability and enforcement of "no-action" clauses and demonstrates an effective use of the no-action clause by non-parties to the indenture to prevent suit. Importantly, the "no-action" clause litigated in the case was the standard clause provided in indentures, and therefore, should be persuasive in jurisdictions outside of the 11th Circuit.

COUNSEL'S CORNER: NEWS FROM REED SMITH

Presentations

Cory Falgowski is scheduled to speak at the National Food and HBC Manufacturers Credit Group meeting June 25 at the Renaissance Hotel in Baltimore's Inner Harbor. Cory's presentation is on the impact of a creditor's section 503(b)(9) claim on its right to assert a subsequent new value defense to a preference suit under section 547(c)(4).

Bob Simons was a presenter in "Hot Topics in Creditors' Rights and Bankruptcy" for the Pennsylvania Association of Credit Management, March 28 in Pittsburgh, and was also a presenter at the National Business Institute Bankruptcy Forum April 20 in Pittsburgh. The topic there was "Bankruptcy Forum: What a Judge, Trustees and Other Experts Want You to Know."

Bob additionally has two upcoming seminars scheduled, both in Pittsburgh. He will be a presenter:

- On "*Stern v. Marshall* – Have we figured out what it means?" at the Pennsylvania Bar Institute's 17th Annual Bankruptcy Institute, Sept. 12
- At National Business Institute's Bankruptcy Litigation 101, Nov. 9

Articles

Anker Sørenson and **Brice Mathieu** wrote an article entitled, "*De Facto* Management, Mismanagement and Possible Sanctions Incurred by Financial Investors in the Context of Unsuccessful LBO Transactions in France." The article appeared in the March 2012 edition of *International Corporate Rescue*, published by Chase Cambria Company (Publishing) LTD in the UK. *International Corporate Rescue* addresses the most relevant issues in the topical area of insolvency and corporate rescue law and practice.

REED SMITH COMMERCIAL RESTRUCTURING & BANKRUPTCY GROUP

PRACTICE LEADER
Peter S. Clark II
+1 215 851 8142 (Philadelphia)
pclark@reedsmith.com

CHICAGO
Stephen T. Bobo
+1 312 207 6480
sbobo@reedsmith.com

Aaron B. Chapin
+1 312 207 2452
achapin@reedsmith.com

Timothy S. Harris
+1 312 207 2420
tharris@reedsmith.com

Ann E. Pille
+1 312 207 3870
apille@reedsmith.com

Alexander Terras
+1 312 207 2448
aterras@reedsmith.com

FALLS CHURCH
Linda S. Broyhill
+1 703 641 4328
lbroyhill@reedsmith.com

Robert M. Dilling
+1 703 641 4255
rdilling@reedsmith.com

HONG KONG
Andrew K. Brown
+ 852 2507 9778
akbrown@rsrbhk.com

LONDON
Jeffery Drew
+44 (0)20 3116 2900
jdrew@reedsmith.com

Emma J. Flacks
+44 (0)20 3116 2922
eflacks@reedsmith.com

Monika Kuzelova
+44 (0)20 3116 3428
mkuzelova@reedsmith.com

Charlotte Møller
+44 (0)20 3116 3472
cmoller@reedsmith.com

Georgia M. Quenby
+44 (0)20 3116 3689
gquenby@reedsmith.com

LOS ANGELES
Marsha A. Houston
+1 213 457 8067
mhouston@reedsmith.com

Christopher O. Rivas
+1 213 457 8019
crivas@reedsmith.com

MUNICH
Dr. Stefan Kugler, LL.M.
+49 (0)89 20304 131
skugler@reedsmith.com

Dr. Etienne Richthammer
+49 (0)89 20304 141
erichthammer@reedsmith.com

NEW YORK
Arnold L. Bartfeld
+1 212 205 6008
abartfeld@reedsmith.com

Aaron Z. Bourke
+1 212 231 2640
abourke@reedsmith.com

Edward J. Estrada
+1 212 549 0247
eestrada@reedsmith.com

Jeffrey L. Glatzer
+1 212 205 6037
jglatzer@reedsmith.com

Christopher A. Lynch
+1 212 549 0208
clynch@reedsmith.com

James C. McCarroll
+1 212 549 0209
jmccarroll@reedsmith.com

Nicole K. O'Sullivan
+1 212 549 0234
nosullivan@reedsmith.com

Andrea J. Pincus
+1 212 205 6075
apincus@reedsmith.com

J. Andrew Rahl Jr.
+1 212 205 6078
arahl@ReedSmith.com

John L. Scott
+1 212 205 6099
jlscott@reedsmith.com

Mark D. Silverschotz
+1 212 205 6086
msilverschotz@reedsmith.com

Michael J. Venditto
+1 212 205 6081
mvenditto@reedsmith.com

PARIS
Anker Sorensen
+33 (0)1 44 34 80 88
asorensen@reedsmith.com

PHILADELPHIA
Derek J. Baker
+1 215 851 8148
dbaker@reedsmith.com

Scott M. Esterbrook
+1 215 851 8146
sesterbrook@reedsmith.com

Barbara K. Hager
+1 215 851 8864
bhager@reedsmith.com

Elizabeth A. McGovern
+1 215 851 8151
emcgovern@reedsmith.com

Jennifer P. Knox
+1 215 851 8190
jknox@reedsmith.com

Brian M. Schenker
+1 215 241 7966
bschenker@reedsmith.com

Claudia Z. Springer
+1 215 241 7946
cspringer@reedsmith.com

Matthew E. Tashman
+1 215 241 7996
mtashman@reedsmith.com

PITTSBURGH
Joseph D. Filloy
+1 412 288 3842
jfilloy@reedsmith.com

Jeanne S. Lofgren
+1 412 288 5936
jlofgren@reedsmith.com

Jared S. Roach
+1 412 288 3277
jroach@reedsmith.com

Eric A. Schaffer
+1 412 288 4202
eschaffer@reedsmith.com

Robert P. Simons
+1 412 288 7294
rsimons@reedsmith.com

Paul M. Singer
+1 412 288 3114
psinger@reedsmith.com

Luke A. Sizemore
+1 412 288 3514
lsizemore@reedsmith.com

Gregory L. Taddonio
+1 412 288 7102
gtaddonio@reedsmith.com

Amy M. Tonti
+1 412 288 3274
atonti@reedsmith.com

David Ziegler
+1 412 288 3026
dziegler@reedsmith.com

SAN FRANCISCO
Douglas G. Boven
+1 415 659 5652
dboven@reedsmith.com

Mike C. Buckley
+1 415 659 4761
mbuckley@reedsmith.com

WILMINGTON
J. Cory Falgowski
+1 302 778 7522
jfalgowski@reedsmith.com

Kurt F. Gwynne
+1 302 778 7550
kgwynne@reedsmith.com

Kimberly E.C. Lawson
+1 302 778 7597
klawson@reedsmith.com

Kathleen A. Murphy
+1 302 778 7572
kmurphy@reedsmith.com

Timothy Reiley
+1 302 778 7528
treiley@reedsmith.com

Richard A. Robinson
+1 302 778 7555
rrobinson@reedsmith.com

ReedSmith

The business of relationships.℠